De Filipps' LIFO LOOKOUT

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

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# LIFO UPDATE

If you had called me personally to ask "what's happening lately with LIFO that I need to know about?"...Here's what I'd say:

As we start our fourth year of publication, let me simply say: THANKS FOR BEING A SUBSCRIBER...WHETHER THIS IS YOUR FIRST ISSUE OR YOUR 13TH. When I first considered writing a quarterly publication exclusively on LIFO, I wondered if there would be enough material to make each issue worth your time and money. But with recent events, including *Hamilton Industries*, *Boecking Machinery*, and Revenue Procedures 92-20 and 92-79, my problem has not been with having enough material...it has been with keeping the length of each issue **down**.

Each issue of the *Lookout* tries to balance in-depth and more technical articles with practical applications and examples you can use based on my own LIFO consulting activities. I also try to **balance** - if that's the right word - coverage of LIFO matters of general interest to all readers (regardless of special application) with coverage of LIFO matters of special interest to CPAs for auto dealers. Revenue Procedure 92-79's Alternative LIFO Method has recently received considerable attention (which it deserves) and it has vindicated what I've been saying, teaching and applying to auto dealers for more than 20 years. However, many other significant events are in the works...and the *LIFO Lookout* will shift its focus each quarter - as it has in the past - to deal with these emerging developments, rulings and LIFO tax cases.

Some readers suggested a "LIFO Year in Review" article summarizing 1993 changes and developments. I've resisted the urge to do this, not out of laziness, but because you can do this easily enough for yourself by taking your four 1993 issues of the *LIFO Lookout* and simply rereading the "LIFO Update" column. My objective in this Update column each quarter is to summarize what's new and interesting. Some developments like *Boecking Machinery*, *Hamilton Industries*, the IRS Motor Vehicle Industry Seminars or Revenue Procedures 92-20 and 92-79 warrant and have received more coverage in feature length articles. So there's not much to be gained by reprinting the four 1993 Update columns and calling the compilation the "LIFO Year in Review."

For your convenience, an index of the major articles appearing in the *LIFO Lookout* over the last three years begins on page 15.

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**#1. COMPONENTS-OF-COST: THE IRS SAYS: "NO!".** Recent issues of the *Lookout* have been warning that the use of the components-of-cost method for computing LIFO inflation indexes by manufacturers was under close scrutiny by the IRS. Update #6 in our last issue predicted a major storm on the way and due to arrive soon. In February, the official text of Letter Ruling 9405005 was released under the Freedom of Information Act. In this ruling, the IRS held that the taxpayer could not use its components-of-cost method in computing its LIFO indexes.

Last year, the *Lookout* (June, 1993) referred to this LIFO controversy as an absolute disaster in the making: "To date, the IRS and the AICPA - in typical lawyerly fashion - have both carved out their technical positions, providing the other with no opportunity for graceful retreat or face saving. The IRS has said: 'No, you can't use this method.' The AICPA has said: 'Yes we can, it's been used for all these years and it satisfies Generally Accepted Accounting Principles'...The components-of-cost issue will be particularly difficult to resolve because, over the last 30-plus years, the IRS has never addressed the use of link-chain, index computations directly in the Regulations. Link-chain indexes are integral to many manufacturers' LIFO elections and particularly to their use of components-of-cost (as opposed to product costing) LIFO methodologies.

see **LIFO UPDATE**, page 6

# IRS DISALLOWS COMPONENTS-OF-COST LIFO METHOD

The taxpayer involved in this Letter Ruling undoubtedly is a world-wide organization having enormous inventories and huge dollars at stake in this issue. The taxpayer had filed its first LIFO election under Section 22(d) of the Internal Revenue Code of 1939: This gives you some idea of how long ago the LIFO election was made. Apparently over the years, numerous extensions of the original LIFO election were made to other inventories until it reached the point that the bulk of the taxpayer's inventories were on LIFO. Taxpayer used the dollar-value LIFO method to determine the costs of its inventories in two Natural Business Unit pools and used the link-chain method to compute the LIFO value of these NBU pools.

In conjunction with its link-chain method, taxpayer uses a so-called "components-of-cost" method to compute the current-year and prior-year cost of its inventory. Under its components-of-cost method, each of taxpayer's NBU pools consist of only three types of items: raw materials, labor, and overhead. At the end of each taxable year, taxpayer extends the quantity of each of its items on hand by their current-year unit cost and their prior-year unit cost. These extensions are then totaled to determine a total current-year cost and a total prior-year cost.

Taxpayer computes its index for the **raw material component** of work-in-process and finished goods by valuing the quantities of unprocessed raw materials in ending inventory at current-year unit costs and prior-year unit costs. Taxpayer computes its index for the **labor component** of work-in-process and finished goods by using average hourly labor rates. The index for the **overhead component** of work-in-process and finished goods is computed by comparing the overhead component of the work-in-process and finished goods in ending inventory (valued using the current overhead rate per labor dollar) with an amount equal to the labor dollar component of the work-in-process and finished goods in ending inventory, deflated by the labor index, and multiplied by the overhead rate per labor dollar for the prior year.

An annual price index is determined by dividing the current-year cost of the ending inventory by the prior-year cost of the ending inventory. The annual index is then multiplied by the prior year (cumulative) index to determine a cumulative index. Finally, the base-year cost is calculated by dividing the current-year cost of ending inventory by the cumulative index.

The Appeals Officer concluded that taxpayer's components-of-cost method is not permitted under Section 1.472-8(e)(2)(i) of the regulations and does not clearly reflect income. The Appeals Officer proposed that taxpayer should change to a so-called "product-cost" method under which items used to compute the base-year and prior-year cost of its inventory would be individual products rather than individual cost elements or components (e.g., materials, labor and overhead). In effect, the IRS is holding that neither labor nor overhead is an "item" for LIFO purposes.

The IRS ruling analyzes the inventory Section 471, as well as the LIFO Section 472, of the Code and Regulations as background for concluding, after a lengthy analysis, that Regulation Section 1.472-8(e)(2)(i) does **not specifically** permit the use of the components-of-cost method (as applied by the taxpayer) to compute a price index.

Despite so holding, the IRS indicated that although the LIFO regulations do not specifically permit the taxpayer's components-of-cost method, the Regulations do not proscribe the components-of-cost method either. "Taxpayer's components-of-cost method may be appropriate to the extent it results in the clear reflection of taxpayer's income. However, based on the facts presented in this case, taxpayer's use of the components-of-cost method does not result in a clear reflection of its income."

The IRS cited *Thor Power Tool Co.* (1979) and *Lucas v. Kansas City Structural Steel Co.* (1930) to establish that it has **great** discretion in determining when a method of accounting for inventory clearly reflects income. After citing *Hamilton Industries* (1991) and *Amity Leather Products Co.* (1984), the IRS indicated its belief that the "correct standard by which to measure whether taxpayer's LIFO method clearly reflects income is whether the costs matched against sales revenue reflect the costs required to replace the inventory sold."

The IRS noted that in certain circumstances, the taxpayer's components-of-cost method may result in a deduction greater than the cost required to replace the inventory sold. This additional deduction occurs as a result of the mechanical process used to compute the price index. In accordance with Section 1.472-8(e)(2)(i) of the Regulations, at the close of each taxable year taxpayer extends the quantity of each item in its Natural Business Unit (NBU) inventory pools at both prior-year unit cost and current-year unit cost. To the extent that quantity inputs in the current year are lower than quantity inputs in the prior year, the extended prior-year cost may be at a level lower than actually possible to manufacture the underlying product in the prior year.

According to the IRS, the taxpayer's components-of-cost method also had other flaws related to the costs used. Specifically, the taxpayer's use of average labor hourly rates did not adequately capture differences in labor grades. Similarly, taxpayer's use of an overhead rate based on its labor rate did not adequately reflect distinctions in overhead costs.

see **IRS DISALLOWS...**, page 4

# COMPONENTS-OF-COST METHOD FOR LIFO INDEX COMPUTATIONS

## LTR 9405005 (OCTOBER 5, 1993)

| ISSUES | IRS' HOLDINGS |
|---|---|
| 1. Does Section 1.472(8)(e)(2)(i) of the Income Tax Regulations specifically permit taxpayer to use a so-called "components-of-cost" method to compute a price index under the dollar-value, last-in, first-out (LIFO) inventory method? | 1. Section 1.472-8(e)(2)(i) of the regulations does not specifically permit taxpayer to use the components-of-cost method to compute its LIFO price index under the dollar-value, LIFO method. |
| 2. Does taxpayer's use of the components-of-cost method result in its income being clearly reflected? | 2. Taxpayer's use of the components-of-cost method does not result in the clear reflection of its income. Taxpayer's particular method does not clearly reflect income because it does not properly take into account the technological changes which occurred during the years at issue. Accordingly, taxpayer's use of the components-of-cost method should be disallowed. |
| 3. Is taxpayer required to change to a so-called "product-cost" method or may it use a components-of-cost method that clearly reflects its income? | 3. Unless taxpayer is able to demonstrate to the satisfaction of the Appeals Officer that an alternative components-of-cost method does not distort income, taxpayer will be required to change to a product-cost method of determining a price index. Although an accurate product-cost method will result in the clear reflection of taxpayer's income, it is within the discretion of the Appeals Officer to approve any proposed mechanism of determining a price index, so long as such method satisfies the concerns expressed herein. |
| 4. If taxpayer is not permitted to use the components-of-cost method, may this ruling be applied without retroactive effect pursuant to the Commissioner's discretionary authority under Section 7805(b) of the Internal Revenue Code? | 4. Taxpayer's request for relief under Section 7805(b) of the Code is denied. Accordingly, taxpayer may not apply this ruling without retroactive effect. |
| 5. If taxpayer is not permitted to use the components-of-cost method, is an adjustment required under Section 481(a) of the Code? | 5. An adjustment under Section 481(a) is required because a change from the components-of-cost method will result in a change in method of accounting, and such change will result in the duplication or omission of income. |

## IRS Disallows Components-Of-Cost Method

(Continued from page 2)

While agreeing that a new item may result when technological change occurs, the IRS said that when *substantial* changes occur in the manufacturing cost of a product, for the LIFO method to function properly, the product may be considered a new item with its own base year.

The IRS pointed out that taxpayer's argument did not represent a realistic application of the product-cost method. For this approach to yield the same result as the components-of-cost method, *small incremental* quantity reductions in the units of input would necessarily result in the creation of a new item. Anytime *any* change occurs in a manufacturing process, a taxpayer would be required to treat the improved production process as creating a new item.

The foundation for the holding in *Wendle Ford Sales* was that adjustments for minor modifications in the composition of a product would impose an unreasonable administrative and computational burden on the taxpayer. The avoidance of such a burden was one of the benefits of dollar-value LIFO. In discussing this inventory method, the Court in *Wendle Ford Sales* had said: "By eliminating the need to match specific goods in opening and closing inventories and focusing instead on the total dollars invested in inventory, dollar-value LIFO necessarily ignores minor changes in the design of a product from year to year." Yet, at some point, there is clearly what would be considered to be a new product for which unreconstructed base-year costs would not be representative.

Although a manufacturer is in the position to determine the point at which a new product is created that would require treatment as a new item, the IRS would not agree with the taxpayer's premise that new items would result from every incremental change.

Based on this analysis and its dismissal of the taxpayer's other arguments, the IRS concluded that it did not believe that the taxpayer's **particular method** of determining its price index clearly reflects income and that consequently, taxpayer's components-of-cost method was not an appropriate means by which it should be allowed to compute its price inflation indexes.

The IRS softened the blow a little bit by stating that "although we do not believe that taxpayer's present use of the components-of-cost method results in a clear reflection of its income, it is not our position that all components-of-cost methods necessarily fail to clearly reflect income. Accordingly, any particular method must be examined on a case-by-case basis." (Note: Will the IRS issue further guidelines on this sometime in the foreseeable near future?)

"Therefore, unless taxpayer is able to demonstrate to the satisfaction of the Appeals Officer that an alternative components-of-cost method does not distort income, taxpayer will be required to change to a product-cost method of determining a price index. Although an accurate product-cost method will result in the clear reflection of taxpayer's income, it is *within the discretion of the Appeals Officer to approve any proposed mechanism* of determining a price index, so long as such method satisfies the concerns expressed herein."

The taxpayer requested that if it were required to change from the components-of-cost method, that it be allowed to do so on a **prospective** basis and it presented a number of arguments in support of this request. One of its arguments was that it had relied on the IRS "position" as contained in the *LIFO Method of Inventory Valuation Training Manual* (Training 3127-01) issued in June of 1976. The Service pointed out that on its cover, the Training Manual states that the material was designed specifically for training purposes only, and "under no circumstances should the contents be used or cited as authority for setting or sustaining a technical position." (Citations omitted) The IRS declined to consider the change as one that could be made on a prospective basis.

The last issue raised was whether the taxpayer would be required to make an adjustment under Code Section 481(a). This section provides that if in computing taxable income for any taxable year, such computation is under a method of accounting different from the preceding taxable year, then there shall be taken into account those adjustments which are necessary solely by the reason of the change in order to prevent amounts from being duplicated or omitted. Thus, an adjustment is required under Section 481(a) if (1) there is a change in the method of accounting and (2) such change results in the duplication or omission of income.

The taxpayer contended that its components-of-cost method of determining a price index is not a method of accounting because the method may not necessarily always distort taxable income. The IRS did not agree. It cited Regulation Section 1.446-1(e)(2)(ii)(a) which provides that a change in accounting method includes a change in the treatment of any material item. A material item is any item which involves the proper time for the inclusion of the item in income or the taking of a deduction. Also, a change in method of accounting includes a change involving the method or basis used in the valuation of inventories. Since taxpayer's consistent use of the components-of-cost method involves the accounting treatment of a material item and the basis used to value inventory, the IRS held that it was an accounting method.

Finally, although the IRS did agree that there is no duplication of income or expense to the extent a "cut-off" approach is used, the limited exceptions allowing the use of the cut-off method for certain LIFO inventory accounting method changes did not include the taxpayer's situation. Accordingly, the Service held that an adjustment would be required under Section 481(a) of the Code.

# IRS' CONCERNS ABOUT COMPONENTS-OF-COST

A manufacturer of widgets adopts in Year One the dollar-value, LIFO method, and elects to use the link-chain method to compute the LIFO value of its inventory in a single NBU pool. At the end of Year One, the taxpayer has a single widget in its inventory, composed of the following costs:

| | | | | | |
|---|---|---|---|---|---|
| Material | 1 unit | @ | $2.00 | = | $ 2.00 |
| Labor | 2 units | @ | 5.00 | = | 10.00 |
| Overhead | 1 unit | @ | 1.00 | = | 1.00 |
| | | | | | $13.00 |

Because the taxpayer adopted the LIFO method for Year One, the Year One price index will be 100%.

In Year Two, the taxpayer manufactures another widget, but because of a more efficient production process needs only one labor unit to manufacture it. The Year Two costs to produce the widget are:

| | | | | | |
|---|---|---|---|---|---|
| Material | 1 unit | @ | $2.50 | = | $ 2.50 |
| Labor | 1 unit | @ | 8.00 | = | 8.00 |
| Overhead | 1 unit | @ | 1.50 | = | 1.50 |
| | | | | | $12.00 |

Thus, at the end of Year Two, the taxpayer determines its price index in the following manner:

| Current-Year Cost * | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | | | | | | Prior-Year Cost ** | | | | |
| Material | 1 | @ | $2.50 | = | $ 2.50 | 1 | @ | $2.00 | = | $ 2.00 |
| Labor | 1 | @ | 8.00 | = | 8.00 | 1 | @ | 5.00 | = | 5.00 |
| Overhead | 1 | @ | 1.50 | = | 1.50 | 1 | @ | 1.00 | = | 1.00 |
| | | | | | $12.00 | | | | | $ 8.00 |

* Year Two Quantity times (x) Year Two Costs

** Year Two Quantity times (x) Year One Costs

The taxpayer's Year Two price index is 150% (determined by dividing the $12.00 current-year cost by the $8.00 prior-year cost). Under the link-chain method, the cumulative index is 150% (determined by multiplying the 150% Year Two price index by the 100% Year One price index). Accordingly, the taxpayer's ending inventory at base-year cost is $8.00 (determined by dividing the $12.00 current-year cost by the cumulative index of 150%).

When the taxpayer determined its total prior-year cost in Year Two, it multiplied the Year One costs by the Year Two quantity. Thus, to determine the prior-year cost of labor, the taxpayer multiplied the $5.00 Year One labor cost by the one unit of labor required to manufacture the widget in Year Two. The problem with this approach is that in Year One, it was not possible to manufacture a widget in a single hour. To the extent the prior-year's labor cost is artificially low, the total prior-year costs, and thus the denominator used in calculating the price index, will be artificially low. This lower denominator results in a higher price index and a relatively lower ending inventory at base year cost.

In contrast, if prior-year labor inputs reflect the inputs at which the widget could have been produced in Year One, prior-year labor costs would be $10.00 (2 hours at $5.00), and the total prior year's costs would be $13.00. The Year Two price index would be 92% (determined by dividing current-year costs of $12.00 by prior-year costs of $13.00). The cumulative price index would be 92%. Accordingly, ending inventory at base-year cost would be $13.00 (determined by dividing current-year costs of $12.00 by the cumulative index of 92%).

In the above example, the taxpayer's ending inventory at base-year cost is $8.00, even though the taxpayer could not have produced a widget in the base year for $8.00. This result does more than merely *alter* the flow of costs; rather, it *creates* artificial costs. In effect, the possibility exists under the components-of-cost method for taxpayers to recover more costs on the sale of the item than it costs to replace such item. Taxpayer's method, which permits a matching of current revenues with costs higher than those incurred by taxpayer in the current period, is similarly improper. Consequently, it is our view that taxpayer's application of the components-of-cost method does *not* clearly reflect income. (Letter Ruling 9405005, October 5, 1993)

 (Continued from page 1)

Unless the Service is willing to allow some cut-off or reasonable transitional treatment on a prospective basis, it may be very difficult for the IRS to say now, after all these years, that a method as commonly accepted as components-of-cost LIFO cannot be used or never was really permissible [for income tax purposes]. However...that is what it has now come out and said...**One side is going to lose...BIG!**"

The **taxpayer is the big loser** in Letter Ruling 9405005. In the ruling, the IRS did throw out a few crumbs by saying that "although we do not believe that the taxpayer's present use of the components-of-cost method results in a clear reflection of its income, it is not our position that *all* components-of-cost methods necessarily fail to clearly reflect income. Accordingly, any particular method must be examined on a case-by-case basis."

The Service did provide that if the taxpayer could modify its components-of-cost approach, that modified approach might be acceptable to the Appeals Officer. So, we may never know for sure the fate of this particular taxpayer. However, all taxpayers using components-of-cost LIFO should take notice and beware, lest theirs be one of those found deficient in the IRS' "case-by-case" analysis.

In LTR 9405005, the Service said that unless the taxpayer is able to demonstrate that an alternative components-of-cost method does not distort income, it will be required to change to a product-cost method of determining a price index and that **this change will result in a Section 481(a) adjustment**. By requiring a Section 481(a) adjustment, the Service has eliminated the possibility of any cut-off or reasonable transition treatment on a prospective basis.

The concerns expressed by the IRS in the ruling were that the use of the components-of-cost method **did not clearly reflect income**. Again we see the unmistakable impact of *Hamilton Industries* being used effectively against LIFO taxpayers who this time happen to be manufacturers.

**#2. ELECTING LIFO IN START-UP SITUATIONS.**

**SHOULD YOU WAIT A YEAR?** Here's one for a mental migrane: Is it worthwhile to elect LIFO in first year start-up situations?

→

**SOME DECEMBER, 1993 YEAR-END INDEX RESULTS**

A LIFO inflation index for 1993 depends on at least six factors or variables:

1. Average beginning-of-the-year inventory costs for each item category are determined by last year's costs and depend on whether or not the dealer had that item category on hand at the end of the previous year.
2. Inventory mixes at the end of each year - December 31, 1992 and December 31, 1993.
3. Whether a more or less detailed approach is taken in determining "item categories." (Be wary of an unintentional change in accounting method if this is the case especially if you aren't sure how your software is calculating beginning-of-the-year inventory costs.)
4. "New item" determinations made regarding "borderline" models, including "special editions," "market editions" and "value-priced" vehicles.
5. Discounts received by certain dealers may have been direct reductions of base unit cost.
6. Different purchasing patterns.

Subject to these factors or variables, the table on page 13 shows some December, 1993 year-end inflation indexes for new vehicles computed under the Alternative LIFO Method.

**Higher than Average Inflation**: **Isuzu** introduced all of its 1993 models on December 8, 1992. This "unusual" introductory date "causes" higher LIFO inflation indexes for an Isuzu dealer with a December 31, 1993 year-end who didn't have certain item categories in stock at December 31, 1992. This happens because the 1994 models that were introduced on October 1, 1993 are repriced against 1992 models if the dealer didn't have that item in stock at December 31, 1992. This follows the requirement in Rev. Proc. 92-79 that the price taken from the manufacturer's price list on the first day of the last month of the previous year must be used to reconstruct the base price when an item category was not on hand at the end of the previous year.

**Mitsubishi** implemented major price increases for its 1994 models. These price increases, coupled with the fact that the Galant was the only new Mitsubishi model, produced high 1993 LIFO inflation indexes for Mitsubishi dealers.

**Flattened Indexes**: The December 31, 1993 LIFO inflation indexes for **Volkswagen**, like those for Isuzu, were influenced by "peculiar" introduction dates. However, Volkswagen's indexes took a turn for the worse. 1993 **Saab** indexes were flattened for many dealers due to the longer wheelbase on the 900 Series (15 new item categories out of a possible 37). General Motors' emphasis on "value" pricing for the 1994 model year flattened the LIFO inflation indexes for **Pontiac, Oldsmobile, Chevrolet**, and **Buick** dealers who had these vehicles in ending inventory, since our computations treated all of these as new items.

Finally, a change in Factory pricing strategy really hurt some dealers LIFO indexes (not to mention their grosses). **Mercedes-Benz** enacted **nominal** price increases for most models (notably the C-Class item categories), but also significantly *decreased* the price of some E-Class item categories. The result was that many overall Mercedes indexes reflected deflation for 1993.

The table on page 14 summarizes some 1992 and 1993 indexes to show the resulting cumulative two-year indexes at the end of 1993 under the Alternative LIFO Method. Keep in mind that the results in both tables reflect our interpretations of which vehicles were "new items" and our "more detailed" approach in determining "item categories."

# "NEW ITEM" 1994 MODELS IN DECEMBER, 1993 INVENTORIES - AN "UNOFFICIAL" LIST

New models or new item categories under the Alternative LIFO Method are required to be included in the annual inflation index computation at a 1.000 factor. For a new item, this is accomplished by using the end-of-the-year base cost as the beginning-of-the-year base cost. Since any number divided by itself equals 1.000, a new item contributes no inflation to the annual index.

A new item category is described in Section 4.02(5) of Revenue Procedure 92-79 as any one of the following:

1. Any new or reassigned manufacturer's model code that was *caused by a change* in an existing vehicle,
2. A manufacturer's model code created or reassigned because the classified vehicle did not previously exist, or
3. If there is no change in a manufacturer's model code, but there has been a change to the platform (i.e., the piece of metal at the bottom of the chassis that determines the length and width of the vehicle and the structural set-up of the vehicle) that results in a change in track width or wheel base, whether or not the same model name was previously used by the manufacturer, a new item category is created.

Based on our review of model change information from various sources, it appears to us that the 1994 model vehicles appearing on our list warrant treatment as new items in December 31, 1993 year-end inventories. **THIS IS NOT AN OFFICIAL LISTING - IT IS SIMPLY A SUMMARY OF OUR OWN CONCLUSIONS IN THIS REGARD.**

We have considered the Nissan Quest that comes into inventory after December 13, 1993 as a new item. Although this Quest is just like its predecessor except for the addition of an air bag, the manufacturer changed the model code number in two places (one to indicate the year of manufacture and the second change to indicate the difference in the vehicle). This seems to fit with the Section 4.02(5) provision that any new...model code that was caused by a change in an existing vehicle results in a "new item" category.

Also included on our list of "new item" categories are the various GM **special editions** (Buick Century, Park Avenue, Regal and Skylark Market Editions; Chevrolet Beretta, Caprice and Corsica Market Editions; Oldsmobile Achieva, Cutlass Ciera, Cutlass Cruiser, Cutlass Supreme, Eighty-Eight, Ninety-Eight, Bravada and Silhouette Special Editions; and Pontiac Grand Am, Grand Prix and Sunbird Value Price Editions). These were considered new items because they were listed separately in the manufacturers' model and price listing information (and for which there was not a corresponding entry in the prior year's price information). This interpretation would be consistent with that informally set forth by the Internal Revenue Service at its Motor Vehicle LIFO Inventory Seminar in September, 1993 at Burbank, CA. (See *LIFO Lookout* September, 1993 issue.)

Note also that where various vehicles were "reskinned" (Chevrolet S10 Pickup and GMC S15 Sonoma Pickup) by the manufacturer, but the model code number was **not** changed by the manufacturer, we did not consider these vehicles to be "new item" categories - and, accordingly, they are not included in our new item listing.

This is our second annual unofficial listing of "new items." Our listing of "new item" 1993 models in December, 1992 inventories appeared in the March, 1993 issue of the *LIFO Lookout*.

see **"NEW ITEM"**...,page 8

**LIFO Update** (Continued)

On pages 10 and 11, we've summarized the results of some "sooner vs. later" projections - assuming a $1.5 million inventory level at December 31, 1993 - with various (1) inflation and (2) inventory level change assumptions.

**#3. ALTERNATIVE LIFO METHOD.** The IRS may clarify certain interpretive questions which have been coming up under the Alternative LIFO Method since it was issued in September, 1992. We will report on these developments as they occur. Robert Zwiers, the IRS Motor Vehicle Industry Specialist, indicated at an Illinois Automobile Dealers Association "Tax Issues for Dealers" presentation recently that although there might be some tweaking or tinkering, it didn't seem that there would be any *major* changes in the (Rev. Proc. 92-79) document.

At that same presentation, in Oak Brook (Chicago) on March 29, he indicated that the IRS has prepared a list of new items for year-end 1992 and 1993 and that these lists have been made available to IRS agents examining dealerships around the country. When Mr. Zwiers was asked how long a dealer should keep LIFO-related records, he answered that they should be kept for as long as the dealer would like to have the LIFO benefit!

Finally, Mr. Zwiers emphasized that even if all these computational matters regarding item definition, new items, and platform changes could be simplified, **CONFORMITY** continues to be a separate major issue

see **LIFO UPDATE**, page 12

## "New Item" 1994 Models... An "Unofficial" List

(Continued from page 7)

| | | |
|---|---|---|
| **ACURA:** | Integra - | **All models** |
| | Legend - | 4-dr Sedan GS |
| **AUDI:** | 100 Series - | 4-dr Wagon S |
| | Cabriolet - | 2-dr Convertible |
| **BMW:** | 3 Series - | 325i 2-dr Convertible |
| | 5 Series - | 530i 4-dr Sedan |
| | | 530iT 4-dr Touring Wagon |
| | | 540i 4-dr Sedan |
| **BUICK:** | Century - | 4-dr Sedan Market Edition |
| | | 4-dr Wagon Market Edition |
| | Park Avenue - | 4-dr Sedan Market Edition |
| | Regal - | 2-dr Coupe Custom Market Edition |
| | | 2-dr Coupe Gran Sport Market Edition |
| | | 4-dr Sedan Custom Market Edition |
| | Skylark - | 2-dr Coupe Market Edition |
| | | 4-dr Sedan Market Edition |
| **CADILLAC:** | De Ville - | 4-dr Concours |
| | | 4-dr Sedan |
| | Eldorado - | 2-dr Touring Coupe |
| **CHEVROLET:** | Beretta - | 2-dr Coupe Market Edition w/SVB2 Options |
| | | 2-dr Coupe Market Edition w/SVB4 Options |
| | | 2-dr Coupe Market Edition w/SVB6 Options |
| | | 2-dr Coupe Z26 |
| | | 2-dr Coupe Z26 Market Ed w/SVB9 Options |
| | Camaro - | RS Convertible |
| | | Z28 Convertible |
| | Caprice - | 4-dr Sedan LS Market Ed w/SVC2 Options |
| | | 4-dr Sedan Market Edition w/SVC1 Options |
| | Corsica - | 4-dr Sedan Market Edition w/SVC4 Options |
| | | 4-dr Sedan Market Edition W/SVC6 Options |
| | C-K Pickup - | 2wd C1500 F/S W/T 117 WB |
| | | 4wd K1500 F/S W/T 117 WB |
| | S10-Pickup - | 2wd F/S Ext Cab LS 122 WB |
| | | 2wd F/S Reg Cab LS 108 WB |
| | | 2wd F/S Reg Cab LS 117 WB |
| | | 4wd F/S Ext Cab LS 122 WB |
| | | 4wd F/S Reg Cab LS 108 WB |
| | | 4wd F/S Reg Cab LS 117 WB |
| | Sportvan - | G30 Sportvan Ext 12 Pass 146 WB |
| **CHRYSLER:** | Lebaron - | 4-dr Sedan Base Model |
| | LHS - | 4-dr Sedan (LH platform) |
| | New Yorker - | 4-dr Sedan (LH platform) |
| **DODGE:** | Dakota - | 2wd Club Cab Sport 131 WB |
| | | 2wd Reg Cab WS LWB 124 WB |
| | | 2wd Reg Cab WS SWB 112 WB |
| | | 4wd Club Cab Sport 131 WB |
| | | 4wd Reg Cab WS LWB 124 WB |
| | | 4wd Reg Cab WS SWB 112 WB |
| | Ram Cab & Chassis- | **All models** |
| | Ram Pickup - | **All models** |
| **EAGLE:** | Summit - | 2-dr Coupe ESI |
| | | 4-dr Sedan ESI |
| **FORD:** | Aspire - | **All models** |
| | Crown Victoria - | 4-dr Sedan - Fleet |
| | Mustang - | All models |
| | F Series Cab & Chassis - | 4x2 F350 Super Chassis DRW 155 WB |
| | F Series Pickup - | 4x2 F150 Styleside S Supercab 139 WB |
| | | 4x2 F150 Styleside S Supercab 155 WB |
| | | 4x2 F150 Styleside S Supercab HD 155 WB |
| | | 4x4 F150 Flareside XL Supercab 139 WB |
| | Ranger | 4x2 Supercab Splash 125 WB |
| | | 4x4 Supercab Splash 125 WB → |

**LIFO LOOKOUT EXCLUSIVE**

Any quoted material must be attributed to *De Filipps LIFO Lookout* published by Willard J. De Filipps, CPA, P.C.

| | | |
|---|---|---|
| **GMC TRUCKS** | C-K Cab & Chassis - | C3500 2wd Crew Cab L/D 168.5 WB |
| | | K3500 4wd Crew Cab L/D 168.5 WB |
| | C-K Sierra Pickup - | C1500 Wideside Reg Cab Special 117.5 WB |
| | | K1500 Wideside Reg Cab Special 117.5 WB |
| | Rally Wagon - | G3500 Rally Ext 146 WB |
| | S15 Sonoma Pickup - | 2wd Wideside Reg Cab SL 117.9 WB |
| | | 4wd Wideside Reg Cab SL 117.9 WB |
| **HONDA:** | Accord - | **All models** |
| | Civic - | 2-dr Coupe EX W/ABS |
| | | 3-dr Hatchback SI W/ABS |
| | | 4-dr Sedan LX W/ABS |
| | Del Sol - | 2-dr Coupe VTEC |
| **JAGUAR:** | XJ - | 4-dr Sedan V-12 w/Dual Air Bag |
| | | 4-dr Sedan V-12 w/Single Air Bag |
| | XJS - | 2-dr Convertible 6.0L |
| | | 2-dr Coupe 6.0L |
| **LEXUS:** | SC 300 Coupe - | 2-dr Luxury Sport CA/NY |
| | SC 400 Coupe - | 2-dr Luxury Sport CA/NY |
| **MAZDA:** | 626 - | 4-dr Sedan LX-V6 |
| | Protege - | 4-dr Sedan Special |
| | Pickup - | **All models** |
| **MERCEDES:** | C Class - | **All models** |
| **MITSUBISHI:** | Galant - | **All models** |
| **NISSAN:** | 4x2 Pickup - | King Cab XE |
| | | Reg Cab XE |
| | | Standard |
| | 4x4 Pickup - | King Cab XE |
| | | King Cab XE V-6 |
| | | Reg Cab XE |
| | Pathfinder - | 4-dr 4x4 LE V-6 |
| | Quest | Minivan GXE Auto w/Airbag |
| | | Minivan XE Auto w/Airbag |
| **OLDSMOBILE:** | Achieva - | 2-dr Coupe S Special Edition w/R7B Options |
| | | 2-dr Coupe S Special Edition w/R7C Options |
| | | 2-dr Coupe SC Special Edition w/R7D Options |
| | | 4-dr Sedan S Special Edition w/R7B Options |
| | | 4-dr Sedan S Special Edition w/R7C Options |
| | | 2-dr Coupe SL Special Edition w/R7D Options |
| | Cutlass Ciera - | 4-dr Sedan Special Edition w/R7B Options |
| | | 4-dr Sedan Special Edition w/R7C Options |
| | Cutlass Cruiser - | 4-dr Wagon Special Edition w/R7D Options |
| | Cutlass Supreme - | 2-dr Coupe Special Edition w/R7B Options |
| | | 2-dr Coupe Special Edition w/R7C Options |
| | | 4-dr Sedan Special Edition w/R7C Options |
| | Eighty-Eight - | 4-dr Royale LS Special Edition w/R7C Options |
| | | 4-dr Royale Special Edition w/R7B Options |
| | Ninety-Eight - | 4-dr Regency Special Edition w/R7B Options |
| | Bravada - | 5-dr Sport Utility Special Edition |
| | Silhouette - | Minivan Special Edition w/R7B Options |
| | | Minivan Special Edition w/R7C Options |
| **PLYMOUTH:** | Acclaim - | 4-dr Sedan Highline |
| **PONTIAC:** | Firebird - | Trans Am |
| | Grand Am - | 2-dr Coupe SE Value Priced Edition |
| | | 4-dr Sedan SE Value Priced Edition |
| | Grand Prix - | 2-dr Coupe SE Value Priced Edition |
| | Sunbird - | 2-dr Coupe LE Value Priced Edition |
| **SAAB:** | 900 Series - | **All models** |
| | 9000 Series - | 5-dr Hatchback Aero w/Sun Roof |
| **SUBARU:** | Legacy- | 4-dr Sedan I, AWD RW Equipment |
| | | 4-dr Sedan L RW Equipment |
| | | 4-dr Sedan L SW Equipment |

(Continued on page 10)

**LIFO LOOKOUT EXCLUSIVE**

 (Continued from page 9)

| | | |
|---|---|---|
| **SUBARU** (Continued) | | 4-dr Sedan L YW Equipment |
| | | 4-dr Wagon Alpine Sport AWD |
| | | 4-dr Wagon GT AWD |
| | | 4-dr Wagon L AWD RW Equipment |
| | | 4-dr Wagon L AWD SW Equipment |
| | | 4-dr Wagon L AWD YW Equipment |
| | | 4-dr Wagon L RW Equipment |
| | | 4-dr Wagon L SW Equipment |
| | | 4-dr Wagon L YW Equipment |
| | | 4-dr Wagon Outdoor AWD |
| | | 4-dr Wagon Sun Sport |
| **SUZUKI:** | Sidekick - | 2-dr 2wd Conv JS CA/NY Special |
| | | 2-dr 4wd Conv JX CA/NY Special |
| | | 4-dr 2wd Hardtop JS Auto |
| **TOYOTA:** | Camry - | All Coupe models |
| | Celica - | **All models** |
| **VOLKSWAGEN:** | Jetta III - | 4-dr Sedan GLS |
| **VOLVO:** | 850 Series - | 4-dr Sedan Turbo |
| | | 5-dr Wagon |
| | | 5-dr Wagon Turbo |
| | 900 Series - | 960 4-dr Sedan w/Moon Roof |
| | | 960 4-dr Sedan No Sun Roof |
| | | 960 5-dr Wagon w/Moon Roof |

**This is our second annual unofficial listing of "new items." Our listing of "new item" 1993 models in December, 1992 inventories appeared in the March, 1993 issue of the *LIFO Lookout*. (Reprints of the March, 1993 issue are available at $65 each - see subscription/order form.)**

## SHOULD A START-UP BUSINESS ELECT LIFO IN ITS FIRST YEAR?

Should a start-up business elect LIFO in its first year of operations...or should it wait until its second year, when it will have a beginning-of-the-year inventory? An initial LIFO election in a start-up situation would result in a LIFO increment computed to be the entire ending inventory expressed in base dollars. This amount is compared with the inventory at the beginning of the year which technically is zero because the IRS position is that if there is no prior taxable year, there can be no prior year ending inventory (which becomes the current year's opening inventory).

Ignoring more aggressive techniques like creating an "artificially shortened" initial year or using a dual-index approach for valuing increments, is there any long-term benefit to establishing a higher cumulative index by electing LIFO in the start-up year?

In the start-up year, although inflation would be recognized, applying the current year inflation index to value the increment would not produce a first-year LIFO reserve. Interestingly enough, an index greater than 1.000 in the start-up year also will not cause the LIFO reserves in the following years to be any greater.

We have analyzed and summarized nine possible combinations of inflation rate and inventory level changes (increasing, decreasing, remaining constant) for two taxpayers (Head Start, Inc. and What's Your Hurry, Inc.) over a period of four years. Head Start, Inc. elected LIFO for the year ended December 31, 1993, although it would not have a LIFO reserve for 1993 if it valued its current year increment using the current year inflation index. What's Your Hurry, Inc. opted to wait until 1994 to elect LIFO.

Based on a December 31, 1993 inventory of $1,500,000 in all cases:

1) Head Start, Inc. has **more** inflation, but **less** base dollars.
2) What's Your Hurry, Inc. has **less** inflation, but **more** base dollars.
3) These factors offset each other. At the end of succeeding years, the differences in LIFO reserves are only small amounts which are due to the rounding of the decimal places in the inflation indexes.

**Conclusion: What's Your Hurry?**

## SHOULD A START-UP BUSINESS ELECT LIFO IN ITS FIRST YEAR?

LIFO RESERVES RESULTING FROM DEFERRING OR NOT DEFERRING LIFO ELECTION BY ONE YEAR
IN A START-UP SITUATION WHERE SAME INDEX IS USED TO VALUE INCREMENTS
FOR THE YEARS 1993 - 1996

| CASE | HEAD START, INC. 1993 | 1994 | 1995 | 1996 | WHAT'S YOUR HURRY, INC. 1993 | 1994 | 1995 | 1996 |
|---|---|---|---|---|---|---|---|---|
| I - 1 | 0 | 45,001 | 92,960 | 143,989 | N / A | 45,000 | 93,000 | 143,956 |
| I - 2 | 0 | 43,689 | 86,072 | 127,277 | N / A | 43,689 | 86,106 | 127,254 |
| I - 3 | 0 | 40,777 | 74,595 | 101,821 | N / A | 40,777 | 74,625 | 101,803 |
| II - 1 | 0 | 60,000 | 140,060 | 241,964 | N / A | 60,000 | 140,000 | 241,858 |
| II - 2 | 0 | 57,692 | 126,423 | 204,185 | N / A | 57,692 | 126,374 | 204,104 |
| II - 3 | 0 | 53,847 | 109,566 | 163,348 | N / A | 53,846 | 109,524 | 163,283 |
| III - 1 | 0 | 75,000 | 138,970 | 189,934 | N / A | 74,999 | 138,999 | 190,062 |
| III - 2 | 0 | 71,428 | 126,350 | 166,331 | N / A | 71,429 | 126,374 | 166,430 |
| III - 3 | 0 | 66,666 | 109,503 | 133,064 | N / A | 66,667 | 109,524 | 133,144 |
| | ELECTS LIFO IN 1993 | | | | ELECTS LIFO IN 1994 | | | |

**CONCLUSION: DIFFERENCES IN LIFO RESERVES ARE INSIGNIFICANT**

| | |
|---|---|
| I - 1 | INFLATION CONSTANT AT 3% PER YEAR; YEAR END INVENTORY INCREASING \$100,000 PER YEAR |
| I - 2 | INFLATION CONSTANT AT 3% PER YEAR; YEAR END INVENTORY CONSTANT \$1,500,000 PER YEAR |
| I - 3 | INFLATION CONSTANT AT 3% PER YEAR; YEAR END INVENTORY DECREASING \$100,000 PER YEAR |
| II - 1 | INFLATION INCREASING BY 1% PER YEAR; YEAR END INVENTORY INCREASING \$100,000 PER YEAR |
| II - 2 | INFLATION INCREASING BY 1% PER YEAR; YEAR END INVENTORY CONSTANT \$1,500,000 PER YEAR |
| II - 3 | INFLATION INCREASING BY 1% PER YEAR; YEAR END INVENTORY DECREASING \$100,000 PER YEAR |
| III - 1 | INFLATION DECREASING BY 1% PER YEAR; YEAR END INVENTORY INCREASING \$100,000 PER YEAR |
| III - 2 | INFLATION DECREASING BY 1% PER YEAR; YEAR END INVENTORY CONSTANT \$1,500,000 PER YEAR |
| III - 3 | INFLATION DECREASING BY 1% PER YEAR; YEAR END INVENTORY DECREASING \$100,000 PER YEAR |

 (Continued from page 7)

that still looms out there and about which the dealer must be concerned. He added that (at the present time) even electing the Alternative LIFO Method will not cure a prior conformity violation or problem.

On the subject of LIFO financial statement conformity, I can attest to his comments, having recently spoken with several CPAs in the Houston area whose dealer clients have been hit particularly hard on the financial statement LIFO conformity requirement...more fully discussed in the December, 1993 *LIFO Lookout.* These dealers have been referred to NADA for financial assistance in funding the very heavy legal fees to be incurred in contesting the conformity issue with the IRS. So don't let your guard down, even momentarily or in haste, when it comes to **CONFORMITY**...it can haunt you forever.

The National Automobile Dealers Association convention held this year in San Francisco from January 28th to February 1st again had no workshops on implementing the Alternative LIFO Method or the interpretive problems arising under it.

**#4. UNAUTHORIZED CHANGES IN ALTERNATIVE LIFO METHOD COMPUTATIONS.** The Internal Revenue Service is aware that many auto dealers either used software or manually computed their 1992 Alternative LIFO calculations without going as far down into the item category determinations as they should have. Technical discussions on this subject appeared in the March, 1993 *LIFO Lookout* (page 6) and September, 1993 *LIFO Lookout* (page 14).

Year-end 1992 was the first year under the Alternative LIFO Method. Perhaps at that time there was some "confusion" on this point. Later in 1993, when the IRS confirmed the necessity for a more detailed item category analysis, some dealers simply fixed or corrected the problem in 1993 by making their 1993 calculations more detailed. But they didn't go back and properly recompute year-end 1992. Some dealers may be unaware that this problem even existed or that anything was done in an effort to correct it in their 1993 calculations. The question remains: What about 1992 LIFO indexes which were not computed in accordance with Rev. Proc. 92-79?

We are all well aware that the IRS keeps a keen eye out for virtually any change in LIFO computation mechanics, no matter how seemingly minor. Any change is usually interpreted as one requiring IRS permission *before* it can be made. This requires a Form 3115 filing within the first 180 days of the year **before** changes in computations are made, and payment of a $600 user fee. If you don't think so, read the sobering discussion of what the IRS considers an accounting method change requiring advance permission in Issue 5 of LTR 9405005.

One policy problem the IRS has to face right now is how to treat auto dealers whose 1992 Alternative LIFO calculations were done incorrectly because they did not go as far down into the item category detail as necessary. Should dealers who took "short-cuts" in 1992 be granted an amnesty? Or should amended returns be required for 1992 under an expedited procedure?

Query: Why should the IRS be lenient here? Dealers who wanted the benefits of the Alternative LIFO Method agreed to pull out all 1992 ending inventory invoices as part of their 1992 calculations and retain them for review by the IRS. Since they should have them readily available, there shouldn't be any real hardship or burden imposed on them by requiring them to go to the file case and pull out the invoices and do their 1992 computations correctly. What do you think?

Many CPAs are interested in seeing how the IRS addresses this problem. Any leniency - from a technical standpoint - towards the errant 1992 computations will be interpreted as a mixed signal to those CPAs and dealers who took the time, trouble and effort to follow **the clear language** in Revenue Procedure 92-79. In addition, leniency by the IRS on this point will be viewed (or at least argued by attorneys) as setting a precedent in the future requiring more of the same...possibly on some of the bigger LIFO issues like **CONFORMITY**. Will CPAs and dealers who tried to "do it right" the first

see **LIFO UPDATE**, page 16

# INFLATION INDEXES. . .SOME 1993 YEAR-END INDEX RESULTS

| MAKE | POOL #1 - AUTOS UNITS | INDEX | POOL #2 - TRUCKS UNITS | INDEX |
|---|---|---|---|---|
| Acura | 45 | 1.056 | | |
| Audi | 10 | 1.072 | | |
| BMW | 40 | 1.049 | | |
| | 15 | 1.022 | | |
| Buick | 30 | 1.059 | | |
| | 20 | 1.051 | | |
| | 115 | 1.041 | | |
| Cadillac | 40 | 1.039 | | |
| | 35 | 1.048 | | |
| | 165 | 1.055 | | |
| | 80 | 1.040 | | |
| Chevrolet/Geo | 35 | 1.060 | 50 | 1.036 |
| | 115 | 1.056 | 105 | 1.044 |
| | 80 | 1.024 | 150 | 1.041 |
| | 70 | 1.048 | 90 | 1.038 |
| | 115 | 1.043 | 140 | 1.017 |
| | 30 | 1.057 | 45 | 1.039 |
| Chrysler | 50 | 1.046 | 5 | 1.067 |
| | 50 | 1.006 | 5 | 1.067 |
| | 15 | 1.035 | 5 | 1.067 |
| Dodge | 15 | 1.076 | 15 | 1.070 |
| | 35 | 1.059 | 65 | 1.071 |
| Eagle | 40 | 1.072 | | |
| Ford | 35 | 1.061 | 85 | 1.061 |
| | 145 | 1.008 | 175 | 1.028 |
| | 130 | 1.034 | 125 | 1.020 |
| | 180 | 1.048 | 270 | 1.048 |
| | 30 | 1.050 | 35 | 1.043 |
| GMC Truck | | | 95 | 1.035 |
| | | | 35 | 1.050 |
| | | | 50 | 1.053 |
| | | | 40 | 1.054 |
| | | | 25 | 1.054 |
| Honda | 120 | 1.036 | | |
| | 55 | 1.014 | | |
| Hyundai | 20 | 1.044 | | |
| | 35 | 1.025 | | |
| Isuzu | | | 15 | 1.047 |
| | | | 80 | 1.101 |
| | | | 255 | 1.117 |
| | | | 25 | 1.134 |
| | | | 15 | 1.126 |
| Jeep | | | 285 | 1.069 |
| | | | 75 | 1.041 |
| Lexus | 25 | 1.054 | | |
| Lincoln | 25 | 1.031 | | |
| | 50 | 1.028 | | |
| | 20 | 1.024 | | |
| Mazda | 55 | 1.052 | 35 | 1.035 |
| | 105 | 1.055 | 65 | 1.017 |
| | 95 | 1.041 | 30 | 1.034 |
| Mercedes-Benz | 5 | 0.885 | | |
| Mercury | 45 | 1.030 | 20 | 1.018 |
| | 90 | 1.038 | 15 | 1.033 |
| | 65 | 1.034 | 15 | 1.028 |
| Mitsubishi | 60 | 1.069 | 15 | 1.168 |
| | 85 | 1.087 | 10 | 1.197 |
| | 45 | 1.032 | 10 | 1.182 |
| Nissan | 25 | 1.068 | 10 | 1.034 |
| | 105 | 1.072 | 20 | 1.047 |
| | 40 | 1.023 | 35 | 1.019 |
| | 105 | 1.036 | 40 | 1.032 |
| Oldsmobile | 30 | 1.000 | | |
| | 40 | 1.011 | | |
| | 30 | 1.030 | | |
| Plymouth | 30 | 1.043 | 45 | 1.077 |
| | 90 | 1.042 | 45 | 1.080 |
| | 15 | 1.048 | 30 | 1.079 |
| Pontiac | 40 | 1.042 | 5 | 1.041 |
| | 100 | 1.057 | 15 | 1.042 |
| | 20 | 1.007 | 5 | 1.009 |
| | 40 | 1.003 | 5 | 1.000 |
| | 45 | 1.039 | 5 | 1.046 |
| | 155 | 1.045 | 10 | 1.041 |
| | 25 | 1.032 | 5 | 1.041 |
| | 40 | 1.046 | 5 | 1.041 |
| Rolls Royce | 10 | 1.039 | | |
| Saab | 35 | 1.001 | | |
| | 10 | 1.005 | | |
| | 20 | 1.032 | | |
| Saturn | 75 | 1.096 | | |
| | 60 | 1.082 | | |
| Subaru | 40 | 1.077 | | |
| | 25 | 1.015 | | |
| | 10 | 1.000 | | |
| | 55 | 1.008 | | |
| | 45 | 1.009 | | |
| Toyota | 90 | 1.051 | 30 | 1.066 |
| | 110 | 1.028 | 80 | 1.034 |
| | 75 | 1.057 | 70 | 1.035 |
| | 65 | 1.027 | 65 | 1.034 |
| | 210 | 1.045 | 170 | 1.039 |
| | 90 | 1.053 | 20 | 1.047 |
| | 95 | 1.051 | 55 | 1.060 |
| | 110 | 1.059 | 30 | 1.059 |
| Volkswagen | 35 | 1.015 | 5 | 1.011 |
| | 75 | 1.022 | 10 | 1.005 |
| | 5 | 1.018 | 5 | 1.015 |

# SUMMARY OF LIFO INFLATION INDEXES

COMPUTED UNDER THE ALTERNATIVE LIFO METHOD FOR AUTOMOBILE DEALERS
FOR THE YEARS ENDED DECEMBER 31, 1992 AND 1993

| TABLE II | 1992 YEAR-END INDEX RESULTS | | | | 1993 YEAR-END INDEX RESULTS | | | | CUMULATIVE 1992-1993 | |
|---|---|---|---|---|---|---|---|---|---|---|
| | POOL #1 AUTOS | | POOL #2 TRUCKS | | POOL #1 AUTOS | | POOL #2 TRUCKS | | | |
| | UNITS | INDEX | UNITS | INDEX | UNITS | INDEX | UNITS | INDEX | #1 AUTOS | #2 TRUCKS |
| BUICK | 45 | 1.043 | | | 30 | 1.059 | | | 1.105 | N/A |
| | 125 | 1.035 | | | 115 | 1.041 | | | 1.077 | N/A |
| CADILLAC | 80 | 1.039 | | | 40 | 1.039 | | | 1.080 | N/A |
| | 45 | 1.041 | | | 35 | 1.048 | | | 1.091 | N/A |
| | 240 | 1.049 | | | 165 | 1.055 | | | 1.107 | N/A |
| | 115 | 1.044 | | | 80 | 1.040 | | | 1.086 | N/A |
| CHEVROLET/ | 40 | 0.998 | 50 | 1.027 | 35 | 1.060 | 50 | 1.036 | 1.058 | 1.064 |
| GEO | 70 | 1.011 | 150 | 1.029 | 80 | 1.024 | 150 | 1.041 | 1.035 | 1.071 |
| | 55 | 1.015 | 105 | 1.046 | 70 | 1.048 | 90 | 1.038 | 1.064 | 1.086 |
| | 35 | 1.014 | 160 | 1.039 | 115 | 1.043 | 140 | 1.017 | 1.058 | 1.057 |
| | 25 | 1.004 | 45 | 1.043 | 30 | 1.057 | 45 | 1.039 | 1.061 | 1.084 |
| EAGLE | 45 | 1.010 | | | 40 | 1.072 | | | 1.083 | N/A |
| FORD | 25 | 1.022 | 60 | 1.026 | 35 | 1.061 | 85 | 1.061 | 1.084 | 1.089 |
| | 155 | 1.004 | 205 | 1.024 | 180 | 1.048 | 270 | 1.048 | 1.052 | 1.073 |
| GMC | | | 50 | 1.030 | | | 35 | 1.050 | N/A | 1.082 |
| | | | 50 | 1.037 | | | 50 | 1.053 | N/A | 1.092 |
| | | | 30 | 1.031 | | | 25 | 1.054 | N/A | 1.087 |
| HONDA | 50 | 1.033 | | | 55 | 1.014 | | | 1.047 | N/A |
| JEEP | | | 350 | 1.003 | | | 285 | 1.069 | N/A | 1.072 |
| LEXUS | 30 | 1.095 | | | 25 | 1.054 | | | 1.154 | N/A |
| MAZDA | 180 | 1.048 | 35 | 1.055 | 95 | 1.041 | 30 | 1.034 | 1.091 | 1.091 |
| | 95 | 1.038 | 30 | 1.078 | 105 | 1.055 | 65 | 1.017 | 1.095 | 1.096 |
| MERCURY | 65 | 0.980 | | | 65 | 1.034 | | | 1.013 | N/A |
| MITSUBISHI | 85 | 1.061 | | | 60 | 1.069 | | | 1.134 | N/A |
| | 50 | 1.061 | | | 45 | 1.032 | | | 1.095 | N/A |
| | 95 | 1.064 | | | 85 | 1.087 | | | 1.157 | N/A |
| NISSAN | 65 | 1.041 | 15 | 1.038 | 105 | 1.072 | 20 | 1.047 | 1.116 | 1.087 |
| OLDSMOBILE | 50 | 1.031 | | | 40 | 1.011 | | | 1.042 | N/A |
| PONTIAC | 240 | 1.044 | | | 100 | 1.057 | | | 1.104 | N/A |
| | 30 | 1.037 | | | 20 | 1.007 | | | 1.044 | N/A |
| | 40 | 1.048 | | | 45 | 1.039 | | | 1.089 | N/A |
| | 190 | 1.041 | | | 155 | 1.045 | | | 1.088 | N/A |
| | 30 | 1.036 | | | 25 | 1.032 | | | 1.069 | N/A |
| SUBARU | 50 | 1.155 | | | 25 | 1.015 | | | 1.173 | N/A |
| TOYOTA | 105 | 1.036 | 45 | 1.053 | 90 | 1.051 | 30 | 1.066 | 1.089 | 1.122 |
| | 130 | 1.056 | 100 | 1.048 | 110 | 1.028 | 85 | 1.034 | 1.086 | 1.084 |
| | 105 | 1.046 | 50 | 1.056 | 110 | 1.059 | 35 | 1.059 | 1.108 | 1.118 |

# INDEX OF ARTICLES IN THE *LIFO LOOKOUT*: 1991-1993


Dec., 1993 Financial Statement Conformity Requirements: The Ultimate LIFO Trap
Technical Analysis, The *William Powell* Decision & Projecting Year-End LIFO Reserve Changes
The *Boecking Machinery, Inc.* Decision: Tax Court Terminates LIFO
Election Due to Inadequate Books and Records
** 1993-1994 Model/Item Category Inflation Survey for Quick Year-end LIFO Estimates
** Revenue Procedure 92-79: Some Questions Still Need Answers

Sept, 1993 IRS Motor Vehicle Industry LIFO Seminar, Sept. 13, 1993 - Burbank, CA
IRS Appeals Settlement Guidelines for Dealers NOT Using Alternative LIFO Method
Dual Index Approaches for Valuing Increments
Dual Index Approaches and Procedures
Start-Up Dual Index Situation Example

June, 1993 S Corporations, Built-in Gains, LIFO inventories and Sec. 1363(d) & 1374
Terminating a LIFO Election: Procedures and Pitfalls, Comparison of
Revenue Procedures 88-15 and 92-20
** Another Rebasing Example - With Proofs: Why LIFO Reserves Go Up EvenThough
Inventory Levels Go Down And Despite Rebasing Indexes to 1.000 In Between

March, 1993 ** Revenue Procedure 92-79 Update, Including How Far do You Have to Go
in Determining "Item Categories?"
** Rebasing Indexes to 1.000...An Expanded Example Involving Dual Indexes,
Splitting a Pool and Adding Demonstrator Vehicles
** December 31, 1992 Inventories
"New Item" 1993 Models: an "Unofficial" List
Some Year-End Index Results

Dec., 1992 Revenue Procedure 92-79, Including Form 3115 Pro Forma Filing Package for
Dealers Electing the New Method
** Rebasing Prior Years' LIFO Indexes to 1.000

Sept, 1992 Revenue Procedure 92-79: Overview, Advantages, Disadvantages, Special Rules
and Definitions, Other Requirements and Consent Conditions
** Step-by-Step Computations and Worksheet Format for Using the Alternative
LIFO Method for Auto Dealers
Proposal Submitted to IRS July, 1992 for Simplified Alternative LIFO Method for Auto Dealers

June, 1992 Revenue Procedure 92-20: Accounting Method Changes
New Procedures for Changing Accounting Methods
Taxpayers Not Currently Under Audit: Pre-Audit (Voluntary) vs. 90-Day Audit Window
Taxpayers Currently Under Audit: The 180-Day Transition Rules
Auto Dealers LIFO Amnesty?...NOT! (For Everybody)

March, 1992 Why Do Some LIFO Reserves Go Up Even Though Inventory Levels Go Down?
What's Wrong With IRS Treatment of Auto Dealers on LIFO?

Dec., 1991 *Hamilton Industries*: A New LIFO Nightmare
Son of *Hamilton*: IRS Announcement 91-173
Bye...Bye...Bargain Purchase LIFO: What the Tax Court Said in *Hamilton Industries*
Conformity Requirement, Year-End Planning and Projections (Updated December, 1992 and 1993)


** The eight articles designated (**) may be of special interest to CPAs using the Alternative LIFO Method for auto dealers. If you would like a complete set of these eight articles, without separately purchasing each back issue of the *LIFO Lookout*, all eight can be obtained as a complete set for $165. Just send a copy of this page as your order form and your check for $165.

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Sept., 1991 IRS LIFO Audits and Issues
Theory, Practice & IRS Audit Issues: What's Going on Out There
The LIFO Taxpayer's "Bill of Rights:" Rev. Proc. 79-23
What Is an "Item?" Does Anybody Know?
Books and Records, Closed Years and Adjusting Prior Year Indexes

June, 1991 Voluntary LIFO Method Change Requests (Note: This has been superseded by Rev. Proc. 92-20)
Rules, Requirements, Practical Problems and Form 3115 Filing Mechanics

March, 1991 NADA Auto Dealer LIFO Workshops
Change Requests: 3115's in the National Office
LIFO Trap of the Year: S Elections


**LIFO Update** (Continued from page 12)

time now feel foolish for being so detail-oriented when others merely winked at the words and the IRS let them off the hook? We shall see.

**#5. NEW ITEM CATEGORIES FOR 1994 MODELS: OUR "UNOFFICIAL" LIST.** A few weeks ago, we pre-released our unofficial listing of new item categories for 1993-1994 new models in year-end inventories. This listing is the center spread on pages 7-10 of this issue. Together with the same "unofficial" listing for 1993 models published in our March, 1993 LIFO Lookout, this shows you what vehicles we feel were new item categories for the two year-ends since the Alternative LIFO Method became available.

**#6. SOME YEAR-END INFLATION INDEX RESULTS.** Included in this issue (page 13) is a table showing some of the 1993 inflation indexes we have computed. The related table (on page 14) shows the cumulative results over two years for dealers using these indexes in their LIFO computations. In some instances, the cumulative indexes reflecting two years under the Alternative LIFO Method (with the pre-1992 indexes rebased to 1.000) show the potential build-up of LIFO reserves.

**#7. LIFO RECAPTURE COMPUTATIONS FOR ALTERNATIVE MINIMUM TAX PURPOSES.** Regular or C corporations are required to adjust for the impact of LIFO in computing their adjusted current earnings for Alternative Minimum Tax purposes. S corporations, you will recall, are not involved with these adjustments because they are not subject to the Alternative Minimum Tax.

For C corporations, however, Form 4626 (Alternative Minimum Tax - Corporations) provides for ACE adjustments to be computed on a separate IRS-worksheet, line 5(d) of which requires "LIFO inventory adjustments." The instructions for this line of the worksheet cryptically indicate that the adjustments provided in Section 312(n)(4) apply in computing ACE, with a reference to Regulation Section 1.56(g)-1(f)(3).

In recently issued Notice 94-27, the IRS has provided further guidance on how C corporations may compute the LIFO recapture adjustments to adjust their current earnings for tax years beginning after 1989 and before 1992 if they elect not to apply this regulation to those years. All of this relates to the so-called "base line" LIFO recapture amount which is the excess, if any, of the beginning FIFO inventory amount for the first taxable year beginning after December 31, 1989 over the taxpayer's beginning LIFO inventory amount for that same year. Notice 94-27 also provides transition rules for these taxpayers. These computations are rather complicated, but if you have C corporations on LIFO, you'll have to deal with them.

The *De Filipps' LIFO Lookout* newsletter is a quarterly publication of LIFO News, Views and Ideas by Willard J. De Filipps, CPA, P.C., 317 West Prospect Avenue, Mt. Prospect, IL 60056. It is intended to provide accurate, general information on LIFO matters and it should not be construed as offering accounting or legal advice or accounting or legal opinion on any specific facts or circumstances. The contents are intended for general information purposes only. Readers should consult their certified public accountant, attorney and/or other competent advisors to discuss their own situations and specific LIFO questions. Mechanical or electronic reproduction or photocopying is prohibited without permission of the publisher. Annual subscription: $285. Back issues available for $65 each. Not assignable without consent. Any quoted material must be attributed to *De Filipps LIFO Lookout* published by Willard J. De Filipps, CPA, P.C. Editorial comments and article suggestions are welcome and should be directed to Willard J. De Filipps at (708) 577-3977; FAX (708) 577-1073. *De Filipps' LIFO Lookout* format designed by *Publish or Perish,* (708) 289-6332. 

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De Filipps'

# DEALER TAX WATCH

A Quarterly Update of Essential Tax Information

Volume 1, Number 1 Publisher: Willard J. De Filipps, C.P.A. June 1994

## DEALER TAX WATCH

Beginning in June, the *LIFO Lookout* will be joined by a sister publication, the *Dealer Tax Watch*. You are invited to become a charter subscriber to this unique publication for the dealer industry.

**SOME BACKGROUND**

For a few years now, the IRS has been actively pursuing the audits of automobile dealerships around the country as a growth business. With the emergence and continued upgrading of the MSSP (Market Segment Specialization Program), dealers' tax affairs are coming under greater scrutiny every day. What's worse, some District Directors are initiating their own "special" forays concentrating on specific areas not necessarily coordinated by the MSSP. (Such as the recent "demonstrator" initiative in Wisconsin.)

In late March, an IRS Motor Vehicle Industry Specialist spoke to three different groups of Illinois Auto Dealer Association members regarding 13 different **areas** on which the IRS is now strategically focusing. (See box below.)

In connection with Forms 8300, did you know that the IRS is about to start a real PIP of a program? PIP stands for the IRS' new PENALTY IMPOSITION PROGRAM consisting of two phases. (You didn't think they were going to give out awards for trying, did you?)

Phase 1 will deal with penalties for non-timely filing of Forms 8300. Phase 2 - coming in September - will deal with penalties for incomplete and incorrect Forms 8300. This was an extremely **hot topic** at the Auto Dealer Tax Issues seminar and it promises to be a real nightmare in every dealership, regardless of size or location. This area will receive full coverage in our publication.

see **DEALER TAX WATCH**, page 2

**THE IRS HIT LIST**

1. Advertising Expenses
2. Buy-Here/Pay-Here Lots
3. Credit Life/Health and Accident Insurance
4. Demonstrators
5. Employee Incentive Bonuses
6. Executive Compensation
7. Finance Reserve Income
8. Improper Accounting Methods
9. Officers Life Insurance
10. Property Taxes
11. Used Vehicle Write Downs
12. Extended Service Contracts
13. LIFO for New Vehicles

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On another front, many dealers and CPAs still do not fully understand the differences between the SWIM method for extended service contracts and the implications of Revenue Procedures 92-97 and 92-98. These also will be receiving attention.

The Illinois Auto Dealer Association recently compiled another list of 30 tax problem areas for dealers. This list adds even more ornaments to the Christmas tree. (See the box at right.)

## THE CONCEPT: A UNIQUE NEWSLETTER DEDICATED STRICTLY TO AUTO DEALER TAX ISSUES AND PROBLEMS

The *Dealer Tax Watch* will be a quarterly publication that brings you up-to-date as if you had called me personally to ask: "What's the IRS been doing lately in its on-going audit activities of dealerships?"

If you are a subscriber to the *LIFO Lookout*, you already are familiar with the type of intensive tax analysis we provide concentrating solely on the area of LIFO (Last-In, First-Out) inventories for automobile dealers. You also know the way we integrate timely technical coverage with helpful worksheets and formats.

As we all know, LIFO is only one of many tax planning and compliance areas requiring constant monitoring and awareness of what is essential and what is changing. Some changes are for the better...others are for the worse. Each quarter, the *Dealer Tax Watch* will focus on a variety of Federal income tax issues that you need to be aware of on a day-to-day basis. Because of its national readership, the *Dealer Tax Watch* will not cover state income tax or state sales tax issues and procedures.

### 30 WAYS TO RUIN YOUR DAY

1. Related Entity Loans
2. Extended Warranty Contracts
3. Executive (Reasonable) Compensation
4. Retirement Plans
5. Accumulated Earnings
6. Finance Income
7. Advertising Rebates
8. Dealer Flooring Credits
9. Life Insurance
10. Self Insurance
11. Property Tax Accrual
12. Customer Accommodation Accounts
13. Vacation Pay Accrual
14. Sales Tax Examinations
15. Travel and Entertainment
16. Demonstrators
17. Salesman Contests
18. Personal Expenses of Owner
19. Reserves
20. Captive Finance Companies
21. Cash Management Fund
22. Ad Association Partnerships
23. Buy Here/Pay Here
24. Rebates on Cars
25. Non-Compete Agreements, Franchise Fees and Consulting Fees
26. Non-Refundable Deposits
27. LIFO
28. Warranty Claims Advance
29. Obsolete Parts Return Allowance
30. Section 7519 Deposits

Some of the problem areas on the lists will be affected by a stream of Tax Court or other court cases. Other areas may be addressed in IRS Revenue Rulings or Revenue Procedures.

The *Dealer Tax Watch* will be written so that it can be used by dealership office managers, as well as CPAs, in keeping up- →

to-date with these current developments, tax cases and IRS audit initiatives. Each quarterly issue will blend technical and practical information that can immediately be put to practical use in the dealership.

## WHY THE DEALER TAX WATCH?

There are already a number of other publications attempting to meet the challenge of reporting tax developments for auto dealers. You've probably seen a few of them already. What do you think they are worth? Are they telling you anything beyond the basics or translating it so you know where you stand or what to do next?

Many readers of the *LIFO Lookout* have commented on the usefulness of that publication. I believe I can bring the same high quality level of coverage to address and interpret these other dealer problem areas.

Each issue of the *Dealer Tax Watch* will reflect my 30 years of tax experience and my familiarity with auto dealerships and dealers all over the country.

Many readers of the *LIFO Lookout* call with questions regarding the tax implications of a variety of subjects other than LIFO, and for some time I have considered a separate publication to cover the many other (non-LIFO) tax problems of auto dealers.

What's wrong with right now?

## AFFORDABLE ANNUAL COST

I believe that as a subscriber to the *Dealer Tax Watch*, the material you will receive and benefit from should more than justify your annual subscription cost of $285 for 4 issues (the full annual subscription rate).

**But... I have a deal for you.**

If you are willing to subscribe now, first issue sight unseen, and remit payment before May 31, 1994, you can take a charter subscriber discount of $85 reducing your cost for your first annual subscription to $200. Just send a check for $200 with the enclosed subscription form.

see **DEALER TAX WATCH**, page 4

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(Continued from page 3)

If you take the $85 discount by paying **before May 31** and are not satisfied after receiving the first issue, just call, write or fax within 30 days and I'll refund your payment in full immediately.

Many of you have attended my LIFO seminars, purchased my materials, or subscribed to the *LIFO Lookout*, so you already know how I think and write about at least one technical tax area affecting auto dealers. This gives you some idea of what to expect even before you receive the first issue of the *Dealer Tax Watch*, so I'll give you $85 towards the first year's subscription cost if you'll pay in advance and simplify my bookkeeping.

If you want to wait until after you've received the first issue, that's also understandable: You can receive the first issue before deciding whether to subscribe and you will be billed for the full 4 issue annual subscription cost of $285 in July.

I would hope that out of **every** issue of the *Dealer Tax Watch*, you will obtain useful tax information that far exceeds the annual cost.

Sincerely,

WILLARD J. DE FILIPPS, CPA

April, 1994



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