De Filipps' DEALER TAX WATCH

A Quarterly Update of Essential Tax Information

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DEALER TAX WATCH *OUT*

If you had called me personally to ask, "What's happening lately with IRS audits of dealers and dealerships that I need to know about?"... Here's what I'd say:

#1. GM DEALERS RUNNING LOW ON INVENTORY FACE STIFF RECAPTURE. Judging by the number of calls we've received, the #1 tax problem facing many GM Dealers–and other dealers–on LIFO is that as their fiscal year-ends approach, they are "out of inventory" and facing stiff LIFO recapture consequences.

So, the #1 tax problem for many dealers right now is not one the IRS is stirring up. Many GM Dealers caught in the throes of the current strike are facing the double whammy of (1) reduced sales and profits while fixed costs continue and (2) the potential of paying income tax on "paper profits" as their reduced inventories release significant amounts of deferred income locked up in their LIFO reserves.

A further consequence is that when a LIFO layer is reduced at year-end and LIFO benefits are recaptured, that "lost" layer with its lower cost can never be re-established or replaced when the inventory level is restored to a more "normal" level...which may be as early as the end of the next year.

The LIFO recapture consequences for dealers with June, September and other fiscal years is by no means hitting all dealers with the same impact. Dealers on LIFO will be hit differently based on their LIFO layer structure, the amount of base-dollars and the recapture potential in the various annual layers that have been built up over the years.

Two other related considerations: First, GM Dealers who also have non-GM franchises will have even further LIFO-related problems if their non-GM inventories are depleted as well. Second, even after the strike is settled, its results will linger, and the possibility of September and/or calendar year-end dealers having significantly lower inventories may have to be reckoned with.

WATCHING OUT FOR

Any dealer who does not understand the full impact of invading his LIFO layers will be in the dark until he finally finds out how much the "big hit" really is. In addition to calculations showing the potential recapture impact by layer as the inventory goes down, there are some steps a dealer may consider to offset some of the LIFO recapture impact. These steps

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should only be considered if they also make sense from a economic and a business standpoint after considering the additional costs of carrying inventory.

Some CPAs do not really understand what LIFO recapture is all about or how to project and evaluate it. Hopefully, they won't try to "generalize" their way around it. Everybody knows there's going to be recapture...it becomes a matter of quantifying the degree and thinking about whether reasonable steps can be taken to avoid some of the payback. A dealer's base inventory and every annual increment has a different LIFO reserve payback potential...even the different inventory pools have different payback potentials for each annual increment. There is much that can be done to make these projections accurately, so that the real thought and effort can go into considering the alternatives. For more, see page 18.

#2. FROM THE IRS: "HEADS WE WIN, TAILS YOU <u>LOSE</u>." When you stop and think about it, the saying "Heads I win, tails you lose" best represents the conclusions drawn from two IRS pronouncements featured in this issue of the *Dealer Tax Watch*. Different situations...but, the same end result.

In the demo ruling 9816007, the IRS has said it isn't bound by advice given to taxpayers in prior tax audits by IRS agents, nor is it even bound in later years by settlements it accepted in prior audits. In Notice 98-31, the proposed procedure for dealing with IRS-initiated changes in accounting methods, the Service shows how it plans to get beyond the statute of limitations most folks thought was three years. Equally unsettling, the Service indicated that after it changes a dealer's accounting method, it can even change it more later on if it wants.

Congress just passed, and the President signed into law, the *Internal Revenue Service Restructuring and Reform Act of 1998*. With this recent legislation intended to provide additional taxpayer fairness provisions and protection, these "Heads I win, tails you lose" positions of the IRS seem a bit backhanded and out of place...don't they?

#3. ARE YOU WAITING FOR THE IRS TO MAKE YOU CHANGE AN IMPROPER ACCOUNTING <u>METHOD</u>? Accounting methods... ***improper*** accounting methods...***changes*** in accounting methods (CAMs)...you can't think of one without thinking about the other two at the same time. IRS agents are often interested in checking up on—or second-guessing—methods of accounting employed by dealers for their inventories and for other day-to-day transactions such as the sale of vehicle service contracts.

In the past year, the IRS has dealt extensively with CAMs. First, the IRS issued Revenue Procedure

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97-27 updating basic rules, terms and conditions for changes in accounting methods, and Form 3115 was revised to reflect these changes. Next, the IRS issued Revenue Procedure 97-37 for dealers making "voluntary" automatic changes in accounting methods. A *voluntary* change is generally a change requested by the taxpayer <u>before</u> an IRS audit examination is under way.

Now, the noose is being drawn tighter around the neck of a taxpayer who persists in using an unjustifiable method of accounting—one that does not clearly reflect income—and hopes to just hide from the IRS and never get caught.

In recently issued Notice 98-31 (1998-22 IRB 10), the IRS sets forth a proposed revenue procedure to explain how IRS examining agents and Appeals officers in the future are to deal with recalcitrant taxpayers. Once finalized, taxpayers who fail to volunteer can expect a 100% pick-up of income in the earliest open year...along with an effort by the IRS to get around the usual three year statute of limitations by picking up adjustments for otherwise closed years through a Section 481(a) adjustment.

It now seems that taxpayers generally should be "volunteering" to make accounting method changes before an IRS audit starts, rather than hanging back in the shadows and hoping not to get caught. In addition to summarizing Notice 98-31 on page 8, we have included a review of the change in accounting method (CAM) rules and a summary of some of the more recent IRS and Tax Court activity bearing on dealerships.

#4. IRS AUDIT UPDATE ... HOT & EMERGING <u>TAX ISSUES</u>. Demonstrator vehicles: Many CPAs specializing in dealerships have indicated recently that the IRS is just as inconsistent as ever in understanding and uniformly enforcing the demo rules recently trotted out for a wake up call in January.

In April, 1998, the IRS released LTR 9816007 which to some seems more narrow in application than LTR 9801002, because it involves an auto distributor. In this case, the IRS would not allow the distributor to value its employees use of demo vehicles by using the simple "manufacturer's invoice plus 4% method." Instead, the IRS concluded that a higher valuation should be used for employment tax/income tax withholding purposes.

More significantly, LTR 9816007 sets forth the proposition that the IRS can come back just about any time it wants and say what you were doing *before* still isn't good enough *now!* The discussion on this demo ruling starts on page 5.

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LIFO conformity for dealership financial statements: May 31 was the deadline for the first (one-third) installment of the LIFO Conformity penalty payment for auto dealers with violations on Factory statements in any of the years 1991 through 1996. The remaining two payments are due on January 31, 1999 and January 31, 2000.

Dealers on LIFO were required to conduct self-audits to determine if LIFO conformity violations were committed in any one of those years. If the dealer did not have a LIFO conformity violation during that six-year period, it was safe and there was no need to pay for *relief.*

If the self-audit ferreted out a LIFO conformity violation during any one of the six most recent taxable years ending on or before October 14, 1997 (i.e., for the calendar years 1991-1996), the dealer's choices came down to three grim alternatives.

1. ***Pay*** the first 1/3 of the settlement fee and file a memorandum statement by May 31, 1998,

2. ***Play*** "IRS audit roulette," and hope that the IRS might not catch the violation (not a very good alternative and hopefully few dealers were tempted unduly on this point), or

3. ***Run away:*** i.e., terminate the LIFO election before May 31, 1998 (also not a very good alternative and hopefully even fewer dealers were tempted by this to cut off their noses to spite their faces).

Now that May 31 has come and gone, what will the IRS be doing after it finishes counting its money and tallying up who has filed and who hasn't?

Will there be more audits, compliance checks, squabbles over "reasonable estimates"? ... Will the IRS sit back contented with its "windfall." Or is it planning to come out aggressively and look for more? Time will tell ... and so will we when there's more to report.

#5. WHATEVER HAPPENED TO THE DISPUTE OVER THE USE OF *REPLACEMENT COST ACCOUNTING* FOR PARTS INVENTORIES AND LIFO? Don't worry ... it hasn't gone away. It's just that the Tax Court still has not issued its decision involving the taxpayer in Letter Ruling 9433004 ...*Mountain State Ford Truck Sales, Inc.* (Docket No. 16350-95). In this case, the IRS has challenged a dealer's use of the generally accepted replacement cost method for valuing its parts and accessories inventories on LIFO.

Be assured that the outcome will affect all auto and truck dealers and many other businesses who use replacement cost for their parts inventories. It will not be limited to dealers using LIFO for their parts inven-

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tories, because all dealers are using replacement cost to value their parts inventories, whether or not they are using LIFO.

#6. ALTERNATIVE LIFO METHOD NEW ITEMS LISTS. For those interested in what are, or are not, new item categories for LIFO computation purposes, the June, 1998 *LIFO Lookout* contains a complete comparison of our new item lists with those issued on May 7 by the Acting Motor Vehicle Industry Specialist of the IRS.

As usual, we found significant differences when we compared our lists item-by-item. This year, ***SUBARU*** (Impreza and Legacy) accounted for major differences, along with ***FORD*** Contour, Escort and Taurus, ***MERCURY*** Mystique and Sable, ***VOLKSWAGEN*** Cabrio, Golf, GTI and Jetta, and the ***VOLVO*** 70 and 90 Series. And we identified "only" 352 new item categories compared to 493 for the IRS. A summary table appears on page 28.

#7. HOW BIG IS THE *Y2K* PROBLEM THE IRS IS SITTING ON? *REALLY?* Recently, we referred to the unflattering look at IRS operational activities reported in *Fortune* (April 13, 1998) and the enormous project and budget the IRS had for dealing with modernizing its data processing equipment. So far, the *Y2K* problem plaguing many other large organizations is something that IRS Commissioner Rossotti has not come out specifically and said that the IRS has under control.

The House Ways & Means Oversight Subcommittee has been holding hearings on the progress of Federal agencies ... including the IRS ... toward meeting the *Y2K* or century date conversion deadlines. Unless corrected, major problems may be created if programs processing year-date information are unable to distinguish the year 2000 from the year 1900 as the first day after December 31, 1999.

The House & Senate Appropriations subcommittees have approved the release of $50 million in unused IRS appropriations ("unobligated funds") from prior years for the *Y2K* effort. But that's not enough: Commissioner Rossotti has requested Congress to relax some of the deadlines in pending legislation "in order to ensure that our tax collection system is able to operate effectively in the year 2000."

There's more: When asked by one Committee member whether the IRS "has the resources to do all this stuff," Rossotti's reply was not very reassuring. He said that "we have an extraordinarily thin management structure at the IRS, ... we have a lot going ... we really cannot cram anything more into this computer system. It's already high risk." This is not very reassuring ... and if the IRS were a publicly held

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company, it's "stock" would probably drop sharply after a whisper announcement like this.

Before being appointed as IRS Commissioner, Mr. Rossotti was the head of a computer consulting firm. He reported that the IRS has retained the firms of Booz-Allen & Hamilton, Inc. and Andersen Consulting to continually monitor the progress of the IRS' *Y2K* and modernization initiatives. Great!

All major corporations who have fixed their own *Y2K* problems still have one more major obstacle with which they must cope. They have to be sure that all of the other businesses with whom they regularly interface do not have *Y2K* problems of their own. Since the IRS is highly "inter-connected" in exchanging information with many businesses, state taxing authorities and other regulatory agencies, the possibilities of misfitting information is not pleasant to contemplate.

The IRS is notorious for failing to meet deadlines... whether these are deadlines the Service imposes on itself (as it sometimes does)...or whether these deadlines are imposed by Congress. At the last minute, the IRS whines and alibis for its failure to perform. Only, this time, the consequences if it fails to perform will be evident to everybody and all taxpayers... and their advisors... will just have to pay the price. Are we too pessimistic on this? What do you think?

#8. MORE GIFT TAX RETURN AUDITS AHEAD? The head of the IRS Estate and Gift Tax Group recently told a meeting of attorneys that there may be more gift tax audits in the near future, in light of the changes recently made in the estate and gift tax area. One area likely to be looked at closely will be valuation discounts claimed and reported on Forms 709.

The IRS speaker, Ronald Watt, said that the emphasis for compliance will be shifting to the gift tax return area because of the increases in the unified credit for estate taxes and the requirements for estate tax return filings.

Readers will recall our observations on the trap in gift tax returns reporting gifts of dealership stock with valuation discounts: After 1995, Form 709-A ... the "short form" gift tax return ... cannot be used to report gifts where valuation discounts are claimed. For a thorough discussion, refer to the article "Gifting Dealership Stock ... IRS Change in Reporting Valuation Discounts on Form 709 Gift Tax Returns" in the March, 1997 issue of the *Dealer Tax Watch*.

#9. DID YOU FILE FORM 709? Just a reminder: many dealers make tax-free gifts of dealership stock each year up to the magic $10,000 per donee tax-free limit. In many instances, the value of the dealership stock before discounts might exceed $10,000 (say

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$13,000), but the discounts reduce the gift to an amount below $10,000 (for example, $9,999). If no gift tax return is filed–because the value of the gift (after discounts) is less than the $10,000 minimum amount required for filing–it is not possible for the taxpayer/donor to notify the IRS by "checking the box" that a discount has been claimed in arriving at the valuation of the gift.

Accordingly, there may be statute of limitation problems created where no gift tax return is filed because the required notice to the IRS that a valuation discount was claimed was not given by the taxpayer (on the Form 709). Dealers who made gifts that netted down to less than $10,000 after valuation discounts... and did not file gift tax returns for 1996 and/or 1997...may want to reconsider the possible consequences of not filing Form 709 with their advisors.

#10. PERSONNEL CHANGES. Our Spring, '98 CPA-Auto Dealership Niche Conference, May 20-22, at Alexis Park Resort & Spa in Las Vegas came off without a hitch. We were very fortunate in having Peter Kitzmiller, formerly with NADA, making his last presentation on dealer tax issues at the Conference. Peter left NADA as of July 1 to become the Executive Director of the Maryland Automobile Dealers Association, and we wish him well.

Also attending the Conference was Robert C. Zwiers, formerly the IRS National Motor Vehicle Specialist (Grand Rapids, MI). After "retiring" from the IRS, Mr. Zwiers joined the accounting firm of Crowe, Chizek & Co. LLP, as National Automotive Tax Executive. He will also be assisting Crowe, Chizek and other member firms of AutoTeam America, one of the consortiums of CPA firms specializing in auto dealerships, as a senior tax consultant.

#11. CONFERENCE MATERIALS AVAILABLE. The mid-year CPA-Auto Dealership Niche Conference (May, 1998 ... Las Vegas) included presentations on industry outlook, the tax and economic implications of Project 2000 downsizing of dealerships, dealership valuations, financial statement analysis and benchmarks, smarter negotiation tactics for dealers upgrading their computer systems, more efficient utilization of computer systems already in place, the LIFO conformity penalty tax due May 31, 1998, IRS Letter Ruling 9801002 on demonstrator use, other IRS issues and recent Tax Court cases, and updates on LIFO developments, producer owned reinsurance corporations (PORCs) & vehicle service contracts (VSCs).

A limited quantity of conference *Manuals* and audio and video tapes of these sessions is still available. Call (847) 577-3977.

LTR 9816007: ANOTHER DEMO RULING WITH AN EVEN MORE DISTURBING MESSAGE

DEMOS
9816007

The December, 1997 *Dealer Tax Watch* analyzed IRS Letter Ruling 9801002 in which the IRS held that dealership employees using demos were not entitled to exclude the value of the use of the vehicles from gross income as a working condition fringe. The IRS also held that the special valuation rules could not be used to report lower amounts of income for the demo users.

After LTR 9801002 was issued, several dealer publications printed letters from CPAs suggesting again that dealers should stop making demos available to employees. The opposite point of view is that for many dealerships, demos are a "necessary evil" and they are here to stay. Furthermore, the dealer in that ruling had very unfavorable facts and should have been much more careful in policing its demo agreements and in following the more conventional advice that dealers need to take demo documentation requirements seriously.

Over the past months, many CPAs specializing in dealerships have said that even after this letter ruling, IRS agents in the field are just as inconsistent now as they were in the past in understanding and uniformly enforcing these rules.

In our March 1998 *DTW,* we expected the IRS to soon release another Technical Advice Memorandum/Letter Ruling with more bad news regarding the special valuation rules for demo use. This Letter Ruling dated December 31, 1997 was issued on April 17, 1998 as LTR 9816007. It contains the expected "bad news" and a very disturbing message bound to make ***all*** demo users nervous.

THE FACTS

In LTR 9816007, the taxpayer was a distributor of vehicles manufactured by an affiliated company. During the years in issue, the taxpayer had included an amount in the recipient employees' incomes based on the same formula the IRS had previously used in settling adjustments for prior taxable years on the same issue. In the prior years which the IRS audited, the taxpayer had originally included an amount in income and wages for each employee's use of the demo; however the amount included in income had not been properly determined.

During the years currently under audit and subject to the LTR, the taxpayer had determined the amount includible in the employees' income by applying the automobile lease valuation rule found in Reg. Sec. 1.61-21(d) to the "manufacturer's invoice price plus 4%." The taxpayer's position was that it should be entitled to use this amount (i.e., 4% over the manufacturer's invoice price) as the fair market value of the vehicle computed under the safe harbor amount provided by Notice 89-110.

IRS Notice 89-110 (IRB 1989-49), provides special rules for (1) determining the annual lease value of an employer-provided vehicle, (2) the valuation of employer paid fuel and (3) how the commuting valuation rule may be used by certain control employees. The taxpayer, a distributor, had determined the manufacturer's invoice price based on the invoice price of the vehicle sold by the manufacturer to the distributor, rather than based on the manufacturer's invoice price to a dealer or on an arm's-length lease.

Since the manufacturer would have invoiced the distributor at a lower invoice price than a retail dealer would be invoiced, one might think that the IRS was looking to require the taxpayer/distributor to use the higher, dealer invoice price for purposes of valuing the fringe benefit to the employee. But that was not the case; the IRS was looking to tax the employees (and thus the employer) on the fair market value of the lease as determined in an arm's-length transaction.

IRS HOLDINGS

On the first issue, the IRS held that the taxpayer was not entitled to use the special safe-harbor valuation method provided by Notice 89-110 for purposes of applying the automobile lease valuation rule for determining the fair market value of the vehicles provided for use by employees. Notice 89-110 otherwise would have allowed the use of "manufacturer's invoice plus 4%" as the basis for valuation.

Next, the IRS also held that the taxpayer was not entitled to use the automobile lease valuation rule provided in Reg. Sec. 1.61-21(d) for purposes of valuing the benefit of the use of the vehicles provided to the employees. This raised the question of how the demo value should be computed...and the result was that the measure was the amount the employees would have to pay in an arm's-length transaction *to lease* (not to purchase) the vehicle.

Finally, and potentially more disturbing, the last issue was whether the IRS was bound by erroneous advice given by an IRS agent in a prior year which was the basis for settling the issue in prior years. On this, the IRS National Office held that the taxpayer was not

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protected by its reliance on an erroneous interpretation of Notice 89-110 ... even though that interpretation had been given directly to the taxpayer during a prior IRS examination by that examining agent ... and which was "nonetheless consistent with the method used by the Service in settling adjustments made during a prior audit cycle" of the taxpayer. Consequently, the taxpayer's reliance on that prior settlement and the IRS agent's erroneous advice "does not preclude the Service from retroactively collecting any underwithheld taxes attributable to the erroneous interpretation."

ANALYSIS OF VALUATION RULES

General rules: The rules generally applied to fringe benefits, including the use of demonstrator vehicles, are summarized as follows. The amount the employee must include in gross income is the excess of the fair market value of the fringe benefit received over the sum of (1) any amounts paid by employee for that benefit and (2) any amounts specifically excluded from gross income by a special provision of the Internal Revenue Code.

The fair market value of a fringe benefit is the amount that an individual would have to pay for the particular fringe benefit in an arm's-length transaction. The effect of any special relationship that may exist between the employer and the employee must be disregarded. Similarly, an employee's subjective perception of the value of a fringe benefit is not relevant to the determination of the fair market value of the fringe benefit. Nor is the cost incurred by the employer to provide that fringe benefit determinable of its fair market value. Generally, the value of an employer-provided vehicle equals the amount that an individual would have to pay in an arm's-length transaction ***to lease*** the same or a comparable vehicle on the same or comparable conditions in the geographic area in which the vehicle is made available for use.

Exceptions. There are exceptions to these general rules. The Regulations do contain special vehicle valuation rules, but these special rules may only be applied in specified circumstances and situations. When a special valuation rule is not properly applied to a fringe benefit, or when a special valuation rule is applied to value a fringe benefit by a taxpayer who is not entitled to use that rule, the fair market value of the fringe benefit may not be determined by using any value calculated under any of the special valuation rules. In that instance, the value of the fringe benefit must be determined under the general valuation rules (i.e., cost to lease in an arm's-length transaction) which result in higher values for the benefit.

In applying the automobile lease valuation rules under Reg. Sec. 1.61-21(d), the determination of the Annual Lease Value is made by reference to the fair market value equal to an amount the individual would have to pay in an arm's-length transaction ***to purchase*** the particular automobile in the jurisdiction in which the vehicle is purchased or leased. The purchase consideration includes all amounts attributable to the purchase of that vehicle including sales tax, title fees and destination charges.

These Regulations provide a safe harbor value which may be used as the fair market value of an automobile owned by the employer: where an automobile is owned by the employer, the safe harbor value is the employer's cost of purchasing the automobile (including sales tax, title and other expenses attributable to the purchase) provided the purchase is made at arm's-length.

TRAPPED BY THE AGGREGATION RULES

However, this safe harbor valuation amount for "owned" automobiles is not available with respect to an automobile that is manufactured by the employer. Therefore, if one entity manufactures an automobile and sells it to another entity with which it is aggregated under the special aggregation rules (found in IRC Section 414(b), (c), (m) or (o)), this safe harbor rule (for employer-owned autos) cannot be used to value the automobile by that "aggregated employer."

In Letter Ruling 9816007, the taxpayer was a distributor of vehicles manufactured by an affiliated company and the National Office "assumed" that the distributor and the manufacturer "are treated as a single employer under the rules of Section 414 (b), (c) (m), or (o)."

As a result of that assumption, the distributor/ taxpayer was treated as manufacturing and owning–rather than leasing–the vehicles it provided to its employees and that made the safe harbor rules provided in Notice 89-110 inapplicable. Instead, the safe harbor rule that would be applicable for the valuation of automobiles owned by an employer would be the employer's cost of purchasing that automobile, provided the purchase were made at arm's-length. However, even this safe harbor (for employer-owned autos) is not available for automobiles manufactured by the employer or an entity with which it is aggregated under the special rules. As a result, the valuation of the vehicles must be determined based on the amount that an individual user would have had to pay in an arm's-length transaction to purchase that particular automobile. In the instant case, that meant that the fair market value of the vehicles should have been determined based upon the amount that an individual would have had to pay in an arm's-length transaction to purchase (not to lease) each vehicle and that value

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should have been applied to the Annual Lease Value Table.

SORRY... "EVEN THOUGH YOU TRIED..."

The Service held that since the fair market value of the demonstrator vehicles provided to employees was not properly determined, the automobile lease valuation rules were not properly applied and, therefore, the taxpayer was not entitled to use any of the special valuation rules for valuing the use of the vehicles by employees.

Instead, the taxpayer was required to value the use of the vehicles under the general rules in Regulation Section 1.61-21(b). These rules provide that the value of the use to an employee equals the amount that that individual would have to pay in an arm's-length transaction to lease (not to purchase) the same or comparable vehicle on the same or comparable conditions in the geographic area in which the vehicle is available for use. Furthermore, the value of that fringe benefit is *remuneration* for employment and, thus, it is *wages* for purposes of FICA tax and income tax withholding, for which the IRS holds the employer responsible.

To arrive at the correct technical result, the analysis of all the related valuation rules takes one through determining whether the employer (1) owns, (2) leases, (3) manufacturers or (4) is treated as an "aggregated" employer with respect to the demo vehicles. Furthermore, in connection with using the appropriate safe harbor rules, the Regulations make distinctions between determining the amount an individual would have to pay in an arm's-length transaction to purchase that vehicle as compared to what he/she would have to pay in an arm's-length transaction to lease the vehicle.

"BUT...BUT...LAST TIME YOU SAID..."

The taxpayer in this case had in prior IRS audits settled with the examining agent on a mutually accepted, but nevertheless erroneous, interpretation. The Letter Ruling states that the operation of the Regulation to make the special rules unavailable to the taxpayer "is not affected by (the taxpayer's) reliance on the method used to settle adjustments made in a prior audit cycle. The adjustment for the years in issue was based on the Service's statement of a rule in *mediums of official pronouncement*.... By contrast, the taxpayer's deficiency resulted from its reliance on a method considered appropriate by an individual agent settling an adjustment for prior years although in apparent direct conflict with the plain language of Reg. Sec. 1.61-21 and Notice 89-110." In support of this statement, the Letter Ruling says that "erroneous advice given by an individual agent does not stop the Service from making adjustments attributable to the taxpayer's reliance on such advice." Cases cited include *Miller v. U.S., Posey v. U.S., Bay Sound Transportation Co. v. U.S. and Elkins v. Commissioner.*

Apparently the taxpayer's (representative) also tried to raise the issue of inconsistent application of the enforcement of the demonstrator rules by examining agents. However, the National Office turned a deaf ear on those arguments. The Ruling states... "Neither is the proper application of the rules hindered by the existence of any settlement between the Service and other taxpayers in the industry on allegedly more favorable terms with respect to valuing employee use of company vehicles."

THE EVEN MORE DISTURBING MESSAGE

The National Office discussion of the taxpayer's "reliance on erroneous advice from IRS agents or reliance on prior settlements" contains a very significant message: Any taxpayer who happens to get by with a "favorable," but erroneous settlement of the demo valuation rules on audit cannot rely on that method as assuring the basis for the settlement of demo valuations in later years.

The IRS simply will not be bound in later years by prior year settlement concessions—(whether arrived at out of ignorance, expediency or other circumstance)—where the application of the "demo rules" in later years to identical facts produces different and obviously less favorable results for the employer and/or the employees.

Few dealers are willing to accept the "fair market value" standard for valuing demos provided to employees (including themselves and their family members) ... Most other employees are not willing to accept this standard either. A blunt interpretation of the "deeper message" in LTR 9816007 is that even though a taxpayer's representative may "BS" his way to a favorable settlement on the valuation of demonstrator vehicles in one year, that settlement will not be worth the paper it is written on as far as binding IRS agents in later years to settle on the same basis.

LTR 9816007 raises even more concern over the holdings in LTR 9801002 earlier this year. It's really very simple once you get through all the technicalities: Demos are little time bombs that can go off just about any time an agent wants to come in and dig into the facts and write up the adjustments. Hopefully, all those little time bombs won't go "bang" at the same time and create one big explosion.

BETTER THINK TWICE ABOUT WAITING FOR THE IRS TO COME IN AND MAKE YOU CHANGE ACCOUNTING METHODS

CAMs NOTICE 98-31

Previous issues of the *Dealer Tax Watch* have summarized the extensive revisions by the IRS in Revenue Procedures 97-27 and 97-37 telling dealers how to apply for changes in accounting methods. Now the noose is being tightened around the neck of a dealer who persists in using an erroneous method of accounting (i.e., one that does not clearly reflect income) and who hopes to just hide from the IRS and never get caught.

Recently published IRS Notice 98-31 (1998-22 IRB 10) contains the text of a proposed revenue procedure explaining how IRS examining agents and Appeals Officers will deal with recalcitrant taxpayers. These procedures will be followed for changes in accounting methods that are initiated by the IRS once an audit starts. It also outlines procedures the IRS will use for accounting method issues that it raises and resolves without changing the taxpayer's method (i.e., on a "nonaccounting method change" basis).

IRS AGENT AUTHORITY

In resolving method of accounting controversies, IRS agents are to treat any timing issue as an accounting method change and to make the change *in the earliest tax year* under examination with a Section 481(a) adjustment with only a one-year period. This will be the standard procedure unless IRS published guidance directs otherwise.

Examining agents changing a taxpayer's method of accounting are to properly apply the law to the facts without taking into account the hazards of litigation when determining the new method. Agents will be required to impose a Section 481(a) adjustment, with the proviso that a change in method may be made using a cut-off method "only in rare and unusual circumstances where the examining agent determines that the taxpayer's books and records do not contain sufficient information to compute the adjustment and the adjustment is not susceptible to reasonable estimation."

APPEALS OFFICERS & GOVERNMENT COUNSEL AUTHORITY

Notice 98-31 also tells how Appeals Officers and Counsel for the Government may do more to resolve timing issues when it is in the best interest of the Government to do so. Typically, this is done to reflect the hazards of litigation and results in either (1) a compromise of terms and conditions, or (2) on a "nonaccounting method change basis" using an alternative-timing or a time-value-of-money resolution. Under these circumstances, the change in accounting method may be made (1) by using a Section 481(a) adjustment (to pick up prior year adjustments) or by (2) a cut-off method (to make the change effective only on a prospective or going-forward basis).

Accordingly, where an Appeals Officer or Government Counsel change a taxpayer's method of accounting, the terms and conditions may be significantly different from those an IRS examining agent would offer. Under this delegation of authority, an Appeals Officer or Government Counsel may compromise the year of change by agreeing to a year of change later than the earliest open year, may compromise the amount of the Section 481(a) adjustment by agreeing to a reduced amount, or may agree to a Section 481(a) adjustment period longer than one year. All such agreements must be in writing.

OTHER FORMALITIES FOR IRS-INITIATED METHOD CHANGES

Notice to taxpayers: The IRS will be required to give taxpayers notice that a timing issue is being treated as an accounting method change. This notice must be in writing, but it can be given in different forms. Typically, it will be in the form of a closing agreement. However, other notices to the taxpayer will suffice for this purpose.

The notice must include a statement that the timing issue is being treated as an accounting method change or a clearly labeled Section 481(a) adjustment, and the new method of accounting must be described. If the Service does not provide this required notice to the taxpayers, the resolution of a timing issue will not establish a new method of accounting for the treatment of that item.

Coordination of CAM with all returns: Notice 98-31 includes procedures to assure that all the adjustments necessary to effect an IRS examining agent/Service-initiated accounting method change will be made in three types of returns: (1) tax returns under examination (before Appeals or before a Federal Court), (2) tax returns filed for succeeding years for which tax returns have already been filed (i.e., typically by the filing of amended returns to reflect the new accounting method), and (3) on all returns filed in future years to assure the continued use of the new method of accounting.

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Once the Service-initiated method change is finalized, that finalization establishes a new method of accounting which the taxpayer is required to use for the year of change and for all subsequent years, unless and until (1) the taxpayer obtains the consent of the IRS Commissioner to change from that new method to another method or (2) until the IRS changes the taxpayer from the new method on subsequent examination.

The proposed revenue procedure makes it clear that the IRS generally will not be precluded from changing the taxpayer from the new method of accounting (i.e., the method the Service puts the taxpayer on) if the Service later determines that the "new" method of accounting still does not clearly reflect the taxpayer's income. In other words, the IRS can modify or enhance the "new" accounting method as it learns more about what is involved.

"NONACCOUNTING-METHOD-CHANGE" RESOLUTIONS

Appeals Officers or Government Counsel may also resolve a timing issue by not changing the taxpayer's method of accounting and by, instead, agreeing that the taxpayer will pay the Government a "specified amount" that approximates the time-value-of-money benefit that the taxpayer has derived from using its method of accounting for the applicable taxable years. This "specified amount" may be subject to a reduction by an appropriate factor to reflect the hazards of litigation. The "specified amount" is not deductible nor capitalizable by the taxpayer, nor is it deductible as interest under Section 163(a).

As a class of taxpayers, automobile dealers with improper LIFO conformity reporting on their year-end Factory statements recently experienced this type of "nonaccounting method change basis" settlement under Revenue Procedure 97-44. In this case, dealers with LIFO conformity violations paid a non-deductible settlement amount spread over three years (4.7% of the LIFO reserves at December 31, 1996) instead of being taken off the LIFO method for their inventories and being put back on specific identification.

By agreeing to "alternative timing" for all or for some of the items, the taxpayer will pay the IRS any taxes and interest due as a result of the resolution, typically on the basis of a time-value-of-money computation. Also under these circumstances, the closing agreement finalizing the case must affirmatively state that the Service is <u>not</u> changing the taxpayer's method of accounting. In these situations (i.e., where what would otherwise be method of accounting changes are resolved on an alternative-timing basis), procedures are set up to assure that the appropriate adjustments are made to the tax returns for all years before the Service, for succeeding years for which tax returns already have been filed, and for future years.

IRS PRIES OPEN THE STATUTE OF LIMITATIONS

Several examples are included in Notice 98-31. It is clear from these examples that by using Section 481(a) adjustments, the IRS will, in effect, reach beyond the earliest open year to undo a deduction taken in a year the taxpayer thought was closed by the statute of limitations. Here's one example:

*"**FACTS.*** A taxpayer that is a corporation deducted certain costs that, as a matter of law, should have been capitalized as part of the cost of a nondepreciable asset that was acquired in 1994. The taxpayer incurred and deducted $1,000,000 of the costs in 1994, $2,000,000 in each of 1995 and 1996, and $5,000,000 in each of 1997 and 1998. The taxpayer is examined for the 1995 and 1996 taxable years (1995 is the earliest open year) and the examining agent discovers the taxpayer's impermissible method of accounting.

*"**EFFECT.*** Under Section 5 of this revenue procedure, the examining agent is required to properly apply the law to the facts and change the taxpayer to the capitalization method of accounting for the costs for 1995. The examining agent will provide the notice required by Section 7.01 of this revenue procedure. <u>The examining agent will impose a Section 481(a) adjustment of $1,000,000 (representing the $1,000,000 of the costs deducted in 1994), the entire amount of which will be taken into account in computing taxable income in 1995.</u>

"The examining agent will also disallow the deductions of $2,000,000 in each of 1995 and 1996. The taxpayer's basis in the property as of the end of 1996 is increased by $5,000,000 (representing the $1,000,000 Section 481(a) adjustment and the disallowance of the $2,000,000 of deductions in each of 1995 and 1996). The method change (once final) is effective for 1995. Thus, the taxpayer is required to capitalize the costs in 1995 and all subsequent taxable years, unless the taxpayer obtains the consent of the Commissioner to change the method or the Service changes the taxpayer from the method on subsequent examination."

From this example, it is clear that if one thought the $1,000,000 deduction taken in 1994 was "safe" or beyond IRS adjustment or correction because 1994 was closed and 1995 was the earliest open year, that would not be the case. An IRS examination-initiated change in accounting method will put an amount of income ($1,000,000) corresponding to that deduction in the closed year (1994) into the earliest open year

see **IRS NOTICE 98-31...**, page 10

 (Continued from page 9)

(1995). Also, the deductions claimed in 1997 and 1998 will have to be capitalized in accordance with the new (capitalization) method under the procedure "for tax returns filed for succeeding years for which tax returns have already been filed."

Note how this approach by the IRS can be used in situations that do not appear on the surface to involve method of accounting issues. In a case involving a disagreement over whether payments in a dealership buy-out were amortizable as payments for a non-compete agreement or were non-deductible for goodwill, the IRS wanted to disallow $1,500,000 that a dealership paid out and deducted over five years ($300,000 per year). This case involved years before Section 197 was enacted.

The IRS wanted to make a Section 481(a) adjustment to the earliest open year (1992) for the entire $1,500,000 that the buyer had paid and deducted in prior (closed) years. On the other hand, the taxpayer's position was that the statute of limitations had already run on the years 1988 through 1991, during which it had claimed a deduction of $300,000 per year.

These were the facts in the *Mealy-Serra Chevrolet* Petition filed in the Tax Court in 1996 (Docket No. 4741-96). The non-compete and consulting agreements arose out of the purchase of the assets of a Chevrolet dealership in California in 1987 with a total price of $7,200,000. Out of that total price, only $200,000 had been allocated to goodwill by the taxpayer.

The IRS wanted to bunch the entire $1.5 million payment into taxable income into 1992 by a two-pronged approach. First, it disallowed the amortization of the covenant not to compete in the amount of $300,000 for 1992. Second, it added $1.2 million ($300,000 x 4 years) to 1992 income under the following rationale:

"It has been determined that you understated income on your return for the taxable year ending June 30, 1992 in the amount of $1,200,000 as a result of claiming a deduction of $300,000 for each of the four prior years based on a covenant which has been determined to have no substance. The understated amount is determined to be taxable to you because you have failed to establish that it is excludable from gross income under provisions of the Internal Revenue Code. Accordingly, income is increased $1,200,000."

Note the absence of any language specifically referring to a Section 481(a) adjustment or to a change in accounting method issue.

TIMETABLE

The IRS has requested that comments on the proposed revenue procedure outlined in Notice 98-31 be submitted by July 31. After studying any comments received, the IRS will finalize this revenue procedure. Once the revenue procedure is finalized, it will become effective 90 days after the date it is published in the Internal Revenue Bulletin. However, taxpayers and the IRS may agree to apply the procedures sooner.

TO WAIT...OR NOT TO WAIT

Meanwhile, the key question remains: To wait–or not to wait–for an IRS audit to force a change in method.

Under an IRS initiated change, the entire amount of Section 481(a) adjustment will come into income in one year, and that year will be the earliest open year under the statute. On the other hand, if the taxpayer volunteers to change from an improper/erroneous accounting method, the taxpayer will receive a four-year spread period for the Section 481(a) adjustment, and the year of change will be pushed forward to the year for which the Form 3115 is filed. Taxpayer initiated (i.e., "voluntary") changes involving LIFO inventories will usually receive the benefit of the cut-off transition method, with no Section 481(a) adjustment being involved.

The IRS hopes to increase the number of accounting method issues that it can resolve earlier in the examination and/or appeals processes and to provide for a more efficient use of IRS and taxpayer resources. Hopefully, there will also be greater *uniformity* in the Service's resolution of accounting method issues.

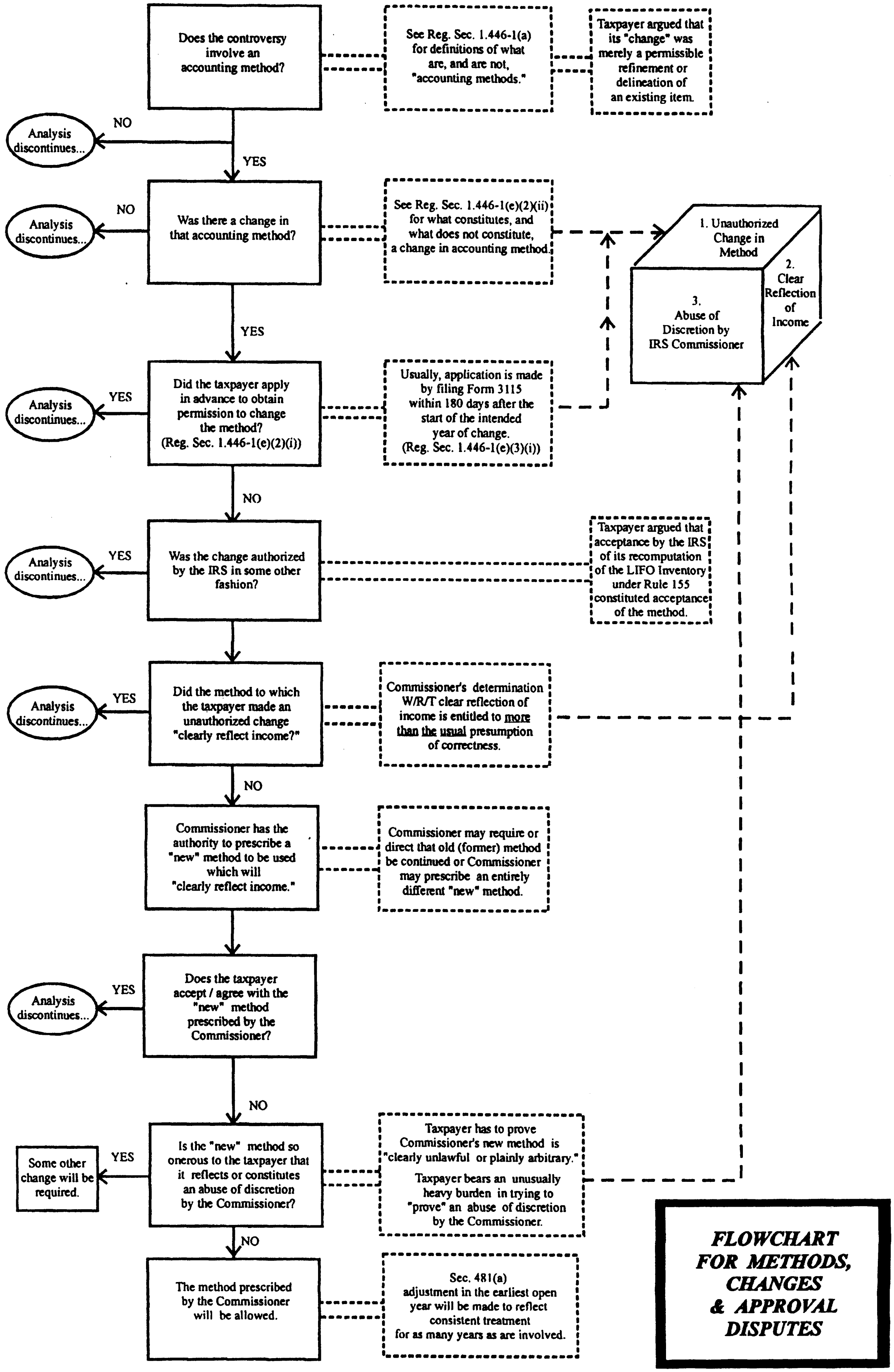
Other CAM subjects on which the IRS later intends to publish guidance include:

1. A prototype or model closing agreement for IRS-initiated accounting method changes, and

2. How taxpayers who are not part of the IRS' Coordinated Examination Program (CEP) may use that program's early referral process to resolve accounting issues.

CONCLUSION

With the publication of Notice 98-31, the general mood among practitioners seems to be that taxpayers should now be "volunteering" to make their changes before an IRS audit starts, rather than waiting until an audit starts and risking "getting caught".



FLOWCHART FOR METHODS, CHANGES & APPROVAL DISPUTES

CAMs	RULES & TERMS CHANGES IN ACCOUNTING METHODS
CAMs IN GENERAL	A change in method of accounting includes a change in the overall plan of accounting for gross income or deductions, or a change in the treatment of any ***material*** item used in such overall plan.
INVENTORY CAMs	A change in an overall plan or system of identifying or valuing items in inventory is a change in method of accounting. A change in the treatment of any material item used in the overall plan for identifying or valuing items in inventory is a change in method of accounting.
MATERIAL ITEMS, TIMING & IMPACT ON LIFETIME INCOME	A ***material*** item is any item that involves the proper time for the inclusion of the item in income...or the taking of the item as a deduction. In determining whether a taxpayer's accounting practice for an item involves timing, generally the relevant question is whether the practice permanently changes the amount of the taxpayer's ***lifetime income***. If the practice does not permanently affect the taxpayer's lifetime income, but does or could change the taxable year in which income is reported, it involves timing, and it is therefore a method of accounting.
CONSISTENT TREATMENT	A method of accounting is not adopted in most instances without consistent treatment. The treatment of a material item in the same way in determining the gross income or deductions in two or more consecutively filed tax returns (without regard to any change in status of the method as permissible or impermissible) represents consistent treatment of that item. If a taxpayer treats an item properly in the first return that reflects the item, however, it is not necessary for the taxpayer to treat the item consistently in two or more consecutive tax returns to have adopted a method of accounting. If a taxpayer has adopted a method of accounting under these rules, the taxpayer may not change the method by amending its prior income tax returns(s).
CHARACTERIZATION	A change in the ***characterization*** of an item may also constitute a change in method of accounting if the change has the effect of shifting income from one period to another. For example, a change from treating an item as income to treating the item as a deposit is a change in method of accounting.
CORRECTING ERRORS	A change in method of accounting does not include the correction of mathematical or posting errors, or errors in the computation of tax liability (such as errors in the computation of the foreign tax credit, net operating loss, percentage depletion or investment credit).
PENALTIES	Any otherwise applicable penalty for the failure of a taxpayer to change its method of accounting (for example, the accuracy-related penalty under Section 6662 or the fraud penalty under Section 6663) may be imposed if the Service initiates an accounting method change. Additionally, the taxpayer's return preparer may also be subject to the preparer penalty under Section 6694.

TIMING ISSUE	The term "*timing issue*" means any issue regarding the propriety of a taxpayer's method of accounting for an item.
YEAR OF CHANGE	The year of change is the taxable year for which a change in method of accounting is effective; i.e., it is the first taxable year the new method is used, even if no affected items are taken into account for that year. The year of change is also the first taxable year for complying with all the terms and conditions accompanying the change. In ***CAMs*** ***<u>initiated by the IRS</u>***, the year of change will be the earliest open year. In ***CAMs*** ***<u>voluntarily applied for by the taxpayer</u>***, the year of change will be the year for which the taxpayer properly and timely files Form 3115.
SECTION 481(a) ADJUSTMENT PERIOD	The *Section 481(a) adjustment period* is the applicable number of taxable years for taking into account the Section 481(a) adjustment required as a result of the change in method of accounting. The year of change is the first taxable year in the adjustment period and the Section 481(a) adjustment is taken into account ***ratably*** over the number of taxable years in the adjustment period. In ***CAMs*** ***<u>initiated by the IRS</u>***, there is no spread period, and the entire Section 481(a) adjustment is taken into income in the earliest open year. In ***CAMs*** ***<u>voluntarily applied for by the taxpayer</u>***, the spread period is four years, regardless of whether the Section 481(a) adjustment is positive or negative.
CUT-OFF METHOD	Under a cut-off method, only the items arising on or after the beginning of the year of change are accounted for under the new method of accounting. Any items arising before the year of change continue to be accounted for under the taxpayer's former method of accounting. Because no items are duplicated or omitted from income when a cut-off method is used to effect a change in accounting method, no Section 481(a) adjustment is necessary. In ***CAMs*** ***<u>voluntarily applied for by the taxpayer</u>*** involving ***<u>LIFO inventory methods</u>*** (except for *Hamilton Industries/Kohler/LaCrosse Footwear* bargain purchase-type inventory transactions), the CAM is ***<u>generally made using the cut-off method</u>***.
EXAMPLES OF CHANGES THAT ARE NOT CAMs	Certain changes do ***<u>not</u>*** rise to the level of a ***change in method of accounting***. • ***<u>Correction of</u>*** mathematical or posting ***<u>errors</u>***. • A change in treatment resulting from a ***<u>change in the underlying facts</u>***. • Adjustment of any item of income or deduction which does ***<u>not</u>*** involve the proper time for the inclusion of an item of income or the taking of a deduction.

IN CAM DISPUTES	THE COMMISSIONER IS ALWAYS RIGHT ... USUALLY
CLEAR REFLECTION OF INCOME	The computation of taxable income must be made in the manner that, in the opinion of the Commissioner, does ***clearly reflect income***.
BROAD DISCRETION UNLESS CLEARLY UNLAWFUL	The Commissioner has ***broad discretion*** in determining whether a taxpayer's method of accounting clearly reflects income, and the Commissioner's determination must be upheld ***unless*** it is ***clearly unlawful***.
QUESTION OF FACT	Whether a taxpayer's method of accounting clearly reflects income is a ***question of fact***, and the issue must be decided on a ***case-by-case*** basis. Section 446(a) requires a taxpayer to compute taxable income using the method of accounting it regularly uses in keeping its books.
TWO TESTS FOR INVENTORY METHODS	In regard to inventory accounting, a method of accounting for inventory must conform to ***two distinct tests***: (1) It must conform as nearly as may be to the best accounting practice in the trade or business, and (2) It must clearly reflect income.
ABUSE OF DISCRETION	The Commissioner has broad discretion in selecting a method of accounting that the Commissioner believes properly reflects the income of a taxpayer once the Commissioner has determined that the taxpayer's method of accounting does not ***clearly reflect income***. The Commissioner's selection (of an appropriate accounting method for the taxpayer) may be challenged only upon showing an ***abuse of discretion*** by the Commissioner.
MORE THAN ONE CHANGE BY THE IRS IS POSSIBLE	The Commissioner has the discretion to change a taxpayer's method of accounting even though the Commissioner previously changed the taxpayer to that method ... if the Commissioner determines that that method of accounting (still) does not clearly reflect the taxpayer's income. The Commissioner is not precluded from correcting mistakes of law in determining a taxpayer's tax liability, including the power to retroactively correct rulings or other determinations on which the taxpayer may have relied. (*Dixon v. United States*, 381 U.S. 68 (1965); *Automobile Club of Michigan v. Commissioner*, 353 U.S. 180 (1957); *Massaglia v. Commissioner*, 286 F.2d 258 (10th Cir. 1961).)
LIMITATION ON COMMISSIONER	The Commissioner does ***not*** have discretion, however, to require a taxpayer to change from a method of accounting that clearly reflects income to a method that, in the Commissioner's view, ***more*** clearly reflects income. (*Capitol Federal Savings & Loan v. Commissioner*, 96 T.C. 204 (1991); *W.P. Garth v. Commissioner*, 56 T.C. 610 (1971), acq., 1975-1 C.B. 1.)
PROTECTION BY FILING FORM 3115 BEFORE IRS AUDIT STARTS	The Commissioner may change the accounting method of a taxpayer that is under examination, before an Appeals Office, or before a Federal Court, except as otherwise provided in published guidance. ***However***, Section 9 of Rev. Proc. 97-27 generally prevents the Service from changing a taxpayer's method of accounting for an item for prior taxable years if the taxpayer has timely filed a Form 3115 (pursuant to Rev. Proc. 97-27) requesting permission to change its method of accounting for the item.
NO RIGHT TO RETROACTIVE CHANGES	A taxpayer does not have a ***right*** to a retroactive change, regardless of whether the change is from a permissible or impermissible method. ***However***, the Commissioner is authorized to consent to a retroactive accounting method change.

IRS WON'T INITIATE CHANGES FAVORABLE TO THE TAXPAYER	The Service ordinarily ***will not*** initiate a taxpayer favorable method change. Consistent with the policy of encouraging prompt voluntary compliance with proper tax accounting principles, the Service ordinarily will not initiate an accounting method change if the change will place the taxpayer in a position more favorable than the taxpayer's position would have been had the taxpayer not been contacted for examination. For example, an examining agent ordinarily will not initiate a change from an impermissible method that results in a negative Section 481(a) adjustment. If the Service declines to initiate such an accounting method change, the District Director will consent to the taxpayer requesting a voluntary change under Revenue Procedure 97-27.
SECTION 481(a) ADJUSTMENTS	Section 481(a) requires those adjustments necessary to prevent amounts from being duplicated or omitted to be taken into account when the taxpayer's taxable income is computed under a method of accounting different from the method used to compute taxable income for the preceding taxable year. When there is a change in method of accounting to which Section 481(a) is applied, income for the taxable year preceding the year of change must be determined under the method of accounting that was then used, and income for the year of change and the following taxable years must be determined under the new method of accounting as if the new method had always been used.
PRE-1954 YEARS	If the adjustments required by Section 481(a) are attributable to a change in method of accounting not initiated by the taxpayer (i.e., a ***CAM initiated by the IRS***), no portion of any adjustments which is attributable to pre-1954 taxable years is taken into account in computing taxable income.
TERMS & CONDITIONS FOR CAMs	The adjustment required by Section 481(a) may be taken into account in determining taxable income in the manner and subject to the conditions agreed to by the Commissioner and the taxpayer. Generally, in the absence of such an agreement, the Section 481(a) adjustment is taken into account completely in the year of change, subject to Section 481(b) which limits the amount of tax where the adjustment is substantial.
CUT-OFF METHOD RELIEF	The Commissioner may determine that certain changes in method of accounting will be made without a Section 481(a) adjustment, using a ***"cut-off method."*** Under a cut-off method, only the items arising on or after the beginning of the year of change are accounted for under the new method of accounting. Any items arising before the year of change continue to be accounted for under the taxpayer's former method of accounting. Because no items are duplicated or omitted from income when a cut-off method is used to effect a change in accounting method, no Section 481(a) adjustment is necessary.
OTHER CAM SITUATIONS	The Commissioner may require a taxpayer that has changed a method of accounting without the Commissioner's consent to change back to its former method. The Commissioner may do so even when the taxpayer changed from an impermissible to a permissible method. The change back to the former method may be made in the taxable year the taxpayer changed without consent, or if that year is closed by the running of the period of limitations, in the earliest open year. (*Commissioner v. O. Liquidating Corp.*, 292 F.2d 225 (3rd Cir.), cert. denied, 368 U.S. 898 (1961); *Handy Andy TV and Appliances, Inc.*, T.C. Memo. 1983-713.)

CAMs	RECENT IRS & TAX COURT ACTIVITY OF INTEREST TO DEALERS
REVENUE PROCEDURE 97-27 ***MAY, 1997***	Revenue Procedure 97-27 issued in May, 1997 considerably simplifies many rules, terms and conditions involved when taxpayers have to request permission from the IRS to change accounting methods ... including LIFO inventory accounting methods. The requirement that the Form 3115 request must be filed within the first 180 days of the year of the change was removed, and several difficult technical definitions were eliminated. The 90-day window for filing 3115s by taxpayers coming under IRS audit also was eliminated. The previous 6-year spread period for reporting positive Section 481(a) adjustments in income was shortened to four (4) years. Effective May 15, 1997. ***DTW - MARCH, 98 - PAGE 8***
REVENUE PROCEDURES 97-36 97-37 97-38 ***SEPT. & OCT., 1997***	Revenue Procedures 97-36, 97-37 and 97-38 collectively deal with accounting method changes where taxpayers will be granted ***automatic*** consent by the Commissioner to make their changes. Relevant changes in these revenue procedures include (1) the termination of LIFO elections, (2) the republication of the Alternative LIFO Method for Automobile Dealers, (3) the republication of the Service Warranty Income Method (SWIM) for dealer obligors in connection with their extended warranty or VSC contract sales, and (4) certain application matters relating to used vehicle LIFO. There is still no IRS approved LIFO method for used vehicles ... although there is one for new vehicles. (R.P. 97-36) The republication of the Alternative LIFO Method in Revenue Procedure 97-36 and the republication of the SWIM method in Revenue Procedure 97-38 share common elements. First, each method is repeated essentially word-for-word, with no real modification or further illumination from the original. Second, the revenue procedures they replaced (Rev. Proc. 92-79 and 92-98, respectively) contained cumbersome transition rules which the 1997 documents were able to delete. The final common element between them is that if an auto dealer previously "volunteered" to make these accounting method changes under the predecessor documents, then no further action is required. ***DTW - SEPT., 97 - PAGE 6 & MARCH, 98 - PAGE 8***
BUYERS HOME WARRANTY COMPANY ***MARCH 9, 1998***	***Buyers Home Warranty Company,*** (T.C. Memo 1998-98) clearly shows the hazards in playing a "wait and see" game with the IRS over questionable accounting methods. The IRS determined that the taxpayer's method of accounting did not accurately reflect income and proposed to change the method, with a corresponding adjustment under Section 481(a). The Tax Court upheld the IRS in determining that the ***year of change*** for starting the new accounting method ***was the earliest open year*** (1990), and not three years later in 1993 when the IRS started its examination. ***DTW - MARCH, 98 - PAGE 4***
VEHICLE SERVICE CONTRACTS (VSCs) & THE SWIM METHOD ***REVENUE PROCEDURE 97-38 (1997)***	Revenue Procedure 97-38 now describes the SWIM (Service Warranty Income Method) that may be used by auto dealers who are ***dealer obligors*** for treating part of the income payments received in the year of sale in a specialized manner. Revenue Procedure 97-37 contains the procedures for obtaining automatic IRS consent to change to the SWIM method, as well as to make a corresponding change in the treatment of deducting insurance premiums related to the multi-year VSCs (or vehicle service warranty contracts). If a dealer properly changed to the SWIM method ... in 1992 or a later year ... pursuant to Revenue Procedure 92-98, it is <u>not</u> required to do anything further to comply with the restatement Revenue Procedure 97-38, nor is it required to refile any Form 3115. ***DTW - SEPT., 97 - PAGE 6***
RAMEAU JOHNSON, ET., AL. ***JUNE 16, 1997***	The dealerships in ***Rameau Johnson Et. Al. V. Comm.*** (108 T.C. No. 22) were dealer obligors using escrow funds under a program administered by Automotive Professionals, Inc. (API). The Tax Court upheld the IRS in requiring the dealerships to currently include in gross income the entire amount of VSC sales proceeds received, even though a substantial portion of the proceeds received was immediately deposited in escrow accounts. The dealerships were not allowed to exclude the sales proceeds under the theories that the amounts were either "customer deposits" or held in a "trust fund" for the benefit of the VSC purchasers. The dealerships must currently include the investment income of the escrow account income in gross income and premiums paid for insurance policies to protect the dealerships against excess losses arising under the VSCs are capital expenditures that must be recovered through amortization. ***DTW - SEPT., 97 - PAGE 15***

CORDES FINANCE CORPORATION ***APRIL 1, 1997***	***Cordes Finance Corporation v. Comm.*** (T.C. Memo 1997-162) is a classic case of the IRS coming in and finding an improper method which it then changes under its authority provided in Section 446. There really was no good argument that could have been raised in defense of the method used by the taxpayer: It accrued interest only when a loan was fully paid or when it repossessed the vehicle securing the loan. As a result of the IRS change, the Company had to accrue interest ratably over the life of each loan, resulting in an adjustment of almost $3.1 million. The Service also found that the Company had understated interest income by another $1.6 million which was the difference between the interest reported on individual customer note cards and the total of the control account which had not been reconciled to the detail for 20 years. The major issues involved the Company's method of accounting for the interest earned on its portfolio of car loans under which the Company (1) did not accrue interest on any loan that was outstanding at the end of the year and (2) treated interest as having been earned only when a loan was fully paid off or after the vehicle securing the loan was repossessed. ***DTW - JUNE, 97 - PAGE 22***
E.W. RICHARDSON ***AUGUST 12, 1996*** ***New vehicle LIFO inventories before the Alternative LIFO Method was available***	The IRS took the position that ***Richardson Investments*** (T.C. Memo 1996-368) made an unauthorized change in the treatment of ***material items*** when it changed the definition of its inventory units for its new car LIFO inventory pool from body size to model line in 1981. The Tax Court concluded that Richardson changed its definition of its ***item*** of inventory without the predicate change in facts required for the creation of a new or separate item. Therefore, the Court held that Richardson's change in definition of its item of inventory was <u>not</u> due to the creation of a new or separate item. When Richardson changed its definition of an item in inventory (which resulted in lower annual and cumulative indexes and, therefore, affected the computation of beginning and ending inventory), <u>the change was a change in the treatment of a material item</u>. After changing its definition of item for its new car pool from body size to model line in 1981, Richardson did not file Form 3115 or otherwise request the IRS' consent to change its LIFO method. Therefore, the Tax Court concluded that *Richardson* had changed its method of accounting without IRS consent. ***LIFO LOOKOUT - SEPT., 96 - PAGE 3***
REV. PROC. 94-49 DEALERS LAST CHANCE TO ADOPT SECTION 263A WITHOUT PENALTY ***JUNE 28, 1994***	In general, taxpayers were allowed to use Revenue Procedure 94-49 if they previously did not capitalize any costs under Section 263A or if they mistakenly thought they were exempt, but in fact were not. Under the revenue procedure, the Commissioner's consent was automatically granted to a taxpayer to make the change to reflect Section 263A Inventory Cost Capitalization adjustments so long as the taxpayer complied with certain provisions, including making a Section 481(a) adjustment to cover all prior years and taking it into income ratably over 4 years (unless a $25,000 *de minimis* rule applies). ***DTW - DEC., 94 - PAGE 9***
HINSHAW'S INC. ***JULY 18, 1994***	In ***Hinshaw's Inc.*** (T.C. Memo 1994-327), the dealer offered extended vehicle services contracts to its customers under which the dealer's liabilities were insured by third parties. The Tax Court held that all amounts collected by the dealer for long term VSCs must be included in gross income in the years of receipt under IRC Section 61. The Tax Court also held that the amounts that Hinshaw's paid for insurance premiums and for administration services fees were not deductible under Section 162, but were amortizable over the life of the vehicle service contracts. Because there was a shifting of risk, the Court concluded that the amounts paid were amortizable. ***DTW- SEPT., 94 - PAGE 22***

GM DEALERS LOW ON LIFO INVENTORY MAY FACE STIFF RECAPTURE ...PLANNING MAY LESSEN THE BLOW

STRIKE & LIFO RECAPTURE

LIFO is a great tax deferral for auto dealers. It allows dealers to deduct the impact of inflation in their inventories while the vehicles are still on hand at year-end ... instead of making the dealers wait until the next year when those inventories are sold.

Over the years, many dealers have built up substantial LIFO reserves and the ups and downs of their inventory levels produce situations that make it desirable—if not imperative—to know and keep track of how the total LIFO reserves are locked into each different year's layer in the ending inventory.

"What goes around...comes around." Even LIFO lives up to this adage, sometimes rearing its recapture potential at the worst of times. For GM Dealers feeling the effect of the union strike at General Motors on their inventories, after dealing with the more pressing problems of trying to get inventory in any way possible to maintain customer loyalty, the secondary impact of reduced inventory levels on the dealer's bottom line creates an unwelcome result: taxable income is triggered which is not matched by dollars received.

As the inventory levels decrease and the LIFO reserves decrease, this produces an increase in the dealer's gross profit based on the "paper income" or previously deferred "inflation" which is now coming into taxable income because inventory levels at the beginning of the year cannot be restored by year end.

Some dealers and CPAs will recall back in the summer of 1984 there was concern about the possibility of strikes affecting year-end inventory levels. At that time, much was said about how dealers might try to "dodge the LIFO recapture bullet." Since then, changes in the LIFO landscape require consideration as to how they affect possible strategies to minimize LIFO liquidations. These changes include

1. The introduction of the Alternative LIFO Method in 1992 for new vehicles,
2. The greater scrutiny the IRS has focused on the dealer financial statement conformity requirement,
3. The success the Internal Revenue Service has had after 1984 in challenging attempts by taxpayers to unreasonably replenish sinking year-end inventory levels, and
4. Recent changes in procedures for changing accounting methods that now require less before-the-fact involvement by the IRS.

PROJECTING THE PAYBACK CONSEQUENCES

It is unrealistic to attempt any serious planning for a dealership without first making projections of the change in the LIFO reserves for the upcoming year-end. These projections should be made far enough in advance so that the dealer can consider not only the financial impact of what is likely to happen, but also whether legitimate steps, motivated by sound business reasons, can or should be undertaken to produce a result different from that shown by the projections.

One thing is certain: After year-end, it will be too late to change the results that might have been avoided by proper planning with adequate timing. Even if a dealer concludes that nothing can be done to avoid the payback consequences, it is far better to know the extent of the impending "hit" so that other buffering actions can be taken, than it is to be caught entirely by surprise, without any idea of how big the hit is going to be.

The net change in the LIFO reserve for any year is the result of complementing or offsetting price and/or inventory investment payback factors.

Upward influences...causing LIFO reserves to increase:

1. Price increases ...inflation.
2. Quantity increases, if a dual index methodology/approach is used. (Note: this does not happen with the Alternative LIFO Method for Auto Dealers.)

Downward influences...causing LIFO reserves to decrease:

1. Price decreases ...deflation.
2. Decreases in inventory investment levels—i.e., paybacks of previously built-up annual LIFO increments and reserves because of the carryback of a current year quantity decrease (referred to as "decrements") against the increases ("increments") that were built up in prior years.

If year-end LIFO projections show that the dollar amount of the ending inventory (expressed in terms of base dollars) is projected to be lower than the beginning of the year inventory amount (also expressed in base dollars), that means there is going to be a liquidation or decrement in a technical LIFO sense.

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However, that liquidation or decrement may not necessarily cause, or result in, payback of some or all of the LIFO reserve at the beginning of the year. Whether or not there is a "payback" depends on how the prior year layers were (1) built up over time and (2) valued for LIFO purposes. (For those who want more mechanical analysis, see: "Why Do Some LIFO Reserves Go Up Even Though Inventory Levels Go Down?" in the March, 1992 *LIFO Lookout* and "Another Rebasing Example—With Proofs: Why LIFO Reserves Go Up Even Though Inventory Levels Go Down and Despite Rebasing Indexes to 1.000 in Between" in the June, 1993 *LIFO Lookout*.)

Often dealers are surprised ... and understandably skeptical ... when they are told that even though their inventory levels are projected to be lower at year-end, their LIFO reserves may actually be expected to increase. And sometimes these increases are significant. Although this may not be likely for many dealers severely affected by a strike, the actual LIFO reserve payback will vary considerably from dealer to dealer because every dealership LIFO calculation has its own unique history of fluctuating inventory levels.

Another thing is certain: The LIFO recapture, or payback, can be ***precisely calculated*** based on the different recapture potential that is associated with each annual layer of LIFO "increment" that has been built up over the years. Often, the payback potential is greater in one pool (either autos or light-duty trucks) than in the other pool for new vehicles. This has to be taken into account in planning which pool to replenish if it is not possible to replenish them both.

DECREMENT CARRYBACKS

The general rule is that the LIFO liquidation or decrement for a given year is carried back against layers built up in prior years on a Last-In, First-Out (LIFO) or reverse-chronological sequence. This means that the most recent/last layer built up is the first one eliminated, and then prior years' layers are eliminated in reverse-chronological order. In other words, a 1998 decrement is first carried back against any 1997 increment, then against 1996, then against 1995, then against 1994, etc. until the entire amount of 1998 decrement (expressed in base dollars) has been fully accounted for. In some instances, a decrement may end up being carried all the way back to the original first LIFO year base layer.

When there is a liquidation and the decrement carryback order described above is followed, any prior layer that is eliminated is gone forever. If the dealer restores his inventory to a higher level in a later year, the later year's increase cannot claim or reclaim the lower cost basis that was associated with the increments that were liquidated. Instead, that later year's increment must be valued at that later year's higher current cost.

PROJECTION EXAMPLE

The example on page 24 takes a dealership which had a $4,100,000 prior year ending inventory and for the next year end projects the change in the LIFO reserve at six (6) different inventory levels starting with $3,500,000 and decreasing successively by $500,000 to $1,000,000. Schedule I shows the complete projections and the net decrease in the LIFO reserve projected for 1998 based on the different inventory levels and an assumed inflation rate of 1.5% for the year.

It is important to understand the facts associated with the LIFO reserve at the end of the preceding year before doing the projections for the next year. The top part of Schedule II (page 25) shows two sets of facts relative to the LIFO reserve at Sept. 30, 1997. The first "fact" is the table showing the build up of annual layers of increment and their respective base dollar amounts, valuation factors, and LIFO valuations. The second "fact" relative to the prior year end inventory is the computation of the LIFO reserve recapture potential by layer as of that year end. This "fact", shown in table form in middle of Schedule II, is the real diagnostic necessary to gauge the impact of falling inventory levels in terms of the amount of recapture.

A summary of the projections for the year end 1998 is shown at the bottom of Schedule II with the net decrease in the LIFO reserve being $143,000 (rounded) if the year ending inventory is $3,500,000. The net decrease in the LIFO reserve (i.e., LIFO recapture) can go up to as much as $1,655,000 (rounded) if the year-end inventory level falls as low as $1,000,000. This projection summary also shows the two components operating to produce the net decreases in the LIFO reserve. The first is a slight upward influence on the LIFO reserve due to the 1.5% inflation for the year—which translates effectively into 1.825% as a result of the compounding. However, this inflation impact is far offset by the LIFO recapture as the previous annual increment layers are eroded by the 1998 decrement and yield their previously deferred inflation in the process.

Schedules III and IV (pages 26 & 27) show the detailed computations for each of the six assumed inventory levels—$3,500,000 down to $1,000,000—in terms of the specific prior year layers that are invaded as the inventory level falls and the corresponding decrements (expressed in base dollars) increase.

see **GM DEALERS LOW ON INVENTORY...**, page 20

The ***rate of payback*** is not a constant. Successive decreases in inventory level result in successive or corresponding increases in the rate of recapture. The rate of payback increases as the inventory level falls.

This can be seen by comparing the net decrease in the LIFO reserve as the ending inventory levels drop and calculating that change as a percentage of the loss of successive $500,000 inventory amounts. As the inventory level drops from $3,500,000 to $3,000,000 the LIFO reserve payback is a net $257,270 or approximately 51.4% of that $500,000 inventory level decrease. As successive $500,000 decrements occur, one would expect the rate of payback to increase...And it does. Our example shows that the rate of payback goes from 51% up to 60%, 60%, 64% and 68% as the successive inventory levels drop. This is relatively consistent with the second "fact" table in Schedule II showing the LIFO reserve recapture potential by layer as of September 30, 1997.

As the inventory levels decrease, there is a decrease in the amount of increase in the LIFO reserve attributable to the 1.5% assumed inflation for the year. Also, as inventory levels decrease, there is an accelerating increase in the payback factor for the lost base dollars due to the penetration deeper into the annual increment layers. The amount of the net change in the LIFO reserve that is due to inflation at each inventory level is simply 1.825% (the assumed 1.5% inflation rate, as compounded) multiplied by the amount on Line G(1) in Schedule I on page 24.

With this type of analysis and information available, one has the "X-rays" which can be read to help a dealer see how his efforts to increase inventory levels (in whatever ways may be most appropriate and feasible under the circumstances) can offset some of the otherwise unpleasant consequences foretold by this analysis. For a dealer able to move his inventory level farther to the left on Line B of Schedule I, the payback amount decreases. If a dealer (with the help of the X-rays interpreted by his advisors) can significantly limit the repayment at year end or even take some small measures to avoid the full projected hit, it may even be "Miller Time!"

NO SPECIAL RELIEF FOR STRIKE "VICTIMS"

There is a section in the revenue code, Section 473, that allows certain taxpayers to avoid the full impact of LIFO recapture when they experience "qualified liquidations" of their LIFO inventories. This section requires that the qualified liquidation be attributable to a "qualified inventory interruption" of the type described in a Department of Energy notice or regulation. Section 473 goes back to the Energy Crisis in the early '80s and is limited to Department of Energy

(Continued from page 19)

regulations with respect to energy supplies, embargoes, international boycotts or other major foreign trade interruptions. Consequently, Section 473 is not applicable in a strike situation for dealers and this Section has no counterpart that might help depressed dealers facing even more depressed inventory levels.

WHAT CAN A DEALER FACED WITH STRIKE-DEPLETED LIFO INVENTORIES DO?

The starting point is to calculate the pay-back potential from a series of reduced inventory levels to determine what the real impact is likely to be. For auto dealers, this recapture impact will be different for the new auto pool compared to what it will be for the new light-duty truck pool. The LIFO reserve repayment potential impact should be computed for <u>each</u> LIFO pool and expressed as a dollar amount that the dealer can understand.

Then, the alternatives fall into three categories, and a dealer fortunate to have the right fact pattern may be able to lessen the LIFO hit that is otherwise foretold:

1. **Manage inventory levels.** Attempt to increase or "manage" the inventory level through transactions that might not otherwise have been considered, but which still have some degree of business justification (other than solely attempting to minimize the impact of LIFO layer liquidations).

2. **Year-end change.** If eligible, change to a fiscal year-end that is prior to the year-end expected to be adversely affected by the significant inventory reduction.

3. **Switch to the BLS/IPIC method.** Consider changing to the BLS/IPIC method under the recent changes...and expeditious consent procedure... available in Section 10.04 of the Appendix to Revenue Procedure 97-37.

WHAT CAN BE DONE TO MANAGE INVENTORY LEVELS?

A dealer might attempt to increase or "manage" the year end inventory level by considering some transactions that otherwise would not have entered his mind. These may be rationalized (but not necessarily justified to the IRS <u>if</u> the IRS digs deeply into them) under the headings of "Nothing ventured, nothing gained" and/or "Desperate times call for desperate measures." These strategies should be regarded by dealers and their advisors as aggressive and not without the likelihood of challenge by the IRS. They are only generalized here and they should be carefully and more fully evaluated by the dealer's advisors before steps are taken to implement them.

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A dealer who considers the second alternative (year-end change) and third alternative (IPIC/BLS change) less appropriate or satisfactory might consider the following:

1. After determining which pool (new automobiles or new light-duty trucks) has the greater LIFO repayment potential, a dealer may simply try to have more inventory dollars in the pool with the greater repayment potential.

In other words, if the dealer can have only $1,000,000 worth of inventory, if the LIFO repayment payback potential is 30% on the dollar in the new automobile pool and 60% on the dollar in the new light-duty truck pool, the dealer should try to have more inventory dollars at year-end in the new light-duty truck pool than in the new automobile pool.

2. Attempt to purchase other make new vehicles (for resale to retail customers) to put into inventory.

Under the Alternative LIFO Method, all new automobiles, regardless of manufacturer, including those used a demonstrators, must be included in a dollar-value LIFO pool and all new light-duty trucks regardless of manufacturer, must be included in another separate dollar-value LIFO pool. Thus, the Alternative LIFO Method would appear to contemplate all new automobiles being placed in one pool, regardless of manufacturer. Accordingly, a GM dealer who has other non-GM franchises in the same selling entity as the GM franchise(s) might try to stock up on the non-GM new vehicles to the extent possible.

3. Similarly, a GM dealer might simply attempt to purchase (for retail sale) some very expensive makes (Lamborghini or Rolls Royce) and put them in the new automobiles pool. ("A few will do.") Does a dealer have to have that franchise to sell those vehicles? What about creating a special joint venture, or flow-through type entity with another *franchised* dealer?

How far can the "retail resale" aspect be pushed? Will this pass muster with the IRS? One cannot be sure...or might even doubt it, but refer to the "desperate measures" citation above.

Caution: Section 4.02 of Revenue Procedure 97-36 does contain some troublesome language relating to LIFO pools. It states that "<u>for each separate trade or business</u>," all autos, regardless of manufacturer, must be placed in one pool. No one really knows what "for each separate trade or business" really means and the IRS has yet to define or explain it. If these words don't mean anything, why are they there? Might the IRS assert some specialized interpretation for this term under these circumstances?

4. A dealer might actively seek out another GM dealer with less of a LIFO recapture impact potential and attempt to purchase inventory from that dealer, perhaps paying a "premium" or offering that dealer some other considerations for that inventory that makes the transaction economically attractive to both parties.

5. Dealers with multiple franchises in different entities should make similar LIFO recapture impact calculations for all their LIFO pools in all entities... to determine whether a shifting of inventory from one entity to another, if feasible, might create a favorable result.

6. Finally, although it may seem heresy, a dealer might consider not closing sales until after the end of the year. For some dealers, the illusion of what they hope to realize in gross profit and potential customer loyalty may be foolishness compared to the real dollar outflow that *definitely* will be caused by the reduction of inventory by that sale which will *definitely* trigger the LIFO recapture. Some dealers may simply be unable to make the right decision on this.

If a dealer is trying to avoid a significant LIFO reserve reduction, steps to increase the inventory level should be completed and documented before the end of the year and they should be considered only if they make sense from a business standpoint, after considering carrying costs, insurance and expected ability to sell the additional inventory.

Despite cautions that inventory purchasing decisions should be based on sound business judgment and not solely on the desire to reduce projected LIFO pay-backs, some dealers may still wish to pursue more aggressive strategies and to take their chances in this regard.

As discussed below, the IRS has been successful in challenging transactions that appeared to be motivated by the desire to avoid LIFO recapture impact. In these cases, the IRS ignored the last-ditch efforts that resulted in inventory on hand at year-end which was not "intended to be sold or placed in the normal inventory channels."

The Tax Court in 1996 observed that taxpayers often "desire a higher base-year cost of ending inventory in a given year to avoid liquidating a LIFO layer, causing a match of historical costs against current revenues" (see *E. W. Richardson*, Tax Court Memo Decision 1996-368). The Court's observation comes against a back-drop involving three other cases and Revenue Ruling 79-188 which collectively stand for the proposition that the IRS may successfully overturn and even penalize year-end inventory transactions that are solely LIFO-benefit motivated:

see **GM DEALERS LOW ON INVENTORY...**, page 22

(Continued from page 21)

1. *INGREDIENT TECHNOLOGY CORPORATION* (Su Crest Corporation, 83-1 USTC 9140, January 5, 1983). Tax fraud convictions by means of LIFO inventory overstatements.

2. *ILLINOIS CEREAL MILLS*, (86-1 USTC 9371 affirming T.C. Memo 1983-469, Dec. 40,342(M), 46 TCM 1001, August, 1983). Legal ownership of the goods did not justify inclusion in the taxpayer's inventory because the taxpayer did not intend to use the corn in its milling business.

3. *BALLOU AND COMPANY, INC.*, (85-1 USTC 9290, U.S. Claims Court, No. 247-82T; March 29, 1985). The Court upheld the IRS' removal of year-end gold purchases from LIFO inventory calculations because the IRS adjustments removed only the amounts of gold that the taxpayer had purchased in order to temporarily inflate inventory levels solely for income tax/LIFO purposes at year end.

Revenue Ruling 79-188 can be given a positive spin and interpreted to indirectly suggest some planning considerations:

1. Attempt to document that sales during the year are at levels that justify the purchase of year-end inventory levels in the ordinary course of business.

2. It helps if the inventory acquired at year-end can be sold to regular customers in due course or to a third party, rather than back to original supplier. This helps to avoid the "cast" as a resale.

3. The inventory acquired at year-end should be paid for before its subsequent sale, again in an effort to demonstrate an intent to receive and use the goods in the ordinary course of the business.

4. The specific mechanics of taking possession and title prior to reselling the inventory should also be considered. But note, even doing all this legally did not stop the IRS in *Illinois Cereal Mills*.

Dealers aggressively planning to avoid year-end LIFO layer liquidations should realize that even satisfying the apparent "boundaries" set by Revenue Ruling 79-188 and these other cases may not be enough. They may still find themselves coming up short even if year-end purchases are not structured to involve subsequent re-sales back to the same source shortly after year-end or otherwise look good on paper.

STRIKES AND YEAR-END CHANGES

A strike-induced inventory shortage may cause a dealer to consider changing the month end of its taxable year. Generally, a taxpayer desiring to change its accounting year-end must first obtain approval from the Commissioner. Approval is requested by filing an application on Form 1128 on or before the 15th day of the second month following the close of the short tax year created by the change in its year.

However, Reg. Sec. 1.442-1(c)(1) and (2) allow a corporation to change its year-end without prior approval if it meets **ALL** the following conditions:

1. The corporation has not changed its annual accounting period within the last ten calendar years,

2. The corporation does not have a net operating loss for the short period created by the change,

3. The taxable income for the short period is, on an annualized basis, 80% or more of the taxable income of the corporation for the taxable year immediately preceding the short period,

4. If the corporation has a special status (such as a personal holding company) for either the short period or the year preceding the short period, it must have that same special status for both years, **and**

5. The corporation cannot attempt to elect S corporation status for the year following the short period.

A corporation that meets these requirements may change its year-end merely by the filing of Form 1128 and by filing a statement with the District Director at or before the time (including extensions) for filing the return for the short period indicating that the corporation is changing its annual accounting period confirming that all of these special requirements are satisfied.

A corporation that cannot meet these requirements has to request approval by filing Form 1128 and waiting for the Commissioner to act upon that request...or else, it may try to qualify for a year end change under Revenue Procedure 92-13. This Revenue Procedure is specifically intended for a corporation that...cannot satisfy all of the conditions of Reg. Sec. 1.442-1(c)(2) ... has not changed its annual accounting period at any time within the last six calendar years...is not an S corporation...and does not attempt to make an S corporation election following its short period effective for the taxable year immediately following the short period...and satisfies certain other conditions.

Two further observations on the year-end change gambit: First, if a business attempting to change its fiscal year-end under Revenue Procedure 92-13 has a net operating loss in excess of $10,000, it must be prepared to spread that net operating over six years, subject to certain exceptions and qualifications.

Second, the current IRS positions relative to dealer financial statement LIFO conformity for the last month of its desired short taxable year may pose some hyper-technical interpretations with respect to the

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placement of LIFO estimates on the last month statement for the short taxable year. Reg. Sec. 1.472-2(e) provides that for one-year periods other than a taxable year the conformity requirements also apply for a "one-year period other than a taxable year, where the one year period both begins and ends in a taxable year or years for which the taxpayer uses the LIFO method."

The recent interpretation of the conformity requirement by the Internal Revenue Service in Revenue Ruling 97-42 with respect to "fiscal taxable years," does not specifically address a situation where there is a short period which is treated as a full taxable year for other purposes under the Revenue Code. Accordingly, to be safe, the last month of the short period return should reflect an estimate of the change in the LIFO reserve on that last monthly statement (to the Factory and to others) to avoid controversy with the IRS on this matter.

Dealers contemplating switching to a fiscal year-end to avoid adverse LIFO consequences may find the IRS attempting to block that change, just as it has attempted to block other year-end maneuvers.

IPIC/BLS INDEXES...SAVES SOME, BUT AT WHAT OVERALL COST?

Some practitioners have steadfastly advised their dealers on LIFO to use the IPIC (Inventory Price Index Computation) method available under Reg. Sec. 1.472-8(e)(3) and Revenue Procedure 84-57 (1984-2 C. B. 496). One reason for their general satisfaction with the BLS inflation index approach, notwithstanding some of its limitations, is that the dealer using it places <u>all</u> of his inventory dollars on LIFO, rather than only the new vehicle dollars.

Consequently, in situations like the current strike environment, a dealer using the BLS method may be able to offset the loss of dollars from GM new vehicles by increasing (where it makes economic sense to do so) dollars invested in the used vehicles and/or parts inventories.

What a dealer using the BLS indexes may lose in the way of a lower LIFO reserve because of the smaller inflation indexes they are required to use may be regarded, in strike years, as a trade-off against broader pooling for IPIC computation purposes.

In connection with considering an automatic change under Revenue Procedure 97-37 to the IPIC method, note that it appears this change can be made after the end of the year, so long as it is made before the tax return for the year end is filed and all of the other procedural requirements are satisfied. This would, or could, also include the filing of Form 970, where appropriate.

Evaluating this possibility of changing to IPIC will require some additional computations and projections as to what the "trade-offs" might be in future years relative to the differential between inflation rates anticipated to be experienced if invoice-specific computations were made under the Alternative LIFO Method verses the more generalized and diluted results available under the PPI or CPI index approaches. As discussed below, there is no official guidance as to whether auto dealers should be using the PPI or the CPI as their point of reference for inflation index determinations under the BLS/IPIC method.

Some IRS agents require or believe that auto dealers using the BLS/IPIC approach should use the Consumer Price Index /CPI Detailed Report, Table 3; others believe that the index should be determined from the Producer Price Indexes, Table 6. The IRS has not officially expressed a position on which of these indexes is appropriate for automobile dealers using the IPIC method to use for LIFO index purposes. One gets different answers depending on who is being asked the question.

It would appear that an automobile dealer should use the Producer Price index for its inflation computations. Reg. Sec. 1.472-8(e)(3)(iii)(C) states that "Retailers may select indexes from either the CPI Detailed Report or Producer Prices and Price Indexes, <u>but if equally appropriate indexes could be selected from either publication</u>, a retailer using the retail inventory method must select the index from CPI Detailed Report and a retailer not using the retail inventory method must select the index from Producer Prices and Price Indexes."

Accordingly, since auto dealers do not qualify to use the "retail inventory method," the Regulation would seem to mandate the use of the PPI indexes. Apparently, some IRS agents believe that the "if equally appropriate" qualification language in the Regulation does not apply since, in their opinions, the Consumer Price Index is "more appropriate" than the PPI. There is a difference between the results under the CPI verses the PPI and clarification on this point should be sought.

CONCLUSION

Hopefully, this article provides some food for thought for inventory starved dealers and their advisors, while illustrating the importance of projecting LIFO recapture consequences well in advance of the end of the year.

XYZ CADILLAC, INC. LIFO INVENTORY PROJECTIONS FOR THE YEAR ENDED SEPTEMBER 30, 1998 SCHEDULE I

	1997 ACTUAL POOL #1	1998 PROJECTED AT 1.50%	1998 PROJECTED AT 1.50%	1998 PROJECTED AT 1.50%	1998 PROJECTED AT 1.50%	1998 PROJECTED AT 1.50%	1998 PROJECTED AT 1.50%
A. BEGINNING OF YEAR INVENTORY AT BASE DATE COST -AS REBASED	6,626,240	3,395,843	3,395,843	3,395,843	3,395,843	3,395,843	3,395,843
B. END OF YEAR INVENTORY AT END OF YEAR (CURRENT) PRICES	4,131,111	3,500,000	3,000,000	2,500,000	2,000,000	1,500,000	1,000,000
C. END OF YEAR INVENTORY AT BEGINNING OF YEAR (BASE) PRICES	NOT FULLY REPRICED	NOT FULLY REPRICED	NOT FULLY REPRICED	NOT FULLY REPRICED	NOT FULLY REPRICED	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	1.01339	1.01500	1.01500	1.01500	1.01500	1.01500	1.01500
E. CUMULATIVE LINK-CHAIN INDEX CURRENT YEAR PRICE INDEX (LINE D) MULTIPLIED BY (X) PRIOR YEAR'S CUMULATIVE INDEX (LINE E OF PRIOR YEAR)	1.21652	1.23477	1.23477	1.23477	1.23477	1.23477	1.23477
F. END OF YEAR INVENTORY AT BASE DATE COST (LINE B DIVIDED BY LINE E)	3,395,843	2,834,536	2,429,602	2,024,669	1,619,735	1,214,801	809,867
G. CURRENT YEAR INVENTORY INCREASE (DECREASE) - EXPRESSED IN BASE DOLLARS							
1. END OF YEAR INVENTORY AT BASE DATE COST (LINE F)	3,395,843	2,834,536	2,429,602	2,024,669	1,619,735	1,214,801	809,867
2. BEGINNING OF YEAR INVENTORY AT BASE DATE COST (LINE A)	(6,626,240)	(3,395,843)	(3,395,843)	(3,395,843)	(3,395,843)	(3,395,843)	(3,395,843)
3. CURRENT YEAR INCREMENT (G(1) EXCEEDS G(2)) OR DECREASE (IF G(2) EXCEEDS G(1))	(3,230,397)	(561,307)	(966,241)	(1,371,174)	(1,776,108)	(2,181,042)	(2,585,976)
4. LIFO VALUATION OF CURRENT YEAR INCREMENT (IF G(1) EXCEEDS G(2), MULTIPLY LINE G(3) BY LINE E)	N/A	N/A	N/A	N/A	N/A	N/A	N/A

H. ANALYSIS OF YEAR-END INVENTORY LIFO "LAYERS" - AS REBASED

	BASE DOLLARS		VALUATION FACTOR	1997 ACTUAL POOL #1	1998 PROJECTED AT 1.50%	1998 PROJECTED AT 1.50%	1998 PROJECTED AT 1.50%	1998 PROJECTED AT 1.50%	1998 PROJECTED AT 1.50%	1998 PROJECTED AT 1.50%
OCTOBER 1, 1974 BASE	942,675	X	0.32934	310,461	310,461	310,461	310,461	310,461	310,461	266,722
FYE SEPT 30, 1977 INCREMENT	620,570	X	0.43440	269,576	269,576	269,576	269,576	269,576	118,212	-
FYE SEPT 30, 1979 INCREMENT	1,066,511	X	0.49855	531,709	531,709	431,922	230,043	28,163	-	-
FYE SEPT 30, 1984 INCREMENT	446,904	X	0.69803	311,952	142,943	-	-	-	-	-
FYE SEPT 30, 1991 INCREMENT	319,183	X	1.00000	319,183	-	-	-	-	-	-
	3,395,843									
ENDING INVENTORY AT LIFO VALUATION, TOTAL PER ABOVE				1,742,881	1,254,689	1,011,959	810,080	608,200	428,673	266,722
LESS: ENDING INVENTORY AT END OF YEAR PRICES (LINE B)				4,131,111	3,500,000	3,000,000	2,500,000	2,000,000	1,500,000	1,000,000
LIFO RESERVE AT END OF CURRENT YEAR				2,388,230	2,245,311	1,988,041	1,689,920	1,391,800	1,071,327	733,278
LESS: LIFO RESERVE AT END OF PREVIOUS YEAR				2,837,627	2,388,230	2,388,230	2,388,230	2,388,230	2,388,230	2,388,230
INCREASE (DECREASE) IN LIFO RESERVE AT END OF CURRENT YEAR				(449,397)	(142,919)	(400,189)	(698,310)	(996,430)	(1,316,903)	(1,654,952)
ADDITIONAL LIFO RESERVE PAYBACK DUE TO ADDITIONAL INVENTORY DROP					142,919	257,270	298,121	298,120	320,473	338,049
PAYBACK / RECAPTURE RATE					23%	51%	60%	60%	64%	68%

XYZ CADILLAC, INC.
PROJECTED CHANGES IN LIFO RESERVE
FOR YEAR ENDING SEPTEMBER 30, 1998

SCHEDULE II

FACTS: LIFO RESERVE AS OF SEPTEMBER 30, 1997
Analysis of year-end inventory LIFO layers
(Indexes rebased to 1.000 as of end of 1991)

	Base Dollars		Valuation Factor	LIFO Valuation
OCTOBER 1, 1974 BASE	$ 942,675	x	0.32934	$ 310,461
FYE Sept 30, 1977 Increment	$ 620,570	x	0.43440	$ 269,576
FYE Sept 30, 1979 Increment	$ 1,066,511	x	0.49855	$ 531,709
FYE Sept 30, 1984 Increment	$ 446,904	x	0.69803	$ 311,952
FYE Sept 30, 1991 Increment	$ 319,183	x	1.00000	$ 319,183
FYE Sept 30, 1996 Increment	$ -	x	1.20045	$ -
FYE Sept 30, 1997 Increment	$ -	x	1.21652	$ -
	$ 3,395,843			

Ending Inventory at LIFO Valuation	$ 1,742,881
Less: Ending Inventory at End of Year Current Costs	$ 4,131,111
LIFO Reserve at September 30, 1997	$ 2,388,230

FACTS: LIFO RESERVE RECAPTURE POTENTIAL BY LAYER AS OF SEPTEMBER 30, 1997

Base Dollars	Index Factor		Composition LIFO Reserve by Annual Layer
$ 942,675	0.88718	(1.21652 - .32934)	$ 836,322
$ 620,570	0.78212	(1.21652 - .43440)	$ 485,360
$ 1,066,511	0.71797	(1.21652 - .49855)	$ 765,723
$ 446,904	0.51849	(1.21652 - .69803)	$ 231,715
$ 319,183	0.21652	(1.21652 - 1.0000)	$ 69,110
$ -			$ -
$ -			$ -
$ 3,395,843			$ 2,388,230

PROJECTIONS FOR FYE 9/30/98 AT DIFFERENT INVENTORY LEVELS

	INVENTORY LEVEL @ Current Cost	LIFO RESERVE	CHANGE IN LIFO RESERVE @ 9/30/98 DUE TO NET DECREASE	Inflation @ 1.5%	Decrease in Inventory Level	
	$ 4,131,111	$ 2,388,230	* -	$ -	$ -	
A	$ 3,500,000	2,245,311	(142,919)	51,730	$ (194,649)	AA
B	$ 3,000,000	1,988,041	(400,189)	44,340	$ (444,529)	BB
C	$ 2,500,000	1,689,920	(698,310)	36,950	$ (735,260)	CC
D	$ 2,000,000	1,391,800	(996,430)	29,560	$ (1,025,990)	DD
E	$ 1,500,000	1,071,327	(1,316,903)	22,170	$ (1,339,073)	EE
F	$ 1,000,000	733,278	(1,654,952)	14,780	$ (1,669,732)	FF

XYZ CADILLAC, INC.
PROJECTED CHANGES IN LIFO RESERVE
FOR YEAR ENDING SEPTEMBER 30, 1998

SCHEDULE III

Base Dollars	Index Factor		Composition LIFO Reserve by Annual Layer	Reserve Recapture Due to 9/30/98 Drop in Inventory Level to $3,500,000			
				BASE DOLLARS	FACTOR	AMOUNT	
$ 942,675	0.88718	(1.21652 - .32934)	$ 836,322				
$ 620,570	0.78212	(1.21652 - .43440)	$ 485,360				
$ 1,066,511	0.71797	(1.21652 - .49855)	$ 765,723				
$ 446,904	0.51849	(1.21652 - .69803)	$ 231,715	$ 242,124	0.51849	$ 125,539	
$ 319,183	0.21652	(1.21652 - 1.0000)	$ 69,110	$ 319,183	0.21652	$ 69,110	
$ -			$ -			$ 1	
$ -			$ -				
$ 3,395,843			$ 2,388,230	$ 561,307		194,649	AA

A Decrease in Base Dollars of $561,307 = $3,395,843 - $2,834,536 (194,649)
Cumulative Inflation Index at September 30, 1998: 1.21652 x 1.015 = 1.23477............................Increase Due to Inflation 51,730
Net Decrease in LIFO Reserve (142,919)

Base Dollars	Index Factor		Composition LIFO Reserve by Annual Layer	Reserve Recapture Due to 9/30/98 Drop in Inventory Level to $3,000,000			
				BASE DOLLARS	FACTOR	AMOUNT	
$ 942,675	0.88718	(1.21652 - .32934)	$ 836,322				
$ 620,570	0.78212	(1.21652 - .43440)	$ 485,360				
$ 1,066,511	0.71797	(1.21652 - .49855)	$ 765,723	$ 200,154	0.71797	$ 143,705	
$ 446,904	0.51849	(1.21652 - .69803)	$ 231,715	$ 446,904	0.51849	$ 231,715	
$ 319,183	0.21652	(1.21652 - 1.0000)	$ 69,110	$ 319,183	0.21652	$ 69,110	
$ -			$ -				
$ -			$ -				
$ 3,395,843			$ 2,388,230	$ 966,241		444,529	BB

B Decrease in Base Dollars of $966,241 = $3,395,843 - $2,429,602 (444,529)
Cumulative Inflation Index at September 30, 1998: 1.21652 x 1.015 = 1.23477............................Increase Due to Inflation 44,340
Net Decrease in LIFO Reserve (400,189)

Base Dollars	Index Factor		Composition LIFO Reserve by Annual Layer	Reserve Recapture Due to 9/30/98 Drop in Inventory Level to $2,500,000			
				BASE DOLLARS	FACTOR	AMOUNT	
$ 942,675	0.88718	(1.21652 - .32934)	$ 836,322				
$ 620,570	0.78212	(1.21652 - .43440)	$ 485,360				
$ 1,066,511	0.71797	(1.21652 - .49855)	$ 765,723	$ 605,087	0.71797	$ 434,434	
$ 446,904	0.51849	(1.21652 - .69803)	$ 231,715	$ 446,904	0.51849	$ 231,715	
$ 319,183	0.21652	(1.21652 - 1.0000)	$ 69,110	$ 319,183	0.21652	$ 69,110	
$ -			$ -			$ 1	
$ -			$ -				
$ 3,395,843			$ 2,388,230	$ 1,371,174		735,260	CC

C Decrease in Base Dollars of $1,371,174 = $3,395,843 - $2,024,669 (735,260)
Cumulative Inflation Index at September 30, 1998: 1.21652 x 1.015 = 1.23477............................Increase Due to Inflation 36,950
Net Decrease in LIFO Reserve (698,310)

XYZ CADILLAC, INC.
PROJECTED CHANGES IN LIFO RESERVE
FOR YEAR ENDING SEPTEMBER 30, 1998

SCHEDULE IV

Base Dollars	Index Factor		Composition LIFO Reserve by Annual Layer	Reserve Recapture Due to 9/30/98 Drop in Inventory Level to $2,000,000 BASE DOLLARS	FACTOR	AMOUNT	
$ 942,675	0.88718	(1.21652 - .32934)	$ 836,322				
$ 620,570	0.78212	(1.21652 - .43440)	$ 485,360				
$ 1,066,511	0.71797	(1.21652 - .49855)	$ 765,723	$ 1,010,021	0.71797	$ 725,165	
$ 446,904	0.51849	(1.21652 - .69803)	$ 231,715	$ 446,904	0.51849	$ 231,715	
$ 319,183	0.21652	(1.21652 - 1.0000)	$ 69,110	$ 319,183	0.21652	$ 69,110	
$ -			$ -				
$ -			$ -				
$ 3,395,843			$ 2,388,230	$ 1,776,108		1,025,990	DD

D Decrease in Base Dollars of $1,776,108 = $3,395,843 - $1,619,735 (1,025,990)
Cumulative Inflation Index at September 30, 1998: 1.21652 x 1.015 = 1.23477............................Increase Due to Inflation 29,560
Net Decrease in LIFO Reserve (996,430)

Base Dollars	Index Factor		Composition LIFO Reserve by Annual Layer	Reserve Recapture Due to 9/30/98 Drop in Inventory Level to $1,500,000 BASE DOLLARS	FACTOR	AMOUNT	
$ 942,675	0.88718	(1.21652 - .32934)	$ 836,322				
$ 620,570	0.78212	(1.21652 - .43440)	$ 485,360	$ 348,444	0.78212	$ 272,525	
$ 1,066,511	0.71797	(1.21652 - .49855)	$ 765,723	$ 1,066,511	0.71797	$ 765,723	
$ 446,904	0.51849	(1.21652 - .69803)	$ 231,715	$ 446,904	0.51849	$ 231,715	
$ 319,183	0.21652	(1.21652 - 1.0000)	$ 69,110	$ 319,183	0.21652	$ 69,110	
$ -			$ -				
$ -			$ -				
$ 3,395,843			$ 2,388,230	$ 2,181,042		1,339,073	EE

E Decrease in Base Dollars of $2,181,042 = $3,395,843 - $1,214,801 (1,339,073)
Cumulative Inflation Index at September 30, 1998: 1.21652 x 1.015 = 1.23477............................Increase Due to Inflation 22,170
Net Decrease in LIFO Reserve (1,316,903)

Base Dollars	Index Factor		Composition LIFO Reserve by Annual Layer	Reserve Recapture Due to 9/30/98 Drop in Inventory Level to $1,000,000 BASE DOLLARS	FACTOR	AMOUNT	
$ 942,675	0.88718	(1.21652 - .32934)	$ 836,322	$ 132,808	0.88718	$ 117,825	
$ 620,570	0.78212	(1.21652 - .43440)	$ 485,360	$ 620,570	0.78212	$ 485,360	
$ 1,066,511	0.71797	(1.21652 - .49855)	$ 765,723	$ 1,066,511	0.71797	$ 765,723	
$ 446,904	0.51849	(1.21652 - .69803)	$ 231,715	$ 446,904	0.51849	$ 231,715	
$ 319,183	0.21652	(1.21652 - 1.0000)	$ 69,110	$ 319,183	0.21652	$ 69,110	
$ -			$ -				
$ -			$ -				
$ 3,395,843			$ 2,388,230	$ 2,585,976		1,669,732	FF

F Decrease in Base Dollars of $2,585,976 = $3,395,843 - $809,867 (1,669,732)
Cumulative Inflation Index at September 30, 1998: 1.21652 x 1.015 = 1.23477............................Increase Due to Inflation 14,780
Net Decrease in LIFO Reserve (1,654,952)

SUMMARY OF NEW ITEM LIST DIFFERENCES
ALTERNATIVE LIFO METHOD ITEM CATEGORIES

Below are summaries of the comparisons of our new item lists with those issued by the Acting Motor Vehicle Industry Specialist of the IRS. The IRS lists were issued May 7, 1998 and, as usual, we found significant differences in our item-by-item comparisons. For a complete listing of all item categories, see the June, 1998 *LIFO Lookout.*

DECEMBER 31, 1997 ... 1998 MODELS

MAJOR NEW ITEM DIFFERENCES

- Ford Contour, Escort & Taurus
- Mercury Mystique & Sable
- Subaru Impreza & Legacy
- Volkswagen Cabrio, Golf, GTI & Jetta
- Volvo 70 & 90 Series

NUMBER OF NEW ITEM CATEGORIES	*LIFO LOOKOUT / SUPERLIFO™*	IRS
Automobiles	200	291
Light-Duty Trucks	152	202
Total New Item Categories	352	493

DECEMBER 31, 1996 ... 1997 MODELS

MAJOR NEW ITEM DIFFERENCES

- Oldsmobiles
- Plymouth Breezes
- Ford F150 Pickups
- Subarus
- Chevrolet Full-Size Vans
- GMC Full-Size Vans

NUMBER OF NEW ITEM CATEGORIES	*LIFO LOOKOUT / SUPERLIFO™*	IRS
Automobiles	205	227
Light-Duty Trucks	160	244
Total New Item Categories	365	471

The differences in LIFO inflation indexes and LIFO reserves may be significant depending on how these vehicles are treated in the dealer's LIFO computations because new item categories are required to be included in the annual computation of inflation (or deflation) at a 1.000 factor. This is accomplished by using the same dollar amount to represent the end-of-the-year base cost and the beginning-of-the-year base cost. Since any number divided by itself equals 1.000, a new item contributes no inflation (or deflation) to the annual index.

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