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. **STORM WARNING.** Depending on where you are, LIFO audits may become a much more distressing part of your life next year. The IRS has found many dealership LIFO audits to be very "profitable" in terms of large dollar adjustments. It is training more agents more intensively to go out and get more.

The last issue of the *Lookout* was written before I started my 1991 LIFO for Auto Dealer seminars which were presented all over the country. Feedback from these seminars appears in this issue, along with an extensive discussion of the recent *Hamilton Industries* case. With the clock ticking down on the end of the year, this issue of the *Lookout* also gives special consideration to the year-end financial statement LIFO conformity requirement.

As you read the articles in this issue, you should reflect on their common theme that the skies overhead are not shining brightly on LIFO. The forecast seems to be cloudy, hazy with storm clouds gathering...at least that's how I see it right now. I have tried to keep my personal views out of the technical discussions as much as possible. I would be very interested in your reaction and outlook if you have the time to call or write.

2. **HAMILTON INDUSTRIES.** The Tax Court dealt a major blow to many LIFO computations in late summer in upholding the IRS in *Hamilton Industries, Inc.* (97 TC 120 (1991)). The IRS quickly followed that up with Announcement 91-173 (IRB 1991-47, November 7, 1991) requiring taxpayers with *Hamilton* type deep discount bulk bargain purchases of inventory to file Form 3115 to change the LIFO accounting methods by which they "locked in" LIFO benefits. Worse still, it will be necessary to compute a Section 481(a) adjustment - that means pay tax immediately on the bargain element that was thought to be delayed by a LIFO election. See the article beginning on page 4.

3. **SAMPLING.** One of the biggest and most obvious issues in LIFO audits involves the use of sampling to compute indexes. There seems to be almost as many different sampling approaches and applications as there are different CPAs and IRS agents. Differences exist in understanding and applying sampling techniques at the practice level - as well as at the agent review level and at the National Office level. Some agents seem to be doing their own sampling to prove or disprove taxpayer index calculations. Nothing substantive can be found in tax literature to offer encouragement, practical guidance or boundaries or guidelines for applying sampling in (LIFO) inventory situations...even though sampling has been applied to inventories ever since Day One. After looking in vain for something, anything, in print anywhere for assistance, one has no choice but to accept the uncertainty and risk attendant with the use of sampling.

The Regulations provide that an index (sampling) method may be used if it is properly elected and can be justified. The Regulations also provide that adequate

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LOOKOUT LOOKS INTO

THE ULTIMATE TRAP
THE FINANCIAL STATEMENT LIFO CONFORMITY REQUIREMENT

The most serious trap of all for LIFO users is highlighted by three questions on line 5 of Form 970. These questions ask whether the taxpayer has issued credit statements or reports at year-end to any one of a variety of users and, if so, what inventory method of accounting was used in determining income, profit or loss in those statements.

Question 5 relates to the requirement that LIFO must be used to compute income in the year-end financial statements: technically, only in the primary presentation of income. For many taxpayers, this LIFO conformity requirement really poses multiple requirements: First, it requires all year-end financial statements sent to the a manufacturer or supplier (12th, 13th and any other fiscal year-end statements) to reflect LIFO. Second, the conformity restriction also requires that any other year-end financial statements issued in report form by the taxpayer to creditors, shareholders, partners or other users must also reflect the year-end results on LIFO.

The intent underlying the LIFO conformity requirement is that the accounting method used for tax purposes for inventories should be the best method available. Accordingly, if a taxpayer wants to use LIFO for tax purposes, then LIFO **must** also be good enough to be used on the year-end income statements sent to shareholders, creditors and other parties.

Section 472(c) of the Code says that a taxpayer may adopt LIFO only if it has used no other procedure than LIFO in preparing an income or profit or loss statement covering the first taxable year of adoption. For subsequent taxable years, similar restrictions are imposed - but the Commissioner has the discretion to allow a taxpayer to continue to use the LIFO method even though conformity violations might have occurred.

Therefore, if a taxpayer violates the conformity requirement, the IRS can terminate the LIFO election. And usually, the IRS will terminate the LIFO election when it detects a conformity violation. Accordingly, a LIFO reserve - no matter how large - can be completely and abruptly lost if careful attention is not paid to the conformity requirement in year-end financial statements sent to the Factory, as well as to year-end statements issued in report form by CPAs.

<u>REPORTS ISSUED BY CPAS</u>

Let us first look at the conformity requirement in relation to year-end financial statements included in reports issued by CPAs where the CPA has control over the release and format of the statements, notes and accompanying supplementary information. These financial statements are unlike "Factory" statements which are routinely sent out directly by the dealership without CPA involvement or review.

The LIFO conformity requirement requires that in the primary presentation of income (i.e., the income statement), the results disclosed must only be the **net of LIFO** results. The primary income statement CANNOT show results before LIFO, followed by either an addition or subtraction for the net LIFO change, coming down to a "final" net income or loss after-LIFO figure. In an inflationary period with stable or rising inventory levels, this means that a business using LIFO will be reporting (without adjacent explanation) lower operating results - maybe even converting income into loss or converting losses into even larger losses - in order to satisfy the conformity requirement.

The Regulations were "liberalized" in 1981 to allow taxpayers to disclose non-LIFO operating results in **supplementary** financial statements as long as those supplementary non-LIFO financial statements are (1) issued as part of a report which includes the primary presentation of income on a LIFO basis and (2) as long as each non-LIFO financial statement contains on its face a warning or statement to the reader that the non-LIFO results are "supplementary to the primary presentation of income" which is on a LIFO basis. Accordingly, for audit, review or compilation reports issued by a CPA to accompanying financial statements at year-end, results on a non-LIFO basis can be disclosed in this manner as supplementary information.

Alternatively, the Regulations permit disclosure of non-LIFO results in a footnote to the regular year-end financial statements, as long as the statement of income itself does not disclose this information parenthetically or otherwise **on its face** and the notes are all presented together and accompany the income statement in a single report. That was the good news or "liberalization" that occurred when the Regulations were changed in 1981.

Some interim reports covering a period of operations that is **less than** the whole of a taxable year may be issued on a non-LIFO basis without violating the LIFO conformity requirement. However, GAAP seems to require that if financial statements at year-end will be reporting using LIFO, then any interim financial statements should also report using LIFO.

<u>"GETTING AROUND" THE CONFORMITY REQUIREMENT</u>

The Regulations do allow taxpayers plenty of opportunity to get around the **intention** of the conformity requirement. Many businesses using LIFO would like to report lower taxable income/earnings in tax returns but report higher earnings/more income to their shareholders and creditors for report card purposes.

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This is legitimately possible because the Regulations allow taxpayers to use **different** LIFO methods and sub-elections in their financial statements than the LIFO sub-elections and methods that are used in their tax return computations. That's right: it is **not** necessary for the year-end financial statements to use the same exact LIFO sub-elections that are used in the tax return LIFO calculations. The Regulations simply require that both sets of statements (financial reports and tax returns) must report using LIFO.

One company reportedly used 200 more pools for financial reporting purposes than it used for tax purposes. It enjoyed the "best of both worlds" without violating the fine print in the "conformity" regulations. Other companies use link-chain or link-chain, index methods to lower LIFO income for tax purposes, but use double extension LIFO for financial reports. Similarly-motivated taxpayers play both ends against the middle by reconstructing base prices for new "items" in their tax return LIFO calculations while pricing new items at current cost in their financial statements. There are lots more ways to do this, just use your

see **THE ULTIMATE TRAP**, page 8

PROJECTING YEAR-END LIFO RESERVES TO MEET THE CONFORMITY REQUIREMENT

Very often, it is not possible to make the computation of the year-end change in the LIFO reserve before the so-called 12th statement has to be sent to the Factory. Nevertheless, these year-end statements must not be released until an **ESTIMATE** of the LIFO reserve change has been computed and reflected in them. In current IRS audits, agents have requested documentation to check compliance with the year-end LIFO conformity requirement. Therefore, it is important to prepare a reasonable estimate of change in the LIFO reserve for the year. The estimate should be documented and saved for all time in the "LIFO-SAVE FOREVER" file.

Computing the estimate of the projected change in the LIFO reserve is usually not too difficult or time-consuming. It involves two factors: (1) the actual ending inventory level and (2) an **estimate** of inflation percentage for the year. By the time the estimate is being prepared, the actual dollar amount of the ending inventory usually is known. That means the only unknown is the estimated rate of inflation for the year. All other factors necessary to compute the estimated change are **known**:

(1) Beginning-of-the-year inventory expressed in total dollars and in base dollars,

(2) Beginning-of-the-year LIFO value of the inventory,

(3) Method used for valuing current year increments, and

(4) Cumulative inflation index as of the beginning-of-the-year.

The computation of the projected change in the LIFO reserve is made by plugging in the estimate of the current year's rate of inflation or inflation index and then working backwards in the following order:

(1) Determine the cumulative index as of the end-of-the-year - this is the estimate of current year inflation index times beginning of year cumulative index,

(2) Divide the end-of-the-year actual inventory dollars by the cumulative index - to get the end-of-the-year inventory stated in base dollars,

(3) Compare the end-of-the-year inventory at base dollars with the beginning-of-the-year inventory stated in base dollars to determine whether there is an increment or a decrement projected for the year,

(4) Proceed to value the projected increment under the method selected. Alternatively, if a decrement is projected for the year, carry the decrement back against prior increments on a LIFO basis.

(5) Next, add all the resulting layers of inventory at their respective LIFO valuations to get the end-of-the-year inventory stated at its LIFO valuation,

(6) Then subtract the ending inventory at its LIFO valuation from the ending inventory at its actual or current non-LIFO cost to determine the projected LIFO reserve as of the end-of-the-year, and

(7) **Finally**, compare the actual LIFO reserve as of the beginning-of-the-year with the projected LIFO reserve as of the end-of-the-year.

The result after step 7 is the estimate of change in LIFO reserve for the year. This amount is usually rounded somewhat and then put into the 12th statement by an adjusting entry before it is sent to the Factory.

These **estimates** of change are routinely prepared and reflected in the dealer's year-end financial statements sent to the Factory: you don't have to know the exact change to reflect LIFO in the December statement. Reasonable estimates are permitted on the 12th statement. The actual computation of the change in the LIFO reserve for the year is usually made **after** the 12th statement has been sent out, when the actual inventory invoices and mix of models and model years can be fully evaluated and the LIFO index computations computed in accordance with the dealer's established LIFO practices. After the actual change in the LIFO reserve for the year has been computed, the 13th statement should adjust the estimated amount to the actual LIFO reserve amount.

Remember: Do it, Do it, Do it...even though you'd rather not!

HAMILTON INDUSTRIES: A NEW LIFO NIGHTMARE

In case you didn't hear it explode, the Tax Court did drop a bomb on LIFO calculations in July when it upheld the IRS in *Hamilton Industries, Inc.* (97 TC 120). This decision was filed July 30, 1991 and it has already produced one aftershock in the form of Announcement 91-173 (IRB 1991-47), which the IRS issued on November 7, 1991. Whether further damage to LIFO will be widespread depends on how aggressively the IRS tries to expand the significant leverage it now enjoys relative to **all** LIFO calculations (not just bargain purchases) and whether the taxpayer can get the IRS position reversed on appeal.

Hamilton Industries involved two bargain purchases of inventory, the earlier one at roughly 4 cents on the dollar and the later one at roughly 40 cents on the dollar. These bargain purchases were "locked in" by double extension LIFO methods in an effort to indefinitely postpone the taxation of income resulting from the bargain elements. In its decision, the Tax Court held that (1) the IRS could reach back to a year otherwise barred by the statute of limitations by requiring an adjustment under Section 481 (a) to the earliest open year and (2) that the significantly large bargain elements represented by discounts as sizable as those enjoyed by *Hamilton* caused those inventories acquired to assume a different character from similar inventories purchased or produced at prevailing or market prices after the bargain purchases took place.

The bargain purchase price allocations resulted in artificially low values assigned to base year inventories as compared to the cost of subsequently purchasing or producing these inventories under normal conditions. According to the Tax Court, this, in turn, resulted in a **factor other than inflation** being introduced into the LIFO indexes and LIFO computations. Consequently, the Tax Court held that in order to avoid a distortion of income and in order to "clearly reflect income," *Hamilton* should be required to recognize the gain inherent in the bargain cost inventory shortly after the purchase transaction when those goods were sold.

In the earlier of the two purchases, the inventory acquired received an allocation of $79,028 - against which the seller's FIFO valuation would have been $2,034,680. That's a bargain of roughly $1,950,000 with the inventory being bought for about 4 cents on the dollar. In the second purchase, the bargain element was about $10 million - or the difference between the purchaser's allocated cost of $6,550,262 compared to the seller's FIFO value of $16,566,320. In both purchases, the taxpayer further allocated the amount paid for the inventory down to each item in inventory in proportion to its relative FIFO value. In both cases, the taxpayer also continued the business of manufacturing and selling goods that had been previously carried on by the seller. The products produced or manufactured after the acquisitions were identical to those previously produced by the sellers. Double extension, dollar value, LIFO elections were made in the initial income tax returns filed by the purchasing corporations.

The Tax Court upheld the IRS position that the substance of each IRS adjustment was a change in the purchaser's method of accounting for inventory and that a Section 481(a) adjustment increasing the purchaser's income with respect to the earlier acquisition →

SON OF HAMILTON: IRS ANNOUNCEMENT 91-173

Did you ever see an elephant run a four minute mile? Yes, you did! In an unbelievably swift but not surprising display of speed, the IRS issued Announcement 91-173 (IRB 1991-47) on November 7, 1991. This Announcement is intended to provide guidance to taxpayers involving certain voluntary accounting method changes for LIFO inventory pursuant to Section 446 and the Tax Court's decision supporting the IRS in *Hamilton Industries, Inc.*

This Announcement contains only three paragraphs: the first is a preface, the second is a brief summary of the decision in *Hamilton Industries*, and the third provides that:

1. Taxpayers requesting the advance consent of the IRS to voluntarily change their method of accounting for bulk bargain purchases of inventory to a method consistent with that required by the Tax Court in *Hamilton* are required to file a current Form 3115, Application for Change in Accounting Method. (Note the new July, 1991 revision of Form 3115 is mentioned in this issue's LIFO UPDATE section.)
2. The IRS will require a Section 481(a) adjustment to implement this LIFO inventory method change for applications filed on or after November 7, 1991 - the date of the Announcement. (This will make the $500 "user fee" look like small peanuts, adding insult to injury for downtrodden filers.)
3. The provisions relating to Category B methods of accounting described in Revenue Procedure 84-74, or any successor document, will apply in determining the applicable adjustment (spread) period.
4. If the taxpayer's books and records do not contain sufficient information to accurately compute the Section 481(a) adjustment and revalue LIFO inventories, the Service will **generally** permit the use of **reasonable** estimation procedures. (What have we here?... **estimation procedures**... how gracious!... "reasonable?")

Query: How come the IRS takes only three months to provide guidance after *Hamilton*...when it takes more than 30 years to provide guidance on far more common LIFO problems?

could be made to the earliest open taxable year (1981) even though that bargain purchase had taken place six years earlier. The Tax Court pointed out that (1) adjustments to correct undervaluations of inventory constitute accounting method changes, (2) the use of a practice that results in an understatement of closing inventory postpones, and does not avoid, the inclusion of income, because the income not included due to such understatement in value eventually will be taken into account at such time as the closing inventory is correctly stated, and consequently that (3) a change in the method of valuing closing inventory constitutes a change in method of accounting to which Section 481 applies. Following from all of this, it was held that Section 481 permits an adjustment with respect to closed years to be made during the earliest open year under audit.

The Tax Court overruled the taxpayer's three arguments that (1) isolated purchase transactions carried on by separate taxable entities did not establish a method of accounting, (2) the determination of when a new item comes into existence is so factual as not to rise to the level of an accounting method, and (3) that inventory acquired from the sellers did not constitute an "item" within the meaning of the regulation.

After ruling on the applicability of Section 481, the Tax Court looked to the interplay between Section 446 (which covers methods of accounting) and Section 471 (which covers inventories in general). Both Sections 446 and 471 grant the IRS broad discretion in matters of inventory accounting and permit the IRS wide latitude to adjust a taxpayer's method of

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BYE... BYE... BARGAIN LIFO

WHAT THE TAX COURT SAID IN HAMILTON

"Petitioner seeks to fill its inventory with goods purchased at a steep discount, and then replace them with goods purchased and produced at higher cost. The difference between petitioner's base year inventory cost and inventory cost incurred after the acquisition is **not attributable to inflation**, but rather to the artificially low value assigned base year inventory as compared to the cost of subsequently purchasing or producing such inventory at prevailing market prices. The consequence of permitting such replacement is an increase in the cost of goods sold, resulting in an understatement of petitioner's income.

"The disparity between the value assigned (to the bargain purchase inventory when compared to the seller's FIFO value for the same inventory) indicates that petitioner purchased such inventory at a substantial discount from its replacement cost or market value, and that such inventory therefore possessed **materially different cost characteristics** from inventory purchased or produced after the acquisitions. We hold that the significantly large bargain element represented by such discount caused inventory acquired to assume a **different character** from inventory purchased or produced at market prices as represented by the FIFO value of the inventory after the acquisition....

"We do not believe...that permitting a taxpayer to defer recognition of the gain realized on the disposal of such assets by means of accounting devices is appropriate under the circumstances of the instant case. If petitioner were permitted to combine the bargain cost inventory with goods carried at a higher cost, representing the current costs of production, petitioner could postpone recognition of the gain realized on disposal of the bargain cost inventory until such time as it decided to permit a liquidation of the inventory...

"In order to clearly reflect income, (taxpayer) should be required to recognize the gain inherent in the bargain cost inventory at the time such gain is realized, rather than at a later time of petitioner's choosing. Such a requirement is in harmony with the matching principle which is at the heart of the inventory accounting rules (under Section 471). To hold otherwise would permit petitioner to include the cost increases attributable to the replacement of bargain cost inventory with inventory produced at prevailing market prices in the cost of goods sold **as though such cost increases were attributable to inflation**. The LIFO method was not intended to permit taxpayers to include in cost of goods sold cost increases attributable to the replacement of goods with low cost characteristics with goods possessing higher cost characteristics.

"Thus, even though the two classes of inventory were physically the same, the great disparity in their cost warrants separating them. Accordingly, we hold that the inventory acquired (in the bargain purchases) should be treated as items separate from the inventory acquired or produced subsequent to such acquisitions. Such treatment avoids a distortion of petitioner's income, produces a better measure of inflation, and results in a clear reflection of petitioner's income."

In a footnote, the Tax Court made an analogy between the result under the LIFO lock-in of the bargain purchase element and the **base stock** method of accounting. The **base stock** method is not a permissible method of tax accounting because it "obscures the true gain or loss of the year, and thus, misrepresents the facts."

The Tax Court did say that "had the cost characteristics assigned to the inventory acquired in (the bargain purchases) not been so disparate from the cost of later acquired inventory, we would not have required their separation."

Query: Are other taxpayers' bargain purchase situations distinguishable from *Hamilton* if their bargain purchase elements are not as extreme as 4 cents on the dollar or 40 cents on the dollar? Where should the line be drawn? Where do you draw the line in light of Announcement 91-173?

records must be maintained to support the appropriateness, accuracy and reliability of an index. An index method reprices less than every item, and is subject to the requirement that a "representative portion" of the inventory must be repriced.

IRS agents are usually reluctant to accept the results of taxpayer's sampling because the "double extension" method sets the standard requirement that every item must be repriced in the LIFO computations. While some CPA's mention that they have "heard" that the IRS will accept sampling if it includes 70% of the dollars in ending inventory **and** 50% of the items, this guideline does not seem to be expressed anywhere in IRS official print. Has any reader ever seen this in print?...if so, where?

Some agents will accept only statistical (as opposed to judgmental) sampling approaches; others seem more inclined to apply common sense to get the **estimating** job done. More on this topic in a future *Lookout* issue. Like icy roads in the winter, no one knows whether any sampling direction is safe and, unfortunately, the collaboration between the IRS and the AICPA to come up with some guidelines for statistical sampling in LIFO calculations seems to have come to a dead end. I wonder... why?

The absence of any discussion and guidance on the use of sampling in LIFO inventories has created confusion and it may help to explain IRS resistance to formally acknowledge or recognize the existence of the link-chain, **index** method. This method has been used by many major corporate taxpayers in the real world since long before the Regulations were issued in 1961. The Service seems to prefer instead to acknowledge only the "link-chain" method (see the newer revisions of Form 970 and 3115 which refer only to link-chain) and leave it to agents to fight this out on an audit-by-audit basis. In some instances, IRS agent's "reconstruction" of indexes on audit are based on the agent's understanding of sampling which may be far from sound or accurate, but the taxpayer may accept that agent's results despite their flaws because that's the easiest way just to settle the audit and get on with life.

4. **DO WE NEED A SAMPLING REFERENCE LIBRARY?** If readers will send me a list of sources they have found useful in explaining or illustrating Sampling in (LIFO) inventory situations, I will compile a bibliography from these sources and print it in the March or the June, 1992 issue of the *Lookout*. This can be useful to all of us...but it requires your input.

5. **ITEM CLARIFICATION?** In the November, 1991 *Automotive Executive*, page 5 of the NADA Report indicated that "the IRS has been accepting LIFO accounting methods that define an item of inventory based on the manufacturer's vehicle code, rather than on individual parts and accessories." The comment is also made that "this unannounced shift in practice to a less restrictive method shows a new willingness by the IRS to compromise on this issue." Apparently this relates to the listing of an option and accessory package on a new vehicle invoice, rather than to a dealer's inventory of parts and accessories. Query: Does this mean we have still another possible definition of the term "item" for an auto dealer?

Because it was so condensed, this piece of "news" seems to confuse, rather than to clarify, the interpretive problems surrounding dealer LIFO calculations. Also, the general reference to "IRS acceptance" raises the question of whether this "IRS acceptance" is at the agent/audit level or at the National Office level in connection with Form 3115 filings when permission to change methods is requested. Reader feedback or clarification on this point would be appreciated and shared in a future issue.

6. **THEORY vs. PRACTICE.** Conversations with some former IRS agents included their observations that dealing with the National Office occasionally can be frustrating if a technician comes up with an impractical or theoretical response to an issue raised on audit that requires computations involving an enormous amount of time. If the agent in the field expends a large amount of time and comes up with a relatively small

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dollar adjustment (because in practice the theory doesn't stand up), then the agents have a difficult time justifying why they spent so many hours just to come up with a small dollar deficiency or, worse yet, a "no change" result.

For auto dealer LIFO situations, the IRS has been exposed to assertions that LIFO computations for car dealers can be done with 100% accuracy and exactitude - the antithesis of "sampling." The National Office certainly seems to believe this and some agents have started to believe this. The absence of any counterbalancing commentary or unified opposition from within our profession has aided the Service with even more leverage to intimidate dealer calculations one-by-one.

7. **FORM 3115, APPLICATION FOR CHANGE IN ACCOUNTING METHOD**, was revised July, 1991 and requires (on Page 4, Schedule B, Parts I, II & III) more information to be completed in connection with LIFO method change requests. The prior Form 3115 (January, 1989) had only one Section C for Change in Method of Valuing Inventories. The new Form 3115 (July, 1991) has one section (Section B, page 4, Parts I, II and III for Changes **Within** the LIFO Inventory Method) and a separate section (Schedule C, page 5, Part II for Changes in Valuing Inventories) for use in requesting permission to terminate a LIFO election under Section 472 or to make other changes in valuing inventory under Section 471.

The instructions for completing Schedule B, where changes in LIFO methods are involved, specifically requires an explanation "if any of the present methods indicated in items 1 through 4 are different from those selected on Form(s) 970." This will immediately bring to light any unauthorized changes made in sub-elections on previously filed Forms 970.

For LIFO Termination requests, copies of prior filed Form 970's must be submitted. If a copy of Form 970 can't be submitted, a statement under the penalties of perjury may be provided as a substitute.

WARNING: Just like the most recent April, 1990 revision of Form 970, the most recent revision of Form 3115 refers only to the "link-chain" method - for which there is no official definition. Therefore, if you actually are using, or are requesting to change to a "link-chain, **index**" method, be sure you add the word "index" to "link-chain". Or be sure you define exactly what you mean by the term "link-chain." Technically, this could make all the difference in the world if you think link-chain means one thing (i.e., your way) and the IRS comes along later and says it means something else (i.e., their way).

NATIONAL OFFICE... IN THE LION'S DEN

NATIONAL OFFICE...THE LION'S DEN? Some CPAs are now questioning the wisdom of voluntarily going to the National Office to request permission to change from less desirable LIFO methods...and it's not because of the $500 user fee involved. In looking back on many IRS audits going on now, some CPAs are finding an interesting sequence of activity:

A. The taxpayer filed a Form 3115 in the National Office in Washington, DC to request to voluntary change from a less desirable LIFO method to what was hoped to be a more accurate, more acceptable method,

B. The taxpayer received significant static and opposition to the requested change from the National Office. This sometimes included the message that a Section 481(a) income adjustment would be required (instead of allowing the taxpayer to use the previously traditional, hassle-free "cut-off method"),

C. The taxpayer withdrew the request for ruling because a "favorable" ruling was not likely to be granted, and **THEN**

D. The taxpayer eventually was contacted by the local IRS to set up an audit of their LIFO computations.

This A-B-C-D pattern seems especially common where Form 3115 requests involved efforts to change from the unit (or specific goods) method or from a double extension, dollar value approach where averaging calculations were being used. See June, 1991 *Lookout* for extensive coverage on Form 3115 filings and voluntary change requests. In some instances the National Office is telling dealers filing 3115's that if their demonstrators are not on LIFO, they must be put on LIFO if the other LIFO changes being requested are allowed. Some CPAs have been told that they are "required" to reprice every option and accessory on a new vehicle invoice as part of their index calculations by including all inventoriable costs in the cost of the items used in computing indexes.

Given the intensifying anti-LIFO attitude in the National Office, some taxpayers are understandably reluctant to voluntarily expose less attractive LIFO methods to the National Office in Washington, DC. They feel their only realistic option is to continue using less desirable LIFO methods. This is unfortunate if higher-level Treasury-IRS officials are really concerned about overall compliance and taxpayer consistency.

Taxpayers are now more likely to just "wait and see" or take their chances on audit. But, for taxpayers with less desirable LIFO methods, the problem with a "wait and see" approach may be that the IRS, with *Hamilton* under its belt, seems to have effectively torn down significant, if not all, statute of limitation protection. That statute of limitation protection otherwise might have prevented IRS LIFO exams from going all the way back to the first LIFO year regardless of how long ago that was. Also note the Update discussion below about the revised and expanded Form 3115 relative to LIFO changes is probably not purely coincidence, either.

The Ultimate Trap (Continued from page 3)

imagination or read what Abraham Briloff had to say (make that denounce) in connection with these "have your cake and eat it too" dual reporting LIFO practices allowed by the Regulations.

DEALERSHIP YEAR-END STATEMENTS SENT TO THE FACTORY

The **"BAD NEWS"** is that the Regulations contain severe LIFO conformity reporting restrictions that apply to the Factory-prescribed format financial statements sent by a dealership to the Factory immediately after year-end. These restrictions are the ultimate LIFO trap and are potentially more troublesome than those previously discussed for year-end reports issued by CPAs.

In this regard, the Regulations provide that any income statement that reflects a full year's operations must report on a LIFO basis, whether it is the last in a series of interim statements, or the December statement itself which shows two columns - one for "current month" and one for "year-to-date" figures. The Regulations provide that a series of credit statements or financial reports is considered a single statement or report covering a period of operations if the statements or reports in the series are prepared using a single inventory method and can be combined to disclose the income, profit, or loss for the period. Sometimes this is referred to as the "aggregation" theory, meaning that if you can combine or aggregate a series of interim or partial-year statements to disclose the results of operations for a full year, then the last statement must reflect income computed using LIFO to value the inventory.

Literally interpreted, this wording applies to an auto dealer's 12th statement (i.e., December - unadjusted) as well as the 13th statement. The 12th statement is usually issued on a "preliminary" basis, before accruals are refined by detailed adjusting entries. The 13th statement is usually issued several weeks after the 12th, and it reflects year-end accrual adjustments and other computations not otherwise permitted by the tight time frame for the issuance of the December/12th statement.

This conformity requirement means that **every year** to remain eligible to use LIFO, the dealership's December (or last monthly) statement must reflect an estimate of that year's change in the LIFO reserve.

If the dealer is anticipating making a LIFO election for the year, an estimate of the LIFO reserve should be placed in the year-end statements issued to the Factory or issued to anyone else in order to preserve the option to elect LIFO available when the tax return for the year is filed. Don't overlook this conformity requirement if a dealer already has new vehicles on LIFO and is considering extending LIFO to either used vehicles or to parts and accessories. In this case, the dealer's year-end statement going to the Factory should also reflect an estimate of the size of the LIFO reserve expected upon making the additional LIFO election(s) in order to preserve the dealer's eligibility to extend LIFO to whatever class of goods is under consideration.

Special reporting situations exist in some dealerships where a so-called "different year end" is used for reporting to the Factory (calendar year - Dec. 31) than the fiscal year used for income tax purposes. Separate wording in the Regulations requires the dealership's financial statements to reflect LIFO at the end of both twelve month annual reporting periods or "years" in order to satisfy this **strict** conformity requirement.

The actual wording of the regulation on this point is that the conformity rules also apply to the determination of income, profit, or loss for a one-year period other than a taxable year and credit statements or financial reports that cover a one-year period other than a taxable year, but only if the one-year period both begins and ends in a taxable year or years for which the taxpayer uses the LIFO method for Federal income tax purposes. For example,...in the case of a calendar year taxpayer, the requirements...apply to the taxpayer's determination of income for purposes of a credit statement that covers the period October 1, 1981, through September 30, 1982, if the taxpayer uses the LIFO method for Federal income tax purposes in taxable years 1981 and 1982.

The intention underlying the conformity requirement is that LIFO should be used in all reports covering a full year to insure that the use of LIFO for tax purposes conforms as nearly as possible with the best accounting practice in the trade or business in order to provide a clear reflection of income. If one simply remembers that this exists as a restriction on the taxpayer's general desire to pay lower taxes using a favorable LIFO method while reporting more income to their shareholders or banks using a non-LIFO method, that should dispel any temptation to try to get around the conformity requirement.

The projection of year-end change in the LIFO reserve is usually needed in planning estimated tax payments either for the corporation (due December 15 - if a regular C corporation) or by January 15 for dealerships that operate as S corporations and flow net income, or loss, through to their individual shareholders via Schedule K-1's. See the accompanying box for steps in making the projections.

POWELL AND INSILCO

CPAs and their clients should be especially careful to monitor all year-end financial statements so as not to get trapped by the conformity requirement...since the position of the IRS is that once financial statements have been issued on a non-LIFO basis, it is too late to →

recall them and reissue statements on a LIFO basis. The *William Powell Company* decision (81-1 USTC P 9449) illustrates one taxpayer's success in avoiding having the IRS terminate its LIFO election when it came down to "all-or-nothing" with the IRS on this issue. This case, decided in 1981, involved what would have been the termination of a LIFO election made in 1973 because the taxpayer had first issued non-LIFO statements and then later made a LIFO election when it filed its tax return. In that case the taxpayer recalled its non-LIFO statements and replaced/reissued LIFO statements. The taxpayer probably would have lost its LIFO election if it had gone to the Tax Court, but fortunately the taxpayer can chose the forum in which it will litigate a LIFO controversy...and the Powell Company chose (wisely) to litigate this issue in the District Court in Ohio.

The NADA Bulletin on *Dealer Monthly Reports and the LIFO Conformity Requirement* in December, 1985 stated: "Unfortunately, the inadvertent violation of the LIFO conformity requirement cannot be retroactively corrected. Once the violation has occurred, the only thing that can be done at the present time is for the dealer to make sure that the problem does not reoccur and to hope that the statute of limitations runs on the year(s) of violation without discovery by a revenue agent. Many practitioners believe that a revenue agent can only terminate LIFO if the conformity requirement has been violated in a so called "open" year and that once the statute of limitations has run on the year(s) of violation, a revenue agent may not terminate LIFO."

For an auto dealer unwittingly trapped by this Factory financial statement requirement, perhaps one defense may be to question whether the additional change made in the Regulations in 1981 to include a series of interim financial statements under the conformity requirement is a reasonable interpretation by the IRS or the Treasury of the Congressional intent underlying the conformity requirement.

For another example of how seriously the Treasury/IRS polices the conformity requirement, consider the origin of Code Section 472(g). This subsection was added because the IRS lost the *Insilco* decision in the Tax Court. After its loss, the Treasury persuaded Congress to change the law (which it did by amending Section 472 to add subsection (g)) so that taxpayers in the **future** couldn't abuse the conformity requirement the way *Insilco* had been able to.

The bottom line is that the IRS takes the conformity requirement seriously. On many audits, instead of assuming that the taxpayer has complied, the IRS is now asking for "proof" that financial statements at year-end were not in violation of the LIFO conformity requirements. Don't be a nonconformist or let this requirement catch you unaware. *

accounting for inventory "so as to clearly reflect income." The Tax Court noted that even if a method of accounting comports with generally accepted accounting principles, consistently applied, if that method does not clearly reflect income, then that method will not control for tax purposes. Here it cited *Thor Power*, among others. Consequently, even though the principle of matching current costs and current revenues is involved under Section 472, it appears that Section 471 takes precedence because the "clear reflection of income" requirement/ standard appears in both Sections 471 and in 472.

Other observations made by the Court were that the Commissioner's determination with respect to the **clear reflection of income** is entitled to **more than** the usual presumption of correctness, and that the taxpayer bears a **heavy** burden in trying to overcome an IRS determination that a particular method of accounting should be used by the taxpayer in order to clearly reflect income. Whether a particular method of accounting clearly reflects income is a question of fact, and that must be decided on a case-by-case basis. More ominously, the Court indicated that the taxpayer carries the burden of showing that the method selected by the Commissioner to clearly reflect income is incorrect and that this burden of proof is extremely difficult for any taxpayer to carry, since the Commissioner's determination as to the proper method of accounting for inventory must be upheld unless it is shown to be plainly arbitrary.

As technical arguments, the IRS asserted that the bargain purchase inventory either should not have been included in the same pool or, alternatively, it should not have been included in the same item category as inventory manufactured by the taxpayer **after** the acquisition. Apparently the IRS learned well the lesson from *Fox Chevrolet* as to the importance of introducing both "pool" and "item" arguments in tandem against a taxpayer. Why throw a spear at a slow-moving target when you can throw a pitchfork?

As to the IRS assertion that separate **pools** were required, the Tax Court disagreed with the IRS and held for the taxpayer on the "pooling" issue. The Court distinguished its 1984 decision in *Amity Leather Products Co.* in which *Amity* was viewed as a "dual-function entity" both manufacturing leather goods **and** regularly purchasing identical goods from a subsidiary for resale...a situation requiring separate pools for manufactured and for purchased inventory. The Tax Court also distinguished its 1989 decision in *UFE, Inc.* in which the taxpayer was not required to have separate pools because it was not held to be a wholesaler or retailer of goods based on a single, isolated purchase occurring in the context of acquiring an ongoing manufacturing business where the taxpayer-acquirer continued to manufacture identical items after the

see **HAMILTON INDUSTRIES**, page 10

BASIC CONSIDERATIONS IN EVALUATING LIFO

1. Inventory writedowns in prior years must be taken into income ratably over the year of change and the next two (2) years. Also, there can be no other writedowns from cost. Cost requirement.
2. All reports covering the full taxable year, whether they are annual reports to shareholders, to banks, to manufacturers or suppliers, or to any other financing sources, or for any other purpose, must report on the LIFO basis at least in the primary presentation of income. Conformity requirement.
3. Form 970 and complete information concerning inventories must be submitted to the Internal Revenue Service with the tax return for the year of the LIFO election. Special, further filing requirements are involved if the link-chain, index method is used. Consent requirement.
4. Any contractual relationship dependent upon the definition of "net income" or "net book value" will be affected. Owner bonuses and profit sharing plan contributions based on "net income" may be reduced unless those agreements are amended. Buy-sell and other shareholder purchase agreements also should be reviewed. Directors' resolution to adopt LIFO is advisable.
5. Overall exposure before the Internal Revenue Service may be increased and may not necessarily be limited to (LIFO) inventory matters.
6. Additional costs - internal and external - usually are incurred. It costs money to implement a switch to LIFO, and (sometimes) to later defend it to the IRS.
7. Considerable time and expense may be involved in explaining and justifying the LIFO application to the Internal Revenue Service and to bankers.
8. One cannot change from LIFO without IRS permission - thus, for all practical purposes, one may become "locked in" to LIFO.
9. Overall price levels and/or inventory levels may eventually go down or the business may be liquidated, thereby requiring a repayment of part or all of the cumulative tax deferral. However, computational techniques and the planning of year-end inventory levels in future years could lessen this consequence considerably. **Tax rates are also likely to be changing over the years.**
10. Beware: There is a lot of misinformation about LIFO, especially as it relates to a closely-held business and its owners. Be sure you are not misled by some of the myths or an apparent lack of practical or objective information.
11. Future Shock for LIFO Users? Is LIFO still viable?
    - Reserves getting "too big" or "out of hand"
    - "S" Election problems and considerations
    - Deferring from corporate level to shareholder level and vice versa
    - Deferring from low tax rate years to higher tax rates?
    - AMT (Alternative Minimum Tax) and "E & P" computations for C corporations
    - Repeal of LIFO? Or modification of LIFO as we know it today?

Hamilton Industries (Continued)

acquisition. *Hamilton Industries* was found to satisfy the *UFE, Inc.* fact pattern and the Tax Court did not agree with the IRS on the pooling issue.

However, on the **"ITEM"** issue, the Tax Court examined relevant case law from which various factual patterns have produced isolated definitions of the term "item" on a case-by-case basis. It recognized that prior cases have held that the definition of the term "item" must not be so narrow as to impose unreasonable administrative burdens upon taxpayers, thus rendering impractical the dollar value LIFO inventory approach. On balance, however, it also recognized that the term "item" should be construed in a manner that most closely satisfies the "clear reflection of income" requirement found in the inventory provisions of the Revenue Code. The Court noted that inventory goods may be in separate "item" categories because they have substantially dissimilar characteristics, whether in terms of their **physical** nature or whether in terms of their **cost characteristics**. The Court reanalyzed its holding in *Amity Leather Products Co.* where the fact pattern involved the substitution of less expensive goods (at year-end) for more expensive goods (at the beginning of the year), thus tending to overstate taxable income. The *Amity* fact pattern was just the opposite of that found in *Hamilton*, where less expensive goods (at the beginning of the year) are offset by more expensive goods (at the end of the year), thus tending to understate taxable income.

The Tax Court rejected *Hamilton's* arguments that requiring separate accounting for the different items of bargain purchased inventory would impose an undue recordkeeping burden. It noted that the taxpayer could have easily tracked this inventory as it was being sold off or liquidated by sales in the ordinary course of the conduct of its business. The Tax Court also said that eliminating the significant distortion in taxable income which otherwise would have resulted if the two types of inventory had been allowed to be combined actually justifies or warrants the extra recordkeeping burden that might be imposed on the taxpayer in this case.

Hamilton further argued that the IRS method of correcting its inventories "might not be completely accurate," since the IRS treated all of the bargain purchase inventory as having been sold in the first full taxable year following each acquisition. The Court pointed out that the taxpayer had to do more than

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CONSIDERING A LIFO ELECTION THIS YEAR? RETHINKING OLD BASICS IN LIGHT OF NEW CONDITIONS

There is no question that many LIFO elections in the early 70's, late 70's and most of the 80's were advisable. However, a number of factors warranting those elections now seem to be somewhat different. The big question is: Are they different enough to warrant **not** making a LIFO election in 1991? See the accompanying box for a summary of basic considerations in evaluating LIFO. Consider the following.

FACTORS FAVORING A LIFO ELECTION IN THE 70'S

1. Inflation rates were significantly higher in the 70's and even some of the 80's than they are right now. Query: Are long term inflation rates likely to be significantly lower and/or likely to change very much?
2. Tax rates, both corporate and personal, were considerably higher in the past. Personal rates were as high as 70%, and then were reduced to a maximum of 50% by **ERTA**, the Economic Recovery Tax Act of 1981. Businesses operating under Subchapter S elections in the '70's achieved LIFO deductions and deferrals for their individual owners at very high 60%+ effective rates.
3. Inventory levels were growing, especially from the early 70's onward. Inventory levels now seem to be subject to continuing pressure to be kept on the modest side.
4. Investment yields from taking the tax dollars LIFO deferred and using them to pay down floor plan were comparatively higher because interest rates were higher then than they are now.

ANOTHER BIG DIFFERENCE: TRA '86

The Tax Reform Act of 1986 introduced two very significant changes: **First**, individual rates were **reduced** to a maximum of 28%, although they have since increased slightly to higher marginal rates of 33% or 31%. Generally, S corporation shareholders now enjoy a comparatively lower effective maximum rate of 33% for individuals.

Second, the repeal of the *General Utilities* doctrine by TRA '86 resulted in most automobile dealerships making an election to be taxed as S corporations. The reason for switching to S from C status was to minimize future tax expected to be incurred upon liquidation.

What all of this means is that taxpayers considering LIFO elections for 1991 may be deferring income taxes at comparatively lower shareholder rates (because of the S elections). But...what **IF** income tax rates on individuals go up significantly in the future?? For example, **if** individual rates were to go up to 45% or 50%, and **if** there should be a significant payback of LIFO reserves, the shareholders' payback of the LIFO reserves could be at significantly higher income tax rates than the rates in effect when the LIFO election began the deferral. Furthermore, when many businesses, especially dealerships, are sold or go out of business, the sale transactions usually involve sales of assets (resulting in liquidation of the entire inventory) rather than sales of stock (whereby carryover of LIFO reserves and LIFO inventory methods are transferred to the purchaser of the dealership's stock).

Do these factors and speculations make the "deferral advantages" of a new LIFO election for 1991 considerably less attractive than they were in the past...say in 1981 or in 1974? With lower interest rates, even if a dealer uses the LIFO "savings" to pay down floor plan, the compounded rate of return is comparatively lower. What about deferring into higher tax rate years? What about tighter control over inventory levels possibly limiting the growth of LIFO reserves? Not to mention the new breed of IRS agents examining LIFO nowadays and whittling down the inflation rates originally computed?

I certainly don't have or know any or all of the answers. I do know this: One should not simply take it for granted that because LIFO was so attractive in the past, it still continues to be as attractive now as it was then. If relatively low inflation is projected or computed for 1991, might it not be more prudent to stay off of LIFO for one more year and reconsider the advisability of electing LIFO next year? There seems to be a lot blowing in the wind.

Keep in mind, there are only three problems with LIFO: (1) getting on, (2) staying on, and (3) getting off. It is definitely easier to get on to LIFO than it is to get off. And once you're on, it may be a long, wild ride.

Hamilton Industries (Continued)

suggest that the IRS' method might be less than perfect...and the Court noted that since the taxpayer did not maintain any records, it therefore had no basis for demonstrating any alleged inaccuracy in the IRS' assumptions.

Hamilton and its progeny Announcement 91-173 raise a number of speculations and questions, while littering the LIFO landscape with all sorts of hazards and traps.

If *Hamilton* is reversed on appeal, look for the Treasury-IRS to look for still other ways to attack LIFO... perhaps on even broader and more destructive levels. I believe *Hamilton* will end up adversely affecting far more taxpayers than just those who have a bargain purchase in their past. A year from now, it will be interesting to see just how far the fallout from *Hamilton* has carried.

More on *Hamilton* in the next issue.

LIFO LIQUIDATORS: A "NEW" BREED OF IRS AGENTS

In the past, some IRS agents achieved legend status as a result of the extremes they were willing to pursue to avoid reviewing LIFO computations. To them, LIFO meant **Leave It For Others** while I do something else I like better. "T & E and home by 3" was the theme of these LIFO oldtimers.

That was then; this is now. A new image is emerging from LIFO audits where agents are taking LIFO far, far more seriously: it is the image of a new breed of IRS agents destined to be known as the "LIFO Liquidators" - ready, willing and often able to make shambles of any LIFO election involved in their audit. Are you ready? Here is the profile:

1. They come in equipped with lap tops and other effective tools for doing what used to be tedious computations and for preparing lengthy reports, schedules and tables that will make your eyes water.

2. They have access to the thinking, writing and teaching of the IRS' Industry Specialization Group task force members. This means they are familiar with current IRS Coordinated Issues LIFO memos and policies. They have attended specialized training sessions taught by key IRS LIFO specialists. And they are up-to-date on the new cases like *Hamilton*. Many have a LIFO "specialist" assigned to assist them or their office with more technical matters and they can receive direct or satellite group support.

3. Before starting the audit, they literally blow the taxpayer away with an expansive document request in which they ask for (1) all Forms 970 and change Forms 3115's related to the LIFO election, (2) copies of **all** end of the year vehicle invoices for **all** LIFO years, (3) all Factory price information for all years on LIFO, (4) all vehicle model change information for all years on LIFO and (5) proof that the year-end financial statement conformity requirement has not been violated, especially in the 12th statement and in the 13th statement.

4. These agents usually end up examining and adjusting **all** years covered by the LIFO election, not just a few obvious "open" years. They start with the earliest year under audit, then work their way all the way back to the initial LIFO election year. They also sometimes extend their adjustments to years **after** the years under audit for which tax returns have been filed, thus covering **all** computations to date.

5. These agents already have a sense of what is a reasonable range for inflation indexes, and they seem to know instinctively whether or not indexes are out of line. One IRS supervisor told me he had all of the Ford prices since 1974 in his lap top computer and could easily relate taxpayer indexes to his own pro forma information and guidelines. I just took his word for it. Another rattled off almost 40 platform changes and new items in the Toyota line going all the way back to 1975 and coming forward through 1989. Scary!

6. These agents, or their LIFO backup specialists, sometimes refer to Schneider's *Federal Taxation of Inventories* as a LIFO reference to develop their positions or to better understand what a taxpayer has done.

7. Finally, these agents go right for the jugular. They are quick to review the taxpayer's eligibility to use LIFO before getting bogged down in sleep-inducing index computations. If the taxpayer can't produce a Form 970 or if the taxpayer has violated the conformity requirement, the agent just takes 'em off LIFO...and that's all there is to it! Mega-dollar deficiencies within minutes after starting the audit. They're heroes, becoming new legends in their own time.

Some of these LIFO Liquidators are very capable and willing to leave no stone unturned in going through a LIFO audit with you. Maybe every agent doesn't reflect all these traits, but each one certainly has the potential to go 7 for 7. Just 1 or 2 for 7 is plenty enough.

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