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 REVENUE PROCEDURE 92-79

It finally happened: The IRS has unveiled a new, simplified **Alternative LIFO method** for auto dealers and transition rules for making the change. Although it's quite a challenge, let me attempt to put Revenue Procedure 92-79 in perspective.

This Procedure is a **COMPROMISE DOCUMENT** - a treaty of sorts between the IRS and dealers. The Service has granted dealers and the rest of us what we have long sought: A response to our request to just tell us what we *can do* (not what we can't) in our LIFO calculations.

It would appear the new Alternative LIFO method officially blessed by the IRS caught some folks by surprise, since they had been telling dealers, dealer associations and CPAs all over the country a few months ago they knew **exactly** what method the IRS would accept (April fool!). To borrow a phrase, now... IRS offers amnesty to car dealers on LIFO - finally there is good news. The IRS has actually come out and said you don't have to reprice options or be 100% accurate in your LIFO calculations!

So, how does the new IRS method look? That may depend on whom you ask! Like hound dogs barking and chasing the fire engine down the street, what do we do now that the fire engine has stopped? Is Revenue Procedure 92-79 a panacea or a poisoned apple? Let the debate begin.

Let me say this unmistakably up front: I think Revenue Procedure 92-79 is a very good deal for auto dealers and CPAs—about the best anyone can expect under the circumstances. As you evaluate its merits, I suggest the following guideline: **Unless you can come up with a good reason for not changing to the Alternative LIFO method, then changing to it would seem advisable for a lot of reasons.**

Rev. Proc. 92-79 is a significant document because the IRS has gone out of its way to try to achieve certainty and simplification in an otherwise no-win situation. I believe many auto dealers and CPAs should favorably respond to the new method, despite certain features in it that are not exactly what we would like to have if we could simply have everything our way. That's the point: we can't have everything our way. And that's what a compromise is all about.

Still attempting to shed perspective on this, keep in mind that Rev. Proc. 92-79 only addresses LIFO computations. Auto dealers using LIFO will continue to face many other significant attacks from aggressive IRS "LIFO-Liquidating" agents. These exposures include the risk of LIFO elections being terminated because of failure to satisfy the year-end financial statement conformity requirements, Form 970 filing requirements and where other sensitive issues are involved.

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In addressing only index computation mechanics, Rev. Proc. 92-79 leaves many significant technical questions unanswered because it has established an Alternative LIFO method without amending the underlying Regulations. Therefore, for a long time to come, it will still be open season on these technical issues. With the Rev. Proc. 92-79 Alternative LIFO method out there now, aggressive dealer LIFO calculations are more likely to eventually end up in expensive, high-stakes, litigation.

#2 SOME BACKGROUND ON REV. PROC. 92-79

On July 7, I attended the second meeting between NADA and IRS to discuss the need for non-technical guidance and some practical alternative index computations that dealers could use with far less risk.

It was pointed out that according to the Tax Court in *Wendle Ford Sales*, auto dealers won the legal point that year-to-year adjustments were not required in their LIFO index computations for base price comparability. Although *Wendle* involved emission controls and catalytic converters (which were standard equipment additions rather than options), dealers would like this freedom to avoid year-to-year adjustments for all optional-to-standard equipment changes. Unless the IRS wanted to relitigate *Wendle*, adjustments for optional-to-standard equipment changes should **not** be necessary in annual index computations in order to clearly reflect income.

No one seemed to be denying that over the years, cars have become "richer" as more and more "options" and features have been added as standard equipment. But once you start making adjustments for this in your LIFO computations, where do you stop? According to dealers, these changes tend to even out over the years, so the results produced by averaging approaches should be revenue neutral. The IRS requested computations in support of this claim as well as information to show how dealer calculations would differ from results produced under the Bureau of Labor Statistics (Consumer Price Index and/or Producer Price Index) approaches.

It appears that the BLS, after collecting what information it can, arbitrarily reduces any overall index that it develops for autos by anywhere from 25% to 33% to reflect *estimated* technological improvements. If so, most dealers currently incur a significant double disadvantage in using(or being put on by audit default) a current BLS index because that index must be further reduced by 20% (i.e., larger dealers and businesses can only use 80% of a BLS index).

The IRS observed that an incentive for dealers to use a BLS index approach could be introduced by allowing them to use more than the current 80% allowable. However, even at 100%, a dealer still might be short-changed because of the arbitrary reductions made for technological change factors which even the BLS cannot compute.

You can see the impasse between IRS and dealers on this: Pure unadjusted averaging seemed to be less attractive to the IRS - Bureau of Labor Statistics indexes seemed to be less attractive to dealers. (That's why, I think, Rev. Proc. 92-79 is a remarkable, compromise document and merits being called "The Treaty of 1992." Dealers: you're lucky: it could be — or get—far worse.)

Near the close of that meeting I mentioned my own thoughts on a method between these extremes, patterned substantially after my own practice and experiences with auto dealer LIFO calculations since 1974. About a week later, I submitted my proposal for a "comparability-adjusted base price component" approach and have included it in this issue of the *Lookout* (see pages 16-18) now that the IRS has released its document. Coincidentally, or otherwise, many similarities are evident.

Therefore, I cannot deny my own bias in favor of the Alternative LIFO method in Rev. Proc. 92-79—because many features I thought ought to be acceptable in a compromise between the IRS and dealers appear in it. I'm sure that others will analyze the document only for its flaws and limitations. Fortunately, quick or immediate action is not required, so in the next few months CPAs and dealers should take their time and evaluate as many *reasoned and balanced* evaluations as they can find.

#3 IRS AUDIT ACTIVITY

For an excellent summary of the overall status of IRS audit activity of auto dealers, see "Does the IRS Have You in Its Sights?...LIFO and Extended Warranties are on the IRS' Hit List," by Joan Mooney in Automotive Executive, July, 1992, pages 30-32.

It appears that most IRS audit activity during the last three months has been significantly postponed or interrupted in anticipation of the September 18 transition rule deadline under Revenue Procedure 92-20. Although this is not to say that there was no new audit activity, it seems that work on many of the ongoing audits was significantly decreased to find out whether taxpayers under audit are going to file Forms 3115. Now Revenue Procedure 92-79 has put a further crimp in the overall timetable, since December 31, 1992 is the deadline for action by dealers who want to elect the Alternative LIFO method.

After all the dust settles and the smoke clears, the IRS, if it chooses, may notch up to an incredibly painful level its audit of dealers' LIFO computations by simply rephrasing a few LIFO questions on the tax forms for 1993 and running a printout by taxpayer business code. Might not the IRS take the *"attitude"* that if a

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REVENUE PROCEDURE 92-79: OVERVIEW

Right after Labor Day, the Internal Revenue Service issued an advance release of Revenue Procedure 92-79 which is scheduled for formal release on September 28, 1992 in Internal Revenue Bulletin 1992-39. This Revenue Procedure reflects the IRS response to auto dealers, NADA and CPAs for some official IRS pronouncement to clarify and calm the chaotic LIFO situation that was snowballing from (1) conflicting audit standards, interpretations and settlements of dealer LIFO computations and (2) vendor advertising in recent years.

For dealers (not currently under audit) changing under Rev. Proc. 92-79 to the Alternative LIFO method, the IRS offers complete immunity, amnesty and relief from audit of all LIFO computations for the years *prior to the year of change.* Section 10 of the Revenue Procedure affords protection to the years prior to the year of change by providing that "if an automobile dealer timely files a Form 3115 in accordance with all of the requirements and conditions of this Revenue Procedure, an examining agent may not propose that the automobile dealer change the same method of accounting for a year *prior to a year of change* required under this Revenue Procedure."

Revenue Procedure 92-79 will become effective on September 28, 1992 and it is applicable to new automobile and new light-duty truck inventories - it is not applicable to used vehicles nor to parts and accessories. Light-duty trucks are defined as trucks with a gross vehicle weight of 14,000 pounds or less, sometimes referred to Class 1, 2 or 3 trucks.

The Procedure provides a new, simplified **ALTERNATIVE LIFO METHOD** to which auto dealers may change anytime before December 31, 1992 - so long as (1) the change is made in accordance with the terms and conditions of Revenue Procedure 92-79 and (2) the dealer agrees to be bound by **all** of its rules and consent provisions. The new method is a dollar-value, link-chain LIFO method.

This expeditious consent Procedure will apply even if the dealer has *recently* received an accounting method ruling letter from the National Office allowing the dealer to change its LIFO method to some other LIFO method. *Recent* may mean that the dealer has not already filed a tax return using the change permitted method. The new procedures also apply to dealers under audit as of September 8, 1992 and to dealers coming under examination on or before December 31, 1992. The special transition rules provided for dealers under examination as of September 8, 1992 do not allow the year of change to be as late as 1992; instead it must be a year earlier than 1992 depending on the specifics of the IRS exam.

The more comprehensive and more recent Revenue Procedure 92-20 (released in March, 1992) cannot be used by a dealer to change to the Alternative LIFO method for any year of change specified in Rev. Proc. 92-79. (Note: Apparently a dealer may use Revenue Procedure 92-20 to change to a LIFO method other than the Alternative LIFO method, however.)

If an auto dealer is before an IRS appeals office (and technically no longer under examination or under audit), that dealer may not file Form 3115 to change to the Alternative LIFO method unless the dealer obtains an agreement from the appeals officer stating that there is no objection to the proposed change in LIFO method. Hopefully, appeals personnel will not withhold permission unreasonably or otherwise condition it as a way of gaining dealer concessions on other audit issues under consideration.

In general, the principles of Revenue Procedure 92-20, the broader method of accounting change pronouncement issued in March, 1992, will apply to any change in dealer LIFO methodology made under Revenue Procedure 92-79. In other words, these two Revenue Procedures (92-20 and 92-79) are meant to interface smoothly with each other. For auto dealers who already have Forms 3115 pending in the National Office as of September 28, 1992, the National Office will return these pending Forms 3115, and the $500 user fee paid at the time of filing, to give the dealer the opportunity to change to the Alternative LIFO method under Rev. Proc. 92-79 *without* the payment of any user fee.

If an auto dealer is (1) initially electing LIFO or (2) extending LIFO, that dealer is required to complete and file a current Form 970, Application to Use LIFO Method, modifying it on its face or in an attachment so that the election to use the Alternative LIFO method is clearly indicated. On the Form 970 or on an attachment, reference should also be made to Revenue Procedure 92-79. This is required by Section 15 because the current Form 970 bears a release date of April, 1990 and it will not be immediately revised or updated by the IRS to reflect the sub-elections involved in the new Alternative LIFO method. Therefore, the dealer electing LIFO will have to be sure that Form 970 clearly indicates the intention to elect the Alternative LIFO method and the corresponding LIFO sub-methods that are an integral part of the Alternative LIFO method.

The Revenue Procedure sets forth in complete detail the 14 steps comprising the new computational methodology, along with sub-methods, definitions and special rules and conditions of consent, **all** of which must be followed and are part of the "total package" that is only available on a "take it or leave it" (or to use the industry expression, "as is") basis. Because Revenue Procedure 92-79 is a "compromise" between the IRS and dealers, the "total package" must be accepted **as is**, or rejected. A dealer cannot select only those favorable features while substituting other sub-methods or interpretations that are more favorable for the less attractive features.

It's now time for dealers to **put up** by changing to the new Alternative LIFO method or **shut up** by not changing to it and accepting significantly enhanced audit risk.

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ADVANTAGES AND DISADVANTAGES OF THE NEW ALTERNATIVE LIFO METHOD

The pros and cons, or advantages and disadvantages of Revenue Procedure 92-79 depend on whether you're on the dealer's side... the IRS' side... or some other side.

ADVANTAGES

1. **The cut-off method is used** to change from the previous LIFO methodology. Under the cut-off method, the requirement that a net Section 481(a) adjustment be made is waived because no items are considered to be duplicated or omitted from income. This assumption or willingness to look the other way on the part of the IRS is very favorable to most dealers because it overlooks differences of interpretation, computational errors, shortcuts, blunders of all degree and magnitude, regardless of ineptitude, aggressive tactics or dumb luck and allows bygones to be bygones - **and no recomputation of prior years' inventories under the new method is required.**

2. Consequently dealers can **completely avoid any interest** on deficiencies that might have been computed if the IRS audited and changed prior year LIFO reserves. Also avoided are corresponding taxpayer **penalties** and tax return preparer penalties that otherwise might be imposed where LIFO deficiencies are determined by IRS audit. Also **significantly reduced** are **professional fees** involved in IRS audit controversies.

3. **Dealers are not required to reprice any options or accessories** in computing the inflation indexes under the Alternative LIFO method. This totally eliminates from consideration the terms and implications of the IRS 1990 Industry Specialization Bulletin, and all claims that the IRS insists on the repricing of **all** options and accessories. Therefore, **the dealer's annual expense for LIFO computations may be comparatively lower.**

4. In repricing current year models as compared with last year's models to determine inflation, **prices do not need to be adjusted to reflect optional equipment that becomes standard at the end of the year or other value-enhancing equipment additions if the manufacturer does not change manufacturer codes or platforms**. In other words, prices do not have to be adjusted to factor out costs attributable to optional or extra equipment that become standard equipment at the end of the year. As air bags, anti-lock brakes and other features are added, the dealer will get to treat those price increases as if they were pure inflation... when in fact they are not. **This is a major concession by the IRS to dealers and goes far to offset disadvantages #1 and #2.**

5. **Dealers are not forced to make a snap decision:** the period of time to evaluate the desirability of making a change has been extended to **December 31, 1992.** The usual "make up your mind" requirement has been extended in an unprecedented fashion allowing a longer evaluation.

6. **A dealer does not have to pay a user fee** in connection with filing Form 3115 to make a change. The user fee is currently $500: This is not much, but every little bit helps.

7. **Dealers can combine all new automobiles *regardless of manufacturer* in the same pool.** Similarly, they can also combine all new light-duty trucks, *regardless of manufacturer*, in the same light-duty truck pool. If they were not already doing this, they may achieve significant future benefits with these broader pools.

DISADVANTAGES

As with any compromise, there are trade-offs and requirements or conditions that are less beneficial to the dealer. These disadvantages or deterrents to its use include:

1. **New items must be repriced at 1.000.** In other words, there can be no price reconstruction or sampling attributing inflation to new items in ending inventory or analogizing it to them from continuing models.

2. **The determination of when a new item is deemed to come into existence is quite strict or narrow and, in some instances, will be a factor tending to lower overall indexes that otherwise might have been higher.**

3. **A dealer is required to have two pools for new vehicle inventories:** one pool for new automobiles (including demonstrators) and a second, separate pool new light-duty trucks (including demonstrators). Many dealers believe their fact patterns are sufficiently different or distinguishable from those addressed by the Tax Court in *Fox Chevrolet* and in *Richardson Investments* and still have only one pool for all new vehicles in which new cars and new light-duty trucks are combined.

4. **A dealer must include demonstrators in the two required LIFO pools.** This is logical; otherwise, a dealer might be tempted to assign all new items/models to demonstrator status before year-end, thus excluding them from the LIFO pool - Right? Also, many dealers previously excluded demonstrator vehicles from their LIFO pools - perhaps so they could take writedowns - and this can no longer be done.

5. **A single index approach must be employed,** and that index is computed with reference to the vehicles actually on hand at the end of the year. This means that more aggressive dual index approaches and/or single index, earliest acquisition index methodologies cannot be used in connection with the new method.

SPECIAL RULES AND DEFINITIONS FOR THE ALTERNATIVE LIFO METHOD

1. **POOLS** Two (2) pools: one for new autos (including demonstrators) and one for new light-duty trucks (including demonstrators).

   All new automobiles can be combined in the same pool **regardless of manufacturer.** Similarly, all new light-duty trucks can be combined in the same pool, **regardless of manufacturer.**

2. **INCREMENT VALUATION** Must value increment for a pool using actual cost of specific vehicles actually in ending inventory. (No dual indexing; no early acquisitions (E/A) methodologies.) This corresponds with the increment valuation sub-election on Form 970, item 6, and would be described as a specific identification based on vehicles on hand at year-end. This method for valuing increments would **approximate** the most recent purchases method, but it would not necessarily be identical in result to the most recent purchases method.

3. **"ITEM" DEFINITION** "Item" must be determined using the entire manufacturer's base model code number that represents the most detailed description of the base vehicle's characteristics, such as model line, body style, trim level, etc. The manufacturer's base model code numbers are almost always used as part of the vehicle identification on each invoice (e.g., domestic model, trim level, 4-door sedan has a specific model code; foreign model, 4-door sedan, trim level, 5-speed has a specific model code). Conversion vans must use both (i) the entire manufacturer's base model code and (ii) the most detailed conversion package designation.

4. **COST FOR PURPOSES OF COMPUTING POOL INDEX** The actual base vehicle cost of each of the specific vehicles in ending inventory is used to compute the index under the Alternative LIFO method. The base vehicle cost of each vehicle is **not** adjusted for any options, accessories or other costs. The pool index computed from only the base vehicle cost of vehicles is applied to the total vehicle cost, including options, accessories, and other costs of all vehicles in the pool at the end of the taxable year.

   This means that equipment that was optional at the beginning of the year and made standard at the end of the year does **NOT** have to be adjusted for in arriving at "comparable" base vehicle costs. The IRS comparability requirement stated in the August, 1989 IRS Industry Specialization Program Memorandum is not applicable under the Alternative LIFO method.

   Also, this means **options and accessories do not have to be repriced**. Dealers can now **assume** that the inflation rate in options and accessories and other costs - such as destination charges - is the same as the inflation rate computed by reference to the (unadjusted) base vehicle costs.

5. **NEW ITEM DEFINITION** A new item category, which is an item category not considered in existence in the prior taxable year, is (any) one of the following:

   - Any new or reassigned manufacturer's model code **that is caused by a change in an existing vehicle,**
   - A manufacturer's model code created or reassigned because the classified vehicle did not previously exist,
   - Where there has been a change to the platform of the vehicle that results in a change in track width or wheel base, whether or not the same model name was previously used by the manufacturer, or whether or not there is any change in the manufacturer's model code. (A vehicle's platform is described as the piece of metal at the bottom of the chassis that determines the length and width of the vehicle and the structural setup of the vehicle.)

6. **TREATMENT OF NEW ITEM NOT IN EXISTENCE IN PRIOR YEAR** Must use the current-year base vehicle cost of the new item category as the prior-year base vehicle cost of the new item category. In other words, a new item is repriced at 1.000 (i.e., no inflation) in the index computation.

7. **ITEM IN EXISTENCE IN THE PRIOR YEAR, BUT NOT ON HAND AT END OF PRIOR YEAR** Repricing reference may be made to the manufacturer's price list that provides dealer purchase prices. For each such item category, use the manufacturer's price list in effect as of the beginning of the last month of the prior taxable year.

SHOULD A DEALER ADOPT THE ALTERNATIVE LIFO METHOD?
QUANTIFYING AND COMMUNICATING THE PROS AND CONS TO DEALERS

A number of observations can be made about the "new ball game" brought about by the IRS issuance of Revenue Procedure 92-79.

FIRST: **The advantages and disadvantages of the Alternative LIFO method cannot easily be quantified and reduced to dollars gained on one side vs. dollars lost on the other. How much is peace of mind worth?** Ask any dealer who's been raked over the audit coals for many years, and is facing or has paid big deficiencies because of faulty LIFO computations or simply because an IRS agent has disagreed with the computations or has some different theory or a bigger ego. How many dealers are willing to stand up to this? How many couldn't put the time and resources to better use in running their business? How many can afford to lose? How many can afford the escalating fees in defending them? More than one dealer has sacrificed his or her health or business during the IRS audit process - how much was that worth?

SECOND: **The IRS has invested significant time and personnel resources in shaping the new, simplified Alternative LIFO method it is willing to accept.** If it really wants dealers to embrace its new method in large numbers, then overly restrictive interpretations in the new item area (Disadvantage #2) will be a strong disincentive against more popular acceptance. Considering the thankless and nearly impossible task the IRS faced in trying to address a Revenue Procedure to an industry whose international manufacturers' product code classifications are so diverse, mysterious and secretive, it is not surprising that some questions will focus on item definition interpretations. Section 4.01 has the following statement: "Generally, the manufacturer's base model codes used in defining items and identifying new items under the Alternative LIFO method have an *average life of approximately five to seven years.* Keep that 5 to 7-year turnover in mind as a balancing factor in discussions about how frequently new items may crop up in future years.

But it should be remembered that this is part of the big picture: the trade off of some points for others. If the IRS will now just "signal" some further intention to be reasonable in this area or to clarify some of the potential interpretations, then more analytic critics might find their case severely weakened. In light of the reasonable and flexible approach already exhibited by the IRS in working with dealers to untie this Gordian knot, the collective IRS judgment and rationale that has prevailed in the release of Rev. Proc. 92-79 might not want to sacrifice or risk being neutered by artificial or unnecessarily restrictive interpretations. (On the other hand, it is not necessarily my opinion that the IRS needs to back off on this matter at all since it has to draw a line in the sand somewhere and say "enough is enough.")

THIRD: **If a dealer sells vehicles made by a manufacturer who frequently changes model codes and/or platforms when actual vehicle changes are relatively slight, then the more restrictive definition of what is an "item" and the requirement that it be repriced at 1.000 may be disadvantageous.** Under these circumstances, for a dealer *with higher ending inventories* retailing these makes, the Alternative LIFO method might be significantly less attractive in this respect and maybe it should be avoided. But what about all the other dealers?

The compensating advantages of "free inflation" built into the indexes elsewhere is part of the overall equation which includes the disadvantage of a narrower item definition. The new method does not require adjustments to base prices to achieve comparability for optional equipment that became standard at the end of the year (or vice versa) and for technological or other changes if they do not result in a model code change or a platform change. This clearly gives the dealer more inflation where there is none—and larger LIFO reserves than are warranted—where price increases are really due to air bags, ABS brakes, etc. And, since options and accessories do not have to be repriced at all, that may reduce computation costs every year, as well.

FOURTH: **CPAs are under an obligation to present a BALANCED discussion of the implications and ramifications of Revenue Procedure 92-79 to their auto dealer clients.** In these litigation prone times, my recommendation is that CPAs document these discussions in writing to avoid misunderstandings and recollections that get foggy over the years. A CPA might want to consult Statements on Responsibilities in Tax Practice, "Form and Content of Advice to Clients" in charting a course of client service in the context of Revenue Procedure 92-79.

IN THE FINAL ANALYSIS, the ultimate decision must be made by the dealer. Whether the decision to change to the Alternative LIFO method is made or not may depend on whether the dealer sees a glass as half full or half empty. Numbers can be made to present anyone's position convincingly, depending on a wide range of assumptions and variables. If a dealer is given access to all—or as many as possible—of the major considerations in a balanced presentation, then he or she can assess how much risk they want to take in their LIFO computations.

For more discussion, see "Projecting the Net Advantage or Loss of Benefits Under the Alternative LIFO Method" on page 10.

It is unlikely that any dealer is using this new method exactly in all of its aspects at the present time. You may want to include some of the thoughts on page 9 in a letter to your dealers about Rev. Proc. 92-79 and the opportunity to change to the new Alternative LIFO method. ✻

TO THE AUTO DEALER ON LIFO

NEW ALTERNATIVE LIFO COMPUTATION METHOD

On September 8th, 1992 the IRS announced a new, simplified Alternative LIFO computation for new vehicle inventories that can be made effective for calendar year 1992 for dealers not currently under audit. The new alternative method has several advantages, including (1) the certainty that the IRS will not second-guess your *future years'* LIFO computations in any significant way, (2) the certainty that the IRS will not review, audit, change or disturb your *prior years'* LIFO computations, (3) in computing your indexes you will not be required to reprice any options or accessories, and (4) comparability adjustments between continuing models for year-to-year minor or major changes do not have to be made unless there are platform changes or manufacturer model code changes.

Obviously, a LIFO method beneficial in these respects is not without some compensating disadvantages. These include requirements that (1) you must have a single pool for new cars and a separate single pool for new light-duty trucks, (2) you must include demonstrators in these respective pools, (3) you must use an index that is developed from actual end-of-the-year invoice information to value increases in your ending inventory, (4) new models and new items are treated as if they include no inflation, and (5) subject to a 5 to 7 year turnover guideline, these new models in some cases may be deemed to be introduced more frequently than they might otherwise be if one were only using "radical change" as an indicator.

There are other significant factors in considering the advisability and/or opportunity to change to the IRS officially sanctioned Alternative LIFO method. It appears that in the future the Internal Revenue Service may be more likely than not to more severely challenge any other LIFO method than a method that is either (a) the new Rev. Proc. 92-79 Alternative LIFO method or (b) a method in which all options and accessories on all vehicles in ending inventory are repriced **and** which employs equally strict criteria for determining when new items are deemed to occur **and** reprices them at 1.000.

This is not to say that other LIFO methods, including the one you currently employ, cannot or may not continue to be used. However, it is to say that **if** methods other than the new Alternative method are used, you should expect that it may be nearly impossible to satisfy some increasingly aggressive IRS agents, supervisors, other technical advisors, and even Appellate conferees that any method other than (a) or (b) is acceptable.

Furthermore, you may incur significant expense in going to Court to defend your LIFO application, and an unfavorable verdict will create interest and possibly penalties in addition to any tax deficiency. While it is not possible to predict the outcome if LIFO computational (or other) issues were litigated in Court. It is likely that defense costs would be significant and if you were to choose *not* to have your case heard by the Tax Court, then it would be necessary for you to first pay the tax deficiency and then sue the Government for a refund. Thus, you might incur further adverse cash flow in an effort to have your LIFO tax case heard in a more sympathetic, more favorable forum.

Consequently, it appears that the use of methods *other than* the Alternative LIFO method should be continued only if you now understand "up front" that it may be *very expensive* to defend them, even if you should eventually win.

Should you consider (1) continuing to use your current method or (2) changing to a method that reprices all options and accessories and perhaps uses a less restrictive definition for estimating or determining when "new models" are created? In part, that depends on whether the benefit of any **NET** increase in your LIFO reserve that *might be* obtained will be worth more to you on a present value basis than your *additional annual immediate* out-of-pocket cost to compute more detailed LIFO computations.

Also, in part, that depends on whether you are seeking "less hassle from the IRS" in the future. The new Alternative LIFO computation affords the trade-offs of relative certainty, simplification and lower annual computation costs, on one hand, against what might be higher costs of more detailed calculations which the IRS officially has now said are not absolutely necessary. So how much is a theoretically higher LIFO reserve--- that you will have to repay someday--really worth to you today?

You don't have to make your mind up about this in a hurry. In general, you have at least until December 31, 1992 to decide and change to use the new method if you want. If you're not already under audit, action before December 31, 1992 would make the new method effective for 1992 and secure an "amnesty" for you from any deficiencies that might be found by the IRS in a review of your earlier years' LIFO computations.

The IRS has been extraordinarily benevolent in relieving the current threatening state of affairs. While the resulting new Alternative LIFO method reflects many trade-offs and compromises, rather than perfection and 100% accuracy, if you value certainty and peace of mind in connection with your LIFO tax matters, you now have a means to simply and inexpensively obtain them.

Finally, consider that the possibility to change to the new Alternative LIFO method "with no questions asked" may not necessarily be available in future years. Any Revenue Procedure issued by the IRS can always be revoked. Accordingly, what is here today, may be gone tomorrow...and resulting IRS audit standards of your LIFO computations might be tightened even more. The old sayings about "not looking a gift horse in the mouth" or that "half a loaf is sometimes better than none" are worth considering...especially if you are not entirely comfortable with--or paying for--your current LIFO computations.

Please call me immediately if you want to review the specifics of your present LIFO calculations and go through a more detailed discussion of this new Revenue Procedure.

Sincerely,
WILLARD J. DE FILIPPS, CPA

CHANGING TO THE ALTERNATIVE LIFO METHOD BEFORE DECEMBER 31, 1992

The procedures for changing to the Alternative LIFO method before December 31, 1992 **depend upon whether or not the dealer has a LIFO issue pending on September 8, 1992.**

For an automobile dealer for which a LIFO issue is not pending as of September 8, 1992, the year of change will be the first taxable year ending after September 28, 1992 - providing the dealer files Form 3115 with the National Office before December 31, 1992. Any Form 3115 requesting permission to change to the alternative LIFO method that is filed on or before December 31, 1992, including those filed before September 28, 1992 **must** be for a year of change that is the automobile dealer's first taxable year ending after September 28, 1992.

Therefore, the Form 3115 "early filing provisions" of Revenue Procedure 92-20 are not applicable to any Form 3115 filed on or before December 31, 1992, including any that have already been filed with the National Office before September 28, 1992. Those already filed are being returned to the dealer, along with a refund of the user fee, to give the dealer an opportunity to change to the Alternative LIFO method now available under Rev. Proc. 92-79.

An issue is "pending" if the automobile dealer has received written notification from an examining agent indicating that an adjustment is being or will be proposed with respect to the dealer's use of the particular LIFO inventory method or sub-method. This will generally occur after the examining agent has gathered information sufficient to identify a particular erroneous LIFO inventory method or sub-method and to determine that a proposed examination adjustment is appropriate and justified, although the amount of the adjustment may not yet be determined (as of September 8, 1992).

The Form 3115 filing mechanics for a dealer for whom a LIFO issue is not pending as of September 8, 1992 are:

1. An original copy of a completed Form 3115, including attachments, must be attached to the dealer's timely filed (including extensions) original Federal income tax return for the year of change..
2. A **copy** of the completed Form 3115, including attachments, must be filed with the IRS National Office is Washington, DC on or before December 31, 1992 (Note: this filing of the **copy** of Form 3115 with the National Office will occur **before** the filing of the tax return for the year of change). The filing address is: Commissioner of Internal Revenue, Attention: CC:IT&A, P. O. Box 7616, Benjamin Franklin Station, Washington, DC 20044.
3. The dealer must also attach an extra acknowledgement copy of page 1 of the Form 3115 to the copy filed with the National Office so that the copy filed can be date stamped by the National Office and returned to the automobile dealer.
4. If the dealer is under examination as of September 8, 1992 (but a LIFO issue is not pending), or if the dealer is contacted for examination during the period beginning September 9, 1992, and ending December 31, 1992, the dealer must give a copy of the completed Form 3115, including attachments, and a copy of the National Office date-stamped acknowledgement copy of page 1 of the Form 3115, to the examining agent promptly upon receipt of the National Office date-stamped copy of page 1 of the Form 3115.
5. Type of legibly print across the top of Form 3115: **"FILED UNDER SECTION 5.01 OF REVENUE PROCEDURE 92-79" and** remember to **attach the signed Consent Statement** that under the penalties of perjury, the dealer agrees to all of the consent conditions contained in Section 9 of Revenue Procedure 92-79 to change to the Alternative method.

For an automobile dealer under examination on September 8, 1992 and for whom a LIFO issue is pending as of September 8, 1992, the year of change and Form 3115 filing mechanics are different. As for the year of change, where a LIFO issue is pending on September 8, 1992, the dealer's year of change will be the most recent taxable year that is being examined by the IRS as of September 8, 1992, but **not later than the most recent taxable year for which a Federal income tax return had been filed as of the date the examination (in which the issue is pending) began, provided the Form 3115 is filed with the National Office on or before December 31, 1992.**

The Form 3115 filing mechanics where a LIFO issue is pending on September 8, 1992 are as follows:

1. The original of completed Form 3115, including attachments, must be filed with the examining agent before December 31, 1992 and when the **copy** of the Form 3115, including attachments, is filed with the National Office.
2. The copy of the completed Form 3115, including attachments, must be filed with the National Office on or before December 31, 1992. This copy must be addressed to the Commissioner of Internal Revenue, Attention: CC:IT&A, P. O. Box 7616, Benjamin Franklin Station, Washington, DC 20044.
3. The dealer must also attach an extra acknowledgement copy of page 1 of the Form 3115 to the copy filed with the National Office. The copy of page 1 of the Form 3115 will be date-stamped by the National Office and returned to the dealer.
4. Upon receipt of the National Office date-stamped copy of page 1 of the Form 3115, the dealer must promptly provide a copy to the examining agent.
5. Type or legibly print across the top of Form 3115: **"FILED UNDER SECTION 5.02 OF REVENUE PROCEDURE 92-79" and** remember to **attach the signed Consent Statement** that under the penalties of perjury, the dealer agrees to all of the consent conditions contained in Section 9 of Revenue Procedure 92-79 to change to the Alternative method.

CHANGING TO THE ALTERNATIVE LIFO METHOD AFTER DECEMBER 31, 1992

If, after December 31, 1992, but before the close of the **first** taxable year ending after December 31, 1992, the dealer is **not under examination on the date the Form 3115 is filed** with the National Office, then the year of change to the Alternative method will be the dealer's first taxable year ending after December 31, 1992.

1. An original copy of a completed Form 3115, including attachments, must be attached to the dealer's timely filed (including extensions) original Federal income tax return for the year of change.

2. A **copy** of the completed Form 3115, including attachments, must be filed with the IRS National Office is Washington, DC on or before the last day of the year of change. (Note: this filing of the **copy** of Form 3115 with the National Office will occur before the filing of the tax return for the year of change.) The filing address is: Commissioner of Internal Revenue, Attention: CC:IT&A, P. O. Box 7616, Benjamin Franklin Station, Washington, DC 20044.

3. The dealer must also attach an extra acknowledgement copy of page 1 of the Form 3115 to the copy filed with the National Office so it can be date stamped by the National Office and returned to the dealer.

4. Type or legibly print across the top of Form 3115: "**FILED UNDER SECTION 6.01 OF REVENUE PROCEDURE 92-79**" **and** remember to attach the signed Consent Statement that under the penalties of perjury, the dealer agrees to all of the conditions of consent contained in Section 9 of Revenue Procedure 92-79 to change to the Alternative LIFO method.

For dealers under examination after December 31, 1992 who want to file Form 3115 to change to the Alternative LIFO method after that date, they may only request to make this change under the applicable provisions of Revenue Procedure 92-20 - which may involve filing during the "90-day audit window."

If an automobile dealer not under examination desires to change to the Alternative LIFO method for a taxable year *later than* the first taxable ending *after* December 31, 1992, the dealer may only request to change to the Alternative LIFO method under the applicable provisions of Revenue Procedure 92-20 (which require filing Form 3115 with the National Office within the first 180 days after the start of the year of change).

CPA RESPONSE TO REV. PROC. 92-79 — FIVE (5) MINUTE QUESTIONNAIRE

Please photocopy, complete and fax to (708) 577-1073 — *"Courtesy Copy"*

1. Overall, my reaction is favorable. I think it's very much needed and probably will end up advising many dealer clients to change to it the new Alternative method. YES NO

2. Overall, I don't think it's so beneficial to dealers and probably will not advise many dealer clients to change to the new Alternative method . YES NO

3. With how many dealers have you already discussed Rev. Proc. 92-79? (Estimate) ______
Out of that number, how many are:
(a) Leaning toward changing to the alternative method? ______
(b) Leaning toward not changing ______
(c) Undecided ______

4. What was the major deciding factor?

5. Do you believe the trade-offs or compromises are fair and about equal? YES NO
If not, who got the better deal: Circle one: IRS Dealers

6. Do you believe the IRS will strictly interpret the narrower "new model" definition against dealers, or interpret it in a liberal, or at least, neutral fashion towards dealers? STRICT LIBERAL/NEUTRAL

7. Any other comments and signature (optional)

PROJECTING THE NET ADVANTAGE OR LOSS OF BENEFITS UNDER THE ALTERNATIVE LIFO METHOD

Let's not beat around the bush. The least attractive feature of Revenue Procedure 92-79 is that almost any change in manufacturer model code or any platform constitutes a "new item" which must be included in the computation of the inflation index at 1.000 - as if there were no inflation built into that vehicle's cost. This is one of the disadvantages or trade-offs that dealers who want to use the Alternative method must accept in exchange for the benefits of not having to make optional-to-standard equipment price adjustments and not having to reprice all options and accessories and a calmer audit environment.

The requirement that new items must be repriced at 1.000 is hard to swallow. We **know** there is some inflation in new models; the product is just too complex and the inflation is too cleverly concealed. But it is there; it just cannot be **proven** to the IRS. Therefore, since this is one of the dealer's concessions in order to get favorable results elsewhere, no purpose is served in analyzing or challenging the lack of rationale underlying this treatment. One must be willing to either take it or leave it.

Automotive News, on September 14, 1992, described the issuance of Revenue Procedure 92-79 as a victory handed to NADA and quoted Chris Groff, President of LIFO Systems, Inc. (a major provider of detailed LIFO computation services), that "Under the new ruling, dealers could lose about 20 per cent of their benefits if they used the new method...It looks like the IRS said dealers will have to give up something to get an easier method of computing for inflation." If anyone will put this disadvantage under a microscope, it will be LIFO Systems, and its analysis may be helpful to dealers and CPAs in evaluating whether or not to adopt the new LIFO method.

Realistically, however, the downside of this condition or detriment to dealers has to be evaluated in comparison with other advantages, chief of which is that some price increases will be counted as pure inflation, thus artifically increasing indexes and benefitting dealers, when, in fact, these price increases really represent value added equipment improvements.

In attempting to quantify the "no inflation in new models" disadvantage, one can expect that the stricter definition of a new item (all by itself) will tend to lower the inflation index compared to what it might have been if a more liberal guideline or standard were in place. In trying to accurately **quantify** any anticipated **NET** loss of benefits, many factors that do not readily lend themselves to a worksheet presentation or a particularly narrow range of alternatives must be considered.

FIRST: One must look at the particular manufacturer or make involved, and the history to date of frequency of model or platform changes, as well as changes in the manufacturers code which might not necessarily reflect **substantive** vehicle changes. For example, if a manufacturer every year changes model codes to incorporate reference to the year of manufacture, that change alone should not constitute the creation of a new item to be repriced at 1.000 in the index computation. Section 4.02(5) of the Revenue Procedure states that a new item is "any new or reassigned model code...that is caused by a **change** in the existing vehicle." A strict reading does not seem to support the interpretation that the mere change in code number without a change in the vehicle results in creating a "new item" to be repriced at 1.000. If the intention of the IRS underlying Rev. Proc. 92-79 is to provide an Alternative LIFO methodology that will encourage dealers to adopt it, then vehicles with very minor changes should not be treated as new items and repriced at 1.000 even though accompanied by a change in model code. Rev. Proc. 92-79 indicates that a 5 to 7 year turnover of new models *may* be a guideline for this purpose.

On the other hand, if the intention of the IRS is to simply draw the line somewhere, then this becomes a stronger signal that this is a bigger negative factor to be considered by dealers selling certain makes whose manufacturers are anticipated to more frequently change model codes in the future.

SECOND: Any projection of loss of benefits would have to assume a certain frequency or mix of new items in the ending inventory. It would also have to be assumed that the dealer will be unable, uninterested, unmotivated or unwilling to take legitimate action to eliminate as many of the new items from ending inventory as possible or practical. Many CPAs engage in year-end planning and projection work **before year-end** and will have no difficulty in knowing which new models are the undesirable "black sheep" to be minimized in ending inventory from a new item/LIFO reserve standpoint. Consequently, dealers should be in a position to "dodge the bullet" at least to some extent and mitigate some portion of the new item definition detriment if they are willing to seek year-end planning and monitoring with their CPAs.

THIRD: In many cases, depending on the dealer's actual mix of vehicles in ending inventory, the presence of a lesser amount of new items repriced at 1.000 often does not amount to any **significant** dollar difference in the final computation of the overall inflation index and the LIFO reserve. In short, having a few new models in ending inventory is rarely significant in the overall big

→

picture. Since the overall index for the pool would be weighted according to all the vehicles in the pool, assuming one-of-each may not necessarily be realistic. Looking at the pure number of changes is sophomoric as one could hardly conclude that if there were six models at the beginning of the year and two of them changed at year end, there would be a one-third reduction of benefit!

Furthermore, in some instances, "new items" are in greater demand and because they move faster they are less likely to be in inventory **at year-end** when the computation is actually made. In some years, new items may appear at the higher dollar end of the line; in other years, they may be at the lower end. That dispersion also affects the size of an index.

FOURTH: Notwithstanding the foregoing, some hypothetical reduction in the LIFO reserve may be estimated as due to the more restrictive item definition. Once that is done, a balanced evaluation suggests that it would only be fair to **offset** that by the significantly favorable aspects of the new Alternative method provisions which allow a dealer to ignore optional-to-standard equipment changes (thus benefiting the dealer with an artificially high inflation index) and to treat the addition of more equipment (such as air bags, ABS brakes, etc.) as if the resulting price increases were inflation. All of these have to be worth something...and this is happening all the time.

FIFTH: The decrease in annual computation costs that might go along with not having to reprice all options and accessories would need to be factored in somewhere.

SIXTH: Note that the **combination** of assumptions for any given year end that involve (a) the inflation index for continuing models, (b) the decrease in the index attributable to repricing new items *that really aren't new items* at 1.000 and (c) the unmerited benefit of treating some - if not all - pure equipment changes as if they were inflation, thus increasing the annual inflation index, may be weighted any way you want to make a point. In other words, if in one year the benefits of not having to make option-to-standard and value-added comparability adjustments are combined with high inflation in continuing models and the introduction of relatively few new models that are actually on hand at year end, there may be a favorable, unrealistic "surge" in the inflation index for that year because of the mix of these components.

The point is that in considering the **net** loss of the benefits, if any, under the new method, one may be looking at things backwards: **There may actually be a *net increase* in benefits for many dealers under the new method where new items are less frequent and manufacturers add equipment without changing model codes or platforms. Under different combinations of assumptions involving all the factors, *net advantages* under the new method can be just as readily demonstrated to dealers as net disadvantages.** And, rather than looking at how many model changes or platform changes have taken place, central to the analysis should be only those model changes or platform changes that are treated as new items under the new method but would not be treated as new items under the old method. Only those new items that result in *different* treatment under the new method, rather than all new items, affect the evaluation.

SEVENTH: After quantifying any projected decrease in the LIFO reserve, quantifying any projected increase in the LIFO reserve, and then *offsetting* them, any **net** decrease would be multiplied by the applicable tax rate of the dealer (if an S shareholder) or of the dealership corporation (if a C corporation) to arrive at a net tax reduction amount. What tax rates should be assumed? Over how many years does one multiply this tax reduction? Is the amount likely to vary over the years? At what rate of return, net-of-tax, would the hypothetical tax savings be invested? How would one discount this computation over a number of years?

EIGHTH: Since LIFO is a deferral mechanism, how would the eventual repayment of the LIFO reserve be factored back in? What will the tax rates be in those years? Will partial repayments be occurring over a number of years, or will the repayment be assumed to be all at once?

NINTH: What if tax rates **increase** in the future...making any deferral today at lower tax rates less advantageous when compared to a future repayment at higher rates?

TENTH: What if the dealer is an S Corp and the dealer-shareholder has a "basis problem" so that losses (as increased by LIFO reserve increases) cannot be used currently and are suspended? What is the time value of losses that can't be used immediately?

STOP, STOP: ENOUGH IS ENOUGH!! Some dealers may have difficulty following, or agreeing with, all the assumptions cranked into a really balanced and comprehensive projection of alleged "loss of benefits." Against such a computation, the dealer can consider (a) the comparative peace of mind—if that is important to him or her - that follows from using the Alternative method and (b) the possible actual annual reduction in costs in making the LIFO computations. At least, most dealers can follow that. To some, this may be a more tangible and real measure than a whole lot of futuristic assumptions likened to guessing how many angels can dance on the head of a pin.

If the cash out-of-pocket for LIFO computations is significant, some dealers, cash tight or otherwise, may decide that a bird in the hand is worth two (maybe even three, four or five?) in the bush. I rest my case.

STEP-BY-STEP COMPUTATIONS... ALTERNATIVE LIFO METHOD FOR AUTO DEALERS

Under the new, simplified Alternative LIFO methodology, the inflation index is computed by reference to the *invoices for every vehicle in ending inventory* - no sampling, no shortcuts in this regard. *Copies of these invoices should be saved indefinitely.* The procedural steps in the computation are listed below:

STEP #1: Obtain the actual invoice for each vehicle in the ending inventory.

STEP #2: For each pool, group all of the invoices from Step 1 by item category (i.e., using the manufacturer's base model code numbers broken down as finely as possible [see "item" definition under special rules and definitions]).

STEP #3: For each item category, add together the dealer's base vehicle costs of all vehicles within each item category, from Step 2.

STEP #4: *Within each pool, compute an average base vehicle cost* for each item category by dividing the result from Step 3 for each item category by the number of vehicles in the item category. This average base vehicle cost for each item will be used in Step 6 of the succeeding year's computations.

STEP #5: For each pool, compute the total current-year base vehicle cost of the pool by adding together the separate item category totals from Step 3.

STEP #6: For each pool, compute the total base vehicle cost of the ending inventory at prior-year's base vehicle cost:

First, multiply the number of vehicles in the current year's ending inventory for each item category by the average base vehicle cost of the same item category from Step 4 of the preceding year's inventory calculation.

If the same item was not in the prior year's ending inventory, special rules apply. *If an item was **not** in existence in the prior year, then it must be repriced at 1.000* (since it is a "new" item) by using the current-year base vehicle cost of the new item category as (if it were) the prior-year base vehicle cost of that item category.

If an item in the ending inventory was in existence in the prior year, but was not stocked by the dealer at the end of that prior year, then repricing reference may be made to the manufacturer's price list that provides dealer purchase prices using the list in effect as of the beginning of the last month of the prior taxable year.

Finally, add together the total prior-year base vehicle cost of all of the item categories.

STEP #7: For each pool, compute the current-year (annual) index by dividing the amount from Step 5 by the amount from Step 6.

STEP #8: For each pool, compute the cumulative index by multiplying the current-year index from Step 7 by the cumulative index at the end of the preceding year (from Step 8 of the preceding year's computation).

STEP #9: For each pool, compute the total current-year total-vehicle cost by adding together the total invoice cost, including installed options, accessories, and other inventoriable cost(s), of all of the vehicles in inventory at the end of the current year.

STEP #10: For each pool, compute the total cost of the current-year's ending inventory at base-year cost by dividing the total current-year total-vehicle cost of all of the vehicles in ending inventory, from Step 9, by the cumulative index from Step 8.

STEP #11: For each pool, determine if there is an increment for the current year by comparing the total cost of the pool's current-year ending inventory at base-year cost, from Step 10, with the total cost of the pool's preceding year's ending inventory at base-year cost, using the amount from Step 10 of the preceding year's calculation. If the amount from Step 10 of the current year's calculation is greater, there is an increment.

STEP #12: For each pool, value the current year's increment at current-year cost by multiplying the increment amount from Step 11 by the cumulative index from Step 8.

STEP #13: If there is no increment for a pool, but, rather, a liquidation (also referred to as a decrement), reduce the LIFO layers in reverse chronological order until the liquidation is fully absorbed.

STEP #14: For each pool, add together the current year's increment, if any, at current-year cost and the prior years' increments at each prior year's current-year cost to compute the total LIFO value for the pool.

NOTE: The result in step 14 is the total LIFO value for the pool. The LIFO reserve for the pool is determined be subtracting the result in Step 14 (the ending inventory at LIFO) from the result in Step 9 (the ending inventory at actual cost).

See the worksheet for the computational format on page 13.

KKK DEALERSHIP, INC.
POOL #1: NEW AUTOMOBILES (INCLUDING DEMONSTRATORS) INVENTORY
CALCULATION OF ANNUAL LIFO INVENTORY INCREASES (DECREASES)
AS CALCULATED UNDER THE DOLLAR VALUE, LINK-CHAIN ALTERNATIVE LIFO METHOD
FOR THE YEARS ENDED DECEMBER 31, 19XX AND 19YY

	OLD METHOD LINK-CHAIN, INDEX		NEW ALTERNATIVE LIFO METHOD REV. PROC. 92-79 *
	19XX	19YY	
A. BEGINNING OF YEAR INVENTORY AT BASE DATE COST	$558,078	$764,616	STEP 10 OF PRIOR YEAR (LINE F OF PRIOR YEAR)
B. END OF YEAR INVENTORY AT END OF YEAR (CURRENT) PRICES	$820,662	$1,288,009	STEP 1 & STEP 9
C. END OF YEAR INVENTORY AT BEGINNING OF YEAR (BASE) PRICES	NOT FULLY REPRICED	NOT FULLY REPRICED	STEP 6
D. CURRENT YEAR PRICE INDEX:			
RATIO OF: END OF YEAR INVENTORY PRICED AT END OF YEAR PRICES (DIVIDED BY) — STEPS 3 & 5 END OF YEAR INVENTORY PRICED AT BEGINNING OF YEAR PRICES — STEPS 3, 4 & 6	1.0218	1.0485	STEP 7
E. CUMULATIVE LINK-CHAIN INDEX: CURRENT YEAR PRICE INDEX (LINE D) MULTIPLIED BY (x) PRIOR YEAR'S CUMULATIVE INDEX (LINE E OF PRIOR YEAR)	1.0733	1.1254	STEP 8
F. END OF YEAR INVENTORY AT BASE DATE COST (LINE B DIVIDED BY LINE E)	$764,616	$1,144,490	STEP 10 (9 DIVIDED BY 8)
G. CURRENT YEAR INVENTORY INCREASE (DECREASE) - EXPRESSED IN BASE DOLLARS			STEP 11
1. END OF YEAR INVENTORY AT BASE DATE COST (LINE F)	$764,616	$1,144,490	STEP 10 OF CURRENT YEAR
2. BEGINNING OF YEAR INVENTORY AT BASE DATE COST (LINE A)	558,078	764,616	STEP 10 OF PRIOR YEAR
3. CURRENT YEAR INCREASE (DECREASE)	$206,538	$379,874	STEP 11
4. LIFO VALUATION OF CURRENT YEAR INCREMENT	x 1.0733	x 1.1254	STEP 8
AMOUNT CARRIED TO LIFO SCHEDULE (BELOW) LINE G(3) x LINE E	$221,673	$427,510	STEP 12 (STEP 11 x STEP 8)
H. ANALYSIS OF YEAR END INVENTORY LIFO "LAYERS"			
BASE INVENTORY	$330,103	$330,103	FROM PRIOR YEAR
CALENDAR YEAR 19WW INCREMENT	227,975	227,975	FROM PRIOR YEAR
CALENDAR YEAR 19XX INCREMENT	221,673	221,673	FROM PRIOR YEAR
CALENDAR YEAR 19YY INCREMENT	-	427,510	STEP 12
ENDING INVENTORY AT LIFO VALUATION, PER ABOVE	$779,751	$1,207,261	STEP 14
LESS: ENDING INVENTORY AT END OF YEAR PRICES (LINE B)	820,662	1,288,009	STEP 9
LIFO RESERVE AT RESPECTIVE YEARS' END	$40,911	$80,748	LIFO RESERVE - EOY
LIFO RESERVE AT END OF PRIVIOUS YEAR	(28,127)	(40,911)	LIFO RESERVE - BOY
INCREASE (DECREASE) IN LIFO RESERVE AT CURRENT YEAR END	$12,784	$39,837	NET CHANGE IN LIFO RESERVE

* NOTE: THIS ILLUSTRATES ONLY THE COMPUTATIONAL METHODOLOGY OF SECTION 4.03 OF REV. RPOC. 92-79.
IT DOES NOT REFLECT REBASING OF BEGINNING INVENTORY OF YEAR OF CHANGE TO 1.000 REQUIRED BY SECTION 9.02(8).
NEW LIGHT-DUTY TRUCKS MUST BE PLACED IN A SEPARATE POOL #2.

OTHER REQUIREMENTS AND CONSENT CONDITIONS

When a dealer files Form 3115, Application for Change in Accounting Method, in addition to other filing attachments, the dealer must also attach the following statement: *"Under penalties of perjury, (insert name of automobile dealer) agrees to all of the conditions of consent contained in Section 9 of Rev. Proc. 92-79, to change to the Alternative LIFO method."*

In addition, there are nine (9) conditions of consent to which the automobile dealer must agree:

FIRST, the dealer must keep its books and records for the year of change and later taxable years on the LIFO inventory method and it must use the LIFO inventory method for all reports, including consolidated financial statements, if any, and statements for credit purposes in conformity with Regulation Section 1.472-2(e).

SECOND, the dealer must value the inventory (of new automobiles and new light-duty trucks) as of the end of the year of change and for later taxable years under the Alternative LIFO method, unless it obtains permission to change to another recognized method.

THIRD, the third condition relates to auto dealers changing from the Inventory Price Index (IPI) method.

FOURTH, the conversion from the specific goods LIFO method, if applicable, to the dollar value LIFO method, must be made in accordance with Regulation Section 1.472-8(f)(2).

FIFTH, the dealer must file Form 970 with its income tax return for the year of change, or with an IRS examining agent if applicable, **and** otherwise comply with various requirements...to *extend* the LIFO election (1) for example, to include demonstrator vehicles not previously subject to a LIFO election and/or (2) for certain "IPI" computation method changes. For dealers changing to the new method, apparently Form 970 only needs to be filed if the change also involves the ***extension*** of LIFO to inventory costs not previously on LIFO.

SIXTH, the dealer must effect the change to the Alternative LIFO method using the **cut-off method.** Under the cut-off method, the value of the automobile dealer's new automobile and new light-duty truck inventory...at the beginning of the year of change shall be the same as the value of such inventory at the end of the preceding taxable year, plus market value restorations, if any are required in connection with the fifth condition above.

SEVENTH, the dealer must combine and/or separate the dollar inventory pool or pools, to conform to the inventory pooling requirement of separate pools for all new cars regardless of manufacturer (including demonstrators) and for all new light-duty trucks regardless of manufacturer (including demonstrators) in accordance with the provisions of Regulations Section 1.472-8(g)(2).

EIGHTH, in making these changes, any layers of inventory increments previously determined and the LIFO value of any such increments shall be retained.

Instead of using the earliest taxable year of the LIFO election as the base year, the year of change shall be used as the base year in determining the LIFO value of the inventory pool or pools for the year of change and later taxable years. In other words, the cumulative index at the beginning of the year of change shall be 1.000. **The base-year costs of layers of increments in the pool or pools at the beginning of the year of change shall be restated in terms of the new base-year costs using the year of change as the new base year.** (See, for example, Letter Ruling 8137143.)

NINTH, and finally, the dealer must maintain and retain complete records of the computations of the LIFO inventory under the Alternative LIFO method, as well as copies of the actual purchase invoice for each vehicle used in the computation.

De Filipps' LIFO LOOKOUT
Willard J. De Filipps, CPA, P.C.
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LIFO Update

(Continued from page 2)

dealer has not changed to the Alternative method, it is a prime candidate (sitting duck) for audit, because doing otherwise warrants a closer look?

Recently (July, 1992) one District Director's office sent out letters to auto dealers statingthat the letter was not notification of the beginning of an examination. However, to determine the effects of Revenue Procedure 92-20 and Announcement 92-93 on LIFO inventories and extended service contracts, it would be appreciated if the dealer would complete and return a questionnaire... within two weeks from the date of the letter.

The questionnaire asked for general information that would take only a few minutes to fill out **and** that if a change in method was or is instituted, that the taxpayer send a *"courtesy copy"* of Form 3115 to an individual designated in the IRS letter. (Courtesy copy... what's that?)

To my knowledge, only one District did this. Could this be a hint of more ominous things/letters to come?

#4 NATIONAL OFFICE FORM 3115 FILINGS

In speculating over whether the IRS National Office might be swamped with 3115 filings, it now appears the National Office has somewhat lessened its workload, at least for the short term, by issuing a number of *expeditious* change procedures. The IRS recently released two Revenue Procedures, 92-74 and 92-75, which permit taxpayers to obtain expeditious consent to change their accounting methods in connection with other inventory applications.

Revenue Procedure 92-79 also is an expeditious consent procedure, meaning that Forms 3115 filed under it do not first require National Office approval. It will be interesting to see how large the Form 3115 processing backlog really becomes once the extent of September 18 transition rule filings under Rev. Proc. 92-20 and the December 31 transition rule filings under Rev. Proc. 92-79 are known.

#5 REVENUE PROCEDURE 92-20: EXTENDED SERVICE CONTRACTS UPDATE

In followup to the discussion in the June, '92 *Lookout* of auto dealer extended service contracts as another application of Revenue Procedure 92-20, the issuance of Announcement 92-92 was mentioned. That Announcement number should have been 92-93 and I apologize for any inconvenience. This Announcement was updated on September 2, 1992 by Announcement 92-127 containing Settlement Guidelines for Motor Vehicle Extended Warranty Contracts.

In Announcement 92-127, the Service's settlement offer will be based on the present value of a taxpayer's insurance cost deduction for each year a multi-year service warranty was issued by the taxpayer. The present value amount will be calculated based on the statutory underpayment rate as the discount rate, and the term of the service warranty contract as the number of years over which the cost is to be discounted. The IRS indicated that certain simplifying assumptions, such as treating each warranty contract sold as if it were sold at the beginning of the year, would be made. The amount calculated would be permitted as a deduction in the year the service warranty related to the insurance cost was sold, and statutory interest will be imposed on any resulting deficiency.

Any taxpayer agreeing to the IRS offer would settle this issue for its open years, and change its method of accounting to the method of amortizing the cost of the multi-year insurance policies over the term of the policies for the tax years ending on or after June 12, 1992. No Section 481(a) adjustment would be necessary. Taxpayers have been given until November 20, 1992 as the deadline by which they must notify, in writing, the IRS representative handling the issue if they wish to accept this offer.

In this settlement scenario, many dealers receive the benefit of significant reductions in the assessments they would otherwise be facing, although many still feel the incentives to settle are not strong enough.

#6 MANUFACTURERS' USE OF COMPONENTS-OF-COST INDEX METHODS

This important issue continues to receive attention from the AICPA and the IRS. The IRS recently concluded in a letter dated July 31, 1992 that the LIFO Regulations do not specifically permit the use of cost components (i.e., raw materials, labor and overhead) as items in the computation of a LIFO price index. The IRS also concluded that the components-of-cost method "has the potential to distort income by permitting a taxpayer to deduct as a cost of goods sold an amount greater than the cost of creating the inventory sold. Some applications of the method can convert the changes in the component mix (often occasioned by technological advances) into apparent inflation in the cost of the inventory, even though overall product costs have not increased."

The Service stated its belief that "it is appropriate to continue the examination of the method used by particular taxpayers to assure compliance with a statutory requirement that income be clearly reflected." In this respect, the IRS has identified three questions or issues that need to be resolved. The *first* relates to when a component becomes a new or a different item, the *second* involves attempting to separate efficiencies out of the computational results and the *third* involves how units of overhead should be measured.

Comment: Auto dealers should be grateful the IRS didn't reach a similar "clear reflection of income" conclusion in their case that would have left them, too, twisting in the wind.

*Below is the written proposal I submitted to the IRS for a simplified LIFO method for auto dealers. (See Update item #2 on page 2.) In its original state, it was a "comparability-adjusted base price" approach. You can see my thoughts on comparability/Wendle adjustments in #2 and on the treatment of new items in #4 of the proposal. After describing the seven elements, I further suggested that an even greater compromise version might get the job done (See **"Splitting the Difference: A Compromise Approach"** on the last page). I was pleased to see that some of my thoughts coincide with portions of the Alternative LIFO method in Revenue Procedure 92-79.*

PROPOSAL TO IRS FOR SIMPLIFIED ALTERNATIVE LIFO METHOD SUBMITTED BY W. J. DE FILIPPS TO IRS - JULY 14, 1992

July 14, 1992

Ms. Brenda Wilson
Internal Revenue Service
Room 5411
P. O. Box 14095
Benjamin Franklin Station
Washington, DC 20044

Dear Ms. Wilson:

RE: SIMPLIFIED ALTERNATIVE LIFO METHODS FOR AUTO DEALERS

At the IRS-NADA meeting on July 7th, I mentioned an approach somewhat different from either a Bureau of Labor Statistics (BLS) index approach or an "averaging" approach. My suggestion for auto dealer LIFO involved computing inflation indexes developed (1) from a dealer's actual ending inventory invoices (2) by repricing the base price component of the vehicle cost (3) after optional-to-standard "comparability" adjustments had been made. I referred to this as a "comparability-adjusted base price" approach.

Under this approach, an auto dealer would use a dollar value, link-chain index methodology computing the LIFO values for its new vehicle inventories. There would be two pools (Pool #1: all new cars, including demonstrators and Pool #2: all new trucks, including demonstrators). Under this link-chain, index approach, the dealer would use a moving or updated base date cost each year, repricing a representative portion of the inventory dollars in determining the annual index. Year-to-year changes in cost levels would be measured first on an annual basis, and then the cumulative change forward from the new base date would be determined by multiplying the current annual index by the last previously determined cumulative index.

Exhibit 1 is a proforma link-chain, index computation showing the step-by-step mechanics of the computation. The seven elements of the proposed "comparability- adjusted base price" alternative method are discussed below:

1. INFLATION INDEX TO BE COMPUTED BY USING ACTUAL INVOICES DETERMINED BY SPECIFIC IDENTIFICATION

The inflation index to be applied to each pool would be determined by repricing all vehicles included in ending inventory, based on the dealer's actual invoices determined by specific identification.

Using actual invoices would assure that the inflation index was determined only from those vehicles specifically identified by invoice as being in the dealer's ending inventory at actual current year-end cost, and at actual prior year-end cost. This would satisfy the "clear reflection of income" requirement by using the dealer's actual costs and inventory mix - instead of substituting assumptions regarding current year costs or mix. These assumptions are readily eliminated simply by using actual invoices.

Repricing all of the vehicles in ending inventory (in computing the inflation index) would avoid any and all problems and judgements associated with statistical or other sampling approaches, design and subsequent execution. Many statistically sound sampling approaches tend to be mishandled as they are "followed" from year-to-year by different people who may not be familiar with the underlying theory.

The use of actual invoices would also reduce the impact of some factors that otherwise might introduce distortions: i.e., price rebate/reductions offered by the manufacturer to a dealer would be reflected in the dealer's actual invoice costs used to compute the inflation index for that year. Also, if certain (demonstrator) vehicles remain in inventory for longer periods spanning several factory price changes during the year, the use of the dealer's actual invoice base price will introduce greater accuracy because the dealer's own exact invoice prices will be used.

2. "COMPARABILITY ADJUSTMENTS" TO REFLECT OPTIONAL—TO—STANDARD EQUIPMENT CHANGES

As part of the proposed methodology, before any inflation indexes are computed, relevant changes would be taken into account by adjusting the base price of the respective vehicles and models to achieve comparability with year-end vehicles and models.

→

Each vehicle in an auto dealer's inventory consists of the aggregate of differing combinations of capitalizable costs including the vehicle base price which is the principal component, and other lesser sub-components such as destination charges, factory-installed options (both individual as well as in package combinations), options and accessories installed by the dealer, and other capitalizable charges. Under the proposed alternative, repricing only the base price component will reflect price changes and price trends in new vehicle inventories in a practical and reasonable manner.

Under the proposed alternative, adjustments similar to those illustrated in the ISP Memorandum (namely, optional equipment on models at the beginning of the year made standard equipment on models at the end of the year) would be made only if the cost of the options made standard exceeded 2% of the previous year's unadjusted base price. This would be consistent with the Industry Specialization Program, Motor Vehicle Industry, Coordinated Issue Memorandum dated July, 1989, but it would temper the application of the principle with a practical and inoffensive de minimis.

As part of this proposed alternative approach, dealers could be required to prepare and retain a schedule or listing showing new models and comparability adjustment amounts. This schedule or workpaper could be similar in content and/ or format to Exhibit 2.

3. MODEL / BODY TYPE DESIGNATIONS AS THE BASIS FOR COMPARISON

LIFO index repricing for auto dealers using comparable "models, by body type and style," when combined with actual ending inventory invoice information, should provide a level of accuracy sufficient to satisfy the statutory clear reflection of income requirement.

The adjusted base price component (step 2) of the overall vehicle cost would then be repriced on a comparative basis (i.e., beginning-of-the-year/denominator vs. end-of-the-year/numerator) to determine the current year inflation index.

Exhibit 3 shows that the third, fourth and fifth digit or character spots in the VIN (vehicle identification number) on the invoice correspond to the manufacturer's "body type number;" Exhibits 4 and 5 are copies of the manufacturer price information for a 1991 and 1992 Cadillac Sedan DeVille invoice showing corresponding information.

This approach is simple and feasible - even for dealers who do not retain the price and model change information that manufacturers send them throughout the year. Exhibits 6 through 9 show that the same information can be found in any one of many independent compilations of manufacturer new vehicle prices and model change data. If not retained by the dealer, this information can be purchased over-the-counter throughout the year at bookstores and discount stores, or on a subscription basis.

Therefore, concerns over obtaining or retaining price or model information can be overcome by purchasing a relatively inexpensive subscription to any one of these compilations.

4. TREATMENT OF NEW MODELS / ITEMS

While inflation factors do increase the cost of new models as well as continuing models, dealers and their CPAs face significant difficulty in demonstrating or "proving" this to examining agents. To eliminate judgment (on both sides) in this regard, under the proposed alternative new models/items would be repriced in the following manner:

- If the dollars (i.e., dealer's actual cost for) of ending inventory consisting of new models is less than 10% of the total dollars of ending inventory at actual cost, all new models in ending inventory would be repriced at 1.0000...showing no inflation.
- If the dollars in ending inventory consisting of new models/items exceeds 10% - but is not greater than 20% - of the ending inventory dollars, then all new models would be repriced at 1.0100 (i.e., new models would be allowed to reflect a 1% inflation factor).
- If new models/items in the ending inventory exceeded 20% of the ending inventory dollars, all new models would be repriced at 1.0200 (i.e., a 2% inflation factor).

This sliding scale is realistic in that it allows some inflation, but only if new models are present in ending inventory in a significant dollar amount. Absent the dealer's ability to demonstrate that inflation might otherwise be in new models/ items, under the proposed alternative, dealers are accorded a modest inflation factor well below independently compiled previous inflation levels.

5. USE OF SINGLE (SAME) INDEX APPROACH TO VALUE INCREMENTS

To achieve simplification by eliminating alternative sub-elections, as an adjunct to the proposed alternative method, the dealer would value any annual increments in the LIFO pools by using the same cumulative index that is used to deflate or convert the ending inventory from actual cost to base dollar equivalence. See Line E and Line G-4 in the Exhibit 1 proforma.

The use of the same index would closely approximate the "most recent purchases" method, but it would not necessarily be identical to it. The reason the use of the same index is not exactly the same as the "most recent purchases" method is because of the fact that the very last vehicles bought by a dealer near the end of the year may not actually be on hand at year-end. Most customers select the vehicle they want to purchase with total disregard for whether or not the vehicle of their choice was one of the last few vehicles acquired near the end of the year by the dealer.

This single or same index approach for valuing increments will simplify the LIFO computations by eliminating all other cost assumptions and alternatives, including "dual" index approaches. It will also eliminate taxpayer-IRS audit controversies over the appropriateness or mechanics of increment valuation techniques.

see PROPOSAL, page 18

6. **RETENTION OF ENDING INVENTORY INVOICES**

As part of the proposed alternative methodology and recordkeeping requirements, the taxpayer would be required to retain as part of its annual tax records a separate (duplicate) copy of all invoices for all vehicles in year-end inventory for subsequent review by IRS examining agents. Many dealers already on LIFO do this at a cost of not more than an hour or two of inexpensive clerical effort.

7. **CUT-OFF TRANSITION / NO SECTION 481(a) ADJUSTMENT**

Finally, I would suggest that auto dealers changing to the proposed method be allowed to use the cut-off method to avoid the need to make any Section 481(a) computations or adjustments.

SPLITTING THE DIFFERENCE: A COMPROMISE APPROACH

There are some further refinements or simplification compromises that could be made if the overall inflation measurement approach is attractive. While sacrificing some accuracy, these modifications might result in even lower annual index computation/compliance costs for dealers, increased administrative feasibility to the IRS, and the removal of the need for professional judgment to an even greater extent.

In this regard, the proposed approach could be streamlined further to (1) require the repricing of all new models at 1.000 without exception (thus favoring the Treasury and leaving dealers more unhappy) while (2) eliminating completely the requirement for any optional-to-standard equipment repricing (thus favoring dealers, partially incorporating *Wendle*, and reflecting the NADA position that over time, optional-to-standard equipment changes tend to average out).

These "compromise" modifications are the type I probably would recommend that a dealer accept even though I might not like the sacrifices in overall accuracy. In this "compromise" version, I see dealers and the IRS "giving up" something more in the overall approach to get closer to a more practical, less judgment intensive, alternative.

This less refined, more compromise-oriented, alternative might simply be referred to as an "actual invoice, modified base price" approach.

* * *

(References to other exhibits attached are omitted.)

As a CPA extensively involved with auto dealer LIFO calculations since 1974, I am hopeful that guidance published by the IRS at this time will provide dealers with some certainty and realistic alternatives. Both are necessary to qualify the impression that under TAM 8906001 and/or the ISP Bulletin, the IRS absolutely and without exception requires a dealer to reprice 100% of all options and accessories. Even if nothing can be published in terms of acceptable "simplified" LIFO methods for auto dealers at this time, clarification of that point by the IRS would be most helpful.

Sincerely,

WILLARD J. DE FILIPPS, CPA

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

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