



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. DECEMBER IS ALWAYS HECTIC. We've been working up year-end LIFO projections, assisting CPAs rushing down-to-the-wire to beat the December 31 deadline for filing Forms 3115 to change to the Alternative LIFO Method (and avoid Rev. Proc. 92-20), and to complete our make/model analysis data base for 1993 dealer LIFO inflation indexes.

#2. LIFO INFLATION RATES MAY BE FAIRLY HIGH FOR MANY DEALERS THIS YEAR. Many callers are interested in knowing what inflation rates we are using for auto dealers in our year-end projections. Most are likely to be higher than those reported in the *Automotive News* and/or *Wall Street Journal* because manufacturers play the game of releasing inflation statistics based on "comparably equipped vehicles." Many 1994 vehicles ("item categories") reflect the addition of equipment that had previously been optional or safety-related features added as part of the dealer's base cost. In addition, the difficulties the Japanese have had with their Yen have only helped camouflage our domestic manufacturers' "yen" for greater profits: Both have resulted in significant price increases this year.

Our model/item category inflation survey for 1993-94 may be helpful if you are looking for quick inflation percentages somewhat tailored to a dealer's year-end inventory mix. See special report take-out section, pages 7-14. This '93-'94 survey will also give you an idea of the extent of the detailed analysis necessary to track down all of the item categories included in a particular model. Each manufacturer is unique and we have accounted for the change from the total number of 1993 item categories to the total number of 1994 item categories.

#3. LIFO FINANCIAL STATEMENT CONFORMITY REQUIREMENTS. At year-end it is appropriate to review the traps LIFO sets in year-end statements. This emphasizes our need to monitor the release of all year-end financial statements by our clients. Our prior conformity discussions have been expanded and updated, starting on page 2. And don't

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forget those dealer statements going out to the Factory in the next few days.

#4. TAX COURT TERMINATES LIFO ELECTION DUE TO INADEQUATE "BOOKS & RECORDS".

The Tax Court memo decision October 27, 1993 in *Boecking Machinery, Inc.* interpreted the taxpayer's "books and records" responsibilities very strictly and ended up terminating this Company's LIFO election in 1980, some 10 years after the election had been made. This case is both interesting and distressing at the same time.

#5. MORE ON "BOOKS & RECORDS"

Recent Letter Ruling 9343001 (June 25, 1993) is also related to the adequate "books and records" provision of Revenue Procedure 79-23. However, the taxpayer did not lose its LIFO election. It was able to keep its LIFO election because its books and records were adequate to support its current method of inventory valuation, even though the examining agent thought the Company should have maintained books and records to support other LIFO computations as well.

see LIFO UPDATE, page 19

YEAR-END WARNING: THE ULTIMATE LIFO TRAP

FINANCIAL STATEMENT CONFORMITY REQUIREMENTS

The intention underlying the conformity requirement is that LIFO should be used in all reports covering a full year to insure that the use of LIFO for tax purposes conforms as nearly as possible with the best accounting practice in the trade or business in order to provide a clear reflection of income. Accordingly, if a business wants to use LIFO for tax purposes, then LIFO **must** also be "good enough" to be used on the year-end statements sent to shareholders, creditors and other parties.

The "conformity requirement" actually consists of many conformity requirements which affect different situations differently. If one simply remembers that these requirements exist as restrictions on a taxpayer's general desire to pay lower taxes using LIFO while reporting more income to shareholders or banks using a non-LIFO method, that should dispel any temptation to try to get around the conformity requirement. Play it safe... you can't afford not to!

Until 1938, LIFO was not acceptable for tax accounting purposes. In that year Congress allowed tanners and producers of non-ferrous metals to use LIFO, expanding this privilege to all taxpayers the following year. The 1939 amendments added a conformity requirement, which was amended in 1942 to its current form. As the District Court in *Powell* summarized LIFO: The principle purpose of LIFO is to mitigate inflation and to protect the taxpayer from paying taxes on profits resulting from price inflated inventories. Under the FIFO method the earliest historical costs are matched against current revenues and, to the extent that current costs exceed such historical costs, gross profit is overstated and distorted. Rather than being available totally for the payment of operating expenses, the repayment of debt, new investment, distribution to owners and the like, a portion of such "profit" must be used merely to replace the inventory which was sold. It is this distortion of profit which may be substantially mitigated by the use of LIFO. Accordingly, the objective of the LIFO method is to match relatively current costs against current revenues in order to produce a more realistic gross profit.

Code Section 472(c) provides that subsection (a) shall apply only if the taxpayer establishes to the satisfaction of the Secretary that the taxpayer has used no procedure other than that specified in paragraphs (1) and (3) of subsection (b) in inventorying such goods to ascertain the income, profit, or loss of the first taxable year for which the method described in subsection (b) is to be used, for the purpose of a report or statement covering such taxable year:

1. To shareholders, partners or other proprietors, or to beneficiaries, or
2. For credit purposes.

Three questions on line 5 of Form 970 ask whether the taxpayer has issued credit statements or reports at year-end and, if so, what inventory method of accounting was used in determining income, profit or loss in those statements. These questions relate to the requirement that LIFO must be used to compute income in the year-end financial statements: technically, only in the primary presentation of income. For many taxpayers, this LIFO conformity requirement really poses multiple requirements. **First**, it requires all year-end financial statements sent to a manufacturer or supplier (12th, 13th and any other fiscal year-end statements) to reflect LIFO. **Second**, it also requires that any other year-end financial statements issued in report form by the taxpayer to creditors, shareholders, partners or other users must also reflect the year-end results on LIFO.

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

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

REPORTS ISSUED BY CPAs

Let us first look at the conformity requirement in relation to year-end financial statements included in reports issued by CPAs where the CPA has control over the release and format of the statements, notes and accompanying supplementary information. These financial statements are unlike monthly statements which may be prepared internally and sent out to the manufacturer or supplier without CPA involvement or review.

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

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Year-End Conformity Requirements...

ing losses into even larger losses - in order to satisfy the conformity requirement. And, in many instances where ending inventories are lower, the LIFO reserve for the year may actually reflect a net increase and a correspondingly lower net income.

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

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

These LIFO conformity requirements don't present any major reporting problems for publicly-held companies.

(Continued)

In some annual reports, the notes to the financial statements essentially disclose the inventories as being composed of finished goods, raw materials and work-in-process and supplies with an indication of the amount of the LIFO reserve described variously as either "less-adjustment to LIFO basis," "reduction to LIFO cost," "excess of current cost over stated LIFO value" or in a sentence indicating that the excess of current cost over LIFO cost at the end of each year was \$x and \$xx, respectively (1992 annual reports K-Mart, Merck, Campbell Soup, and Colgate-Palmolive).

In others, only a sentence or two appear indicating that at the respective year-ends, inventories would have been greater by \$x and \$xx, respectively, if they had been valued on a lower of First-In, First-Out (FIFO) cost or market basis. As Rite-Aid put it: "Under the FIFO method, these inventories would have been higher by \$x and \$xx, respectively" (1992-1993 Sherwin Williams, Rite-Aid, Walgreens and Wrigley). In summary, it appears that publicly-held companies report LIFO results in very general terms in notes to their financial statements in one of two very general ways. These notes either (1) show the inventory elements in very general terms or (2) they disclose the LIFO reserves in a single sentence - or two, at most.

"GETTING AROUND" THE CONFORMITY REQUIREMENT

Many businesses using LIFO would like to report lower taxable income/earnings in tax returns but report higher earnings/more income to their shareholders and see **YEAR-END CONFORMITY REQUIREMENTS...**, page 5

WHAT THE DISTRICT COURT SAID IN WILLIAM POWELL

This leads us to the purpose of the conformity requirement. Why did Congress, when it made the LIFO method available to all taxpayers, include a subsection requiring conformity of method? The IRS asserts that such a requirement assures that the taxpayer is motivated by business considerations, not only tax consequences. *Powell* argues that the requirement was included to exact a price from the taxpayer electing LIFO.

In essence, the government is asking this Court to add a business purpose requirement to Section 472(c)(1). Strict compliance with Section 472(c)(1) does not require that the electing taxpayer be motivated by a business purpose. We refuse to read such a requirement into the statute.

We feel equally compelled to reject the taxpayer's alternate purpose. The taxpayer has adopted the deterrence theory. This theory is attractive, as evidenced by its impressive following, but there is no support for this approach in the legislative history. We cannot presuppose this purpose on the basis of what we think Congress was contemplating, for such action is speculation, not evidence of legislative intent.

Legislative and judicial history of the conformity requirement are of limited value. In *Insilco Corp. v Commissioner*, Judge Tannenwald stated that the underlying intent behind the conformity requirement was to insure that the use of LIFO for tax purposes conformed as nearly as possible with the best accounting practice in the trade or business in order to provide a clear reflection of income. This intent supports an interpretation that Section 472(c)(1) was designed to require consistency in accounting method in order to insure that the method used by the taxpayer most clearly reflected income.

This consistency requires the taxpayer, at the time he elects LIFO, to be using LIFO for the business reports mentioned in Section 472(c)(1). This consistency is connected neither to guaranteeing the existence of a business purpose nor to deterring the use of LIFO. The conformity requirement, in essence, is designed to establish prima facie evidence that at the time of its election, the taxpayer feels LIFO provides a clear reflection of its income.

Powell has demonstrated that it felt LIFO provided a clear reflection of income at the time it was elected. This does not result in an emasculation of the statute, particularly in light of its past interpretation. This interpretation requires that the taxpayer be using consistent methods at the time he elects to use LIFO, but is contingent on the recall and reissue present in this case. Absent this action, *Powell* would not be in compliance with Section 472(c)(1). By taking this action, however, *Powell* met the level of the consistency demanded by the conformity requirement.



TAX COURT TERMINATES LIFO ELECTION DUE TO INADEQUATE RECORDS

BOECKING, "BOOKS AND RECORDS," AND REVENUE PROCEDURE 79-23

On October 27, 1993, the Tax Court issued T. C. Memo Decision #1993-497 involving Boecking Machinery, Inc., a Caterpillar machinery and equipment dealer. Boecking elected LIFO in 1970 and lost it in 1980 as a result of the IRS' determination that the Company had failed to maintain adequate books and records.

As anyone who has worked with LIFO knows, LIFO is not a single, cut and dried calculation. Detailed records which should already exist in the business must be analyzed and summarized, and various alternative sub-procedures and sub-elections must be interpreted and evaluated. All of these records should be saved indefinitely because the IRS may want to see all detail records and verify the underlying reasoning, assumptions, procedures and methods. A taxpayer who can't produce this information can be at the mercy of the examining agent...as was *Boecking*...and the results may be shocking!

Revenue Procedure 79-23 (1979-1 CB 564) offers guidance in three areas that come up in LIFO audit situations. These are: (1) what to expect an IRS agent to look at in connection with LIFO, (2) what are grounds for holding that a LIFO election can be terminated or disallowed, and (3) what are situations that do not warrant the disallowance or termination of a LIFO election.

Section 3.01 of Rev. Proc. 79-23 provides that the LIFO election can be disallowed for the following reasons:

1. Failure to value LIFO inventory at cost for tax purposes for the year preceding the year of LIFO election, the election year, and all subsequent years;
2. Violation of the financial statement reporting conformity requirements (the IRS has the authority to invalidate a LIFO election because of failure to satisfy these eligibility requirements; but the exercise of that authority is discretionary with the IRS.);
3. Failure to properly elect LIFO (Form 970 deficiencies);
4. "Failure by the taxpayer to maintain adequate books and records with respect to its LIFO inventory and all computations incident thereto."

Even if one of these situations exists, the IRS - District Director has the discretionary power to allow the LIFO election to remain in effect - if it can be persuaded to exercise that power in the taxpayer's favor. Although Revenue Procedure 79-23 reflects the position of the Service that a LIFO election can be disallowed if the taxpayer fails to "maintain adequate books and records," if a taxpayer can reconstruct or otherwise provide satisfactory information necessary to calculate the LIFO inventory valuation properly, it **may** be possible to avoid termination of the LIFO election for this infraction by working out other computational adjustments to compensate for deficiencies in record keeping. Or: shouldn't it be possible?

According to Revenue Procedure 79-23, the following situations do not warrant disallowance or termination of the LIFO election:

1. Computational errors;
2. Selection of a lesser or greater number of inventory pools that those the IRS thinks should be used;
3. Use of Bureau of Labor Statistics price indexes by non-department store taxpayers (Note: R.P. 79-23 predates the introduction of various Simplified Index IPIC Methods under which BLS indexes may now be used if properly elected.);
4. Improperly including (or excluding) a specific "item" in a particular inventory pool;
5. Differences in the level of costing inventories between financial statements and tax returns.

From the above list of situations that do **not** warrant termination of a LIFO election, it is clear that where a taxpayer has made a reasonable or good faith effort at applying the LIFO concept but has "bungled" (is anybody perfect?) the mathematics, pooling, or index conceptual applications, IRS agents are not supposed to disqualify the taxpayer from using LIFO or terminate the election. But some agents may (threaten to) terminate the election anyway!

While one may attempt to raise technical defenses under Section 481 or under the statute of limitations, when faced with a "books and records" issue, common sense and Compliance 2000 suggest looking for reasonable and practical ways to compromise the matter with the IRS. Consequently, if a taxpayer has not retained detailed information for all prior years for which it used LIFO, it would be advisable to (1) immediately start saving all information for current year computations, (2) immediately attempt to save or acquire information relative to prior years, starting with the most recent years and moving back in time as far as possible, and (3) attempt to develop an information sharing capability through a trade association or peer group that might be able to fill in product and/or price information for prior years. This information is usually available within and without the industry from many sources and should be documented as thoroughly as possible - sooner rather than later - to avoid guesswork, speculation or extrapolation in later years...and to counter a threatened termination of the LIFO reserve on a retroactive basis. As *Boecking* illustrates, the failure to save or maintain all necessary LIFO-related information can be used on audit against the taxpayer in a variety of unpleasant ways. And there seems to be no limit to the ingenuity, aggressiveness and negotiating position of the IRS, especially with *Hamilton Industries* on its side **and** if the case is being tried in the Tax Court where the straight jacket of *Hamilton* was forged.

In considering the Tax Court's decision in *Boecking Machinery, Inc.*, keep the following in mind:

1. The taxpayer elected to use a dollar-value, double-extension method. It appears it would have been far better off to have elected to use a link-chain, index method for valuing its dollar-value LIFO pools. The double-extension method caused the taxpayer considerable
- see **TAX COURT TERMINATES...**, page 16



Year-End Conformity Requirements...

creditors for financial purposes. Did you know that the Regulations do allow taxpayers to legitimately avoid the intent of the conformity requirement?

The Regulations allow taxpayers to use LIFO methods and sub-elections in their financial statements that are different from those LIFO sub-elections and methods that are used in their income tax return computations. That's right: **DIFFERENT LIFO METHODS FOR BOOK AND FOR TAX PURPOSES**. It is **not** necessary for the year-end financial statements to use the same exact LIFO sub-elections that are used in the tax return LIFO calculations. The Regulations simply require that both sets of statements (financial reports and tax returns) must report using LIFO methods.

One company reportedly used 200 more pools for financial reporting purposes than it used for income tax purposes. Other companies use link-chain or link-chain, index methods to lower LIFO income for tax purposes, but use double-extension LIFO for financial reports. Similarly-motivated taxpayers play both ends against the middle by reconstructing base prices for new "items" in their tax return LIFO calculations while pricing new items at current cost in their financial statements. These companies enjoy the "best of both worlds" without violating the fine print in the "conformity" regulations and, as indicated above, they don't make any disclosures about the differences in LIFO methods in their financial statements.

INTERIM REPORTS

Interim reports covering a period of operations that is **less than the whole** of a taxable year may be issued on a non-LIFO basis without violating the LIFO conformity requirement. However, GAAP seems to require that if the financial statements at year-end will be reporting using LIFO, then any interim financial statements should also report using LIFO. This may present some difficulties in estimating LIFO reserve changes for the year before the year is over.

DEALERSHIP YEAR-END STATEMENTS SENT TO THE FACTORY/MANUFACTURER/SUPPLIER

The **BAD NEWS** is that the Regulations contain severe LIFO conformity reporting restrictions that more adversely affect smaller, closely-held businesses. These conformity reporting restrictions apply to the Factory-prescribed format financial statements sent by a dealership immediately after year-end to the Factory/Manufacturer/Supplier. For some businesses, these restrictions pose the ultimate LIFO trap and are potentially more troublesome than those for year-end reports issued by CPAs.

In this regard, the Regulations provide that any income statement that reflects a full year's operations must report on a LIFO basis. This would apply whether it is the last in a series of interim statements, or the December statement itself which shows two columns - one for current month and one for year-to-date figures. The Regulations provide that a series of credit statements or financial reports is considered a single state-

(Continued from page 3)

ment or report covering a period of operations if the statements or reports in the series are prepared using a single inventory method and can be combined to disclose the income, profit, or loss for the period. Sometimes this is referred to as the "aggregation" theory: If one can combine or aggregate a series of interim or partial-year statements to disclose the results of operations for a full year, then the last statement must reflect income computed using LIFO to value the inventory.

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

This conformity requirement means that to remain eligible to use LIFO **EVERY YEAR**, the dealership's December (or last monthly) statement must reflect an estimate of that year's change in the LIFO reserve. If the dealer is anticipating making a LIFO election for the year, an **ESTIMATE** of the LIFO reserve should be placed in the year-end statements issued to the Factory/Manufacturer or issued to any other party in order to preserve the ability to elect LIFO by filing Form 970 when the tax return for the year is filed at a later date. Don't overlook this conformity requirement if a dealer already has new vehicles on LIFO and is considering

see **YEAR-END CONFORMITY REQUIREMENTS...**, page 15

READER COMMENTS ON CONFORMITY

In correspondence dated December 16, 1993, one reader stated:

"...I have found that most IRS auditors ask for the twelfth and thirteenth factory statement in addition to the accountant prepared financial statement to see that they, in fact, comply with the reporting requirements. When the factory requires the LIFO adjustment to be shown in other than the cost of goods sold area, I have my clients prepare two financial statements, one that is in compliance with the factory requirement and is clearly marked as **'supplemental data'** across the top and attach this to the back of the financial statement which indicates the LIFO adjustment as an adjustment to cost of goods sold. I have them send these statements along with a cover letter to the factory indicating that they are enclosing the dealer financial statement, as required for the 12 or 13 months (which ever the case may be) along with the supplemental data that is requested by the factory. The financial information transmitted via computer to the factory only includes the LIFO adjustment as cost of goods sold. I feel that this is one of the safest methods for our clients to use and falls within the parameters of the IRS requirements. Specifically, I have had discussions with American Honda and they said they would accept this without any problem."



PROJECTING YEAR-END LIFO RESERVES CHANGES

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

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

- (1) Beginning-of-the-year inventory expressed in total dollars and in base dollars,
- (2) Beginning-of-the-year LIFO valuation of the inventory,
- (3) Method used for valuing current year increments, and
- (4) Cumulative inflation index as of the beginning-of-the-year.

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

- (1) Determine the cumulative index as of the end-of-the-year - this is the estimated current year inflation index times (i.e. multiplied by the) beginning of year cumulative index,
- (2) Divide the end-of-the-year actual inventory dollars by the year-end cumulative index - to get the end-of-the-year inventory stated or expressed in base dollars,
- (3) Compare the end-of-the-year inventory at base dollars with the beginning-of-the-year inventory stated in base dollars to determine whether there is an increment or a decrement projected for the year,
- (4) Value the projected increment under the method already selected. Alternatively, if a decrement is projected for the year, carry the decrement (expressed in base dollars) back against prior years' increments (also expressed in base dollars) on a LIFO or reverse-chronological-order basis.
- (5) Add all the resulting layers of inventory at their respective LIFO valuations to get the end-of-the-year inventory stated at its LIFO valuation,
- (6) Subtract the ending inventory at its LIFO valuation from the ending inventory at its actual or estimated current non-LIFO cost to determine the projected LIFO reserve as of the end-of-the-year, and
- (7) **Finally**, subtract the **actual** LIFO reserve as of the beginning- of-the-year from the **projected** LIFO reserve as of the end-of- the-year.

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

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

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

Also, see the '93-'94 Model/Item Category Survey included in this issue of the *Lookout* for "shortcut" inflation estimates when projections are needed and time is of the essence.



1993-1994 MODEL/ITEM CATEGORY INFLATION SURVEY FOR QUICK YEAR-END LIFO ESTIMATES

For auto dealers who need an estimate of their LIFO reserve change before all the detailed inventory repricing can be made: By now everyone is sure that new vehicle prices have increased. The question is: How much?...and the answer depends on where you've read about it, whether you're using the Alternative LIFO Method and how far you're going in your make/model analysis to determine detailed item categories. It also depends on whether certain vehicles in the ending inventory are classified as new items.

The Wall Street Journal recently reported that "by the time January (1994) rolls around, the average car price in the U.S. will have jumped \$1,000 or 5.6% to \$18,800 from a year ago." This reflects the fact that many manufacturers are already into a second round of price increases after the intro price hikes.

Among reasons cited for the new vehicle price increases are (1) the Japanese Yen has continued to increase over the past year, thus driving up prices on Japanese cars and giving the Big 3 - Chrysler, Ford and GM - an opportunity to further increase prices, (2) lower interest rates and leasing popularity tend to melt customer resistance to price increases, (3) many buyers are choosing vehicles that are loaded with expensive extras which have become part of the base price of the vehicle, and (4) some safety equipment has been added on many continuing models. All of this adds up to significant price increases for some 1994 models.

GM claims that its 1994 car prices have risen only 2.3%, excluding the cost of additional equipment such as air bags in new models. However, this is important in LIFO index computations only if a dealer is not using the Alternative LIFO Method.

Automotive News has reported that its analysis finds the average increase on the leading Japanese makes was more than 7 times as high as the average price increase for the Big 3 on comparably equipped models, which excludes price adjustments for equipment that is made standard on the 1994 models. *Automotive News* reported sticker-to-sticker price

increases on 1994 models for Chrysler at 5.6%, Ford at 2.1% and General Motors at 5.8% for an overall Big 3 average of 4.6%. For "Japanese leaders," *Automotive News* reported Acura price increases at 7.7%, Honda at 3.3%, Infiniti at 6.0%, Lexus at 6.5%, Mazda at 4.0%, Mitsubishi at 8.4%, Nissan at 5.2% and Toyota at 6.3%.

Our analysis reflects a weighted average by model for 1994 models. This listing shows for each model the weighted average intro-to-intro increase; it also indicates the change in underlying item categories. This increase was determined by taking all of the underlying 1994 item categories and assuming a dealer had "one of each" and then dividing the total dealer base cost of one of each at the end of the year by the comparable beginning-of-the-year totals. This assumes that for each model, the dealer would have had one of each "new" item category in the ending inventory and this "one of each" assumption tends to decrease the overall model index where many new item categories were introduced in '94. These weighted increases vary significantly depending on a number of factors. In our computations, market editions, special editions and "value priced" vehicles (item categories) were considered as new items based on a narrow interpretation of Revenue Procedure 92-79. Accordingly, each of these new item categories results in a 1.000 index on its own.

When the year-end LIFO repricings are made using all actual year-end invoices, the inflation increases based on detailed item category costs may be significantly greater than the "one of each weighted average" assumed for all item categories within the given model. Also, a dealer's beginning-of-the-year average cost for an item category may be considerably less than the 1993 intro dealer cost used in compiling the intro-to-intro averages. This would give the dealer a higher inflation index. Despite these general limitations, we have found the inflation percentages that follow to be useful in estimating LIFO reserve changes where time is of the essence.

LOOKOUT EXCLUSIVE



FOR QUICK YEAR-END LIFO ESTIMATES

Make/Model	Total 1993 Item Categories	Continuing	New	Dropped	Weighted	
					Total 1994 Item Categories	Average Intro to Intro
ACURA						
Integra	19	-	10	9	10	1.00000
Legend	12	9	2	3	11	1.07751
NSX	2	2	-	-	-	-
Vigor	4	4	-	-	4	1.09492
AUDI						
100 Series	9	3	1	6	4	1.04214
90 Series	5	1	-	4	1	1.06669
S4 Series	1	1	-	-	1	1.04707
V8 Quattro	1	1	-	-	1	1.04056
BMW						
3 Series	10	10	-	-	10	1.04767
5 Series	6	3	4	3	7	1.01197
7 Series	3	3	-	-	3	1.03604
8 Series	2	2	-	-	2	1.02515
BUICK						
Century	6	3	2	3	5	1.04513
Lesabre	2	2	-	-	2	1.08666
Park Avenue	2	2	1	-	3	1.03624
Regal	6	5	3	1	8	1.04081
Riviera	1	-	-	1	-	-
Roadmaster	4	3	-	1	3	1.06548
Skylark	6	5	2	1	7	1.08676
CADILLAC						
Allante	1	-	-	1	-	-
De Ville	4	-	2	4	2	1.00000
Eldorado	1	1	1	-	2	1.04425
Fleetwood	1	1	-	-	1	1.05782
Seville	2	2	-	-	2	1.08737
CHEVROLET						
AUTOMOBILES:						
Beretta	3	1	5	2	6	1.01229
Camaro	2	2	2	-	4	1.00000
Caprice	3	3	2	-	5	1.03754
Cavalier	9	8	-	1	8	1.10824
Corsica	1	1	2	-	3	1.04487
Corvette	2	2	-	-	2	1.04425
Geo Metro	6	3	-	3	3	1.07113
Geo Prism	4	4	-	-	4	1.08760
Geo Storm	2	-	-	2	-	-
Lumina	6	5	-	1	5	1.06209

LIFO LOOKOUT EXCLUSIVE



**1993-1994 MODEL/ITEM CATEGORY INFLATION SURVEY
FOR QUICK YEAR-END LIFO ESTIMATES**

Make/Model	Total 1993 Item Categories	Continuing	New	Dropped	Weighted	
					Total 1994 Item Categories	Average Intro to Intro
CHEVROLET (continued)						
LIGHT-DUTY TRUCKS:						
Astro Van	8	8	-	-	8	1.03180
Blazer-K	1	1	-	-	1	1.05581
C-K Chassis Cab	17	13	-	4	13	1.03459
C-K Pickup	30	28	2	2	30	1.06280
Chevy Van	10	6	-	4	6	1.06236
Geo Tracker	5	5	-	-	5	1.05500
Lumina APV	3	2	-	1	2	1.05591
S10 Blazer	4	4	-	-	4	1.04942
S10 Pickup	8	4	6	4	10	1.01618
Sportvan	8	2	1	6	3	1.04176
Suburban	4	4	-	-	4	1.05377
CHRYSLER						
Concorde	1	1	-	-	1	1.06050
Fifth Avenue	1	-	-	1	-	-
Imperial	1	-	-	1	-	-
Lebaron	8	3	1	5	4	1.01248
LHS	-	-	1	-	1	1.00000
New Yorker	-	-	1	1	1	1.00000
DODGE						
AUTOMOBILES:						
Colt	4	4	-	-	4	1.17194
Daytona	4	-	-	4	-	-
Dynasty	2	-	-	2	-	-
Intrepid	2	2	-	-	2	1.09872
Shadow	6	4	-	2	4	1.04509
Spirit	2	2	-	-	2	0.98130
Stealth	4	3	-	1	3	1.13768
Viper	1	1	-	-	*	*
LIGHT-DUTY TRUCKS:						
Cab & Chassis	7	-	-	7	-	-
Caravan	14	11	-	3	11	1.06107
Caravan C/V	2	2	-	-	2	1.04961
D/W Pickups	15	-	-	15	-	-
Dakota	10	9	6	1	15	1.04658
Ram 50	4	-	-	4	-	-
Ram Cab & Chassis	-	-	6	-	6	1.00000
Ram Pickup	-	-	12	-	12	1.00000
Ram Vans	7	7	-	-	7	1.00561
Ram Wagon	6	5	-	1	5	1.00345
Ramcharger	4	-	-	4	-	-
EAGLE						
Summit	7	7	2	-	9	1.11285
Talon	4	4	-	-	4	1.01150
Vision	2	2	-	-	2	1.09228

LIFO LOOKOUT EXCLUSIVE



FOR QUICK YEAR-END LIFO ESTIMATES

Make/Model	Total 1993 Item Categories	Continuing	New	Dropped	Weighted	
					Total 1994 Item Categories	Average Intro to Intro
FORD						
AUTOMOBILES:						
Aspire	-	-	3	-	3	1.00000
Crown Victoria	2	2	1	-	3	1.00988
Escort	7	6	-	1	6	1.07038
Festiva	2	-	-	2	-	-
Mustang	9	-	4	5	4	1.00000
Probe	2	2	-	-	2	1.05762
Taurus	5	5	-	-	5	1.06554
Tempo	3	3	-	-	3	1.05535
Thunderbird	2	2	-	-	2	1.06103
LIGHT-DUTY TRUCKS:						
Aerostar	28	28	-	-	28	1.03308
Bronco	3	3	-	-	3	1.05589
Cutaway Van	12	12	-	-	12	0.98727
E Series Van/Wagon	15	15	-	-	15	1.01755
Explorer	14	14	-	-	14	1.03346
F Series Cab & Chassis	9	9	1	-	10	1.02691
F Series Pickup	28	26	4	2	30	1.05205
Ranger	20	20	2	-	22	1.06253
GMC TRUCKS						
C-K Cab & Chassis	15	11	2	4	13	1.03911
C-K Sierra Pickup	30	28	2	2	30	1.06494
Rally Wagon	8	2	1	6	3	1.04144
S15 Jimmy	4	4	-	-	4	1.04874
S15 Sonoma Pickup	8	8	2	-	10	1.07952
Safari	8	8	-	-	8	1.03165
Suburban	4	4	-	-	4	1.04455
Typhoon	1	-	-	1	-	-
Vandura	10	6	-	4	6	1.06227
Yukon	1	1	-	-	1	1.04702
HONDA						
Accord	19	-	24	19	24	1.00000
Civic	17	15	5	2	20	1.06045
Del Sol	4	4	1	-	5	1.06171
Prelude	7	7	-	-	7	1.08584
HYUNDAI						
Elantra	4	4	-	-	4	1.07221
Excel	8	6	-	2	6	1.04782
Scoupe	5	5	-	-	5	1.04465
Sonata	6	6	-	-	6	1.03041
INFINITI						
G20	2	2	-	-	*	*
J30	1	1	-	-	*	*
Q45	2	2	-	-	2	1.05873

LIFO LOOKOUT EXCLUSIVE

FOR QUICK YEAR-END LIFO ESTIMATES

Make/Model	Total 1993 Item Categories	Continuing	New	Dropped	Weighted	
					Total 1994 Item Categories	Average Intro to Intro
ISUZU						
AUTOMOBILES:						
Stylus	2	-	-	2	-	-
LIGHT-DUTY TRUCKS:						
Amigo	7	4	-	3	4	1.14433
Pickup	6	6	-	-	6	1.07650
Rodeo	9	8	-	1	8	1.10805
Trooper	6	6	-	-	6	1.06822
JAGUAR						
XJ	2	2	2	-	4	1.01849
XJS	2	2	2	-	4	1.01056
JEEP						
Cherokee	12	12	-	-	12	1.04400
Grand Cherokee	6	5	-	1	5	1.07534
Wrangler	4	4	1	-	5	1.05674
LEXUS						
ES 300 Sedan	4	1	-	3	1	1.07746
GS 300 Sedan	2	2	-	-	2	1.06400
LS 400 Sedan	2	2	-	-	2	1.07082
SC 300 Coupe	2	2	2	-	4	1.04484
SC 400 Coupe	1	1	1	-	2	1.04277
LINCOLN						
Continental	2	2	-	-	2	1.01378
Mark VIII	1	1	-	-	1	1.06348
Town Car	3	3	-	-	3	1.03941
MAZDA						
AUTOMOBILES:						
323	2	1	-	1	1	1.07320
626	3	3	1	-	4	1.05496
929	1	1	-	-	1	1.04449
Miata	2	1	-	1	1	1.07519
MX-3	3	2	-	1	2	1.13364
MX-6	2	2	-	-	2	1.10054
Protege	2	2	-	-	2	1.04686
RX-7	1	1	-	-	1	1.04616
LIGHT-DUTY TRUCKS:						
MPV	4	4	-	-	4	1.08723
Navajo	4	4	-	-	4	1.05384
Pickup	9	-	17	9	17	1.00000

LIFO LOOKOUT EXCLUSIVE

FOR QUICK YEAR-END LIFO ESTIMATES

Make/Model	Total 1993 Item Categories	Continuing	New	Dropped	Weighted	
					Total 1994 Item Categories	Average Intro to Intro
MERCEDES-BENZ						
190E Class	4	-	-	4	-	-
C Class	-	-	2	-	2	1.00000
E Class	10	8	-	2	8	0.95954**
S Class	7	7	-	-	7	1.00981
SL Class	4	3	-	1	3	1.00793
MERCURY						
AUTOMOBILES:						
Capri	2	2	-	-	2	0.94857
Cougar	1	1	-	-	1	1.09482
Grand Marquis	2	2	-	-	2	1.00995
Sable	4	4	-	-	4	1.12240
Topaz	2	2	-	-	2	1.06781
Tracer	3	3	-	-	3	1.02441
LIGHT-DUTY TRUCKS:						
Villager	4	4	-	-	*	*
MITSUBISHI						
AUTOMOBILES:						
3000GT	5	5	-	-	5	1.10895
Diamante	3	2	-	1	2	1.11140
Eclipse	10	10	-	-	10	1.04196
Expo	8	4	-	4	4	1.01830
Expo-LRV	6	4	-	2	4	1.15920
Galant	4	-	6	4	6	1.00000
Mirage	11	10	-	1	10	1.15902
LIGHT-DUTY TRUCKS						
Montero	6	3	-	3	3	1.18708
Pickup	5	5	-	-	5	1.09750
NISSAN						
AUTOMOBILES:						
240SX	9	1	-	8	1	1.07264
300ZX	11	11	-	-	*	*
Altima	7	7	-	-	7	1.06871
Maxima	3	3	-	-	3	1.05743
NX	6	-	-	6	-	-
Sentra	18	14	-	4	14	1.09981
LIGHT-DUTY TRUCKS:						
4x2 Pickup	8	3	5	5	8	0.99954
4x4 Pickup	4	2	4	2	6	0.99430
Pathfinder	6	6	1	-	7	1.05653
Quest	4	2	-	2	2	1.06599

LIFO LOOKOUT EXCLUSIVE



FOR QUICK YEAR-END LIFO ESTIMATES

Make/Model	Total 1993 Item Categories	Continuing	New	Dropped	Weighted	
					Total 1994 Item Categories	Average Intro to Intro
OLDSMOBILE						
AUTOMOBILES:						
Achieva	6	4	6	2	10	1.04835
Cutlass Ciera	4	1	2	3	3	1.06008
Cutlass Cruiser	2	1	1	1	2	1.07049
Cutlass Supreme	7	4	3	3	7	1.05678
Eighty Eight	2	2	2	-	4	1.02585
Ninety Eight	4	2	1	2	3	1.02357
LIGHT-DUTY TRUCKS:						
Bravada	1	1	1	-	2	1.01259
Silhouette	1	1	1	-	2	1.01487
PLYMOUTH						
AUTOMOBILES:						
Acclaim	1	1	1	-	2	1.02048
Colt	7	7	-	-	7	1.14711
Laser	4	4	-	-	4	1.01138
Sundance	4	4	-	-	4	1.04352
LIGHT-DUTY TRUCKS:						
Grand Voyager	5	5	-	-	5	1.06150
Voyager	7	4	-	3	4	1.06666
PONTIAC						
AUTOMOBILES:						
Bonneville	3	2	-	1	2	1.04559
Firebird	3	3	1	-	4	1.00000
Grand Am	4	4	2	-	6	1.03406
Grand Prix	5	2	1	3	3	1.05045
Le Mans	3	-	-	3	-	-
Sunbird	6	4	1	2	5	1.06281
LIGHT-DUTY TRUCKS:						
Trans Sport	1	1	-	-	1	1.04071
SAAB						
900 Series	14	-	15	14	15	1.00000
9000 Series	41	21	1	20	22	1.06140
SATURN						
Coupe	4	4	-	-	4	1.03550
Sedan	5	5	-	-	5	1.07005
Station wagon	4	4	-	-	4	1.04516
SUBARU						
Impreza	14	14	-	-	*	*
Justy	6	6	-	-	*	*
Legacy	17	17	19	-	36	1.00961
Loyale	8	2	-	6	2	1.05538
SVX	1	1	-	-	*	*

LIFO LOOKOUT EXCLUSIVE

**1993-1994 MODEL/ITEM CATEGORY INFLATION SURVEY
FOR QUICK YEAR-END LIFO ESTIMATES**

Page 8 of 8

Make/Model	Total 1993 Item Categories	Continuing	New	Dropped	Weighted Total Average 1994 Item Intro to Categories Intro
SUZUKI					
AUTOMOBILES:					
Swift	7	7	-	-	1.08208
LIGHT-DUTY TRUCKS:					
Samurai	2	1	-	1	1.12559
Sidekick	9	9	4	-	1.05855
TOYOTA					
AUTOMOBILES:					
Camry	12	10	5	2	1.05512
Celica	11	-	8	11	1.00000
Corolla	7	7	-	-	1.06567
MR2	4	4	-	-	*
Paseo	2	2	-	-	1.08153
Supra	7	7	-	-	1.06259
Tercel	7	5	-	2	1.05730
LIGHT-DUTY TRUCKS:					
4 Runner	4	4	-	-	1.05512
4x2 Pickup	15	9	-	6	1.06478
4x4 Pickup	11	8	-	3	1.06393
Land Cruiser	1	1	-	-	1.09910
Previa Van	5	4	-	1	1.12325
T100 Pickup	10	10	-	-	1.05318
VOLKSWAGEN					
AUTOMOBILES:					
Cabriolet	4	-	-	4	-
Corrado	2	2	-	-	1.11888
Fox	2	-	-	2	-
Golf III	2	2	-	-	1.02457
Jetta III	2	2	-	-	1.02424
Passat	6	4	-	2	1.11044
LIGHT-DUTY TRUCKS:					
Eurovan	6	-	-	6	-
VOLVO					
240 Series	4	-	-	4	-
850 Series	4	4	4	-	1.01664
900 Series	8	6	3	2	0.98424

* Complete 1994 intro price information is not currently available.

** Index excludes certain item(s) for which 1994 intro price information is not currently available.

Note: In the above compilation, market editions, special editions and "value priced" vehicles (item categories) were considered as new items based on a narrow interpretation of Revenue Procedure 92-79. Accordingly, as new items, they result in a 1.000 index in a '93 to '94 Intro price comparison.

Source: *W.J. De Filippis' Make/Model Analysis Data Base Report*, Preliminary Edition (Copyright, 1993)

LIFO LOOKOUT EXCLUSIVE



Year-End Conformity Requirements...

extending LIFO to another class of goods, such as used vehicles or parts and accessories. In this case, the dealer's year-end statement going to the Factory should also reflect an estimate of the LIFO reserve expected by extending the LIFO election(s) to the additional class of goods under consideration. The projection of year-end change in the LIFO reserve is also usually needed in planning estimated tax payments either for the corporation (due December 15 if a regular C corporation) or by January 15 if the business operates as an S corporation and flows net income, or loss, through to the individual shareholders via Schedule K-1's.

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

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

DIFFERENT YEAR-ENDS FOR BOOK AND FOR TAX PURPOSES

Special reporting situations exist where a different year end is used for reporting to the Factory/Manufacturer/Supplier (calendar year - Dec. 31) than the fiscal year used for income tax return purposes. The Regulations require the financial statements to reflect LIFO at the end of **BOTH** twelve month annual reporting periods or years in order to satisfy this **strict** conformity requirement.

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

(Continued from page 5)

RECALLING NON-LIFO STATEMENTS: THE WILLIAM POWELL CASE

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

The *William Powell Company* decision (81-1 USTC ¶ 9449) illustrates one taxpayer's success (or was it luck?) in avoiding termination of its LIFO election when it came down to "all-or-nothing" on this issue. This case, decided in 1981, involved what would have been the termination of a LIFO election made in 1973 because at the end of the first LIFO year, the taxpayer had issued non-LIFO statements and then later made a LIFO election when it filed its tax return. In that case the taxpayer recalled its non-LIFO statements and replaced/reissued LIFO statements to all the banks, creditors and shareholders before the income tax return for the first year was filed. The taxpayer probably would have lost its LIFO election if it had gone to the Tax Court, but the taxpayer can choose the forum in which it will litigate a LIFO controversy...and the *Powell* Company chose (wisely) to litigate this issue in the District Court in Ohio.

Powell took the position that it had not "used" FIFO within the meaning of Section 472(c). Its position with respect to Section 472(c)(2) was that non-LIFO "worksheets" were not used for "credit purposes," since the credit had been extended prior to the delivery of the worksheets. The District Court accepted that. With respect to Section 472(c)(1), *Powell* contended that use is determined at the time of the LIFO election and that this election need not be made until the taxpayer files its return. At the time *Powell* elected LIFO, it was no longer "using" the FIFO statements, inasmuch as they had been recalled prior to the election and LIFO statements had been reissued.

The District Court, while agreeing that *Powell's* activities seemed to violate the plain language of Section 472(c)(2), was hesitant to strictly apply the "plain meaning rule" in this case. The Court said that it is the general rule that the words of a revenue statute are interpreted "in their ordinary, everyday senses" and a rigid application of this rule would not be consistent with the Commissioner's ongoing interpretation of the conformity requirement. See accompanying box on page 3: "What the District Court said in *William Powell*."

INSILCO AND ITS AFTERMATH

Here's another example of how seriously the Treasury/IRS polices the LIFO conformity requirement: Consider the origin of current Code Section 472(g). This subsection was added because the IRS lost the *Insilco* decision in the Tax Court. This case involved a subsidiary using LIFO who reported to its parent corporation using see **YEAR-END CONFORMITY REQUIREMENTS...**, page 19



Tax Court Terminates LIFO Election...

(make that insurmountable) difficulty in repricing its parts and machinery and equipment as those inventories changed due to technological advancements and as the years progressed farther and farther away from the 1970 base year.

2. As a Caterpillar dealer, the taxpayer, at one time or another, had in its hands all the information it might have needed, as well as detailed monthly records which might have been of some use. Couldn't much of this information be reasonably reconstructed or documented?

3. The taxpayer had pleaded guilty to a conspiracy to defraud the United States and certain counties in Oklahoma, and these tax evasion and mail fraud charges may have whetted the appetite of the Internal Revenue Service to "lay it on" this taxpayer wherever the opportunity presented itself.

4. The entire deficiency in tax arising from the termination of the LIFO election was subject to the additional 50% fraud penalty!! The applicable code section provides that "if any part of the underpayment...of the tax required to be shown on a return is due to fraud, there shall be added to the tax an amount equal to 50% of the underpayment." After examining various indicia (or badges) of fraud, the

(Continued from page 4)

Tax Court found enough of them present to sustain the fraud penalty. Because 1980 was the year the IRS "chose" to terminate the LIFO election, all (100%) of the deficiency due to the recapture of the LIFO reserves in the year of termination was also hit with fraud penalty!! The kickbacks deducted over 1979-1980-1981 for all three years were "only" \$85,000 - yet these deductions for kickbacks ended up exposing all of the LIFO reserve recapture in 1980 to the 50% fraud penalty!

BOECKING'S FACTS AND THE ISSUES

In 1970, the Company filed Form 970, Application to Use LIFO Inventory Method. It elected to use the dollar-value, double-extension, earliest acquisitions methods. It also used two pools: Pool #1 - Caterpillar and Towmotor Parts; and Pool #2 - Caterpillar and Towmotor Machines, Engines and Equipment. As of the beginning of calendar year 1980, its LIFO reserves were over \$2,900,000. The additions and reductions to the Company's LIFO reserves during the years in 1980 through 1984 were \$2,100,000, \$850,000, \$650,000, \$220,000, and a reduction of \$2,250,000, respectively.

In defending its LIFO election, the taxpayer asserted three positions. First, its method clearly reflected income. see **TAX COURT TERMINATES LIFO...**, page 20

WHAT ABOUT LETTER RULING 9343001 ON BOOKS AND RECORDS?

Letter Ruling 9343001, dated June 25, 1993, involves a situation where the examining agent threatened to terminate the taxpayer's use of the LIFO method by questioning:

1. The means by which the taxpayer sampled its inventory to calculate a price index,
2. The number of pools that the taxpayer maintained, and
3. The taxpayer's use of a fixed cost complement in reducing its inventory from retail to cost.

Because of these problems, the examining agent had proposed that the taxpayer recompute the valuation of its ending inventory. The taxpayer's position was that it was unable to recalculate its inventory in the manner proposed by the examining agent because it had not maintained the detailed records necessary for it to redetermine its sample and make other inventory calculations. It was because of this lack of records (i.e., the lack of records to support alternative LIFO calculations that the agent asserted were more appropriate) that the examining agent proposed to terminate the taxpayer's LIFO election in accordance with Section 3.01(d) of Revenue Procedure 79-23.

In this Technical Advice/Letter Ruling 9343001, the taxpayer's LIFO election was not terminated. In its analysis, the National Office indicated that "even if the District Director determines that the taxpayer's sample is inadequate, an inadequate sample is a computational error within the meaning of Section 3.02(a)." Similarly, the National Office held that the selection by the taxpayer of fewer inventory pools than determined by the examining agent did not warrant termination of the LIFO election. Finally, the use of a fixed cost complement with which the examining agent disagreed also is a computational error within the meaning of Section 3.02(a) and did not warrant termination of the LIFO election.

In addressing the "books and records" provision in Revenue Procedure 79-23, the IRS National Office indicated that the taxpayer's LIFO election should not be terminated because the issue is not the adequacy of the taxpayer's records, but rather the means by which the taxpayer computed its price index. The National Office interpreted all of these errors in computing the LIFO price indexes, even collectively, as not warranting termination of the taxpayer's LIFO election. Certainly the taxpayer's LIFO computations were required to be adjusted to reflect the IRS' computational interpretations, but at least the LIFO inventory election was not lost.

...AND WHAT ABOUT LETTER RULING 8851001?

A few years earlier, in Letter Ruling 8851001 the IRS held that a taxpayer's LIFO election would not be terminated under Section 3.01(d) of Revenue Procedure 79-23 in a situation where the taxpayer's books and records supported the taxpayer's current LIFO computations but were not adequate to enable the IRS examining agent to compute the LIFO valuation under an alternative method that he considered more appropriate in the taxpayer's circumstances. Letter Ruling 8851001 concluded that Revenue Procedure 79-23 contemplates "that the taxpayer's books and records need not substantiate any computation other than the taxpayer's current method of inventory valuation." The fact that the taxpayer's records were inadequate to value the inventory in any other manner that the examining agent may consider appropriate did not change the result since the taxpayer's books and records were adequate to support its own LIFO computations.

Query: How does the liberal logic in Letter Rulings 9343001 and 8851001 reconcile to the punitive result in *Boecking*?



WHAT THE TAX COURT SAID IN *BOECKING*

Inventory valuation constitutes a method of accounting which is governed by Sections 446 and 471. Sections 446 and 471 grant the Commissioner broad discretion in matters of inventory accounting and give the Commissioner wide latitude to adjust a taxpayer's method of accounting for inventory so as to clearly reflect income. For tax purposes the requirement that a method of accounting clearly reflect income is paramount. Even if a method of accounting comports with generally accepted accounting principles, where such method does not clearly reflect income, such method will not control for tax purposes.

The Commissioner's determination with respect to clear reflection of income is entitled to more than the usual presumption of correctness, and the taxpayer bears a heavy burden of overcoming a determination that a method of accounting does not clearly reflect income. Whether a particular method of accounting clearly reflects income is a question of fact which must be decided on a case-by-case basis.

Section 471 provides two tests to which each inventory must conform: (1) It must conform as nearly as may be to the best accounting practice in the trade or business, and (2) It must clearly reflect the income. Section 472(a) authorizes the use of LIFO subject to the condition that the taxpayer abide by "such regulations as the Secretary may prescribe as necessary in order that the use of such method may clearly reflect income." Regulations Section 1.472-2(h) provides that the records and accounts employed by the taxpayer in keeping his books shall be maintained in conformity with the inventory method referred to in Section 1.472-1; and such supplemental and detailed inventory records shall be maintained as will enable the District Director readily to verify the taxpayer's inventory computations as well as his compliance with all other LIFO requirements.

The Commissioner has the discretion to approve or reject a taxpayer's application for the adoption and use of the LIFO inventory method. The Commissioner also possesses the discretion to examine the electing taxpayer's tax returns and books and records pertaining to the LIFO method utilized in order to determine whether the taxpayer will be permitted to continue to utilize the LIFO method elected.

Revenue Procedure 79-23 provides for the disallowance or termination of a LIFO election when the taxpayer has failed to maintain adequate books and records with respect to its LIFO inventory and all computations incident thereto. The Commissioner's determination as to the proper method of accounting for inventory must be upheld unless shown to be plainly erroneous.

FAILURE TO CLEARLY REFLECT INCOME: STRIKE ONE... ¶

When the Company elected LIFO, it agreed to keep detailed inventory records which would comply with Section 472 and the regulations. It further agreed to compute its inventory utilizing the specific LIFO method originally elected on Form 970 (i.e., the dollar-value, double-extension, earliest acquisitions costs method).

The Company, however, did not keep detailed inventory records as contemplated by Section 472 and the regulations thereunder. Nor did it compute its inventory utilizing the specific LIFO method originally elected on Form 970. It did not use the value of the current quantities in ending inventories as it had elected to do, but instead it used each prior year's ending inventory value and each prior year's corresponding base-year cost in developing its index percentage. The use of prior year ending inventory values resulted in an inaccurate cost calculation of the current year ending inventory which caused a distortion of income.

Because the Company failed to keep adequate books and records relating to its LIFO inventory method and failed to properly develop its index percentage, the LIFO method utilized by the Company did not clearly reflect its income. Because the LIFO method employed by the Company did not clearly reflect income, such method fell short of being an acceptable adaptation of the LIFO method originally elected by the Company in 1970. Accordingly, the IRS had the authority to terminate the Company's LIFO method as of January 1, 1980.

The Tax Court dismissed as "unpersuasive" the taxpayer's argument that all differences between the Company's computation of LIFO and the IRS' computation of LIFO are merely timing differences which, when consistently observed, do not distort income. The taxpayer's other arguments on this issue were also found to be without merit.

NO TACIT APPROVAL OF LIFO IN PRIOR IRS AUDITS: STRIKE TWO... ¶

The IRS was not estopped from terminating the Company's LIFO election on the ground that no adjustments had been proposed to the LIFO valuations during earlier IRS examinations of the Company's tax returns for the years in issue and prior years. The taxpayers did not establish that the scope of the prior examinations included any analysis of the Company's LIFO methods. We (i.e., the Tax Court) have consistently held that the IRS' mere acquiescence in the treatment of an item in prior years does not preclude future adjustment in later years. (Note: Lengthy citations to case law are included in the decision on this point.)

NO ABUSE OF DISCRETION BY THE IRS: STRIKE THREE... ¶

The Company's assertion that the IRS' termination of the LIFO method constituted an abuse of administrative discretion and was arbitrary and unreasonable was found to be without merit. The Tax Court said: "Petitioners did not offer a shred of evidence to support this accusation." When the taxpayer's inventory accounting method does not clearly reflect income, the IRS may require the taxpayer to use a method that clearly reflects income even without a showing of bad faith on the part of the taxpayer.

T.C. Memo 1993-497, October 27, 1993; Lengthy citations omitted, emphasis added.



SOME QUESTIONS STILL NEED ANSWERS

REVENUE PROCEDURE 92-79: ALTERNATIVE LIFO METHOD

Unanswered questions still cloud the computation of auto dealer inflation indexes under the Alternative LIFO Method. These are summarized below, with references to discussions in prior issues of the *LIFO Lookout*.

"ITEM CATEGORIES" DETAIL TROUBLES MANY CPAS
ARE YOU GOING AS FAR AS YOU SHOULD?
IF YOU'RE USING SOFTWARE, IS IT?

A glance at the '93-'94 model item category inflation summary gives you an idea of how many different item categories there can be for AltLIFO computation purposes. See How Far Do You Have To Go In Determining "Item Categories", March, 1993, page 6 and IRS reply September, 1993, page 2, in which the IRS answered: "All the way down...as far as you can go!"

ARE THESE "NEW" ITEMS FOR 1994?
WHAT ABOUT MARKET EDITIONS, SPECIAL EDITIONS AND "VALUE PRICED" VEHICLES?

Acura 4-dr Sedan	Honda Civic EX and DX
Chevrolet S10 Pickup	Hyundai Excel 4-dr Sedan
Chevrolet Beretta Z26	Mitsubishi Expo
Chevrolet Corsica	Oldsmobile Ciera Special Edition
GMC Truck S15 Sonoma Pickup	

ARE MINIVANS CARS OR TRUCKS?
IF SO, UNDER WHAT CIRCUMSTANCES?
LETTER RULING 9332003

IRS Letter Ruling 9332003 (mentioned in September, 1993 issue, LIFO Update Item #7) held that a dealer's minivans belonged in the auto pool because those minivans were essentially substitutes for station wagons. These particular minivans were not built on truck chassis. This seems to have confused many people. Why does IRS muddy the water when customary business classification clearly placed minivans in the light-duty truck category?

Before changing treatment of minivans in '93 year-end inventories, consider (1) this letter ruling has no precedential value and it applies only to the taxpayer who received it and (2) filing of Form 3115 Change in Accounting Method implications - timely filing, permission required, etc.

WHEN DOES A DEALER NEED MORE THAN ONE POOL FOR AUTOS OR FOR TRUCKS?...WHAT DOES "SEPARATE TRADE OR BUSINESS" REALLY MEAN?

See March, 1993 *LIFO Lookout*, page 3 discussion, followed by IRS unofficial response at September, 1993 Motor Vehicle Industry seminar reported in September, 1993 *LIFO Lookout* on page 3.

AFTER JANUARY 1, 1994, DEALERS CHANGING TO THE ALTERNATIVE LIFO METHOD FACE GREATER RISKS UNDER REVENUE PROCEDURE 92-20

These Rev. Proc. 92-20 new Form 3115 filing mechanics for changes to AltLIFO method require filing within the first 180 days of the year of change. IRS may not automatically allow cut-off method amnesty for prior LIFO reserves. If taxpayer has been notified for audit by IRS before Form 3115 is filed, considerably more detrimental terms and conditions may apply to the change in method.

IS AMNESTY PROTECTION AVAILABLE FOR COMPUTATIONAL ERRORS?

It is not really difficult to compute and reconcile the mathematical accuracy of LIFO reserves as a function of (1) inflation indexes and (2) years on LIFO. Many CPAs have gone back and checked their own calculations and found computational errors or errors in carrying back later decrements against earlier increments affecting the overall valuation of the LIFO inventories. What should be done?

See discussion in March, 1993 *LIFO Lookout* at page 3 under "cut-off method protection." Also see LIFO Seminar Day, II-Advanced Applications manual.

ARE COMPUTATIONAL ERRORS (AS DISTINGUISHED FROM INDEX METHODOLOGIES) TO BE PROTECTED AND GRANDFATHERED IN REBASED LAYERS?

(Continued) →

De Filippis' LIFO LOOKOUT



FOR DEALERSHIPS THAT JUST STARTED BUSINESS THIS YEAR, WHAT DO YOU USE FOR BEGINNING-OF-THE-YEAR PRICES?

For dealers who have not been in business for a full year, how are they to reprice current year ending inventory item categories? Rev. Proc. 92-79 indicates that the repricing of an item in existence in the prior year, but not on hand at the end of the prior year, is made by reference to the manufacturer's price list in effect as of the beginning of the last month of the prior taxable year.

Consider a dealer starting business on October 1, 1993 whose tax year ends December 31, 1993. Is the reference date for beginning-of-the-year repricing purposes December 1, 1992 or should it be September 1, 1993? Or should it be some other date? Or should it be the date of the first purchase of a vehicle in that item category?

LIFO Update

(Continued from page 1)

#6. COMPONENTS-OF-COST UPDATE. Nothing new to report...at this time. However, a major storm is on its way right now and it is due very soon.

#7. PARDON THE PLUG... Let us make your LIFO life easier this year...by using our database or having us do all your LIFO calculations. You'll save time, money, supervision problems and costs, and avoid

deadline problems. If you're at the NADA Convention in San Francisco in January, stop by our Booth #3463 or call for more information.



Year-End Conformity Requirements...

(Continued from page 15)

LIFO but the parent corporation reported its consolidated earnings (which included those of the LIFO-user subsidiary) to its own shareholders on a non-LIFO basis.

In upholding the taxpayer, the Tax Court told the IRS that if it didn't like the result, it should get Congress to change the law. And that's exactly what the IRS/Treasury did! After its loss, the Treasury persuaded Congress to change the law (which it did by amending Section 472 to add subsection (g)) so that taxpayers in

the **future** couldn't get around the conformity requirement the way *Insilco* had.

The bottom line is that the IRS takes all of these conformity requirements seriously. On many audits, instead of assuming that the taxpayer has complied, the IRS asks for proof that all financial statements at year-end were not in violation of the LIFO conformity requirements. Don't be a nonconformist or let these requirements cost a LIFO election. *



De Filippis' LIFO LOOKOUT

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Tax Court Terminates LIFO...

(Continued from page 16)

Second, its method of calculating the LIFO reserves had been tacitly approved by the IRS because no adjustments thereto were made during earlier tax audits and thus the IRS was estopped from subsequently terminating the Company's LIFO election. Third, its position was that the IRS' **termination of the Company's LIFO method as of January 1, 1980**, the earliest open year on this issue, was arbitrary, unreasonable and an abuse of discretion.

The IRS position was that it had the authority to terminate the Company's LIFO election as early as January 1, 1980. The IRS asserted that due to the Company's failure to maintain certain required books and records, the Company's method of valuing its LIFO reserves did not comport with the method elected by the Company in 1970, and, accordingly, the method utilized by the Company did not clearly reflect its income.

The brief filed with the Tax Court contains extensive stipulations relating to the LIFO inventory computations, problems the IRS raised in what the taxpayer did for LIFO purposes and key statements regarding errors in sampling. Stipulations 11 through 133 point out the need for retaining invoices (which seems to be possible) and making accurate computations (which seems to be impossible in situations like this) where technologically changing inventories are involved and the double-extension method has been elected on Form 970. **Clearly from a LIFO technicality standpoint, the link-chain, index method would have been preferable to the double-extension method; but from a practical standpoint within the context of the *Boecking* fact pattern, would it really have made any difference?**

Another interesting observation from the brief is that the Company relied principally on a report and expert witness testimony which the Tax Court did not fully accept because the Company's expert had relied only on the CPA's workpapers and the Company's inventory account sheets and extensions of physical inventory at replacement cost. What the expert had not done was to go beyond the workpapers to test invoices and the Tax Court noted that "it is beyond those workpapers where the errors are present." For more of what the Tax Court said in *Boecking*, see page 17.

From all of this, it appears that the IRS will aggressively interpret Section 3.01(d) of Revenue Procedure 79-23 in situations where the facts (apparently including the inability of the taxpayer to submit alternative calculations) support a "termination position." One tax reporter (Commerce Clearing House ¶ 48,088(M)) summarizes *Boecking* as follows: "The IRS properly terminated a corporation's election to value inventory under the LIFO method where adequate records were not maintained, an index was not properly computed, and inventory was not computed using the specific LIFO method originally elected. Use of each prior year's ending inventory value and each prior year's corresponding base year cost in developing an index percentage, rather than the use of the value of the current quantities in ending inventories as the company had elected, resulted in an inaccurate cost calculation of the current-year ending inventory and a distortion of income." Although this accurately describes the *Boecking* LIFO issues, the result seems to be inconsistent with Section 3.02 of Revenue Procedure 79-23 which describes computational errors, etc. as not warranting the disallowance or termination of a LIFO election. Also related are Letter Rulings 9343001, issued mid-1993, and 8851001, both of which evidence a more liberal interpretation of the "books and records" provision. See the accompanying box on page 16.

Letter Rulings such as 9343001 and 8851001 may not be used or cited as precedent. But one must surely wonder about the parity of treatment or interpretation of Section 3.01(d) of Revenue Procedure 79-23 that *Boecking* received in the hands of the Tax Court relative to the treatment the taxpayers in Letter Rulings 9343001 and 8851001 received from the National Office. Absent the fraud and county scandal portions of the fact pattern - and they clearly are not integral to the LIFO calculations in any way - ...haven't we all seen LIFO computations and applications that might be interpreted the same way as *Boecking's*?

As a footnote (and here's one for *Ripley's*), I was told that *Boecking* was the examining agent's first encounter with a taxpayer on LIFO. In my book, that qualifies him for the 1993 "LIFO Liquidator of the Year Award." ✱

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