De Filipps' LIFO LOOKOUT

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

Volume 2, Number 1 Publisher: Willard J. De Filipps, C.P.A. March 1992

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:

First, thanks for renewing your subscription into the second year of our publication or welcome if this is your first issue as a new subscriber. I welcome and appreciate your calls, comments and questions. You can see more evidence of your input in various places in this issue.

From the Contents box, you can see this issue tries to deal with several major questions. Unfortunately, I can answer only one of these questions with confidence.

1. STORM WARNING CONTINUES:

My Update columns during 1991 became increasingly pessimistic. This one continues that ominous theme. There are many things out there moving very fast, in many different directions, in some instances in uncoordinated ways.

On top of all the other issues NADA and other dealer groups are trying to help their dealer members fight off, they now have their hands full with the LIFO audit controversies swirling all over the country.

The IRS seems to be moving and closing in on at least three fronts. FIRST, it has just issued Revenue Procedure 92-20, completely updating method of accounting change procedures in the National Office (see #4 on page 2). SECOND, the IRS is planning another round of LIFO training very soon for its agents and specialists to help them get their dealer-squeezing act together even more. There is significant evidence that some agents all over the country are much better coordinated as a result of their phone consultations with each other. But some aren't using the party line at all.

THIRD, the IRS may be close to issuing Technical Advice holding that an auto dealer cannot sample anything and must reprice everything. That would mean every vehicle invoice for the ending inventory must be analyzed all the way down to the last nut and bolt...even that "free" 1/2 gallon of gas. In other words, the IRS does not want to accept indexes developed from repricing base prices only. Apparently, the IRS will also hold that there can be no price reconstruction for new models so that new models have to go into the index computations at a 1.000 factor.

LOOKOUT LOOKS INTO

Did that comment in the *Automotive Executive* (see December, 1991 *LIFO Lookout* Update item #5) about there being a new "willingness by the IRS to compromise on this issue" not sit well somewhere? Or was the word "not" accidentally left out of the quote?

As the IRS seems to be "coordinating" or intensifying its audit activity in the LIFO area, how can it realistically or intelligently audit LIFO without coming to grips with sampling as part of the process? Joint efforts with the AICPA have fallen flat on their face...and a Procedure dealing with sampling has yet to see the light of day. How can the IRS pretend to be certain about inventory values while it has yet to publish guidance (or anything) regarding sampling? See also Update item #9 on "dollar bill" sampling.

2. AN OFFER YOU CAN'T REFUSE?

Some IRS agents in certain instances seem to be acting beyond previously established boundaries of what some CPAs consider good conduct and fair play. Some agents seem to be hiding behind inexperience or lack of familiarity with automobile

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dealerships by substituting a "take it or leave it" approach with taxpayers. They do this by telling the taxpayer that "their" (the IRS) position is the taxpayer is going to be thrown off of LIFO unless the taxpayer can meet some (unreasonable) demand...like producing all inventory invoices and records for the last XX years on LIFO.

Unable to satisfy this demand, the taxpayer is set up for the next knock-out punch: The agent says "these are my recomputations of your LIFO calculations, take 'em or leave 'em." The agent may even go out of his or her way to tell you how reasonable, or what a good deal, the calculations are. It's called the "I'm on your side" ploy.

Sometimes they even add a comment or two about how they'll gladly switch you over to a Producer Price Index approach if you want...Adding that although a PPI approach is even less favorable, at least it gives you some "protection" against future adjustment. This leaves you no room to discuss further alternatives, since the primary position of the Service is that you're off LIFO...unless you accept their recomputation with no further questions. Talk about a "closer."

3. BUT...ON THE OTHER HAND... in spite of 1 and 2 above, what puzzles me -and reassures me at the same time - is that I know many agents who have been more than fair, reasonable and impartial in conducting LIFO audits. I know many of them are out there...right now. Early this month, one *Lookout* subscriber told me about a lengthy and comprehensive LIFO audit that was just concluded. It involved a LIFO election made in the mid-70's. The CPA could not have been more complimentary in speaking of the agent's attitude, behavior and reasonable approach.

The agent *did not* insist upon splitting one new vehicle pool - this was a pre-*Fox* LIFO election, and the agent concluded that splitting the pools wouldn't make enough difference to warrant bothering with. He *did not* insist upon seeing every invoice - he asked if they had been saved and was told they had been and could be produced if necessary, but the agent said that would not be necessary. He *did not* insist upon repricing ALL options and accessories (he did not insist on the need to reprice ANY options and accessories in computing the inflation index) - despite all the TAM's and huge advertising expenditures screaming that the IRS insists that LIFO repricing must be done with 100% accuracy. And the agent *did not* even mention terminating LIFO as a threat.

The auto dealer's LIFO computations had consistently repriced only base price under a link-chain, index A-B-C-D-E-F-G methodology - with which many readers are familiar. See the article I wrote in 1975.

The agent was described as reasonable, realistic and objective... Oh yes, *he did* require that new models be repriced at 1.000 and recomputed all the LIFO indexes accordingly. *He did* carry the recomputation all the way back to the mid-70's initial LIFO year. *He did* make an adjustment in the earliest open year. But, *he did* allow the taxpayer a six-year spread period over which to take into income the majority of the Section 481(a) adjustment...which was over a half million dollars.

Now...why can't more agents be "reasonable" like that? Doesn't the overall result seem to be practical and reasonable, while giving both the IRS and the taxpayer realistic benefit of the doubt? Why can't there be some formal expression of a national policy along the lines evidenced by this settlement?

This result, achievable only by the cooperation of both the CPA and the Agent, is what I believe is worth the extra effort now to try to clear the air for...if the IRS is really serious about Credibility and Compliance 2000.

So if you are being audited now, draw your own conclusions about whether you think you are being treated unfairly. Or if you have already settled for less, were you treated unfairly?

4. REVENUE PROCEDURE 92-20, just issued by the IRS, contains new rules superseding Revenue Procedure 84-74 to encourage taxpayers to voluntarily request permission to change from impermissible accounting methods before they have been contacted by an IRS agent for an audit examination. These new procedures are effective for change requests filed on Forms 3115 after March 23, 1992 (I.R.B. 1992-12, March 2, 1992). Many LIFO situations are covered in this Procedure, but don't kid yourself into thinking this is any kind of panacea or the "solution" to all the issues.

Revenue Procedure 92-20 provides for what it describes as a "gradation of incentives" to encourage prompt voluntary compliance. Under Rev. Proc. 92-20, a taxpayer generally receives better terms and conditions for any change in accounting method if the taxpayer files its request to change methods before it is contacted for examination by the Internal Revenue Service. Upon contact for examination, the Revenue Procedure provides a limited 90-day window period during which the taxpayer may file a request to change an accounting method without first obtaining the approval of the District Director.

Consistent with the "gradation of incentives," a taxpayer receives terms and conditions during this 90-day window time frame that are less favorable than those available for method changes requested prior to contact by the IRS, but are more favorable

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WHY DO SOME LIFO RESERVES GO UP EVEN THOUGH INVENTORY LEVELS GO DOWN?

One question asked quite often is simply: how can a LIFO reserve go up even though the inventory level went down? You need to understand the answer to this question because often your clients can't understand why you are telling them their LIFO reserve increased when they know their ending inventory level is lower than last year's. The analysis is not limited to any particular type of taxpayer, nor is it limited to link-chain LIFO computations. It can be made for any set of LIFO computations.

Over the years the taxpayer is on LIFO, the cumulative inflation impact becomes a powerful factor causing the LIFO reserve to increase every year. Unless interrupted by price deflation, this inflation "engine" is at work and it picks up steam over the years as the computations take on a cumulative effect. The longer on LIFO, the greater the momentum.

At the end of any year, there are actually two factors or components at work in determining the *net* change in the LIFO reserve: (1) the inflation rate and (2) the level or amount of inventory investment, expressed in base dollars. The fact pattern that raises our question involves looking at this year's ending inventory level, seeing that it is considerably lower than last year's (either actual dollars or expressed in base dollars) and expecting that there will be some "payback" this year of the LIFO reserve. In fact, an inventory level drop always generates a "payback" component. However, the "payback" component is usually smaller than the upward inflation component and together these produce a net change. The net increase results because the inflation component exerts a greater pressure to raise the LIFO reserve than the offsetting payback component.

Caution: the payback can vary between taxpayers given exactly the same inventory levels. Why? Because a critical factor in the analysis is the sub-election made on Form 970, item 6, which selects the method used to value or raise the annual increment, expressed in base dollars, to current cost for LIFO valuation purposes.

Where the taxpayer has used the same index to (1) deflate the ending inventory from actual dollars to base dollars **and** (2) to reinflate the computed increment to "current cost", there is no increase in the LIFO reserve as a result of the inventory increment in the year that increment is experienced. Consequently, if in the next year there is a decrement or liquidation and this decrement is carried back and is fully absorbed by the preceding year's increment, then the payback due to the layer penetration must be, and is, zero! No benefit in year #1 - no payback in year #2. If there were no benefit at the end of year #1, there is nothing to pay back at the end of year #2.

This discussion is accompanied by two examples with contrasting increment valuation sub-elections. Each involves a 5-year LIFO profile. In Case I, the five years portrayed comprise the entire LIFO election period **and** the index used each year to value current year increments was the same index used for that year to deflate the ending inventory. In Case II, the five years ending December 31, 1991 are portrayed, although the actual LIFO election began in 1985. In Case II, the taxpayer employs a "dual index" approach, having elected on Form 970, item 6, to use an "earliest acquisition" index approach.

Under the earliest acquisition dual index approach illustrated in Case II, for each year, the earliest acquisition index applied to that year's increment has been computed to be 1.000. This 1.000 multiplied by the cumulative index at the beginning of the year produces the cumulative earliest acquisitions index used to value (i.e., raise) that respective year's increment expressed in base dollars to current cost for LIFO purposes.

Case I Analysis. As the Case I computations show, the LIFO reserve at December 31, 1991 went up even though the ending inventory went down compared to the December 31, 1990 level. Note that the 1991 ending inventory was approximately $90,000 smaller than the 1990 inventory in actual dollars and this translated into a decrease in base dollars of approximately $136,000.

The LIFO reserve *increase* under these circumstances is explained as follows. The ending inventory expressed in base dollars was $136,362 smaller than the beginning inventory expressed in base

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dollars, resulting in a sizable penetration of the 1990 layer (expressed in base dollars). However, the cumulative inflation factors (including the 1991 inflation factor of 3.4%) pushed the LIFO reserve up by $73,975 **and** there was no (i.e., zero) payback due to the penetration of the 1990 layer because the method previously elected on Form 970 for valuing increments used the same index to value any increment as the index used to deflate the dollars of ending inventory. As a consequence of this LIFO sub-election made on Form 970 to use the same index to both deflate and reinflate the inventory for LIFO valuation purposes, this sub-election produced no increase in the LIFO reserve attributable to the increment in the year (1990) when the increment was first experienced. The LIFO reserve will increase as a result of a particular increment only in a later year, and then only to the extent that the increment remains in tact throughout that later year.

Consequently, if an increment is computed for one year and in the next following year there is a decrease or decrement which is carried back (and confined) to that year's layer of increment, there can be no payback - and there was none in this case. Technically, the payback component is computed to be $0 (zero). Therefore, these two factors - an inflation increase computed to be $73,975 offset by an inventory level decrease computed to be zero ($0) produce the *net* $73,975 increase in the LIFO reserve for 1991.

CASE II ANALYSIS. In Case II, note that the December 31, 1991 inventory was about $108,000 smaller than the 1990 ending inventory and this translated into a LIFO liquidation of approximately $117,000 expressed base dollars. Although the ending inventory expressed in base dollars was $117,000 smaller than the beginning inventory expressed in base dollars, resulting in a complete payback of the 1989 net layer and some 1987 layer penetration, the cumulative inflation factor (including the 1991 inflation factor of 3.2%) pushed the LIFO reserves up by $59,273 and this more than offset the $13,030 payback due to the layer penetrations. These two factors and amounts net to the $46,243 increase in the LIFO Reserve for 1991.

Consistent with prior years' computations, the 1991 LIFO decrement or decrease calculated for the current year ($117,373 expressed in base dollars) had been carried back against the most recent increment year (1989) first to the extent of the net $103,139 remaining as of December 31, 1990, and the balance of the decrement, or $14,234, was carried back against the calendar year 1987 net increment. In Case II, calendar year 1990 had resulted in a decrement of its own of $46,029 and this decrement, expressed in base dollars, had been carried back against the 1989 increment of $149,168, expressed in base dollars, leaving a net increment from calendar year 1989 in the amount of $103,139, expressed in base dollars, as of December 31, 1990. This amount -$103,139 as of December 31, 1990 - is the first previous layer that absorbs most, but not quite all, of the 1991 decrement penetration. See "Analysis of Increase" in Case II.

As of December 31, 1991, the taxpayer in Case II has remaining only its January 1, 1985 base inventory and calendar year 1985 and 1986 increments and less than half of its 1987 original increment. As the schedules show, at year-end 1991 there are no increments remaining for the last four (4) consecutive years: 1988-1989-1990-1991.

Each year it is very important to reconcile the LIFO reserve ending balance, as well as to analyze the net increase or decrease in the LIFO reserve. Details of both analyses are shown in full for Cases I and II. Without these analyses, if your review of your LIFO reserve computation is simply a rechecking of your own math, it is quite easy to fall into the trap of following the wrong numbers to the wrong result every time you review your own work.

Therefore, the reserve *reconciliations* are an independent, objective proof satisfying the precise mathematical relationships which are the foundation for the LIFO reserve. Over more than 20 years of use, I found this combination to be foolproof. Countless times when I could not get my reconciliations to "reconcile," I went back and found errors that would have been embarrassing if discovered later.

This gives you the ability to understand and explain why some LIFO reserves go up even though inventory levels go down. Apply it just once and it should be worth the entire price of your 1992 *Lookout* subscription. ✱

CASE I

Calculation of Annual LIFO Inventory Increases (Decreases) As Calculated Under the Link-Chain, Index Method For the Years Ended December 31, 1987 to Date	1987	1988	1989	1990	1991
1. End of year inventory at end of year (current) prices	$2,460,259	$1,800,481	$2,011,546	$2,340,590	$2,250,099
2. Current year price index	1.0500	1.0600	1.0309	1.0512	1.0340
3. Cumulative link-chain index	1.0500	1.1130	1.1474	1.2061	1.2471
4. End of year inventory at base date cost (Line 1 divided by Line 3)	$2,343,104	$1,617,683	$1,753,134	$1,940,627	$1,804,265
5. Current year inventory increase (decrease) - expressed in base dollars					
1. End of year inventory at base date cost (Line 4)	$2,343,104	$1,617,683	$1,753,134	$1,940,627	$1,804,265
2. Beginning of year inventory at base date cost	XXX	(2,343,104)	(1,617,683)	(1,753,134)	(1,940,627)
3. Current year increase (decrease)	XXX	($725,421)	$135,451	$187,493	($136,362)
4. LIFO valuation of current year increment Line 5(3) x Line 3	XXX	N/A	$155,416	$226,135	N/A
6. Analysis of Year End Inventory LIFO "Layers"					
"Base" inventory at 1.0000 - net	$2,343,104	$1,617,683	$1,617,683	$1,617,683	$1,617,683
Calendar year 1987 increment as price adjusted	XXX	N/A	N/A	N/A	N/A
Calendar year 1989 increment as price adjusted			155,416	155,416	155,416
Calendar year 1990 increment as price adjusted				226,135	61,669
Calendar year 1991 increment as price adjusted					
Ending Inventory at LIFO Valuation, per above	$2,343,104	$1,617,683	$1,773,099	$1,999,234	$1,834,768
Less: Ending Inventory at end of year prices	2,460,259	1,800,481	2,011,546	2,340,590	2,250,099
LIFO Reserve at respective years' end	$117,155	$182,798	$238,447	$341,356	$415,331
LIFO Reserve at end of previous year	-	117,155	182,798	238,447	341,356
Increase in LIFO Reserve at current year end	$117,155	$65,643	$55,649	$102,909	$73,975

LIFO Valuation and Inventory Layers	Base Dollars	Index Factor	Valuation
Base Inventory at 1.0000 - net	$1,617,683	1.0000	$1,617,683
Calendar Year 1989 increment	135,451	1.1474	155,416
Calendar Year 1990 increment - net	51,131	1.2061	61,669
Totals	$1,804,265		$1,834,768

December 31, 1991 LIFO Reserve Consists of			LIFO Reserve
Base Inventory at 1.0000 - net	$1,617,683	x 0.2471 =	$399,730
Calendar Year 1989 increment	135,451	x 0.0997 (1.2471 - 1.1474) =	13,505
Calendar Year 1990 increment - net	51,131	x 0.0410 (1.2471 - 1.2061) =	2,096
Totals	$1,804,265		$415,331

Analysis of Increase in LIFO Reserve - December 31, 1991				
Base Inventory at 1.0000 - net		$1,617,683	x 0.0410 (1.2471 - 1.2061) =	$66,325
Calendar Year 1989 increment		135,451	x 0.0410 (1.2471 - 1.2061) =	5,554
Calendar Year 1990 increment - net		51,131	x 0.0410 (1.2471 - 1.2061) =	2,096
				73,975
Payback due to 12-31-91 Decrement Applied to reduce 1990 increment	$136,362		x 0.0000 (1.2061 - 1.2061) =	(0)
Totals		$1,804,265		
Net Increase in LIFO Reserve for 1991				$73,975

CASE II

Calculation of Annual LIFO Inventory Increases (Decreases)
As Calculated Under the Link-Chain, Index Method
For the Years Ended December 31, 1985 to Date

	1987	1988	1989	1990	1991
1. End of year inventory at end of year (current) prices	$2,141,708	$1,739,919	$1,994,635	$2,004,664	$1,896,247
2. Current year price index	1.0638	1.0775	1.0284	1.0380	1.0323
3. Cumulative link-chain index	1.2421	1.3384	1.3764	1.4287	1.4748
4. End of year inventory at base date cost (Line 1 divided by Line 3)	$1,724,264	$1,300,000	$1,449,168	$1,403,139	$1,285,766
5. Current year inventory increase (decrease) - expressed in base dollars					
1. End of year inventory at base date cost (Line 4)	$1,724,264	$1,300,000	$1,449,168	$1,403,139	$1,285,766
2. Beginning of year inventory at base date cost	(930,057)	(1,724,264)	(1,300,000)	(1,449,168)	(1,403,139)
3. Current year increase (decrease)	$794,207	($424,264)	$149,168	($46,029)	($117,373)
4. LIFO valuation of current year increment under separate calculated "earliest acquisitions" method index	$794,207 x 1.1676	N/A	$149,168 x 1.3384	N/A	N/A
5. Amount carried to LIFO schedule below	$927,316		$199,646		
6. Analysis of Year End Inventory LIFO "Layers"					
"Base" inventory - January 1, 1985	$470,905	$470,905	$470,905	$470,905	$470,905
Calendar year 1985 increment as price adjusted	278,118	278,118	278,118	278,118	278,118
Calendar year 1986 increment as price adjusted	193,996	193,996	193,996	193,996	193,996
Calendar year 1987 increment as price adjusted, net	927,316	431,945	431,945	431,945	415,326
Calendar year 1989 increment as price adjusted, net			199,646	138,041	0
Ending Inventory at LIFO Valuation, per above	$1,870,335	$1,374,964	$1,574,610	$1,513,005	$1,358,345
Less: Ending Inventory at end of year prices	2,141,708	1,739,919	1,994,635	2,004,664	1,896,247
LIFO Reserve at respective years' end	$271,373	$364,955	$420,025	$491,659	$537,902
LIFO Reserve at end of previous year	(142,916)	(271,373)	(364,955)	(420,025)	(491,659)
Increase in LIFO Reserve at current year end	$128,457	$93,582	$55,070	$71,634	$46,243

LIFO Valuation and Inventory Layers	Base Dollars	Index Factor *	Valuation
Base Inventory (January 1, 1985)	$470,905	1.0000	$470,905
1985 Increment	278,118	1.0000	278,118
1986 Increment	181,034	1.0716	193,996
1987 Increment (originally $794,207, reduced by 1988 decrement of $424,264 and by 1991 decrement to the extent of $14,234)	355,709	1.1676	415,326
Totals	$1,285,766		$1,358,345

December 31, 1991 LIFO Reserve Consists of			LIFO Reserve
Base Inventory (Jan. 1, 1985)	$470,905	x 0.4748 =	$223,585
1985 Increment	278,118	x 0.4748 =	132,050
1986 Increment	181,034	x 0.4032 (1.4748 - 1.0716) =	72,993
1987 Increment, net	355,709	x 0.3072 (1.4748 - 1.1676) =	109,274
Totals	$1,285,766		$537,902

Analysis of Increase in LIFO Reserve - December 31, 1991					
Base Inventory (Jan. 1, 1985)		$470,905	x 0.0461 (1.4748 - 1.4287) =		$21,708
1985 Increment		278,118	0.0461 (1.4748 - 1.4287) =		12,821
1986 Increment		181,034	x 0.0461 (1.4748 - 1.4287) =		8,346
1987 Increment, net		355,709	x 0.0461 (1.4748 - 1.4287) =		16,398
		$1,285,766			59,273
Payback due to 12-31-91 Decrement					
Applied to 12-31-87 Increment	$14,234		x 0.2611 (1.4287 - 1.1676) =	(3,716)	
Applied to 12-31-87 Increment	103,139		x 0.0903 (1.4287 - 1.3384) =	(9,314)	
Subtotal	$117,373			(13,030)	(13,030)
Net Increase in LIFO Reserve for 1991					$46,243

* Note: the Earliest Acquisition Index for each respective year of 1.00 multiplied by the cumulative index at the beginning of the year produces the cumulative earliest acquisitions index used to value each respective year's increment expressed in base dollars.

NATIONAL OFFICE...IN THE LION'S DEN

Update items #1, #4 and #8 should be considered as part of the ongoing perspective of National Office activities discussed below.

In the National Office, it now seems you get "two (or more) for the price of one." When Form 3115 is filed, not only does the National Office consider the LIFO method change you are requesting, but it also tries to tell you how your future LIFO index computations should be made under the new method. Must you agree with that as the "cost" of obtaining permission to change from a less desirable method? You're really getting your money's worth for your $500 abuser fee.

The National Office is taking the position in Technical Advice memoranda and in phone consultations with agents in the field that auto dealers cannot use sampling and that all options and accessories need to be repriced in the course of determining the inflation index. The National Office seems to be carrying its enthusiasm for its own position even further by insisting that - in order to obtain permission to make the LIFO change being requested on Form 3115 - the taxpayer must agree to make its computations in the future in the most comprehensive (and expensive) manner possible by repricing all options and accessories.

I am told that correspondence coming back from the National Office asking for more "information" relating to some LIFO change requests has indicated that vehicles/items need to be comparable so that the indexes will clearly reflect income (that's no surprise) **and** that it will be necessary for the taxpayer to provide a representation that it will include all inventoriable costs in the cost of the items used in computing indexes under the proposed new method. This is interpreted as the National Office saying it won't approve any auto dealer's LIFO changes unless the taxpayer agrees to reprice all options and accessories. (In contrast, please go back and reread Update #3.)

One CPA told me that the National Office even contacted his clients directly (despite the Power of Attorney!) to be sure the taxpayers understood what they were being forced to agree to. The confused clients hadn't the foggiest idea of what the IRS caller was talking about.

Interestingly enough, the National Office doesn't seem to come right out and put this **demand** in print when it issues its final approval letter. Instead, it appears to favor including a recitation of the taxpayer's "representation" that under the proposed new method, all items, including new items, will have an equal chance of selection in computing LIFO indexes. This "representation" is then referred to as a "material representation" upon which permission to change is based. So nowhere in print does it appear that the IRS has said you **must** do this...it just withholds permission to make the change if you won't agree.

If there has been some prior phone discussion between the IRS and the taxpayer and CPA, during which the IRS is obviously taking notes, this may not be incorporated into the letter approving the change request. So there may be inconsistencies if the letter wording simply indicates that all items, including new items, will have an equal "chance of selection." Can this be interpreted as giving the taxpayer the green light to reprice less than every item, i.e., sample in some way of its own so long as it satisfies the requirement that all items have an *equal chance* of being included in the index computation? Will an index developed from 25 out of 200 invoices be acceptable as long as all 200 invoices had an equal chance of being selected? (Get out your dollar bills.)

Apparently, the National Office indicates that under the new method the taxpayer will compute its annual inflation index by extending each **item** (including options) and that the principles of Reg. Section 1.472-8(e)(iii) will be applied in determining costs for new models. What this means is that if you can't satisfy the IRS as to a reconstructed or "would have been price," you default to the use of the higher earliest price at which the new item or product was first purchased or could have been purchased.

Another position of the National Office seems to be that if demonstrators are not valued on LIFO, in order to get permission to make other LIFO changes, the taxpayer must also agree to file an election to put all demonstrators on LIFO. In other words, no more writedowns or other reasons for keeping demos off of LIFO!

Finally, if a taxpayer going into the National Office with a Form 3115 requesting to get off the double extension method has a single pool for cars and trucks, it is unlikely to obtain permission to change from double extension unless it agrees at the same time to split its pools in accordance with the *Fox Chevrolet* decision.

For those who were attracted to "take advantage" of the offer for a low cost, quickie, before-its-too-late change mentioned in Update #7, all of this, as well as new Revenue Procedure 92-20 with its late-March cut off date, has significant implications. ✱

WHAT'S WRONG WITH IRS TREATMENT OF AUTO DEALERS ON LIFO?

Auto dealers now undergoing IRS audits all over the country are experiencing different levels of challenge on technical issues, different degrees of acceptance of "practical" approaches, and unrealistic or impractical positions asserted by agents and the National Office. Added to this are numerous other problems including (1) long delays - many of which are necessitated by two or three changes in IRS agents during the course of the audit and endless visits to collect "more information," (2) uncertainty about the cost of future compliance with restrictive LIFO requirements and (3) rapidly escalating costs in terms of professional fees and time lost from other business activities by the dealer in these deliberations with the IRS.

To all of this must be added the broader considerations involving the uneven application and inconsistency of IRS positions to dealers on LIFO in different parts of the country. Dealers have experienced significantly different results on audit depending on whether and when the local examining agent involved the National Office or personnel within the Motor Vehicle Industry Specialization Program for advice. Dealers also have experienced significantly different results in direct proceedings with the IRS National Office in requesting and/or receiving permission to change LIFO methods.

The problem in a nutshell is that the IRS is continually refining its thinking and arriving at increasingly more restrictive interpretations limiting the use of LIFO by auto dealers under audit. It is doing this despite the fact that it has never published any official guidance on the subject and despite the fact that the regulations are totally silent on what is or is not acceptable in the specific area of auto dealer LIFO computations.

This adds another dimension to the overall problem since the resolution of current cases indirectly involves the thousands of auto dealers whose LIFO calculations have been audited in recent years and accepted without change or with little change by the IRS. Where do their LIFO calculations, accepted in prior audits, now stand as the IRS continually changes its mind? When the IRS makes up its mind, how will they be affected? This is especially significant because the IRS seems to recognize no statute of limitations or boundaries to prevent it from going back and reopening all prior year's LIFO calculations for adjustment.

Dealers under audit, one by one, are caving in to the enormous financial costs of defending themselves, the incredible weight of the bureaucracy against them and the need to get on with their own individual lives and businesses without regard for the overall consequences to the "dealer body at large." This is understandable and, at the same time, this is tragic and unfair.

To me, we are now at a point where if this country's auto dealers do not speak out for themselves immediately and forcefully - before it is too late - then their own silence will make LIFO relatively useless to them in the future, as well as very expensive in the past.

I believe the most significant action that can be taken now is to IMMEDIATELY bring these problems and inconsistencies to the attention of members of Congress who have expressed concern for the interests of automobile dealers and other businesses struggling to survive current economic conditions. I believe this can be accomplished directly by dealer organizations and by auto dealers themselves on the strength of their personal contacts with their legislative friends. Auto dealers must bring their own case directly to the attention of individuals in the very top levels of government to protect their own interests.

What Congress needs to know immediately is that many dealers are being treated unfairly and differently than other businesses despite the lip service the IRS seems to give all the time about being sympathetic to the practical administration of complex tax laws.

Ironic, isn't it that former IRS Commissioner Fred T. Goldberg, Jr. in August, 1990 said that the IRS needs

> "to build on, and...accommodate common commercial practice. We can't operate on the assumption that...small businesses...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."

No one has seen much evidence of IRS acceptance of "simplifying assumptions." Were personnel in the IRS National Office and in the Motor Vehicle Specialization Group exempted from paying attention to what Mr. Goldberg said?

I believe those members of Congress who can be contacted should be asked to consider taking three steps on behalf of auto dealers:

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1. Investigate, by holding hearings or otherwise, the oppressive IRS audit activity dealers are now experiencing.
2. Bring this matter directly to the attention of Shirley D. Peterson, Commissioner of the Internal Revenue Service, asking her how auto dealers can reconcile the "simplifying assumptions" objective stated by former IRS Commissioner Fred T. Goldberg, Jr. with what is going on today.
3. Request or direct, if necessary, the IRS to declare a moratorium suspending all auto dealer LIFO audit activity. This moratorium should last until the Treasury amends the LIFO regulations or the IRS publishes a formal Revenue Procedure stating specifically what is expected of auto dealer LIFO calculations so that all auto dealers in the country who use LIFO will be treated more uniformly, whether fairly or otherwise.

I believe communications and conversations with members of Congress should focus on exposing many of the IRS audit positions as ILLOGICAL and UNFAIR. Many can be translated out of their LIFO-technical issue context into understandable, everyday examples:

1. Every member of Congress arrived at his or her office today by sitting in an automobile. That's how everybody gets to and from the office these days. What IRS agents are saying in LIFO audits is that there is no inflation in any new automobile models. Why?...Simply because CPAs cannot "prove" it to them.

   Although we can't prove it to the satisfaction of IRS agents (have they bought a car lately or do they bike to work?), wouldn't members of Congress agree that every year car prices have gone up? Isn't it illogical for the IRS to say that auto workers on an assembly line where a new model was produced did NOT get an hourly pay raise or increased benefits when labor contracts were negotiated, while their co-workers on the assembly line right next to them working on a continuing model did? Was there some exclusion in the union negotiations or the labor contract for auto workers working on new platforms? What do these workers say to each other on their lunch breaks?

   What about the raw materials that go into new models? Doesn't it stand to "reason" that they also went up in price, even though supporting cost data may be hard to come by? Is somebody at the plant sorting out raw materials that went up in price so they will be the only ones put into continuing models?...and deliberately choosing only raw materials that did not go up in price to be assembled into new models? Do they use some kind of tag system?

   All of this relates to a major technical issue over price reconstruction and whether a new "item" can be repriced - to the satisfaction of the IRS - or not. The IRS says a new model cannot, and therefore it must be introduced at a 1.0000 (i.e., no inflation) factor in LIFO calculations. This hurts the dealer using LIFO.

2. Picture in your mind a listing of the 30 or more different models and body styles a typical auto dealer might have in stock. Pick any make you want or whatever you happen to drive. Assume that 28 out of 30 different model/body styles are continuing models that reflect inflation. And the IRS agent agrees there is inflation in the continuing models and accepts your inflation figures or computes his or her own.

   Now, about the other 2 models that happen to be new models: The IRS agent says that because you can't prove there was any inflation in these two new models, they will not allow any inflation for the new models...even though the agent was satisfied that the other 28 continuing models did experience inflation. Is this logical?

3. When a member of Congress wants to know certain facts about his or her average constituent, do they call or talk to everybody in the state? Of course not: they rely on polls...samples...for vital information on which they base their own (business) decisions.

   Don't they call a few people based on time constraints, personnel available to make the calls, and other financial considerations like how much will it cost to find this out?

   Alternatively, if they wanted to know the average height of everybody in their city, would they go out and measure every single person in the city? Or would they measure enough people walking down a few streets in different parts of town until they felt they had gotten a pretty good cross section?

   Why can't auto dealers use sampling techniques and approaches? (Just like Congress does!) Thousands of other businesses using LIFO are able to. Why not auto dealers? Or, if auto dealers can't use sampling, why not treat all other businesses using LIFO the same way and forbid them to use sampling, too? Isn't the integrity and fairness of the tax system in question when many groups of taxpayers are allowed to use approximation and sampling techniques, while one group - auto dealers - cannot?

see **WHAT'S WRONG...?** page 10

 (Continued from page 9)

The IRS audit position on dealer inflation indexes is that in order to compute a valid LIFO inflation index, the auto dealer must reprice every separate option and accessory item listed on every invoice...no matter how small dollar-wise or how inconsequential operations-wise. Many auto dealers properly elected a LIFO method that allows them to use sampling and reasonable approximation techniques to determine their indexes. Now the IRS is saying it will be satisfied only if 100% of every option and every invoice dollar is repriced.

The LIFO regulations do not say LIFO must be computed this way. They were written over 30 years ago and they expressly allow the use of sampling techniques. The regulations have never been modified to give any rules or guidance on sampling procedures for LIFO inventories. CPAs and the IRS still can't agree on how to sample today! Why are auto dealers' LIFO calculations now singled out in this regard, doomed to never be able to satisfy the arbitrary opinions of a few individuals?

Does a dealer really have to reprice every rear view mirror, antenna, special option and every other piece of equipment on a car to get a "satisfactory" index computation? What ever happened to "simplifying assumptions?"

The fact of the matter is that on many audits IRS auditors themselves use or accept information from secondary sources and engage in practical sampling approaches that are not necessarily statistically sound nor valid. Does anybody...at the IRS or elsewhere...really understand "statistical sampling?"

From a moral standpoint, if LIFO really has to be computed by auto dealers with no sampling and repricing 100% of every inventory dollar, then isn't it fair to apply these same restrictions and standards to all other businesses using LIFO? Why single out auto dealers for punishment of this offense while letting other taxpayers get by with lesser standards?

4. If a member of Congress started his or her own business 20 years ago and received professional advice from their CPA and faithfully followed that advice for all these years, how would he or she feel to find out that:

   A. There were never any real rules, just general "guidelines." Now, about 20 years later, the IRS is just getting around to deciding what those rules should be with revenue raising 20-20 hindsight. Where were they all these years?

   B. The IRS doesn't really feel the issues are important enough to be bothered with the traditional process of amending the regulations, holding hearings or publishing advice in the form of a Ruling or Revenue Procedure.

   C. The IRS says your business has no protection from retroactive adjustment under what most people call a statute of limitations and...

   D. The IRS feels that it can take its new and more restrictive theories and go all the way back to the first LIFO year and adjust the tax liability for every year since then. And hit you with one big "catch up payment." (But some dealers are allowed to spread the catch up payment, depending on the policy of the agent's office...is this fair either??)

   E. The IRS says pay up now - or if you don't like it, we'll add to your agony by requiring you to spend thousands of dollars to defend your interpretations (and educate us), even though you made them in good faith.

   F. The IRS adds: Don't even bother to tell us that you were audited years ago by an IRS agent and that he or she accepted your prior LIFO calculations. Don't try that for an excuse! We're not bound by what those agents did or didn't do years ago unless you've got some kind of "proof" or evidence that they really "knew" what they were doing and raised all the technical arguments we are now able to come up with.

   G. Finally, for good measure, the IRS expects the business to be able to produce all your inventory records for the last 20 years or for however long you have been using LIFO. (Paperwork reduction...where are you?)

   H. In short, how would anyone in business feel if they were up against these arguments and obstacles?

5. In settling issues over the reasonableness of an auto dealer's LIFO indexes, many times the IRS requires (forces?) the dealer to accept the Producer Price Index results instead of allowing the dealer to use his or her own computations.

   Do we give the IRS credit for being reasonable or practical here?

   This approach may seem to be logical or practical for dealers who sell vehicles that are manufactured in the United States. But how "logical" is it for the IRS to insist on applying these U.S. Producer Price

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Indexes/PPI indexes which reflect inflation in the United States economy to auto dealers selling IMPORTS? What logical connection is there between (a) the costs of manufacturing Toyotas, Nissans, Mazdas, BMWs, and Volvos outside the United States and (b) the IRS' applying the inflation rate estimated for the U.S. economy to auto dealers selling these imports as if they had been manufactured here in the U.S.? Doesn't this fail the common sense test?

If the IRS' justification for this approach is not logic, but rather administrative feasibility or simplicity, then where else can or should this factor (i.e., "simplifying assumption") be involved in resolving all the other issues? And...is it never to be applied in favor of the taxpayer?

As stated above, the IRS fondness for applying the U.S. economy's PPI indexes to dealers selling vehicles that were manufactured in, and imported from, FOREIGN countries seems illogical. But this approach by the IRS is equally questionable because it is inconsistent with certain Tax Court cases in which learned judges concluded that U.S. taxpayers using LIFO should not reflect the influence of inflation factors of a foreign economy in their own LIFO computations. How does the IRS explain its own apparent contradiction of the Tax Court in auto dealer LIFO audits it conducts?

Congress should be made aware that the IRS doesn't have to explain these inconsistencies. Auto dealers simply have to swallow hard and accept them - if they want to close up the audit and get on with their business. So much for logic, and principle, and consistency, and fair play.

6. Relating the Producer Price Indexes to the matter of inflation in new items or new models discussed previously, don't the Producer Price Indexes (as well as other Bureau of Labor Statistics measurements) reflect inflation in new goods and new items in our marketplace? If so, then why not let auto dealers reflect inflation in their new models?

   Here's the IRS using another assumption for its own convenience, but denying the taxpayer the use of the same assumption. Is that fair? Or logical?

7. Without lengthening this further, isn't it starting to look like everything is not really too well thought out yet on an overall issues, and on a nationwide coordinated, basis?

   If so...can the IRS be allowed in this fashion to suffocate and undo nearly 20 years of auto dealers' LIFO elections on a retroactive basis?

   If the answer to this is "yes," then: WHO'S NEXT?

I believe the overall "solution" to the problem is for NADA, with the assistance of concerned CPAs, auto dealers and other individuals to work jointly with the Internal Revenue Service to draft the equivalent of a Revenue Procedure intended to clarify acceptable LIFO procedures to replace the current confused, chaotic, inconsistent and ever-changing audit environment that now exists.

The Revenue Procedure I have in mind would (1) identify those LIFO practices and alternatives for automobile dealers which fall within an acceptable range and those which do not, and (2) provide reasonable, practical and administratively acceptable transition rules and procedures. My hope would be that transitional rules and procedures would not impose severe retroactive financial consequence on dealers desiring to change from less acceptable LIFO methods to more acceptable methods, or on dealers desiring to terminate their LIFO elections in view of the newly clarified alternatives and procedures.

In all of this, I believe a reasonable middle ground can be achieved and the result would be a much higher overall level of auto dealer/taxpayer compliance with more realistic and satisfactory alternatives. Other benefits, equally valuable to auto dealers and to the IRS, would be the significant reduction of dealer time and expense and IRS audit time in subsequent LIFO audit examinations, and an increased respect for the IRS integrity in dealing with admittedly troublesome and long-standing controversial tax issues. At present, the credibility gap on this is enormous.

Despite my strong sense of dealer advocacy as a CPA, I believe that in trying to work with the IRS to resolve these matters, reasonable compromises probably will have to be made. It seems unlikely that a clear winner will emerge at the expense of an obvious loser, as we are really seeking a greater level of certainty and fairness in LIFO matters for all auto dealers.

We need to eliminate the confusion and inconsistency that now exists and hopefully replace it with something that is administratively workable and reasonable to the IRS and cost efficient and acceptable to dealers and their CPAs.

We need to do this even if it entails the overall risk of losing the LIFO election through a repeal of Section 472. That would, at least, place all dealers at the same level of competitive disadvantage. Anything, even no LIFO, would be an improvement over the present state of affairs! ✱

WHAT'S WRONG WITH IRS TREATMENT OF AUTO DEALERS ON LIFO?

CAN ANYTHING BE DONE ABOUT IT?

You might expect me to answer this question with: *"I'VE ALWAYS BEEN READY, LET'S GO TO COURT WITH A TEST CASE."*

Sorry to disappoint you. But, based on predominant IRS and Tax Court behavior so far, I believe a better way to accomplish something positive is to ask Congress to make the IRS stop, get its act together, publish some uniform and reasonable guidelines or Regulations...and, after that, take whatever enforcement action is necessary. Even if it means adding more specific LIFO related questions to Page 2 of the tax return and sorting returns by SIC codes for audit selection purposes.

If auto dealers aren't willing to speak up for themselves, and CPAs aren't willing to try to speak out for them, then we'll all just have to accept what's left after that IRS steamroller out there runs over us.

Section 263A cost capitalization is a classic example of what happens when the IRS "writes the rules." But, at least with Section 263A, some rules were written. Not to worry, however, because all that meaningless pencil pushing keeps many accountants employed and IRS agents busy double checking the drivel that does not amount to a hill of beans. And it always brings a smile to poke fun at the absurdity of the results - instead of at the absurdity of ourselves for letting it happen.

Not so with LIFO! LIFO involves big dollar deficiencies and the IRS is energetically out there collecting them. As more taxpayers and CPAs simply cave in, the IRS gets more motivation and incentive to collect even more on the next audit. Worse still, the twin precedents of lack of logic and make-it-up-as-you-go-along secrecy set the tone for more of the same - not only in LIFO situations, but in other tax areas.

I try to practice what I preach and I try to preach what I practice. I've attempted to communicate with as many dealer associations as I reasonably can, urging them to unite and organize their dealers. I've also "found" the time to send the letter below to Dan Rostenkowski.

Congressman Dan Rostenkowski
Committee on Ways and Means
United States House of Representatives
1102 Longworth House Office Building
Washington, DC 20515

February 26, 1992

Dear Congressman Rostenkowski:

Every time you come home to Illinois, you have to ride in an automobile. I'm sure many of your friends here and elsewhere are auto dealers - outstanding business and civic leaders and hard-working men and women coping with more than their fair share of problems right now.

There is an enormous injustice that auto dealers are currently experiencing at the hands of the IRS that you have an opportunity to redress in your current deliberations and efforts to create a Tax Fairness and Economic Growth Bill for 1992. The key is tax FAIRNESS.

The IRS is creating impossibly unfair rules and restrictions out of ambiguous regulations that contain only inadequate guidelines on how auto dealers should use the Last-In, First-Out (LIFO) inventory valuation method. To make matters worse, the IRS is retroactively applying its interpretations so harshly that some auto dealers will be put out of business because they cannot afford the tax consequences. This hardly seems to be the time to hit them when many are already down and struggling.

One by one, dealers now under IRS audit are caving in to the enormous financial costs of defending themselves, the incredible weight of the IRS bureaucracy against them and the urgent need to get on with their own individual lives and business affairs. In the process, and as a consequence, long-standing principles and practices are being sacrificed or ignored as if they never existed.

These inequities and inconsistencies are extremely unfair and discriminatory to automobile dealers as a business group. There never were any specific rules on what auto dealers or their CPAs should be doing in applying LIFO to their complex inventories. There are still no specific rules today...only those some IRS agents secretly make up on an audit-by-audit basis with 20-20 hindsight and an unsympathetic, perfectionistic, and revenue-driven attitude.

These ever-changing and still unpublished "new LIFO rules" seem to vary all over the country depending on the "LIFO specialist"/IRS agent in charge. Some agents, now "expert" in LIFO, were never in a car dealership until a year or two ago (except maybe to buy a car). These agents are now upsetting tax calculations that have been made in good faith over the past 20 years! Thousands of auto dealers have had their calculations accepted with little or no change on audit by the IRS. What happens to them now, or in the future? →

I would be pleased to appear as a witness to testify before the Committee on this matter and I respectfully request that you consider the following:

FIRST: Investigate, by holding hearings or otherwise, the inconsistent and oppressive IRS audit activity now going on.

SECOND: Bring this matter directly to the attention of Ms. Shirley D. Peterson, Commissioner of the Internal Revenue Service, asking her how auto dealers can reconcile the "simplifying assumptions" objective stated by former IRS Commissioner Fred T. Goldberg, Jr. with what is going on today.

Even Mr. Goldberg, in departing from the IRS to become Assistant Secretary for Tax Policy at the Treasury Department, has said: "We're killing people out there. We have got to make (simplification) a priority." He's right and there is no better example than this.

THIRD: Request or direct, if necessary, the IRS to declare a moratorium suspending all auto dealer LIFO audit activity. This moratorium should last until the Treasury amends the LIFO regulations providing specific rules or the IRS publishes a formal Revenue Procedure stating specifically what is expected of auto dealer LIFO calculations. This would result in all auto dealers in the country who use LIFO being treated alike, whether fairly or otherwise.

The "Revenue Procedure" to which I refer would (1) identify those LIFO practices and alternatives used by automobile dealers for years which fall within an acceptable range and those which do not, and (2) provide transition rules and procedures that are reasonable, cost efficient, practical, administratively acceptable and revenue neutral.

Transitional rules and procedures should not impose severe retroactive financial consequences on dealers desiring to change from less acceptable LIFO methods to more acceptable methods, or on dealers desiring to terminate their LIFO elections in view of the newly clarified alternatives and procedures.

In all of this, I believe a more reasonable and tolerable middle ground can be achieved. This would result in a much higher overall level of auto dealer/taxpayer compliance with more realistic and satisfactory alternatives. Other benefits, equally valuable to the business community of auto dealers and to the IRS, would be the significant reduction of taxpayer AND IRS audit time, expense and delay in subsequent LIFO audit examinations. An important by-product would be increased respect for the IRS integrity in dealing with admittedly troublesome and long-standing controversial tax issues.

I have been all over the United States during the past six months and have had over a hundred conversations personally and by phone with other CPAs on this subject. CPA firms all over are experiencing these IRS patterns of inconsistency, uncertainty and delay. Some IRS employees are also genuinely concerned. But, auto dealers voicing their own concerns and frustrations with the IRS over this matter are the best evidence of this problem which I believe is worthy of your consideration at this time.

Please write or call me at (708) 577-3977 if you need additional information or assistance, or if there are others in Congress who might also be interested in this.

Respectfully,

WILLARD J. DE FILIPPS, CPA

P.S. I've tried to be brief in this letter. Following draft after draft, it was run through "Spell Check" to catch any spelling errors. My secretary tells me that in coming across your name, which is unfamiliar to our computer's built-in dictionary of correct spellings, the screen flashed as alternatives: (1) "Restitutions," (2) "Rustications," and (3) "Wastebasket." (It's true!) I trust #3 is not prophetic of where our auto dealer friends will end up after the IRS finishes with them if you don't intervene. Have a good day, Sir, and thanks again.

than those required by the District Director as part of an audit examination. These terms and conditions involve the year of change, the applicability of the cut off method and the Section 481 (a) adjustment period.

5. ANY VOLUNTEERS OUT THERE?

One of the efforts being talked about involves presenting a request for Technical Advice to the IRS National Office by a taxpayer who represents all, or as many as possible, of the major issues on LIFO rolled into one. Since the IRS will not rule on a hypothetical case...it requires a real flesh and blood taxpayer...are there any volunteers? If anyone knows of an auto dealer willing to participate in this capacity, contact Doug Greenhaus, the Senior Attorney for Federal Regulatory Affairs, at NADA (703) 821-7000.

Questions to be worked out concerning this approach include (a) how long will it take, (b) what are the "desirable" LIFO issues to set before the IRS, (c) will anything meaningful be learned from a technical advice, which lacks precedential stature and (d) do we already have a pretty good idea of what the National Office will say eventually?

6. HAMILTON INDUSTRIES UPDATE

Apparently, the Tax Court decided not to reconsider its decision in *Hamilton Industries*, so for the time being the IRS stands as the clear winner. However, that does not rule out appeal by *Hamilton*, an Illinois taxpayer, to the Seventh Circuit.

So if *Hamilton* has become a recent addition to your inventory vocabulary or liability nightmares, a few articles and commentaries have appeared for your enlightenment . These articles include: (1) "Tax Court Requires Separate Item Treatment for Bargain Purchases of Inventory" by W. Eugene Seago, *Journal of Taxation*, February, 1992 and (2) "*Hamilton Industries*: Abusing the Clear Reflection Standard" by Marc D. Levy, C. Allen MacNeil, and Herbert J. Guarascio *Tax Notes*, Special Report, February 10, 1992. The three authors of the *Tax Notes* Special Report are tax partners in Arthur Andersen and have a somewhat different perspective from that reflected by Mr. Seago, a Professor of Accounting at Virginia Polytech Institute and State University.

Another commentary on *Hamilton* appeared in *The Tax Adviser*, Tax Clinic, January, 1992: "When Bargain Purchase Inventory Exists, the Effect of LIFO Should Not be Disregarded" by Bary A. Tovig and Andrew B. Lee.

7. HAVE YOU (OR YOUR CLIENTS) SEEN THESE?

The February 11, 1992 issue of *Car Dealer Insider* contains the kind of writeup on IRS agents auditing car dealers that will certainly get some attention. Maybe it belongs in supermarket checkout →

BEST AUDIT TECHNIQUE - COMPLIANCE 2000?

During a discussion with a south Florida CPA, I was told that the IRS Ft. Lauderdale district has contacted certain manufacturers to generate or assist in generating a data base of price/inflation information for various makes and models. Conversations with other CPAs in other areas have also referred to similar activity.

Apparently, IRS agents will be able to use this data base to develop their own indexes to compare with the dealer's indexes. If the dealer's indexes are reasonably close, the agent may leave well enough alone and not adjust the dealer's calculations for nominal differences.

Great potential: If the IRS were to carry it this approach further and sell the data base information indexes directly to the taxpayers to use in preparing their tax return LIFO calculations. (Has the IRS ever thought of asking CPAs for some help or input in this project?)

Many taxpayers or CPAs - if not locked in elsewhere - would probably be willing to pay the IRS a reasonable "user fee" for inflation index information that is known in advance to be acceptable to the IRS. The price charged for this information could be structured so as to equal or (almost) fully offset the cost to the IRS of developing the information. In other words, it might not even cost the IRS anything to develop the data base!

Advantages: (1) More dealers might be treated more fairly and consistently on audit as well as in future index computations since the same indexes would be applied, (2) Even if they weren't, the perception of equal treatment would placate many, (3) Significant reduction in audit time from both the IRS side and the taxpayer/CPA defense side, (4) More reasonable than applying the BLS Producer Price Indexes...especially to import/foreign manufactured makes...because the index used would be the index developed for the specific make, (5) Ease in administration, especially if tied into a Revenue Procedure addressed to auto dealer LIFO practices and procedures, and (6) Less confusion on everybody's part.

Couldn't this somehow be made a part of Compliance 2000?

lanes or paid advertising somewhere. Entitled: "LIFO Tax Pitfalls Cost Dealers Hundreds of Thousands," it starts out by referring to the ink just drying on a giant size check written by a dealer who was recently audited. (Almost reads like an advertisement?)

Other CPAs have called my attention to a message being circulated by a midwest CPA firm inviting auto dealers to take advantage of the "Opportunity to Correct LIFO Pooling" by going to the National Office for permission to split a single pool for vehicles into one pool for cars and one pool for trucks. Taxpayers contemplating a move in this direction should consider the implications of the new rules and timing in Revenue Procedure 92-20. See also the comments on National Office tactics elsewhere in this issue.

The particular bulletin dated late January, 1992, included a cover letter from the Ohio Automobile Dealers Association forwarding a copy to all dealer members along with mention of the special fee structure that the accounting firm had agreed to for working with any association member on this matter. (Almost reads like an advertisement?)

8. AICPA STALLS WITH IRS ON LIFO, SAMPLING AND 263A PROJECTS

The AICPA seems to be pretty much at a standstill with the IRS in trying to work out guidance or procedures regarding statistical and/or judgmental sampling. Ditto for Section 263A simplification, components of cost, Hamilton (bargain purchase situations) and a variety of other inventory issues. The report recently issued by the AICPA Tax Division to Tax Accounting Committee members reflects an overall impasse on all of these issues.

9. "DOLLAR BILL" SAMPLING...AND OTHER EMERGING AUDIT TECHNIQUES

It's interesting to note evidence of one IRS concept of sampling, at least in some auto dealer audits. I'll call it "dollar bill" sampling. It starts and ends with somebody pulling out a dollar bill from his or her pocket, looking at the serial number, selecting a specific digit or digit location from the serial number and using that as the starting number in a random selection of the number of items to be repriced or to be included in the sample recomputation by the agent.

This seems somewhat removed from the more sophisticated approaches suggested by the IRS as standards to which LIFO sampling should be held. Query: Do we have to save and use the same dollar bill in every future year? If a different dollar bill is used next year, should a Form 3115 be filed for a change in accounting method? If it's your dollar bill, did you remember to put in on your expense report?

Another "new development" of sorts involves some audits where IRS agents are requesting certain "representations" as to future LIFO computations even where they may be accepting without change the current LIFO figures under audit. Those "representations" involve the taxpayer agreeing to do more repricing in the future. One needs to consider what the effect of these "representations" will be: are they changes in accounting method requiring a closing agreement, a Form 3115, or involving some new procedure? Even the agents requesting them seem unsure. Are these part of Compliance 2000...or what?

A new term turned up in another recent conversation: "enforced link-chain change in accounting method." The key is "**enforced**." Apparently, this is where the taxpayer allows the IRS agent to make all the LIFO calculations and places them in the hands of the IRS agent who handles a change in accounting method request with the National Office for them.

10. DO YOU STILL REALLY WANT TO ELECT LIFO FOR 1991?

I've had a number of questions recently regarding first year mechanics in LIFO elections. Near the end of each conversation, I usually ask a question of my own: With all the uncertainty, are you really sure you want to put your client on LIFO this year? You might want to protect yourself with your client (or *from* your client) by being sure the client is adequately informed in writing and upfront of the can of worms LIFO has become. You may even change that from *can* of worms to *barrel* of worms.

In first year LIFO situations, questions have come up regarding earliest acquisitions, especially where the taxpayer began business in the current year by buying someone else's inventory, usually paying full dollar for it (i.e., not a *Hamilton* bargain purchase situation). The IRS does not like the "earliest acquisitions" approach either used alone or as part of a "dual index" approach. It seems to want to interpret "earliest acquisitions" in a most burdensome computational way, and agents usually look for any position to deny the taxpayer a LIFO reserve in the first year.

Even with S elections where the dollars deferred up front go directly into an individual's pocket, might it not be more advisable to wait until some of the problem areas are resolved or some alternatives better defined?

If you want to go ahead and elect LIFO anyway, or as Admiral David G. Farragut said during the Battle of Mobile Bay: "Damn the torpedoes, full speed ahead," you might at least want to consider extending the due date for filing the tax return so you have some additional time...until September 15th...before making the final decision. A lot could change - for better or for worse - over the summer months. Stay tuned.

WHO PAYS THE LIFO RECAPTURE TAX?

Very little has been written about who pays, or should pay, the tax when a LIFO recapture occurs. Everybody knows that the corporation owning the inventory *reports* the recapture, but what happens or should equitably happen beyond that if there has been a change in taxpayer entity over the years?

In many instances, the IRS is in auditing LIFO over the entire span of the LIFO election. In some instances, the LIFO election may go back almost 20 years, to the early 70's. Consider the possibility that during many of the early years the LIFO election was in place, the LIFO corporation may have been either a C corporation, an S corporation, or a C switched to S, or an S switched back to C. More recently, as a result of the Tax Reform Act of 1986, a LIFO user might have been a C corporation for some of the years before the Tax Reform Act, but after the Act it may have elected S status because of the repeal of the *General Utilities* doctrine.

In its zeal and effectiveness in auditing and adjusting LIFO for all LIFO years prior to the last year under audit, when the IRS computes an overall net deficiency attributable to LIFO, that deficiency may be paid by the current tax entity which may - or may not - be the same tax entity that received the benefit of the LIFO deferral in some or all of the prior years.

For many years, individual income tax rates were higher than the corporate rates. Taxpayers electing LIFO in pre-1981 or in pre-1986 S years received the advantage of taking the LIFO deduction benefits against their individual income tax liabilities. Some individuals even became jittery over the size of their S corporation's LIFO reserves that they had deducted in their personal returns and may have switched the corporation's tax status from S back to C in order to have the C corporation bear the repayment of LIFO recapture dollars. Is the current C corporation tax entity the right entity to repay the recapture tax?

Consider the implications where the composition of the individual shareholders of an S corporation changes over the years from when the reserves were built up to the years when they are either decreased or adjusted downward on audit.

Looking beyond the complexity of LIFO calculations, equitably, what tax entity should repay the LIFO deficiency dollars? To the extent the LIFO reserve was built up in a C corporation year, should a LIFO deficiency correspondingly be charged against that C taxpayer entity even it if is an S in a later year? Or should the LIFO deficiency be paid by the entity in the year in which the "catch up" or net adjustment is made...which might just happen to be an S corporation? And what about section 481(a) spread forward years?

Quite possibly, the individual shareholders of that S corporation may not even have been shareholders in the prior years when the LIFO reserve was built up. Did they reduce the purchase price paid for the shares of the S corporation to reflect the potential recapture liability? If so, by how much? Did they even realize what they were getting into?

These questions don't seem to have much in the way of specific answers... but when somebody gets burned, they sure want answers!

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. 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.

De Filipps' LIFO LOOKOUT
Willard J. De Filipps, C.P.A., P.C.
317 West Prospect Avenue
Mt. Prospect, IL 60056

First-class postage paid at Mt. Prospect, IL