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. ON THE SURFACE, NOT MUCH IS NEW.

But, beneath the calm surface, there's lots brewing, promising more interesting developments...sooner or later.

During the last quarter, there haven't been any new LIFO-related tax cases, Revenue Rulings or Revenue Procedures. The major Revenue Procedures of 1992 (namely 92-20 and 92-79) have not been amplified or clarified in any respect to date...although they both surely need it. In speeches to practitioner groups, Treasury and IRS personnel have acknowledged that additional clarification of Revenue Procedure 92-20 is warranted. According to one report, the IRS is considering updating 92-20, particularly in regard to late-filed applications and automatic rollovers of Form 3115 requests to subsequent years where the IRS fails to respond by the extended due date of the income tax return for the year of change.

For those particularly interested in the Alternative LIFO Method for Automobile Dealers under Revenue Procedure 92-79, no further announcement or clarification of issues has been provided by the IRS to date.

#2. PROPOSED REGULATIONS ON SECTION 1374 INVENTORY BUILT-IN GAINS.

On December 8, 1992, Proposed Regulations regarding built-in gains for S corporations under Section 1374 were issued. These regulations included *clarification* of how inventories of *certain* S corporations will be affected. These rules are discussed as part of the article on S corporations and build-in gains in this issue.

#3. MANUFACTURERS' USE OF COMPONENTS-OF-COST INDEX METHODS.

This area of major LIFO controversy is continuing to grow. Previous *LIFO Lookout* updates - September, 1992 at pg. 15; June, 1992 at pg. 2-3; June, 1991 at pg. 14 and March, 1991 at pg. 5 - mentioned the issues and the confrontational battle lines now drawn by the AICPA and the IRS. These will be addressed in detail in future issues of the *LIFO Lookout*.

LOOKOUT LOOKS INTO

For now, let me emphasize that the components-of-cost LIFO issue is an absolute disaster in the making. To date, the IRS and the AICPA - in typical lawyerly fashion - have both carved out their technical positions, providing the other with no opportunity for graceful retreat or face saving. The IRS has said: "No, you can't use this method." The AICPA has said: "Yes we can, it's been used for all these years and it satisfies Generally Accepted Accounting Principles."

The component-of-cost issue will be particularly difficult to resolve because, over the last 30-plus years, the IRS has never addressed the use of link-chain, index computations directly in the Regulations. Link-chain indexes are integral to many manufacturers' LIFO elections and particularly to their use of component-of-cost (as opposed to product costing) LIFO methodologies. Unless the Service is willing to allow some cut-off or reasonable transitional treatment on a prospective basis, it may be very difficult for the IRS to say now, after all these years, that a method as commonly accepted as component-of-cost LIFO cannot be used or never was really permissible. However...that is what it has now come out and said.

One side is going to lose...BIG!

see **LIFO UPDATE**, page 7

S CORPORATIONS, BUILT-IN GAINS, LIFO INVENTORIES AND SECTIONS 1363(d) AND 1374

There are a number of S corporation ramifications affecting taxpayers using the LIFO inventory valuation method. Two major Internal Revenue Code Sections are of importance: Section 1363(d) and Section 1374. Section 1374 imposes a tax on certain built-in gains and it applies only to a C corporation that made an S election **after 1986**. Certain C corporations that elected S status after 1986 but before 1989 qualified for special transitional relief available only to certain qualified small S corporations.

Congress anticipated that taxpayers would be more attracted to S corporation status after 1986 because the Tax Reform Act of 1986 lowered individual income tax rates and repealed the *General Utilities* rule which had previously allowed C corporations to entirely avoid or significantly minimize the tax impact otherwise incurred upon most liquidating sales and distributions. Accordingly, the "old" Section 1374 was amended in 1986 to impose a tax at the corporate level on an S corporation's recognition of income or gain to the extent that income or gain reflected unrealized appreciation in the corporation's assets on the date it converted from C status to S status. Note that Section 1374 will not apply to a corporation that has always (i.e., since inception) been an S Corporation.

In general, the original legislative concern and wording in Section 1374 was directed more to corporate terminating activities involving liquidating sales and distributions in liquidation - and comparatively less attention had been focused on business-as-usual corporate activities, such as the sale of inventory in the everyday/ordinary course of business. However, after enactment of Section 1374 and a short period of reflection, the Treasury and the IRS became concerned that taxpayers using the LIFO method for valuing inventories might be able to avoid the impact of the built-in gain rules of Section 1374. All of a sudden, Congress believed that LIFO method taxpayers, "which have enjoyed the deferral benefits of the LIFO method during their status as a C corporation," should not be treated more favorably than their FIFO (First-In, First-Out) counterparts. To eliminate this potential disparity in treatment, Congress believed it would be appropriate to require a C corporation to recapture the benefits of using the LIFO method in the year when it converted to S status.

Accordingly, a new Section 1363(d) was added somewhat after-the-fact (by Section 10227 of the Revenue Act of 1987) to provide that if a C corporation uses the LIFO method for its last taxable year before an S election becomes effective, that C corporation must include in income its entire LIFO reserve as a LIFO recapture amount in its last taxable year as a C corporation. For this purpose, the LIFO recapture amount is defined as the excess of the inventory's value using a FIFO or first-in, first-out cost flow assumption over its LIFO value at the close of its last taxable year as a C corporation. Any amount included in income under this provision is correspondingly allowed as an increase in the tax basis of the inventory.

The additional tax attributable to the inclusion in income of the LIFO recapture amount is payable in four equal installments. The first installment must be paid by the due date of the income tax return for the electing corporation's last taxable year as a C corporation. The other installments are due by the respective due dates of the corporation's returns for the three succeeding taxable years. No interest is payable on these installments if they are paid by the respective due dates. IRS Announcement 88-60 (IRB 1988-15, 47) spells out the special disclosures and computations to be made in the last regular C corporation tax return, Form 1120.

The effective date of Section 1363(d) is that it applies to S elections made after December 17, 1987. As a further limitation, in the case of elections made after December 17, 1987 and before January 1, 1989, Section 1363(d) did not apply if, on or before December 17, 1987, the board of directors of the corporation had adopted a resolution to make an S election, or if a ruling request had been filed with the Internal Revenue Service expressing an intent to make such an election. With these effective dates and limitations now well past, Section 1363(d) has become the current provision of more immediate (but not necessarily exclusive) importance to C corporations using LIFO that are contemplating an S election.

For S corporations subject to Section 1363(d), it is clear - except for the fact that the IRS has not specifically come out and so stated - that the conversion from C status to S status does *not* terminate the LIFO election of the C corporation. No new Forms 970 nor 3115 need to be filed in connection with an election to convert from C to S status. The interrelation between Section 1363(d) and Section 1374 has not been precisely coordinated. As a result of the imposition of the additional tax under 1636(d), the taxpayer receives a step-up in basis for its LIFO inventories, the result of which increases their adjusted tax basis from the previous LIFO valuation to the newly mandated FIFO (First-In, First-Out) method valuation.

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Although the IRS has not formally stated how taxpayers should handle the Section 1363(d) step-up in basis in connection with their LIFO layers, the "prevailing" approach would appear to be that all of the prior layers are combined into a single layer that becomes the equivalent of a LIFO base layer as of the last day of the C corporation year/first day of the S corporation year. An article in *The Tax Advisor*, October, 1991, entitled "Treatment of LIFO Inventory Reserve When Converting From C to S Status" contains a discussion of alternative treatments which might involve (1) treating the first S year as a new base year or (2) keeping all of the prior LIFO layers separate, but applying to each of them the same unified "revised LIFO index."

Some older S corporations may have avoided Section 1363(d) because of its December 17, 1987 effective date and they may be only marginally affected - if at all - by Section 1374. For a business that operated as a C corporation, subsequently elected S status after December 17, 1987 and, therefore, paid the "LIFO recapture tax" under Section 1363(d), the interplay with Section 1374 needs to be reckoned with. However, the practical result from paying the additional tax under 1363(d) may be that most LIFO inventories would not have "built-in" gain *in any significant amount* since their adjusted tax basis would be stepped up to equal their FIFO value. As will be discussed next, this Section 1363(d) FIFO value may even be greater than the "bulk sale" valuation standard set forth on December 8, 1992 for built-in gains under Section 1374.

Section 1374 of the Code imposes a tax on an S corporation's net recognized built-in gain during the 10-year period beginning on the date it converts to S status (the "recognition period"). In general, this tax is not triggered until assets are disposed of; i.e., the mere holding of assets is not sufficient to trigger the tax. The net recognized built-in gain for any taxable year is the S corporation's taxable income for that year determined as if it were a C corporation and only recognized built-in gain and loss were taken into account. However, net recognized built-in gain is limited to the lesser of the corporation's taxable income for the year (generally determined as if it were a C corporation and all items were taken into account) and its net unrealized built-in gain limitation for the year (that is, net unrealized built-in gain reduced by net recognized built-in gain in prior years throughout the 10-year recognition period). The action of these rules can best be conveyed by detailed examples which are outside the scope of this discussion.

Obviously, determinations of the adjusted tax basis and the "values" of assets on hand as of the conversion to S status are of critical importance. Section 1374 also provides rules for determining recognized built-in gain and loss and for determining built-in income and deduction items. With respect to built-in gain, any gain recognized by an S corporation during the recognition period is presumed to be recognized built-in gain except to the extent the S corporation can show (1) that it did not hold the asset on the first day of the recognition period, or (2) that the asset has appreciated since that day. There are similar rules for built-in loss.

Proposed Regulations under Section 1374 were published in the Federal Register on December 8, 1992. Only the Section 1374 rules related to inventory are analyzed below.

Under the Proposed Regulation, the fair market value of a corporation's inventory on the day when it converts from C to S status is "the amount that a willing buyer would pay to a willing seller for the inventory in a purchase of **all** the assets of the S corporation on that day." This is how the valuation standard or rule is stated, without any further elaboration, in the regulations. Stated another way, Prop. Reg. Sec. 1.1374-7(a) provides that the fair market value of the inventory of an S corporation on the first day of the recognition period equals the amount that a willing buyer would pay to a willing seller for the inventory in a purchase of all the assets of the S corporation on that day.

This approach is *considerably more favorable* to taxpayers... than one requiring valuations of inventories based upon retail sale values or FIFO valuations.

On April 28, 1993, these Section 1374 proposed regulations were discussed at an IRS hearing and taxpayer representatives suggested that the IRS should explicitly state in the proposed regulations that it would allow a "bulk-sale" approach to valuing inventory. It was reported that even after issuance of the proposed regulations in December of 1992, IRS examining agents in some instances continue to assert that retail value should be used to value the inventory. The rebuttal to these comments by the IRS was that the term "bulk-sale" was intentionally not used by the drafters in order to prevent the misconception that the IRS would approve of distress sale valuations (i.e., apparently significantly reduced sales prices) or at valuations based on a sale of the inventory apart from the rest of the business. It was added that the inventory should be valued on the basis of a non-distress sale of the entire business "to someone who can use the inventory as part of the business."

Revenue Procedure 77-12, 1977-1 C.B. 569, provides guidance for valuing inventory where the assets of a business are purchased for a lump sum or the stock of a corporation is purchased and the corporation is liquidated under former Section 334(b)(2).

see **S CORPORATIONS...**, page 12

TERMINATING A LIFO ELECTION: PROCEDURES AND PITFALLS

There are a number of technical matters that, if not properly handled, could result in the loss of the LIFO election. These "termination events" include failure to file Form 970, infractions of the LIFO financial statement conformity requirement and, in some instances, failure to value the inventory on LIFO at cost. Where the IRS raises issues concerning the improper handling of these technical mattes, Revenue Procedure 92-20 (Section 3.06, Example (7)) states that the use of the LIFO method where there has been a termination event during a year not barred by the statute of limitations is a Category A method of accounting. "Category A" treatment means significant adverse consequences for LIFO elections under IRS audit.

In other circumstances, a taxpayer on LIFO may decide that it would prefer to voluntarily discontinue or terminate its LIFO election. The voluntary termination of a LIFO election constitutes a change in accounting method subject to sections 446 and 481 of the Internal Revenue Code. Under these provisions, if a taxpayer wants to discontinue its LIFO election, it must first receive permission from the IRS to do so by filing Form 3115 and it must repay the deferral locked up in its LIFO reserves.

The procedure for terminating a LIFO election depends upon whether Revenue Procedure 92-20 or Revenue Procedure 88-15 is involved. Revenue Procedure 92-20 (a more general procedure) will apply only if Revenue Procedure 88-15 (a more specialized procedure) does not apply. If Revenue Procedure 88-15 applies, then Revenue Procedure 92-20 does not.

REVENUE PROCEDURE 88-15

Revenue Procedure 88-15 (1988-1 CB 683) allows certain taxpayers to obtain **expeditious consent** (which includes waiver of the user fee) to discontinue the use of LIFO. This Revenue Procedure will apply to voluntary termination requests unless the taxpayer is ineligible for its provisions, in which case Revenue Procedure 92-20 (1992-12 IRB 10) will be applicable.

In general, it would seem to be preferable for the LIFO termination to be made under Revenue Procedure 88-15 since this procedure allows the filing of Form 3115 as late as 270 days after the start of the year of termination. Revenue Procedure 88-15 can be used by any taxpayer desiring to discontinue the use of the LIFO method for *all* of its inventories on LIFO and who will change to a permitted method prescribed by the Revenue Procedure.

For some taxpayers, Revenue Procedure 88-15 is a real lifesaver because it allows an additional 90 days for consideration of whether or not to go ahead with a LIFO termination request. Revenue Procedure 88-15 waives the 180-day period for the filing of Form 3115 and instead requires that Form 3115 be filed in duplicate: one copy mailed to the IRS National Office in Washington, D.C. (with no user fee required to be paid) within 270 days after the beginning of the year of change. The original of Form 3115 is to be attached to the timely filed Federal income tax return for the year of change.

Revenue Procedure 88-15 **does not apply** (i.e., Revenue Procedure 92-20 must be used):

1. If the taxpayer is in violation of Section 263A inventory cost capitalization requirements.
2. To a taxpayer already under audit by the IRS or before an Appeals Office unless the taxpayer receives permission from the agent or from the appeals officer to file its request to terminate under Rev. Proc. 88-15.
3. To any taxpayer that did not previously file Form 970 when electing LIFO.
4. If the taxpayer has had a LIFO "termination event" as described in Revenue Procedure 79-23 occur in a year that is still open under the statute of limitations. For this purpose, a "termination event" does not include the issuance of non-conforming financial statements if the first such issuance occurs in the tax year in which the request to discontinue the LIFO inventory method is properly filed.
5. If the taxpayer wants to terminate its LIFO election for some, but not for all, of its inventories on LIFO.
6. If the taxpayer previously requested permission from the IRS to terminate its LIFO election, but subsequently decided not to make that change.
7. Section 3.02 of Revenue Procedure 88-15 should be consulted for other limited exceptions to its use.

Page 1 of Form 3115 should be clearly marked at the top in either of 2 different ways as being "Filed Under Rev. Proc. 88-15." Taxpayers involved with the Section 263A inventory cost capitalization rules, should mark their Form 3115 as "FILED UNDER NOTICE 88-23 AND REV. PROC. 88-15." This caption is to be used on Form 3115 only by taxpayers complying with the provisions of Section 263A for the first tax year that begins in 1987 and in all other years that the taxpayer is subject to Section 263A. In other words, the taxpayer must have always been in compliance with Section 263A beginning with the first year in which Section 263A became applicable and in all subsequent years.

All other taxpayers (not subject to Section 263A - because those who are otherwise subject to Section 263A but not in compliance cannot use Rev. Proc. 88-15) should indicate at the top of page 1 of Form 3115 "FILED UNDER REV. PROC. 88-15." This labeling requirement (found in Section 7.02 of R.P. 88-15) clearly shows the significance the IRS attaches to →

TERMINATING A LIFO ELECTION
COMPARISON OF APPLICABLE REVENUE PROCEDURES

Requirements, Conditions & Limitations Applicable to Voluntary Terminations	88-15 Controls Termination Process Unless Taxpayer Fails to Qualify	92-20 Applies Only if R.P. 88-15 Does Not Apply
Time for filing Form 3115 (number of days after start of year)	270 days	180 days
Filing mechanics		
88-15: File 3115 with NTO before 270th day. Attach copy of Form 3115 to Form 1120 when timely filed. No advance NTO reply or approval needed.	Expedited Procedure	
92-20: File 3115 with NTO before 180th day. Must secure NTO written approval first. Attach copy of NTO change approval letter to Form 1120 when it is filed.		Requires Affirmative Reply from IRS
Spread period for repayment of LIFO reserve	6 Years Maximum - May be Shorter	6 Years Maximum - May be Shorter
Use of net operating loss carry forwards against Section 481(a) adjustment income from repayment of LIFO Reserves in year of change	Limited	Not Limited
Must terminate all LIFO elections for all classes of goods on LIFO	Yes	No - Can keep some goods on LIFO
New accounting method for goods going off LIFO	Technical Problems may exist. See Section 4.02	See Reg. Sec. 1.472-6 Technical Problems may exist
After termination, must use same non-LIFO method for valuing inventories in financial statements as that used in tax return	Yes	Yes
User fee	None/Waived	Must be Paid
Reelection of LIFO - waiting period or with consent	10 Years	5 Years
Terminating event statement	Required	Required
Citation for Revenue Procedure 88-15	1988-1 C.B. 683	
Citation for Revenue Procedure 92-20	-	1992-12 IRB 10

Terminating a LIFO Election: Procedures and Pitfalls

(Continued)

compliance with the Section 263A inventory cost capitalization rules.

The Section 481(a) adjustment by which a taxpayer repays the LIFO reserves cannot be spread over more than six (6) years. The actual number of years over which the Section 481(a) spread is allowed and the amount to be repaid each year will depend on the historical build-up of the LIFO reserve. If there has been a "terminating event," the spread period can be as short as one year. In other circumstances, the spread period may be lessened from six years to three years where certain Category A LIFO methods are involved.

Or, if the entire amount of Section 481(a) adjustment is attributable to the year before the year of

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WHY LIFO RESERVES GO UP EVEN THOUGH INVENTORIES GO DOWN AND DESPITE REBASING INDEXES TO 1.000 IN BETWEEN

Some accountants are still having difficulty with the transitional computations required to rebase prior LIFO indexes to 1.000 when a LIFO method is changed. The December, 1992 *LIFO Lookout* contained a lengthy article: "Rebasing Indexes to 1.000" with detailed references on the rebasing requirement and a relatively straightforward example of the computation. On page 17, that article stated: **"...One way to double check the LIFO computations after they are rebased, especially where a subsequent decrement is experienced, is to recompute the LIFO reserve changes as if the computations were not required to reflect any rebasing to 1.000. This could be a means of double checking the results produced from rebasing the computations to 1.000..."** This example - consisting of 9 schedules - shows how to do it.

The explanation of why LIFO reserves go up is simple: there are two components of change - **one** is price inflation or deflation, the **other** is inventory level or quantity change. These two components either add or offset to produce the *net* change in a LIFO reserve. As far as rebasing the indexes to 1.000 is concerned, that should not make any difference in the mathematical reconciliations at all... and it doesn't!

See "Why Do Some LIFO Reserves Go Up Even Though Inventory Levels Go Down?" (March, 1992 *LIFO Lookout*) which includes two case studies uncomplicated by any rebasing due to a LIFO method change. If you will take the time to put your computations in the formats illustrated, you can double check your own work every step along the way.

Schedule 1 reflects 1993 as the year of change, with the December 31, 1992 LIFO inventories (actual cost of $1,963,868; base dollars $1,087,308; and LIFO valuation $1,561,305) shown in their original layer configuration (in the first 3 columns) and after being rebased to 1.000 (in the last 3 columns). Note that the LIFO valuation remains unchanged.

Schedule 2 shows the composition after rebasing of the December 31, 1992 LIFO reserve of $402,563 (i.e., the December 31, 1992 inventory of $1,963,868 minus its LIFO valuation of $1,561,305).

Schedule 3 shows the computation after rebasing of the 1993 increase/change in LIFO reserve. This reflects an inflation index of 1.026 for 1993 and a corresponding decrease of $488,713 in restated base dollars resulting from having a December 31, 1993 inventory ($1,513,533 actual cost) considerably lower than the beginning inventory of $1,963,868 at actual cost *and revised base dollars*. The LIFO reserve for 1993 actually increases by $9,437 despite the decrease in inventory levels.

Schedule 4 analyzes the composition of the LIFO reserve at December 31, 1993 of $412,000 in terms of the rebased (i.e., lowered) indexes.

Schedule 5 reconciles the net increase of $9,437 in the LIFO reserve for 1993 in terms of the two components of change: **First**, the current year's inflation factor caused the LIFO reserve to increase by $38,379. **Second**, a pay-back or reduction factor attributable to the current year's drop in inventory level produced a decrement of $488,713 expressed in base dollars and this, in turn, resulted in the carryback/invasion of three layers of the prior years' recomputed base dollars. The total pay-back due to the decrement was $28,941 (and this is tracked in terms of each year's layer that was involved). This pay-back factor of $28,941 was smaller than the increase in the LIFO reserve due to the inflation factor of $38,379, the net increase in the LIFO reserve.

Schedules 6-7-8-9 validate the suggestion to prove the rebased computations by computing the reserve change as if the indexes did not have to be rebased to 1.000. Rebasing to 1.000 should not change the result...And it does not!

Schedule 6 analyzes the composition of the December 31, 1992 LIFO reserve of $402,563 as if there had been no change in method and, therefore, no requirement to rebase the LIFO indexes to 1.000. Compare Schedules 2 and 6 closely.

Schedule 7 shows the computation of the LIFO reserve for 1993 without any rebasing. Note that the December 31, 1985 base layer retains its 1.000 factor and the cumulative index through the end of December 31, 1993 is 1.853163 (1.806174 x 1.026016 equals 1.853163).

Schedule 8 analyzes the composition of the LIFO reserve which remains at $412,000 as of December 31, 1993.

Schedule 9 reconciles the net increase in the LIFO reserve at that date. Note that all layers and components reflect the same corresponding amounts. The only figures that are different are the differentials between cumulative indexes which are greater when the indexes are not rebased (Schedules 6-7-8-9)...and the $1 rounding here and there.

SCHEDULE 1
LIFO INVENTORY REBASING OF PRE-1993 INDEXES TO 1.000

	DECEMBER 31, 1992 BEFORE REBASING INDEXES			DECEMBER 31, 1992 WITH INDEXES REBASED TO 1.0000		
LIFO VALUATION AND INVENTORY LAYERS	BASE DOLLARS	INDEX FACTOR	LIFO VALUATION	BASE DOLLARS	INDEX FACTOR	LIFO VALUATION
DECEMBER 31, 1985 (BASE)	$116,079.62	1.000000	$116,079.62	$209,659.99	0.553657	$116,079.62
DECEMBER 31, 1986 (NET)	256,712.91	1.180200	302,972.58	463,668.19	0.653425	302,972.58
DECEMBER 31, 1988	233,565.10	1.457100	340,327.71	421,859.21	0.806733	340,327.71
DECEMBER 31, 1989	94,350.27	1.588800	149,903.71	170,413.01	0.879649	149,903.71
DECEMBER 31, 1990	121,174.59	1.657010	200,787.51	218,862.40	0.917414	200,787.51
DECEMBER 31, 1991	178,597.71	1.690283	301,880.67	322,578.54	0.935836	301,880.67
DECEMBER 31, 1992	86,828.11	1.720100	149,353.03	156,826.67	0.952345	149,353.03
CUMULATIVE INDEX AT DEC. 31, 1992	-	1.806174	-	-	1.000000	-
TOTAL BEFORE REBASING INDEXES	$1,087,308.31		$1,561,304.83			
TOTAL AFTER REBASING INDEXES				$1,963,868.01		$1,561,304.83

LIFO Update

(Continued from page 1)

This has been reinforced as recently as in May and June presentations by the IRS to the ABA and to the AICPA Tax Accounting Committee in June. The IRS is still sifting through Form 3115 change requests and current audit situations looking for its prey and sizing up candidates. Couple this with recent rumblings in the press and rhetoric from the podium referring to Compliance 2000 ***in the past tense*** and the emerging image of a new "fair...**but firm**" IRS as one Commissioner exited and a new one was appointed. Things definitely are not looking up for manufacturers using components-of-cost in their LIFO processes.

The IRS is now picking out the best fact patterns (from its point of view). And these will probably be litigated in the most IRS-favorable forum (the Tax Court)... so the IRS will probably win. If some taxpayer is lucky enough to squeak by on technical grounds or manage to avoid the IRS' elusive, but all pervasive, "clear reflection of income" standard, the IRS will probably do what it did after it lost the *Insilco* decision a few years ago: It will go to Congress, cry about it...and then get Congress to change the law. There's too much money at stake for it not to.

Unless some reasonable compromise on this issue appears soon (and don't expect the IRS to propose it!), the stage will be set for another *Hamilton Industries*-type of decision that will set a precedent in favor of the IRS which, at the same time, will not clearly settle anything for all other manufacturers who do not have identical fact patterns. In the current climate of slowed-down (maybe even "frozen") regulatory processes and under the gaze of all those revenue-hungry eyes in Congress, components-of-cost could become the visible scapegoat for the IRS to parade out to show "what's wrong with LIFO." Then what? Repeal of LIFO or some unrealistic watered-down version? Midget-size, maybe even unrealistic, BLS indexes?

Six years ago, I expressed my own views on how I thought this and other major LIFO impasses could, by compromise, be avoided. Now, after six more years of *experience*, I believe even more that a LIFO-User Surtax, with certain modifications, warrants consideration.

#4. TRANSITIONAL COMPUTATIONS TO REBASE INDEXES TO 1.000... STILL A PROBLEM.

The last three issues of the *LIFO Lookout* addressed the transitional computations necessary to comply with a requirement to rebase LIFO indexes to 1.000 when LIFO methods are changed. From many recent calls and computations submitted for my review, some enormous errors are still creeping into LIFO computations for the year of change. Any CPA picking up a new client on LIFO should be sure to review the predecessor CPA's rebasing calculations carefully and prove them out mathematically.

This issue of the *Lookout* updates the article from the March, 1992 issue ("Why Do Some LIFO Reserves Go Up Even Though Inventory Levels Go Down?") with an example of decreasing year-end inventories where the LIFO method has been changed and the indexes have to be rebased to 1.000 as of the beginning of the year of change.

#5. CHANGES IN USER FEES FOR FORMS 3115.

Effective May 10, 1993, Revenue Procedure 93-23 increased from $500 to $600 the user fee paid with the filing of Form 3115 requests under Revenue Procedure 92-20. In situations where a parent corporation requests the identical accounting method change on a single Form 3115 on behalf of more than one member of a consolidated group, **each additional member** of the group seeking the identical accounting method change on the same application is required to pay only $50 - after the $600 fee has been paid for the first member of the group (that's a break).

Requests for an extension of time to file Form 3115 under Section 301.9100-1 of the Regulations were reduced from $500 to $200. Revenue Procedure 93-23 also provides that user fees do *not* apply to elections made in connection with Section 4 of Revenue Procedure 92-85 which may affect certain LIFO automatic extensions of time.

see **LIFO UPDATE,** page 10

SCHEDULE 2 (W/INDEXES REBASED TO 1.000)

DECEMBER 31, 1992 LIFO RESERVE CONSISTS OF:	BASE DOLLARS		INDEX FACTOR		COMPOSITION OF LIFO RESERVE
DECEMBER 31, 1985 (BASE)	$209,659.99	X	0.446343 (1.00000- .553657)	=	$93,580.27
DECEMBER 31, 1986 (NET)	463,668.19	X	0.346575 (1.00000- .653425)	=	160,695.80
DECEMBER 31, 1988	421,859.21	X	0.193267 (1.00000- .806733)	=	81,531.46
DECEMBER 31, 1989	170,413.01	X	0.120351 (1.00000- .879649)	=	20,509.38
DECEMBER 31, 1990	218,862.40	X	0.082586 (1.00000- .917414)	=	18,074.97
DECEMBER 31, 1991	322,578.54	X	0.064164 (1.00000- .935836)	=	20,697.93
DECEMBER 31, 1992	156,826.67	X	0.047655 (1.00000- .952345)	=	7,473.57
CUMULATIVE INDEX AT DEC. 31, 1992	-	X	0.000000 (1.00000-1.000000)	=	-
ROUNDING	-				(0.22)
TOTAL	$1,963,868.01				$402,563.17

SCHEDULE 4 (W/INDEXES REBASED TO 1.000)

DECEMBER 31, 1993 LIFO RESERVE CONSISTS OF:	BASE DOLLARS		INDEX FACTOR		COMPOSITION OF LIFO RESERVE
DECEMBER 31, 1985 (BASE)	$209,660	X	0.472359 (1.026016- .553657)	=	$99,035
DECEMBER 31, 1986 (NET)	463,668	X	0.372591 (1.026016- .653425)	=	172,759
DECEMBER 31, 1988	421,859	X	0.219286 (1.026016- .806733)	=	92,508
DECEMBER 31, 1989	170,413	X	0.146366 (1.026016- .879649)	=	24,943
DECEMBER 31, 1990	209,555	X	0.108606 (1.026016- .917414)	=	22,759
CUMULATIVE INDEX AT DEC. 31, 1992	-	X	0.000000 (1.026016-1.000000)	=	0
ROUNDING					(4)
TOTAL	$1,475,155				$412,000

SCHEDULE 5 (W/INDEXES REBASED TO 1.000)

PROOF/RECONCILIATION OF NET INCREASE (DECREASE) IN LIFO RESERVE AS OF DECEMBER 31, 1993			LIFO RESERVE CHANGE
AMOUNT OF BASE DOLLARS THAT REMAINED IN TACT THROUGHOUT CALENDAR YEAR 1993			$1,475,155
(X) MULTIPLIED BY CURRENT YEAR INFLATION		X	0.026016
INCREASE IN LIFO RESERVE DUE TO INFLATION FACTOR			$38,379
LESS: PAYBACK DUE TO DECREMENT CARRIED BACK AGAINST PRIOR YEARS			
(1990) $ 9,307 X .082586 (1.000000- .917414)	($769)		
(1991) $322,579 X .064164 (1.000000- .935836)	(20,698)		
(1992) $156,827 X .047655 (1.000000- .952345)	(7,474)		
$488,713			
TOTAL PAYBACK DUE TO DECREMENT	($28,941)		($28,941)
SUBTOTAL			$9,438
ROUNDING			(1)
NET INCREASE (DECREASE) IN LIFO RESERVE AT END OF CURRENT YEAR			$9,437

SCHEDULE 6 (W/O INDEXES REBASED)

DECEMBER 31, 1992 LIFO RESERVE CONSISTS OF:	BASE DOLLARS		INDEX FACTOR	COMPOSITION OF LIFO RESERVE
DECEMBER 31, 1985 (BASE)	$116,080	X	0.806174 (1.806174-1.000000)=	$93,581
DECEMBER 31, 1986 (NET)	256,713	X	0.625974 (1.806174-1.180200)=	160,696
DECEMBER 31, 1988	233,565	X	0.349074 (1.806174-1.457100)=	81,531
DECEMBER 31, 1989	94,350	X	0.217374 (1.806174-1.588800)=	20,509
DECEMBER 31, 1990	121,175	X	0.149164 (1.806174-1.657010)=	18,075
DECEMBER 31, 1991	178,597	X	0.115891 (1.806174-1.690283)=	20,698
DECEMBER 31, 1992	86,828	X	0.086074 (1.806174-1.720100)=	7,474
CUMULATIVE INDEX AT DECEMBER 31, 1992	-	X	0.000000 (1.806174-1.806174)=	-
ROUNDING	-			(1)
TOTAL	$1,087,308			$402,563

SCHEDULE 8 (W/O INDEXES REBASED)

DECEMBER 31, 1993 LIFO RESERVE CONSISTS OF:	BASE DOLLARS		INDEX FACTOR	COMPOSITION OF LIFO RESERVE
DECEMBER 31, 1985 (BASE)	$116,080	X	0.853163 (1.853163-1.000000)=	$99,035
DECEMBER 31, 1986 (NET)	256,713	X	0.672963 (1.853163-1.180200)=	172,758
DECEMBER 31, 1988	233,565	X	0.396063 (1.853163-1.457100)=	92,506
DECEMBER 31, 1989	94,350	X	0.264363 (1.853163-1.588800)=	24,943
DECEMBER 31, 1990	116,022	X	0.196153 (1.853163-1.657010)=	22,758
CUMULATIVE INDEX AT DECEMBER 31, 1993	-	X	0.000000 (1.853163-1.853163)=	0
TOTAL	$816,730			$412,000

SCHEDULE 9 (W/O INDEXES REBASED)

PROOF/RECONCILIATION OF NET INCREASE (DECREASE) IN LIFO RESERVE AS OF DECEMBER 31, 1993			LIFO RESERVE CHANGE
AMOUNT OF BASE DOLLARS THAT REMAINED IN TACT THROUGHOUT CALENDAR YEAR 1993			$816,730
(X) MULTIPLIED BY CURRENT YEAR INFLATION (1.853163-1.806174)		X	0.046989
INCREASE IN LIFO RESERVE DUE TO INFLATION FACTOR			$38,377
LESS: PAYBACK DUE TO DECREMENT CARRIED BACK AGAINST PRIOR YEARS			
(1990) $ 5,153 X .149064 (1.806174-1.657010)	($768)		
(1991) $178,597 X .115891 (1.806174-1.690283)	(20,698)		
(1992) $ 86,828 X .086074 (1.806174-1.720100)	(7,474)		
$270,578			
TOTAL PAYBACK DUE TO DECREMENT	($28,940)		($28,940)
SUBTOTAL			$9,437
ROUNDING			0
NET INCREASE (DECREASE) IN LIFO RESERVE AT END OF CURRENT YEAR			$9,437

(Continued from page 7)

#6. FINANCIAL STATEMENT CONFORMITY REQUIREMENT FOR AUTO DEALERS.

The keynote item reported in the *Automotive Executive*, April, 1993, NADA Report underscores the importance of the *Lookout*'s prior warnings to auto dealers on LIFO about the very dangerous financial statement conformity requirement. The *Automotive Executive* reports that "a Southeastern dealer must pay $1 million in back taxes for violating the LIFO conformity requirement." It reports that the IRS is taking dealers off of LIFO for violations in financial statements sent to manufacturers, even in closed years. Apparently, there are several dealers already in a bind over this...and those who are...are in a panic because they stand to lose their **entire** LIFO reserve, not just some recomputed portion of it.

Are financial statements sent by dealers to manufacturers really subject to this conformity requirement? This question needs to be dealt with head on, right now. Any volunteers?

#7. THE POSTMAN COMETH WITH ANOTHER LETTER (FROM THE IRS) REQUESTING FORM 3115 INFORMATION.

The third quarter 1992 *LIFO Lookout* reported that last July, one District Director's office sent out letters to many auto dealers. After stating that the letter was not notification of the beginning of an examination, the dealer was requested to complete and return a questionnaire within 2 weeks **AND** to send in a "courtesy copy" of the Form 3115 that was filed under Revenue Procedure 92-79.

In April, 1993, automobile dealers in another IRS district received a similar letter. This letter recited **four** Revenue Procedures (92-20, 92-79, 92-97 and 92-98) of special interest to auto dealers along with some "Compliance 2000" rhetoric and requested that copies of Forms 3115 filed to comply with **any** of the Revenue Procedures listed above be sent to that Director's office. Again, that letter finished up by saying: trust me - "this inquiry does not constitute an examination of your tax return." That makes two DDs who have sent out LIFO letters.

What would you do if you received one?

Okay, now that you've resolved that handily...consider IRS Letter Ruling 9316002. This involved a Form 3115 filing where the Service ruled that a telephone conversation between the IRS agent and the parent corporation's controller constituted "contact for the purpose of scheduling an examination"...and thereby put the taxpayer at a disadvantage. Where does one draw the line these days?

#8. IS IT A "CAR" OR A "TRUCK"?

We're still not sure. But on May 14, 1993 the Court of International Trade ruled that Nissan Motor Company's 2-door Pathfinder Sport-Utility vehicle should be treated as a *car* for purposes of the 2.5% duty imposed on imported *cars*. The result is that this Nissan Pathfinder is classified as a *car* for import duty purposes, even though it is classified as a *truck* for U.S. fuel economy, emissions and gas guzzler rules as well as when sales are reported in the media.

It was reported that Judge Restani, after test driving the vehicle around New York City, remarked that "the sample virtually shouts to the consumer, *'I am a car, not a truck.'*"

#9. MEDIUM AND HEAVY DUTY TRUCKS... SOME LIFO PROBLEMS.

Several CPAs have reported running into unexpected problems and a tougher stance from the IRS in filing Form 3115 change requests. Several have reported difficulties in attempting to formalize their LIFO computations for medium and heavy-duty trucks under Revenue Procedure 92-20. (Compliance 2000... where are you?)

Last quarter's issue of the *Lookout* observed that after splitting a single truck pool into one pool for light-duty trucks (which are subject to Revenue Procedure 92-79) and a second pool for medium and heavy-duty trucks (which are not), one might request permission to change the LIFO methodology for the medium and heavy-duty trucks to one similar or identical to the 14-step approach provided for light-duty trucks in Section 4.03 of Revenue Procedure 92-79. This could be done by listing the 14 steps as set out in Revenue Procedure 92-79 as the procedure to be followed in the computation of the inflation index for medium and heavy-duty trucks.

It was reported that the IRS National Office has taken the position in reviewing several specific LIFO change requests of this nature that the **methodology** of Revenue Procedure 92-79 could **not** be applied to medium and heavy-duty trucks. Instead, the IRS indicated that in addition to the base price, *all optional and accessory equipment* had to be repriced in computing the index inflation. (Here we go again??)

P.S.: The good news was that the IRS did not object to the inclusion of both medium and heavy-duty trucks in the same pool.

#10. USED VEHICLE LIFO CHANGES... SOME EMERGING PROBLEMS?

A few other CPAs who have filed Form 3115 requests to change the LIFO methodology for *used vehicles* have indicated that the National Office seems to be changing its requirements for *used vehicle* LIFO calculations. In these situations, it appears the Service now wants the *used vehicle* computations to reflect more exact comparisons, based on actual costs - rather than comparisons based upon information from regional used vehicle price guides. More on this later.

SCHEDULES 3 & 7
CALCULATION OF ANNUAL LIFO INVENTORY CHANGES
AS CALCULATED UNDER THE LINK-CHAIN, INDEX METHOD
FOR THE YEAR ENDED DECEMBER 31, 1993

							SCHEDULE 3 REBASED TO 1.000			SCHEDULE 7 W/O REBASING
A. BEGINNING OF YEAR INVENTORY AT BASE DATE COST - AS RESTATED							$1,963,868			$1,087,308
B. END OF YEAR INVENTORY AT END OF YEAR (CURRENT) PRICES							1,513,533			1,513,533
C. END OF YEAR INVENTORY AT BEGINNING OF YEAR (BASE) PRICES							NOT FULLY REPRICED			NOT FULLY REPRICED
D. CURRENT YEAR PRICE INDEX:										
RATIO OF: END OF YEAR INVENTORY PRICED AT END OF YEAR PRICES (DIVIDED BY) END OF YEAR INVENTORY PRICED AT BEGINNING OF YEAR PRICES							1.026016			1.026016
E. CUMULATIVE LINK-CHAIN INDEX:										
CURRENT YEAR PRICE INDEX (LINE D) MULTIPLIED BY (X) PRIOR YEAR'S CUMULATIVE INDEX (LINE E OF PRIOR YEAR)							1.026016			1.853163
F. END OF YEAR INVENTORY AT BASE DATE COST										
(LINE B DIVIDED BY LINE E)							1,475,155			816,730
G. CURRENT YEAR INVENTORY INCREASE (DECREASE) - EXPRESSED IN BASE DOLLARS										
1. END OF YEAR INVENTORY AT BASE DATE COST (LINE F)							1,475,155			816,730
2. BEGINNING OF YEAR INVENTORY AT BASE DATE COST (LINE A)							1,963,868			1,087,308
3. CURRENT YEAR INCREMENT (G(1) EXCEEDS G(2)) OR DECREASE (IF G(2) EXCEEDS G(1))							(488,713)			(270,578)
4. LIFO VALUATION OF CURRENT YEAR INCREMENT (IF G(1) EXCEEDS G(2), MULTIPLY LINE G(3) BY LINE E)							N/A			N/A
H. ANALYSIS OF YEAR-END INVENTORY LIFO "LAYERS" - AS RESTATED										
DECEMBER 31, 1985 (BASE)	$209,660	X	.553657	$116,080	$116,080	X	1.000000	$116,080		
DECEMBER 31, 1986 (NET)	463,668	X	.653425	302,972	256,713	X	1.180200	302,972		
DECEMBER 31, 1988	421,859	X	.806733	340,328	233,565	X	1.457100	340,328		
DECEMBER 31, 1989	170,413	X	.879649	149,904	94,350	X	1.588800	149,904		
DECEMBER 31, 1990	209,555	X	.917414	192,249	116,022	X	1.657010	192,249		
CUMULATIVE INDEX AT DEC. 31, 1992	-	X	1.000000	-	-			-		
	$1,475,155				$816,730					
ENDING INVENTORY AT LIFO VALUATION, PER ABOVE				$1,101,533				$1,101,533		
LESS: ENDING INVENTORY AT END OF YEAR PRICES (LINE B)				1,513,533				1,513,533		
LIFO RESERVE AT END OF CURRENT YEAR				$412,000				$412,000		
LIFO RESERVE AT END OF PREVIOUS YEAR				402,563				402,563		
INCREASE (DECREASE) IN LIFO RESERVE AT END OF CURRENT YEAR				$9,437				$9,437		

S Corporations - Built-In Gains - LIFO Inventories and Sections 1363(d) And 1374

(Continued from page 3)

The Preamble to the proposed regulations under Section 1374 states that the Treasury and the IRS are considering whether Rev. Proc. 77-12 should be modified to (1) provide guidance for valuing inventory for purposes of Sections 336, 338, 1060 and 1374, and (2) incorporate the principles of relevant case law such as *Knapp King-Size Corp. v. United States*, 527 F. 2d 1392 (Ct. Cl. 1975), and *Zeropack Company v. Commissioner*, T.C. Memo. 1983-652.

The Preamble to the proposed regulations also states that the IRS and the Treasury are considering whether a "safe harbor" rule should be provided under which taxpayers may determine recognized built-in gain from inventory for purposes of Section 1374. *(See the accompanying box on page 13.)*

As to this "safe harbor" rule, it was also reported at the hearings on April 28, 1993 that AICPA members have been working on consensus language, but at that time were unable to agree on a formula. For an analysis especially critical of the ambiguous language in the IRS' safe harbor proposal, see Steven Dilley's article in *Tax Notes*, March 29, 1993, entitled "Inventory Method May Dramatically Affect Section 1374 Built-In Gain Recognition."

There is a second facet in these proposed regulations concerning LIFO inventories. Prop. Reg. Sec. 1.1374-7(b) provides that "the inventory method used by an S corporation for tax purposes must be used to identify whether inventory it disposes of during the recognition period is inventory it held on the first day of that period. **Thus, a corporation using the LIFO method does not dispose of inventory it held on the first day of the recognition period unless the carrying value of its inventory for a taxable year during that period is less than the carrying value of its inventory on that day (determined using the LIFO method as described in Section 472).** However, if a corporation changes its method of accounting to the LIFO method with a principal purposes of avoiding the tax imposed under Section 1374, it must use the FIFO method to identify its dispositions of inventory."

Under this part of the proposed regulation, LIFO taxpayers will not be treated as disposing of inventory until a year in which they have a liquidation of their LIFO inventory so great that all increments experienced since the conversion to S status have been completely invaded or eliminated. In other words, for purposes of the Section 1374 built-in gains tax, a LIFO taxpayer will not recognize any built-in gain until the year when a LIFO decrement results in completely eroding or eliminating all of the LIFO increments experienced since the S election was made so that the only remaining LIFO inventory layers are those that were on hand as of the last day of the corporation's status as a C corporation. Accordingly, some S corporations using LIFO may never be subject to the Section 1374 built-in gains tax until, upon liquidation, there is a final sale or other taxable event terminating the corporation's existence.

Since LIFO computations for any year are only made with respect to the inventory level or balance on the *last day* of the year, it appears that taxpayers who experience significant decreases in their inventory levels during the year such that the built-in gains tax might be incurred if those lower levels remain at year-end can avoid the built-in gains tax by increasing their inventory to a pre-S level before year-end. In other words, year-end projections of LIFO inventories for S corporations may also need to take into account the Section 1374 built-in gains implications (especially if the Section 1363(d) tax was not paid upon converting to S status).

For S corporations that were subject to the Section 1363(d) tax upon converting from C to S status, the impact of Prop. Reg. Sec. 1.1374-7(a) seems to be slight, except that the increase or step-up in the LIFO adjusted tax basis resulting from the Section 1363(d) income amount **may** result in a valuation of the inventory on the first day of the first S year (i.e., the conversion date) that is different from the fair market value as determined under the "bulk sale" standard. A "bulk sale" valuation under Section 1374 may be less than a "FIFO value" under Section 1363(d).

An article appearing in the *Wall Street Journal* on December 7, 1992 indicated that these new rules might prompt some CPAs to advise clients to apply for tax refunds (for example, in situations where a retail basis valuation instead of a lower bulk sale valuation were used) or to more steadfastly resist IRS auditors on examinations still in progress where a Section 1374 built-in gain tax computation is in issue. This may be especially appropriate where IRS agents are attempting to enforce their opinions or assumptions in terms of a "safe harbor" type of computation.

But watch out for the effective date: The proposed regulations under Section 1374 are effective for taxable years ending on or after the date the regulations are published in the Federal Register as *final regulations*, but only in cases where the return for the taxable year is filed pursuant to an S election made *on or after that date*. Since the effective date of the proposed regulations is both distant and unpredictable (i.e., the rules apply to taxable years ending on or after the date the regulations are published in final form, but then only in connection with returns filed for S elections

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SAFE HARBOR FOR LIFO INVENTORIES
SECTION 1374*

*An S corporation's recognized built-in gain from inventory is equal to the gross profit (that is, gross receipts, less cost of goods sold and direct selling expenses) from one inventory turn after the first day of the recognition period multiplied by a designated percentage (for costs that add value to the inventory but were not taken into account in determining the inventory's gross profit). Thus, recognized built-in gain from inventory for the first year of the recognition period is equal to the inventory's gross profit for that year divided by the number of inventory turns in that year multiplied by the designated percentage. The number of inventory turns in the first year of the recognition period is equal to the cost of goods sold for that year divided by that year's opening FIFO value. **IN THE CASE OF LIFO TAXPAYERS, NO GROSS PROFITS FROM INVENTORY WOULD BE TREATED AS RECOGNIZED BUILT-IN GAIN UNTIL THE TAXPAYER INVADES LIFO LAYERS IN EXISTENCE ON THE FIRST DAY OF THE RECOGNITION PERIOD.** **

* As set forth in supplementary information accompanying proposed regulations issued December 8, 1992

** The first day of the recognition period is the first day of the first S year after the change from C status.

S Corporations - Built-In Gains - LIFO Inventories and Sections 1363(d) And 1374 (Continued)

made **after** the final publication of the regulations), the "gap" otherwise left by the effective date provision for S elections prior to the finalization of the 1374 regulations is covered by Prop. Reg. Sec. 1.1374-10(a). Here the regulation provides that Announcement 86-128 (1986-51 IRB 22) and Notice 90-27 (1990-1 C.B. 336) will continue to apply to S corporations to which the regulations proposed on December 8, 1992 do not apply. The IRS previously issued guidance to S corporations on the built-in gain tax under Section 1374 in Revenue Ruling 86-141, as modified by IRS Notice 88-134, and in IRS Announcement 86-128. These indicated, among other things, that Section 1374 regulations will require an S corporation to use the same inventory method for purposes of Section 1374 that it uses for other tax purposes.

Several commentators have observed that, notwithstanding the gap in the effective date provisions, it may be difficult for the IRS to successfully sustain a position that the treatment afforded by the proposed regulations should not apply to taxpayers who have already made S elections. However, the reality is that with the Section 1374 effective date off somewhere in theunknown distant future, all S corps today with built-in gains really don't know what the rules are!

SELECTED BIBILIOGRAPHY

Several articles have appeared during the second quarter of 1993 to more fully analyze the proposed regulations under Section 1374. These include:

1."Prop. Regs. on Built-In Gains Tax Provide Long-Awaited Guidance for S Corporations," by William J. Dunn and Samuel P. Starr, *The Journal of Taxation*, April, 1993 (pages 202-208).

2."The Built-In Gains Tax - The IRS Issues Proposed Regs.," by Gary L. Maydew, *Taxes*, May, 1993 (pages 294-299).

3."IRS Finally Clarifies Built-In Gains Tax Computation," by Thomas J. Callahan, *The Practical Accountant*, April, 1993 (pages 47-51).

4."Built-In Gain Prop. Regs. Provide Planning Opportunities," by Denise B. Robeson, CPA, *Taxation for Accountants*, May, 1993 (pages 260-268).

5.In addition to the above, see also "The S Corporation Built-In Gains Tax - Can it be Avoided?" by Patrick Schultz, CPA and John J. Connors, J.D., LL.M., CPA, *The Tax Adviser*, June, 1989 (pages 383-395) and Steven Dilley's article referenced previously.

 (Continued from page 5)

termination, then the entire Section 481(a) adjustment is taken into account in the year of change/termination. If this does not apply, and the LIFO method has been used for more than 4 years and certain other percentage-reserve build up tests described next are satisfied, the taxpayer is entitled to a spread period of not more than six (6) years.

If (1) the entire amount is not attributable to the immediately preceding year, (2) the LIFO inventory method has been used for more than 4 tax years, and (3) 67 percent or more of the adjustment is attributable to the 1-tax-year period, 2-tax-year period, or 3-tax-year period immediately preceding the year of change, then the highest percent attributable to such 1-, 2-, or 3-tax-year period is to be taken into account ratably over a 3-tax-year period beginning with the year of change. Any remaining balance is to be taken into account ratably over an additional period equal to the remainder of the number of tax years the taxpayer has used the LIFO inventory method. However, **the total adjustment period shall not exceed six (6) tax years.**

The amount attributable to the 1-, 2-, or 3-tax-year period immediately preceding the year of change is the amount of the adjustment determined under Section 481(a) of the Code for the year of change less the amount that would have been required under Section 481(a) if the same change had been made at the beginning of such preceding 1-, 2-, or 3-tax-year period.

If the LIFO inventory method has been used for 4 tax years, 75 percent is substituted for 67 percent in the percentage tests described above.

The Section 481(a) adjustment spread period - which cannot be more than 6 years - may nevertheless be accelerated under certain circumstances if inventory levels in subsequent years drop sharply or if the taxpayer ceases to do business. These special inventory reduction rules key off of a one-third reduction and are found in Section 5.03 of Rev. Proc. 88-15. "C" corporations that are in the process of repaying their LIFO reserves after terminating their LIFO election also are required to accelerate their repayment if they elect "S" status during the Section 481(a) spread period years.

With respect to the use of net operating losses, a taxpayer going off of LIFO under Revenue Procedure 88-15 cannot use any part of a net operating loss carryover or a tax credit carryover available at the beginning of the year of change against the amount of Section 481(a) adjustment taken into income in the year of change/termination. That is, the net operating loss carryover available at the beginning of the year of change may be offset only against income (other than the Section 481(a) adjustment) generated in the year of change. **This condition does not apply to years subsequent to the year of change.** Any portion of the positive Section 481(a) adjustment attributable to the year of change may be offset against any net operating loss otherwise incurred in the year of change as well as against any future net operating losses carried *back* to the year of termination/change.

Revenue Procedure 88-15 imposes three other conditions in connection with a voluntary LIFO termination request:

1. LIFO cannot be reelected for ten (10) years, unless Form 3115 is filed and permission to make the reelection is granted by the IRS,
2. The same non-LIFO inventory method must be used for financial statements, books and tax return purposes. In other words, there is a financial statement conformity requirement as a result of the termination of a LIFO election that requires that the same non-LIFO method be used in future years for both tax and financial statement purposes), and
3. The inventory method to be used by the taxpayer after terminating the LIFO election is subject to special rules (contained in Section 4.02) which depend upon whether the taxpayer previously had all inventoriable goods on LIFO. The Revenue Procedure contains a lengthy discussion of the "method to be used" and specifically conditions the eligibility to use the Procedure upon the taxpayer's adoption of the "method to be used."

In determining the method to be used, Revenue Procedure 88-15 provides that a permitted method is a method under which (a) the identification method is either the first-in, first-out (FIFO) method or the specific identification method, and (b) the valuation method is cost or cost or market, whichever is lower.

Some termination requests are being delayed in the National Office where the taxpayers are not confirming that if the proposed method of valuing inventory goods will be cost or market, whichever is lower, in accordance with Regulation Section 1.471-4, the market price of the goods in inventory will be determined in accordance with Section IV(N) of Notice 88-86 (1988-2 C.B. 401). Under the uniform capitalization rules, Notice 88-86, Section IV(N) states that, in general, with respect to inventories that are produced or acquired for resale, the market price will include all direct and indirect cost pertaining to such inventories as described in Section 1.263A-1T(b)(2) of the Temporary Regulations, including, but not limited to, the cost of purchasing, handling and storage activities conducted by the taxpayer. This is another reminder of the impact of Section 263A and the importance attached to it by the IRS National Office.

The termination event statement below (Section 7.04) must be signed and attached to Form 3115. A "termination event" is a situation described in Revenue Procedure 79-23, with certain exceptions.

"Under penalties of perjury, I hereby certify that to the best of my knowledge and belief, with respect to (name of taxpayer)'s use of the LIFO inventory method, no termination event (as defined in Section 3.02(5) of Revenue Procedure 88-15) has occurred during a year not barred by the statute of limitations as of the date of the filing of the Form 3115 with the National Office."

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Terminating a LIFO Election: Procedures and Pitfalls (Continued)

In addition to the above termination event statement, a taxpayer must attach to the Form 3115 either (1) a copy of the Form or Forms 970 filed to adopt the LIFO inventory method or (2) if the taxpayer properly elected the LIFO method but is unable to furnish a copy of such Form(s) 970, the following signed statement:

"Under penalties of perjury, I certify that to the best of my knowledge and belief (name of taxpayer) properly elected the LIFO inventory method by filing a Form 970 with its return for the taxable year(s) ended (insert date(s)) and otherwise complied with the provisions of Section 472(d) of the Code and 1.472-3 of the Regulations."

As a practical matter, where a taxpayer has changed accounting firms several times, it may not be possible to attach a copy of Form 970 (because it cannot be located) and the individuals currently responsible for the filing of Form 3115 may have some trouble with the required statement insofar as it relates to the best of their knowledge and belief. Under these circumstances, whether some modification of the wording should be attempted is a more difficult practical problem. This may be the case where the current CPA has no way of knowing - one way or the other - or maybe hasn't even inquired as to whether such an election was properly made and/or the other compliance requirements under Section 472(d) were satisfied.

REVENUE PROCEDURE 92-20

Under the "alternative" application of Revenue Procedure 92-20 to voluntary LIFO terminations, the filing of Form 3115 with the IRS National Tax Office must take place **within 180 days** after the beginning of the year of change (not 270 days as under Rev. Proc. 88-15) and the spread period for repaying the LIFO reserve may be shorter (possibly as short as all in one year). However, it appears the spread period for the Section 481(a) adjustment is not more than six (6) years.

Under Rev. Proc. 92-20, the use of net operating losses and tax credit carryforwards against the LIFO reserve recapture income, generally, is **not** limited. Also, the possibility of reelecting LIFO can be considered sooner (five years instead of ten). But, under Rev. Proc. 92-20, a user fee must be paid with the filing of Form 3115.

If a taxpayer does not qualify to use Rev. Proc. 88-15, consent to terminate the LIFO method will ordinarily be granted subject to the requirements of Regulations Section 1.472-6 and the provisions of Section 9.03 of Revenue Procedure 92-20. Under Rev. Proc. 92-20, the taxpayer agrees not to try to re-elect LIFO for a period of at least five (5) taxable years beginning with the year of change, unless consent to re-elect is granted by the Commissioner to change the method of accounting at an earlier time based on a showing of extraordinary circumstances.

Regulations Section 1.472-6 provides that if a taxpayer is granted permission to discontinue the use of LIFO, the new accounting method to be used for the inventories formerly on LIFO shall be:

1. In conformity with the method used by the taxpayer under Section 471 in inventorying goods not included in his LIFO inventory computations; or
2. If the LIFO inventory method was used by the taxpayer with respect to all of his goods subject to inventory, then in conformity with the inventory method used by the taxpayer prior to his adoption of the LIFO inventory method; or
3. If the taxpayer had not used inventories prior to his adoption of the LIFO inventory method and had no goods currently subject to inventory by a method other than the LIFO inventory method, then in conformity with such inventory method as may be selected by the taxpayer and approved by the Commissioner as resulting in a clear reflection of income; or
4. In any event, in conformity with any inventory method to which the taxpayer may change pursuant to application approved by the Commissioner.

The taxpayer filing under Revenue Procedure 92-20 for permission to discontinue its LIFO election must attach to Form 3115 the following signed "termination event" statement:

"Under penalties of perjury, I hereby certify that to the best of my knowledge and belief, with respect to (Name of taxpayer)'s use of the LIFO inventory method of accounting, there (indicate either "has" or "has not") been a termination event (as described in Rev. Proc. 79-23, 1979-1 C.B. 564, or any other applicable revenue ruling or revenue procedure) for purposes of Rev. Proc. 92-20 that occurred during a year not barred by the statute of limitations as of the date of the filing of the Form 3115."

Note that before this statement can be signed, the taxpayer (or the taxpayer's CPA) has the responsibility to make a thorough review of the taxpayer's eligibility to use LIFO **for all open years** and based upon "**any other applicable revenue ruling or revenue procedure**"! If the above statement is not filed or if the answer is that a termination event has occurred, then the LIFO termination request will be processed under Revenue Procedure 92-20 as a change from a Category A method of accounting (perhaps with a 3-year spread) for the Section 481(a) adjustment.

For purposes of the Rev. Proc. 92-20 "termination event" statement, a terminating event does not occur if the taxpayer first issues non-conforming financial statements during the taxable year for which the LIFO inventory method is discontinued (the year of change) and the non-conforming financial statements relate either to the year of change or the year preceding the year of change. For example, if a taxpayer issues non-conforming financial statements for its 1991 calendar year on March 15, 1992, and properly files in 1992 a

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Terminating a LIFO Election: Procedures and Pitfalls

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request to discontinue the LIFO inventory method for its 1992 taxable year, there has been no termination event for purposes of Revenue Procedure 92-20.

It should be noted that this "waiver" of sorts only applies to statements for the year of change or the year preceding the year of change...there may be other years open under the statute which are subject to the conformity requirement that have to be analyzed. Also note that the waiver of the financial statement conformity requirement for purposes of Revenue Procedure 92-20 is somewhat different from the corresponding conformity requirement waiver in Revenue Procedure 88-15 which provides that the term "termination event" does not include the issuance of non-conforming financial statements if the first such issuance occurs in the tax year in which the request to discontinue the LIFO inventory method is properly filed.

Taxpayers requesting permission to terminate their LIFO elections under Revenue Procedure 92-20 are required to include, in addition to all other required information, a statement that (1) the taxpayer "agrees to all of the conditions of Revenue Procedure 92-20" and (2) that it "proposes to take the net Section 481(a) adjustment into account over (state the Section 481(a) adjustment period required by Section 5, 6, 7 or 8 of this revenue procedure)." This required statement appears in Section 10.05 of Rev. Proc. 92-20.

In one situation (Letter Ruling 9306036), a company incorrectly assumed that it met the requirements of Revenue Procedure 88-15 to terminate its LIFO election. When it was discovered that it did not qualify for the automatic termination provisions in 88-15, the company requested an extension of time to file Form 3115 under Revenue Procedure 92-20 and the IRS allowed the extension, finding that the taxpayer had acted reasonably and in good faith.

Compare this with a less favorable result (Letter Ruling 9205011) where a company filed Form 3115 to voluntarily terminate its LIFO election because it believed that because it had elected S corporation status and recaptured all of its LIFO reserves, it could automatically discontinue its LIFO election. In this case, the company's accountant was not aware that the company preferred to terminate its LIFO election at a later date. The IRS held that good cause was *not* shown to justify the IRS to grant an extension of time to change the request.

Finally, don't make the mistake of thinking that a C Corporation electing S Corporation status and repaying its LIFO reserves under Section 1363(d) automatically experiences a termination of its LIFO election at that time. It does not. Only a proper Form 3115 application for permission to terminate the LIFO election, filed under Revenue Procedure 88-15 or 92-20 (whichever is applicable), can accomplish such an event. ✻

IN COMING ISSUES

- LATEST IRS RULINGS AND CASES.
- COMPONENTS OF COST.
- STATISTICAL SAMPLING AND INVENTORY INDEXES.
- DUAL INDEXES
- READER FEEDBACK

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