INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM
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CASE MIS No.: TAM-113467-99/CC:ITA:B7

Taxpayer's Name:
Taxpayer's Address:

Taxpayer's Identification No:
Years Involved:
Date of Conference:

LEGEND:

X =
Y =
Z =
Date 1 =
Date 2 =
Location 1 =
Location 2 =
Year 0 =
Year 1 =
Year 2 =
Year 3 =
Year 4 =
Year 5 =
B =
C =
D =
E =
F =
U =

ISSUES:

1) Was X eligible to use Notice 88-92, 1988-2 C.B. 416, (an automatic consent procedure for changes in accounting method that were made in order to comply with the requirements of § 263A of the Internal Revenue Code) as the basis for beginning to include the cost of federal excise taxes on B in its dollar-value LIFO (last-in, first-out) inventory computations?

2) If X was required to change its method of accounting in order to include the

cost of federal excise taxes on B in its dollar-value LIFO inventory computations, does the floor stocks tax on certain B held by X on Date 1 have to be taken into account when computing the value of X's LIFO inventory cost layers (rather than taking into account only the excise tax originally applicable in the years to which those layers relate)?

3) Does the increase in the federal excise tax rate on B from C to D on Date 1 require X to treat B with respect to which the higher excise tax rate was imposed as a new item in its double-extension, dollar-value LIFO inventory calculation, different from comparable B in preceding years with respect to which only a C excise tax rate was imposed?

CONCLUSIONS:

1) X was eligible to use the automatic consent procedure set forth in Notice 88-92 to change its method of accounting and begin to include the cost of federal excise taxes on B in its dollar-value LIFO inventory computations because § 263A, coupled with X's use of the double-extension method and a single natural business unit inventory cost pool, required X to incorporate federal excise taxes on B into those calculations.

2) The floor stocks tax on B held by X on Date 1 did not affect the value of X's LIFO inventory. A floor stocks tax is a cost of the B to which it relates and none of the cost of the B held on Date 1 was included in any of X's LIFO inventory cost layers. Thus, X's LIFO inventory cost layers will only include the federal excise tax on B originally applicable in the years to which those layers relate.

3) Under the particular facts of this case, X need not treat B with respect to which a higher federal excise tax rate of D was imposed as a new item in its double-extension, dollar-value LIFO inventory calculation. This increase in tax was inflationary in nature and separate treatment by X was not required under the facts presented in order to accurately measure inflation and to clearly reflect income.

FACTS:

X, whose principal address is Y, is a wholly-owned subsidiary of Z. X uses an overall accrual method of accounting and is included in the consolidated federal income tax returns filed by Z on a calendar year basis.

X is engaged in the production and sale of B as part of its E business. One of the costs incurred in the production and sale of B arises after the manufacturing process is completed. That cost is the federal manufacturer's excise tax on B. After completion of the manufacturing process, the finished B are placed in a federally bonded warehouse. The liability to pay the excise tax does not become fixed until the time that the manufacturer removes the finished B from that warehouse. In the years at issue in X's case, the federal excise tax liability became fixed as the finished B were removed from either X's Location 1 or X's Location 2, both of which were federally bonded facilities. Upon removal from these facilities, B were either sold directly to local distributors or transported to and stored for a relatively brief period in public warehouses until sale to wholesalers or distributors.

For its Year 1 taxable year, X filed Form 970, Application To Use LIFO Inventory Method, and adopted the dollar-value LIFO method for the inventory related to its E business. However, the Form 970 that X filed with its Year 1 tax return listed three specific exclusions from its LIFO election: 1) revenue stamps, 2) advances to a subsidiary company, and 3) manufacturing supplies that do not become part of finished goods. At that time, the payment of federal excise taxes was evidenced by revenue stamps that were affixed to U's of B upon their removal from a federally bonded warehouse. Thus, the exclusion of revenue stamps meant that federal excise taxes were excluded from X's LIFO election.

X adopted and used the double-extension method and included all of its LIFO inventory in a single LIFO pool. The subsequent issuance of § 1.472-8 of the Income Tax Regulations validated X's adoption of a single natural business unit pool for this E business inventory.

In Year 2, X concluded that its exclusion of advances to a subsidiary company from its LIFO calculations was improper, because these advances were part of the cost of acquiring E and § 1.472-8(b)(1) requires that all costs included in the inventory of a natural business unit must be valued on LIFO if a taxpayer elects to use the natural business unit method of pooling. Accordingly, for Year 2, X filed Form 3115, Application for Change in Accounting Method, requesting permission to include these advances in its LIFO inventory computations. X did not at that time request permission to include revenue stamps (federal excise taxes) in its LIFO computations, which had been previously listed on Form 970 as an exclusion from its LIFO election. The national office approved X's request as to advances on Date 2.

The federal manufacturer's excise tax on B increased from C to D on Date 1. The C tax rate had been in effect since Year 0. X represents that the increase in excise tax rate was significantly less, on a percentage basis, than the overall rate of inflation experienced for all other costs of producing B during that same period and that the impact of the excise tax rate increase on its overall inventory index of inflation would be minuscule.

In addition to the federal manufacturer's excise tax rate increase, a floor stocks tax was levied upon unsold B held on Date 1 and previously subjected to a federal excise tax of only C. The purpose of the floor stocks tax was to ensure that all B sold after the effective date of the excise tax increase would bear a total federal manufacturer's excise tax burden of D. All of the B held by X that were subjected to the Date 1 floor stocks tax were produced by X in Year 2. X did not add a LIFO cost layer to its inventory in Year 2.

X did not account for the federal excise taxes on B as an element of the inventory cost of B in its books and tax returns for Year 3 through Year 4. X asserts that it accounted for the excise tax in these years separately by including an amount in year-end prepaid expense equivalent to the full D rate on all B held in ending inventory that were then subject to an excise tax liability. Although X deducted excise taxes as "cost of goods sold" on line 2 of Form 1120, U.S. Corporation Income Tax Return, rather than as an "other deduction" on line 26 of the return, X claims that this treatment resulted from a misclassification and does not evidence its previous inclusion of these taxes in inventory.

X filed a Form 3115 with its Year 5 return pursuant to the procedures of Notice 88-92, based upon the position that § 263A required it to account for the federal manufacturer's excise tax under the LIFO method that it used to account for other cost elements of B. X asserts that since the federal excise tax prior to Year 3 was only C, its pre-Year 3 LIFO inventory layers should only reflect that amount. Because X's returns for Year 3 through Year 4 reflected an excise tax of D associated with these layers, and not C, X included an adjustment for this difference as part of the calculation of its total § 481(a) adjustment for its Year 5 change in accounting method.

LAW AND ANALYSIS:

ELIGIBILITY FOR AN ACCOUNTING METHOD CHANGE UNDER NOTICE 88-92

Section 446(e) and § 1.446-1(e)(2)(i) require that, except as otherwise expressly provided, a taxpayer must secure the consent of the Commissioner before changing a method of accounting for federal income tax purposes.

Section 1.446-1(e)(2)(ii)(c) provides that a change in an overall plan or system of identifying or valuing items in inventory, as well as a change in the treatment of any material item used in the overall plan for identifying or valuing items in inventory, is a change in method of accounting.

Section 1.446-1(e)(2)(ii)(a) provides that a material item is any item which involves the proper time for the inclusion of the item in income or the taking of a deduction.

Section 1.446-1(e)(3)(ii) provides that the Commissioner may prescribe administrative procedures setting forth the limitations, terms and conditions deemed necessary to permit a taxpayer to obtain consent to a change in its method of accounting in accordance with § 446(e) and § 1.446-1(e)(2)(i).

Section 1.263A-1T(e)(11) of the temporary Income Tax Regulations provided for an automatic change in method of accounting for changes in methods of accounting required under § 1.263A-1T. These changes were to be made in accordance with such additional procedures as the Commissioner shall prescribe.

Section 1.263A-1T(e)(11)(iii) provided that a change in method of accounting is required for purposes of § 1.263A-1T(e)(11) if such change is necessary in order for the taxpayer to properly capitalize and allocate costs with respect to production and resale activities in the manner prescribed in § 1.263A-1T, irrespective of whether the taxpayer's previous method of accounting resulted in the capitalization of more (or fewer) costs than the costs required to be capitalized thereunder and irrespective of whether the taxpayer's previous method of accounting was a correct method under the law in effect at that time. A change in method of accounting is not required for purposes of § 1.263A-1T(e)(11) if such change relates to factors other than those described in § 1.263A-1T. A required change in method of accounting does not include a change from one inventory valuation method to another inventory valuation method or a change within inventory valuation methods.

Notice 88-92 provided automatic consent procedures for use by taxpayers who were required to change their method of accounting in order to comply with the rules under § 263A. These procedures generally required taxpayers to complete certain sections of Form 3115 and a § 263A checklist and to file these items no later than the due date (including extensions) of the taxpayer's Federal income tax return for the year of change by attaching them to the return.

Section 803(d)(2) of the Tax Reform Act of 1986, Pub. L. No. 99-514, 1986-3 C.B. 1, provides that the rules for inventory property reflected in § 263A apply to taxable years beginning after December 31, 1986. If a taxpayer is required to change its method of accounting with respect to such property for any taxable year, such change shall be treated as initiated by the taxpayer and made with the consent of the Secretary.

Section 263A(a) provides, in the case of property which is inventory in the hands of the taxpayer, that the direct costs and an allocable share of the indirect costs (including taxes) of the property must be included in inventory.

Section 1.263A-1T(b)(2)(ii) provided that all indirect costs that directly benefit or are incurred by reason of the performance of a production or resale activity must be capitalized with respect to the property produced or acquired unless otherwise provided.

Section 472 and §§ 1.472-1 through 1.472-8 contain rules applicable to LIFO inventories.

Section 1.472-8(b)(1) provides that a natural business unit pool shall consist of all items entering into the entire inventory investment for a natural business unit of a business enterprise.

X's Year 5 change in the income tax treatment of federal manufacturer's excise taxes on B was a change in method of accounting because it involved a change in the treatment of a material item used in X's overall plan for valuing items in inventory for purposes of § 1.446-1(e)(2)(ii)(c). X's accounting treatment of this excise tax qualifies as a material item, which is defined in § 1.446-1(e)(2)(ii)(a) as any item that involves the proper time for a deduction or inclusion in income, because the timing of a deduction is affected.

Section 446(e) and § 1.446-1(e)(2)(i) generally require consent of the Commissioner in order to change a method of accounting. The automatic consent procedure prescribed in Notice 88-92 [as authorized by § 1.263A-1T(e)(11), which was applicable to the time period involved] was available for use by X as a means to secure consent to a change in method of accounting required in order to comply with the rules under § 263A and § 1.263A-1T.

The issue presented in this case is whether X was entitled to change its method of accounting for federal manufacturer's excise taxes on B under the automatic consent procedures of Notice 88-92. Resolution of this issue is dependent on whether the rules of § 263A and § 1.263A-1T "required" X to make a change in its method of accounting for those taxes, thereby rendering X eligible to use the automatic consent change procedure. *See* § 1.263A-1T(e)(11). If the change was required in order to comply with § 263A and § 1.263A-1T, X's filing of Form 3115 pursuant to Notice 88-92 was proper and X thereby had consent to change its method of accounting. If these sections did not require the change, X would not have been permitted to change its method of accounting under the terms of Notice 88-92 and no consent would be deemed to have been granted by reason of a filing made pursuant to those procedures. In that event, X would then have to change its method of accounting for federal excise taxes on B pursuant to the procedures governing changes in methods of accounting that are in effect when a new request for permission to change is filed.

Section 263A(a) provides that indirect costs, including taxes, that are allocable to inventory property are to be included in inventory; § 1.263A-1T(b)(2)(ii) required that indirect costs are to be included in the cost of property produced. Thus, federal manufacturer's excise taxes on B are an inventoriable cost under § 263A and § 1.263A-1T. Section 1.472-8(b)(1) provides that a LIFO natural business unit pool shall consist of all items entering into the entire inventory investment of a natural business unit. This means that all inventory costs in a natural business unit pool are to be valued using LIFO. Since X maintains a single natural business unit inventory pool, § 263A and § 1.472-8(b)(1), taken together, require X to treat federal manufacturer's excise taxes on B as a cost that is to be incorporated into its LIFO inventory calculation.

Prior to Year 5, X did not treat federal manufacturer's excise taxes as a component of the inventory cost of the B that it produced, as required by § 263A. Instead, X accounted for these costs separately on a non-LIFO basis (either as a prepaid expense, as X contends, or as inventory). Under § 1.263A-1T(e)(11)(iii), a change in method of accounting is "required" for purposes of § 263A and § 1.263A-1T if necessary in order for the taxpayer to properly capitalize and allocate costs with respect to its production activities. Thus, X was required to change its method of accounting for federal excise taxes on B in order to comply with the rules of § 263A and § 1.263A-1T. Therefore, X was eligible to use the automatic consent procedures of Notice 88-92 to change its method of accounting for those taxes.

Two additional points support this conclusion. First, under § 1.263A-1T(e)(11)(iii), an assessment of whether a change in accounting method is required by § 263A and § 1.263A-1T is made irrespective of the amount of costs that would have been capitalized under the taxpayer's previous method of accounting and irrespective of whether the previous method was correct under the law in effect at that time. Thus, whether X's previous method of accounting for federal excise taxes on B was proper has no bearing on resolution of the issue presented and need not be examined. Second, § 1.263A-1T(e)(11)(iii) also provided that a "required" change does not include a change from one method of inventory valuation to another or a change within inventory valuation methods. X is not changing from one inventory valuation method to another and is not changing within inventory valuation methods. X will continue to use double-extension, dollar-value LIFO to account for all of the inventory costs in its natural business unit pool. X is merely incorporating federal excise taxes on B into its inventory calculation as part of the cost of its finished product, as required by § 263A.

In summary, X was required to incorporate federal manufacturer's excise taxes on B into its LIFO inventory calculations in order to properly capitalize and allocate these costs in the manner prescribed by § 263A and § 1.263A-1T and in conformity with the rules applicable to its use of the double-extension, dollar-value LIFO inventory method and a single natural business unit pool. Accordingly, X's change in its method of accounting for those costs was a required change for purposes of § 1.263A-1T(e)(11). Since X was required to change its method of accounting for federal excise taxes on B in order to properly incorporate these costs into its determination of inventory cost, X was eligible to use the automatic consent procedures of Notice 88-92. X filed a Form 3115 and § 263A checklist with its Year 5 tax return in conformity with the procedures set forth in Notice 88-92. X is therefore deemed to have received the consent of the Commissioner to change its method of accounting for federal manufacturer's excise taxes on B beginning with its Year 5 taxable year.

ACCOUNTING FOR THE FLOOR STOCKS TAX

Section 471(a) provides that inventories must be taken on such basis as the Secretary may prescribe as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting income.

Section 1.471-3 provides rules for determining the cost of merchandise on hand at the beginning of the taxable year and the cost of merchandise purchased or produced since the beginning of the taxable year.

Section 472(b) and § 1.472-1 require taxpayers using the LIFO inventory method to treat goods remaining on hand at the close of the taxable year as being: first, those included in the opening inventory of the taxable year, in the order of acquisition and to the extent thereof; and second, those acquired during the taxable year. Section 472(b) and § 1.472-2 require taxpayers using the LIFO method to inventory their goods at cost.

Section 263A(a) provides, in the case of property which is inventory in the hands of the taxpayer, that the direct costs and an allocable share of the indirect costs (including taxes) of the property must be included in inventory.

Section 1.263A-1T(b)(2)(ii) provided that all indirect costs that directly benefit or are incurred by reason of the performance of a production or resale activity must be capitalized with respect to the property produced or acquired unless otherwise provided.

Rev. Rul. 2001-8, 2001-9 I.R.B. 726, provides that payments made or received with respect to floor stocks must be accounted for as adjustments to the invoice price or production cost of the goods physically held on the floor stocks date to which the payments relate. Payments made or received with respect to floor stocks affect inventory valuation only to the extent that the invoice price or production cost of the goods on hand that gave rise to the payments has not been included in cost of goods sold but remains in ending inventory under the taxpayer's inventory cost flow assumption.

X obtained consent to change its method of accounting for federal manufacturer's excise taxes on B for its Year 5 taxable year, permitting X to begin to incorporate those taxes into its LIFO inventory calculations. When making this change in accounting method, X properly incorporated excise taxes related to its pre-Year 3 LIFO inventory cost layers at a rate of C. Prior to Year 3, the federal manufacturer's excise tax rate on B was C. X's inclusion of this tax in inventory at a C rate was consistent with the requirements of § 472(b) and § 1.472-2, which require taxpayers using the LIFO method to inventory their goods at cost. Although the federal manufacturer's excise tax on B increased from C to D in Year 3 on Date 1, under the facts presented there was no requirement for X to reflect the amount of excise tax included in its pre-Year 3 LIFO inventory layers at a D rate, whether by reason of the imposition of a Date 1 floor stocks tax or otherwise.

X did not include any of the floor stocks tax imposed on Date 1 in its LIFO inventory. X's treatment of that tax is consistent with relevant guidance that was subsequently provided in Rev. Rul. 2001-8, which requires that floor stocks taxes be accounted for as adjustments to the production cost of the goods to which those taxes relate (i.e., goods physically held on the floor stocks date). Accordingly, inventory valuation is affected by a floor stocks tax only to the extent that the production cost of the goods on hand that gave rise to the tax remains in ending inventory under the taxpayer's inventory cost flow assumption.

The floor stocks tax paid by X in Year 3 is a cost attributable to B physically held on Date 1. B held on Date 1 that were previously taxed at a C rate upon removal from a federally bonded warehouse were subjected to the floor stocks tax. All of the B held by X that were subjected to the Date 1 floor stocks tax were produced by X in Year 2. X did not add a LIFO cost layer to its inventory in Year 2. Since no LIFO inventory layer was added by X in Year 2, none of the cost of the B produced in Year 2 that gave rise to a floor stocks tax on Date 1 remained in Year 5 ending inventory under X's LIFO cost flow assumption. Thus, the entire amount of the floor stocks tax imposed on Date 1 was properly excluded by X from its Year 5 LIFO inventory amount. Additionally, in determining the value of its pre-Year 3 LIFO inventory cost layers as part of its Year 5 LIFO calculation, there is no other basis upon which X was required to include the federal manufacturer's excise tax on B at a D rate rather than at the C rate that it actually utilized.

NEW ITEM DETERMINATION

Section 472(a) provides that taxpayers may use the LIFO method of inventorying goods in accordance with such regulations as the Secretary may prescribe as necessary in order that the use of such method may clearly reflect income.

Section 1.472-8(a) provides that any taxpayer may elect to determine the cost of its LIFO inventories under the "dollar-value" LIFO method, provided such method is used consistently and clearly reflects income. The dollar-value method of valuing LIFO inventories is a method of determining cost by using base-year cost expressed in terms of total dollars rather than the quantity and price of specific goods as the unit of measurement. The term "base-year cost" is the aggregate of the cost of all items in a pool determined as of the base date.

Section 1.472-8(e)(1) provides that a taxpayer may ordinarily use only the "double-extension" method for computing the base-year and current-year cost of a dollar-value LIFO inventory pool.

Section 1.472-8(e)(2)(i) provides that under the double-extension method the quantity of each item in the inventory pool at the close of the taxable year is extended at both base-year unit cost and current-year unit cost. The respective extensions at the two costs are then each totaled. The first total gives the amount of the current inventory in terms of base-year cost and the second total gives the amount of such inventory in terms of current-year cost.

Section 1.472-8(e)(2)(iii) provides that under the double-extension method a base-year unit cost must be ascertained for each item entering a pool for the first time subsequent to the beginning of the base year. In such a case, the base-year unit cost of the entering item shall be the current-year cost of that item unless the taxpayer is able to reconstruct or otherwise establish a different cost. If the entering item is a product or raw material not in existence on the base date, its cost may be reconstructed; that is, the taxpayer using reasonable means may determine what the cost of the item would have been had it been in existence in the base year. If the item was in existence on the base date, but not stocked by the taxpayer, the taxpayer may establish, by using available data or records, what the cost of the item would have been to the taxpayer had the item been stocked. If the base-year unit cost of the entering item is either reconstructed or otherwise established to the satisfaction of the Commissioner, such cost may be used as the base-year unit cost in applying the double-extension method. If the taxpayer does not reconstruct or establish to the satisfaction of the Commissioner a base-year unit cost, but does reconstruct or establish to the satisfaction of the Commissioner the cost of the item at some year subsequent to the base year, the taxpayer may use the earliest cost which was reconstructed or established as the base-year unit cost.

The term “item”, as used in § 1.472-8(e)(2)(iii), is not defined in the Internal Revenue Code or the Income Tax Regulations. However, a line of cases decided by the Tax Court sets forth principles that provide guidance on when product or cost differences give rise to a need to treat something as a separate item for dollar-value LIFO inventory purposes.

Wendle Ford Sales, Inc. v. Commissioner, 72 T.C. 447 (1979), *acq*., 1980-1 C.B. 1, involved an automobile dealer using the double-extension method under dollar-value LIFO. The meaning of the term “item” in § 1.472-8(e)(2)(iii) was the basic issue. Specifically, the question raised was whether catalytic converters and solid-state ignition systems were either themselves new items entering the inventory pool for the first time or, when added to vehicles, whether they rendered the vehicles different items which required an adjustment to base-year cost. The court held that the term “item” in the case of a retailer refers to a finished product and not individual components or parts, and that minor modifications in the composition of a product do not render it a different item. The court stated that the point at which modifications become so substantial as to render a product a new item for LIFO inventory purposes would have to be decided on a case-by-case basis. Under the facts presented, the court found that the modifications and their cost were not significant and concluded that no new item entered the inventory pool for the first time.

In *Amity Leather Products Company v. Commissioner*, 82 T.C. 726 (1984), the court in a manufacturing context adopted a more narrow definition of an item in order to clearly reflect income. The taxpayer, a manufacturer of leather products, used double-extension, dollar-value LIFO and a single natural business unit pool. At issue was whether billfolds manufactured in Puerto Rico, which were basically identical to those manufactured in the United States but produced at a substantially lower cost, were properly treated as a new item in its inventory pool. The court stated that the definition of “item” is extremely important to the clear reflection of income; it must be narrow enough to accurately measure inflation or deflation and clearly reflect income, but at the same time must be administratively feasible and not unduly burdensome. *See Amity Leather Products* 82 T.C. at 734. Income would not be clearly reflected, according to the court, in situations where a reliable index could not be computed because factors other than inflation were permitted to enter into the cost of inventory items. The court held that a new item did exist where its cost was substantially different and the failure to treat it as a new item (considering potential changes in pool product mix and the different rate of inflation attributable to each product) would lead to an inaccurate measure of inflation.

The basic principles established in *Wendle Ford* and *Amity Leather Products* were subsequently addressed by the court in *Hamilton Industries, Inc. v. Commissioner*, 97 T.C. 120 (1991), a bargain purchase case. The taxpayer used dollar-value, double-extension LIFO with a single natural business unit pool. The court held that similar characteristics must be present to enable things to be treated as the same "item"; thus, a sufficiently large bargain element, arising out of a discount purchase, was found to give rise to a different item since separate treatment would produce a better measure of inflation and more clearly reflect income. The court noted that the LIFO method is directed toward dealing with inflationary cost increases; LIFO was not designed to allow cost of goods sold to include cost increases attributable to the replacement of goods having materially lower cost characteristics with goods possessing higher cost characteristics, which would occur through a combination of goods with greatly disparate cost characteristics. The court also reiterated that substantial differences in either cost or physical characteristics can give rise to a separate item and that "item" must not be so narrowly defined as to impose unreasonable administrative burdens on taxpayers so as to render use of the double-extension method impractical.

Other taxpayers were likewise required to treat bargain-priced inventory as a separate item for dollar-value LIFO accounting purposes in *Kohler Co. v. United States*, 124 F.3d 1451 (Fed. Cir. 1997), and *La Crosse Footwear Inc. v. United States*, 191 F.3d 1372 (Fed. Cir. 1999).

In X's case, the issue is whether the increase in the federal manufacturer's excise tax on B from C to D required X to treat B subjected to a D tax rate as a "new item" for LIFO inventory purposes in order to accurately measure inflation and to clearly reflect income. Since an accurate index under double-extension, dollar-value LIFO is critical to the clear reflection of income, a higher-cost item must be treated as a new item when more than an insignificant change in cost occurs that is attributable to factors other than inflation. *See Wendle Ford*, *Amity Leather Products* and *Hamilton Industries*. The general principles that emerge from these three cases are broadly summarized as follows: A "new item" arises when substantial differences in cost exist that require separate treatment in order to accurately measure inflation (or deflation) and to clearly reflect income. Income is not clearly reflected if items are not treated separately in situations where factors other than inflation produce a substantial differential in cost. The determination of when cost differences are sufficiently substantial to give rise to a new item can only be made on a case-by-case basis. The administrative burden of an overly restrictive view of the definition of an item on the use of dollar-value LIFO is a factor to be considered.

Under the specific facts presented in this case, X is not required to treat B bearing a higher excise tax rate of D as a new item in its LIFO inventory calculations. The federal manufacturer's excise tax on B is just one element of the cost of producing B. The legislative history, F, associated with this increase in excise tax indicates that Congress believed an increase in that tax (a tax imposed as a set amount rather than on a percentage basis and unchanged since Year 0) was appropriate because: the effective level of tax had declined significantly since Year 0; the new rate did not increase the tax in real terms above the Year 0 level; and, the increase was deemed necessary in order to raise revenue. Thus, this particular increase in excise tax did not involve any special purpose and was clearly inflationary in nature. In addition, X has represented that the increase in the federal manufacturer's excise tax on B was significantly less, on a percentage basis, than the overall rate of inflation since Year 0 that was experienced for all other cost elements of producing B.

CAVEATS:

A copy of this technical advice memorandum is to be given to the taxpayer. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.