



De Filipp's

# LIFO LOOKOUT

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

Volume 3, Number 3

Publisher: Willard J. De Filipp's, C.P.A.

September 1993

## 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. IRS TAKING HARDER LINE IN LIFO AUDITS.** There seems to be a lot of evidence of an IRS metamorphosis going on behind a Compliance 2000 rhetoric smokescreen. In many LIFO audit situations, the IRS has changed from a "kinder, gentler IRS" under Commissioner Peterson into a newer and significantly more aggressive KGB (that's Kinder, Gentler Bureau).

About two years ago I referred to an emerging tough, new breed of IRS agents, called "LIFO Liquidators"... In case you weren't a *Lookout* subscriber then, see **page 16** for a more complete description. If you have not run into one of them yet, consider yourself fortunate.

They are quickly, and not too quietly, arriving on the scene in force! These young, aggressive, studious, and highly networking individuals are out there attacking LIFO calculations, posing LIFO recapture theories, and threatening to terminate LIFO elections any way they can. If a major "kill" (i.e., termination of the LIFO election) can't be scored with an early shot, they can always pick over the index and/or reserve calculations... or quickly move on to another taxpayer and size up in short order whether it's going to be a golden goose or a tough nut to crack. They can obtain 15 years' worth of IRS audit experience in a few training sessions or over the phone with calls to the right support person.

In addition to the IRS seminar discussed below and ongoing discussions with *Lookout* readers, many other recent events indicate the hard line and tough road ahead for many LIFO elections: Be forewarned... and read this entire issue of the *Lookout* carefully! Many of your peers are finding that the IRS is even more aggressive and bullish than you'd ever have thought.

### **#2. IRS SEMINAR ON MOTOR VEHICLE INDUSTRY LIFO ISSUES.**

On September 13, 1993, I attended the first IRS Motor Vehicle Industry Seminar for Tax Practitioners and Industry Executives at Burbank, California. High level IRS personnel from all over the country discussed many auto dealer LIFO and other examination issues. Overall, the seminar reinforced my notion that IRS positions on LIFO issues are getting tougher and tougher every day.

The articles on pages 2 and 4 give you an opportunity to "hear" what the IRS had to say at the Seminar so you can judge for yourself.

### **#3. SECTION 263A (COST CAP)**

**REGULATIONS FINALIZED.** The IRS has now issued final regulations for Section 263A Inventory Cost Capitalization Rules become effective on January 1, 1994. That means that current practices and regulations still remain in effect through December 31, 1993.

Hearings on the new rules are scheduled in October. Certain wholesalers and distributors are going to be significantly hurt by the rules for distribution costs. So sensitive and uncertain are these rules for wholesalers that they were not included in the final regulations, but were published again as *proposed* regulations. Another unfavorable, but not surprising, position expressed in the final regulations is that manufacturers may not use the practical capacity concept.

On the more liberal side: An exemption from Section 263A has been added for very small manufacturers/producers with annual total indirect costs of \$200,000 or less. Also, under the final regulations, taxpayers will have an option to use a historically determined capitalization percentage for several years without having to recompute cost capitalization ratios every year. In general, there is a "three-year test

see LIFO UPDATE, page 5

## LOOKOUT LOOKS INTO

LIFO UPDATE .....	1
IRS MOTOR VEHICLE INDUSTRY LIFO SEMINAR SEPTEMBER 13, 1993 - BURBANK, CA	
GOOD BYE TO A "KINDER & GENTLER" IRS .....	2
STAT SAMPLING "GUIDANCE" FOR PARTS .....	4
HOW FAR DO YOU HAVE TO GO IN DETERMINING "ITEM CATEGORIES?"...ALL THE WAY! .....	14
IRS DOCUMENT REQUEST - LIFO AUDIT .....	15
IRS APPEALS SETTLEMENT GUIDELINES FOR DEALERS <u>NOT</u> USING ALTERNATIVE LIFO METHOD .....	7
DUAL INDEX APPROACHES FOR VALUING INCREMENTS	
DUAL INDEX APPROACHES - IN GENERAL .....	8
DUAL INDEX PROCEDURES .....	9
START UP DUAL INDEX SITUATION EXAMPLE .....	11
LIFO LIQUIDATORS .....	16

## IRS SEMINAR ON MOTOR VEHICLE INDUSTRY LIFO ISSUES

On September 13, I attended the first Motor Vehicle Industry Seminar for Tax Practitioners and Industry Executives sponsored by the Los Angeles District of the IRS. About 150 people attended the seminar in Burbank, CA to hear the IRS speakers listed below.

Apparently, the IRS is going to audit a lot more auto dealerships in California since most of the IRS speakers were staying over to conduct training sessions during the rest of the week for 35 more agents so they can go out and "audit all the dealerships in California." Attendees also were told there is a whole new IRS initiative involving retailers and wholesalers starting October 1, 1993 which will involve the coordination of 50 agents from four different IRS branches. Apparently retailers/wholesalers are perceived by the IRS as a low-compliance group in terms of (1) timely payment of tax, (2) timely filing of tax returns, and (3) accuracy of calculations.

The IRS hand-out material on LIFO issues consisted of 9 pages. Page 1 was entitled "Common LIFO Issues" on which were listed, without further comment, the following:

1. Definition of Item
2. Earliest Acquisition Index
3. New Items Valuation
4. Segment of Inventory
5. Sampling Error
6. 263A Issues

Pages 2, 3 and 4 were a reprint of the ISP Coordinated Issue dated July, 1989 on the dollar-value LIFO definition of an item. Page 5 was a summary of Section 4.02 of Revenue Procedure 92-79 and Page 6 was a summary of Section 9 regarding the "conditions of consent" to which a dealer agreed upon making the election to use the Alternative LIFO Method. Page 7 was a reprint of 1992 and 1993 Ford Explorer truck models price information for the purposes of pointing out that each and every separate line description constituted an "item category." Page 8 was a one paragraph summary (from CCH) of TAM 9243010 dated July 15, 1992 and TAM 9251001 dated August 26, 1992. Page 9 of 9 was a reprint of Form 4564, IRS Information Document Request, relative to LIFO in-

ventories. Interestingly, the IRS (Appeals) Settlement Guideline effective June 21, 1993 was not reproduced as part of any IRS hand-out material nor was it specifically referred to at all during the day.

Each speaker made a presentation which was followed by a question and answer session late in the afternoon.

In summary: Brace yourselves - there is going to be a lot of action in the LIFO area for auto dealers, and you probably aren't going to like what the IRS had to say. As best as I could record them - and decipher my own notes - here are the major points made by various IRS panelists and speakers during the day.

**First:** How Far Do You Go In Determining "Item Categories?" According to the IRS: All The Way Down...As Far As You Can Go! Each separate line item on the manufacturer's price list is considered to be a separate "item" for index computation purposes. Larry Walter indicated that in the case of the 1993 Ford trucks, although there are only two different model codes (U22 and U32) for the Explorer 2-wheel drive, each vehicle type listed is a separate "item" so there are seven (7) item categories, and not just two (2)! Furthermore, in comparing the 1993 model and price information with the 1992 model and price information, the U32 Limited Utility 4-door Explorer 2-wheel drive and the U34 Limited Utility 4-door Explorer 4-wheel drive were each considered to be new items since there was no corresponding vehicle in the 1992 model information. (See page 14 of this *LIFO Lookout* for these 1992-1993 price lists.)

**Second:** Larry Walter indicated that word gets around within the IRS of large dollar deficiencies collected from auto dealers' LIFO computations - and this has stimulated other IRS agents to want to know how they could go out and do likewise. Auto dealers provide the IRS with an ideal training ground because (1) a dealer's inventory is easy to work with because it involves relatively few, high dollar, tangible items, (2) dealership books and records are similar, and (3) there can be quite a bit of time savings once familiarity is gained with index determinations and dealership terminology. The feeling was that many young,

### IRS Speakers

1. Ted Meyer - Branch Chief, Field Examination, Los Angeles District
2. Preston Butcher - Assistant Division Chief, Examination Division, Los Angeles District
3. Robert C. Zwiers, Sr. - Examination ISP Specialist (Motor Vehicle), Detroit District
4. Larry Walter - LIFO Inventory Specialist, Detroit District
5. Edward Hill - Computer Audit Specialist, Los Angeles District
6. Mark Miskiewicz - Revenue Agent, Seattle District
7. Fred Gavin - Appeals ISP Coordinator (Motor Vehicle), Central Region
8. Eliot Kaplan - Chief Counsel Attorney, Income Tax and Accounting Division, National Office



aggressive agents are able to receive 10 or 15 years' worth of experience in just a few days training by the right top-level people and that they are now very well equipped to go out and come back with big dollar LIFO deficiencies.

Third: If you're audited, you can expect that there will be a minimum 10-year LIFO recomputation or reserve look-back...with a maximum possibility being that indexes will be adjusted all the way back to the base year if a Form 3115 filing is not made under the 90-day audit window of Revenue Procedure 92-20. The IRS is very confident that there is no statute of limitations standing in its way thanks to its victories in *Hamilton Industries* and in *Amity Leather*.

In informal discussion with several IRS officials, the statement was made that IRS agents should not be threatening to add penalties in non-flagrant situations simply to put pressure on the taxpayer to settle.

Fourth: The IRS stressed that for parts inventories on LIFO using the LIFO method, it is not possible to use one single category for all auto parts. They must be separated into various categories. In discussing parts sampling, the IRS sampling specialist indicated that presently there are no IRS documents or publications that can be referred to for any type of guidance in constructing sampling and that reference should be made to textbooks for this information. For other comments on parts inventories sampling, see the accompanying article on page 4.

Fifth: Fred Gavin, the Appeals ISP Coordinator, indicated that "at this time, we're going to take a hard line against auto dealer LIFO calculations that are not reflecting the Alternative LIFO methodology." He indicated that if you choose to litigate, you may become a test case because the IRS is looking for good litigating *vehicles* (no pun intended) for various LIFO issues. He indicated that just as IRS auditors are getting "networked," so are Appeals personnel in striving to come up with uniformity and consistency in resolution of unagreed audit issues at the Appellate level.

Sixth: There can be no better evidence of even tougher LIFO exams ahead than Form 4564, Information Document Request (IDR), that was distributed as page 9 of 9 of the LIFO hand-outs. Form 4564 is reproduced on page 15 of this *LIFO Lookout*.

Seventh: The IRS does not like "Earliest Acquisitions" (i.e., dual index) LIFO...because "they're not in the regs." (Query: Whose fault should that be?)

Eighth: If a dealer thought that he could lower his audit profile by electing the Alternative LIFO Method, forget it! The IRS indicated that it will be checking auto dealer LIFO calculations, *even for dealers using the Alternative LIFO Method*, if everything else looks okay

(Continued)

simply because the IRS is now more alert to ferret out situations where LIFO reserves can be recaptured because of (1) bulk sales of inventories, (2) separate trade or business interpretations which may result in multiple pools, and (3) abnormal year-end inventory purchasing just to avoid LIFO decrements. (Wow!)

For example: If a dealer had all Cadillacs at the beginning of the year and all Chevrolets at the end of the year due to the fact that the dealer sold the Cadillac franchise mid-year and replaced it with a Chevrolet franchise, the IRS can be expected to take the position that all of the LIFO reserve attributable to its Cadillac vehicles should be recaptured when that franchise is sold (or *dropped!*?)...in order to "*clearly reflect income*."

In illustrating a situation where a dealer might/would be required to have separate pools for new automobiles (notwithstanding Rev. Proc. 92-79?), the IRS indicated that if a dealer had one facility on the East coast and another one on the West coast, the IRS would consider each facility as a separate trade or business requiring separate pools. But where does one (or the IRS) draw the line? What if the dealer has one facility on the East side of the street and another facility on the West side of the street? If there is to be any uniformity - not to mention fairness - in this area, the IRS ought to publish its position regarding what constitutes separate trades or businesses so that everyone knows exactly what it is.

Ninth: It was pointed out that many dealer cost cap situations are incorrectly handled because cost capitalization adjustments have not been applied to all LIFO layers, including the base year and increments for years prior to 1987. Some CPAs *incorrectly* think that because Section 263A came into effect in 1987, only 1987 and later years need to be adjusted for Section 263A purposes. Apparently, the IRS' concern in raising Section 263A issues is that it has found many LIFO layers that have not reflected cost capitalization increases, particularly layers before 1987.

Finally, during the late afternoon question and answer session I attempted to express, with all due respect, my incredulity at the inconsistency between the opening remarks by Messrs. Meyer and Butcher regarding the Compliance 2000 "customer-oriented new" spirit of the IRS and the ominous technical positions expressed by all of the technical speakers throughout the remainder of the day. It would appear that the IRS knows that it can go into auto dealerships time after time and raise many of these LIFO issues, and collect large amounts of money in the process, simply because it will cost dealers more to fight than to give in. That's sad. Who's next?



## STATISTICAL SAMPLING "GUIDANCE" FOR PARTS INVENTORIES

The Computer Audit Specialist with the Los Angeles District of the IRS (Edward Hill) spoke on sampling approaches to be employed in index computations for Parts & Accessories inventories. His comments, with some additional background, are summarized below.

### STEPS TO BE FOLLOWED WHEN USING STATISTICAL SAMPLING TO VALUE INVENTORY ITEMS:

1. Define the population from which the sample will be drawn (e.g., new parts).
  - Other franchise parts belong in separate pools
  - Cannot use the entire listing of the manufacturer
  - Cannot use an index computed for another dealership
2. Define the sampling unit. This is a physical representation of the items comprising the population, such as part numbers.
3. Construct or identify the sampling frame (e.g., parts pads). This is a systematic listing of the items belonging to the population from which the sample will be drawn. This list must be constructed in such a way that it allows for the random selection of sample items. A problem here is that many dealers do not save their parts pads for subsequent review.
4. Determine the sample size. The sample size should be as large as necessary to meet the 95% confidence level requirement. Some dealers sample 5% of the part numbers, with a minimum sample size of 100.
5. Generate a list of random numbers equal to the desired sample size. Every possible combination of sampling units must have an equal probability of being included in the sample. Methods of obtaining the list of random numbers include use of a computerized random number generator or use of a table of random numbers.
6. Draw the sample by matching the random numbers to the sampling units in the population. In other words, assign the random numbers to the parts listing.
  - All items selected must be valued (compared)
  - New items should be assigned an index of 1.000
7. Evaluate the sample results.

There are no specific guidelines as to whether the IRS allows the use of the point estimate (i.e., the index as determined from the sample drawn) as the LIFO index. It is clear, however, that the precision of the estimate, if it is material, must be factored into the allowable index. Not surprisingly, the IRS gives no indication of what it considers to be "material." Rather, authority to decide what is "material" is given to the agent on a case by case basis. (Mr. Hill simply suggested that there are no guidelines and that reference should be made to a textbook.)

One of the IRS's statistical sampling modules (obtained under the Freedom of Information Act) provides that: "If the taxpayer has failed to receive written permission from the Service to use sampling, the use of an estimate may not be acceptable. ***This should be the agent's primary position.*** This position avoids the question of sample bias, material precision, and the use of the point estimate. Since no rules exist concerning these questions, debate becomes difficult and resolution of the problem must be subjective rather than objective." Note: This means that an IRS agent will first look at your LIFO election to confirm that an "index" method has been checked off on Form 970 and that you have received permission to use it. If not, your sampling and "index" computations are dead!

Returning to the so-called "point estimate," the IRS Student Coursebook for Advanced Statistical Sampling contains the following: "The sample will give a point estimate in the form of an index. This index is an estimate of the inflation the taxpayer has experienced from the beginning of the year to the end of the year (assuming link chain). The sample, however, will also have precision. Unfortunately, the Regulations do not offer any guidelines for precision regarding the computation of the index. In many instances, the taxpayer ignores this precision and the point estimate is used as the index.

"Suppose a situation where the taxpayer's sample gave an index of 1.0800 at point estimate. If the precision of that index was .0600, the sample has indicated that inflation is between 2% and 14% (1.0800 indicates 8% inflation). The previous discussions regarding taxpayer samples indicate a need for those estimates to be precise. LIFO index estimates are not different. If this "error" of the index is material, *the taxpayer should be required to use the least advantageous position for this estimate.* In this case, the link index should be 1.0200."

In no unmistakable terms, the IRS at the Motor Vehicle Industry Seminar indicated that it would take the position that the taxpayer should be required to use the equivalent of the 1.02 figure as its inflation index (and not the 1.08) so as to give the IRS "the benefit of the doubt."

(continued) →



**VARIABILITY**

The primary goal of sampling is to accurately estimate total population values from selected sample values. Consequently, the amount of variability (or difference in value) among the population items, sample items and resulting sample estimates is of great concern. If there is a wide range in value among items in the population, there will most likely be a similarly wide range among selected sample values. This spread is undesirable because it increases the variability and, therefore, the standard error (or sampling error) of the estimates from the sample. (The sampling error is the error associated with the estimate because it is based on a sample, and not on the entire population.) The sampling error must be minimal in order for the estimate to be acceptable.

Two methods of reducing the variability of the sample estimates and increasing the precision of the results are to either (1) increase the sample size or (2) to stratify the population into homogeneous sub-populations (e.g., those items having similar dollar values). However, each method is not without its drawbacks. Increasing the sample size can add to the cost of the sample exercise because of the additional time required to handle more repricings (and to clear up any exceptions). On the other hand, it may be very difficult to appropriately stratify the entire parts inventory because the parts pad listings are usually printed out in part number order, and not in size (dollar value) order.

\* \* \* \* \*

**SAMPLING DOCUMENTATION: WHAT THE IRS IS LOOKING FOR**

No specific guidelines relating to the use of sampling have been set forth by the IRS. However, the list below was given as comprising the written documentation that the IRS is looking for:

1. Well-defined sampling plan stating the objectives of the sample, as well as the population definition and size, frame definition and sample size
2. Source of random numbers, including the starting point and method used in the selection process
3. Description of the procedures to be followed
4. Examination steps considered in analyzing the sample items
5. Instructions given to the people who examined (and repriced) the units
6. The appraisal methods and workpapers used in evaluating the sample
7. Narrative description of any decision rules needed and applied, and a statement as to the consistency of their application
8. Statements as to unusual factors or complications in the process and the implications of such events

While retaining such written documentation is essential, by no means does it assure IRS approval of the sample results. To put all of this in perspective, Mr. Hill indicated that he has yet to see anything he would readily accept. Have you? \*

**LIFO Update**

(Continued from page 1)

period" which results in a capitalization ratio that may be used for the next five years...but there are some awkward details if you want to use this shortcut method.

Resellers will have only the simplified resale method as the basic simplified method to be used, although "permissible variations" are allowed by the Regulations. The exception from the Section 263A cost cap rules for "small" resellers (i.e., those with three-year average gross receipts under \$10 million) has been retained.

Almost all adjustments that will be required to convert post-1993 Section 263A computations to the new rules effective in 1994 will be changes in accounting method. Consequently, they will require the filing of Forms 3115 either as part of 1994 tax returns or with the IRS National Office at some time or other. So much for less paperwork and Compliance 2000 simplification objectives.

**#4. SECTION 1363(d) LIFO**

**RECAPTURE REGULATIONS.** The IRS has issued proposed regulations covering events that trigger the recapture of LIFO reserves when a C

corporation elects S treatment and/or a C corporation merges into an S corporation in a tax-free reorganization. These proposed regulations (PS 16-93) can be commented on in writing before October 18, 1993.

**#5. IRS APPEALS SETTLEMENT****GUIDELINES FOR AUTO DEALERS****NOT USING ALTERNATIVE LIFO METHOD.**

Prior issues of the *Lookout* have suggested that CPAs should expect the IRS to take a hard stance against dealers using LIFO who do not elect the Alternative LIFO Method. The IRS just published its Appellate settlement guidelines for the dollar-value LIFO definition of an "item." In this guideline (effective June 21, 1993), the IRS indicates that its current position is consistent with the position set forth in Issue 5 of Public Letter Ruling (TAM) 8906001 which "essentially establishes a general comparability standard," and a relatively narrow definition of an "item" for dealers not using the Alternative LIFO Method. This would seem to require each and every option and accessory on a new vehicle invoice to be repriced in computing the

see **LIFO LOOKOUT**, page 6

overall LIFO inflation index for a dealer not using the Alternative LIFO Method.

However, only by carefully comparing the facts in Letter Ruling 8906001 and noting that it involved an automobile dealer who used very rough averaging computations can one find the opportunity for defending calculations that are less than "perfect" and/or that do not reprice every option and accessory. For more on these settlement guidelines, see page 7.

#### **#6. STILL ONE MORE REASON TO ADOPT THE ALTERNATIVE LIFO METHOD.**

Letter Ruling 9332003 comes down hard on automobile dealers who try to justify LIFO computations that were not using the equivalent of the 14-step methodology available under the Alternative LIFO Method, especially where new models are excluded from the computation of the annual LIFO index.

It is not surprising that the IRS, after bending over backwards to make the Alternative Method available, now is clamping down hard wherever it can on folks who think they "have a better way to do it." Ironically, it is doubtful that any dealer will really fight this out in Court as a matter of principle. Why?...because of the high cost of fighting the IRS in Court...not to mention the possibility that the IRS might win! And the IRS knows that dealers are either too busy or too chicken or too cash poor to fight over this for very long.

**#7. MORE ON "CARS" VS. "TRUCKS".** In the above ruling, the IRS held that minivans were properly included in the auto pool. Because minivans are essentially substitutes for station wagons... and these particular minivans were not built on truck chassis.

**#8. IRS "PRO FORMA" LIFO TEMPLATES.** Information obtained under the Freedom of Information Act and reported in the *Car Dealer Insider*, July 26, 1993, referred to the availability within the Internal Revenue Service of 63 LIFO Inventory Calculation Templates (Spreadsheets) created by the Los Angeles District covering 49 auto manufacturers. Some of my comments to the editor of the *Car Dealer Insider* were reported in that issue.

The underlying information made available under the FOIA disclosed that notices were sent out in a few IRS regions indicating that cases involving dealers not under exam who had filed 3115's electing the Alternative LIFO Method "should be removed from the examination selection process provided there are no other issues warranting an examination."

Later correspondence indicated that in situations where dealers not under audit filed a Form 3115 before December 31, 1992 or, if they filed after January 1, 1993 for 1993 also warranted the following treatment: "Unstarted returns for the year of change, as well as prior year returns, should not be examined unless other issues warranted examination. Other subsequent returns should be classified without regard to this listing."

Finally, the FOIA information indicated that "a compliance check strategy, not constituting an examination, is currently being considered to ensure that

taxpayers filing the election have properly recalculated their inventory."

Questions arising from all of this include: (1) What does the IRS mean by "properly recalculated their inventory"?...is that a reference to the requirement that indexes be rebased to 1.000?, (2) Are the LIFO inventory templates or spreadsheets available under the FOIA? (3) Just what is a "compliance check strategy?" - is it an audit (i.e., walks like a duck, quacks like a duck, etc.)? Or what? and (4) How does all of this square with the hard line on LIFO issues the IRS presented at its seminar on September 13?

#### **#9. LIFO FOR NEW MEDIUM & HEAVY-DUTY TRUCKS.**

Several CPAs have filed Forms 3115 to request permission to use the 14-step methodology outlined in Revenue Procedure 92-79 for dealers' inventories of new medium and heavy-duty trucks (which are not specifically covered in the revenue procedure).

The position of the National Office is one of flat rejection and denial. Without any logical explanation, they say that the 14-step methodology cannot per se be used. If not, what then can be used? Are we back to "square one" as far as LIFO for medium and heavy-duty truck dealers is concerned? Compliance 2000?? Go figure!

#### **#10. HAMILTON INDUSTRIES FOLLOWUP: BARGAIN PURCHASE LIFO BENEFITS DENIED.**

There have been a few commentaries in tax publications on the significant IRS victory in *Hamilton Industries* (covered extensively in the December, 1991 issue of the *LIFO Lookout*). Recently issued Technical Advice Memorandum 9328002 contains two lengthy and informative discussions that LIFO practitioners may want to review.

TAM 9328002 addresses retail department store LIFO and compares and contrasts retail LIFO methodology with "ordinary" double extension LIFO methodology used by other taxpayers. The latter portion of the TAM contains deep discussions comparing the positions of the IRS in *Hamilton Industries*, *UFE* and other pooling cases with the retail department store LIFO situation presented for consideration in the TAM.

The TAM concludes that because the allocation to inventory was approximately 50% below the prevailing market prices for comparable goods on the same date, the inventory acquired in a Section 338(b) residual method valuation was really acquired in a "bargain purchase." Therefore, the National Office required that inventory (i.e., the bargain purchase inventory that was the subject of the allocation under Section 1.338(b)-2T of the temporary regulations) **to be placed in separate pools from inventory subsequently acquired.**

What this means, quite simply, is that bargain purchase LIFO benefits are not going to be automatically allowed by the IRS.





## IRS APPEALS SETTLEMENT GUIDELINES FOR DEALERS NOT USING THE ALTERNATIVE LIFO METHOD

IRS Settlement Guidelines for Appeals personnel were recently released with an effective date of June 21, 1993. Based on preliminary filings and discussion with the industry, the IRS believes that the majority of the 24,000 auto dealers in the United States utilizing LIFO will elect to use the new Alternative LIFO Method under Revenue Procedure 92-79.

The Appeals Settlement Guideline Paper states that the Commissioner will waive strict adherence to the "comparability requirement" in the regulations for taxpayers utilizing the Alternative LIFO Method because those taxpayers must use the compensating sub-methods described in Revenue Procedure 92-79 to insure that the Alternative LIFO Method "clearly reflects income." Therefore, the IRS Appeals Guideline applies only to those taxpayers that do *not* elect to use the Alternative LIFO Method."

Here is what dealers not using the Alternative LIFO Method can expect: "If taxpayers fail to timely elect the new Alternative LIFO Method, the waiver of IRC Section 481(a) adjustment generally will not be allowed after the deadline. Based upon facts and circumstances, an intermediate settlement of the Section 481(a) adjustment may be appropriate. However, if no agreement is reached, a Statutory Notice of Deficiency will be issued which takes the position consistent with the Examination Division Position, that vehicles with significant differences in optional equipment or having other material qualitative differences should be treated as separate items."

Part of the explanation given is that "although PLR 8906001 does not indicate exactly the differences in options and accessories between vehicles that are necessary to constitute a new item, it does conclude that the comparison on an automobile in current year inventory that *includes every available option* with an automobile that has no options may result in a distortion in the computation of the LIFO index."

The Appeals Settlement Guideline Paper also provides that "the National Office advocates a relatively narrow view of an item for those taxpayers using an internally computed index and not using the Alternative LIFO Method, while at the same time acknowledging the litigating hazards associated with embracing too narrow of a definition."

In regard to considering the hazards of litigation, the statements are made that... "If the only difference between two vehicles is an insignificant option, this difference may be equivalent to a 'minor modification' (either in terms of utility to the consumer or cost to the retailer) within the meaning of the court's holding in *Wendle Ford*'..."

..."Options and accessories can comprise a significant cost of a vehicle when compared to the 'minor modifications' present in *Wendle Ford*. However, the National Office recognizes that under the Tax Court's holding in *Wendle Ford* taxpayers computing internal price indexes appear to have some degree of tolerance with respect to minor variations in physical attributes, not constituting a 'new item.'"

Issue 5 in TAM 8906001 addressed the use of averaging in LIFO computations where vehicles that might have been fully loaded with options at the end of the year were being compared with beginning of the year vehicles that might have either been stripped or less fully equipped with options. Obviously, the use of averages by the dealer in the TAM under a rough, oversimplified averaging computation can create distortions in the index that are not attributable to inflation and that do not clearly reflect income. However, that "averaging" fact pattern/application is considerably different from a repricing issue carefully focused in terms of whether repricing comparable base prices but less than all of the options has...or might have...resulted in an inaccurate index.

Thus, the ISP Appeals Settlement Guideline Paper does not say that a dealer has to reprice every option on every vehicle, since the Technical Advice to which it refers (8906001) is limited to averaging calculation situations - and not to a situation where a dealer was comparing base prices only.

There still seems to be room for guarded optimism insofar as the Appeals Settlement Paper cautions that the hazards of litigation need to be considered where too narrow a definition of the term "item" is advocated. And well they should, since countless other businesses would not be able to use LIFO if a similarly restrictive "item" definition were applied to their inventories as well.



## DUAL INDEX APPROACHES FOR VALUING INCREMENTS

### EARLIEST ACQUISITION APPROACHES IN START-UP AND OTHER SITUATIONS

One of the LIFO sub-elections or sub-methods under increasing review by the IRS relates to the use of a so-called "dual index" approach. This is where a taxpayer uses not one index, but two, in the LIFO calculations.

#### **BACKGROUND AND PERSPECTIVE**

Generally, the "dollar value method" is preferable to use in LIFO calculations because it treats the inventory as representing an investment of dollars rather than as an aggregate of individual items (unit method). The dollar-value method uses "base year" costs which are expressed in terms of total dollars invested in the inventory as its unit of measurement. This unit of measurement is applied to groupings, or categories, of inventory referred to as "pools".

An **increment** in a dollar-value LIFO pool occurs when the year-end inventory for the pool, expressed in terms of base year cost, exceeds the beginning of the year inventory for that pool, also expressed in base year cost. To determine the ending inventory LIFO value for a pool, any increment is adjusted for changing unit costs by reference to a percentage or index, relative to base year cost, determined for the pool as a whole. This is the sub-election required by item 6 on Form 970 when a taxpayer elects LIFO.

Form 970, item 6(a) asks the taxpayer to select a method "used to figure the cost of goods in the closing inventory over those in the opening inventory," by checking one of four boxes:

1. Most Recent Purchases
2. Average Cost of Purchases During the Year
3. Earliest Acquisitions During the Year
4. Other - Attach Explanation

The fourth box or category ("other") above really allows a universe of choices, so long as the method selected can be properly identified or described and justified.

From all of this it may be observed that in connection with the use of the **link-chain, index method**, there may be two separate index calculations involved:

1. The computation of the current year index of inflation, sometimes referred to as the "primary", "conversion" or "deflator" index. This index is used to reduce or "deflate" the ending inventory from its actual cost to its base dollar equivalent.
2. The computation of a second, separate index for purposes of valuing the actual increment, sometimes referred to as the "secondary" or "incremental valuation" index. This second index is used to raise any increment computed for the year from its expression in terms of base dollars to its equivalent in terms of "current cost."

For a thorough discussion of the different ways a current year's increment may be valued for LIFO purposes see: "LIFO Layer Valuations Under the Dollar-Value Index Method," by Laroy Wolff, Jr., *The Tax Advisor*, March 1981, page 161-171.

#### **APPLICATION EXAMPLES & IRS COMMENTARY**

In many instances, where the increment inflator index is computed by specifically identifying goods or items in ending inventory (and this same index has been used to deflate the ending inventory from actual cost to base dollars), it is more technically accurate to check the Form 970, line 6(a) fourth box ("other") and to indicate (in an attached statement) that the taxpayer has elected to value any annual inventory increment by applying an index developed with reference to the specific identification of items in inventory at year-end, and that this method will closely approximate the "most recent purchases" method, although it may not necessarily be identical to it.

For another point of view, see Schneider, *Federal Income Taxation of Inventories*, Chapter 15, page 15-17, note 40 stating that..."in completing Form 970, taxpayers using one of the short-cut procedures are advised to check the block for the earliest, latest or average acquisitions cost method (depending on which method is appropriate), rather than the block labeled 'other.' Checking the 'other' box may cause the issue of the propriety of the method to surface more readily on audit."

This "specific identification" method for valuing increments is required by Revenue Procedure 92-79 in connection with the Alternative LIFO Method for automobile dealers where it is referred to as the "specific identification increment method" which requires that "the current-year cost of the items making up the pool must be determined by reference to the actual cost of the specific new vehicles or new light-duty trucks in ending inventory. Therefore, the actual cost of the specific vehicles on hand at year-end will be the current-year cost of such vehicles." This is also evident by reviewing the pertinent steps set forth in Section 4.03 for the computational methodology under the Alternative LIFO Method for Auto Dealers.

In another context, where a taxpayer is electing to use the Published Price Index method (also known as the Inventory Price Index Computation under Reg. Sec. 1.472-8(e)(3)), it appears that the National Office looks for a correlation or nexus between the month selected for index reference purposes and the method checked on Form 970, item 6(b) as the method for valuing increments. In this regard, the IRS appears to

see **DUAL INDEX APPROACHES...**, page 10





## DUAL INDEX PROCEDURES

IRS National Office Technical Advice Memorandum issued as Letter Ruling 8421010 dated January 3, 1984 provides some insights into the dual index approach. The method applied by the taxpayer and approved by the Service is set forth in some detail below:

"...Corp X proposed to change to a "link-chain" method that made use of two indexes to determine the year-end dollar value of its LIFO inventory: an annual index and an incremental index. In its request, Corp X indicated that the annual index measures the price level change for the year, adjusting the year-end FIFO inventory values generated by Corp X's cost accounting system to beginning of the year prices. The incremental index measures the price level change in the current year by reference to the actual cost of goods purchased or produced during the taxable year in the order of acquisition to the extent of the quantity increment. The indexes were further defined by Corp X as follows:

<b>ANNUAL INDEX =</b>	End of Year Prices	x	End of Year Sample Quantities
	Beginning of Year Prices	x	End of Year Sample Quantities
<b>INCREMENTAL INDEX =</b>	Earliest Current Year Prices	x	End of Year Sample Quantities
	Beginning of Year Prices	x	End of Year Sample Quantities

"In addition for all years beginning after December 31, 1973 (the last non-LIFO year), Corp X proposed to calculate a cumulative annual index and cumulative incremental index as follows:

$$\text{Cumulative ANNUAL Index} = \text{Current Year Annual Index} \times \text{Previous Year's CUMULATIVE ANNUAL Index}$$

$$\text{Cumulative INCREMENTAL Index} = \text{Current Year Incremental Index} \times \text{Previous Year's CUMULATIVE ANNUAL Index}$$

"By use of the foregoing cumulative indexes, Corp X proposed to calculate all inventory balances as follows:

PROCEDURE	PURPOSE
1. The year-end inventory divided by the cumulative annual index.	1. To deflate year-end inventory to base-year dollars.
2. The opening inventory at base year dollars is subtracted from deflated year-end inventory obtained in Procedure 1.	2. To determine the amount, if any, of the increment for the year in terms of base-year dollars. This represents the quantity increase for the year.
3. The annual increment obtained in Procedure 2 is multiplied by the cumulative incremental index.	3. To determine the quantity increase for the year expressed in terms of current year costs. This is the LIFO "layer" for the year.
4. The increment for the year expressed in terms of current-year costs (Procedure 3) is added to the beginning of the year LIFO inventory.	4. To determine the year-end LIFO inventory.

"Under Procedure 1, the year-end inventory is computed on the basis of year-end quantities at year-end prices.

"If Procedure 2 results in a quantity decrease (decrement), the amount of the decrement reduces the LIFO layer for the previous year. This is done by subtracting the decrement expressed in base-year dollars from the previous year's layer (also expressed in base-year dollars). If the prior year's layer is larger than the current year's decrement, the excess is multiplied by the cumulative incremental index for the prior year. This restates the remaining portion of the prior year's layer in terms of the proper price level for the year. The remaining portion of the prior year's layer is added to the sum of the LIFO base and any annual layers not affected by the current year's decrement. If the decrement is larger than the prior year's layer, such a prior year's layer is reduced to zero, and the layer for the second prior year is reduced in the same manner."



permit the selection of any month during the last calendar quarter where the "most recent purchases" sub-method is selected. Similarly, the IRS would appear to permit the selection of any month during the first calendar quarter where the "earliest acquisitions during the year" sub-method were selected - and probably it would allow May, June or July if the "average cost of purchases during the year" method were selected on line 6(b) of Form 970 as the representative month used in selecting the index to determine current-year cost.

The IRS issued Revenue Ruling 79-103 (1979-1 C.B. 192) which addressed the question of dual indexes in terms of a manufacturer using the double-extension LIFO method. Revenue Ruling 79-103 holds that items of inventory for which no purchases were made during the year cannot be included in developing an index to be used to determine the LIFO value of the dollar value pool (i.e., to value an increment in order to raise it to current cost). However, it requires the cost of all items in ending inventory (including those not purchased during the year) to be included in determining the ending inventory expressed in terms of base dollars. Revenue Ruling 79-103 indicates that if the taxpayer were able to reconstruct hypothetical current-year costs for items not purchased during the year, then reconstructed/hypothetical costs would be used in the double extension computations. This hypothetical current-year cost might be the cost that the taxpayer would have incurred if it had purchased or produced the item in the current year.

In Letter Ruling 8749005 dated August 12, 1987, the IRS addressed whether a manufacturer using a standard cost method for its production activities could use a dual index approach in connection with its link-chain LIFO inventory computations. The question was whether the manufacturer could calculate its increment under a dual index approach with reference to the mix and quantity of items purchased and produced during a period of time during the year, or whether it must calculate its increment with reference to the mix and quantity of items actually in ending inventory. After analyzing several alternatives, the Service ruled that the index used to value increments must be based on the mix and quantity of items in ending inventory.

In dual-index situations involving retailers and/or wholesalers, insistence by the IRS upon an identical mix and quantity of items on hand at year-end creates practical problems, especially where the increments may be small relative to the overall size of the ending inventory. Note also that LTR 8749005 did not address a situation where the taxpayer was using an index method in connection with which a representative

(Continued from page 8)

portion or sample of the inventory was selected for purposes of computing the inflation index.

Other Letter Rulings issued by the Internal Revenue Service involving the use of dual indexes include: LTR 7816003 (January 3, 1978), LTR 7947001 (July 23, 1979) issues 4,5,6,7, LTR 8138005 (May 29, 1981)...holding that use of multiple indexes "may be appropriate," and LTR 8421010 (January 3, 1984) and LTR 8437004 (May 16, 1984). These last two are discussed in more detail below.

### IRS LETTER RULING 8421010 ON DUAL INDEXES

The issues presented in Technical Advice Memorandum 8421010 basically concern LIFO layer valuations under the dollar value, link-chain method using two indexes. The ruling states that "the use of the two index method is not addressed in the Income Tax Regulations. However, the Service has indicated in private ruling letters that the index method...does not prohibit the use of two indexes and that it is clearly an acceptable method under Section 1.472-8(e)(2) of the Regulations. However, **THE USE OF TWO INDEXES MUST**, in the opinion of the District Director, **BE APPROPRIATE, ACCURATE, RELIABLE AND CLEARLY REFLECT INCOME** under the circumstances."

After an extended discussion indicating why certain adjustments proposed by the examining agent did not have to be made, the ruling concluded that "the examining agent has not demonstrated that Corp X's method does not clearly reflect income".

In its final technical commentary, the ruling sets forth a standard against which the use of dual indexes might be measured. The ruling states that the **"USE OF DUAL INDEXES...IS NOT PROHIBITED PER SE, BY THE REGULATIONS...; the USE, HOWEVER, MUST CLEARLY REFLECT INCOME WITH THE STANDARD BEING THE USE OF A SINGLE OVERALL INDEX."** In other words, if the use of a dual index distorts income (vis-a-vis an overall single index) the taxpayer could be required to discontinue the use of such dual indexes or it may be denied the opportunity to use that approach retroactively back to the first year of the LIFO election.

### APPLICATION OVER MULTIPLE YEARS

Over a multi-year period, several alternatives appear to exist for valuing subsequent years' increments. Assume the following:

1. Year # 1 earliest acquisition index: 1.026
2. Year # 1 current year (end of year) price index: 1.075
3. Year # 2 earliest acquisition index: 1.04
4. Year # 2 current year (end of year) index: 1.10

see DUAL INDEX APPROACHES..., page 12



**Difference Between Dual Index (E/A) and Same Index (MRP) in Start Up Situation**  
**Calculation of Annual LIFO Inventory Changes**  
**As Calculated Under the Link-Chain, Index Method**  
**Initial (First) Inventory Purchase on July 1, 1993 in the Amount of \$1,140,790**  
**LIFO Reserve For the "Year" Ended December 31, 1993**

	E/A or "Dual" Index		(MRP) or Same (6.7%) Index	
	July 1, 1993	Alternatively: If Inventory Purchased July 1, 1993 Were Treated As Opening Inventory	July 1, 1993	Alternatively: If Inventory Purchased July 1, 1993 Were Treated As Opening Inventory
A. Beginning of year inventory at base date cost	INITIAL YEAR=0	\$1,140,790 *	INITIAL YEAR=0	\$1,140,790 *
B. End of year inventory at end of year (current) prices	\$1,254,246	\$1,254,246	\$1,254,246	\$1,254,246
C. End of year inventory at beginning of year (base) prices	NOT FULLY REPRICED	NOT FULLY REPRICED	NOT FULLY REPRICED	NOT FULLY REPRICED
D. Current year price index: End of year inventory priced at end of year prices (divided by) Ratio of: ----- End of year inventory priced at beginning of year prices	1.067	1.067	1.067	1.067
E. Cumulative link-chain index: Current year price index (Line D) multiplied by (x) prior year's cumulative index (Line E of prior year)	1.067 INITIAL YEAR	1.067	1.067	1.067
F. End of year inventory at base date cost (Line B divided by Line E)	\$1,175,488	\$1,175,488	\$1,175,488	\$1,175,488
G. Current year inventory increase (decrease) - expressed in base dollars				
1. End of year inventory at base date cost (Line F)	\$1,175,488	\$1,175,488	\$1,175,488	\$1,175,488
2. Beginning of year inventory at base date cost (Line A)	INITIAL YEAR=0	1,140,790 *	INITIAL YEAR=0	1,140,790 *
3. Current year increase (decrease)	\$1,175,488	\$34,698	\$1,175,488	\$34,698
4. LIFO valuation of current year increment (Line G3) under separately calculated "earliest acquisitions" method index (1.000 for current year - columns 1 and 2) (If there were no interim price increases before "first" purchases equal to increment)	x 1.000 ----- \$1,175,488 =====	x 1.000 ----- \$34,698 =====	x 1.067 ----- \$1,254,246 =====	x 1.067 ----- \$37,023 =====
H. Analysis of Year End Inventory LIFO Layers				
"Base" inventory	INITIAL YEAR=0	\$1,140,790	INITIAL YEAR=0	\$1,140,790
Calendar Year 1993 increment as price adjusted above	\$1,175,488	34,698	1,254,246	37,023
Ending inventory at LIFO valuation, per above	\$1,175,488	\$1,175,488	\$1,254,246	\$1,177,813
Less: Ending inventory at end of year prices (Line B)	1,254,246	1,254,246	1,254,246	1,254,246
LIFO Reserve at respective years' end	\$78,758	\$78,758	NONE = 0	\$76,433
LIFO Reserve at end of previous year	NONE	NONE	NONE	NONE
Increase in LIFO Reserve at year end	\$78,758 =====	\$78,758 =====	\$0 =====	\$76,433 ** =====

Difference is that either (1) there is no beginning inventory and the entire ending inventory is an increment or (2) the first purchase is the beginning inventory and an increment is reflected in the first year calculation. Either way, under the E/A or dual index approach, if the Earliest Acquisition subelection is made, the LIFO reserve amount will be the same (i.e., \$1,175,488 x .067 = \$78,758. However, in the MRP situation (columns 3 and 4), if the base or initial inventory is zero (0), then there will be no LIFO Reserve at year-end (that's why the Earliest Acquisitions (E/A) subelection is so important!).

\*\* LIFO Reserve = \$1,140,790 x .067% = \$76,433. Difference between E/A and MRP methods is (and should be) \$34,698 x .067 = \$2,325, which it is. \$78,758 - \$76,433 = \$2,325.



## Dual Index Approaches for Valuing Increments

Assuming an increment were computed for the second year, among the choices for valuing the increment in the second year are the following:

1. Each year stands alone:  
value second year increment at 1.04      **1.040**
2. Multiply first year E/A index of (1.026)  
by second year E/A index (1.04):  
(1.026 x 1.04 = 1.067)      **1.067**
3. **Value increment in the second year by the last cumulative index (1.075) x multiplied by the second year E/A index (1.04):**  
**(1.075 x 1.04 = 1.118)      1.118**

The procedure applied by the taxpayer and the standard apparently set forth by the Service in the TAM would suggest that the last choice listed above (1.118 valuation of the increment in the second year) would be more acceptable to the Internal Revenue Service. Note that this approach results in a greater amount of dollars being allocated to the valuation of the increment - thus producing the lowest LIFO reserve amount out of the three possibilities.

### SHORTCUT PROCEDURES

If a 1.000 Earliest Acquisition index were used, that might reflect either the assumption or the determination that the first purchases made up to an amount equal to the increment were made before the first price increase experienced during the year.

Often a shortcut may be taken by reviewing the purchase journal to confirm that the appropriate current year Earliest Acquisition index would be 1.000 or something less than the overall index for the year. If there were no price increases until significantly well into the year, an Earliest Acquisition index of 1.000 might almost be evident by inspection or logic, instead of being necessitated by a more detailed computation. In other instances, inventory turns may be computed and used to approximate acquisition levels during the year. However, these are the kinds of "shortcuts" to which the IRS usually objects, so care should be taken to carefully document this step in the calculations.

### IRS LETTER RULING 8437004

In Letter Ruling 8437004, dated May 16, 1984, the IRS ruled that a franchised auto dealer inappropriately applied a dual index approach. In that ruling, the Service stated that:

"The use of two indexes is not addressed in the regulations. Normally, a taxpayer will use two indexes to (a) measure quantity changes and (b) value increments. If properly applied, the use of a two index method or dual indexes should result in an inventory valuation that is substantially the same as if the ending

(Continued from page 10)

inventory was double-extended on an item-by-item basis. Verification of this result must be satisfactorily demonstrated by the taxpayer to the District Director.

"In this case, M's method involves the computation of a yearly index and a first purchase index. Both of these indexes are based on cars without options. However the indexes are applied to an inventory which includes cars with options. The facts as presented in this case indicates (sic) that the use of dual indexes does not clearly reflect the LIFO inventory valuation particularly since one computation takes into account the value of automobiles excluding options and the second computation takes into account the value of automobiles including options. Accordingly, the facts in this case do not justify the use of the two index method since the use of such indices does not result in a clear reflection of the value of the LIFO inventory."

It is unclear whether the conclusion in this ruling might have been reversed by the submission of additional facts or repricings showing the extent to which an inflation index for options might parallel the inflation index computed for "cars without options", i.e., the base price of a car excluding options and accessories. Nevertheless, it would appear that the first paragraph above from LTR 8437004 can be considered without regard to the auto dealer application addressed in the Ruling. However, it should be noted that letter rulings contain the statement that the ruling is directed only to the taxpayer who requested it and that the ruling may not be used or cited as precedent under Internal Revenue Code Section 6110(j)(3).

### DUAL INDEX APPROACH IN START-UP SITUATIONS

Practitioners are often attracted to apply a dual index approach to the first year LIFO election for in a business start up situation. Why? Because what it all boils down to in a start up situation is that if you do not elect the earliest acquisition approach, you will not have any LIFO reserve at the end of the first year.

If the earliest acquisition approach is selected, the taxpayer will have a LIFO reserve at the end of the first year; however, at the same time it has the risk of having no LIFO reserve at the end of that first start-up year if the IRS prevails in a position it sometimes takes that the opening inventory for LIFO purposes technically is zero. The IRS position is that because there is no prior taxable year, there can be no prior year ending inventory which, by identity, becomes the current year's opening inventory.

In many instances involving start up situations, the taxpayer may be willing to take the risk of IRS disagreement with the earliest acquisition or dual index sub-election position because of the size of the possible

→



## Dual Index Approaches for Valuing Increments

"first year" LIFO reserve. In an initial LIFO election in a start up year, the LIFO increment is computed to be the entire ending inventory expressed in base dollars. This amount is compared with the inventory at the beginning of the year expressed in base dollars which technically is zero. If the increment is valued using the earliest acquisitions method, then the application of a 1.000 or any other very low Earliest Acquisition index will result in the creation of a LIFO reserve in the first year.

The illustration/example shows the alternative treatments involved and the technicalities involved in order to gain the same result under either (1) the earliest acquisition approach where the opening inventory is zero or (2) under an alternative approach that treats the first bulk purchase of inventory as if it were the "opening inventory" for the year. Note that the first "bulk purchase" situation usually does not necessarily have to involve any *Hamilton Industries*-type of bargain purchase discount, where the taxpayer is simply starting business and purchasing opening inventory at current costs.

In the illustration/example, if the taxpayer elects the earliest acquisition approach, and the IRS disagrees with the dual index approach and prevails, then the inflation factor for the year (6.7% in the example) is multiplied by the increment raising it to a current cost for LIFO purposes which is equal to actual carrying value for book purposes...and the result is a zero LIFO reserve for the first LIFO year.

Consequently, the use of the earliest acquisition or dual index approach (especially in mid-year start up situations like this) should be regarded as aggressive and the taxpayer/client should be aware of the strong possibility of IRS challenge and the further possibility that the IRS might prevail. This "likelihood to prevail" is more ominous when the IRS raises the issue and the taxpayer realizes that it may have to go all the way to

(Continued)

Conference or beyond, and this can be a very expensive process. As a result, many taxpayers simply cave in because of the financial cost of trying to support their "earliest acquisition" assumptions.

To be safe, or as safe as possible, the earliest acquisition sub-election on Form 970, item 6(a) provides the taxpayer with a fall back position, where otherwise this position might not exist. In situations like this it may be advisable to include an attachment or computation schedule with the Form 970 initial election to indicate that a position is being taken involving the earliest acquisition sub-election. This matter of what constitutes "adequate disclosure" in the tax return is not really addressed in LIFO situations, but that is always a matter of concern.

Most important of all, and possibly even surpassing all of this "earliest acquisition-dual index" technicality, is the overriding consideration of whether it really makes sense for the start-up situation taxpayer to elect LIFO in its first year under these circumstances...when the risks may be greater than simply waiting until next year to make the LIFO election.

## CONCLUSION

The fact remains that the LIFO regulations currently do not specifically address this use of dual indexes to value LIFO increments one way or the other. IRS agents may try to intimidate taxpayers when they challenge the use of dual indexes by simply asking to be shown "where the Regulations authorize this approach." Often, that question will cut off any further discussion. But, as can be seen from the foregoing discussion, it shouldn't.



### De Filippis' LIFO LOOKOUT

Willard J. De Filippis, CPA, P.C.  
317 West Prospect Avenue Mt. Prospect, IL 60056  
(708) 577-3977 FAX (708) 577-1073

Published Quarterly  
March, June, September  
and December  
\$285

Start my subscription for the next four issues of the *LIFO Lookout* with the \_\_\_\_\_ issue.

☐ YES!

My check for \$285 is enclosed for 4 issues.

Back Issues of the *LIFO Lookout* are available for \$65 each. Please send me:

1993:	<input type="checkbox"/> 1Q (Mar '93)	<input type="checkbox"/> 2Q (June '93)	<input type="checkbox"/> 3Q (Sep '93)	
1992:	<input type="checkbox"/> 1Q (Mar '92)	<input type="checkbox"/> 2Q (June '92)	<input type="checkbox"/> 3Q (Sep '92)	<input type="checkbox"/> 4Q (Dec '92)
1991:	<input type="checkbox"/> 1Q (Mar '91)	<input type="checkbox"/> 2Q (June '91)	<input type="checkbox"/> 3Q (Sep '91)	<input type="checkbox"/> 4Q (Dec '91)

NAME(S): \_\_\_\_\_

FIRM NAME: \_\_\_\_\_

ADDRESS: \_\_\_\_\_

CITY: \_\_\_\_\_ STATE: \_\_\_\_\_ ZIP: \_\_\_\_\_ PHONE: (\_\_\_\_) \_\_\_\_\_

## HOW FAR DO YOU HAVE TO GO IN DETERMINING "ITEM CATEGORIES"?

(Answer: Each line entry is a separate "item category")

### 1993 FORD TRUCKS

MODEL NO	BODY TYPE	DEALER INVOICE	SUGG. RETAIL	DEALER INVOICE	SUGG. RETAIL
		F O B.		Freight Incl.	
Explorer					
EXPLORER 2WD—V6 245 CID EFI (4.0 Liter)					
	U22 XL Utility 2D	14862.00	16690.00	15347.00	17175.00
	U32 XL Utility 4D	15619.00	17550.00	16104.00	18035.00
	U22 Sport Utility 2D	15742.00	17690.00	16227.00	18175.00
	U32 XLT Utility 4D	17519.00	19710.00	18004.00	20195.00
	U22 Eddie Bauer Utility 2D	18655.00	21000.00	19140.00	21485.00
	U32 Eddie Bauer Utility 4D	19931.00	22450.00	20416.00	22935.00
→	U32 Limited Utility 4D	22766.00	25672.00	23251.00	26157.00
EXPLORER 4WD—V6 245 CID EFI (4.0 Liter)					
	U24 XL Utility 2D	16446.00	18490.00	16931.00	18975.00
	U34 XL Utility 4D	17238.00	19390.00	17723.00	19875.00
	U24 Sport Utility 2D	17265.00	19420.00	17750.00	19905.00
	U34 XLT Utility 4D	19060.00	21460.00	19545.00	21945.00
	U24 Eddie Bauer Utility 2D	20177.00	22730.00	20662.00	23215.00
	U34 Eddie Bauer Utility 4D	21471.00	24200.00	21956.00	24685.00
→	U34 Limited Utility 4D	24307.00	27422.00	24792.00	27907.00

Add for Local & National Advertising

### 1992 FORD TRUCKS

MODEL NO.	BODY TYPE	DEALER INVOICE	SUGG. RETAIL	DEALER INVOICE	SUGG. RETAIL
		F.O.B.		Freight Incl.	
Explorer					
EXPLORER 2WD—V6 245 CID EFI (4.0 Liter)					
U22 XL Utility 2D		14192.00	15854.00	14677.00	16339.00
U32 XL Utility 4D		14929.00	16692.00	15414.00	17177.00
U22 Sport Utility 2D		15200.00	17000.00	15685.00	17485.00
U32 XLT Utility 4D		16649.00	18647.00	17134.00	19132.00
U22 Eddie Bauer Utility 2D		18217.00	20428.00	18702.00	20913.00
U32 Eddie Bauer Utility 4D		19422.00	21798.00	19907.00	22283.00
EXPLORER 4WD—V6 245 CID EFI (4.0 Liter)					
U24 XL Utility 2D		15766.00	17644.00	16251.00	18129.00
U34 XL Utility 4D		16524.00	18505.00	17009.00	18990.00
U24 Sport Utility 2D		16723.00	18731.00	17208.00	19216.00
U34 XLT Utility 4D		18193.00	20401.00	18678.00	20886.00
U24 Eddie Bauer Utility 2D		19740.00	22159.00	20225.00	22644.00
U34 Eddie Bauer Utility 4D		20967.00	23553.00	21452.00	24038.00

Add for Local & National Advertising





INTERNAL REVENUE SERVICE  
**INFORMATION DOCUMENT REQUEST**

To:

(Name of Taxpayer and Company, Division or Branch)

Subject:

LIFO Inventory, Initial Request

SAIN Number

103

Submitted to:

Dates of Previous Requests

## Description of Documents Requested

Provide the following items for \_\_\_\_\_:

1. Copies of all effective Form 970 LIFO elections and attachments.
2. Copies of any request for change in method of accounting Forms 3115 filed regarding inventories.
3. Financial statements, annual reports to shareholders and other financial reports that may have been issued to creditors or SEC.
4. A schedule reconciling inventory by accounts in the general ledger with the inventory amounts shown on the returns. This should be a detailed listing of accounts (not summary, for example, only three categories, Raw Materials, Goods-in-Process and Finished Goods).
5. A schedule reconciling inventory by accounts to the LIFO workpapers. This schedule should reflect all adjustments with a brief explanation of each adjustment.
6. LIFO workpapers reflecting index computations (double-extensions). Summary workpapers that show indexes and layers all the way back to the first year of LIFO. This should show the layers at base cost, the index used to value the layers and the layer at current cost.
7. Provide physical inventory workpapers.
8. Provide access to the individual who did the LIFO computations so that person can explain the various methods used, how inventory is priced, and how they determined the base or beginning of the year costs of new items entering the pool.

Response date: \_\_\_\_\_

Name and Title of Requester

Revenue Agent

Date

Office Location

FORM 4564

Page 9 of 9



## LIFO LIQUIDATORS: A "NEW" BREED OF IRS AGENTS

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

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

1. They come in equipped with lap tops and other effective tools for doing what used to be tedious computations and for preparing lengthy reports, schedules and tables that will make your eyes water.
2. They have access to the thinking, writing and teaching of the IRS' Industry Specialization Group task force members. This means they are familiar with current IRS Coordinated Issues LIFO memos and policies. They have attended specialized training sessions taught by key IRS LIFO specialists. And they are up-to-date on the new cases like *Hamilton*. Many have a LIFO "specialist" assigned to assist them or their office with more technical matters and they can receive direct or satellite group support.
3. Before starting the audit, they literally blow the taxpayer away with an expansive document request in which they ask for (1) all Forms 970 and change Forms 3115's related to the LIFO election, (2) copies of **all** end of the year vehicle invoices for **all** LIFO years, (3) all Factory price information for all years on LIFO, (4) all vehicle model change information for all years on LIFO and (5) proof that the year-end financial statement conformity requirement has not been violated, especially in the 12<sup>th</sup> statement and in the 13<sup>th</sup> statement.
4. These agents usually end up examining and adjusting **all** years covered by the LIFO election, not just a few obvious "open" years. They start with the earliest year under audit, then work their way all the way back to the initial LIFO election year. They also sometimes extend their adjustments to years **after** the years under audit for which tax returns have been filed, thus covering **all** computations to date.
5. These agents already have a sense of what is a reasonable range for inflation indexes, and they seem to know instinctively whether or not indexes are out of line. One IRS supervisor told me he had all of the Ford prices since 1974 in his lap top computer and could easily relate taxpayer indexes to his own pro forma information and guidelines. I just took his word for it. Another rattled off almost 40 platform changes and new items in the Toyota line going all the way back to 1975 and coming forward through 1989. Scary!
6. These agents, or their LIFO backup specialists, sometimes refer to Schneider's *Federal Taxation of Inventories* as a LIFO reference to develop their positions or to better understand what a taxpayer has done.
7. Finally, these agents go right for the jugular. They are quick to review the taxpayer's eligibility to use LIFO before getting bogged down in sleep-inducing index computations. If the taxpayer can't produce a Form 970 or if the taxpayer has violated the conformity requirement, the agent just takes 'em off LIFO...and that's all there is to it! Mega-dollar deficiencies within minutes after starting the audit. They're heroes, becoming new legends in their own time.

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

*Reference: LIFO Lookout, December 1991, Vol. 1 No. 4, page 12.*

The *De Filippis' LIFO Lookout* newsletter is a quarterly publication of LIFO News, Views and Ideas by Willard J. De Filippis, 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: \$285. Back issues available for \$65 each. Not assignable without consent. Any quoted material must be attributed to *De Filippis LIFO Lookout* published by Willard J. De Filippis, CPA, P.C. Editorial comments and article suggestions are welcome and should be directed to Willard J. De Filippis at (708) 577-3977; FAX (708) 577-1073. *De Filippis' LIFO Lookout* format designed by *Publish or Perish*, (708) 289-6332. © Copyright 1993 Willard J. De Filippis.

### De Filippis' LIFO LOOKOUT

Willard J. De Filippis, C.P.A., P.C.  
317 West Prospect Avenue  
Mt. Prospect, IL 60056

First-class postage paid at Mt. Prospect, IL

