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subject: Chief Counsel Advice on the Acceleration of a § 481(a) Adjustment

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

QUESTIONS:

1. If an automobile dealer that loses one of its five dealer franchises ("franchises") properly obtains automatic consent to terminate its election to use the last-in, first-out ("LIFO") method for the dollar-value pool that includes only the new vehicles sold under that lost franchise, must the taxpayer accelerate the corresponding § 481(a) adjustment because its ending inventories for the year of change do not include any of those new vehicles?

2. Is the answer to Question 1 the same if the automobile dealer loses its only franchise but still operates the remaining portions of its trade or business?

3. If the automobile dealer maintains one pool for all new vehicles, may the automobile dealer change from the LIFO method for only the vehicles sold under the lost franchise?

CONCLUSIONS:

1. No, the automobile dealer must include only one-fourth of the § 481(a) adjustment in the taxable income of each year of the four taxable years that begin with the year of change ("four-year adjustment period").
2. Yes.
3. The automobile dealer may not change its method of accounting for some of the vehicles that are within the scope of a single dollar-value pool. However, the automobile dealer may either change from the LIFO method for its single dollar-value pool that includes all new vehicles or change its dollar-value pooling method to a method of pooling based on vehicles sold under each franchise and change from the LIFO method for the dollar-value pool that includes only the vehicles sold under the lost franchise.

FACTS:

Situation 1:

In 1990, an automobile dealer ("Taxpayer") obtained a franchise to sell new Pontiac-brand vehicles ("Pontiacs"). At Taxpayer's dealership, Taxpayer also sells used vehicles and new automotive parts and accessories. In addition, Taxpayer's service department provides vehicle maintenance and repair service for customers as well as for used vehicles acquired for resale. Taxpayer has treated all these activities as a single trade or business since Taxpayer obtained its Pontiac franchise. Between 1991 and 1992, Taxpayer expanded its single trade or business as it obtained the following franchises: (1) new Ford-brand vehicles ("Fords"); (2) new Chevrolet-brand vehicles ("Chevys"); (3) new Toyota-brand vehicles ("Toyotas"); and (4) new Honda-brand vehicles ("Hondas").

Effective for the taxable year ending December 31, 2001, Taxpayer elected to use the dollar-value LIFO method for all inventories and to maintain multiple pools based on the vehicles sold under each franchise. Thus, Taxpayer maintains five dollar-value LIFO pools: (1) Pontiacs; (2) Fords; (3) Chevys; (4) Toyotas; and (5) Hondas. On January 1, 2009, Taxpayer's LIFO reserve attributable to each pool was $8x ($40x total).

On July 7, 2009, Taxpayer lost its Pontiac franchise and quickly liquidated its inventories of new Pontiacs. Taxpayer did not have any new Pontiacs in ending inventories on December 31, 2009. Despite the loss of its Pontiac franchise, Taxpayer still sells Fords, Chevys, Toyotas, and Hondas and still operates the other activities of its trade or business (*i.e.*, selling used vehicles, selling vehicle parts and accessories, and servicing and repairing vehicles).

In March of 2010, Taxpayer decided it wants to cease using the LIFO method and to begin using the specific identification method for new Pontiacs effective for the taxable year ending December 31, 2009 ("year of change"). From reading Rev. Proc. 2008-52, 2008-36 I.R.B. 587, Taxpayer determined that it can obtain automatic consent to change its inventory-identification method from the LIFO method to another permissible inventory method for one or more dollar-value pools. *See* section 22.01(a) of the APPENDIX of Rev. Proc. 2008-52, 2008-36 I.R.B. at 666. Taxpayer also determined that the § 481(a) adjustment attributable to a change from the LIFO method to the specific identification method is $8x (a positive amount). *See* section 2.05 of Rev. Proc. 2008-52, 2008-36 I.R.B. at 607. Finally, Taxpayer determined that one-fourth of the § 481(a) adjustment ($2x) must be included in the taxable income of each year of the four-year adjustment period. *See* section 5.04(1) of Rev. Proc. 2008-52, 2008-36 I.R.B. at 611.

On March 15, 2010, Taxpayer carefully completed and signed a Form 3115, Application for Change in Accounting Method, and attached that copy to its timely filed original federal income tax return for the year of change. On the same day, Taxpayer mailed a duplicate copy to the national office. *See* section 6.02(3)(a) of Rev. Proc. 2008-52. Taxpayer computed its taxable income for the year of change using the new method for Pontiac vehicles and included one-fourth of the § 481(a) adjustment in the taxable income computation on its timely filed original federal income tax return for the year of change.

Upon examining that return, the Revenue Agent questions whether Taxpayer's inclusion of only one-fourth of the § 481(a) adjustment in the taxable income of the year of change was proper, given the fact that Taxpayer's inventories on December 31, 2009, contained no Pontiacs subject to the new method. Stated differently, the Revenue Agent wants to know whether Taxpayer must accelerate the reporting of the § 481(a) adjustment and, thus, must include the entire amount of the adjustment in the taxable income of the year of change.

Situation 2:

The facts are the same as Situation 1, except that Taxpayer never acquires the Ford, Chevy, Toyota, and Honda franchises. After losing the Pontiac franchise, Taxpayer continues to operate the remaining activities of its trade or business (*i.e.*, selling used vehicles; selling automotive parts and merchandise; servicing and repairing vehicles) in 2010.

Situation 3:

The facts are the same as Situation 1, except that effective for the taxable year ending December 31, 2007, Taxpayer elected to use the vehicle-pooling method for all new vehicles. *See* Rev. Proc. 2008-23, 2008-12 I.R.B. 664. On January 1, 2009, the LIFO reserve attributable to the single pool was $40x. If Taxpayer used its LIFO method for the taxable year ending December 31, 2009, the LIFO reserve would be reduced by $8x as a result of having no Pontiac vehicles in ending inventory.

LAW & ANALYSIS:

1. Law:

Section 446(e) of the Internal Revenue Code provides, in relevant part, that a taxpayer who changes the method of accounting on the basis of which he regularly computes his income in keeping his books shall, before computing his taxable income under the new method, secure the consent of the Secretary.

Section 481(a) provides that in computing the taxpayer's taxable income for any taxable year ("year of the change") (1) if such computation is under a method of accounting different from the method under which the taxpayer's taxable income for the preceding taxable year was computed, then (2) there shall be taken into account those adjustments which are determined to be necessary solely by reason of the change in order to prevent amounts from being duplicated or omitted, except there shall not be taken into account any adjustment in respect of any taxable year to which this section does not apply unless the adjustment is attributable to a change in the method of accounting initiated by the taxpayer.

Section 481(c) provides that in the case of any change described in section 481(a), the taxpayer may, in such manner and subject to such conditions as the Secretary may by regulations prescribe, take the adjustments required by section 481(a)(2) into account in computing the tax imposed by this chapter for the taxable year or years permitted under such regulations.

Section 1.446-1(e)(3) of the Income Tax Regulations explains how a taxpayer may secure the Commissioner's consent to change a method of accounting. In relevant part, the regulation generally requires the taxpayer to compute a § 481(a) adjustment to prevent the omission or duplication of income.

Sections 1.481-1 and 1.481-4 provide guidance concerning section 481(a) adjustments.

Rev. Proc. 97-27 provides procedures concerning method changes that require the Commissioner's advance consent. Section 7.03 of Rev. Proc. 97-27 requires shortened or accelerated adjustment periods for the § 481(a) adjustments of three categories of taxpayers: (1) taxpayers who elect to accelerate under the de minimis rule; (2) taxpayers classified as cooperatives under § 1381(a); and (3) taxpayers that cease to engage in the trade or business before the adjustment period ends.

Rev. Proc. 2008-52 provides procedures concerning automatic method changes. Section 2.05 of Rev. Proc. 2008-52 provides, in relevant part, that § 481(a) requires those adjustments necessary to prevent amounts from being duplicated or omitted to be taken into account when the taxpayer's taxable income is computed under a method of accounting different from the method used to compute taxable income for the preceding taxable year. When there is a change in method of accounting to which § 481(a) is applied, income for the taxable year preceding the year of change must be determined under the method of accounting that was then employed, and income for the year of change and the following taxable years must be determined under the new method of accounting as if the new method had always been used. Section 5.04(1) of Rev. Proc. 2008-52 provides that except as otherwise provided in section 5.04(3) of Rev. Proc. 2008-52, in the APPENDIX of Rev. Proc. 2008-52, or in other guidance published in the IRB, the § 481(a) adjustment period is four taxable years for a net positive § 481(a) adjustment for an accounting method change, and one taxable year for a net negative § 481(a) adjustment for an accounting method change. Section 5.04(3) of Rev. Proc. 2008-52 requires shortened or accelerated adjustment periods for the § 481(a) adjustments of three categories of taxpayers: (1) taxpayers who elect to accelerate under the de minimis rule; (2) taxpayers classified as cooperatives under § 1381(a); and (3) taxpayers that cease to engage in the trade or business before the adjustment period ends.

Section 22.01(a) of the APPENDIX of Rev. Proc. 2008-52 applies to a taxpayer that wants to change from the LIFO method for all its LIFO inventory or for one or more dollar-value pools and that changes to a permitted method or methods as determined in section 22.01(1)(b) of this APPENDIX.

Section 22.01(b) of the APPENDIX of Rev. Proc. 2008-52 provides, in relevant part, that a taxpayer may change to one or more non-LIFO inventory methods for the LIFO inventories that are the subject of this accounting method change, but only if the selected non-LIFO inventory method is a permitted method for the inventory goods to which it will be applied. For purposes of section 22.01 of this APPENDIX, an inventory method (identification or valuation, or both) is a permitted method if it is specifically permitted by the Code, the regulations, a decision by the United States Supreme Court, a revenue ruling, a revenue procedure, or other guidance published in the IRB for the inventory goods and if the taxpayer is neither prohibited from using that method nor required to use a different inventory method for those inventory goods.

Rev. Proc. 2008-23 authorizes a reseller of cars and light-duty trucks to use the "vehicle-pooling" method. Under this method, the reseller assigns all new cars and new light-duty trucks to one pool and assigns all used cars and used light-duty trucks to a second pool.

2. Analysis:

In Situation 1, Taxpayer is required to include only one-fourth of the § 481(a) adjustment in the taxable income of the year of change. Taxpayer properly obtained automatic consent under Rev. Proc. 2008-52 to change from the LIFO method to the specific identification method for new Pontiacs. Thus, the terms and conditions of Rev. Proc. 2008-52 apply to this case. Section 5.04(3) of Rev. Proc. 2008-52 does not require the acceleration of a § 481(a) adjustment attributable to a change in inventory method when there is no ending inventory of the goods for which the change was made.[1] Thus, Taxpayer may continue to spread the § 481(a) adjustment over the four-year period in accordance with Rev. Proc. 2008-52.

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[1] Previous revenue procedures governing inventory-accounting method changes would have required the acceleration of the § 481(a) adjustment when a taxpayer changed from the LIFO method for the

In Situation 2, Taxpayer is required to include only one-fourth of the § 481(a) adjustment in the taxable income of the year of change. The rationale applicable to Situation 1 applies here, too. However, if Taxpayer actually ceases to engage in this trade of business or terminates its existence, the acceleration rules of section 5.04(3)(c) of Rev. Proc. 2008-52 will apply and will likely require Taxpayer to include any remaining § 481(a) adjustment in the taxable income of the taxable year that includes the cessation or termination.

In Situation 3, Taxpayer uses a single dollar-value pool to account for all of its LIFO inventories. Taxpayer may not change from the LIFO method for some of the goods properly includible in a single dollar-value pool. Taxpayer may change from the LIFO method for the entire dollar-value pool under Rev. Proc. 2008-52. Alternatively, Taxpayer may change its pooling method to a method of pooling based on the vehicles sold under each franchise pursuant to Rev. Proc. 97-27 by filing a Form 3115 before the end of its taxable year and change from the LIFO method for the dollar-value pool that includes vehicles sold under the Pontiac franchise by filing a Form 3115 pursuant to Rev. Proc. 2008-52.

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goods in a dollar-value pool and had none of those goods in ending inventory. *See* section 5.08 of Rev. Proc. 84-74, 1984-2 C.B. 736, and section 8.01(3) of Rev. Proc. 92-20, 1992-1 C.B. 685. This acceleration condition is not included in Rev. Proc. 97-27 or in Rev. Proc. 2008-52.