No. 93-722T

(Filed May 15, 1998)

* *		
LACROSSE FOOTWEAR, INC., AND	*	Tax; dollar-value,
INTERNATIONAL FOOTWEAR	*	double-extension LIFO
CORPORATION,	*	inventory; base-year
	*	cost of inventory acquired
Plaintiff,	*	by new corporation is
	*	market value, not bargain
v.	*	cost; goods are not new
	*	"item" based solely on
THE UNITED STATES,	*	cost difference; only
	*	goods regularly whole-
Defendant.	*	saled or retailed belong
	*	in purchased pool.
* *		

Timothy A. Frautschi, Milwaukee, Wisconsin, for plaintiffs.

Stuart J. Bassin, Washington, D.C., with whom was **Loretta C. Argrett, Assistant Attorney General**, for defendant.

Opinion and Order[1]

The question presented by this income tax case is whether the Internal Revenue Service (IRS) abused its discretion in determining that a new corporation's valuation of bargain goods under the dollar-value, double-extension last-in-first-out (LIFO) method of inventory accounting failed clearly to reflect income, as required by numerous provisions of the IRS's inventory accounting statutes and the regulations thereunder. See, e.g. I.R. Code §§ 446, 472.[2]

The Federal Circuit's decision constrains this court to conclude that the IRS's disallowance of plaintiff's accounting method was not an abuse of discretion, when plaintiff did not place its opening inventory acquired as a bargain bulk purchase in separate item categories from identical goods subsequently purchased at full (market) price.

However, **Kohler** did not address the issue raised by this court's earlier opinion, namely, how to set the base-year cost of the items purchased in the bargain purchase. Neither the Federal Circuit nor the Court of Federal Claims opinions in **Kohler** indicated which specific dollar-value LIFO accounting method (such as the double-extension, index, or link-chain method) was used in that case. See **Kohler**, 124 F.3d at 1451; **Kohler Co. v. United States**, 34 Fed. Cl. 379, 384 n.3. (Fed. Cl. 1995), aff'd, 124 F.3d 1451 (Fed. Cir. 1997). The court concludes that it correctly decided this issue in its earlier opinion and that a taxpayer using the dollar-value, double-extension LIFO inventory accounting method described in Treas. Reg. § 1.472-8(e)(2), is required by that regulation to set the base-year cost of items entering its inventory in the base year at the FMV of those items rather than the (bargain) cost.

Prior to the issuance of this court's April 25, 1997, opinion, plaintiff, LaCrosse Footwear, Inc. (LaCrosse), contended that it was entitled to use the dollar-value, double-extension LIFO inventory accounting method and that, under the rules applicable to such method, "items" of inventory it acquired in a bulk purchase, and at a bargain price, from LaCrosse Rubber Mills Company (Rubber Mills), [(3)] may (or must) be valued at the bargain purchase cost, rather than at the considerably higher book value used for financial reporting purposes. In its post-opinion brief, however, plaintiff indicated that it now agrees with the opinion's holding that items of inventory acquired in a bulk purchase are required to be valued at the fair market value of those items. Plaintiff's Response to Defendant's Brief and Status Report, filed August 13, 1997.

Defendant has two principal arguments. One is that the goods LaCrosse subsequently (after the purchase of Rubber Mills) purchased, whether for resale or for use in the manufacturing process, must be treated as different classes of goods ("items") from the identical goods acquired earlier from Rubber Mills, because of the significant price differential between the bargain cost of the acquired goods and the (market) cost of the goods it bought or manufactured subsequently (the "item" argument). The second defense argument is that all of the inventory purchased at a bargain from Rubber Mills, including what would have been Rubber Mills' manufactured inventory, belongs in LaCrosse's purchased goods pool (the "pooling" argument). Moreover, defendant contends that the valuation of the opening inventory should be based on actual (bargain) cost rather than fair market value. Defendant's Brief and Status Report, filed July 31, 1997.

Background[(4)]

This case involves the issue of the proper valuation of bargain goods, purchased as a new corporation's entire opening inventory, under the dollar-value, double-extension LIFO method of inventory accounting.

Generally, taxable income for a merchant is based on total sales (gross receipts), from which is deducted the "cost of goods sold" (CGS), and any other applicable deductions. See Treas. Reg. § 1.61-3(a); **Grant Oil Tool Co. v. United States**, 381 F.2d 389, 397 (Ct. Cl. 1967). CGS in turn consists of the beginning inventory, plus production and acquisition costs during the year, less the closing inventory. **Peninsula Steel Prods. & Equip. Co. v. Commissioner**, 78 T.C. 1029, 1953 n.32 (1982) (citing W.B. Meigs et al., Accounting: The Basis for Business Decisions 845-50 (4th ed. 1977)). All other factors remaining equal, a decrease in the closing LIFO inventory will increase CGS and decrease a taxpayer's taxable income.

The often-stated purpose of the LIFO inventory flow method is to match current revenues against current costs, and thus to remove "inflationary increases in inventory costs" from the cost of closing inventory. **Hamilton Indus. v. Commissioner**, 97 T.C. 120, 130 (1991) (citing **Amity Leather Prods. Co. v. Commissioner**, 82 T.C. 726, 732 (1984)). The taxpayer achieves this by being permitted (1) not to have to trace particular goods, and (2) to treat the goods last purchased as those first sold. This reverses the presumption in the other major inventory flow rule that does not trace particular goods, the first-in-first-out (FIFO) inventory accounting method.

Unlike other cost-flow inventory accounting systems that identify the specific goods to determine which are present at year end or sold, the dollar-value LIFO method does not identify and count particular units. Instead, the method counts dollars (base dollars). In this method, the goods contained in the inventory are grouped into one or more pools, each containing one or more classes of goods ("items"). Treas. Reg. § 1.472-8(a). Changes in inventory levels are accounted for in terms of pools of dollars of cost, not by numbers of specific physical units. Exh. 53 (Gaffney report) at 9.

The taxpayer selected the double-extension dollar-value LIFO inventory accounting method, which is authorized and governed by Treas. Reg. § 1.472-8(e)(2). This method values the increment in inventory by extending the current-year per-unit cost for each item in ending inventory (in both base-year and current-year dollars). See Treas. Reg. § 1.472-8(e)(2). Within pools, inventory is divided into "items." The total dollar-value unit "base-year" cost of the "items" in a pool at the beginning of the year is totaled. The total dollar-value of the units in the pool at year end at base-year cost also is calculated, for each item, and totaled. If the ending inventory for a pool at base-year cost exceeds the beginning inventory for that pool at base-year cost, an increment has occurred. That increment is valued by multiplying it by the "LIFO index" (the ratio of ending inventory at current-year cost to ending inventory at base-year cost), which gives the "LIFO layer." The layer is added to base-year opening inventory to yield closing inventory for that taxable year. Treas. Reg. § 1.472-8(e)(2)(iv). Since the closing inventory becomes the next year's opening inventory, the LIFO layer is carried forward from year to year. S. Rep. No. 648, 76th Cong., 1st Sess. 6-7 (1949), 1939-2 C.B. 524, 528 (cited in Rev. Rul. 85-172, 1985-2 C.B. 151, 152).

When the ending inventory at base-year cost is less than the beginning inventory at base-year cost, however, a liquidation occurs. Any liquidation is subtracted from opening inventory, reducing in reverse chronological order the most recently added increments, to yield the closing inventory. Treas. Reg. § 1.472-8(e)(2)(iv). In this manner, cost increases that were sheltered in prior years become taxable (up to the extent of the liquidation). Id.

Current-year cost may be, at the taxpayer's election: (1) the actual price the taxpayer most recently paid (that taxable year) for goods of the same type or category ("item"), (2) the actual price it paid after the beginning of the taxable year for such goods, or (3) the average of the actual prices paid for such goods during the taxable year. Treas. Reg. § 1.472-8(e)(2)(ii). LaCrosse chose method (2), the so-called "earliest acquisitions" method.

The regulations define the term "base-year cost" as "the aggregate of the cost (determined as of the beginning of the taxable year for which the LIFO method is first adopted, i.e., the base date) of all items in a pool." Treas. Reg. § 1.472-8(a) (emphasis added). The "base year" for a particular pool is defined as "[t]he taxable year for which the LIFO method is first adopted with respect to any item in the pool." Id.

This dispute centers on the tax years following LaCrosse's purchase on May 26, 1982 of substantially all of the assets, including all of the inventory, of Rubber Mills, a closely-held shoe-selling and shoe-manufacturing corporation. LaCrosse purchased these assets, the book value of which was, according to Rubber Mills' financial statements, $10,670,498, for only $7,491,606. In accordance with an allocation agreement signed by LaCrosse and Rubber Mills, LaCrosse assigned to the cash and accounts receivable a tax basis equivalent to their full book value to Rubber Mills, less a slight allowance for doubtful accounts, for a total of $4,525,095. Rather than the $ 5,524,492[(5)] total book value carried by Rubber Mills, LaCrosse for tax purposes allocated only $494,145 to plant, property, and equipment and $1,905,755 to inventory, based, purportedly, on unspecified tax "basis" rules that require a purchaser to allocate no more than the actual total purchase price among purchased assets.

The "tax" allocation for the non-cash assets purchased from Rubber Mills was substantially lower than either the fair (market) value or the acquisition/manufacture (book) cost to Rubber Mills: the inventory had a book value to Rubber Mills of $4,015,269, an agreed-upon market value of $5,817,321, but an allocated bargain purchase cost for tax purposes of only $1,905,755. For non-tax purposes, LaCrosse valued the inventory at $5,817,321 (book value). The actual cost to LaCrosse of Rubber Mills' inventory, thus, was only thirty-three percent of, or sixty-seven percent less than, its market value.

As previously stated, LaCrosse selected the dollar-value, double-extension LIFO inventory accounting method for its first taxable year, ending April 30, 1983, for both tax and accounting purposes. Plaintiff also selected the earliest acquisitions method for establishing current-year inventory cost when valuing closing inventory, and created two pools, a natural business unit (NBU) pool for manufactured goods, and a purchased pool.

In 1986, the IRS audited the 1983 return, challenging plaintiff's valuation of the base-year cost of its inventories at the bargain purchase price on the grounds that goods obtained in a bulk purchase immediately after a taxpayer's incorporation may not be treated as opening inventory, but merely as the first acquisition. It also required LaCrosse to place the finished goods portion of the bargain bulk purchase inventory into its purchased pool. LaCrosse agreed to increase its base-year cost valuation by $1,491,625, from $1,905,668 to $3,397,293 and correspondingly reduce its "cost of goods sold," from $17,940,983 to $16,449,358. The agreed-upon adjustment for 1983 was $686,148, plus interest and penalties. The amount of the adjustment to its tax liability for taxable years 1984 to 1986 also was negotiated, and set at approximately $165,233, plus interest and penalties.

Plaintiff paid the tax and interest in 1987, filed amended returns seeking a refund in 1989, and filed this refund suit on November 29, 1993.

Defendant asserted two principal arguments in this litigation. One was that the goods LaCrosse subsequently (after the purchase of Rubber Mills) purchased, whether for resale or for use in the manufacturing process, must be treated as different classes of goods ("items") from the identical goods acquired earlier from Rubber Mills, because of the significant price differential between the bargain cost of the acquired goods and the (market) cost of the goods it bought or manufactured subsequently (the "item" argument). The second defense argument was that all of the inventory purchased at a bargain from Rubber Mills, including what would have been Rubber Mills' manufactured inventory, belonged in LaCrosse's purchased goods pool (the "pooling" argument). Defendant maintained that plaintiff's item and pooling treatments allowed LaCrosse to defer, through each succeeding year that the goods comprising that "item" or pool of inventory were not liquidated (i.e., so long as plaintiff kept its year-end inventories up to prior levels), any recognition and taxation of plaintiff's actual income or "profit" from its bargain purchase.

In its April 25, 1997 opinion, the court rejected defendant's "item" argument based on the unworkability of defendant's standard, its inconsistency with LIFO principles, and the absence of any support for that standard in the statute or regulations. The court also rejected defendant's "pooling" argument, concluding that only those finished goods manufactured by Rubber Mills that are identical to goods that LaCrosse intended to (or did) engage in wholesaling belong in LaCrosse's purchased pool.

In addition, the court rejected both parties' implicit positions regarding the proper measure of the base-year cost of the taxpayer's inventory. The court concluded that a new taxpayer first electing LIFO must calculate the base-year cost of the bargain-purchase inventory at the fair or market value of those items at the beginning of its first taxable year, not at the taxpayer's actual bargain cost.

The court concluded that the general LIFO regulation, Treas. Reg. § 1.472-2, which states that "inventory shall be taken at cost regardless of market value," Treas. Reg. § 1.472-2(b), did not apply since the regulation specifically excepts computations under § 1.472-8 "with respect to the 'dollar-value' method." Treas. Reg. § 1.472-2. The court therefore looked at Treas. Reg. § 1.472-8(e)(2), which is the specific rule for dollar-value, double-extension LIFO.

The court noted that § 1.472-8(e)(2) provides no express guidance as to how to set the base-year "cost" of items or other inventory entering at the beginning of the first taxable year for a new taxpayer, since the regulation measures only the cost of new items entering after the base date. For such inventory, the regulation states that current-year cost is the measure of cost of a new item unless the taxpayer reconstructs its cost on the base date (the first day of the taxable year that the pool was created). See Treas. Reg. § 1.472-8(e)(2)(iii).

The court nevertheless concluded that the specific dollar-value LIFO regulation relied upon certain presumptions that, if accepted, do "otherwise provide." The first is that base-year cost will be based either on an approximation of current market value, determined by actual current-year purchase cost (whether first acquisition, average cost or latest purchase, see Treas. Reg. § 1.472-8(e)(2)), or on an historical (reconstructed) market value. The second is that the regulation presumes that the higher cost (in a time of rising costs, such as would prompt a LIFO election in the first place) is the taxpayer's current-year cost, and that this presumptively will be imposed in lieu of a lower cost, unless the taxpayer is able to reconstruct the lower cost. Treas. Reg. § 1.472-8(e)(2)(iii).

The court also concluded that the use of the FMV of the inventory as its base-year cost was the approach most consistent with generally accepted accounting principles (GAAP), and therefore ordinarily the most accurate method for clear reflection of income. See Treas. Reg. § 1.446-1(a)(2) ("A method of accounting which reflects the consistent application of [GAAP] in a particular trade or business . . . will ordinarily be regarded as clearly reflecting income.")

As defendant's expert repeatedly noted, Accounting Practices Board Opinion (APB Op.) No. 16 [(6)] , the most authoritative pronouncement of GAAP principles, requires that the base-year cost for this inventory be stated at fair or market value. Exh. 53 at 4, 6-7; Exh. 55 ¶ 87; Tr. 246-48, 254-59; see **Thor Power Tool Co. v. Commissioner**, 439 U.S. 522, 532 (1979) (GAAP followed when the statute and regulations provide no clear guidance). The AICPA accounting rules reflected in APB Op. No. 16 require that the "fair value" at the acquisition date of such bargain-purchased goods be reflected on a company's financial statements; and that, if the fair value exceeds the cost, negative goodwill (a deferred credit) be recorded and amortized. See APB Op. No. 16 ¶¶ 11, 67 (Exh. 55). (The negative goodwill is simply the difference between FMV and cost.)

Based on the language and logical effect of the regulations, particularly Treas. Reg. § 1.472-8(e)(2)(iii), and GAAP principles, and no apparent grounds for valuing bargain opening inventory differently than bargain inventory acquired in subsequent years, the court held that the bargain purchase items were required to be valued at their FMV as of the first day of LaCrosse's first taxable year, rather than at their bargain cost.[(7)]

Discussion

Item treatment

Kohler addressed the issue raised by defendant's item argument. 124 F.3d at 1451. **Kohler** involved a corporate taxpayer, that had acquired another company (Sterling) that, in turn, had purchased the assets of a third company at a substantial discount several years earlier. The bulk bargain purchase was obtained at a 50% discount in that case. See **Kohler Co. v. United States**, 34 Fed. Cl. 379, 385 (Fed. Cl. 1995), aff'd, 124 F.3d 1451 (Fed. Cir. 1997). Sterling's entire opening inventory consisted of the bargain-purchased assets. The company elected the LIFO method to account for both these assets and any subsequently manufactured inventory. Sterling treated the bargain-purchased goods as the same "items" as identical finished goods manufactured by the company after the purchase. Id. at 1452-3.

The IRS determined that Sterling's method of dollar-value LIFO inventory accounting did not clearly reflect income. It changed Sterling's accounting method by treating the bargain-purchase goods as separate items from those subsequently manufactured. Id. at 1453. As a result of this change, the bargain-purchase inventory was deemed liquidated within two years of the bargain purchase, resulting in an increase in Kohler's taxable income in 1984. Id.

The Federal Circuit held that the IRS did not abuse its discretion in determining that the **Kohler** taxpayer's inventory accounting method did not clearly reflect income. Id. at 1458. It held that bargain bulk purchase inventory must be treated as a different item from identical goods acquired or manufactured afterward at greater (full) cost. 124 F.3d at 1451. See also **Hamilton Indus.**, 97 T.C. at 136-39. Under **Kohler**, the creation of a new item based on increased cost is required when the price increase causes the prices to be "greatly disparate," see **Kohler**, 124 F.3d at 1457 (citing **Hamilton Indus.**, 97 T.C. at 139 (different item if increase is "substantial" or "material")).[(8)] However, these terms are not quantified.

The consequence of placing bargain items in separate item categories from identical but subsequently purchased goods is that the bargain items as treated as having been sold first. In other words, "item" treatment reverses the normal presumption of LIFO inventory accounting, that the last goods purchased are the first ones sold, and instead imposes a FIFO-type approach to the bargain goods, while retaining a LIFO approach to all other goods entering the inventory after the base year.

This court respectfully disagrees with the reasoning in **Kohler**, because it endorses the imposition of ad hoc unquantified standards that give insufficient notice and guidance to permit a taxpayer to plan its business operations in light of its tax liability. Moreover, the decision ignores the practical difficulties inherent in creating a new item classification, and separately tracking the new items, every time there is a price difference (of uncertain magnitude). This court is of the opinion that the dollar-value, double-extension LIFO inventory accounting rules were designed to eliminate such tracking based on comparing only two aggregate costs, base-year and year-end.

Nevertheless, **Kohler** is binding precedent. Thus, plaintiff, which acquired its opening inventory at a discount of 67% (a larger discount than the 50% discount in **Kohler**), must place the goods acquired from Rubber Mills in separate item categories from the identical goods subsequently acquired for manufacture (at full market price), manufactured, or purchased for resale, as the case may be, by LaCrosse.

Determination of Base-Year Cost

While deciding the "item" issue in defendant's favor, the Federal Circuit's decision in **Kohler** does not resolve all the issues involved in determining plaintiff's taxable income in the years at issue. Specifically, the Federal Circuit was not presented with, and did not decide, whether a taxpayer using the double-extension dollar-value LIFO inventory accounting method must set the base-year cost of goods purchased as part of a bulk bargain purchase of inventory in the base year at the bargain cost or at the FMV at the time of purchase.

Neither the Federal Circuit nor the Court of Federal Claims (CFC) in **Kohler** indicated which specific dollar-value LIFO accounting method (such as the double-extension, index, or link-chain method) was used in that case. See **Kohler**, 124 F.3d at 1451; **Kohler**, 34 Fed. Cl. at 384 n.3. Rather, the CFC opinion stated, in footnote 3: "We do not discuss the intricacies of the dollar-value method or the methods of computing dollar-value LIFO pools such as double-extension, index, or link-chain. We did not take testimony on these matters at trial because counsel agreed they were unnecessary for this decision." Id.

Defendant's post-opinion brief disputes the court's conclusion that Treas. Reg. § 1.472-8(e)(2)(iii) requires the opening inventory in the base year to be valued at FMV. Defendant sets out three reasons why:

First, defendant argues that § 1.472-8(e)(2)(iii) refers to cost, not to FMV. However, this ignores the fact that the regulation refers, not to actual cost, but to reconstructed cost in a year other than the year in which the item was purchased. This cannot be anything other than FMV for the year for which the cost is being reconstructed.

Second, defendant argues that this regulation, by its terms, applies only to items entering the pool for the first time in a year subsequent to the base year. While the regulation does not expressly apply to items entering the pool for the first time in the base year for the pool, it provides useful guidance for the determination of base-year cost for items entering the pool in the base year.

Finally, defendant argues that Treas. Reg. § 1.472-2 controls, specifically §1.472-2(b), which provides that "[t]he inventory shall be taken at cost regardless of market value," and requires valuation of the opening inventory in the base year based upon actual cost. However, as previously stated, § 1.472-2 specifically provides that its requirements do not apply where "otherwise provided . . . in § 1.472-8 with respect to the 'dollar-value' method." In other words, the provisions of § 1.472-2 apply only where they would not conflict with the provisions of § 1.472-8, the specific regulation dealing with the dollar-value methods. See **Busic v. United States**, 446 U.S. 398, 403 (1990) (specific rules are given precedence over general rules).

Basically defendant's argument is that, since § 1.472-8 does not expressly address the issue of how to set the base year cost for items entering the inventory in the base year, it does not "otherwise provide" and therefore § 1.472-2 becomes the applicable regulation requiring the base year cost to be set at cost rather than market value. However, § 1.472-8 does not require a default to §1.472-2, because § 1.472-8(e)(2)(iii) implicitly provides guidelines for setting base year cost for items entering the inventory after the base year. These guidelines incorporate the presumption that, under the dollar-value double-extension method, base-year cost should approximate FMV. Since this presumption conflicts with the general § 1.472-2(b) requirement that "[t]he inventory shall be taken at cost regardless of market value," § 1.472-2(b) by its terms would not govern the base-year cost determination under the dollar-value double-extension method.

Defendant also cites several general basis rules in support of its contention that plaintiff was required to value the bargain purchase at the allocated actual purchase cost. The court concludes that, even if certain basis rules use cost rather than market value, defendant does not establish why any of these rules would apply in this case, nor why, if they did, they would override the more specific tax and financial accounting rules regarding valuation of bargain purchases that are applicable to inventory accounting. Cf. Treas. Reg. § 1.1060-1T(e)(2) (1996) ("The amount of consideration allocated to an asset is subject to any applicable limitations under the Code or general principles of tax law.")

As explained above, in order to calculate the cost of the closing inventory under dollar-value, double-extension LIFO inventory accounting (for a pool having an increment), one adds to the value of the beginning inventory at base-year cost a LIFO layer (units in closing inventory at base-year cost minus units in opening inventory at base-year cost, times a LIFO index (total current-year cost divided by total base-year cost)). Treas. Reg. § 1.472-8(e). Since the LIFO layer is equal to the value of the closing inventory less the value of the beginning inventory, CGS can also be stated as the production and acquisition costs during the year less the LIFO layer. Therefore, a decrease in the LIFO layer will increase CGS and decrease taxable income.

The use of FMV instead of bargain cost to determine the base-year cost of opening bargain inventory has a significant impact on the cost of goods sold and therefore on the income realized by the taxpayer if the taxpayer places the bargain items in a separate item category as required by the Federal Circuit's decision in **Kohler**. As previously stated, placing the bargain items in separate item categories treats the first-in bargain items as those first sold. This, however, is the FIFO rule, not the LIFO one.

If, as defendant proposes, the base-year cost for the bargain items is set at the bargain cost, and item treatment is given, then the taxpayer will realize income upon the entire benefit of the bargain purchase in the first year (assuming, as occurred here, that the bargain goods, which are deemed sold first, were sold within the first year). This is because the opening inventory in the base year consists only of the bargain purchase goods valued at their (discounted) bargain cost, whereas the base-year closing inventory contains only the subsequently-purchased (full-market-price) goods. As a result, the LIFO layer in the base year consists of the entire difference in cost between the bargain goods and the full-price goods.

However if item treatment is given, as required by **Kohler**, and the base-year cost is set at FMV, as Treas. Reg.§ 1.472-8(e)(2)(iii) appears to require, then there will be little difference between the dollar-value of the opening inventory (consisting of bargain goods valued at FMV) and that of the closing inventory (consisting of full-market-value subsequently-purchased goods). As a result, the LIFO layer will not include any of the difference in cost between the bargain goods and the full price goods. In effect, the bargain goods (which, again, are deemed sold first with item treatment) are provided a stepped-up basis such that the benefit of the bargain purchase is never realized as income or taxed.[(9)] Of course, stepped-up basis is accorded in several other circumstances. See, e.g., IRC § 1014(a)(1) (providing that the basis for property acquired from decedent is its fair market value at time of decedent's death, thus giving the property a stepped-up basis in the hands of the donee).

Despite the creation of some anomalous results when, as **Kohler** requires, bargain goods and subsequently-acquired goods are placed in separate item categories, the court concludes that LaCrosse is required to use a market-based cost to measure the base-year cost of the bulk purchase items acquired from Rubber Mills, because it accords with the language and intent of the regulations, particularly Treas. Reg. § 1.472-8(e)(2)(iii) and with generally accepted accounting principles.

Conclusion

The Commissioner's disallowance of plaintiff's accounting methods was proper. On or before May 31, 1998, the parties shall file a joint status report stipulating to whether, after plaintiff's income tax liability for the years at issue is recalculated in accordance with this opinion (i.e.: (1) allocating the items between the pools in accordance with the court's conclusion that manufactured goods identical to regularly-purchased goods belong in the purchased pool, (2) placing the bargain goods in separate item categories from identical, but subsequently-acquired goods, and (3) recalculating the cost of goods sold in accordance with the court's conclusion that the base-year cost must be FMV), plaintiff is entitled to a refund, and if so, how much; or setting forth the reasons for their failure to so stipulate.

DIANE GILBERT WEINSTEIN

Judge, U.S. Court of Federal Claims

Attachment

1. On April 25, 1997, this court issued an (unpublished) opinion (a copy of which is appended), see **LaCrosse Footwear, Inc. v. United States**, No. 93-722T, 1997 WL 375260 (Fed. Cl. Apr. 25, 1997), concluding that the IRS's disallowance of plaintiff's accounting method was proper because plaintiff erroneously used the bargain price, rather than the market value, for its base-year inventory cost.

Subsequent to the issuance of this opinion, the court requested supplementary briefing solely on the issue of whether the base-year cost of items entering the inventory in the base year should be set at bargain cost or fair market value (FMV). Also subsequent to this court's earlier opinion, the Federal Circuit issued its decision in **Kohler Co. v. United States**, 124 F.3d 1451, 1456-57 (Fed. Cir. 1997), which held that the taxpayer's dollar-value LIFO inventory accounting method for an opening inventory purchased at a substantial discount did not clearly reflect income, where the taxpayer treated this opening inventory as the same "item" as identical goods acquired later at full market price. The parties did not request to brief the effect of Kohler, which was decided after the parties had briefed the base-year cost issue. The only reference to Kohler has been defendant's Notice of New Authority, attaching the Kohler opinion, on Sept 22, 1997.

2. Unless otherwise indicated, citations to the Internal Revenue Code of 1954, as amended ("I.R.C." or "Code"), codified at Title 26, United States Code, and to the Treasury Regulations ("Treas. Reg.") found at Title 26, Code of Federal Regulations, are to the provisions in effect during the years at issue.

3. \3 LaCrosse was incorporated on April 27, 1982. Stip. 2. Although LaCrosse's immediate predecessor, LaCrosse Acquisition Corp., initially purchased the Rubber Mills assets, see Exh. 1 at 1, and LaCrosse Footwear was known as LaCrosse Rubber Mills, Inc., Stip. 3, until December 26, 1985, the court, for convenience, refers throughout to the new company (buyer) as "LaCrosse" and the seller as "Rubber Mills."

International Footwear Corporation, the other named plaintiff, is a holding company that acquired LaCrosse after the transaction at issue here, on August 15, 1983. Stip. 4. As the subsidiary's dispute with the Internal Revenue Service does not directly involve the parent corporation, the court treats LaCrosse as the sole plaintiff and refers to plaintiff in the singular.

4. The background facts in this case are more fully set out in the court's earlier opinion, attached hereto.

5. The earlier opinion set out an erroneous total book value of $5,817,321, which is the figure for the inventory's fair market value. As the parties' stipulation of facts no. 12 indicates, Rubber Mills' book value for fixed assets (i.e. plant, property and equipment) was $1,509,223 and its book value for inventory was $4,015,269, for a total of $5,524,492.

6. APB opinions, which are issued by the American Institute of Certified Public Accountants (AICPA), are the most authoritative pronouncements of the accounting profession, and thus provide a standard as to the most accurate method for clear reflection of income provided by accounting practice. Exh. 53 at 4; see, e.g., **United States v. Winstar Corp.**, 116 S. Ct. 2432, 2443 (1996).

7. In its earlier opinion, the court incorrectly concluded that plaintiff violated the conformity-of-reports requirement in Treas. Reg. §1.472-2(e), because it used the bargain price of the inventory acquired from Rubber Mills to determine its tax liability, but used the FMV of that inventory in its financial statements (with the tax method calculation appearing only as a footnote in the financial statements).

However, LaCrosse's asset purchase falls within the "business combination" exception to this requirement set out in Treas. Reg. § 1.472-2(e)(1)(viii) and 1.472-2(e)(8)(xiii), which allow taxpayers, in the case of a business combination, to use a different method for valuing inventory and allocating basis in their financial statements from that used for Federal income tax purposes. The IRS has interpreted the term "business combination" to include business combinations discussed in APB Op. No. 16, which discusses the "purchase method" business combination, where one company acquires the assets and liabilities of another, resulting in new ownership of the business. See APB 16 ¶11.

8. **Kohler** did not address the issue of whether "item" treatment should be applied to a bargain purchase occurring in a year subsequent to the base year. However, the Tax Court in **Hamilton Indus.**, 97 T.C. at 139 n.6, a case which the Federal Circuit in **Kohler** found persuasive, suggested that the creation of new items was not necessary for bargain purchases occurring in years subsequent to the base year: subsequent-year purchases "differ[] materially from the case where a taxpayer attempts to value its entire base-year inventory at bargain cost."

9. Some confusion has arisen concerning the meaning of footnote 19 of the April 25, 1997 opinion, which noted, in passing, that valuing the opening inventory at market value would lead to "substantially the same [result] as that advocated by the government because LaCrosse must carry over the value of both new and old items at market value." 1997 WL 375260, at *16 (emphasis in original). Defendant has interpreted this foonote to mean that the same monetary result as that advocated by defendant would occur. The court, however, as the rest of the opinion indicates, intended merely to note that under such valuation there would be no carry-over from year to year, a result decried repeatedly by defendant. The

monetary tax consequence for plaintiff in the first year remains essentially that advocated by plaintiff.