APPEALS

INDUSTRY SPECIALIZATION PROGRAM

COORDINATED ISSUE PAPER

INDUSTRY: Motor Vehicle

ISSUE: Remanufacturers' Inventory of Cores

COORDINATOR: Fred Gavin

TELEPHONE: (616) 235-0612

UIL NO: 471.02-04

FACTUAL/LEGAL ISSUE: Factual

APPROVED:

/s/ Timothy Dreyer **6/4/93**
for REGIONAL DIRECTOR OF APPEALS DATE

CENTRAL REGION

/s/ Donald E. Bergherm **6/16/93**
for NATIONAL DIRECTOR OF APPEALS DATE

*** FOR OFFICIAL USE ONLY ***

EFFECTIVE DATE: 6/21/93

SETTLEMENT GUIDELINES

REMANUFACTURERS' INVENTORY OF CORES

STATEMENT OF ISSUE

Whether taxpayer may value the "core" segment of its rebuilt inventory at an amount that is less than cost or market, whichever is lower.

FACTS

This coordinated issue of the Examination Division Industry Specialization Program (ISP), as framed above, was approved by the office of Chief Counsel in September of 1989. There are many taxpayers who are engaged in the business of remanufacturing motor vehicle parts. As part of the remanufacturing process, taxpayers disassemble old automobile parts which are called "cores" and rebuild these cores with new or other used component parts, so that the cores may again function properly as an automobile part. For example, taxpayers may disassemble a brake shoe by removing the worn brake shoe lining and any grease or rust, straighten the metal parts where necessary, and affix a new lining to the metal parts which completes the process for an operational break shoe. There are virtually thousands of automobile parts that may be remanufactured and are considered as good as new parts. This industry has evolved because as cars get older the supply of new parts is unavailable or extremely expensive. Further examples of motor vehicle parts that are remanufactured are: water pumps, clutches, clutch discs, solenoids, alternators, starters, fuel pumps, master cylinders, batteries and larger items such as engine blocks.

The remanufacturer usually sells the smaller parts to a distributor or retailer. The distributor or retailer, upon sale of the rebuilt parts, accepts the old parts, or "cores," as a trade-in with the customers receiving credits or rebates when purchasing new or

remanufactured parts that are similar. The distributor returns the cores to the remanufacturer who credits the account of the respective distributor. These credits are only given to the distributor by the remanufacturer if inspection determines that the "cores" are remanufacturable. Generally, these processes are very detailed inspections by the remanufacturer and a large amount of time is devoted to this activity. These inspections are essential because the credit amounts mean real money and profit to the remanufacturer.

Remanufacturers encourage individual car owners, garage owners, fleet owners, distributors and other users to return cores because the remanufacturer needs these parts, especially early on in the life of the part, to have a supply of cores available for remanufacture to meet future sales demands. After the initial manufacturing and supply to the automobile companies, new parts become scarce because the parts manufacturers will not periodically make new runs of parts because of excessive retooling costs.

The arrangements vary from remanufacturer to remanufacturer but generally they follow a similar pattern in the motor vehicle industry. When a rebuilt part is sold, the amount stated on the invoice is comprised generally of three elements, the "gross charge," the "core charge," and the "flat rate selling price." The "flat rate selling price" is the ultimate amount a customer pays for a rebuilt part if they return their old core. Many individual or non business customers ultimately pay full price, since they do not exchange old cores, often because they are unaware that they could receive credits.

Taxpayers argue the "core charges" are simply the amounts the remanufacturer has determined are necessary to include on the invoices to motivate its customers to return old cores. Remanufacturers argue that "core charges" bear no relationship to any inherent values the cores might have and is intentionally inflated so that the remanufacturer, as a marketing tool, can offer significant discounts to its repeat customers.

For financial and tax inventory purposes, remanufacturers generally assign no value to the old cores, or values that equate to scrap prices. Therefore, the only significant cost assigned to this inventory is the direct labor, material and overhead incurred to rebuild the old cores. These cores may not be rebuilt for years. This zero to scrap value approach has been followed consistently in the industry for over 40 years.

The remanufacturers' rationale for this treatment is that old, worn-out parts are always available at scrap or diminutive prices from core brokers. Remanufacturers generally do not obtain their core supply from core brokers, or if they do it is a diminutive amount for a rush order. Most remanufacturers find that it is nearly impossible to get a stream of cores in the quantities needed from brokers at the time they are needed for remanufacturing.

EXAMINATION DIVISION'S POSITION

For cores that have been or will be remanufactured, the proper inventory values are the credit amounts which equate to costs. Since these cores are not offered for sale at scrap prices, and the amount allowed as credits seldom change, these items should be valued in accordance with Treas. Reg. Sec. 1.471-2(c) which is: (1) cost and, (2) cost or market, whichever is lower.

For cores that have been determined to be unsuitable for remanufacturing, the proper inventory value is cost, unless the taxpayer can substantiate that they have been offered for sale for salvage in which case they can be valued at scrap prices. This is a strict burden for the taxpayer to substantiate in accordance with the Supreme Court case of Thor Power Tool Co. v. Commissioner, 439 U.S. 522 (1979), (79-1 U.S.T.C. para. 9139).

DISCUSSION

The remanufacturers take the position that the credit amount given to a customer is merely a marketing tool and in no way denotes a value that should be considered "cost." It is their position that the cores are equivalent to sub-normal goods or raw materials and may be valued on a "reasonable basis" which generally equates to "scrap value."

Under I.R.C. Sec. 471, whenever the use of inventories is necessary to clearly determine income, inventory shall be taken on a basis as the Secretary may prescribe as conforming to the best accounting practice in the trade or business and as most clearly reflecting the income.

Treas. Reg. Sec. 1.471-2(b) provides that the inventory practice of a taxpayer should be consistent from year to year, and greater weight is to be given to consistency than to any particular method of inventorying or basis of valuation, so long as the method or basis used is in accordance with Treas. Reg. Secs. 1.471-1 through 1.471-11.

Treas. Reg. Sec. 1.471-2(c) provides that the bases of valuation most commonly used by business concerns which meet the requirements of I.R.C. Sec. 471, are (1) cost, and (2) cost or market, whichever is lower. Generally, taxpayers who are engaged in the remanufacturing of parts adopt the cost or market, whichever is the lower method.

In general, Treas. Reg. Sec 1.471-4 provides that ordinarily the market value of purchased goods is the prevailing current bid price (i.e., replacement cost or reproduction cost). However, Treas. Reg. Sec. 1.471-4(b) recognizes two exceptions to the determination of market by using replacement or reproduction cost: First, where it is impossible to obtain a bid price (i.e., no open market exists). Second, where merchandise has been offered for sale in the regular course of business at prices lower than current bid price.

In the case of subnormal goods, Treas. Reg. Sec. 1.471-2(c) provides that such goods should be valued at net realizable value. If such subnormal goods are raw materials or partly finished goods held for use or consumption, Treas. Reg. Sec. 1.471-2(c) provides

that such goods should be valued upon a reasonable basis, taking into consideration the usability and the condition or goods, but in no case shall such value be less than the scrap value. Service position is that old cores received by remanufacturers in exchange for new cores are not subnormal goods within the meaning of Treas. Reg. Sec. 1.471-2(c)).

The Supreme Court in Thor Power Tool Co. v. Commissioner, supra, held that write downs of excess inventory were unallowable if the items were held out for sale at their original quoted prices. 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 to essentially scrap value. Thor was dealing with finished goods and not with used goods as in the instant issue. The court cited Treas. Reg. Sec. 1.471-4(a) which defines "market" to mean, ordinarily, "the current bid price prevailing at the date of the inventory for the particular merchandise and in the volume in which usually purchased by the taxpayer."

Remanufacturers' supply of cores is generally from customer returns and would be the volume in which the taxpayers/ remanufacturers usually purchased their cores, rather than from the core brokers. The Service position is to follow Treas. Reg. Sec. 1.471-4(a), and the Supreme Court in Thor Power Tool Co., supra, which is to say "bid price" is the taxpayers' replacement cost.

A case that addresses this issue of market is D. Loveman & Son Export Corporation v. Commissioner, 34 T.C. 776 (1960). In that case, the government argued that the proper bid price was that of the customers from whom the taxpayer had actually purchased its steel during the applicable period. The Tax Court agreed and held that the relevant market was of critical importance in determining the bid price. The taxpayer unsuccessfully argued for quoted prices of regular generic steel that was lower priced, but not the taxpayer's source of supply.

The case of Abbeville Cotton Mills v. Commissioner, 10 B.T.A. 646 (1928), decided that the bid price for the type of goods in question should be based on the quantity and quality of goods normally purchased by the taxpayer. This theory is further supported in two recently reported LIFO inventory cases. These cases separated identical inventory for purposes of valuing the index where some goods were either purchased in bulk as a bargain purchase or were produced at different manufacturing locations and had different respective cost although the items were the same. See Amity Leather Products Co. v. Commissioner, 82 T.C. 726 (1984), and Hamilton Industries, Inc. v. Commissioner, 97 T.C. 120 (1991).

The Tax Court held in the LIFO cases that the taxpayers were precluded from treating bargain purchase inventory as the same "item," as otherwise identical inventory manufactured after the date of acquisition. The result was that the bargain purchase inventory was replaced by subsequently manufactured goods with the higher current cost and the bargain purchase element was eliminated from the LIFO valuation.

This issue worked in the reverse of what the instant issue addresses, but holds for the same theory: since the quantities that were purchased in the bargain purchase have specific identifiable costs, they should be separated. In the instant issue, remanufacturers purchased cores in quantities from their customers and gave in exchange credits that are equivalent to cash purchases. Therefore, the Examination Division position is that outside market quotes of core brokers should not be used as the "reasonable basis" for the value of such cores, since these are not the quantities or market in which the taxpayers normally acquire their inventories.

The market price is the credit amount for returned cores provided to retailers and distributors because this amount represents the price in the market in which a remanufacturer normally participates. The market price for cores acquired from brokers may not be applicable for the additional reason that they are not comparable to cores acquired from distributors and retailers. Unlike the cores acquired from distributors and retailers, the cores acquired from brokers are not inspected and there is a good likelihood that they may not be usable by the remanufacturer.

The Appeals ISP Coordinator supports this premise, but recognizes certain hazards, as explained below.

TAXPAYERS' ARGUMENTS

Taxpayers will argue there are special rules for determining cost of, and for valuing used goods--such as cores, acquired in exchange for new goods. Taxpayers will likely cite Treas. Reg. Sec. 1.471-2(c) which provides the following:

> "Any goods in an inventory which are unsalable at normal prices or unusable in the normal way . . . , including second-hand goods taken in exchange, should be valued at bona fide selling prices less direct cost of disposition, . . . or if such goods consist of raw materials or partly finished goods held for use or consumption, they shall be valued upon a reasonable basis, considering the usability and the condition of the goods, but in no case shall such value be less than the scrap value."

The taxpayers will likely argue these used "cores" are "second-hand" goods that were taken in exchange for new or rebuilt parts, and as such, should be valued on a "reasonable basis." Therefore, these cores are akin to the cores that are available through core brokers or junkyards. The taxpayers fail to recognize the elaborate inspection processes they perform before credits are given to customers. Because of these inspections, we believe the argument is rebuttable.

In the case of Burrell v. Commissioner, T.C. Memo 1967-160, aff'd, 400 F.2d 682 (10th Cir. 1968), the Tax Court found that the credits or refunds given in exchange for engine cores

had no relationship to the values of the cores. In that case, the taxpayer was engaged in rebuilding automobile motors that he sold to both retail and wholesale customers. The taxpayer's invoices to its customers reflected charges for the rebuilt motors and separate charges for the old engine cores the taxpayer wanted to receive back to have in stock for further rebuilding. Each customer who purchased a remanufactured motor from the taxpayer, and later returned an old engine core of similar make, received a credit for the core charge.

For internal accounting purposes, the core charges to the customers were reflected in the account called "customer core deposits." The taxpayer did not include the deposit amounts for cores in income, and the Commissioner argued the taxpayer should have done so. The taxpayer argued the deposit amount included in the sales price of a rebuilt engine was not includable in gross income unless the customer failed to return the core. The Commissioner argued that only by accruing such deposit amounts, and taking the deductions for any credits subsequently issued for the return of cores, could the taxpayer clearly and accurately reflect income. The Tax Court held that the deposits received were income, the credits of the deposits were deductions, and that the cores should be inventoried based on their value.

Burrell is a case taxpayers might cite or attempt to use for principles beyond its holding. Although in Burrell the Tax Court found that the credits or refunds given in exchange for old engine cores were greater than their value, Burrell was not an inventory case and its holding did not have a specific application to inventory. Thus, in the context of inventory valuation, we question any broad interpretation of Burrell or its extension to the instant issue. If the market values materially differ from the amounts credited or refunded for cores received in exchange, then the cores should be carried in inventory at market with write-offs for the difference between the market values and credits or refunds given.

The court in Canada Dry Bottling Company of Florida, Inc., 109 F. Supp. 187 (S.D. Fla. 1952), concluded that whether or not the taxpayer designates the method of crate and container returns, which were deposit arrangements, he is compelled to inventory the items at the repurchased prices, refunds, or so-called deposit prices which were established as market value.

To the extent a taxpayer acquires excess cores and these cores are properly characterized as raw materials rather than finished goods, the cores do not have to be offered for sale in order to be written-down under Treas. Reg. Section 1.471-2(c) below the credit amount provided to retailers and distributors for the cores. However, they must experience a diminution in utility to justify such a write down. To the extent they can be used in the remanufacturing process, we believe taxpayers will not be able to establish that there has been an impairment of the cores' utility. Moreover, the mere fact that a taxpayer acquires more cores than it needs (i.e., it acquires excess inventory) is not a proper basis for writing down the inventory. See Thor Power Tool Co. v. Commissioner, supra.

There is support for the position that the old cores are raw materials. See Jostens, Inc. v.

Commissioner, T.C. Memo. 1989-656, modified, T.C. Memo. 1990-97, aff'd, 956 F.2d 175 (8th Cir. 1992), infra. Nevertheless, the Service position is not undermined by the cores being treated as raw materials for the following two reasons. First, the cores are not subnormal goods (even though they are second-hand goods taken in exchange) within the meaning of Treas. Reg. Sec. 1.471-2(c). Second, even if the cores were raw materials within the meaning of Treas. Reg. Sec. 1.471-2(c), requiring a valuation upon a reasonable basis, a valuation upon a reasonable basis would not automatically require that the value be represented by the cost of obtaining cores from core brokers as opposed to the price paid to customers for old cores taken in exchange.

REBUTTAL TO TAXPAYERS' ARGUMENTS

In Jostens, Inc. v. Commissioner, the Tax Court held that the Commissioner did not abuse its discretion by disallowing a ring manufacturer's write-down of allegedly obsolete stone inventory. The manufacturer used the lower of cost or market method and wrote down to zero the number of stones in any stone style that exceeded three times the current year's usage. The court held the write-down did not clearly reflect income because the manufacturer failed to show that the write-down was proper. The court found there were inactive stones used for sales, and that these were sold at the same prices as active stones of the same style. The petitioner did not offer the stones for sale at less than replacement cost. Petitioner, therefore, did not come within the first exception of valuing inventories at other than market or bid price. Further, the petitioner could not substantiate that the inactive stones were distinguishable from the commingled stones that were in inventory and were not written down. The court granted reconsideration of its 1989 opinion, at T.C. Memo 1990-97, but the original position was not changed. It did restate its position that the stones could be raw materials, but the court stated "the regulations under section 471 do not define raw materials."

In Jostens, Inc. v. Commissioner, supra, the court decided that the excess stones did not fit within the description of subnormal inventory which are "unsalable" at normal prices or unusable in the normal way because of damage, imperfections, shop wear, changes of style, odd or broken lots, or other similar causes as required under Treas. Reg. Sec. 1.471-2(c).

The Appeals ISP coordinator's position is that the Jostens, Inc. v. Commissioner, supra, case has significant parallels to the instant issue. In the instant issue the cores generally have an elaborate inspection by the taxpayer to determine that they can be remanufactured into like-new operational parts.

The cases of Jostens, Inc., D. Loveman & Son Export Corporation, and Abbeville Cotton Mills, supra, emphasize that the stated bid prices should be based on the quantities of goods normally purchased by the taxpayer and the quality of the goods should be comparable to those which are in the taxpayer's inventory. This body of case law, both "old" and "new," supports the rationale for sustaining the Examination Division's coordinated issue position.