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:

Update items 1, 5 and 6 indicate that some parts of the IRS are out of sync with others. This is not only troublesome for CPAs dealing with the IRS in day-to-day audits; it should be a concern for everyone in a tax system which depends on voluntary compliance and trust because the IRS cannot personally audit every taxpayer every year.

#1. LIFO FINANCIAL STATEMENT CONFORMITY REQUIREMENT. As we remind readers constantly, this is the biggest booby trap of all. The IRS has several dealers in its clutches right now who are facing the retroactive termination of their LIFO elections because of "problems" with their 12th or 13th statement sent to the manufacturers or to the credit corporations.

This IRS audit activity is particularly heavy in Texas and it is taking on some bizarre aspects. In one case, the examining agent handed the taxpayer somebody else's "boilerplate" report and simply said "tell me why I shouldn't terminate your LIFO election."

A request for Technical Advice on dealer conformity is in process and it includes many technical reasons which could provide a way for the IRS to back away from this issue gracefully...and non-confrontationally.

As we've said before: The conformity issue for dealers needs to be addressed immediately in a responsible and reasonable way at a policy level by the Treasury/IRS. Until that happens, "progress" resulting from the cooperative efforts between NADA and the Treasury/IRS in other LIFO areas can only be regarded as conditional.

With the Commissioner...and Congress...so dependent on voluntary compliance, why allow a credibility gap over this issue to undo years of progress?

Everybody seems to be waiting to see what will happen to somebody else first. That's part of the problem. Another is that no one seems to know which branch (National Tax Office, the Treasury, the Motor Vehicle ISP?) is encouraging the aggressive positions some examining agents are taking. The IRS audit side is highly integrated on this issue and seems to have extremely effective and almost instantaneous communication.

From a different point of view, see pages 10-11: "Who's Minding The Store?"

LOOKOUT LOOKS INTO

#2. AICPA NATIONAL AUTO DEALERSHIP CONFERENCE. The AICPA First Annual Auto Dealership Conference to be held in Las Vegas October 31-November 1 will include several speakers (discussing LIFO) ... Robert C. Zwiers, the IRS/MSSP Specialist, J. Peter Kitzmiller from NADA, and *Lookout* editor Willard J. De Filipps, who will be presenting a "LIFO Update" session. This Conference is sold out, but the AICPA is scheduling another just like it in December.

#3. IRS CLARIFIES C TO S CONVERSIONS. Revenue Procedure 94-61 issued in August provides a good example showing how C corporations electing S status should handle their LIFO

see **LIFO UPDATE**, page 2

(Continued from page 1)

computations and many other "clarifications." It also raises still more problems. New math: One Answered Question = More New Problems.

This will cause real problems for practitioners who either (1) thought switching from C to S terminated their LIFO elections or (2) started all over with indexes for the first S year at 1.000.

Any CPA involved with financial statements (certified or not) or who prepared tax returns on the mistaken assumption that the S corporation election terminated the LIFO election...has a host of problems and liabilities to deal with now. You can refer to your June, 1994 *LIFO Lookout:* "Changes from C-S to S-C Status: It Only Gets Worse for LIFO Inventories" as background for further coverage in this issue.

#4. REPLACEMENT COST ACCOUNTING, LIFO AND PARTS-TYPE INVENTORIES.
The June, 1994 *LIFO Lookout* also indicated our expectation that a Letter Ruling/TAM was coming on the use of replacement cost for valuing inventories that would essentially knock out that accounting method and require **actual** cost to be used instead.

Letter Ruling 9433009, issued on August 29, 1994, is analyzed in three feature articles. See the June, 1994 *Lookout* (pages 4 and 5) as background for this unfavorable and puzzling development for all taxpayers using replacement cost accounting.

#5. ALTERNATIVE LIFO, THE IRS/MSSP LISTINGS OF NEW ITEMS, & IRS COMPLIANCE CHECKS OF 92-79 DEALERS.
In LIFO Update #4 last quarter, we discussed the IRS' spot-checks (not examinations) to assess compliance with Revenue Procedure 92-79. We are now hearing from some CPAs that the agents guided by the MSSP are using a somewhat restrictive list of new items as a yardstick for checking dealer computations.

It appears that the ISP-MSSP's listing of new items has not been coordinated with the IRS National Tax Office in Washington, D.C. as far as various interpretations go and agents conducting these reviews are arbitrarily determining deficiencies in LIFO computations where differences in new item analysis have occurred. Apparently, this listing was never coordinated or reviewed by the National Tax Office which wrote Revenue Procedure 92-79.

Some dealers and CPAs are confused because they think "the IRS" has made certain determinations in this regard. In fact, at least three different IRS agencies (i.e., the National Tax Office, the MSSP Specialists and the District Director's examining agents) are all involved...and they are not always "coordinated" with each other, nor are they always in agreement on matters of interpretation, judgment or policy. Nevertheless, the examining agent closest to the taxpayer conveys "the IRS'" thinking without letting on that there is room for disagreement. Even if there is, many dealers and their CPAs feel that further protest is not worth the effort...and just let the steamroller lumber on over them.

Without a timely "coordinated" listing of new items published by an authoritative source, eventual real "audit" situations will become more uncertain. This will undermine the underlying policy intent of the Alternative LIFO Method which was to minimize or greatly reduce *uncertainty*.

Hopefully, we will soon have some clarification and/or interpretation from the National Office to guide us on some of the questions that have surfaced in working with the Alternative LIFO Method. For some dealers, this affects their last **three** taxable years... and that's a long time to be in the dark.

In "Confusion Creeping Back into Alternative LIFO Method," we can't help but ask: How many steps backward are necessary before we can go forward again? See page 9.

#6. ISP PAPERS. Over the summer, the Motor Vehicle Industry Specialization Program released three proposed Coordinated Issue Papers, two of which are analyzed in this issue of the *Lookout*. These Issue Papers seem to reflect the lack of a uniform "IRS" theory or understanding of more technical matters. In some instances, they directly contradict the "theory" expressed previously by the ISP in a 1989 Paper and Appeals in a 1993 Paper and by the National Office in matters involving link-chain, indexes and sampling!

Articles in this issue of the *Lookout* (pages 16-20) relate to

- the IRS warnings on sampling shortcuts and
- how the IRS thinks dual indexes for valuing increments should be computed.

Although there are gaps in the theory and concepts, the IRS' conclusions are unmistakably harsh and restrictive.

A third Issue Paper released this year addressing dollar-value LIFO/bargain purchase inventory will be covered in a future issue of the *Lookout*.

#7. INVENTORY AND LIFO CHANGES IN GATT FUNDING PACKAGE. The General Agreement on Tariffs and Trade (GATT) requires funding action by Congress and changes have been proposed for certain inventory and LIFO accounting practices.

Proposed change would eliminate writedowns under the lower of cost or market method and prohibit the use of the components-of-cost method for valuing LIFO inventories. A third would allow taxpayers using the Bureau of Labor Statistics indexes to use 100% of the index change (instead of only 80%).

The AICPA has opposed the repeal of the lower of cost or market method and many larger firms have opposed repeal of the component-of-cost LIFO method. (Nobody's objecting to the third proposal!) The status of all proposals at this time is uncertain. *

REPLACEMENT COST ACCOUNTING FOR "PARTS-TYPE" INVENTORIES THE IRS SAYS "NO"

LTR 9433004

We may now have a major problem for businesses with parts-type inventories. This includes entire industries of wholesalers, distributors and retailers, such as auto, implement and heavy-duty truck dealers, who maintain inventories of parts and accessories for - or as - their major products and use replacement cost (in one form or another) to account for them.

Standard industry practice, generally accepted accounting principles, franchise requirements imposed by manufacturers and standardized inventory accounting systems for such inventories all recognize that - as a practical matter - these diverse inventories cannot be valued at year-end by using **actual** cost. Instead, these parts-type inventories are valued using the most recent price information taken from manufacturers' catalogs or price lists, or the most recent price paid for that item. These practices are uniformly followed even though theoretically it is possible to go back and do a detailed, perpetual cost accounting for each individual item in inventory...were it not prohibitively expensive to do so.

In inflationary times, inventories valued using replacement cost accounting are somewhat overstated, and this means that income taxes are being paid **in advance**...unless businesses are using LIFO to mitigate the overstatement in year-end inventories.

The taxpayer in Letter Ruling 9433004 (August 29, 1994) is a retail dealer of heavy-duty trucks and truck parts and accessories. The taxpayer's Form 970 elected the dollar-value, link-chain LIFO method for valuing its parts and accessory inventories. It also elected to determine total current-year cost for that pool by reference to **actual cost of most recent purchases** of these items. **In practice, however, the taxpayer had always used the replacement cost for each item of inventory at year-end** to determine its total current-year cost of these items. This replacement cost was determined by reference to the manufacturer's prevailing price list on the last day of the year. For LIFO inflation index computation purposes, the taxpayer determined replacement cost based upon weekly price appreciation lists provided by the manufacturer. In one year, the taxpayer believed the amount of inflation computed by using the manufacturer's price appreciation lists was unrealistically high and...to be "fair" about it to the IRS(!)...the taxpayer used an index considerably lower than the price appreciation reported for the year by the manufacturer.

The examining agent contended that the taxpayer's use of replacement cost was not in accordance with its election to determine the total current-year cost of parts and accessories by reference to the actual cost of most recent purchases. The examining agent also contended that use of replacement cost violated the statutory requirement in Section 472(b)(2) that LIFO inventories shall be stated at **cost**.

The taxpayer argued that its consistent use of its method of accounting for parts and accessories inventory satisfies the requirements under Code Section 471 and Reg. Section 1.471-2 insofar as its method for inventory valuation (1) conforms as nearly as may be to the **best accounting practice in the trade or business** and (2) **clearly reflects income**.

The IRS relied heavily on the Supreme Court's holding in *Thor Power Tool*(1979) that writedowns of excess inventory did not clearly reflect income because they were prohibited by regulation... even though they were in accordance with generally accepted accounting principles (GAAP) for financial reporting purposes. The IRS concluded that any specific statutory or regulatory requirement applicable to LIFO must be complied with in order for a method to clearly reflect income.

According to the IRS, the applicable regulation provides that the total current-year cost of items making up a dollar-value LIFO pool be determined by reference to the **actual cost** of the goods most recently purchased or produced. By its specific language, cost must be determined by reference to actual cost. Thus, the taxpayer's use of replacement cost violated this specific regulation.

The Letter Ruling also states that, under Reg. Sec. 1.472-8(e)(2)(ii)(d), taxpayers are permitted to determine the total current-year cost of items making up an inventory pool pursuant to any other proper method which, in the opinion of the Commissioner, clearly reflects income. However, the taxpayer had specifically elected on the Form 970 filed to determine the total current-year cost of items in its parts and accessories inventory pool by reference to the **actual cost** of its most recent purchases of these goods. Therefore, the National Office felt it unnecessary to consider whether taxpayer's use of replacement cost would be permitted as an "other" increment valuation method. In this regard, the IRS did say that the use of any "other" method for valuing increments would also have to satisfy the

see **THE IRS SAYS NO...**, page 4

requirement under Section 472(b)(2) that LIFO inventories be stated **at cost**.

The IRS expressed its view that replacement cost is "arguably" more analogous to the concept of **"market"** in the lower of cost or market (LCM) inventory method, under which the term "market" generally means the current bid price prevailing at the date of the inventory for the particular merchandise in the volume usually purchased by the taxpayer. As a consequence, the Service felt the use of replacement cost may potentially violate the requirement under Section 472(b)(2) of the Code that LIFO inventories must be stated **at cost**.

Although for purposes of some LIFO inventory methods (e.g., the retail LIFO method), cost may be based on something other than actual cost, the IRS held that the taxpayer in question was using replacement cost as a surrogate for the actual cost of its parts and accessories...and the "taxpayer may never have actually purchased these items for the replacement cost amount, even at a different point in time."

The discussion of IRS Letter Rulings 7503130350B and 8906001 were included in the June, 1994 *LIFO Lookout* article, as were some further LIFO technicalities...none of which are mentioned in the IRS' current Letter Ruling 9433004.

Although not necessary for it to reach its adverse conclusion, the IRS stated that the taxpayer's arbitrary departures from replacement cost based on the subjective belief that the manufacturer's price appreciation list did not accurately measure inflation would, in any event, be improper. (In other words, the taxpayer would have been better off if it had simply and blindly used the unrealistic result provided by the manufacturer's appreciation lists.)

In this Letter Ruling, the IRS picked a very "good" fact pattern for itself - and an equally "bad" fact pattern for taxpayers. Although the IRS has, with supreme confidence, stated that replacement cost cannot be used...can it tell us what method entire industries really should be using instead?

Accompanying articles discuss practical implications and provide more details.

FRED, FRED...WHERE ARE YOU? PLEASE COME BACK

Wouldn't it be nice if some IRS technicians took to heart what former IRS Commissioner Fred T. Goldberg, Jr. **meant** when he said in 1990 that:

> "the IRS needs to build on, and...accommodate common commercial practice. We can't operate on the assumption that...small businesses...can be expected to modify and tailor their behavior to the world of taxes - it ought to run in the other direction...Many of the problems we have in the (tax) system right now are traceable back to an honest, genuine, but terribly misguided quest for theoretically pure answers...(we) really cannot live with theoretically pure answers...we need, instead, to be looking for simplifying assumptions."

And, in connection with Compliance 2000 objectives, haven't some IRS Commissioners since then said something about IRS agents needing to get a better **understanding of the business** they are auditing?

FURTHER REPLACEMENT COSTS LIFO TECHNICALITIES

In the LIFO context, possibly all of the technical sparring necessary to resolve this issue might come down to whether the taxpayer elected on Form 970 to use the "double extension" method in Regulation Section 1.472-8(e)(2) or to use an "other" method for valuing the dollar-value pools. Under the regulation cited above - 8(e)(2), specific rules are provided for the double extension method. Under 472-8(e)(1), other methods are referred to, but not given any special rules.

Therefore, if a taxpayer had elected to use the link-chain method (and was covered under -8(e)(1)), a case may be made that Regulation Sections 1.472-2(b) and (c) are applicable. Under this interpretation, it would appear that a distributor or parts-type inventory taxpayer that had valued its **pre-LIFO inventory at unit costs based on last vendor sheet prices** or catalog costs or replacement costs **would not be required to recalculate** the last pre-LIFO inventory at actual cost.

Why?...Because Reg. Sec. 1.472-2(c) provides that "the actual cost of the aggregate (value of the last pre-LIFO year ending inventory, which constitutes the first year LIFO inventory) shall be determined pursuant to the inventory method **employed by the taxpayer** under the Regulations **applicable to the prior taxable year**...with the exception that restoration shall be made with respect to any write**down** to market values resulting from the pricing of prior inventories."

The history of the Treasury LIFO regulations on this point (possibly going back to changes in 19**42**) might be interpreted to support the position that actual cost does not necessarily mean original cost, except in the case of inventory that had been written down below original cost. In all other cases, the term "actual cost" could be taken to mean the cost aggregate used in the preceding year's closing inventory.

This interpretation would help taxpayers avoid the need to perform detailed "actual cost" computations which the IRS may now be insisting upon.

REPLACEMENT COST ACCOUNTING IS THERE ANY HOPE?...WHAT SHOULD BE DONE?

LTR 9433004

For starters, relax a bit... things may not be as bad as they seem. The IRS has just what it wanted: A Letter Ruling based on "bad" facts that shout a conclusion that many superficial observers may accept at far more than face value. Second, remember that every Letter Ruling/TAM concludes with the statement that Section 6110(j)(3) of the Code provides that it may not be used or cited as precedent. But, everybody does that every day...even the IRS.

Let's further analyze this Letter Ruling to see which taxpayers currently using replacement cost accounting might not necessarily be adversely affected by it. What possible distinguishing facts or characteristics can we identify?

First of all, the Form 970 of the taxpayer in this ruling stated that the LIFO election was being made to use **actual** cost. This reference to **actual** cost would, upon reflection, be ill-chosen wording insofar as the facts of the matter were that the taxpayer in question never used **actual** cost...it always had used **replacement** cost! For parts-type inventories, a more accurate response to the Form 970 requirement for a brief description of the "cost system used" might be:

> "Parts and Accessories: Pursuant to accepted industry-wide practice, the cost of parts and accessories inventories is determined at year-end by reference to manufacturer current price lists in effect at year-end. As a result, the ending parts and accessories inventory is valued at higher replacement costs. This practice results in an overall valuation for parts and accessories inventories that closely approximates, but usually is slightly in excess of, cost."

This language is taken right from our LIFO Seminar Manual and has been employed countless times. It holds true in periods of rising prices (i.e., inflation) and typically can be backed up and justified by inventory turnover computations (generally: cost of goods sold divided by "average" inventory - but subject to a variety of computational refinements such as using average **quarterly** inventory amounts or average **monthly** inventory amounts instead of simply using an **annual** average of opening and closing inventory amounts).

If a taxpayer's rate of parts inventory turnover is less (or significantly less) than the industry standards, there could be a real problem and the IRS may not accept the use of current replacement cost as an approximation of the taxpayer's actual cost. However, where the rate of parts turnover for the industry and the taxpayer's turnover experience are fairly close, then shouldn't the concerns expressed in the ruling about replacement cost being used as a "surrogate for...actual cost" be (far) less valid? With an inventory turnover rate approximating, or even exceeding, the industry turnover rate, the taxpayer should be in a better position to demonstrate that it would have purchased in the normal course of its operations items in its parts inventory at year-end at the replacement costs listed in the manufacturer's price lists. Obviously, the IRS' broad and speculative argument that the "...taxpayer **may never**..." will be impossible to refute if the IRS doesn't give an inch on this perfectionistic line of reasoning into never-land. Who knows what may ever happen in the future?

The AICPA's Auto Dealership Engagement Manual (Sections 3.306 and 3.307) supports the industry practice of maintaining parts inventory at current replacement costs, for which unit costs are typically updated at the beginning of each month (from information received from the manufacturer) to reflect current replacement costs. Section 3.307 of the AICPA Manual states that "while this is not in keeping with the concept of valuing inventory at the lower of cost or market, the effect on the financial statements is generally immaterial and approximates the FIFO basis, because the parts inventory turns over several times a year."

It would seem that taxpayers using replacement cost accounting in connection with their parts-type LIFO or non-LIFO inventories at a minimum ought to make and retain inventory turnover computations for the current year and for prior years. They should also obtain and retain information as to the turnover rate that is "standard" for the industry and compare it to their own.

Another factor suggesting...**caution**...but not necessarily disaster: If a taxpayer is using price appreciation information provided by a manufacturer to derive its own appreciation/inflation factor for the year, the taxpayer/CPA should expect that the IRS will want an explanation or demonstration (*by the taxpayer!*) of **how** the manufacturer's inflation computations or explanation determinations are actually being made and what implicit assumptions affect the results. Furthermore, the IRS may question the

see **REPLACEMENT COST ACCOUNTING... IS THERE ANY HOPE?**, page 7

REPLACEMENT COST ACCOUNTING FOR "PARTS-TYPE" INVENTORIES WHAT THE IRS SAID IN LTR 9433004

LTR 9433004

ISSUE	HOLDING
Is taxpayer that elected to use the dollar-value last-in, first-out (LIFO) link-chain inventory method and to determine total current year cost of items in its parts and accessories inventory pool using most recent purchases **permitted to use replacement cost instead of the actual cost** of most recent purchases in determining its total current year cost for this inventory pool?	**No:** Taxpayer is **not** permitted to use replacement cost to determine total current-year cost of items in its parts and accessories inventory pool. Use of replacement cost is inconsistent with its election to determine total current-year cost of these items by reference to the **actual cost** of its most recent purchases.

Section 472(b)(2) of the Code provides that in inventorying goods under the LIFO method, the taxpayer shall inventory them **at cost**. Any taxpayer may elect to determine the cost of its LIFO inventories under the dollar-value LIFO method, provided such method is used consistently and clearly reflects income.

The total current-year cost of items making up a pool may be determined:

(a) By reference to the **actual cost** of the goods most recently purchased;
(b) By reference to the **actual cost** of the goods purchased during the tax year in the order of acquisition;
(c) By the application of **an average unit cost** equal to the aggregate cost of all of the goods purchased throughout the tax year divided by the total number of units so purchased; or
(d) Pursuant to **any other proper method** which, in the opinion of the Commissioner, clearly reflects income. (Note: (a), (b), (c) and (d) are all part of Question 6 on the Form 970.)

Taxpayer contends that its method of accounting for motor vehicle parts and accessories satisfies the requirements in that its inventory (1) conforms as nearly as may be to the best accounting practice in the trade or business and (2) clearly reflects income. In addition, taxpayer argues that its consistent use of this method necessarily means that it is also complying with any requirements specific to LIFO.

However, in *Thor Power Tool Co. v. Commissioner*, 439 U.S. 522 (1979), the United States Supreme Court held the taxpayer's writedown of excess inventory did not clearly reflect income because the writedown was in direct contravention to specific regulatory authority notwithstanding the fact that the taxpayer's writedowns of its excess inventory were in accordance with generally accepted accounting principles (GAAP) for financial reporting purposes. Thus, any specific statutory or regulatory requirement applicable to LIFO must be complied with in order to conclude that a taxpayer's method clearly reflects income. In other words, compliance with the specific LIFO requirements is a prerequisite to clearly reflecting income.

In this case, in order to determine whether taxpayer has satisfied the requirements...it is necessary to **first** determine whether it is complying with any other specific requirements imposed by the Code or underlying regulations. **Taxpayer's failure to comply with the requirements of Section 472 of the Code and/or Section 1.472-8 of the regulations would support a per se conclusion that its method does not clearly reflect income under the holding in *Thor Power Tool*.**

The specific provision that applies in this case is Reg. Sec. 1.472-8(e)(2)(ii)(a) which provides that the total current-year cost of items making up a dollar-value LIFO pool be determined by reference to the **actual cost** of the goods most recently purchased or produced. Accordingly, this specific language requires that cost be determined by reference to **actual cost**. Thus, taxpayer's use of replacement cost was not in compliance with this specific regulatory requirement. **Generally, use of invoices or production cost is necessary to reflect the actual cost of inventory acquired by a taxpayer.** (Note use of qualifier "Generally"...Query: What are some allowable exceptions?)

Under Reg. Sec. 1.472-8(e)(2)(ii)(d), taxpayers are permitted to determine the total current-year cost of items making up an inventory pool pursuant to **any other proper method which**, in the opinion of the Commissioner, **clearly reflects income**. Because the taxpayer specifically elected on its Form 970 to determine the total current-year cost of items in its parts and accessories inventory pool by reference to the **actual** cost of its most

see **REPLACEMENT COST ACCOUNTING...WHAT THE IRS SAID IN LTR9433004**, page 8

 (Continued from page 5)

inventory mix at different times during the year, as well as the assumed inventory mix inherent in any price information the manufacturer provides. Still another problem surrounds how, or if, new items are being treated or repriced in the compilation of that inflation information.

Finally, observe how the taxpayer addressed in the Ruling thought it was being a good citizen by doing something "reasonable" in not using the manufacturer's appreciation figures for the year because the results seemed to be "unrealistically high." The CPA involved indicated that, in fact, the manufacturer's price appreciation for the year was about 9% and they actually ended up using only 3% instead because they did not want to appear to be unreasonable. So they reduced the inflation rate by two-thirds from 9% to 3%!

This was an obvious good faith effort by the taxpayer **NOT** to run afoul of the "clear reflection of income" standard by overstating the inflation index for the year. For its good intentions, the taxpayer was slapped by the IRS with the charge that it had changed its accounting method without first obtaining permission. (Sin of sins!) So much for trying to "do right by the IRS" in matters of conscience or fairness. Observe carefully here how the IRS took the taxpayer's "good faith" judgment and used it for punishment purposes to create a technical argument against which there is little defense. (But if the IRS did it, they would call it a "correction of the valuation.")

One IRS concern is that possibly replacement cost at year-end might be lower than actual cost and this would create a conflict with the statutory requirement that LIFO inventories be stated at cost. Shouldn't somebody try to persuade the Treasury/IRS that for many decades (do you remember deflation?) the general price trend has been inflationary...and that using replacement costs results in the prepayment of tax by businesses not using LIFO? Maybe some taxpayers will file Forms 3115 (better yet, refund claims) using ersatz "cost" computations to make this point.

SUGGESTIONS FOR COPING WITH LETTER RULING 9433004

1. Accurately and carefully describe the cost method used for parts inventories in the attachment to the Form 970. (See the suggested descriptive wording in this article and modify it to your situation accordingly.)

2. Be careful **NOT** to state that the parts inventory is valued at **actual** cost (unless, of course, it really is).

3. On question 6(a) on the Form 970, reference the election for valuing increments to the "Other...method" under Reg. Sec. 1.472-8(e)(2)(ii)(d). This may be described by language along the following lines:

   "Taxpayer elects to value any annual increment (as determined under the link-chain, index method) by applying an index developed with reference to the specific identification of items in inventory at year-end, and this method will closely approximate the 'most recent purchase method.'"

4. Develop and retain inventory turnover information to demonstrate that the use of replacement cost "approximates" or "closely approximates" actual cost. (This apparently was a problem for the taxpayer in this ruling.)

5. Be prepared to explain to an IRS agent how manufacturer appreciation information is compiled. Call the manufacturer and find out now...and get it in writing. This may be tough, but be persistent.

6. Think twice about trying to "do the Government any favors" by applying judgment in cases where you believe/feel/think/know the resulting index is unrealistically high. The taxpayer, in voluntarily lowering its index (to what it *believed* to be more in line with prevailing conditions), unintentionally gave the IRS a devastating weapon.

7. Don't overlook the technical arguments, including the history of the Regulations going as far back as 1942 that can be made, but were not raised in the Ruling. See "Further Replacement Cost LIFO Technicalities" on page 4.

8. If you conclude you've got a severe problem after evaluating all of this, consider changing over to the Bureau of Labor Statistics Published Price Index/Producer Price Index method.. and file Form 3115 *fast*. The BLS method has its own limitations (i.e., all LIFO inventories must be converted to PPI) and restrictions (i.e., most taxpayers can use only 80% - not 100% - of the applicable index). However, filing a Form 3115 before the IRS starts an audit protects against IRS adjustment of your LIFO reserves. Section 9.01 of Revenue Procedure 92-20 grants the "cut-off" method for "voluntary" changes.

 (Continued from page 6)

recent purchases of these goods, it is unnecessary to opine as to whether taxpayer's use of replacement cost would be permitted under Section 1.472-8(e)(2)(ii)(d) as an "other" increment valuation method.

We note that the arbitrary departures from replacement cost based on taxpayer's subjective belief that the manufacturer's price appreciation list did not accurately measure inflation would, in any event, be improper.

Moreover, any "other" method would have to satisfy the requirement under Section 472(b)(2) of the Code that LIFO inventories be stated **at cost**. For purposes of some LIFO inventory methods, cost may be based on something other than actual cost. For example, under the retail LIFO method selling prices on hand at the beginning of the year in each department or of each class of goods is reduced to approximate cost based on a cost to retail ratio. Similarly, under the Inventory Price Index Computation (IPIC) method, manufacturers are required to convert Producer Price Indexes (based on the producers' selling prices) to cost price indexes based on gross margins.

However, these other methods used to derive the "approximate" cost of items comprising a LIFO increment are, nevertheless, based on actual cost data, albeit not necessarily the actual cost of items actually in or deemed to be in ending inventory under the LIFO cost flow assumption. **In this case, taxpayer is using the replacement costs of its parts and accessories as a surrogate for their actual cost. Taxpayer may never have actually purchased these items for the replacement cost amount, even at a different point in time.**

LIFO IN A WINERY

In a Tax Court Memo Decision (1994-396)...*Oak Knoll Cellar v. Comm*....filed August 18, 1994, taxpayers challenged the authority of the IRS to question their LIFO computations and tried to recover attorneys fees when the IRS later dropped all objections to their LIFO computations.

If you are interested in how the specific-goods LIFO method might be applied to a winery, or knowing that red wine apparently should not be mixed with white wine (in the same LIFO pool, of course), read this *case*. The Tax Court supported the wide latitude and authority the IRS has to question LIFO methods and later concede them without liability for an award for attorneys fees.

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CONFUSION CREEPING BACK INTO THE ALTERNATIVE LIFO METHOD SHOULD "SUBSTANTIAL COMPLIANCE" MEAN "GUESSING RIGHT"?

The party's over: The ISP seems to be taking a very restrictive view of what constitutes a "new item"...in direct contradiction to Revenue Procedure 92-79, as written by the National Tax Office.

In drafting Revenue Procedure 92-79, the National Tax Office commendably tried to define "new items" to reflect industry practice which, although hard to pinpoint, seems to result in different levels of "change" related to the degree or percentage of tooling effort required of automobile manufacturers to meet market demands. In order of complexity, these tooling levels would seem to be:

TOOLING LEVELS

1. New minor tooling efforts to revise auto trim items, i.e., bumpers, molding, ferrings, etc. (lowest level of change).
2. New moderate tooling efforts to revise drive train items, i.e., transmissions, rear axle design, etc.
3. New tooling for some engine and accessory changes, a minor "refreshening" of body design parts such as fenders, trunk shape, grille area parts (every 2-3 years).
4. New tooling for a major refreshening of body design parts, engine and accessories, i.e., complete new body style, but still within prior year's vehicles overall shape.
5. Complete new extensive tooling for a "platform" change which introduces a new overall length and/or width of the car. Occurs with introduction of new model or new class of car.

Unless there were some change in a vehicle that ***caused*** a change in the model number, the fifth level revision appears to be the one contemplated as the level signalling a "new" item for purposes of Revenue Procedure 92-79.

Section 4.02(5) defined a new item category as (1) a 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 has been no change in the manufacturer's model code, but there has been a ***change to the platform,*** then a new item category is created whether or not the same model name was previously used by the manufacturer.

It appears that the Motor Vehicle MSSP has expanded the concept of "new items" for purposes of Revenue Procedure 92-79 beyond the National Office's definition in Section 4.02(5) to include vehicles reflecting many, if not all, of the other tooling revision levels ***even where there has not been a change in model number***. Literally, any change whatsoever seems to be characterized by these agents as resulting in a new item. Certain vehicles that were "reskinned" are treated by the MSSP as new items even though the model numbers didn't change.

A few practitioners involved with "compliance checks" indicate that the Service is comparing vehicles treated as new items by the taxpayer with the list previously released by the MSSP and this, in substantial part, affects the compliance grade or determination the taxpayer receives for the year of change:

COMPLIANCE GRADES

1. You are in compliance with *the election,*
2. You are substantially in compliance with *the election,*
3. You are in compliance with *the election* but there are material errors in the computations. You may file an amended return(...)to correct any errors in the computations, or
4. You are not in compliance with *the election.* You may be eligible for the relief provisions for Revenue Procedure 92-20 or Revenue Procedure 92-85.

In connection with these ratings, if the recomputed LIFO reserve adjustment is under a certain dollar limit ($10,000) or a certain percentage of cost of sales (remember: this is not an audit), apparently the IRS won't "require" an amended return.

The June, 1994 issue of the *LIFO Lookout* extensively analyzed the MSSP's "unofficial" new item lists and numerous differences between those lists and others (including our own) independently compiled. So far the IRS/MSSP has not released/finalized '93 or '94 model lists, leaving many practitioners uneasy because these lists will be the basis for auditors second-guessing them on new item determinations.

Another possible difference of interpretation relates to situations where the beginning inventory contains older model year vehicles. The 14-step methodology provides that more than one year's inflation may be included in an annual index because averaging as to model years occurs in the

see **CONFUSION CREEPING BACK INTO THE ALTERNATIVE,** page 10

determination of the average base vehicle costs at both the beginning and the end of the year. Accordingly, a dealer with a beginning inventory which includes 1991 model vehicles and an ending inventory which includes 1993 model vehicles will reflect more than one year's worth of inflation for that year. Under Rev. Proc. 92-79, that's the result - even though it may be inaccurate. If, in the opinion of 92-79 compliance checkers, only one year's worth of inflation is "allowable," what is one to do? These "compliance" checks are not official audits...But, if they aren't..., What are they?

Some of us interpreting Revenue Procedure 92-79 as written, or literally, are concerned that an evaluation by the MSSP of compliance with the substance of Revenue Procedure 92-79 may be confused and diluted by differences of opinion over interpretive issues, judgment calls and second-guessing.

As pointed out in our Update comment on this, what's worse is that many dealers have the mistaken impression that there is a right answer or a unified IRS position or interpretation on some matters...when *in fact* there may not be.

SUBSTANCE

- Filing Form 3115. Timely filing.
- Proper pooling.
- Item category determination.
- *New item determination*.
- New items at 1.000.
- Rebasing indexes to 1.000.
- Retention of invoices and calculations for review by IRS.
- Proper valuation of increment.

More realistically, the National Office may take one position on a technical matter and the IRS/MSSP specialists and agents in the field may take a different position and enforce and communicate only their own in the field.

NADA is trying to obtain IRS cooperation in reviewing and coordinating new item determinations so they can be timely released for 1995. Hopefully, this will happen. But what's to happen in the meantime?

DEALER LIFO CONFORMITY... WHO'S MINDING THE STORE?

Isn't it about time somebody asks: Who's minding the store?

This has nothing to do with the *usual* technical arguments; but I think it has **everything** to do with resolving the conformity issue in favor of automobile dealers.

If you agree, perhaps we can join together and assist NADA in bringing our concerns to the attention of the Treasury with a view toward clarifying...**once and for all**...this issue.

I have in mind something like a petition. Something simple enough to express our concerns, yet broad enough - by reflecting many signatures - to reflect the unanimity of opinion by CPAs willing to speak out on this matter. What do you think? How can we best ask: Who's minding the store?

AUTOMOBILE DEALERS LIFO CONFORMITY REQUIREMENTS WHAT DID THE TREASURY *REALLY* MEAN IN 1981?

The amendment of the regulations by the Treasury in 1981 was intended to provide **all** taxpayers with **relief** from the LIFO conformity requirement. This is evident from a number of statements by high ranking Treasury/IRS personnel. The majority of the changes, including all of the substantive changes, granted broad relief to large, publicly-held corporations by providing for "supplementary information" reporting of non-LIFO information.

There is ample evidence that the **overall intention of the Treasury** in amending the LIFO conformity regulations in 1981 **was to liberalize** them...not to make them more restrictive for any select group of taxpayers.

Consider the statements of several ranking Treasury officials to different members of Congress. These statements were made at different times during the period when the regulations were in proposed form (Messers. Halperin and Lubick) as well as after the regulations were issued in final form (Mr. Chapoton).

On **February 12, 1980, Daniel I. Halperin**, Deputy Assistant Secretary, Tax Legislation, Department of the Treasury, stated the following during Hearings before the Subcommittee on Access to Equity Capital and Business Opportunities of the Committee on Small Business, House of Representatives:

> "Let me say this. We have, in the rules issued last July (1979), substantially eliminated difficulties. We have allowed supplemental disclosure of income on the LIFO (sic) so that the taxpayers are able to report to the shareholders and give shareholders information they should have **without problems with the Internal Revenue Service."**

On **October 24, 1980, Ronald C. Lubick**, Assistant Treasury Secretary for Tax Policy, in a letter to Senator Gaylord Nelson, Chairman of the Senate Select Committee on Small Business, stated:

> "In order to make the LIFO rules realistic in today's accounting environment of promulgating full financial disclosure, the IRS on July 20, 1979 issued proposed regulations **to allow *any* type of non-LIFO disclosure** statement. This ***liberalization*** allowed major corporations using LIFO for tax and book purposes to comply with Statement No. 33 of the Financial Accounting Standards Board. ...The IRS is in the process of finalizing these regulations.
>
> "We believe **the time has come to repeal the LIFO conformity requirement**. We do not believe it serves any useful tax policy purposes. Repeal of the LIFO conformity requirement would save taxpayers, taxpayer representatives and the Internal Revenue Service from the burden of having to deal with rules that do not directly affect the computation of tax liability. In addition, it will greatly simplify the ability of small businesses to use the LIFO methods of inventory valuation."

On **September 25, 1981, John E. Chapoton**, Assistant Secretary (Tax Policy), Department of the Treasury, made the following statement before the Subcommittee on Taxation and Debt Management of the Senate Finance Committee. This statement was made as part of his testimony before the Subcommittee presenting the views of the Treasury Department on various bills, including one to repeal the LIFO conformity requirement:

> "...it is Treasury's position that this relief should come in the form of amending current rules with respect to the LIFO method to make that method *more accessible to all businesses*. We have taken steps in this regard. **For instance, the LIFO conformity rules...*have been significantly liberalized.*"**

Isn't it reasonable to interpret Mr. Lubick's reference to *"repeal"* of the LIFO conformity requirement as a reference to repealing the substance of the previously restrictive regulations?

If the restrictive interpretations being advocated today by certain IRS agents had been brought up for discussion during *any* of the exchanges quoted above between the Treasury representatives and Congress, these quotations indicate that neither the Treasury, nor Congress, would have agreed with today's IRS agents who are trying to trick auto dealers out of their LIFO elections.

When the LIFO conformity regulations were published in final form on January 22, 1981, their examples did not specifically address the application of these revised conformity requirements to dealers' financial statements which are required to be submitted in prescribed format at the end of every month and at year-end to the manufacturers.

The current dispute has been precipitated by the failure of the regulations in 1981 to clarify this important issue for automobile dealers. This should be corrected as quickly as possible **without retroactive penalty.**

Willard J. De Filipps, CPA

LIFO RECAPTURE TAX & MECHANICS IN C TO S CONVERSIONS REVENUE PROCEDURE 94-61 PROVIDES GUIDANCE

Our article in the June, 1994 *LIFO Lookout* on going from C to S conversions concluded that... "Until we have answers to these LIFO-related questions, switching from C to S status or vice versa unavoidably and automatically raises the possibility of nightmarish tax consequences to be dealt with in the future."

The "future" just arrived in the form of questions, answers and an example in Revenue Procedure 94-61 (I.R.B. 1994-38, 56).

This Revenue Procedure applies to S elections made after December 17, 1987, except to the extent provided in Q&A-2, relating to the special collapsed layer for pre-S years.

Good News: The IRS confirmed that a LIFO election is not terminated upon a switch from C to S status. All prior C corporation LIFO layers are rolled up - "collapsed" - into one single layer having an average weighted LIFO index valuation.

The IRS explains that collapsing the LIFO layers is appropriate because (1) the revaluation of ending inventory to FIFO (using the lower of cost or market as of the date of conversion to S status) is inconsistent with the LIFO layering approach and (2) Section 1363(d) was enacted to create parity between LIFO and FIFO taxpayers when LIFO users elect to be taxed as S corporations.

The index for the Special Collapsed Layer (for the last C corp year) is relevant only for the purpose of computing the LIFO carrying value of a decrement in the event there is a decrement experienced in a later S year which has to be carried back to the LIFO inventory as of, or prior to, the last C corp year.

Thus, this adjusted index for the Special Collapsed Layer would be used only if the end-of-year inventory, expressed in terms of base-year cost, for a taxable year subsequent to the last C corp taxable year (i.e., in an S year), is less than the base-year cost of the inventory as of the last day of the last C year.

More Good News: If you didn't quite adjust the pre-S years LIFO layers the way the IRS shows in an example, the Service "will accept as appropriate any reasonable method used by the taxpayer for adjusting its LIFO inventory to reflect the LIFO recapture amount"... for a taxable year ending before September 19, 1994.

There is no indication in the Revenue Procedure of which "alternative methods" (for adjusting a LIFO inventory to reflect the recapture amount) the IRS considers "reasonable." The following *might* qualify:

ARE THESE OKAY?

1. Allocating the LIFO reserve recapture amount pro rata to each annual increment layer on a "vertical slice" basis.
2. Recomputing all prior years' ending inventories under FIFO and using ratios of the inventory balances as developed from that FIFO recomputation as the basis for allocating the LIFO recapture amount to the annual increment layers.
3. Setting up a "suspense account" as the mechanism for keeping track of the LIFO reserve recapture.

REFUND CLAIMS

Finally, Some Really Good News: As illustrated in the June, 1994 issue of the *LIFO Lookout* (see page 3), taxpayers might have significantly shortchanged themselves if they started over with a LIFO inflation index on of 1.000 the first day of the first S year.

Revenue Procedure 94-61 clearly states that the cumulative inflation index as of the end of the last C year carries over! Accordingly, as we illustrated in that article, the IRS may owe you some money and refund claims may be in order!!!

But, One Caution: Carefully study the Unanswered Questions on page 15...there's more to this than meets the eye!

LIFO RECAPTURE TAX & MECHANICS IN C TO S CONVERSIONS SPECIAL "COLLAPSED LAYER" FOR PRE-S YEARS

REV. PROC. 94-61

Taxpayer elected LIFO in 1988. On December 31, 1991, the LIFO carrying value is $1,600 and the inventory is valued at $1,900 under the FIFO method using cost or market, whichever is lower. If the taxpayer elected to be taxed as an S corporation effective January 1, 1992, the LIFO recapture amount is $300 ($1,900 less $1,600).

The appropriate adjustments are made by collapsing the LIFO layers and adding the $300 LIFO recapture amount to the LIFO carrying value of the ending inventory as of the end of the 1991 taxable year. The index is then changed/adjusted to reflect the adjusted relationship between the new LIFO carrying value ($1,900) and base-year costs ($1,500). The base year and base-year costs do **not** change.

		BEFORE			AFTER		
		Base Year Cost	Index	LIFO Carrying Value	Base Year Cost	Index	LIFO Carrying Value
Jan. 1, 1988	Base-year	$ 1,000	100%	$1,000	—	100%	—
Dec. 31, 1988	Layer	200	110%	220	—	110%	—
Dec. 31, 1989	(Decrement year)	—	115%	—	—	115%	—
Dec. 31, 1990	Layer	100	120%	120	—	120%	—
Dec. 31, 1991	Layer	200	130%	260	—	130%	—
Dec. 31, 1991	Special Collapsed Layer Resulting From Section 1363(d) Adjustment	—	—	—	1,500	126.67%	1,900*
Totals		$ 1,500		$1,600	$ 1,500		$ 1,900

* ($1,900 = $1,600 LIFO value + $300 recapture amount)

Note that the beginning inventory is $1,900 for the 1992 taxable year, which is the first year the taxpayer is taxed as an S corporation. Also, note that for a taxpayer using the link-chain method the cumulative index is not recomputed. The cumulative index at December 31, 1991 is 130 percent, even though the adjusted index for the special collapsed layer resulting from the Section 1363(d) adjustment is 126.67 ($1,900 divided by $1,500) percent. The cumulative index at December 31, 1992 will be the product of 130 percent and the annual link for the December 31, 1992 taxable year.

If, in 1992, the taxpayer's ending inventory at base-year cost is $1,400 (a decrement of $100), the LIFO carrying value of the Special Collapsed Layer Resulting From Section 1363(d) Adjustment will decrease by $126.67 ($100 x 126.67%) to $1,373.33 ($1,400 x 1.2667, ignoring rounding).

If a taxpayer has experienced a decrement in its LIFO inventory for a taxable year ending before September 19, 1994, the Service will accept as appropriate any reasonable method used by the taxpayer for adjusting its LIFO inventory to reflect the LIFO recapture amount.

The index for the Special Collapsed Layer (for the last C corp year) is relevant only for the purpose of computing the LIFO carrying value of a decrement in the event there is a decrement experienced in a later S year which has to be carried back to the LIFO inventory as of, or prior to, the last C corp year.

Thus, this adjusted index for the Special Collapsed Layer would be used only if the end-of-year inventory, expressed in terms of base-year cost, for a taxable year subsequent to the last C corp taxable year (i.e., in an S year), is less than the base-year cost of the inventory as of the last day of the last C year.

LIFO RECAPTURE TAX AND MECHANICS IN C TO S CONVERSIONS

REVENUE PROCEDURE 94-61

QUESTIONS	IRS ANSWERS
1. Does inclusion of the LIFO recapture amount in gross income of a C corporation under Section 1363(d) result in the termination or discontinuance of the LIFO method?	1. No; the LIFO election is not terminated. Inclusion of the LIFO recapture amount in gross income will not result in a termination or discontinuance of a taxpayer's LIFO election.
2. How does a taxpayer make the appropriate adjustments to the basis of inventory required by Section 1363(d)(1)?	2. The appropriate method to effect the adjustment is to collapse any LIFO layers and add the LIFO recapture amount to the LIFO value of the ending inventory as of the end of the taxpayer's last year as a C corporation. See example.
3. If a taxpayer makes the appropriate adjustment to the tax basis of its inventory, as required by Section 1363(d), but does not make such adjustment for financial reporting purposes, is the LIFO conformity requirement violated?	3. No; the taxpayer does not violate the LIFO conformity requirement by making the appropriate adjustment to the basis of its inventory for tax purposes but not for financial reporting purposes. The revenue procedure contains a detailed explanation of this favorable conclusion.
4. Is a taxpayer entitled to reduce its gross income if the amount of its inventory under the LIFO method exceeds the amount of its inventory under the FIFO method? (This is where FIFO is less than LIFO - a "negative" LIFO reserve situation.)	4. No; the taxpayer may not reduce gross income under these circumstances. This is implicit from Section 1363(d)(3)'s definition of the term "LIFO recapture amount" as the amount - if any - by which the inventory amount under the FIFO method exceeds the amount of such asset under the LIFO method.
5. May a net operating loss (NOL) carryover be applied against the LIFO recapture amount included in the gross income of a C corporation?	5. Yes, subject to applicable Code restrictions. To the extent the NOL carryover offsets the LIFO recapture amount, there would be no increase in tax by reason of Section 1363(d). However, the appropriate Section 1363(d) adjustment to the basis of inventory is the LIFO recapture amount unreduced by any NOL carryover.
6. If the LIFO method has been used for less than four taxable years prior to a taxpayer's first year as an S corporation, should the number of, or period over which, installment payments for the additional tax resulting from the LIFO recapture amount be reduced from the four equal installments required in Section 1363(d)(2)?	6. No; neither the number of installments nor the period for their payment should be reduced. Any increase in the tax imposed as a result of including the LIFO recapture amount in gross income shall be payable in four equal installments with the first installment being paid by the due date of the return for the electing corporations's last taxable year as a C corporation. The other three installments are due by the respective due dates of the S corporation's returns for the three succeeding taxable years without regard to the number of years the C corporation may have used the LIFO method.
7. Should an S corporation's obligation to pay an installment of tax resulting from the LIFO recapture amount be taken into account in determining the amount of estimated tax an S corporation is required to pay?	7. No; an S corporation should not include the obligation to pay an installment of tax resulting from the LIFO recapture amount in its determination of its estimated tax payment under Section 6655.
8. If an S corporation files a final return, are any unpaid annual installments of the increase in tax required under Section 1363(d) (that otherwise would be payable in subsequent taxable years) due and payable with the S corporation's final return?	8. Yes; any remaining unpaid annual installments of the increase in tax which would have been due by the respective due dates of the S corporation's returns for the succeeding taxable years, are accelerated and are due and payable with the S corporation's final return.

LIFO RECAPTURE TAX & MECHANICS IN C TO S CONVERSIONS ...MORE UNANSWERED QUESTIONS

REV. PROC. 94-61

1. What will the IRS accept for years ending before September 19, 1994 as "any reasonable method used by the taxpayer for adjusting its LIFO inventory to reflect the LIFO recapture amount" in cases where the taxpayer has experienced a decrement in the previous years? (The Revenue Procedure merely says the IRS will accept "any reasonable method" without any further clarification or illustration of either acceptable or unacceptable methods.)

   Where an acceptable different method was used, are the net LIFO layers remaining as of the end of the first year ending before September 19, 1994 required to be collapsed into a Special Collapsed Layer as of that date in accordance with the principles in the example in the Revenue Procedure? (That appears to be the result because the Revenue Procedure does not say acceptable alternatives may continue to be used in the future - it merely says that for years ending before September 19, 1994, the Service will accept "as appropriate any reasonable method...") Presumably, any adjustments necessitated in the first year ending after September 19, 1994 would <u>not</u> constitute a change in accounting method requiring a Form 3115 filing.

2. If the taxpayer has used some method other than that in the example, is the taxpayer required to initiate any action or file any form or schedule to receive approval from the IRS of its alternative treatment?

3. What should a taxpayer do if it mistakenly concluded that its LIFO election as a C corp was simultaneously terminated by its S election? Should amended returns be filed for all S years to recompute continuing LIFO reserves? How are these taxpayers now to disclose their unauthorized termination of their LIFO election? (Although these taxpayers may have inadvertently violated the conformity requirement based on the mistaken assumption that they were not still on LIFO, that violation of the conformity requirement does not *per se* terminate their LIFO election since the Commissioner has discretionary authority in "conformity" situations.)

   This is a major problem. Hopefully, the NTO Accounting Methods Section will address it.

4. What if a taxpayer began its LIFO computations for its first S year using an index of 1.000 instead of using the cumulative index as of the end of the last C year? **This throws off all LIFO calculations for all S years.** Should amended tax returns be filed? Even for years beyond the normal 3-year statute of limitations? Can taxpayers apply the *Hamilton* result (i.e., no statute of limitations on inventory adjustments) and make the net cumulative adjustment for all closed years in the earliest open year? For administrative purposes, would it be "easier" or "more practical" to roll the net change in the LIFO valuation forward to the beginning of the first taxable year ending after September 19, 1994 and take the net adjustment into income all at once? (See example at pages 2-3 in June, 1994 *LIFO Lookout.*)

5. How should auto dealers who use specific identification... and all other taxpayers who do not value their inventory at <u>FIFO</u>... determine their Section 1363(d) adjustment amount? Are they really required to go back and resequence the flow of their purchases during the year to replicate a <u>**FIFO**</u> identification at year-end? May a "shortcut" method be used to approximate FIFO?

? ?

SAMPLING SHORTCUTS:
DON'T EVEN THINK ABOUT TRYING THESE!

In April, 1994, the ISP issued a Proposed Coordinated Issue Paper entitled: "Segment of Inventory Excluded from the Computation of the LIFO Index." This provides fair warning to taxpayers that examining agents are becoming much more skeptical about sampling techniques (or should we say about the lack of sampling techniques). Although there is only general guidance available on what is meant by "other sound and consistent statistical methods," that doesn't stop everyone from throwing those words around as if everyone else knew exactly what they meant.

What is discussed in the ISP Paper is sufficient to reach the conclusion that the IRS is becoming increasingly less tolerant with bungled and botched *"sampling"* indexes. Sampling shortcuts and less than representative sampling attempts will result in the Service allowing no inflation in LIFO inventories. Although some of the technical discussion in this Issue Paper may be questionable, the conclusions still follow regardless of how inartfully some technical terms are treated.

ISSUE	**HOLDING**
Whether a LIFO index developed by double-extending (i.e., repricing) one segment of the inventory can be applied to another segment of the inventory that was not double-extended (i.e., repriced).	The LIFO index cannot be applied to a portion of inventory which was not represented when the index was computed.

Readers of the complete text of this Issue Paper with a technical eye will note the *complete contradiction* in the statement that "a taxpayer using the index **or link-chain method** may compute an index by double extending **a representative portion** of the inventory in a pool or by the use of other sound and consistent statistical methods." In an earlier Coordinated Issue Paper (Definition of an Item, July, 1989)...as well as in the Appeals Coordinated Issue Paper in June, 1993...it is stated that "under the **link-chain method**, the quantity of **each item** in the inventory pool at the close of the year is extended at both the beginning-of-the-year unit cost and the end-of-the-year unit cost."

Under these 1989 and 1993 "definitions" of the link-chain method, the use of "the quantity of **each item**" clearly expressed the position of the IRS that sampling may *not* be used in connection with the link-chain method. Is the Service now saying that sampling can be used with link-chain? What is meant by "each item" and is the Service now "liberalizing" its definition of the link-chain method or its tolerance of how that method may operate? Although it would help us all and be less distracting if the "IRS" had a better handle on its own theory, the point is that less than a complete command of theory and technical terms will not stand in the way of the IRS' ready attack of any LIFO method or practice it doesn't like under any guise, theoretical or not.

In PLR 9332003, the statement appears: "even if X (i.e., the taxpayer) were able to prove no distortion *had ever resulted* from its method, *there is no assurance* that a distortion would not result *in some future year.*" Is this not one of the most impossible and oppressive standards ever enunciated by the IRS to thwart a taxpayer's LIFO application? Incredibly, the very next sentence in the original text of PLR 9332003 (which is *not* included in the text of the ISP!) states: "accordingly, X **must consider each item**, including the new models in its dollar-value LIFO pools, when computing its annual LIFO index **under the link-chain method**."

Thus, PLR 9332003 (authored by the National Tax Office) states unequivocally that **each** item must be repriced under the link-chain method. This is now completely contradicted by the statement in the April, 1994 Coordinated Issue Paper on sampling shortcuts. Was this ISP Paper coordinated with the National Office, whose Letter Rulings/TAMs usually evidence greater care in technical discussions? Is the National Office (which authored the PLR) ever consulted before Coordinated Issue Papers are released?

Keep your eye on the doughnut and not upon the hole: Although the theoretical discussions in this Issue Paper may be debatable or inconsistent, the conclusion is not. Taxpayers should not even think about trying... or trying to get away with... the sampling shortcuts mentioned.

PROHIBITED SAMPLING SHORTCUTS
TEXT OF ISP COORDINATED ISSUE PAPER

ISP
APRIL 1994

"SEGMENT OF INVENTORY EXCLUDED FROM THE COMPUTATION OF THE LIFO INDEX"

A taxpayer may ordinarily use only the so-called "double-extension" method for computing the base-year and current-year cost of a dollar-value inventory pool. This requires the repricing of every item, i.e., no sampling is allowed in connection with the double-extension method. The Regulation also provides that an index may be computed by double-extending (i.e., repricing) a representative portion of the inventory pool or by the **use of other sound and consistent statistical methods**. The index used must be appropriate to the inventory pool to which it is to be applied.

Where the use of the double-extension method is impractical, the taxpayer may use the index method or the link-chain method. There are no examples or other regulations that relate specifically to the use of the index or link-chain methods.

Even though the regulations do not provide specific rules for the link-chain or index methods, it is **commonly agreed** that those methods are **conceptually comparable** to the double-extension method. Except for the sampling **techniques** used in both the link-chain and the index methods and the use of a cumulative index in the link-chain method, the principles, concepts, and operating rules in the double-extension regulations are conceptually applicable to taxpayers on the index or link-chain methods.

Thus, a **taxpayer using** the index or **link-chain method may compute an index by double-extending a representative portion of the inventory in a pool** or by the use of **other** sound and consistent statistical methods. (LL Comment: This statement insofar as it refers to the link-chain method directly contradicts the July, 1989 Issue Paper on "Definition of an Item," the Appeals Coordinated Issue Paper in June, 1993 and PLR 9332003.)

The use of the word "**other**" in the regulations implies that the "representative portion" must be selected using sound and consistent statistical methods. Those methods require that every item in the population must have an equal non-zero chance of selection. If some portion of the population has no chance of selection, defensible statistical projections cannot be made to that portion.

In PLR 9332003 the taxpayer argued that if a large portion of the inventory items are (sic) double-extended, the sample is representative. The Service

NO-NO • NO-NO • NO-NO

Many taxpayers attempt to shortcut the requirements of the regulations.

- Double-extend only the large dollar items in the inventory and then apply the derived index to the entire inventory,
- Taxpayers who use samples that are not statistically valid and apply the derived index to the population,
- Taxpayers who do not include new items in the computation of their index and apply the index to the entire inventory including new items, and
- Taxpayers who determine an index for one segment of the inventory (a warehouse for example) and apply that index to other segments of the inventory (its stores for example).

rejected the taxpayer's position, however, stating "even if X were able to prove no distortion had ever resulted from its method, **there is no assurance that a distortion would not result in some future year**. X has not met its burden of establishing that its method results in the double-extension of a representative portion of its inventory, or that X has used other sound and consistent statistical methods. Thus, the index computed...does not clearly reflect income."

In *Basse*, 10 TC 328, the Tax Court did not allow a taxpayer to apply an index, computed without reference to a material segment of inventory, to the total inventory. *Basse* was a retailer using the LIFO method of valuing inventory. *Basse* had a pool containing inventory at both a warehouse and a number of stores. The goods located at the warehouse were the same as the goods at the stores, but in a different ratio or mix. *Basse* double-extended 100 percent of the warehouse goods in order to determine an index of inflation for the year. None of the goods located at the stores were double-extended. *Basse* divided the end-of-year costs at the stores by the warehouse index in order to determine the beginning-of-year costs for the stores.

The Service challenged the application of *Basse's* warehouse index to goods located at the stores on the grounds that the flow of goods at the warehouse was different from the flow of goods at the stores, and

see **SAMPLING SHORTCUTS...**, page 20

DUAL INDEX (EARLIEST ACQUISION) APPROACHES FOR VALUING LIFO INCREMENTS - A 1994 ISP UPDATE

The September, 1993 *LIFO Lookout* contained three articles on dual index approaches for valuing increments and how they might be employed. These articles summarized the attitude of the IRS in one word: **HOSTILE**. In a Proposed Coordinated Issue Paper released July, 1994 entitled "The Earliest Acquisition Method," the IRS/ISP addressed dual indexes.

In the Alternative LIFO Method for Auto Dealers (Rev. Proc. 92-79), the IRS cleanly eliminated dual index approaches by providing that in valuing increments, the "specific identification" method is required. This requires the current year cost of the items making up the pool to be determined by reference to the actual cost of the specific new vehicles in ending inventory. In other dual index situations, insistence by the IRS upon an identical mix and quantity of items on hand at year-end creates practical problems, especially where the increments may be small relative to the overall size of the ending inventory.

This Issues Paper does not state, one way or another, whether the Service will accept a cumulative Earliest Acquisition index that is the product of multiplying the prior year's cumulative deflator index by a separately computed Earliest Acquisition index for the current year (which very often is 1.000). A current year Earliest Acquisition index of 1.000 when multiplied by the previous year's cumulative index, results in a cumulative index to value the current year's increment which, by identity, is the same as the previous year's cumulative index. If all items in the ending inventory were "new" items, wouldn't that produce an Earliest Acquisition index of 1.000 for the current year (i.e., especially since there is no inflation in new items according to the IRS)?

For taxpayers trying to defend a dual index approach, the ISP's line of reasoning in this Paper is inconsistent with the dollar-value LIFO concept under which quantity increases or decreases of specific items are ignored so long as all of the items involved properly fall within the same pool. It would appear that the IRS/ISP is stretching for a result that is not supported by dollar-value LIFO concepts and making up "theory" as it goes along because the original regulations intentionally were drafted with these gaps in them. The expression of some "concepts" contradict one another - not to mention contradicting some of the National Tax Office's letter rulings and TAMs. The careless(?) use of technical terms and incomplete concepts allows the IRS to find some "theory" or way to declare any result it disagrees with to be out of bounds, unacceptable...not fitting into "their" concept of LIFO.

> One puzzling aspect is the indiscriminate use in this Issue Paper of the technical term "index" method of dollar-value LIFO. (Was the reference intended to be to the *link-chain* method?) An "index" method has a different meaning than the context in which it is used. The "index" method refers to a repricing process by which a representative portion of items in the ending inventory is repriced by comparing year-end prices with prices as of the base date (i.e., the first day of the first LIFO year). Despite some of this technical groping, the position of the Service seems to be fixed upon the need to determine the "quantity of each item" in the ending inventory and finding or comparing that same quantity of items first purchased or produced during the year...all of which is in direct contrast to the overriding dollar-value concept which provides the umbrella over the double-extension, index, link-chain, link-chain, index and other dollar-value methods.

Under the dollar-value method, "liquidations and increments of items contained in the pool shall be reflected only in terms of a net liquidation or increment for the pool **as a whole**. Fluctuations may occur in quantities of various items within the pool, new items which properly fall within the pool may be added, and old items may disappear from the pool, all without necessarily effecting a change in the dollar value of the pool **as a whole**." So long as the items properly fall within the pool, any further specific identity they might have for purposes of valuing an increment should be disregarded.

An increment in the LIFO inventory occurs when the end-of-the-year inventory for a given pool expressed in terms of base-year cost is in excess of the beginning-of-the-year inventory for that pool expressed in terms of base-year cost. Apparently, the measurement of specific items within the pool is to be resurrected, according to the IRS/ISP view, in quantifying increment valuations.

Despite its logic, this recent Paper serves notice that the IRS/ISP now believes it has a standard against which to measure the computation of a secondary index where dual index approaches are used. Taxpayers not computing their second/dual indexes in accordance with this ISP approach should reevaluate their LIFO reserve exposure and consider appropriate "protective" action under Revenue Procedure 92-20.

DUAL INDEXES FOR VALUING INCREMENTS TEXT OF ISP COORDINATED ISSUE PAPER

"EARLIEST ACQUISITION METHOD"

CONCLUSION

The "index" method of dollar-value LIFO does **not** permit the taxpayer to use two indexes determined as follows:

(a) One index to restate year-end inventory to base-year cost using end of the year cost for "current year cost," and

(b) A second index to value the increment in inventory quantity *which is the prior year cumulative index or an index determined using a short-cut method.*

A taxpayer electing the earliest acquisition method must compute the layer valuation index by determining the **quantity of each item** (or a representative portion) in the ending inventory, including new items, and by comparing that quantity of items purchased or produced during the year, starting with the first day of the year and working forward until the number of units which are priced equals the quantity of such items in the taxpayer's ending inventory.

"The use of a dual index method, per se, is not wrong since the method, if correctly applied, produces accurate results. Most taxpayers, however, shortcut the steps thereby leaving the second index in question. One common shortcut method is to use the prior year's cumulative index to value the layer; in other words, the ratio of the prior year cost of the pool to the total base-year cost of the pool. This method assumes there is no inflation whatsoever in the current layer. In most situations, such an assumption is unrealistic. Moreover, this method is in direct violation of Regulation 1.472-8(e)(2)(iv) which requires that increments be valued using the ratio of the total current-year cost of the pool to total base-year cost of the pool.

"This method, rather than valuing the increment at current-year costs, actually values it at prior-year costs. The method violates the LIFO election to use the earliest acquisition costs and it does not clearly reflect income. (See PLR 9332003).

"The so-called inventory turn method is another common shortcut method used to determine the earliest acquisition index. Under this method, if the inventory turned twelve times a year, the operative portion of the index would be divided by twelve. For example, if the current index was (sic) 1.12, the operative portion would be .12 (1.12 minus 1). This method would then assume the secondary index was 1.01 (.12 divided by 12 equals .01 and 1. plus .01 equals 1.01).

"The use of the inventory turn method has several inherent flaws. One flaw is that it assumes a constant rate of inflation throughout the year. If inflation does not occur at a constant rate, the inventory turn method will not produce the same result which the earliest acquisition method described in Regulation 1.472-8(e)(2)(ii)(b) would produce.

"The distortion is not limited to understatement of the index. The method could similarly result in a large overstatement of the index. This is because the amount and severity of the distortion is dependent upon the actual rate of inflation throughout the year compared to an assumed constant rate. It would be quite rare, though, for the distortion to be zero, indicating actual inflation was at a precisely constant rate throughout the time period of the first purchases of a sufficient quantity of each item to equal the quantity in the year end inventory.

"Another inherent flaw in the inventory turn method involves new items in the inventory. One of the reasons taxpayers elect the link-chain method is because they have a significant number of new items entering the inventory every year. This inherent flaw occurs because these new items are purchased throughout the year but not at a constant rate. The turn method assumes that not only is inflation constant but that items are purchased at a constant rate and mix throughout the year.

"Most new items would be purchased (or produced) after the first inventory turn. If new items make up a material portion of the overall inventory, and the new items are not considered in the computation of the secondary index, the layer valuation index will be understated during periods of inflation. PLRs 9243010 and 9251001...confirm that new items must be included in the computation of the annual LIFO index. They are important because in both cases the annual index was used to value the LIFO layers."

 (Continued from page 17)

the application of the warehouse index to the goods at the various stores would not clearly reflect income. The Court agreed with the Service, holding that *Basse* could not use the warehouse index to compute the beginning-of-year costs of the stores' inventories. **Many taxpayers have situations similar to *Basse* in that they also do not double-extend (i.e., reprice) a representative portion of the inventory when they compute the index for their pools.**

In *Basse*, the taxpayer failed to prove that the warehouse index applied to goods located at the stores. Taxpayers may claim that they "considered" all segments of inventory when they computed the pool index. The regulations, however, require more than consideration. They require double-extension. The **taxpayer must offer proof that the computed index is appropriate for the entire inventory.** Failure to prove this will, as the Court ruled in *Basse*, prevent the application of the indexes to the inventory not double-extended. (LL Comment: Presumably, these statements are not applicable to auto dealers who have elected to use the Alternative LIFO Method for new vehicle LIFO, since the inflation index computed by repricing the base vehicle cost is applied to the entire cost of the car (including options, accessories, etc. which are not required to be repriced)! Right? Shouldn't there be some qualification of this general language to recognize this exception provided by Revenue Procedure 92-79...or was that not an oversight, but intentional?)

The National Office has taken the same position for cases with similar factual patterns. LTR 9010002 cited *Basse* and held that an inventory price index developed by double-extending the cost of **new** equipment could not be used to determine the LIFO value of **used** equipment. LTRs 9243010 and 9251001 held that an inventory price index developed by double-extending the cost of existing vehicle models could not be used to determine the LIFO value of "non-comparables" or new items. The exclusion of non-comparables or new items was considered arbitrary, not a clear reflection of income, and in direct violation of the regulations.

The Supreme Court, in *Commissioner v. Samuel F. Houston*, (283 U.S. 223) stated "The impossibility of proving a material fact upon which the right to relief depends, simply leaves the claimant upon whom the burden rests with an unenforceable claim, a misfortune to be borne by him, as it must be borne in other cases, as the result of a failure of proof." (LL Comment: That's Sad...and outside legal circles, this language is sometimes simplified and referred to as the "T.S." doctrine.)

The taxpayer clearly has the burden of proving its LIFO index. Treasury Regulations, which are legislative regulations, place the burden of proof directly upon the taxpayer: "The appropriateness of the method of computing the index and the accuracy, reliability, and suitability of the use of such index must be demonstrated to the satisfaction of the district director in connection with the examination of the taxpayer's income tax returns." (Regulation 1.472-8(e)(1))

If the taxpayer is unable to substantiate the accuracy, reliability, and suitability of the LIFO index for a segment of its inventory, then the district director has the authority to hold that the base-year cost of that inventory is equal to the current-year cost. **Based upon the *Houston* case, the district director could assume no inflation (or other assumptions that protect the Government's interest) for that segment of inventory until the taxpayer meets its burden of proof.** *

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