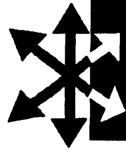
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A Quarterly Update of LIFO - News, Views and Ideas

LIFO LOOKOUT

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LIFO UPDATE

If you had called me personally to ask "What's happening lately with LIFO that I need to know about?"... Here's what I'd say:

#1. INDEX OF *LIFO LOOKOUT* ARTICLES THROUGH JUNE, 2001 IS NOW AVAILABLE. We have updated the previous index of all articles in the *LIFO Lookout* from our first issue, over 10 years ago (March, 1991) through June, 2001.

This *Index of Articles* has fourteen sections. In addition to listing all articles by subject, there are *Finding Lists* for all tax cases, IRS Coordinated Issue Papers, Field Service Advice Memoranda, Letter Rulings (including TAMs), Revenue Rulings, Revenue Procedures and the *Practice Guides* included with various articles.

You can see and print the entire *Index of Articles* on our web site, www.defilipps.com, or you can obtain the Word™ document by calling or e-mailing us with your request.

#2. TAX COURT UPHELD IN THROWING OUT A LIFO ELECTION...TAXPAYER DENIED A SECOND CHANCE TO MAKE A PROPER ELECTION. The major focus of this issue of the *Lookout* is on the recent victory the IRS gained (or retained) when its success in the Tax Court was appealed to the 10th Circuit.

In May, the U.S. Appeals Court for the Tenth Circuit issued its opinion in *Consolidated Manufacturing, Inc.* The Appeals Court upheld the IRS and the Tax Court on all of the LIFO issues in this case. The Appeals Court agreed that the taxpayer was not entitled to another chance to revise or correct its initial LIFO election.

We have been following this case closely because of its significant precedential value. Not only is it important because of the LIFO issues it presents in terms of its own fact pattern, it also impacts ***all*** other manufacturers who are using a components-of-cost LIFO methodology. Finally, *Consolidated* sends a very disturbing message to all other taxpayers using replacement cost to value their parts inventories.

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In the Sept. 1998 *LIFO Lookout*, we first reported this case when the Tax Court upheld the IRS in disallowing the LIFO election of Consolidated Manufacturing, Inc. After electing LIFO and using it for more than a decade, the Company lost its LIFO election because it tried to "pick and choose" what inventory goods it put on LIFO. The Tax Court held that the taxpayer had made an invalid LIFO election.

The Company had elected LIFO for certain cost components which experienced inflation. Other inventories, such as used cores, used engines and other used parts, were not put on LIFO. Instead, these were written-down to scrap value at year-end.

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In short, the taxpayer wanted the best of both worlds: LIFO reserve deductions for inventory that experienced inflation...and write-downs for inventory that did not.

The one ***non***-LIFO issue in this case involved the proper determination of market value for customer cores. The Appeals Court remanded the case to the Tax Court for further proceedings *only* on this ***non***-LIFO issue.

With this success on all of the LIFO issues, the IRS has significantly more power and leverage in attacking other LIFO cases. Our coverage of the Appeals Court decision begins on page 16.

#3. LIFO FOR USED VEHICLES ... PART II ... MORE DETAILS & ATTEMPTS TO CLEAR UP CONFUSION. The June issue of the *LIFO Lookout* explored many of the nitty-gritty details of the IRS-approved LIFO method in Revenue Procedure 2001-23. In this issue, we present the second part of our coverage.

We have received many questions concerning the use of official car guides and/or the requirement that indexes be rebased to 1.000 as part of making the change to the Used Vehicle Alternative LIFO Method.

As to confusion over the use of different price guides, see page 3. In discussing the rebasing requirements, we've updated some prior information on this subject and included several rebasing examples beginning on page 5.

Finally, there are a number of other special provisions, some might call them *traps for the unwary,* in the Revenue Procedure. We've discussed a few of them on page 13-14.

#4. USED VEHICLE LIFO ... RESULTS VARY BY REGION. The IRS method requires dealers to use prices specific to their areas–not national averages–in computing their inflation indexes for used vehicles.

We ran the LIFO inflation calculations for a fairly large dealer's used vehicle inventories assuming the inventory was located in 9 different states. The differences in results are shown on page 4.

#5. USED VEHICLE PRICES ... *MANHEIM* PUBLISHES INDEX. Manheim Auctions has introduced a *Used Vehicle Value Index* which may provide information to correlate with used vehicle LIFO inflation indexes.

This index starts from a base of 100 in 1995. From May 1995 through December of 1996, prices increased 8.2%. From December 1997 to February 1999, prices increased approximately 9%. Then between February 1999 and February 2001, prices fell 1%. For August 2001, the index was at 114, up slightly from July's measurement of 113.8.

Manheim's index is based on more than 4 million used vehicle wholesale transactions that occur annually at its 85 North American auctions. According to Manheim, its index is more accurate than the Consumer Price Index data because it adjusts for differences in mileage, seasons, market segment and model mix.

#6. NEW VEHICLE LIFO ... MORE COMPLEXITY FOR FORD DEALERS. Ford recently announced it was significantly increasing its model count for 2002 models. This means more complexity at year-end for Ford dealers using the Alternative LIFO Method for their new vehicles.

Ford indicated that it was attempting to simplify the buying process for both customers and dealers. As reported in *Automotive News* (July 30, 2001), in Ford's view, more models means a greater spread of standard equipment. This, in turn, reduces "the maze of stand-alone options through which the customer and the salesperson must wade." Bundling options reduces plant complexity dramatically, improves quality and allows Ford to build according to what it predicts customers will want.

Be that as it may, for those involved with Alternative LIFO computations, this means there's more *item category* analysis to be done at year-end. And it means that there will be more *new items* in Ford new vehicle inventories this year.

#7. TAXPAYER WITH BARGAIN PURCHASE INVENTORY ESCAPES SECTION 481(a) ADJUSTMENT IN CHANGING LIFO METHODS. There was at least one happy LIFO taxpayer earlier this year. That taxpayer had applied for a change in accounting method which involved the LIFO accounting for its bargain purchase inventory. It applied for the change using the cut-off method.

The examining agent was upset and tried to convince the National Office that a Section 481(a) adjustment should be required.

Due to a fluke in the language of Rev. Proc. 97-37, under which the taxpayer requested the automatic change, the taxpayer escaped having to make a Section 481(a) calculation. FSA 200121022 relates this unusual happy ending for the LIFO taxpayer. However, this result would not apply if another taxpayer were requesting the same change today. For more, see page 15. *

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CONFUSION OVER THE USE OF DIFFERENT OFFICIAL GUIDES

THE CONFUSION ... Here's one e-mail that we received recently, edited ever so slightly ...

"I have heard the IRS is saying that dealerships should be using the same book for their regular used appraisals that they will be using for Alt. Used LIFO. I do not agree it should be this way. This means to me that if a dealer uses *Black Book* in their Alt. Used computations, this dealer should also be a subscriber to *Black Book* and use *Black Book* for their daily operations. If this is accurate, I might suggest you make sure (that the dealers) have signed up to subscribe to *Black Book* if they are not already a *Black Book* customer."

THE REPLY ... Here's our reply, also edited ever so slightly ...

"Thanks for your e-mail ... Here's what I can tell you for sure. I'm not sure where you 'heard the IRS as saying ...'. As you know, that's always a problem when someone says they heard *the IRS* say something and you can't pin down the source.

"Here are the facts: Revenue Procedure 2001-23 makes no such requirement. I have confirmed this orally with the author of the Revenue Procedure, as well as with Ms. Terri Harris, the IRS Motor Vehicle Technical Advisor. On several occasions, Ms. Harris has stated this publicly at dealer-CPA conferences, like ours this past June in Dallas. Therefore, until or unless there is some official change in the Revenue Procedure, I think your understanding (which is the same as mine) on this subject is correct.

"Obviously, there are some who might profit by the interpretation. Also, there are others who have simply jumped to the (erroneous) conclusion concerning the same book requirement.

"The next time you hear someone say that, why don't you suggest they call the author of the Revenue Procedure, Alan J. Tomsic in the National Office at (202) 622-4970 and/or Ms. Terri Harris in Grand Rapids at (616) 235-1655. Better yet, suggest they subscribe to the *LIFO Lookout* since this question was covered extensively in the June 2001 issue, on page 11."

OTHER COMMENTS

Quite possibly the IRS person whom our e-mailer quoted failed explain the context for his/her comment. There is a situation where the same official used vehicle guide must be used at year-end: That is the situation where the dealer is ***not*** on LIFO, and the dealer is using the guide book to determine lower-of-cost-or-market valuations for purposes of his year-end used vehicle inventory writedowns.

For example, in the *Used Car News, Auto Auction Shopper*, July 16, 2001, Ms. Harris of the IRS was quoted as having said at the National Convention of Buy-Here, Pay-Here Dealers in Las Vegas that, "The book you use must be consistent, ... You can't use a different guide book for determining trade-in values than you do for determining LCM." Obviously, Ms. Harris was stating the IRS position in the context where the dealer was not on LIFO. She was not referring to the situation where the dealer was on LIFO and needed to consult an official guide to compute the annual inflation index for LIFO purposes.

Below we repeat what we said in our last issue on this subject, with a last sentence added for emphasis.

USING DIFFERENT OFFICIAL GUIDE BOOKS FOR DIFFERENT PURPOSES

The Revenue Procedure introducing the Used Vehicle Alternative LIFO Method incorporates the industry-wide practice of using Official Used Car Guides in several ways. It recognizes that dealers use Car Guides in many ways:

(1) in discussions with customers,
(2) in determining vehicle cost for book purposes,
(3) in determining writedowns at year-end if the dealer is not on LIFO, and
(4) in determining inflation indexes based on comparable beginning and end-of-the-year prices.

The following paragraphs indicate those situations where the IRS requires the use of the same Official Used Car Guide and those situations where different Official Used Car Guides can be used for different purposes.

Salespersons (on the lot, in negotiating the deal with the customer) can use book #1 or #2 or any other book, even though a ***different book*** is used to determine (1) ***cost*** as of the date of acquisition, and/or (2) ***value*** as of end-of-the-year if LIFO is not used and the ending inventory is valued at lower-of-cost-or-market (LCM).

It is the position of the IRS that where the dealer has not elected LIFO and at year-end is valuing used vehicles at LCM, ... the ***same book*** (i.e., the same *Official Used Vehicle Guide*) must be used (1) to determine cost of that vehicle as of the date of acquisition, and (2) to determine the LCM (lower-of-cost-or-market) value of that vehicle in ending inventory.

In other words, if the dealer is using *Black Book* to determine the cost of the vehicle when it is acquired, then that cost stays on the books and remains its cost (unless increased by other cost elements, such as transportation, reconditioning, etc.) until at year-end when that vehicle's cost carrying value is written down to LCM by a writedown that must be determined from the year-end *Black Book*. Values for year-end LCM adjustments cannot be determined from a different source (i.e., *NADA* or *Kelley*) if *Black Book* is used to determine cost during the year.

Revenue Procedure 2001-23, Section 4.02(5)(a), permits a dealer to use ... a ***different book*** at the end of the year to reprice vehicles at their beginning-of-the-year and end-of-the-year prices in order to compute a LIFO inflation/deflation index. In other words, a dealer could use *Black Book* to determine acquisition cost during the year and (he could use) a book other than *Black Book* at the end of the year in order to compute the LIFO inflation/deflation indexes. ***Section 4.02(5)(a) does not say that the same Guide the taxpayer selects to determine current cost during the year (referred to in Section 4.02(4)(b)) must be used to determine the LIFO inflation indexes at the end of the year.***

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SAME INVENTORY ... DIFFERENT LOCATIONS ... DIFFERENT USED VEHICLE LIFO RESULTS

There is one obvious difference in computing LIFO inflation indexes for inventories of ***new*** vehicles versus inventories of ***used*** vehicles. Since ***new*** vehicles can only be purchased from the manufacturer (ignoring dealer trades), dealers in different locations around the country all would have the same LIFO inflation index if they had the same mix of ***new*** vehicles in their ending inventories.

This would not be the case for LIFO inflation calculations for ***used*** vehicles. Dealers in different locations around the country could have differing LIFO inflation indexes even though they might have the identical mix of ***used*** vehicles in their ending inventories.

Accordingly, the more regional differentiation or breakdown that an Official Used Vehicle Guide provides, the more likely it is that the resulting inflation indexes will be more accurate, since they would reflect more discrete price factors specific to the dealer's location.

Black Book's database breaks cars into four regions, and it breaks light-duty trucks into six regions. Accordingly, in some instances, a dealer located in a given state (i.e., California or Washington) would reference the same regional database for both used auto and used light-duty truck inflation prices. In other cases, a dealer in a given state (i.e., Illinois or Florida) would be referencing different regional databases for the vehicles in each pool.

To illustrate the difference in inflation indexes for the same inventory held in different states, we ran the following computations. For a dealer with 100 vehicles in his used auto pool (cost $881,500) and 91 units in his used light-duty truck pool (cost $1,233,000), we ran computations as of June 30, 2001, assuming that the same inventory was located in the following states: California, Delaware, Florida, Georgia, Illinois, Pennsylvania, New York, Texas and Washington.

Below are the annual inflation/deflation indexes computed for the same inventory as of June 30, 2001. The last column shows the dollar change in the total of the used vehicle LIFO reserves for that dealer. The largest difference from the least change (a decrease of $18,524) to the greatest change (a decrease of $20,090) was only $1,566.

State	***Used Autos Pool #1***	***Used L/D Trucks Pool #2***	***Computed LIFO Reserve Change for the Year***
California	*1.00640*	*.98118*	*(18,524)*
Delaware	*1.00604*	*.98055*	*(19,560)*
Florida	*1.00604*	*.98071*	*(19,364)*
Georgia	*1.00618*	*.98071*	*(19,262)*
Illinois	*1.00618*	*.98024*	*(19,840)*
Pennsylvania	*1.00604*	*.98055*	*(19,560)*
New York	*1.00604*	*.98012*	*(20,090)*
Texas	*1.00604*	*.98073*	*(19,340)*
Washington	*1.00640*	*.98118*	*(18,524)*

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REBASING INDEXES TO 1.000 IN CONNECTION WITH LIFO METHOD CHANGES

2001-23 REBASING

In changing voluntarily to the IRS-approved Used Vehicle Alternative LIFO Method under Revenue Procedure 2001-23, accountants working with the detailed inflation indexes and corresponding LIFO layers are required to make special adjustments to the prior year figures.

Ordinarily, when the IRS permits taxpayers to change an accounting method, it requires an adjustment under Section 481(a) in order to properly mesh the new method with the previous method. This is intended to assure that income has not either been omitted or double counted.

One exception is if the change is made voluntarily under Rev. Proc. 2001-23, no special recomputation adjustment under Section 481(a) is required. However, in making the change to the Used Vehicle Alternative LIFO Method, the Revenue Procedure does require dealers to "rebase" their previous inventory index computations.

Section 5.02(3) of Rev. Proc. 2001-23 states the requirement: In making the change to the new method, "any LIFO inventory cost increments previously determined and the LIFO value of such increments shall be retained. Instead of using the earliest taxable year for which the taxpayer (dealer) adopted LIFO as the base year, the year of change must be used as the new base year in determining the value of all existing LIFO cost increments for the year of change and later taxable years."

It further states that the cumulative index at the beginning of the year of change will be 1.000. "The base-year cost of all LIFO cost increments at the beginning of the year of change must be restated in terms of new base-year costs, using the year of change as the new base year, and the indexes for previously determined inventory increments must be recomputed accordingly." It adds, "The new base-year cost of a pool is equal to the total current-year cost of all the vehicles in the pool."

NO OFFICIAL GUIDANCE

There are no official examples or illustrations in the Regulations under either Section 446 for accounting method changes or under Section 472 for LIFO method changes that show exactly how this rebasing is to be accomplished. Also, there is no further guidance on rebasing procedures (beyond what is quoted from the Revenue Procedure above) to be found in any other official sources.

Rebasing of indexes to 1.000 seems to be a general requirement that the IRS National Office prescribes when LIFO changes are made from double-extension method to link-chain, (index) methodologies. For consistency or other reasons, the National Office included the rebasing requirement in prescribing safe-harbor LIFO calculations for auto dealerships. Therefore, the rebasing requirement is not new to many CPAs for auto dealerships: The same rebasing requirement was incorporated in the Alternative LIFO Method for New Vehicles by the IRS in Revenue Procedures 92-79 and 97-36.

GENERAL PRINCIPLE

The ***general principle*** underlying the rebasing requirement appears to be that the index for each year's increment is restated by creating a fraction, the numerator of which is the cumulative index for valuing that year's increment and the denominator of which is the cumulative index as of the end of the last year before the year of change. Then each year's LIFO valuation index or factor is multiplied by that fraction to reduce it to a decimal that is less than 1.000.

Since all prior year increments retain their same LIFO valuations in the rebasing process, this simply "forces" all of the prior indexes or valuation factors to be changed to become the quotients produced by dividing (A) the fixed/unchanged LIFO valuation amount for that year's layer by (B) the corresponding "grossed up" or "new" base dollar amount. This "new" base dollar amount, in turn, is determined as the product of multiplying (1) the "old" base dollar inventory amount for that year by (2) the deflator index that was used at the end of the last year under the old method to reduce that ending inventory at cost to its equivalent amount expressed in original base dollars.

LETTER RULINGS INVOLVING REBASING

LTR 8137143. Two IRS Letter Rulings offer some unofficial guidance. Technical Advice Memorandum (Letter Ruling) 8137143 (dated June 1981) indicates that when LIFO inventories are to be rebased, the key procedure involved is one whereby the LIFO indexes generated in years ***before*** the year of change are restated to indexes of less than 1.000, gradually rising or ascending according to the overall inflation pattern so that they reach (but do not exceed) 1.000 as of the beginning of the year of the

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change, while retaining their percentage relationships to each other year-by-year in the restatement.

Letter Ruling 8137143 involves computations for splitting one pool into several dollar-value LIFO pools. Therefore, the facts in that Ruling are somewhat involved and make it more difficult to see what is actually supposed to happen. The rebasing principles in Letter Ruling 8137143 appear on the facing page.

LTR 8008012. The rebasing situation in LTR 8008012 is more straightforward. This LTR states: "In changing to the link-chain method without performing a recomputation of the LIFO value of the inventory at the beginning of the year of change under the link-chain method, it is necessary for the ratios of costs in layers added prior to the year of change to be computed in their relationship to the new base year costs rather than the old base year costs."

It adds, "For this purpose, an appropriate index to base (*i.e., to determine*) costs for each layer added prior to the year of change would be the ratio of the LIFO value of such layer to the base cost of the layer. The LIFO value of the inventory is not changed and the total of the new base year costs is treated in the same manner as the old base year costs; that is, used solely for the purpose of determining whether there has been an increase or a decrease in the inventory value, and as a basis for determining the value of such increase or decrease.

"For example, if in a taxable year subsequent to the year of change, a decrease in inventory at base costs were to occur, the decrease in inventory at base costs would be applied to reduce the value of the successive layers of increment in reverse chronological order. If the layer being reduced was added in the year of change or in a taxable year subsequent thereto, the cumulative index for the year of the layer would be applied to the decrease in base costs to determine the amount of reduction in the layer. If the year the layer was added was a year prior to the year of change, the index of the LIFO value of the layer to base cost of the layer would be used to determine the portion of the LIFO value of the layer equivalent to the reduction at base costs.

"Since permission to use the link-chain method is granted only when one of the base year cost methods is impractical or unsuitable, the indexes used prior to the change are not suitable. In order to obtain a good basis for future computations of the cumulative indexes, it is necessary to establish a new base year. ***The LIFO value of the inventory prior to the change remains unchanged*** and the purpose of

(Continued from page 5)

the new base year cost is to establish a basis for determining future increments or decrements."

DUAL INDEX SPECIAL PROBLEMS

Various factual patterns will present difficulties in interpretation and application, especially where a dual index (or "earliest acquisition") approach may have been elected for valuing increments. This is what Question 6 on Form 970 is all about!

Where dual indexes or earliest acquisitions methods have been used for valuing annual LIFO increments, the ***key to understanding*** the rebasing is this: ***You should incorporate the cumulative index factor that was used to deflate the ending inventory to base dollars at the end of the last year under the old method (i.e., December 31, 2000 if calendar year 2001 is the year of change) somewhere into the rebasing schedule so that it will stand out as the principal reference point.*** That cumulative index factor is the one that must be used as the denominator in the rebasing fraction by which prior years' layers of base dollars are multiplied.

Sometimes, the cumulative index as of the beginning of the year of change may not be 1.000 ... instead, it may be a decimal less than 1.000. In other situations, the rebasing results may depend on whether a strict or literal interpretation focuses on the amount of costs at the "beginning of the year of change" or on the costs in the last year prior to the year of change (more generally) as the critical denominator in the recomputation of indexes.

HOW TO DOUBLE-CHECK OR "PROVE" YOUR REBASING COMPUTATIONS

The intention underlying the requirement is simply to provide a means or mechanism to more accurately keep track of increments and layers ***before*** the year of change when a decrement is experienced after the year of change, and that decrement needs to be carried back against the appropriate prior years inventory layers expressed in base dollars. Therefore, there should not be a major difference in result where indexes are rebased to 1.000.

Where the prior LIFO method was a link-chain method, there is a way to double check the LIFO computations after they are rebased, especially where a subsequent decrement is experienced.

All you have to do is to recompute the LIFO reserve changes as if the computations were not required to reflect any rebasing to 1.000. The computed change in LIFO reserve should be the same amount regardless of whether or not the indexes have been rebased to 1.000.

→

This is an easy way to double check the results produced from rebasing the computations to 1.000 as required by Revenue Procedure 2001-23. A comprehensive illustration of this is included on pages 9 through 12 (updated from the June 1993 *LIFO Lookout*).

SELECTED REFERENCES

For more discussion and examples where rebasing has been required, see also *Rebasing Indexes to 1.000* in the December, 1992 *LIFO Lookout*.

Other *LIFO Lookout* articles include *Rebasing Indexes to 1.000 ... An Extended Example Involving Dual Indexes, Splitting a Pool and Adding Demonstrator Vehicles* (March 1993, page 8) and *Why LIFO Reserves Go UP Even Though Inventories Go Down and Despite Rebasing Indexes to 1.000 in Between* (June 1993, page 6).

Additional discussion on the rebasing to 1.000 requirement is included in an article in *The Tax Advisor*, July, 1991, at pages 447-451. Finally, there is always the AICPA Issues Paper: *Identification and Discussion of Certain Financial Accounting and Reporting Issues Concerning LIFO Inventories*, dated November 30, 1984 (File 3175). This important LIFO document contains a discussion of substitute base years on pages 26-27 and illustrates an application for a double-extension LIFO taxpayer on pages 97-98. ✻

REBASING EXAMPLE FROM LTR 8137143

YEAR	*ORIGINAL INDEX*	*REBASING FRACTION*	*REBASED INDEX*
1974	1.00	1.00/1.25	.80
1977	1.10	1.00/1.25	.88
1979	1.20	1.20/1.25	.96
1981	1.25	1.25/1.25	1.00

Letter Ruling 8137143 addresses the need to split out costs and allocate them to the new LIFO pools with reference to prior year costs.

In LTR 8137143, the total "new base year costs to be allocated" simply represents the product of the (1) sum of the old base year costs multiplied by (2) the cumulative index at the end of the year before the year of change. In the Letter Ruling 8137143 example, this is $20,000 times 1.25 or $25,000.

Based on assumed facts, the Letter Ruling then allocates the new base year costs of $25,000 between the two pools with an allocation of $8,000 to one pool and $17,000 to the other pool, and with the "new base year costs as allocated" multiplied by each year's rebased index (i.e., .80, .88, .96 and 1.000, respectively). After this process, the result is that the LIFO valuation of the inventory as of the end of the year before the year of change is still exactly the same LIFO valuation (i.e., $22,100) as it was before any of the rebasing mechanics were applied.

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REBASING EXAMPLE ... Rebasing as of Jan. 1, 2001
NEW BASE YEAR FOR COMPUTATION PURPOSES ONLY

ORIGINAL LAYER HISTORY ... To be Rebased as of the End of Year 2000

(A) Year	(B) Old Base Year Costs	(C) Original (Cumulative) Index	(D)	(E)	(F) LIFO Valuation
1997	$ 1,000	1.000	-	-	$ 1,000
1998	200	1.050	-	-	210
1999	100	1.070	-	-	107
2000	300	1.100 *	-	-	330
	$ 1,600				$ 1,647

LAYER HISTORY as RESTATED/REBASED ... to 1.000 as of the End of Year 2000

Year	Old Base Year Costs	Conversion Factor 1.100 * Index	New Base Year Costs	New Indexes To Reflect Rebasing	Same LIFO Valuation
1997	$ 1,000	x 1.100	$ 1,100	.90909	$ 1,000
1998	200	x 1.100	220	.95455	210
1999	100	x 1.100	110	.97273	107
2000	300	x 1.100	330	1.00000	330
	$ 1,600 *No Change*	(x 1.100)	$ 1,760		$ 1,647 *No Change*

Note that the total old base year costs of $1,600 and the total LIFO Value of $1,647 do not change after the restatement of indexes to 1.000.

Through this procedure a new base year (i.e., 2001) is credited solely for computation purposes. Under this procedure, the original or oldest base year and the layer increments experienced before the year of change (i.e., before the new or substitute base year) are restated in terms of the new base year levels.

The LIFO values [detail in Column F, total of $1,647] for the original base year and all annual layer increments for the years between (a) the original LIFO election (1997) and (b) the year of change to the new method (2001) remain the same in total and for each respective year.

The old LIFO indexes [Top, Column C] are simply recomputed (and appear in Bottom, Column E) to reflect the ratio percentages of the new base costs [Column D] to the old LIFO values [Column F]. This can be observed from the 4th and 5th columns [i.e., Columns D & E] added to the "Restatement" portion of the example.

Note also that the same decimals shown for the "new indexes" [in Column E] could be obtained by dividing each year's original (cumulative) index by the year 2000's cumulative index of 1.100.

WHY LIFO RESERVES GO UP EVEN THOUGH INVENTORY LEVELS GO DOWN & DESPITE REBASING INDEXES TO 1.000 IN BETWEEN

The nine schedules that spread over pages 10, 11 and 12 show that after LIFO computations have been rebased, the correctness of that rebasing can be demonstrated by recomputing the LIFO reserve changes ***as if*** the computations were ***not*** required to reflect any rebasing to 1.000.

Here's why the LIFO reserves went up even though the year-end inventory levels went down. There are two components of change: (1) price inflation or deflation and (2) the inventory level or quantity change. These two components either add or offset to produce the *net* change in a LIFO reserve. However, ***as far as rebasing the indexes to 1.000 is concerned, the net effects of these components should not make any difference in the mathematical reconciliations ... and they don't!***

Schedule 1 reflects 1993 as the year of change, with the December 31, 1992 LIFO inventories (actual cost of $1,963,868; base dollars $1,087,308; and LIFO valuation $1,561,305) shown in their original layer configuration (in the first 3 columns) and after being rebased to 1.000 (in the last 3 columns). Note that the LIFO valuation amounts before and after remain unchanged.

Schedule 2 shows the composition after rebasing of the December 31, 1992 LIFO reserve of $402,563 (i.e., the December 31, 1992 inventory of $1,963,868 minus its LIFO valuation of $1,561,305).

Schedule 3 shows the computation after rebasing of the 1993 increase/change in LIFO reserve. This reflects an inflation index of 1.026 for 1993 and a corresponding decrease of $488,713 in restated base dollars resulting from having a December 31, 1993 inventory ($1,513,533 actual cost) considerably lower than the beginning inventory of $1,963,868 at actual cost *and revised base dollars*. The LIFO reserve for 1993 actually increases by $9,437 despite the decrease in inventory levels.

Schedule 4 analyzes the composition of the LIFO reserve at December 31, 1993 of $412,000 in terms of the rebased (i.e., lowered) indexes.

Schedule 5 reconciles the net increase of $9,437 in the LIFO reserve for 1993 in terms of the two components of change: ***First***, the current year's inflation factor caused the LIFO reserve to increase by $38,379. ***Second***, a pay-back or reduction factor attributable to the current year's decrease in inventory level produced a decrement of $488,713 expressed in base dollars. This decrement, in turn, resulted in the carryback/invasion of three layers of the prior years recomputed base dollars. The total pay-back due to the decrement was $28,941 (and this is tracked in terms of each year's layer that was involved). This pay-back factor of $28,941 was smaller than the increase in the LIFO reserve due to the inflation factor of $38,379 ... thus, there was a net increase in the LIFO reserve of the difference, or $9,437.

Schedules 6, 7, 8 and 9 show that you can prove that the rebasing computations are correct. This was done by computing the LIFO reserve change for 1993 as if the indexes did not have to be rebased to 1.000. Rebasing to 1.000 should not change the result...And it does not!

Schedule 6 analyzes the composition of the December 31, 1992 LIFO reserve of $402,563 as if there had been no change in method and, therefore, no requirement to rebase the LIFO indexes to 1.000. Careful comparison of Schedules 2 and 6 show that the composition of each year's LIFO reserve layer is exactly the same.

Schedule 7 shows the computation of the LIFO reserve for 1993 without any rebasing. Note that the December 31, 1985 base layer retains its 1.000 factor and the cumulative index through the end of December 31, 1993 is 1.853163 (1.806174 x 1.026016 equals 1.853163).

Schedule 8 analyzes the composition of the LIFO reserve which remains at $412,000 as of December 31, 1993. Careful comparison of Schedules 4 and 8 show that the composition of each year's LIFO reserve layer is exactly the same.

Schedule 9 reconciles the net increase in the LIFO reserve for the year 1993. Careful comparison of Schedules 5 and 9 show that all layers and components reflect the same corresponding amounts. The only figures that are different are the differentials between cumulative indexes which are greater when the indexes are not rebased (Schedules 6-7-8-9)...and the $1 rounding here and there.

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SCHEDULE 1
LIFO INVENTORY REBASING OF
PRE-1993 INDEXES TO 1.000

LIFO VALUATION AND INVENTORY LAYERS	DECEMBER 31, 1992 BEFORE REBASING INDEXES			DECEMBER 31, 1992 WITH INDEXES REBASED TO 1.0000		
	BASE DOLLARS	INDEX FACTOR	LIFO VALUATION	BASE DOLLARS	INDEX FACTOR	LIFO VALUATION
DECEMBER 31, 1985 (BASE)	$116,079.62	1.000000	$116,079.62	$209,659.99	0.553657	$116,079.62
DECEMBER 31, 1986 (NET)	256,712.91	1.180200	302,972.58	463,668.19	0.653425	302,972.58
DECEMBER 31, 1988	233,565.10	1.457100	340,327.71	421,859.21	0.806733	340,327.71
DECEMBER 31, 1989	94,350.27	1.588800	149,903.71	170,413.01	0.879649	149,903.71
DECEMBER 31, 1990	121,174.59	1.657010	200,787.51	218,862.40	0.917414	200,787.51
DECEMBER 31, 1991	178,597.71	1.690283	301,880.67	322,578.54	0.935836	301,880.67
DECEMBER 31, 1992	86,828.11	1.720100	149,353.03	156,826.67	0.952345	149,353.03
CUMULATIVE INDEX AT DEC. 31, 1992	-	1.806174	-	-	1.000000	-
TOTAL BEFORE REBASING INDEXES	$1,087,308.31		$1,561,304.83			
TOTAL AFTER REBASING INDEXES				$1,963,868.01		$1,561,304.[illegible]

SCHEDULE 2 (W/INDEXES REBASED TO 1.000)

DECEMBER 31, 1992 LIFO RESERVE CONSISTS OF:	BASE DOLLARS		INDEX FACTOR	COMPOSITION OF LIFO RESERVE
DECEMBER 31, 1985 (BASE)	$209,659.99	X	0.446343 (1.00000- .553657) =	$93,580.27
DECEMBER 31, 1986 (NET)	463,668.19	X	0.346575 (1.00000- .653425) =	160,695.80
DECEMBER 31, 1988	421,859.21	X	0.193267 (1.00000- .806733) =	81,531.46
DECEMBER 31, 1989	170,413.01	X	0.120351 (1.00000- .879649) =	20,509.38
DECEMBER 31, 1990	218,862.40	X	0.082586 (1.00000- .917414) =	18,074.97
DECEMBER 31, 1991	322,578.54	X	0.064164 (1.00000- .935836) =	20,697.93
DECEMBER 31, 1992	156,826.67	X	0.047655 (1.00000- .952345) =	7,473.57
CUMULATIVE INDEX AT DEC. 31, 1992	-	X	0.000000 (1.00000-1.000000) =	-
ROUNDING	-			(0.22)
TOTAL	$1,963,868.01			$402,563.17

SCHEDULE 4 (W/INDEXES REBASED TO 1.000)

DECEMBER 31, 1993 LIFO RESERVE CONSISTS OF:	BASE DOLLARS		INDEX FACTOR	COMPOSITION OF LIFO RESERVE
DECEMBER 31, 1985 (BASE)	$209,660	X	0.472359 (1.026016- .553657)=	$99,035
DECEMBER 31, 1986 (NET)	463,668	X	0.372591 (1.026016- .653425)=	172,759
DECEMBER 31, 1988	421,859	X	0.219286 (1.026016- .806733)=	92,508
DECEMBER 31, 1989	170,413	X	0.146366 (1.026016- .879649)=	24,943
DECEMBER 31, 1990	209,555	X	0.108606 (1.026016- .917414)=	22,759
CUMULATIVE INDEX AT DEC. 31, 1992	-	X	0.000000 (1.026016-1.000000)=	0
ROUNDING				(4)
TOTAL	$1,475,155			$412,000

SCHEDULE 5 (W/INDEXES REBASED TO 1.000)

PROOF/RECONCILIATION OF NET INCREASE (DECREASE) IN LIFO RESERVE AS OF DECEMBER 31, 1993		LIFO RESERVE CHANGE
AMOUNT OF BASE DOLLARS THAT REMAINED IN TACT THROUGHOUT CALENDAR YEAR 1993		$1,475,155
(X) MULTIPLIED BY CURRENT YEAR INFLATION	X	0.026016
INCREASE IN LIFO RESERVE DUE TO INFLATION FACTOR		$38,379
LESS: PAYBACK DUE TO DECREMENT CARRIED BACK AGAINST PRIOR YEARS		
(1990) $ 9,307 X .082586 (1.000000- .917414)	($769)	
(1991) $322,579 X .064164 (1.000000- .935836)	(20,698)	
(1992) $156,827 X .047655 (1.000000- .952345)	(7,474)	
$488,713		
TOTAL PAYBACK DUE TO DECREMENT	($28,941)	($28,941)
SUBTOTAL		$9,438
ROUNDING		(1)
NET INCREASE (DECREASE) IN LIFO RESERVE AT END OF CURRENT YEAR		$9,437

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SCHEDULE 6 (W/O INDEXES REBASED)

DECEMBER 31, 1992 LIFO RESERVE CONSISTS OF:	BASE DOLLARS		INDEX FACTOR		COMPOSITION OF LIFO RESERVE
DECEMBER 31, 1985 (BASE)	$116,080	X	0.806174	(1.806174-1.000000)=	$93,581
DECEMBER 31, 1986 (NET)	256,713	X	0.625974	(1.806174-1.180200)=	160,696
DECEMBER 31, 1988	233,565	X	0.349074	(1.806174-1.457100)=	81,531
DECEMBER 31, 1989	94,350	X	0.217374	(1.806174-1.588800)=	20,509
DECEMBER 31, 1990	121,175	X	0.149164	(1.806174-1.657010)=	18,075
DECEMBER 31, 1991	178,597	X	0.115891	(1.806174-1.690283)=	20,698
DECEMBER 31, 1992	86,828	X	0.086074	(1.806174-1.720100)=	7,474
CUMULATIVE INDEX AT DECEMBER 31, 1992	-	X	0.000000	(1.806174-1.806174)=	-
ROUNDING	-				(1)
TOTAL	$1,087,308				$402,563

SCHEDULE 8 (W/O INDEXES REBASED)

DECEMBER 31, 1993 LIFO RESERVE CONSISTS OF:	BASE DOLLARS		INDEX FACTOR		COMPOSITION OF LIFO RESERVE
DECEMBER 31, 1985 (BASE)	$116,080	X	0.853163	(1.853163-1.000000)=	$99,035
DECEMBER 31, 1986 (NET)	256,713	X	0.672963	(1.853163-1.180200)=	172,758
DECEMBER 31, 1988	233,565	X	0.396063	(1.853163-1.457100)=	92,506
DECEMBER 31, 1989	94,350	X	0.264363	(1.853163-1.588800)=	24,943
DECEMBER 31, 1990	116,022	X	0.196153	(1.853163-1.657010)=	22,758
CUMULATIVE INDEX AT DECEMBER 31, 1993	-	X	0.000000	(1.853163-1.853163)=	0
TOTAL	$816,730				$412,000

SCHEDULE 9 (W/O INDEXES REBASED)

PROOF/RECONCILIATION OF NET INCREASE (DECREASE) IN LIFO RESERVE AS OF DECEMBER 31, 1993			LIFO RESERVE CHANGE
AMOUNT OF BASE DOLLARS THAT REMAINED IN TACT THROUGHOUT CALENDAR YEAR 1993			$816,730
(X) MULTIPLIED BY CURRENT YEAR INFLATION (1.853163-1.806174)		X	0.046989
INCREASE IN LIFO RESERVE DUE TO INFLATION FACTOR			$38,377
LESS: PAYBACK DUE TO DECREMENT CARRIED BACK AGAINST PRIOR YEARS			
(1990) $ 5,153 X .149064 (1.806174-1.657010)	($768)		
(1991) $178,597 X .115891 (1.806174-1.690283)	(20,698)		
(1992) $ 86,828 X .086074 (1.806174-1.720100)	(7,474)		
$270,578			
TOTAL PAYBACK DUE TO DECREMENT	($28,940)		($28,940)
SUBTOTAL			$9,437
ROUNDING			0
NET INCREASE (DECREASE) IN LIFO RESERVE AT END OF CURRENT YEAR			$9,437

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SCHEDULES 3 & 7
CALCULATION OF ANNUAL LIFO INVENTORY CHANGES
AS CALCULATED UNDER THE LINK-CHAIN, INDEX METHOD
FOR THE YEAR ENDED DECEMBER 31, 1993

	SCHEDULE 3 REBASED TO 1.000	SCHEDULE 7 W/O REBASING
A. BEGINNING OF YEAR INVENTORY AT BASE DATE COST - AS RESTATED	$1,963,868	$1,087,308
B. END OF YEAR INVENTORY AT END OF YEAR (CURRENT) PRICES	1,513,533	1,513,533
C. END OF YEAR INVENTORY AT BEGINNING OF YEAR (BASE) PRICES	NOT FULLY REPRICED	NOT FULLY REPRICED
D. CURRENT YEAR PRICE INDEX:		
RATIO OF: END OF YEAR INVENTORY PRICED AT END OF YEAR PRICES (DIVIDED BY) END OF YEAR INVENTORY PRICED AT BEGINNING OF YEAR PRICES	1.026016	1.026016
E. CUMULATIVE LINK-CHAIN INDEX:		
CURRENT YEAR PRICE INDEX (LINE D) MULTIPLIED BY (X) PRIOR YEAR'S CUMULATIVE INDEX (LINE E OF PRIOR YEAR)	1.026016	1.853163
F. END OF YEAR INVENTORY AT BASE DATE COST		
(LINE B DIVIDED BY LINE E)	1,475,155	816,730
G. CURRENT YEAR INVENTORY INCREASE (DECREASE) - EXPRESSED IN BASE DOLLARS		
1. END OF YEAR INVENTORY AT BASE DATE COST (LINE F)	1,475,155	816,730
2. BEGINNING OF YEAR INVENTORY AT BASE DATE COST (LINE A)	1,963,868	1,087,308
3. CURRENT YEAR INCREMENT (G(1) EXCEEDS G(2)) OR DECREASE (IF G(2) EXCEEDS G(1))	(488,713)	(270,578)
4. LIFO VALUATION OF CURRENT YEAR INCREMENT (IF G(1) EXCEEDS G(2), MULTIPLY LINE G(3) BY LINE E)	N/A	N/A

H. ANALYSIS OF YEAR-END INVENTORY LIFO "LAYERS" - AS RESTATED				Schedule 3				Schedule 7
DECEMBER 31, 1985 (BASE)	$209,660	X	.553657	$116,080	$116,080	X	1.000000	$116,080
DECEMBER 31, 1986 (NET)	463,668	X	.653425	302,972	256,713	X	1.180200	302,972
DECEMBER 31, 1988	421,859	X	.806733	340,328	233,565	X	1.457100	340,328
DECEMBER 31, 1989	170,413	X	.879649	149,904	94,350	X	1.588800	149,904
DECEMBER 31, 1990	209,555	X	.917414	192,249	116,022	X	1.657010	192,249
CUMULATIVE INDEX AT DEC. 31, 1992	-	X	1.000000	-	-			-
	$1,475,155				$816,730			
ENDING INVENTORY AT LIFO VALUATION, PER ABOVE				$1,101,533				$1,101,533
LESS: ENDING INVENTORY AT END OF YEAR PRICES (LINE B)				1,513,533				1,513,533
LIFO RESERVE AT END OF CURRENT YEAR				$412,000				$412,000
LIFO RESERVE AT END OF PREVIOUS YEAR				402,563				402,563
INCREASE (DECREASE) IN LIFO RESERVE AT END OF CURRENT YEAR				$9,437				$9,437

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USED VEHICLE LIFO
... FIVE OTHER APPLICATION ISSUES

REV. PROC. 2001-23

WATCH EFFECTIVE DATES FOR CALENDAR YEAR AUTOMATIC CHANGES

Generally, the intention of the IRS was to provide dealers with 2 years of choice to decide whether or not they wanted to change to the Used Vehicle Alternative LIFO Method. If dealers decide to change voluntarily within two years, the change would not require IRS approval, it would be automatic (except for certain IPIC users, discussed below, and certain dealers under IRS audit.)

Section 5.02(1) states that the change can be made automatically "***provided the change is made for the first or second taxable year ending on or after December 31, 2000.***"

In other words, a dealer with a fiscal year ending Sept. 30 can make the change without permission for either the fiscal year ending September 30, 2001 or for the fiscal year ending September 30, 2002.

What about a calendar year taxpayer? As indicated above, the intention of the IRS was not to give a calendar year taxpayer "three years of choice." Accordingly, a calendar year taxpayer may make the change to the R.P. 2001-23 Method without permission for either its calendar year 2000 or its calendar year 2001.

A voluntary change to the R.P. 2001-23 Method would require permission if that change were being made for calendar year 2002, notwithstanding the fact that literally "the ***second*** taxable year ending on or ***after*** December 31, 2000" for a calendar year would be calendar year 2002.

Note: In this case, the voluntary change for calendar year 2002 would have to be under Rev. Proc. 97-27 and it would involve different requirements for *timely* filing of the Forms 3115. Also, the payment of a filing fee would be required.

WAIVER OF 5-YEAR WAITING PERIOD TO RE-ELECT LIFO

Some dealers voluntarily terminated their LIFO elections for used vehicles in a recent year and they may be subject to a 5-year wait before they can re-elect LIFO without securing consent of the IRS.

In recognition of the publication of an acceptable LIFO method for used vehicles, Section 6.02 of Rev. Proc. 2001-23 waives the 5-year limitation on the re-election of LIFO, that would otherwise be required by Rev. Proc. 99-49.

Accordingly, dealers who previously voluntarily terminated their used vehicle LIFO elections are offered the immediate opportunity to re-elect LIFO using the more certain computational approach now available.

SPLITTING A SINGLE POOL INTO TWO POOLS

Under Revenue Procedure 2001-23, if a dealer has been using a single pool for LIFO purposes, that pool must be split into two pools: Pool #1–all used autos regardless of manufacturer, and Pool #2–all used light-duty trucks regardless of manufacturer.

Section 5.04(3) of Rev. Proc. 2001-23 directs a taxpayer separating a dollar-value inventory pool to do so in accordance with Reg. Sec. 1.472-8(g)(2). The problem with this is that the example in the Regulations is based on a taxpayer separating pools under a double-extension LIFO application. The fact pattern of the example in the Regulations is therefore "rigged" by the underlying assumption that *all* information regarding prior year base costs is either known or readily determinable.

In many instances, that prior year information is not known nor available. This is usually the case where the taxpayer has previously used a link-chain LIFO methodology. Unfortunately, the Regulations do not provide any guidance on how to split pools where a link-chain LIFO methodology was used before the change.

Under these circumstances, it would appear that a single used vehicle pool can be split into the required two pools (one for used autos and one for used light-duty trucks) by ***using the ratio of the current costs*** of these two inventory classes as reflected in the ending inventory for the taxable year immediately before the year of change.

In other words, for a calendar year 2001 taxpayer, the ratio of the total actual cost at December 31, 2000 of used autos and the total actual cost of used light-duty trucks at December 31, 2000 could provide the ratio for splitting or allocating the total used vehicle LIFO reserve of the single pool as of December 31, 2000 between the two used vehicle pools required by the Alternative LIFO Method. The base inventory and each subsequent year's increment as of the end of the last year would be allocated in this ratio to arrive at this overall result.

see **OTHER APPLICATION ISSUES**, page 14

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This would appear to be a reasonable and practical approach. In fact, this approach was permitted by the National Office in Letter Ruling 8137143 and probably in many other situations where a link-chain method was previously used. For a good example of splitting a LIFO pool and rebasing it to 1.000, see *The Tax Advisor*, July, 1991 at page 451.

If this approach (i.e., using only the prior year-end ratio of costs) provides some extreme or unusual result, or if it might be unacceptable for some other reason, this general ratio approach could be modified. One way could be to apply the ratio of used auto and used light-duty truck costs to each other over a period of three years prior to the year of change (or some more "representative" combination of years) to obtain a more correspondingly weighted average as the basis for allocating the single pool's LIFO reserve between the two used vehicle pools.

FOR FISCAL YEAR TAXPAYERS... POSSIBLE DIFFERENT VALUATION DATE OTHER THAN YEAR-END

The IRS has indicated informally that it would allow an auto dealer to compute LIFO inflation indexes using the pricing information from an Official Used Vehicle Guide that is not co-terminal with the dealer's year-end, as long as the reference month was close to the actual taxable year-end.

This was confirmed in informal discussion with the author of Rev. Proc. 2001-23. This was also confirmed with Ms. Terri Harris, the IRS Motor Vehicle Technical Advisor.

In other words, a dealer with a July 31 year-end could elect to use an Official Used Vehicle Guide that provides pricing information as of June 30 in order to determine the annual LIFO inflation indexes that could be applied to the cost in its July 31 year-end LIFO inventory pools.

This favorable interpretation or permission is consistent with the election available to IPIC users to elect to use BLS indexes for a month-end other than December in the computation of their LIFO calculations. Often, a calendar-year IPIC user will elect to use indexes as of October 31 or November 30 to determine its annual LIFO inflation indexes.

This also reflects some parity with situations where the dealer may elect to use *Kelley Book* prices which are published only six times a year for a year-end that is not the same as the second month covered by the *Kelley Book.*

(Continued from page 14)

IPIC USERS ... SPECIAL RULES FOR CHANGING TO THE 2001-23 METHOD

Some Background. The IPIC Regulations provide that ... "a taxpayer using the inventory price index computation (IPIC) method provided by paragraph (e)(3) must use such method in determining the value of all goods for which the taxpayer has elected to use the LIFO method." (Reg. Sec. 1.472-8(e)(3)(i))

The Regulation does not say that *all* of the inventory must be subject to BLS indexes if any is subject to BLS indexes. Rather, the Regulation requires only that if the taxpayer desires to use BLS indexes for any portion or portions of its LIFO inventory, then all portions of its inventories on LIFO must use BLS indexes. Since a taxpayer is permitted to pick and choose what classes of goods it wants to cover in its LIFO election, it may make a valid election to include less than all of its inventory in its LIFO election.

On the other hand, some auto dealers have elected to establish one LIFO pool for all inventories that fit within one of the eleven general categories of consumer goods in the *CPI Detailed Report*. One of the eleven categories is "private transportation (including gasoline)." This would be consistent with Reg. Sec. 1.472-8(e)(3)(iv). These dealers have set up a single pool for all of their new automobiles, new trucks, used vehicles and parts and accessories inventories.

Certain IPIC users may not be able to make an automatic change. Section 5.03 of Rev. Proc. 2001-23 lists special procedures for IPIC LIFO taxpayers with used vehicles ***as well as other goods*** in inventory.

Automatic permission to change to the R.P. 2001-23 Method is granted in Section 5.03(1) only to IPIC LIFO dealers who have "only" new vehicles, used vehicles and parts and accessory inventories. These dealers, who have no "extras" or other inventories, can make their change under the automatic provisions of Revenue Procedure 99-49.

In contrast, IPIC LIFO dealers who have "extras" or other classes of inventory involved with their IPIC LIFO elections are not permitted to make an automatic change to the R.P. 2001-23 Method. If an IPIC LIFO dealer (in addition to new and used vehicles and parts) also has boats, motorcycles, recreational vehicles or other "extras," that IPIC LIFO dealer is required to obtain IRS permission to change to the R.P. 2001-23 Method by following the provisions of Revenue Procedure 97-27. Note: This involves different requirements for *timely* filing of the Forms 3115 and it also requires the payment of a filing fee. *

TAXPAYER WITH BARGAIN PURCHASE INVENTORY ESCAPES SEC. 481(a) ADJUSTMENT DUE TO FLUKE IN REV. PROC. 97-37

Field Service Advice 200121022 (released May 25, 2001) shows how lucky one taxpayer was when it changed its LIFO method to the IPIC method.

The taxpayer in this FSA was the target or newly acquired company whose stock had been purchased by another company. The parties elected to treat the transaction as a purchase of assets under Section 338(h)(10). The taxpayer's inventory was valued by the purchaser in accordance with the allocation rules at Reg. Sec. 1.338(b)-2T. Afterward, the target company's name was changed, and it elected the LIFO inventory valuation method using the "link-chain" method by filing Form 970 with its tax return for its first post-acquisition taxable year.

As a result of applying the purchase price allocation mechanism included in the regulations, the taxpayer's inventory on hand was allocated a cost that was significantly lower than the corresponding cost of similar inventory that was subsequently manufactured by the company. However, for LIFO inventory purposes, the taxpayer treated its pre-acquisition inventory and its post-acquisition inventory as if they were the same "item."

Subsequently, the taxpayer filed a Form 3115 application under the automatic consent for change in accounting method provisions of Revenue Procedure 97-37. The taxpayer wanted to change its LIFO method of accounting to the IPIC method. The taxpayer made this change on a "cut-off" basis. In other words, it did not first make an adjustment under Section 481(a).

In examining the tax return, the IRS agent took the position that the pre-acquisition inventory should be treated as a separate "item" for LIFO purposes. The agent's position was based on the rationale in *Hamilton Industries, Inc. v. Comm.* (97 T.C. 120 [1991]).

In requesting Field Service Advice, the agent wanted the IRS to take the position that Revenue Procedure 97-37 did not apply because Announcement 91-173 should apply and it would require a Section 481(a) adjustment).

In Announcement 91-173, the IRS held that taxpayers requesting advance consent to change their method of accounting voluntarily to comply with the Tax Court's holding in *Hamilton Industries* were required to (1) file a current Form 3115 and (2) for applications filed after November 6, 1991, make a Section 481(a) adjustment in connection with the request.

The IRS agent reasoned that although Rev. Proc. 97-37 did not mention or refer specifically to Announcement 91-173, Section 5.02(1) of Rev. Proc. 97-27 makes passing reference to the Announcement as "an example of other published guidance that requires a Section 481(a) adjustment." The agent argued that Section 10.04(3), Appendix of Rev. Proc. 98-60 (the Rev. Proc. that superceded Rev. Proc. 97-37), takes the same position as that of Announcement 91-173. Therefore, the agent concluded that Rev. Proc. 97-37 should not apply and the taxpayer should not have any audit protection for taxable years proceeding the change.

Revenue Procedure 97-37 by its own terms is controlling in the case of a taxpayer qualifying for treatment under its provisions. Section 4.01 of the Rev. Proc. states, "This Revenue Procedure is the ***exclusive*** Procedure for a taxpayer within its scope to obtain the Commissioner's consent." And, Rev. Proc. 97-37 provides that a taxpayer changing its LIFO inventory method to the IPIC method will use the cut-off method in making the change.

In superceding Rev. Proc. 97-37, Revenue Procedure 98-60 required a taxpayer that improperly accounted for bargain purchase inventory to make a Section 481(a) adjustment before changing its LIFO method to the IPIC method. However, Rev. Proc. 98-60 is effective for taxable years ending on or after December 21, 1998 ... and the taxpayer had filed its Form 3115 prior to that effective date. Therefore, the provision of Rev. Proc. 98-60 that requires a Section 481(a) adjustment did not apply to the taxpayer's change.

As a result, this taxpayer fell through the cracks. More precisely, it benefited from the drafting oversight in Rev. Proc. 97-37. FSA 200121022 held that the taxpayer met the requirements of Rev. Proc. 97-37, and therefore it could use a cut-off method.

Note the limited situation to which this FSA applies. For taxpayers with bargain purchase inventories and adjustments significant enough to invoke the *Hamilton* rationale, requests for changes to the IPIC method filed under either Rev. Proc. 98-60 or Rev. Proc. 99-49 (which superceded Rev. Proc. 98-60) will not allow the taxpayer to escape a Section 481(a) adjustment. ✻

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APPEALS COURT UPHOLDS TERMINATION OF LIFO ELECTION *IN CONSOLIDATED MANUFACTURING, INC.*

Consolidated Manufacturing, Inc. (CMI) is an auto parts remanufacturer engaged in the business of recovering, reconditioning, restoring and then selling used automobile parts, including engines, crankshafts, cylinder heads and transmissions. Used cores and/or other new or used purchased parts constituted the equivalent of the raw materials which were integral to Consolidated's remanufacturing activities. Consolidated generally acquired its used cores from customers.

In 1980, Consolidated elected LIFO. At that time, it included only *new* purchased parts and remanufacturing conversion costs (labor and overhead) in its LIFO election.

Consolidated deliberately excluded *used* customer cores, *used* engines, and other *used* parts...which comprised the major part of the product...from its LIFO election. For these *used* raw materials inventories, Consolidated continued to use the First-In, First-Out (FIFO) method and the lower-of-cost-or-market basis for valuation purposes. The result was that these *used* raw materials inventories were almost all written-down to scrap or salvage value at year-end for tax purposes.

The IRS determined that Consolidated's method of electing LIFO for only *new* parts, labor and overhead (while excluding *used* parts which comprised substantially all of the product cost) did not clearly reflect income. According to the IRS, Consolidated's method was contrary to the requirements of Section 472 and the underlying regulations. As a result, the IRS terminated Consolidated's LIFO election and assessed roughly $1.3 million.

In a non-LIFO method of accounting issue, the IRS also challenged Consolidated's method of valuing its used customer core raw material inventory. The IRS took the position that Consolidated did not reflect the proper amounts for customer cores under the First-In, First-Out, lower-of-cost-or-market method of valuation. This non-LIFO accounting issue involved roughly $2.4 million.

ANALYSIS OF THE LIFO ISSUES

During the IRS audit, the Service concluded that Consolidated had improperly elected the LIFO method, and proposed to terminate its use of the LIFO method. As a result, Consolidated would be forced to use the FIFO method to value all of its inventory. CMI did not agree, and it went to the Tax Court. In July of 1998, the Tax Court upheld the IRS on both LIFO issues in *Consolidated Manufacturing, Inc. v. Comm.*, 111 T.C. No 1 (Tax Court Docket No 6176-96). After losing in the Tax Court, CMI filed its appeal to the U.S. Court of Appeals for the 10th Circuit.

In holding that the taxpayer's LIFO method did not clearly reflect income, the Tax Court held that a taxpayer may not elect LIFO for anything other than a ***good***. In other words, the Tax Court held that a taxpayer cannot elect LIFO for certain ***costs*** which constitute a portion of a ***good***.

After reaching those conclusions, the Tax Court held that the Commissioner did not abuse her discretion in terminating the taxpayer's LIFO election. This holding interpreted Revenue Procedure 79-23 more favorably for the IRS than some (taxpayers) might have expected.

The Tax Court observed that Rev. Proc. 79-23 does not contain an exclusive list of circumstances under which LIFO elections may be terminated, and that LIFO elections may be terminated under the Commissioner's discretionary power at least in this case where the taxpayer's method did not clearly reflect income. In the Tax Court's view, the taxpayer's failure to apply LIFO to its entire ***good*** (i.e., the taxpayer applied LIFO to only some of the cost components) constituted a ***failure to properly elect LIFO***. And, the failure to properly elect LIFO is one of the grounds listed in Rev. Proc. 79-23 for termination of a taxpayer's LIFO election.

The Tax Court stated the issues to be decided in terms of the rather elusive concepts of "clear reflection of income" and the Commissioner's "abuse of his/her discretion in forcing changes in accounting methods on taxpayers."

The first issue was: Did the respondent (i.e., the IRS Commissioner) abuse her discretion in determining that ***Consolidated's method of reporting*** (certain raw materials, labor, and overhead on the LIFO inventory method and certain other raw materials on the FIFO inventory method) ***does not clearly reflect income*** because it contravenes the requirements of Section 472 and the regulations thereunder ***and that therefore*** Consolidated's election to use that method should be terminated?

The Tax Court held that the IRS was correct and that the Commissioner had not abused her discretion in this regard.

see ***CONSOLIDATED MANUFACTURING, INC.***, page 18

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CONSOLIDATED MANUFACTURING, INC. v. COMMISSIONER*

<table>
<tr><th>ISSUES</th><th>HOLDINGS</th></tr>
<tr><td rowspan="2">1. Did the IRS Commissioner abuse her discretion in determining that the taxpayer's method of reporting only certain raw materials, labor and overhead in its LIFO election (while reporting certain other raw materials on the FIFO inventory method) does not clearly reflect income ...?

<u>LIFO issue: Section 472</u></td><td><u>TAX COURT</u>
1. <u>NO</u>: The Commissioner did not abuse her discretion.
The taxpayer's method of electing LIFO for only new purchased parts and remanufacturing conversion costs (labor and overhead) ... while excluding used parts which comprised substantially all of the product cost ... was invalid because it was contrary to the requirements of Section 472 and did <u>not</u> clearly reflect income.</td></tr>
<tr><td><u>APPEALS COURT</u>
<u>NO</u>: The Commissioner did not abuse her discretion.
For more on the Appeals Court's analysis, see page 19.</td></tr>
<tr><td rowspan="2">2. If the taxpayer's method of applying LIFO did not clearly reflect income, could the Commissioner terminate the taxpayer's LIFO election under Revenue Procedure 79-23 or under any other authority?
Note: The taxpayer's position was that the Commissioner could not terminate its LIFO election if the taxpayer agreed to "reform" its LIFO election to avoid termination by including its used core inventory in its LIFO election, valuing the cores at cost, & making any necessary adjustments.

<u>LIFO issue: Section 472</u></td><td><u>TAX COURT</u>
2. <u>YES</u>: The Commissioner could terminate the taxpayer's LIFO method because it did not clearly reflect income. In this regard, the Commissioner did not abuse her discretion, either.
The taxpayer's failure to apply LIFO to its entire good (i.e., it applied LIFO to only some of the cost components) constituted a failure to properly elect LIFO, which is one of the grounds for terminating a taxpayer's LIFO election, within the scope of Rev. Proc. 79-23.
Sec. 446(b) and Reg. Sec. 1.472-3(d) both authorize termination by the IRS Commissioner.</td></tr>
<tr><td><u>APPEALS COURT</u>
<u>YES</u>: The Commissioner could terminate the taxpayer's LIFO method.
"Once the Commissioner determined that Consolidated had not properly elected to use the LIFO method, it was not an abuse of discretion to order the Company to use FIFO instead."</td></tr>
<tr><td rowspan="2">3. Did the IRS Commissioner abuse her discretion in determining that the taxpayer's method of valuing certain raw materials (used customer cores) does not clearly reflect income ... because it did not reflect the proper amounts for those raw materials under the FIFO inventory method and the LCM (lower of cost or market) basis of valuation?

<u>Non-LIFO issue: Section 471</u>

* Consolidated Manufacturing, Inc. v. Commissioner,
Tax Court ... 111 T.C. Memo No. 1, Docket No. 6176-96
United States Court of Appeals for the Tenth Circuit
87 AFTR 2d Par. 2001-908, Docket No. 98-9027 (May, 2001)</td><td><u>TAX COURT</u>
3. <u>NO</u>: The Commissioner did not abuse her discretion.
Customer cores should be valued at amounts paid as determined by transactions which were sales by the customers to the taxpayer...i.e., at invoice price. Accordingly, taxpayer should not value ending inventory at scrap value ... nor at prices paid by core suppliers to purchase similar cores from a salvage yard.</td></tr>
<tr><td><u>APPEALS COURT</u>
• Agreed that the cost of a customer core was the Customer Core Amount (CCA) referred to on CMI's customers' invoices as the "price."
• Did not agree and it reversed the Tax Court's finding that the CCA also reflected the market price of the used core for purposes of determining its lower-of-cost-or-market valuation.
• Found that the proper "market" is the Professional Supplier Market, with certain adjustments. Therefore, the case was remanded back to the Tax Court for further proceedings on market price.</td></tr>
</table>

Consolidated Manufacturing, Inc.

The Appeals Court discussion and analysis of the application of the LIFO regulations to CMI (and to other manufacturers like it who want to apply components-of-cost LIFO methods) appears on page 19.

What is likely to trouble many LIFO taxpayers is the fact that CMI was not allowed to merely correct its calculations and/or its LIFO election. Since it had "done it wrong" (i.e., it had selected an invalid option for applying LIFO) in the face of the clear choices provided by the Regulations, ***Consolidated was given no second chance to properly elect LIFO***.

The other LIFO issue was whether the Commissioner had abused her discretion in requiring Consolidated to use the FIFO method. In this regard, the Appeals Court said that the Commissioner had substantial discretion to terminate Consolidated's LIFO election and order the Company to use FIFO instead. It cited the unambiguous language in Section 446(b) that "if the (accounting) method used does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary, does clearly reflect income. ...The Regulations state more specifically that whether or not the LIFO method, once adopted, may be continued, and the propriety of all computations incidental to the use of such method, will be determined by the Commissioner, in connection with the examination of the taxpayer's income tax returns."

Reg. Sec. 1.472-6 provides that if the taxpayer is required by the Commissioner to discontinue the use of the LIFO method by reason of the taxpayer's failure to conform to the requirements governing the election and use of LIFO, the inventory of the goods erroneously placed on LIFO for the first taxable year affected by the change–and for each taxable year thereafter–shall be taken "in conformity with the method used by the taxpayer under Section 471 in inventorying goods not included in his LIFO inventory computations.

Therefore, based on its holding that Consolidated's LIFO election was improper because it did not comply with Reg. Sec. 1.472-2, it was not an abuse of the Commissioner's discretion to order Consolidated to switch to FIFO, which is the method called for by Section 471 to inventory used cores.

Consolidated tried to argue that the *Mamula v. Comm.* decision in 1965 supported its position. In rejecting CMI's argument, the Appeals Court observed that Consolidated used its impermissible LIFO method for more than a decade before being caught.

The harsh conclusion (and lesson to all LIFO taxpayers) is simply this: "Once the Commissioner determined that Consolidated had not properly elected

(Continued from page 16)

to use the LIFO method, it was not an abuse of discretion to order the Company to use FIFO instead."

THE CORE VALUATION ISSUE

As mentioned at the beginning of this article, the other inventory issue in this case involved the proper valuation of the customer core raw material inventory using the FIFO, lower-of-cost-or-market method. The Court also phrased this issue in terms of the more elastic and elusive concepts of "clear reflection of income" and "abuse of discretion."

As the Tax Court phrased it ..."Did the respondent abuse her discretion in determining that ***Consolidated's method*** of valuing certain raw materials (used customer cores) ***does <u>not</u> clearly reflect income*** because it did not reflect the proper amounts for those raw materials under the FIFO inventory method and the LCM basis of valuation permitted by Section 471?"

On this issue, the Tax Court had held that the Commissioner did not abuse her discretion. The Tax Court agreed with the IRS that the higher customer core amount set by CMI in its dealings with its customers constititued their "purchase price" and that amount should be used as the market value. Consolidated's inventories of used customer cores could not be valued at either scrap prices or at amounts paid to core suppliers for cores of comparable quality.

The Appeals Court, however, did not fully agree with the Tax Court, and it sent the case back to the Tax Court "for further proceedings on the market price."

Before the Appeals Court, Consolidated conceded that its method of valuing used cores that were not part of a finished product at scrap value did not clearly reflect income.

The Appeals Court agreed with the Tax Court on its holding that "the cost of a customer core is the customer core amount" as set by CMI on the invoices it prepared for customers to reflect their transactions. It said that ..."Cost is generally defined in terms of the invoice price ... In this case, the invoices referred to the customer core amount as the 'price' ... The Tax Court's finding on this matter was not clearly erroneous."

Taking it one step further, however, the Appeals Court did not agree with the Tax Court's finding that the customer core amount also reflected the market price of the used core. Since it was not entirely persuaded by the Tax Court's finding, the Appeals Court concluded that the method of accounting to which the IRS Commissioner wanted CMI to change was not a method that clearly reflected income as

see ***CONSOLIDATED MANUFACTURING, INC.***, page 22

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CMI's "MIXED METHOD" OF USING LIFO WAS IMPROPER
What the Appeals Court Said *

A taxpayer may elect to use the LIFO method to inventory specified "goods ... properly subject to inventory." The taxpayer may limit its use of LIFO to one or more of the raw materials in a class of goods. In that case, the taxpayer uses FIFO for all remaining costs. Thus, Consolidated presumably could have invoked this provision to use LIFO for its inventory of new parts (a raw material), for example, and FIFO for labor, overhead, and used engine cores.

The question, therefore, is whether labor, overhead, and the new parts alone constitute "goods ... properly subject to inventory." We hold they are not.

In the manufacturing context, goods subject to inventory are tangible, movable objects. The term "merchandise" ... does not include items that "cannot be warehoused in inventory." This accords with the plain meaning of the term "goods. ***Thus, under Reg. Sec. 1.472-1(a) a manufacturer may elect LIFO only with respect to tangible objects.***

In this case, Consolidated produces "goods" - i.e., rebuilt engines. Rebuilt engines are made of cores, new parts, labor, and overhead. Labor and overhead are not themselves "goods," because they are not tangible objects. Even when the new parts are factored in, there is no tangible product; the labor and overhead is applied to the cores together with the new parts. It was therefore improper for Consolidated to use LIFO to inventory these components without also including the cores.

Consolidated had three options under the regulations:

1. It could use FIFO for everything,
2. It could use LIFO for everything; or
3. It could use LIFO for some or all of its raw materials (new parts or cores) and FIFO for the other raw materials, labor, and overhead.

Consolidated chose a fourth, impermissible option: using FIFO for some raw materials (cores) and LIFO for the other raw material (new parts), as well as for labor and overhead. Although option (3) is permitted by the regulations, Consolidated's fourth option is not.

It is true that the regulations pertaining to Section 471 also refer to inventorying "goods." Consolidated is required to include all direct and indirect costs in its inventory, and if Consolidated were to inventory its raw materials using LIFO, then it would inventory only its labor and overhead using FIFO. However, the provision Reg. Sec. 1.471-2(d), that refers to "goods" also explicitly references the regulations under Section 472 that govern the LIFO method. These regulations, not those under Section 471. ***It is clear from the examples in Reg. Sec. 1.472-1(c) that when a company uses LIFO for its raw materials, it uses FIFO for its labor and overhead.*** Thus, even though labor and overhead are not goods, Reg. Sec. 1.472-1(c) requires a taxpayer to use FIFO for them in some circumstances - but not circumstances applicable to Consolidated.

SECOND CHANCE TO DO IT "RIGHT" IS NOT AUTHORIZED

Consolidated also contends that we (i.e., the Appeals Court) should allow "flexibility" in the LIFO regulations because Congress intended that all taxpayers have the option to use LIFO. Our decision does not foreclose the use of LIFO by anyone ***if it is properly elected.*** Consolidated could have elected to use LIFO to value its inventories of used engine cores and new parts and its labor and overhead costs. Rather, ***our decision prevents a taxpayer from mixing methods in a way that is not authorized by the Tax Code or Treasury Regulations.***

Consolidated has not shown that it would have been impossible for the Company to use LIFO for its entire inventory. Thus, even if we were inclined to adopt the dicta in *Hutzler Brothers Co. v. Comm.* that LIFO must be made available to all taxpayers, it would not avail Consolidated.

We hold that Consolidated's election to use LIFO just for its labor, overhead, and new parts inventory was improper.

* ***Consolidated Manufacturing, Inc. v. Commissioner***
Tax Court ... 111 T.C. Memo No. 1, Docket No. 6176-96
United States Court of Appeals for the Tenth Circuit, 87 AFTR 2d Par. 2001-908, Docket No. 98-9027 (May, 2001)

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PRICES OF USED CUSTOMER CORES *

1. ***Customer Core Amount*** **(*CCA*)** This amount was determined by Consolidated Manufacturing after taking into consideration at least four factors • The supply of cores in the used parts market. • The demand for the rebuilt part. • The current inventory levels of the type of core involved in the transaction. • The cost of purchasing that type of core from a core supplier.	1. The *Customer Core Amount* was set by CMI at a price that was ***artificially high***. • Reason for setting the price artificially high was to create an incentive or inducement to get customers to return the used cores to CMI. • The *CCA* or price was set by CMI, and it was listed on the sales invoice CMI that prepared for the customer.
2. ***Professional Core Suppliers*** **(*PCS*)** • These are third party suppliers who specialize in supplying cores to meet specific needs. • *PCS* purchase used cores from three sources ♦ salvage yards, ♦ automobile manufacturers, and/or ♦ customers. • After *PCS* purchases a core, the core is inspected and resold to manufacturers (such as CMI). • There was no evidence that CMI participated in the market between (1) professional core suppliers and (2) salvage yards. * *Consolidated Manufacturing, Inc. v. Commissioner,* Tax Court ... 111 T.C. Memo No. 1, Docket No. 6176-96 United States Court of Appeals for the Tenth Circuit 87 AFTR 2d Par. 2001-908, Docket No. 98-9027 (May, 2001)	2. Prices that *PCS* pay for used cores • Are determined from price schedules set by *PCS*. • Include delivery/transportation charges. Prices at which PCS sells used cores to manufacturers like CMI ... • Are higher than the amounts the *PCS* paid to purchase the cores. • Reflect the cost of inspecting the used cores. • Reflect a profit element to the *PCS*. • Reflect the fact that the cores *PCS* are reselling are guaranteed to be usable. If that core is found by a purchaser (such as CMI) to be defective, that core can be returned to the supplier for credit. • Are somewhat higher prices than the price the *PCS* paid for the core, but for less than the customer core amount that a manufacturer (like CMI) is willing to credit its own customers when they return cores in conjunction with the purchase of rebuilt parts.

HOW SHOULD USED CORES BE VALUED? FIVE POSSIBILITIES

Customer Core Amount (CCA) • Price paid or credited by Consolidated Manufacturing, Inc. (CMI) to customer when the customer returned a used core.	100	The IRS & the Tax Court said that CMI should value all cores at the Customer Core Amount (CCA).
Price CMI paid to a *Professional Core Supplier* (PCS) if it bought the core from the PCS.	75	CMI valued used cores in its ending inventory of remanufactured finished goods at this price (i.e., at price a PCS would charge).
Professional Supplier Market Price, adjusted for • Differences between supplier and customer cores reflected in the lack of a guarantee, and • Transportation cost differences.	XX	This is the price that the Appeals Court indicated should be used in remanding the case to the Tax Court for further proceedings on the market price. (See page 23.)
Price paid by a Professional Core Supplier to acquire the core from a salvage yard, car manufacturer or customer.	55	
Salvage yard scrap metal price of core.	40	CMI valued used cores that had not yet entered into production at scrap metal prices.

Comments:

- The dollar amounts above are arbitrarily determined to emphasize the possible range of different prices. These amounts are not taken from the case specifics.
- The IRS Commissioner determined that the used cores should be valued at the customer core amounts that CMI listed on its sales invoices to its customers.
- The Tax Court upheld the IRS ***and*** it held further that the customer core amount properly reflected both cost and market price, and therefore is the lower-of-cost-or-market.
- Before the Appeals Court, Consolidated Manufacturing Inc. conceded that its method of valuing used cores that were not part of a finished product at scrap value did not clearly reflect income.
- *Consolidated Manufacturing, Inc. v. Commissioner*
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  87 AFTR 2d Par. 2001-908, Docket No. 98-9027 (May, 2001)

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required by Section 446(b). The Appeals Court said: "Even if a taxpayer's method does not clearly reflect income, the Commissioner may not substitute a different method that also does not clearly reflect income."

As a result, the Appeals Court addressed the issue of how "market" should be determined in this case. It found that Consolidated's customer market for cores was not an open market; however, the supplier core market was an open market. The Court also found that using salvage yard prices as replacement cost would be inappropriate. The Appeals Court analysis of this issue is summarized on the facing page.

The Appeals Court said that the proper market is the professional supplier market, with adjustments to reflect differences between supplier and customer cores reflected in the lack of a guarantee and (reflected in) transportation cost differences for customer cores. In remanding *CMI* back to the Tax Court for further proceedings limited to the "market" price issue, the Appeals Court said, "We leave it to the Tax Court to make this determination on remand." As of mid-October, 2001, the Tax Court has not issued its decision on this matter.

The September 1998 *LIFO Lookout* contains more extensive coverage of the proceedings before the Tax Court and includes analyses of the briefs filed by the taxpayer and by the IRS. When the case was docketed in the Appeals Court, the additional briefs filed by the parties were analyzed in the September 2000 *LIFO Lookout*. That article also pointed out the possible implications that *Consolidated Manufacturing, Inc.* could have on other taxpayers using a components-of-cost LIFO methodology.

SIGNIFICANCE OF *CMI* ...BAD NEWS FOR LIFO USERS

LIFO elections may not be made for cost components; LIFO elections may only be made for ***entire*** goods or products. This has great significance for taxpayers using various types of "components-of-cost" approaches in their LIFO elections. Some taxpayers have made LIFO elections from which they think they can enjoy "the best of all possible worlds." By "picking and choosing" to put on LIFO ***only*** partial cost components, they have selected (or, more technically correct, *elected*) an invalid LIFO method.

Such taxpayers should beware because the consequences in an IRS audit situation could be quite adverse. This "picking and choosing" is what Consolidated hoped or thought it could do, but it lost in the Tax Court and at Appeals.

(Continued from page 18)

For many years, Revenue Procedure 79-23 has been thought by many to provide some protection from unwarranted loss of LIFO elections resulting from IRS audits ... except in cases where the cost, conformity, consent (i.e., the filing of Form 970 was overlooked or forgotten), or adequate books and records eligibility requirements were violated.

The Tax Court's interpretation of Revenue Procedure 79-23 in support of the Commissioner came as a surprise to some. The Tax Court's rationale upholding the IRS broke new ground by stating that the so-called conditions for termination of a LIFO election set forth in Rev. Proc. 79-23 do not comprise an exclusive list. And, now that rationale has been upheld on Appeal by the 10th Circuit.

Accordingly, two additional situations can be added the four others listed in Rev. Proc. 79-23 as grounds for termination of a LIFO election:

- Failure to elect LIFO with respect to ***an entire good or goods*** subject to inventory
- Failure to use a LIFO method that ***clearly reflects income***.

The holding by the Appeals Court makes it more likely that the Commissioner will be upheld in terminating LIFO elections or in requiring changes in accounting methods that do not clearly reflect income in almost all cases. The taxpayer cannot challenge the new method selected for it by the Commissioner, even though other alternatives more preferable to the taxpayer might be available. The only exceptions will be where the substitute method selected by the Commissioner does not clearly reflect income.

Cases where the IRS challenges a taxpayer's LIFO methods/elections invariably involve changes in accounting methods. These are the opposite sides of the same coin. Absent a clear reflection of income, the method used by a taxpayer can readily be changed by the IRS/Commissioner...and a change in method by the Commissioner necessitates a termination of the improper method being used.

The presumption of correctness lies with the Commissioner; the burden of proof otherwise lies with the taxpayer. Relatively few taxpayers have been able to successfully navigate up that steep, slippery slope. The Commissioner seems to have all the leverage, and this has been increasing case-by-case. *Consolidated Manufacturing, Inc.* makes that slope even more slippery and adds further weight to the LIFO taxpayer's burden of proof.

Because Consolidated was unsuccessful in its appeal of the LIFO issues in its case, this adverse precedent does not bode well for many LIFO users.

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THE MARKET FOR USED CORES

What the Appeals Court Said *

The market price is "the aggregate of the current bid prices prevailing at the date of the inventory." Reg. Sec. 1.471-4(a)(1). "The courts have uniformly interpreted 'bid price' to mean replacement cost, that is, the price the taxpayer would have to pay on the open market to purchase or reproduce the inventory items." *Thor Power Tool Co. v. Comm.* This open market must be one in which the taxpayer can participate. The determination of market price must be made on the basis of the taxpayer's usual volume of transaction.

To acquire used cores, Consolidated participates in two markets: one with its customers, and one with professional core suppliers. Only the second of these markets, however, is "open" as that term is generally understood.

The *Thor Power Tool* Court did not define the term "open market," but its plain meaning is "a freely competitive market in which any buyer or seller may trade and in which prices are determined by competition." There is no open market for partly finished, custom-ordered products that have firm sales contracts.

Consolidated's customer market for cores is not open, because (1) Consolidated is the only purchaser in that market and (2) the customer must buy a remanufactured part from Consolidated before Consolidated will buy back a used core of the same type - indeed, as noted above, when Consolidated purchased cores of a different type from its consumers, it did not use the customer core amounts. The Tax Court erred in finding this to be an open market.

The supplier core market, by contrast, is open. Multiple suppliers compete to sell used cores to the many remanufacturers of car parts. The market price of a used core, its replacement cost, should be determined by looking to the price that Consolidated would have to pay a professional supplier, not the price that it would pay to a customer.

The supplier market contains some features that distinguish it from the customer market from which Consolidated obtained most of its inventory of cores. For example, the suppliers guarantee that their cores are usable, whereas the customers do not; and Consolidated does not pay freight costs for the customer cores, while the record is not clear whether it does so for supplier cores.

We believe, however, that the Tax Court will be able to factor these differences out of the supplier prices in a reasonably accurate manner. For example, if 16% of customer-provided engine cores have defects that prevent them from being rebuilt, then the Court could reduce the price of supplier cores by 16% to reflect the value of the suppliers' guarantee that their cores will be usable (which guarantee does not apply to the vast majority of Consolidated's cores since they are obtained from customers without guarantees).

On the record in this case, we cannot say how the true market price for used cores compares to the customer core amount after various cost adjustments are considered. We leave it to the Tax Court to make this determination on remand.

If customers could not sell their used cores directly to Consolidated, there would be more cores available to professional suppliers. Thus, both the supply and demand of supplier cores would increase, and it is not clear how price would be affected. In the absence of more concrete data, we find that the supplier market (once the value of the supplier guarantee is factored out and any differences in transportation costs are taken into account) is the appropriate measure.

Consolidated urges us to find that the proper market is the one between professional core suppliers and the salvage yards from which they acquire parts. There is no evidence, however, that Consolidated actually participates in this market, or even that it could realistically do so in the volume that the remanufacturing process requires. It would therefore be inappropriate to use salvage yard prices as Consolidated's replacement costs.

We uphold the Tax Court's determination that the customer core amount is the cost of a used core, but reverse its finding that the customer core amount also represented the market price.

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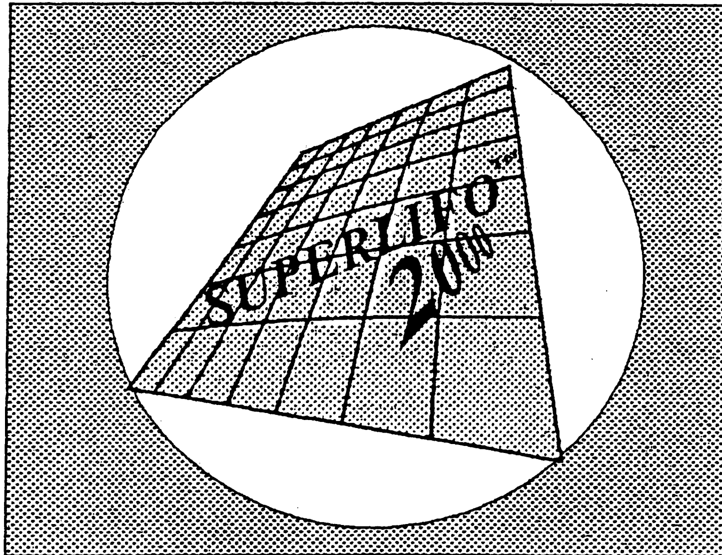

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