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INDUSTRY SPECIALIZATION PROGRAM
COORDINATED ISSUE PAPER

INDUSTRY: Motor Vehicle

ISSUE: Excess Parts Inventory

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SETTLEMENT GUIDELINES

EXCESS PARTS INVENTORY

STATEMENT OF ISSUE

Whether surplus and obsolete material transferred at a loss as part of a purported sale to an unrelated warehouse facility, in prior years that are now closed by the statute of limitations, constitutes inventory for the current year where the taxpayer has retained dominion and control.

BACKGROUND

This coordinated issue of the Examination Division Industry Specialization Program (ISP) specialist, as framed above, and approved on October 2, 1989, by Chief Counsel's Office is utilizing the rules of I.R.C. Sec. 481(a) for their proposals. When beginning inventory for the instant year is understated because of previous write-downs, in otherwise barred years, a catch-up adjustment is necessary for proper reporting of inventory (cost or lower of cost or market) that is under the taxpayer's dominion and control.

Prior to discussing this coordinated issue some background of the government's position is necessary to give the reader a history of our successes in the courts relative to the disallowances of the premature write-downs. These purported sales of excess inventory to third parties were determined by the courts to be warehousing arrangements, rather than sales that would have resulted in a cost of goods sold deduction. Below is an analysis of the law and applicable cases that form the rationale for catch-up adjustments under I.R.C. Sec. 481(a). The accounting method is changed by the Commissioner restoring prior year write-downs of excess inventory purportedly sold.

The "SAJAC" issue described in the section below has been an Appeals Coordinated Issue (ACI) controlled by the Regional Director of Appeals-Midwest Region (Chicago). See IRM 8776.(14). No ACI position or guideline paper has been transmitted to the

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Appeals Offices to date by the Midwest Region, therefore this ISP guideline paper is intended to serve a dual purpose.

FACTS

Manufacturers and distributors must maintain extensive inventories of replacement parts and components to serve customer's future needs. This issue is generic to many manufacturers and distributors and is not unique to just the motor vehicle industry. Therefore, this issue has widespread ramifications in other industries.

When parts or components are manufactured or purchased from vendors it is more economical to manufacture a large run or to order a large quantity sufficient to meet both current demands and anticipated replacements, rather than to manufacture or order a smaller quantity for current demand and then order again for replacement demand. The downside to this method is that the larger amount of items required for future replacement demand may be held for many years before being sold, and may eventually be scrapped. Because of the long retention period and the possibility that the parts might eventually be scrapped, they are commonly referred to as "excess parts."

Taxpayers traditionally have written down this "excess inventory" to scrap value or at least a fraction of its historical cost. This method of write down meets the requirement of generally accepted accounting principles (GAAP). In 1979, the Supreme Court ruled in the case of Thor Power Tool Co. v. Commissioner, 439 U.S. 522 (1979), that these write-downs of excess inventory were unallowable if the items were held out for sale at their original quoted prices. In Thor Power Tool Co., the taxpayer, a manufacturer, sought to retain "excess" inventory items for possible sale at their original prices and at the same time claim, for tax purposes, inventory losses resulting from lowering the valuation of that inventory.

Regulations under I.R.C. Sec. 471 require the taxpayer to value its inventory at the lower of actual cost or replacement cost, unless the taxpayer could demonstrate an even lower value either by actually offering the items for sale at that lower price or by showing that the items were defective. The taxpayer in Thor Power Tool Co., could neither show that it had offered the goods for sale at scrap prices in their regular course of business, nor could it show that the goods were defective and, thus, had value only as scrap. The court accepted the government's determination that the attempted write-down did not clearly reflect the taxpayer's income and would be ignored for tax purposes.

The Government became concerned following the decision of Thor Power Tool Co., that

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taxpayers were devising a method to circumvent the Supreme Court's holding. Treas. Reg. Sec. 1.471-1, provides that a taxpayer should exclude from its inventory the value of goods sold. A taxpayer's ostensible "sale" of excess inventory to a compliant buyer, who would hold the inventory only for resale to the taxpayer, would theoretically enable a taxpayer to reduce its inventory by the value of the excess inventory sold. Such a "sale," however, would still preserve the taxpayer's control over that inventory by virtue of the understanding between the seller and the buyer. Thus, while Thor Power Tool Co., precludes a taxpayer from writing down its inventory to scrap value while still retaining that inventory for sale at normal prices, a taxpayer might achieve the same result through a "sale" to a sympathetic buyer.

The National Office was very concerned about these purported sales between a sympathetic buyer and seller and published Rev. Rul. 83-59, 1983-1 C.B. 103, in which the Commissioner determined the following:

"A manufacturer may not reduce its ending inventory based on purported sales of `excess' inventory at scrap value, when under the sales arrangement the manufacturer continues to possess, as a matter of fact, the benefits and burdens of ownership with respect to the `excess' inventory. This type of transaction is not a bona fide sale for federal income tax purposes."

There are currently four reported court cases that have upheld the position of the Commissioner in Rev. Rul. 83-59, supra. See Paccar, Inc. v. Commissioner, 85 T.C. 754 (1985), aff'd, 849 F.2d 393 (9th Cir. 1987); Clark Equipment Company v. Commissioner, T.C. Memo 1988- 111; Robert Bosch Corporation v. Commissioner, T.C. Memo 1989- 655; and Rexnord, Inc. v. United States, 940 F.2d 1094 (7th Cir. 1991), affirming an unreported District Court decision.

The attempted approach used by the taxpayers was to solve what the Supreme Court in Thor Power Tool Co., called a manufacturer's "unattractive Hobson's choice." Following Thor Power Tool Co., and Rev. Rul. 83-59, the trilogy of Tax Court cases, the so-called "SAJAC" cases, successfully confronted this new angle to circumvent the government's disallowance of the write-downs.

SAJAC, Inc., a Wisconsin warehousing company, would "buy" and hold inventory which would remain readily available to the original supplier or "seller," which in turn claimed an inventory loss on its tax returns. A review of the cases discloses no "real" business other than "buying" excess inventory for later "sale" back to the original owner.

The Government disallowed these deductions and the taxpayers petitioned the Tax Court

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for review. All three cases found that, while these arrangements were arms-length transactions, they did not amount to true sales because, in essence, the manufacturer retained control over its merchandise. In Paccar, and Clark, SAJAC was required to hold the manufacturer's merchandise for a specified period unless it obtained the original supplier's consent. In Robert Bosch Corporation, there was no written contract which restricted SAJAC's ability to sell to third parties but, as in the earlier cases, SAJAC represented to the taxpayer that it would hold their merchandise. The court determined that given the economic reality of the relationship, the heart of the "SAJAC" concept was holding goods for the taxpayers.

The Tax Court in the trilogy of cases employed the familiar substance-over-form analysis. That is to say the economic substance of a transaction, rather than its form, governs whether a transaction is a bona fide sale for income tax purposes. See Gregory v. Helvering, 293 U.S. 465 (1935). In analyzing whether a sale has actually taken place, the courts will look to the "the objective economic realities" of the transaction, rather than to the particular form the parties employed. See Frank Lyon Company v. United States, 435 U.S. 561, 573 (1978).

Even when the form of the transaction is that of "sale," the courts need not treat the transaction as a sale when the substance of the transaction is that the transferor has retained effective control over the items allegedly sold. In some cases, a sale may be voided even when the transferor does not retain control through formal contractual provisions. Thus, the courts have refused to regard as "sales" transactions where the seller retained "sufficient dominion" over the buyer as in Fender Trust No. 1 v. United States, 577 F.2d 934 (5th Cir. 1978).

The Tax Court listed four factors that focused on the control by the taxpayers over their inventory in determining that no valid sales had taken place. The Tax Court in Clark, and Robert Bosch Corporation, followed its rationale in the original case of Paccar, in which it stated the following:

"In our view, the following four factors should be considered in determining the character of the transactions between petitioner and SAJAC: (1) Who determined what items were taken into inventory; (2) who determined when to scrap existing inventory; (3) who determined when to sell inventory; and (4) who decided whether to alter inventory."

Paccar, (85 T.C. at 779).

The Tax Court in all three cases determined that the taxpayers retained effective control over the transferred inventory. In the Robert Bosch Corporation, where there wasn't a

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written agreement the Tax Court still held that the taxpayer had control in substance. The court concluded the taxpayer retained effective control over the inventory transferred to SAJAC like those in Paccar, and Clark, and were not, in substance, sales. In those cases, SAJAC accepted all inventory that was usable; it resold that inventory to no one other than the taxpayers; and, in general, they acted more as a warehouseman than as a dealer in excess inventory.

One significant fact in these cases is that the petitioners demonstrated convincingly to the court the dealings between SAJAC and the taxpayers were made at arms-length and that SAJAC was an independent and viable corporation. Those factors, however, did not affect the Tax Court's determination that the transactions at issue were not sales. SAJAC did not, and for all practical purposes could not, exercise sufficient control over the inventory transferred by the taxpayers to be deemed a purchaser of an inventory. The taxpayer viewed the only substantial right obtained by SAJAC under the agreement was the right to receive an agreed amount for any item "repurchased" by the petitioner.

There was a second issue in the case of Robert Bosch Corporation, that the Government lost relative to the petitioner's purported sales of excess parts to a company called Valley Parts. The court concluded that the reasoning that led to its determination that sales to SAJAC were not valid sales required a finding that the petitioner's sales to Valley Parts were valid sales. Valley Parts was controlled by the same individuals who controlled SAJAC. The executives of Bosch sometimes thought that communications to the executives of SAJAC were effectively communications to Valley Parts as well. Valley Parts business was different than SAJAC. It was a dealer in surplus parts that looked for its profits by a fast turnover in inventory to third parties, as well as to manufacturers who sold it the inventory in the first place.

The distinguishing feature in Valley Parts to that of SAJAC was Valley Parts clearly ceded to Bosch no control over the property transferred by the petitioner. In effect, Valley Parts was free to, and factually did, resell petitioner's parts to third parties; that was the nature of its business. This is a very important aspect and must be evaluated closely when analyzing a purported SAJAC-type issue.

Robert Bosch quickly ceased doing business with Valley Parts because some of its sales to third parties were being returned to the taxpayer as part of their "dealer return" program. As one can see the taxpayer was quickly losing money because they were selling parts to Valley Parts at scrap values and having to refund to customers as dealer returns. This unprofitable relationship with Valley Parts was only minimal. The Tax Court was persuaded that these factors demonstrated that Bosch's transfer to Valley Parts included transfers of control and that Valley Parts proceeded to exercise that control as the new owner of inventory in form, as well as in substance.

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Again, the point relative to Valley parts in Robert Bosch Corporation, is pointed out because issues that will be raised by the Examination Division that are non-SAJAC cases must be factually scrutinized by Appeals. Factual hazards could likely be present and should be evaluated along traditional lines as any other facts and circumstances issue.

The fourth and last case reported on the issue, is Rexnord, Inc. v. United States, 940 F.2d 1094 (7th Cir. 1991) an unreported District Court decision that was affirmed by the Seventh Circuit Court of Appeals in August of 1991. Obviously, the taxpayer saw the position that the Tax Court was taking on the SAJAC issue and opted for the refund litigation route hoping for a different conclusion. The facts in the Rexnord, Inc., case are different than in the trilogy of Tax Court cases in that SAJAC was not involved as the buyer or warehouse of the items. Rexnord used an unrelated company called S. R. Sales.

The Government introduced evidence to the court that the agreement covering the sale of the "scrap" to S. R. Sales was that the items would be marked with Rexnord's inventory numbers to ease the sale back to Rexnord on request. The price was either the manufacturing cost or the price Rexnord proposed to sell the item to its customers. In other words, Rexnord only held or needed these inventory items as a convenience to its existing customers. A review of the case also shows that S. R. Sales could sell these items to third parties without notice or approval from Rexnord. These third party sales only accounted for five percent of S. R. Sales dollar resales of Rexnord's products.

The court pointed out that the "heart" of S. R. Sales business was holding goods to be repurchased later by the seller. The court found that the only reason Rexnord dealt with S. R. Sales instead of immediately scrapping excess inventory was because it had continuing access to the inventory. The Government was also able to introduce an inter-office memorandum written by the taxpayer's controller regarding the company's inventory obsolescence policy which includes a reference to S. R. Sales as a corporation which purchases and "holds" surplus inventory. Although these transactions have the trappings of "bona fide" sales, the economic reality was quite different since 95 percent was sold back to the taxpayer. The District Court looked through the form of the transaction to the substance and held for the Government as did the Tax Court.

In all the above cases cited, the issue was the instant year's write-down of the inventory with no I.R.C. Sec. 481(a) catch-up adjustment for prior year write-downs. Obviously, if this ISP issue were only dealing with the inventory write-down, as described above, there would be no need for national coordination of this issue, since there is ample precedent with the Tax Court and two Circuits sustaining the Government.

The taxpayer's balance sheet relative to inventory is understated by the amount of items that is still being held by the warehousing company. Therefore, the coordinated issue is

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whether the surplus and obsolete items that were previously transferred in prior years that are now closed by the statute of limitations, constitute inventory of the taxpayer for the current year where the taxpayer still retains dominion and control.

EXAMINATION DIVISION'S POSITION

The Examination Division's position is that any excess parts that have been transferred to a warehousing company and deducted in closed years are still the inventory of the taxpayer and are required under Treas. Reg. Sec. 1.471-2 to be included at cost or lower of cost or market. Where the taxpayer has used an improper method of accounting for tax purposes, a change to a correct method may be made during a current year under examination.

Thus, if a taxpayer has excluded items from inventory for a number of years, a change can be made to include in the current inventory all items improperly excluded under the rules of I.R.C. Sec. 481(a). Examination believes that the court would hold this is a mere warehousing operation, and these parts, in essence, are the taxpayer's inventory and inventory must be stated on the balance sheet and on the tax return at the respective cost.

I.R.C. Sec. 481(a) requires adjustments necessary to prevent amounts from being duplicated or omitted by taking them into account when an accounting method is changed. These adjustments distort income since they are valued at zero for the current years under the old method of accounting.

The Examination Division's position is based on Rev. Proc. 84-74, 1984-2 C.B. 736, as amended by Rev. Proc. 92-20, 1992-12 I.R.B. which sets forth the procedures to be followed when a method of accounting is changed, and provides for an adjustment period, under certain conditions. These procedures ameliorate the effects of I.R.C. Sec. 481(a) adjustments. However, the provisions providing for an adjustment period do not apply to this type of coordinated issue change because it is a so-called Category A method of accounting, which is not accorded the relief that a Category B method allows.

Category A methods of accounting are methods that are not permitted to be used by the Code, regulations, or decision of the Supreme Court. Specifically included in this definition are Thor Power Tool-type issues where a taxpayer writes down excess inventory. See Rev. Proc. 84-74, at section 6.02, Example (4). Because taxpayers engaging in SAJAC transactions are generally not considered to be entering into bona fide sales of their excess inventories they are in substance writing down their excess inventories contrary to the Supreme Court's holding in Thor Power Tool.

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DISCUSSION

Adjustments involving accounting method changes are governed by I.R.C. Secs. 446(b) and 481(a). I.R.C. Sec. 446(b) requires that annual taxable income be reported in a manner that clearly reflects income. Consequently, the I.R.C. Sec. 446(b) adjustment is the change that is necessary to restate annual taxable income according to the proposed new method. Such a restatement will require adjusting the beginning inventory in the instant coordinated issue.

An accounting method change generally involves two adjustments. One is under I.R.C. Sec. 446(b), which restates annual taxable income in a manner that clearly reflects income. The other is I.R.C. Sec. 481(a), which eliminates the omitted or duplicated items allowed in the I.R.C. Sec. 446(b) adjustment.

To illustrate this, assume that adjustments increased beginning and ending inventories by \$20,000 and \$30,000, respectively. The change to the annual income was \$10,000 (i.e., \$30,000 minus \$20,000). This \$10,000 amount would be the I.R.C. Sec. 446(b) adjustment. The \$20,000 duplication in beginning inventory would be the adjustment under I.R.C. Sec. 481.

Generally, adjustments reflecting the effect of the change in the beginning inventory of the year omit or duplicate items of income or expense reported in previous tax years. These omissions and duplications may be positive or negative under the rules provided in I.R.C. Sec. 481(a).

In virtually every accounting method change, some items of income or expense will be duplicated or omitted. This is because taxable income for the year an accounting method change occurs is computed by applying the new method to all transactions that occurred during that year. For example, the cost of inventory that was previously deducted under a "cash" method or such as the instant issue, an unallowable write-down, will again be treated as cost of goods sold when the inventory is sold because the previous write-down is restored to the beginning and ending inventory.

I.R.C. Sec. 481 was added to the Internal Revenue Code in 1954 to cure the problem by assuring that the net distortion caused by an accounting method change, defined as the "net adjustment," would be either deducted from or restored to income, as the case may be. The purpose of I.R.C. Sec. 481 is to supply transitional rules specifying: (1) the amount of the omitted or duplicated items; (2) the time when such items will be taken into account in computing taxable income; and (3) the method of calculating the tax attributable to the omitted or duplicated items.

This adjustment includes amounts that would be otherwise barred by the statute of

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limitations. Remember, the taxpayer receives the benefit of the "timing" of the income or deductions relative to interest on the deficiency up until the year of the I.R.C. Sec. 481 adjustment.

The leading case on a challenge to the statute of limitations being barred versus the application of I.R.C. Sec. 481(a) is that of Graff Chevrolet Company v. Campbell, 343 F.2d 568 (5th Cir. 1965). This case answers precisely what the coordinated issue proposes. In the Graff Chevrolet Company, a retail auto dealer had not included in income amounts credited to a dealer reserve account by a finance company in 1956 and 1957, years closed by the statute of limitations. The taxpayer was required to include in income in 1958, the year in which the Commissioner required it to change its accounting method, amounts credited to its reserve account from closed years. This 1958 change was based on a then recent Supreme Court case that ruled on the issue causing it to be reportable income. See Commissioner v. Hanson, 360 U.S. 446 (1959).

The case of W. S. Badcock Corp. v. Commissioner, 59 T.C. 272 (1972), not only supports the Graff Chevrolet Company theory, but it is also interesting to note that there were prior audits and the adjustment was missed and was not proposed until a subsequent year. The court still decided in the Government's favor. This is being pointed out because there may be taxpayers who have this coordinated issue that has been unadjusted that should still be a viable issue in the current year of examination.

On first review the readers may have a question relative to how can the Government pursue only an I.R.C. Sec. 481(a) adjustment if there is not a current year I.R.C. Sec. 446(b) proposal? The review of the Graff Chevrolet Company, case and the literal reading of I.R.C. Sec. 481(a) and its legislative history so state in the Appeals ISP Coordinator's opinion. The reason is that the taxpayer has understated its beginning and ending inventory if these warehoused items are, in essence, valued at zero.

For a taxpayer who is under the first-in, first-out (FIFO) method under I.R.C. Sec. 471, and values inventory at cost or lower of cost or market, its obvious that carrying these warehoused items at zero is incorrect, even when using market. Market should readily be available from "repurchases," the contracts with the warehouse, or the last sales to traditional customers.

A more recent case where there was an inaccurate inventory reporting due to clerical errors on the part of employees is the case of Wayne Bolt and Nut Company, 93 T.C. 500 (1989). The taxpayer accumulated errors in its perpetual inventory system over several years. The Government successfully argued that the taxpayer changed its accounting method and an I.R.C. Sec. 481(a) adjustment for 1981 was required to capture the previously deducted inventory in otherwise barred years. Upon a first impression, the taxpayer was attempting to achieve an outrageous result. Such a result was possible

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before I.R.C. Sec. 481 was enacted. The Tax Court again looked back to Graff Chevrolet Company, relative to the statute of limitations which, in effect, stated that when an erroneous accounting method exists the Government is effectively granted an exception to the application of the statute of limitations. Thus, if a method exists under I.R.C. Sec. 481, the Government can adjust for values otherwise closed by the passage of time.

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