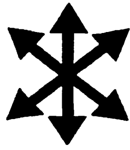

De Filipps'

LIFO LOOKOUT

A Quarterly Update of LIFO - News, Views, and Ideas

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LIFO UPDATE

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

1. Depending on where your clients are located, LIFO audits may be a very distressing part of your life right now - or they may not be a very real source of concern at all.

This issue of the *LIFO Lookout* attempts to overview the major issues and approaches taken by some IRS agents in examining auto dealers on LIFO. Over the past few months, I have talked with more than 50 different CPAs and dealerships in all parts of the country, and I want to thank many readers for their input. I have even been able to obtain further insights through (non-adversarial) discussions with a few current and former agents. If you are one of those who shared your views and experiences with me, I hope you will feel I have done justice to your comments, feelings and interest in the subject. After my modest attempt to place the overall, very inconsistent, state of affairs in a momentary focus, I would greatly appreciate your evaluation and critique of my effort and conclusions.

2. In some instances, the IRS has been very successful in taking a dealer out to the woodshed and either beating the LIFO election out of him or modifying it beyond recognition (so the dealer won't ever do it that way again!) Some disastrous results can be traced to the poor choice of LIFO methods in the initial Form 970 election or to sloppy computations over the years. In other instances, large audit adjustments may be due to the dealer's failure to keep **all** possible information regarding invoices, prices and model changes and LIFO computations ever since their first year on LIFO. You can never save enough information long enough!

In other cases, large deficiencies may be due to a reluctance to stand up for a particular interpretation in an area where the rules and regulations are vague or not even on point. Let's face it, CPAs are either passive or aggressive in LIFO audit situations, and so are dealers. So whether or not one is intimidated by "the IRS" in an audit situation can have a bearing on the overall result.

Furthermore, in some instances, the years following the LIFO election and the build up of the LIFO reserves may have been less than profitable for the dealer. With operating loss carryforwards piled up, some dealers and CPAs are, by necessity, less interested in hassling over the original LIFO election and more interested in just surviving and staying in business. So some are understandably less concerned with spending more time and money trying to block current IRS challenges to their LIFO elections or computations if the dollars at stake are thought to be less significant.

In some dealerships, IRS agents cause far more havoc in checking Form 8300 filing compliance or in raising other issues like the treatment of extended warranty coverage. Then, before leaving, to tick off another item on their checklist, they may get around to

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LIFO Update (Continued from page 1)

looking at LIFO. Whether or not LIFO is the major force in attracting an IRS audit, it may still be full of plump revenue enhancing possibilities and easy pickings for knowledgeable agents who happen to be better trained (especially on the West Coast or in the Southeast) or who have access to more specialized LIFO training, consultation or satellite resources within the IRS. Recent activity in several areas evidences the influence of greater IRS awareness and attention to LIFO details, particularly in the far Northwest (Seattle, Vancouver, Portland) and the Southeast (Atlanta, Orlando) regions. California, where significant dealer LIFO audit activity was initiated and developed over the past few years, still seems to be experiencing significant IRS LIFO audit activity.

3. As you know, I attempted to collect information on existing LIFO practices by sending out a "Survey of Auto Dealer LIFO Tax Practices" with the June issue. Unfortunately, I received so few replies that I don't believe anything meaningful can be published from this limited response. Thank you if you did take the time to fill in the survey form. Still undaunted, I enclose with this issue an IRS LIFO Audit Exam Survey for your consideration. If enough readers fill it out and send it back, the results will be compiled and summarized for your benefit in the next *Lookout* issue. Also, please use the insert for other feedback purposes.

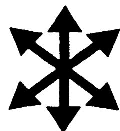
One of my thoughts in publishing the *Lookout* is that if a significant cross-section of input can be obtained on certain issues, that information may be useful in running our practices and in IRS compliance activities. I recently became aware of the efforts of one reader (not me) who not only wrote to his Congressman expressing concern over IRS LIFO audits of his Firm's dealership clients, but also went further and wrote again in reply to the IRS' rebuttal correspondence to the Congressman. I know some readers have very strong feelings about the unfairness or inconsistency in what's going on out there.

By keeping published information vague and at a minimum, the IRS can be successful in a divide and conquer attrition approach to auditing LIFO during which agents may be able to make up their own rules and logic as they go along. There just isn't any organized opposition expressing practical views to balance the Service's restrictive and sometimes unrealistic interpretations of the Regulations.

4. In case you didn't know about it, you can obtain a summary of all of the Letter Rulings and Technical Advice Memoranda issued by the Internal Revenue Service on LIFO during the last ten years (that's right: from 1980 through 1990) for the very modest cost of $39.10. This summary can be ordered from the Tax Analysts' Access Service by calling (800) 955-2444 and asking for the Decennial Index-Digest Bulletin, Pamphlet Series, Letter Ruling Summaries for Accounting Periods and Methods. This 390-page softbound publication covers Code Sections 441 through 483, and this, in turn, includes Section 471 inventories and Section 472 LIFO inventories rulings.

Described as "a comprehensive decade-spanning overview of IRS thinking and interpretation," this inexpensive summary or digest of rulings may be particularly valuable in your reference library if you were not around through the entire decade of the 80's to spot and save these TAMs for your own files. For example, I noted a number of rulings that involved grocery stores and supermarkets that might be especially useful if your retail clientele includes these businesses and you are not too familiar with their special LIFO problems. See the chronological listing on page 12 of 20 rulings that I thought would make a good checklist for your review.

5. Finally, revision of Form 3115, Change in Accounting Method, has not yet been finalized. However, the proof copy of Schedule B relating to changes within the LIFO inventory method asks for far more information than previously, particularly in connection with pooling changes.



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THEORY, PRACTICE & IRS AUDIT ISSUES: WHAT'S GOING ON OUT THERE

Before discussing LIFO index computational issues, we need to first consider some of the theory underlying LIFO computations. From the "theory" and terminology standpoint, let's consider six (6) methods, each one of which has its own specific technical considerations and must be elected and identified on the Form 970 in the first LIFO year.

THEORY AND TERMINOLOGY

1. Unit method.
2. Double extension method.
3. Link-chain method.
4. Link-chain, index method.
5. Indexes computed with reference to Table 6, Producer Prices and Price Indexes.
6. Other index methods.

The unit method is sometimes referred to as the "specific goods" method and, even though it is the easiest LIFO costing approach to understand, its major disadvantage is that each item or group of very similar items is, in effect, treated as a separate inventory pool. Inventory quantities are measured in terms of physical units of individual items and, for this reason, the unit method generally should be limited to inventories which consist of only basic items or substantially similar items. Because of the (assumed) similarity of items, simple averaging computations are employed. This approach requires very detailed record keeping and will result in numerous and significant inventory liquidations over time.

In general, the Service will readily and successfully attack unit method LIFO applications because that method is clearly not suited for automobile dealer inventories. Where the unit method is used, the position of the Service seems to be that since generally accepted accounting principles require that all items must be identical within specific unit LIFO pools, whenever a particular specific model is discontinued, all of the LIFO reserve associated with that particular model has to be repaid since identical "replacement units" no longer can be found. This was discussed in the March, 1991 issue of the *Lookout.*

Disadvantages associated with the unit method may be avoided by using "dollar value" approaches which include those listed above as methods 2 through 6. A dollar-value approach treats the inventory as representing an investment of **dollars**, rather than an aggregate of individual items. To accomplish this result, dollar-value methods use "base year" costs expressed in terms of total dollars invested in the inventory as the unit of measurement or common denominator. This unit of measurement is applied to groupings, or categories, of inventory referred to as "pools."

A dollar-value method is therefore preferable to the unit (or specific goods) method since the dollar-value method permits the partial or complete liquidation of one type of item in the pool to be offset by an increase in investment in another type of item in that pool. A dollar-value method also copes with the situation presented when certain models are discontinued or are not present in succeeding years or when "new" models or items are introduced in subsequent years.

The categorization or "pooling" aspect of LIFO is very important because dollar-value calculations are separately applied to each pool. The more pools there are, the greater the likelihood that even though the overall dollar amount of inventory investment might remain constant, some items within the inventory might be completely liquidated from some pools while different and new items might be added to other pools.

The *Fox Chevrolet* and *Richardson Investments* decisions pretty much set up the prevailing IRS position on auto dealer pooling which is that new vehicles should be placed in two pools: one pool for new cars and a separate pool for new trucks. For purposes of discussing **current** IRS audits and issues, it appears that where LIFO computations are set up showing only one pool for new vehicles, the IRS position more often than not seems to require a split into two pools, consistent with *Fox Chevrolet.* The same line of reasoning has been applied to pooling for used vehicles in Letter Ruling 8906001. In a number of instances, the IRS has taken the position that mini-vans should be placed in a third, separate pool, thus bringing to three the number of pools for a new vehicle inventory on LIFO.

In some recent instances, IRS agents have even signaled or threatened a willingness to go back to the Tax Court and to relitigate the term "item" taking the position that separate pools should be established for each model in the line: whether this is a bluff or not remains to be seen. However, wording in the cases suggests that more than two pools may be justified in the appropriate circumstances. The IRS would like to see as many pools as there are models. Generally speaking, if a taxpayer does not have at least two pools in connection with its new and/or its used vehicle inventories, if the agent chooses to raise the issue, the IRS will usually require at a minimum two pools. Conventional wisdom seems to be that there isn't much point in contesting this with the IRS in Conference or via a Technical Advice request, unless you are willing eventually to go to the Tax Court or other courts for your hearing.

In turning to address various LIFO "practices" (despite their technical names) which auto dealer LIFO

see **THEORY, PRACTICE & IRS AUDIT ISSUES**, page 4

calculations tend to follow, based on my experience over the years, I would describe six general "practices" or computational approaches. In the first four practices described below, practitioners may apply their computations to all vehicles in the ending inventory or they may be applied to a hopefully representative sample quantity which is less than the entire inventory. These six computational practices are summarized and commented on in the following paragraphs:

FIRST PRACTICE: Averaging approaches...whereby essentially the total dollar amount of general ledger cost or carrying value for the inventory is divided by the number of units, irrespective of model designation or body style, in arriving at an average cost per vehicle. Although averaging practices are inherent in use of the unit method as described above, averaging approaches in fact are applied in connection with many dollar-value methods, particularly in connection with the double extension method. Some variations on this approach may compute averages by body style, size or model. Attempts to rationalize various averaging approaches in the context of the dollar-value method usually refer to the double extension regulations which illustrate determining the average price of items A, B, and C. The "problem" with the analogy or rationalization is that items A, B, and C are assumed to be identical or fairly homogenous; unfortunately, new or used vehicles are thought by the IRS to be considerably more complicated, diverse and outside that realm.

Where the Service raises the issue, averaging practices usually do not stand up per se, and are replaced by the use of repricing methods tailored to the satisfaction of the specific agent.

SECOND PRACTICE: Repricing approaches in which every ending inventory invoice and **every** option and accessory included on every invoice, as well as base vehicle price, transportation costs and other cost elements, are repriced in arriving at an overall weighted index for the inventory pool. In other words, 100% of all options and accessories listed on every vehicle invoice are repriced in computing the index...thus all inventory costs are repriced, 100%. Without question, this approach is preferred by the Internal Revenue Service since it reflects the narrowest possible definition or interpretation of the term "item."

This approach has been embraced by many IRS agents upon audit as setting the standard to which it would like to hold all other dealer LIFO computations. However, if that is really the case, why doesn't the IRS come right out and say so in a published ruling and provide appropriate transitional rules under Rev. Proc. 84-74 and Section 481?

THIRD PRACTICE: Repricing approaches in which the index is determined by repricing less than every option and accessory listed on the vehicle invoice. Approaches within this third general practice category reflect a lesser degree or extent of repricing. They usually involve the repricing of all ending inventory vehicle base prices; from there some reprice transportation costs, and some possibly reprice a few selected large-dollar cost options - and some do not reprice any options. These approaches are intended to fall within the link-chain or the link-chain, index methods.

Rationale or argument for repricing less than 100% of all options is believed to be found in the term "index" as that term is used in the regulations and in the term "link-chain, **index** method," which is interpreted as meaning that the repricing will only involve a "representative portion" of the inventory, i.e., repricing something less than 100% of the inventory. Note that, if inadvertently elected on Form 970, the double extension method requires the taxpayer to reprice all, each, every, 100% of all items...and this time-consuming and expensive burden is exactly what the more practical link-chain, **index** method is seeking to avoid.

As may be expected, practitioners and IRS agents may not necessarily agree on how much repricing has to be done before one can conclude that a "representative portion" of the inventory has been repriced. After all, that is what sampling is all about and (in blunt words) the IRS hates sampling! This is evidenced by the obvious lack of any authoritative document or pronouncement on the subject of sampling in connection with LIFO inventories, despite its regular application by CPAs to inventories of all sizes, types and diverse characteristics for over 50 years.

In several recent audit situations, IRS agents are reported to have taken the position that variations under this third practice approach are not acceptable. The July, 1989 Coordinated Issues Memorandum emphasizes (1) the need for comparability in repricing and (2) the fact that information is readily available from published sources on the prices of all options. However, it seems to fall short of specifically and literally requiring repricing of all options. Please see the accompanying reprint from that Memo on page 8 to help you form your own opinion.

Nevertheless, the Coordinated Issues Memo provides the basis for some examining agents taking the position that repricing less than all of the options and accessories is not acceptable. While it is not specifically stated in either the Coordinated Issues Memo, nor in any other authoritative source at the present time, it is my understanding that variations within this third practice approach, per se, will be challenged as unacceptable on audit by the IRS if an agent chooses to raise the issue. Apparently, IRS concern reflects the belief that manufacturers have been unable to resist the temptation to play around with option pricing and therefore, there exists the possibility

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that LIFO indexes may be distorted if they do not reflect (all?) option and option package prices.

In instances where this issue has been raised, as the LIFO audit continues, further repricing of selected optional equipment can readily be done (if the information has been saved!!) to the extent required by an examining agent, and computations can be adjusted accordingly without a significant expenditure of time or dollars...either in advance or after the fact. As mentioned previously, this is where the technical election in the form of the "X" in the box on Form 970 can make or break the case depending on what method was selected; i.e., which box has the "X."

Where this issue has been raised initially by an examining agent, subsequent repricing of a selection of large dollar amount options or other selected options has been accepted by some agents, as they are simply looking for assurance that the indexes have not been exaggerated by leaving options out of the repricing in the first instance. Furthermore, this additional repricing often demonstrates little or no significant change to the overall index and the issue often is ultimately dropped. That is not to say that in certain situations the difference between indexes (i.e., an index developed solely from base prices compared to an index developed from base prices and optional equipment) might not be significant. This is where the judgment of the CPA becomes critical in determining how to proceed to satisfy the examining agent without unduly compromising the dealer. You can see from this, once again, the importance of saving all invoices, model and price information indefinitely.

FOURTH PRACTICE: A fourth general computational approach or practice involves the determination of price indexes for different vehicle body styles and/or models with the resulting indexes applied indiscriminately to value for LIFO purposes the inventories of all similar franchise dealers. Variations within this practice may involve reviewing model change information and adjusting for certain standard-to-optional equipment changes. The overall activity, however, results in the development of a single inflation factor for each model or body style. From that point forward, "one size fits everybody." In some instances, these factors may be applied in developing LIFO indexes without even referring to the dealer's actual vehicle invoices or general ledger control printout or model and body style mix. This could produce serious consequences if the dealer has been lulled into a false sense of security in believing that he does not need to pull out and save invoices and other cost and model and price information for possible subsequent verification on IRS audit. Would you believe that in some instances, copies of the underlying LIFO computations are not even provided to the taxpayer for their records?

Although this fourth general practice has the attractive feature of being easy to apply (you may not even need the invoices...if one index fits everybody...), this approach would not seem to fall within the Service's acceptable limits governing the use of externally-developed indexes. If this approach does not seem to be an acceptable internally-developed index (since it involves averages at the very least), and it does not seem to be an acceptable externally-developed index...what is it? Users/defenders of this approach indicate that IRS auditors have routinely accepted this approach on audit (or at least have done so in the past) notwithstanding its closer relationship to being an external index, than to a required internal index.

To date, the IRS has not even touched on the existence of this fourth practice in any of its rulings or technical advice memoranda...so it is as if it doesn't even exist...unless you happen to be using it or come across it. Then you may be tempted to wonder why all the IRS fuss about repricing options (the second and third practices) when it seems to be so unconcerned about this fourth short-cut external index LIFO practice. It appears that although agents may be aware of the use of external indexes other than those specifically sanctioned under Published Price Index approaches, they may be (1) willing to allow the use of these approaches under their discretionary authority - even though technically they are not sanctioned by the Regulations - or (2) they may be convinced by the persuasive skills and documentation of the taxpayer's advocates that these "one size fits all" LIFO indexes "clearly reflect income."

FIFTH PRACTICE: The fifth group of practices involves the use of acceptable external indexes developed from published price indexes, most notably from Table 6 of the Producer Price Indexes issued by the Bureau of Labor Statistics. Some CPAs and dealers jumped to the use the Producer Price Index, Table 6, approach when it first became available in the early 80's. In other instances, LIFO computations were switched over to this method in a subsequent year when the LIFO index computation proved to be flat under the current approach but the Producer Price Index approach resulted in the ability to use an inflation factor greater than what otherwise would have been computed. I am unable to comment on its effectiveness, usefulness or IRS acceptance of these practices on audit. I must confess I could never feel comfortable relying on a U.S. developed index in cases where the dealer was selling import vehicles...even before *Amity Leather*. Reader feedback on these or any other practices will be appreciated and shared in future issues.

SIXTH PRACTICE: A variety of other approaches may be found, each of which is distinguishable in some way from the other five. This final catch-all category may be defined as including any practice not falling

see **THEORY, PRACTICE & IRS AUDIT ISSUES**, page 6

within the other five practices previously discussed. One example would be computations which reprice **all** options, base price and transportation costs on a sample (less than all) of the ending inventory invoices - essentially a combination of the second practice (full repricing of everything appearing on the invoice), applied to a statistically determined number of invoices (instead of applied to 100% of the invoices).

A dealer may make a LIFO election at any time; once made, the sub-elections on Form 970 must continue to be used until a taxpayer receives permission to change methods. In some instances, methods may be changed over time without going through the formal change request filing of a Form 3115 (this was covered in depth in the June, 1991 *Lookout*). Accordingly, in a LIFO audit situation, an agent will routinely request to see a copy of the Form 970 originally filed and any subsequently filed Forms 970 and/or 3115. The agent's review of Forms 970 and 3115 is intended to make him or her aware of the theoretical and technical elections initially made or subsequently adopted.

Major problems can arise in audit situations where the taxpayer has not saved all inventory information, model descriptive information and price information for all years during which the LIFO election has been in effect. Many agents will immediately push for the termination of the LIFO election. This problem can arise either where the unit method or a dollar-value method is employed. This is discussed elsewhere in the articles on Revenue Procedure 79-23 and on "Books and Records" and adjusting prior year indexes.

Regardless of which computational approach or practice is used, for new models entering dealers' inventories in years after the first LIFO year, the Service uniformly seems to require that **new** models must be included at a 1.000 factor in both the beginning and the ending inventory repricings. In other words, the IRS is unwilling to permit or allow any base date or price reconstruction for new models. This gives the IRS 100% of the benefit of the doubt and completely denies the taxpayer the possibility that there might be some inflation built into the prices of new models.

The inclusion of all new models or items at 1.000 is a position on which the IRS apparently will not concede, notwithstanding the fact that index-type elections are founded in theory, at least, on the assumption that every item need not be repriced or tested so long as a **representative portion** of the inventory is repriced or tested. This IRS position seems to be highly discriminatory against automobile dealers vis-a-vis other LIFO users where sampling approaches or price reconstruction are permitted without requiring items that cannot be repriced to be entered at 1.000. Come to think of it...this isn't how the U.S. Bureau of Labor Statistics constructs its own indexes (which the IRS regularly and solemnly accepts), is it?

Finally, in several instances, agents have specifically asked to review the 12th month financial statement submitted to the manufacturer to be sure that the LIFO conformity requirement on these statements was satisfied. So don't forget the conformity requirement!

In a number of IRS audit situations, agents have cited *Wendle Ford Sales, Inc.* in support of their positions. Other Letter Rulings frequently mentioned by agents in support of their positions are:

LTR 7609281720B Discusses separate pools for different franchises; pre-dates the *Fox Chevrolet* and *Richardson Investments* decisions.

LTR 7827018 Pre-dates the *Wendle Ford Sales* decision, as does 7836011, 7916001 and 7918011.

LTR 7832008 Discusses comparability and pooling within the context of a link-chain dollar value LIFO election. Note this ruling pre-dates both *Wendle Ford* and *Fox Chevrolet*.

LTR 8351163 Discusses the extent of repricing in connection with double extension computations and holds that it is necessary to reprice options, along with base model cost and freight, to come up with an acceptable LIFO index.

LTR 8906001 Holds that it is not proper for a dealer to compute an inventory price index on a model line by model line basis by dividing the aggregate current year cost of each model line by the aggregate beginning of the year cost of each model line.

All of the rulings cited above are of limited use in either supporting or defending one's position on a LIFO issue. They simply evidence the IRS National Office position based on the facts present in the ruling request.

Perhaps the most pleasing comments that can be shared on the subject of IRS LIFO audits have come from a number of practitioners in the Northeast as well as in the Midwest who report that they have recently been through many LIFO audits and experienced no significant difficulty or adjustment, regardless of whether the computations were of the link-chain, index methodology or of some other ilk. In one instance, one CPA reported that the only change made by the IRS was to recompute the index by putting all new models into the index computation at the same price at beginning and end of year, and because of the specific inventory mix, this adjustment did not result in any significant reserve change.

Some colleagues to whom I mentioned these conversations have made the jaundiced observation that no one ever really admits to losing in Las Vegas, either. I don't know, should we take these CPAs at their word, or not?

Let me try to summarize what's going on out there this way: Depending on where you are, what you've

see **THEORY, PRACTICE AND IRS**, page 11

THE LIFO TAXPAYER'S "BILL OF RIGHTS" REVENUE PROCEDURE 79-23

LIFO is not a single, cut and dried calculation. Detailed records which should already exist in the business must be analyzed and summarized, and various alternative sub-procedures and sub-elections must be interpreted and evaluated. All of these records should be saved indefinitely. The Internal Revenue Service, upon examination, may want to see all detail records and be satisfied that reasoning, assumptions, procedures and methods are correct. If you cannot produce this information, you can be at the mercy of the examining agent!

As IRS examining agents take increasingly restrictive views towards LIFO elections and application techniques, you should be aware that Revenue Procedure 79-23 (1979-1 CB 564) offers guidance in three areas addressed specifically to LIFO audit situations:

1. What to expect an IRS agent to look at in connection with LIFO
2. Grounds for holding that a LIFO election can be terminated or disallowed
3. Situations that do not warrant disallowance or termination.

The LIFO election can be disallowed for the following reasons:

1. Failure to value LIFO inventory at cost for tax purposes for the year preceding the year of LIFO election, the election year, and all subsequent years;
2. Violation of the financial statement reporting conformity requirements (Note that the IRS has the authority to invalidate a LIFO election because of failure to satisfy these eligibility requirements; but the exercise of that authority is discretionary with the IRS.);
3. Failure to properly elect LIFO (Form 970 deficiencies);
4. Failure to maintain adequate books and records with respect to the LIFO inventory and all computations related to it.

Note that even if one of these situations exists, the IRS - District Director has the discretionary power to allow the election - if it can be persuaded to exercise that power in the taxpayer's favor. For example, Revenue Procedure 79-23 reflects the position of the Service that a LIFO election can be disallowed if the taxpayer fails to maintain adequate books and records with respect to the LIFO inventory and computations related to it. However, if a taxpayer can reconstruct or extrapolate the information necessary to calculate the LIFO inventory amount properly, it **may** be possible to avoid termination of the LIFO election for this infraction. Also, as discussed in the "Books and Records" article on page 10, there are other computational adjustments that can be worked out with the IRS on audit to compensate for deficiencies in record keeping.

The good news is that, according to the Revenue Procedure, the following situations do not warrant disallowance or termination of the LIFO election:

1. Computational errors;
2. Selection of a lesser or greater number of inventory pools that those the IRS thinks should be used;
3. Use of Bureau of Labor Statistics price indexes by non-department store taxpayers (Note: This Revenue Procedure predates the introduction of various "Simplified Index Rules" under which BLS indexes may be used.);
4. Improperly including (or excluding) a specific **"item"** in a particular inventory pool;
5. Differences in the level of costing inventories between financial statements and tax returns.

From the list above, it is clear that where a taxpayer has made a reasonable or good faith effort at applying the LIFO concept but has "bungled" the mathematics, pooling, or index conceptual applications, IRS agents are not supposed to disqualify the taxpayer from using LIFO or terminate the election. But watch out because some agents will bluff or threaten to terminate the election anyway!

Instead, in these instances the agent should require modification and correction of the underlying LIFO computations. This is very important! And it also indicates that you should not necessarily be intimidated by the absence of a specific answer to practical computational problems.

On some computational matters, insights into the IRS' thinking may be available in the form of Letter Rulings and Technical Advice Memoranda made public under the Freedom of Information Act. Some of these are favorable or unfavorable, depending on your point of view, and some are later reversed by litigated tax cases or subsequent contradictory IRS rulings, and/or retracted. Also, some may have greater precedential value than others as far as IRS examining agents and taxpayers are concerned. Although these may **not** be used or cited as precedent, often they may be used as a guide with other research material in formulating a position on an issue.

*

WHAT IS AN "ITEM"? DOES ANYBODY KNOW?

There is still disagreement over the practical interpretation of the IRS Industry Specialization Program Motor Vehicle Industry Coordinated Issue Memorandum issued in July, 1989 relative to the definition of an "**item**" in dollar value LIFO situations.

Here is the Conclusion and example from that memo:

"While it may not be possible to compare all of the aspects of vehicles on hand at the end of two different taxable years because of differences in make, year, model, body style, standard equipment, options, and other factors, appropriate adjustments should be made to the cost of the vehicles on hand at the end of the prior taxable year to account for as many of these factors as possible. The prices of all factory installed options are readily available to distributors and dealers. For body style, standard equipment, options and other features that are available at one point and not another, the adjustment should be based on the stated or implied price when available and factored in as a percentage of the base vehicle cost.

"An example follows:

"The standard equipment on the 1987 and 1988 Buick Electra Estate Wagons is the same except for the following:

a. 6-way power driver's seat was an option on the 1987 model that cost the dealer $179 but was standard on the 1988 model.

b. Third seat was an option on the 1987 model that cost the dealer $187 but was standard on the 1988 model.

"The dealer cost for the 1987 model including destination charge but with no optional equipment was $15,773. The 1988 cost was $16,837. The 1987 cost should be increased to $16,139 for the cost of the items that were made standard in 1988. ($15,773 + 179 + 187 = $16,139)"

The crucial question is: Has the IRS in this document stated specifically and unequivocally in the above that all optional equipment listed on a new vehicle invoice **must** be repriced in every instance before the IRS will accept a computed LIFO index as valid? The IRS seems to think it has! What do you think? And if it has, what is its precedential value?

As far as the IRS and some attorneys are concerned, the technicalities of comparability boil down to the definition of the term "**item.**" For many CPAs attempting to compute inflation indexes in a practical and competitive way under increasingly severe time and fee limitations, the essence of "comparability" barely comprehends technical jargon and legal concepts. But for what it is worth, here are some of the possible definitions of the term "**item**" as that term relates to possible "**item**" configurations in a new vehicle inventory:

1. All new vehicles are a single "**item**"
2. Each size configuration and/or body style is a single "**item**"
   A. Compact, subcompact, intermediate, standard and luxury (specialty)
   B. Two-door, four-door, hatchback, convertible, station wagon
3. Each model line is a single "**item**"
4. Each model year constitutes a separate "**item**"
5. Each option or accessory on a vehicle is a separate "**item**" distinguishable from the underlying base vehicle **and** the base vehicle is treated as an "**item**" in accordance with one of the alternatives above.
6. Each vehicle is a separate "**item**" taking into account every difference in option and accessory.

This sixth definitional approach treats options and accessories as included with the base vehicle in determining what is an "**item.**" However, under this alternative, a vehicle is treated as a separate "**item**" from an otherwise identical vehicle if there is **any** difference in the options or accessories on the two vehicles. (TAM 8906001). This restrictive view results in (1) almost every vehicle in inventory being treated as a separate "**item**" from every other vehicle in inventory and (2) every vehicle in the current year's inventory is treated as a new "**item**" in comparison with vehicles on hand at the end of the preceding year(s).

Now consider how difficult and expensive it may be to reprice **ALL** options - if that is really the IRS requirement - based on the listing of possible option configurations in the box on page 9.

It is my understanding that the Internal Revenue Service is not inclined to make a determination relative to the definition of the term "**item**" for car dealers unless it can be demonstrated that the difference between interpretations is essentially **REVENUE NEUTRAL.** Since when has revenue neutrality become a factor in evaluating LIFO? No one has yet volunteered to submit complete information on dealer LIFO inventories over several consecutive years in order to generate alternative computations. Do you think anyone ever will?

To this group of six alternatives, one could cynically add a seventh: namely, that the term "**item**" can be defined any way the IRS chooses to define it when it is to the advantage of the IRS to step beyond the six alternatives previously offered. In other

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What Is An "Item"? (Continued)

words, there is nothing limiting the IRS to accepting the definition of an **"Item"** as falling within any one of the six alternatives at hand. Any one who thinks otherwise should become familiar with *Fox Chevrolet* and its underlying history, including the IRS National Office ruling position allowing five (5) pools in various Technical Advice Memos before it went to the Tax Court arguing for two dozen (24). Or take a look at *Hamilton Industries*.

In the *Amity Leather Products Co. vs. Commissioner*, 82 T.C. 726 (1984), the Tax Court said:

"A narrower definition of an item within a pool will generally lead to a more accurate measure of inflation (i.e., price index) and thereby lead to a clearer reflection of income. At the same time, the method of inventory accounting must be **administratively feasible** and **not unduly burdensome** from the standpoint of each of the parties. Within limits of reasonableness, regulations governing LIFO inventory accounting have to be applicable across the board. Whether they achieve the best result in a particular fact situation is not controlling." (Emphasis mine.)

More recently, and equally to the point, in August, 1990, current IRS Commissioner (Goldberg) was quoted as saying that the IRS needs

"to build on, and...accommodate common commercial practice. We can't operate on the assumption that (individual taxpayers, small businesses, or giant corporations) can be expected to modify and tailor their behavior to the world of taxes - it ought to run in the other direction...Many of the problems we have in the (tax) system right now are traceable back to an honest, genuine, but terribly misguided quest for theoretically pure answers... (we) really cannot live with theoretically pure answers...we need, instead, to be looking for simplifying assumptions."

So we have seven vague definitions for the term **"Item,"** poised for a resolution that can only be more legalistically absurd ... sometime before the end of this century. Should somebody ask Mr. Goldberg to clarify what he really means when he says "we need, instead, to be looking for **'simplifying'** assumptions"? *

VEHICLE OPTIONS AND ACCESSORIES

I. BODY STYLES

- 2-Door Coupe
- 2-Door Hatchback
- 4-Door Sedan
- 4-Door Wagon
- 5-Door Hatchback
- Convertibles
- Other specialties

II. TRANSMISSION OPTIONS

- 3-Speed Automatic
- 4-Speed Automatic
- 4-Speed Manual
- 5-Speed Manual
- 4-Wheel Drive
- Limited Slip Differential

III. ENGINE OPTIONS

- V-8 Gasoline
- 6 Cylinder Gasoline
- 4 Cylinder Gasoline
- Multi-Value Engine
- Turbocharging
- Throttle Body Fuel Injection
- Port Fuel Injection

IV. POWER EQUIPMENT AND WHEEL OPTIONS

- Power Steering
- Power Brakes
- Anti-Lock Braking System (ABS)
- 4-Wheel Disc Brakes
- Styled Wheels
- Full Size Spare

V. ROOF OPTIONS

- Vinyl
- Electric Slide
- Pop-Up Sun Roof
- "T" Roof or "T Top"
- Convertibles

VI. CONVENIENCE OPTIONS

- Cruise Control
- Tilt Wheel
- Air Conditioning
- Intermittent Windshield Wipers
- Reclining Seats
- Power Seats
- Power Locks
- Power Windows
- Power Side Mirrors

VII. SEAT OPTIONS

- Bucket Seats
- Split Seats
- Bench Seats
- Cloth Seats
- Vinyl Seats
- Leather Seats

VIII. RADIO INSTALLATIONS

- AM
- AM/FM Stereo
- AM/FM Stereo with Cassette
- AM/FM Stereo with Graphic Equalizer

IX. MISCELLANEOUS OPTIONS

- Rear Window Defogger
- Two-Tone Paint
- Automatic Seat Belts
- Air Bags
- Electronic Dashboard Display
- And many more, some costing as little as $2.69 on a $10,000 invoice or a "free" half a tank of gas on a $30,000 vehicle

"BOOKS AND RECORDS" AND CLOSED YEARS

Problems frequently come up in LIFO audits where the IRS wants to adjust years other than the years under audit or where taxpayers have not saved underlying "books and records."

Revenue Procedure 79-23, discussed on page 7, states that the failure by the taxpayer to maintain adequate books and records with respect to its LIFO inventory **and all computations incident thereto can or might** be grounds for terminating a taxpayer's LIFO election. Approaches vary for dealing with this position, since it seems to be the opinion of some IRS agents that a taxpayer has the additional burden of document retention or proof to the point of keeping records that would also support **alternative** LIFO computations, as well as those computations actually made.

There is no clear definition of what is meant by the term "books and records" as it relates to inventories.

In many instances, agents will request a dealer to produce all invoices, factory cost information and other information regarding model changes from year to year. If this cannot be produced, an agent may take the position that taxpayer has not satisfied its obligation to keep records supporting their LIFO computations. Even though an agent may threaten termination of the LIFO election for this failure, that threat usually gets softened into computational adjustments which reach back into what might otherwise be closed years. Furthermore, there seems to be no specific answer or guidance on how long taxpayers should retain all supporting LIFO computations and records.

As unbelievable as it may seem, some taxpayers do not have copies of their own annual LIFO computations. Imagine the problems this can cause when they change CPA firms, especially in a most competitive environment where the loss of a client may not be accepted with professional grace.

In a number of instances where taxpayers do not have **ALL** of the prior year information, one approach that the Service has accepted in its audits is to apply the average audit adjustment factor for a particular year or years' indexes to all prior years during which the LIFO election was in effect (thus getting around the statute of limitations on previous years). Although this approach gives the taxpayer relief from the impossible task of reconstructing indexes for prior years where information is not available because it has not been retained, it does not spare those earlier years from indirect adjustment, with the result being applied to the open years under audit.

For example, if a taxpayer had been on LIFO since 1975, but had saved records only from the years 1980 to date, if an IRS agent determined that the corrected LIFO inflation indexes for 1980 and 1981 should be 1.04 for each year instead of 1.06 as computed by the taxpayer for 1980 and 1.08 as computed by the taxpayer for 1981, then the average reduction of the index on audit for the open years for which information was available would be 3% (i.e., the sum of the differences between 1.08 minus 1.04 and 1.06 minus 1.04 or .04 plus .02 or .06, divided by 2 years equals .03). This average reduction of 3 percentage points would be subtracted from the indexes as computed in each of the prior LIFO years 1975 through 1979 (the years for which information was not readily available or saved by the taxpayer). See the accompanying example. This at least avoids the more unpleasant alternative of having the LIFO election terminated where prior records have not been retained. In one audit situation, where the original index for one of the previous years resulted in an inflation factor less than the audit adjustment factor as recomputed for a later year, no adjustment was made to the original index computation for any year where the inflation factor was less than what the IRS was satisfied with.

While there may be room in theory to raise technical defenses under Section 481, or under the general statute of limitations provisions, when faced with this issue one usually looks for reasonable and practical ways to compromise with the IRS. Accordingly, it is my opinion that all LIFO cost information should be retained indefinitely.

Another commentator, Leslie J. Schneider, *Federal Income Taxation of Inventories*, Section 10.02(2) at page 10.48 indicates

"If the taxpayer's taxable year is not barred by the statute of limitations, the taxpayer should be expected to retain all of its LIFO computations and all of the supporting cost accounting data that would be necessary to prove the accuracy of the LIFO computation. Once the taxable year is barred by the statute of limitations, the taxpayer should retain only those aspects of the LIFO computations that are necessary to perform subsequent years' LIFO calculations. Under this approach, for example, when the LIFO base year of the taxpayer is open, the taxpayer would retain a listing of all items in the base inventory and supporting cost accounting records and invoices to verify the base-year cost of the item. Once the base year closes, the taxpayer could discard the supporting cost accounting records and invoices supporting the base-year costs, but it would retain the list of items in the base year and their base-year cost for use in future double-extension calculations. In this example, the author contends that it would be unreasonable to expect the taxpayer to retain the underlying cost accounting records and invoices for the base year for as long as the taxpayer uses the LIFO method."

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"Books and Records" and Closed Years (Continued)

Another interesting approach taken by the IRS involves the recent case of *Hamilton Industries* in which the IRS was successful in challenging a method of accounting used in a closed year, enabling it to make an adjustment under Section 481(a) even though the prior year was closed under the statute of limitations.

All of this suggests that if a taxpayer has not retained detailed information for all prior years for which it used LIFO, it should (1) immediately start saving all information for current year computations, (2) immediately attempt to save or acquire information relative to prior years, starting with the most recent years and moving back in time as far as possible, and (3) attempt to develop an information sharing capability through a trade association or peer group that might be able to fill in information (at least as far as model change and factory price information goes) for prior years. This information is readily available within and without the industry from many sources and should be documented as thoroughly as possible sooner rather than later to avoid guesswork, speculation or extrapolation in later years on a retroactive basis.

It should be apparent from the foregoing that the failure to save or maintain all necessary LIFO cost information and records can be used on audit against the taxpayer in a variety of disadvantageous ways, limited only by the ingenuity, aggressiveness and negotiating position of the examining agent.

ADJUSTING PRIOR YEAR INDEXES

	Older Years (Adjusted by Inference)				Open Years Recomputed		
	1975	1976	1977	1978	1979	1980	1981
Index Originally Computed by Taxpayer	1.07	1.05	1.04	1.03	1.05	1.06	1.08
Index as Recomputed by IRS for Open Years						(1.04)	(1.04)
Difference						.02	.04
Adjustment for Average Difference Factor (.02 + .04 = .06) (.06 divided by 2 years = .03)	(.03)	(.03)	(.03)	(.03)	(.03)	N/A	N/A
Index as recomputed for years for which information was not retained by taxpayer or for older years	1.04	1.02	1.01	1.00	1.02	N/A	N/A
CUMULATIVE INDEXES							
Per Taxpayer	1.070	1.124	1.168	1.203	1.264	1.340	1.447
As Adjusted by IRS	1.040	1.061	1.071	1.071	1.093	1.137	1.182

Theory, Practice & IRS Audit Issues (Continued from page 6)

done and who's auditing you, you may find your LIFO computations under extreme IRS scrutiny and challenge or you may find them accepted almost by default. Until the IRS addresses the wide diversity of LIFO practices in a semi-comprehensive Revenue Ruling or Revenue Procedure, spelling out definitively what practices are or are not (more or less) acceptable, as well as providing reasonable and practical transition rules for changing from less acceptable alternative methods, dealers and CPAs can expect little uniformity or certainty across the board in resolving LIFO issues. Whether this current state of affairs is a good omen or a bad omen remains to be seen.

LIFO WATCH: WHAT'S NOT SO NEW

TWENTY LIFO RULINGS AND TAMS FROM THE '80'S

1. LTR 8011028 IRS won't condition bonus ruling on non-availability of statements to employees.
2. LTR 8011064 Use of FIFO to compute bonuses won't violate the LIFO conformity requirement.
3. LTR 8043023 Failure to value inventory at full absorption cost warrants termination of LIFO election. Wow!
4. LTR 8116029 Use of FIFO method to compute employee bonuses does not terminate LIFO election.
5. LTR 8130024 Grocery chain is required to use nine pools, not just one, in applying LIFO method.
6. LTR 8138005 Use of multiple indexes in dollar value "may be appropriate".
7. LTR 8140013 Grocery store's use of historical cost complements under retail LIFO method is held unacceptable.
8. LTR 8332011 Tractor dealer's LIFO election will not be terminated due to improper election of link-chain method.
9. LTR 8410014 Using specific-goods method for financial reports and pooling method for tax purposes satisfies conformity requirement.
10. LTR 8437004 Service concludes that the use of dual indexes is inappropriate for one auto dealer.
11. LTR 8453001 Auto dealers may put all models of manufacturer's cars in one inventory pool.
12. LTR 8503003 Supermarket operator must use more than one LIFO pool.
13. LTR 8721046 Retail department store may use new 23 pool inventory method.
14. LTR 8744003 IRS allows grocery store chain to prove that its LIFO inventory method is satisfactory.
15. LTR 8749005 Index used to value increments must be based on the mix and quantity of items in the ending inventory.
16. LTR 8751005 Retail LIFO department store accounting for inventory in transit.
17. LTR 8851001 Grocery store chain failed to comply strictly with LIFO rules, but the failure to comply does not justify termination of the LIFO election.
18. LTR 8906001 Major letter ruling of interest to auto dealer LIFO inventory enthusiasts: 6 issues are discussed.
19. LTR 8908029 Addendum to financial statement to present comparisons in market values does not violate LIFO conformity requirement.
20. LTR 9010112 Company cannot "simply" use the LIFO index for its new equipment pool in determining the LIFO value of its used equipment pool.

COMMENT: If you're especially interested in grocery, supermarket and other similar retailers, check out items 5, 7, 12, 13, 14, 16, and 17 on the top twenty list above.

If you're especially interested in auto dealer issues, are you familiar with 8, 10, 11, 18, and 20 on the list?

If you're especially interested in financial statement conformity and bonus issues, do items 1, 2, 4, 9, and 19 ring a bell?

And if you enjoy the special excitement of "dual index" computations, have you memorized 6 and 15 yet?

The De Filipps' LIFO Lookout newsletter is a quarterly publication of LIFO News, Views and Ideas by Willard J. De Filipps, CPA, P.C., 317 West Prospect Avenue, Mt. Prospect, IL 60056. It is intended to provide accurate, general information on LIFO matters and it should not be construed as offering accounting or legal advice or accounting or legal opinion on any specific facts or circumstances. The contents are intended for general information purposes only. Readers should consult their certified public accountant, attorney and/or other competent advisors to discuss their own situations and specific LIFO questions. Mechanical or electronic reproduction or photocopying is prohibited without permission of the publisher. Annual subscription: $250. Not assignable without consent. Any quoted material must be attributed to De Filipps LIFO Lookout published by Willard J. De Filipps, CPA, P.C. Editorial comments and article suggestions are welcome and should be directed to Willard J. De Filipps at (708) 577-3977; FAX (708) 577-1073. Lookout format designed by *Publish or Perish*, (708) 289-6332. © Copyright 1991 Willard J. De Filipps.

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