De Filipps' LIFO LOOKOUT

A Quarterly Update of LIFO - News, Views and Ideas

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LIFO UPDATE

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

#1. RECENT CONFORMITY LETTER RULINGS <u>VAPORIZE DEALER LIFO ELECTIONS.</u> Our recent warnings to auto dealers using LIFO about how the conformity requirement applies to their Factory statements have now materialized in Letter Rulings 9535009 and 9535010. Both rulings deny auto dealers their LIFO elections by finding conformity violations in their statements submitted at year-end to the manufacturers and to the credit corporations.

And switching over to the Alternative LIFO Method back in 1992 didn't matter at all. Dealers and CPAs are feeling betrayed because, to them, the IRS seems to be saying: "What you bought - ain't what you thought."

You were warned: read the **LIFO Update** sections in December, 1994 and March and June, 1995. All along we've been urging you to write to your representatives in Congress to help NADA put a bridle on these conformity interpretations. They simply don't square with auto dealer business practices in the real world.

#2. SOUR GRAPES, LIFO "EXPERTS" AND WHY <u>NADA REALLY CAN'T HELP.</u> Lately, I've received several calls asking: "What's wrong with NADA?... Why can't NADA 'do something' about this IRS conformity situation"?

The answer is that NADA can't talk us out of the mess that the profession has behaved itself into.

In case you didn't notice, the IRS is really "in our face" on this. Letter Ruling 9535010 says: "<u>Published guidance</u> addressing this issue <u>specifically states</u> that the provision of monthly statements, reporting income computed using an inventory method other than LIFO, by an auto dealer to its franchisor and the franchisor's credit subsidiary results in a LIFO conformity violation and the termination of the LIFO election." That's right, the IRS is saying that CPAs and dealers knew or should have known this stuff all along.

LOOKOUT LOOKS INTO

Most of these callers, so unhappy over what NADA can't do, simply haven't been aware of what's been going on for years. I've been asking some of them these questions:

- Have you ever read the LIFO regulations? (It's all right there, you know.)
- Haven't you read the old Technical Advice Memos from 1979 and 1980 that threw out dealers LIFO elections way back then? (It's all right there, you know.)
- Haven't you read NADA's 1985 Dealer Bulletin on these very problems? (It's all right there—ten years ago—you know.)

Over the years, we've all known dealers who've been put on LIFO by CPAs who couldn't even spell LIFO, let alone ever knew there were regulations, let alone ever thought about reading them. We've known other CPAs who have risked losing dealer clients in trying to reason caution with them. At times, these conscientious CPAs even lost their dealer clients to others who told their dealers what

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they wanted to hear: forget about it...it will never happen. (I'm looking right now at an opinion letter written a month ago by a Big 6 firm telling a dealer that they *feel* the dealer's Factory statements are not subject to the conformity requirement.)

Over the years, we've all run into self-professed experts and quick buck artists who saw LIFO as a way to higher billings, but who never did their homework. Look at their business cards and their glossy ads in the trade publications with "LIFO" splashed all over them. Should these folks be held to an even higher standard due to their self-professed expertise and eagerness to "do it all" for their LIFO clients? Why, some of them even thought that **CONFORMITY** meant doing the calculations the way they thought the IRS wanted them done. No such luck. Conformity is—and always has been—a LIFO **eligibility** requirement.

Now, many LIFO advisors are trying to hide behind each other, NADA or the hypothetical next poor dealer who'll be flushed out into the open to fight the IRS in Court. Without plenty of help, that poor dealer may end up more like Goliath than David.

The IRS has a long memory on the dealer conformity issue. That doesn't by any means make the Service right; but it will make the fight that much harder and longer for those who take it on.

My advice to anyone wondering why NADA can't do more for them is to write their Congressmen and complain long and hard about the IRS. At the same time, send a big check to NADA's Legal Defense Fund. The poor dealer who's going to battle the IRS on conformity will need a darn big kitty, some darn good lawyers and a whole lot of patience.

#3. ...WHAT'S COMING NEXT? Your crystal ball is as good as mine. I believe things will get even worse...more messy...more confusing. Brace yourselves. Just as Mt. St. Helens had many little earthquakes before completely blowing her top 15 years ago, Letter Rulings 9535009 and -010 are just "little tremors" ahead of a major blowout when the IRS publishes what will be official and precedential guidance.

These Letter Rulings are not official guidance and they are binding only on the IRS and the two taxpayers involved. Each document states that it "may not be used or cited as precedent under Section 6110(j)(3)." What do you think?

Official and precedential guidance when it comes may neuter the benefits of LIFO elections for many auto dealers—and turn conscientious CPAs into revenue agents by fiat because the IRS on its own can't possibly police all the conformity violations because dealer business, reporting and tax practices are so complex. IRS *guidance*—when it comes—will also produce bizarre results for many who have converted from C to S, or vice versa, over the years they've been on LIFO.

See the centerfold flowcharts for just a taste of what I mean.

For fiscal year dealers—like the one in 9535009—what about the fact that the LIFO reserve at the end of the fiscal year used for tax purposes is usually "booked" and reflected in the financial statements at the end of that fiscal year and then carried forward? This <u>little fact</u> presents more complications which the IRS didn't address or maybe overlooked. What are we to do with the wide variety of fact patterns our fiscal year dealer clients present?

In addition, the controversies over running LIFO through an Other Income / Deductions account instead of the Cost of Goods Sold section in the income statement and over the "quality" of *preliminary* estimates still are up in the air.

And, what about the countless dealers on LIFO who have more than one franchise and send monthly statements to more than one manufacturer? How do the conformity requirements affect the year-end financial statements which they send separately to each manufacturer? How are they supposed to allocate the impact of LIFO in their income statements <u>among the franchises</u>? ...Especially when under the Alternative LIFO Method pooling is permitted - no, make that <u>required</u> - to include all makes and franchises in one pool. The factories have designed their reporting requirements so that the dealers cannot hide the impact of LIFO because that is exactly what the Factory wants to be able to see and reverse, with as little effort as possible. The Factories want to analyze the dealer's statements the *right* way by ignoring LIFO and using non-LIFO results. Isn't this what the conformity regulations were trying to aid when they were liberalized in 1981? If so, why make it **harder** on auto dealers but **easier** on everybody else?

Still more: If used vehicles and parts inventories are on LIFO, all these financial statement conformity requirements apply to these other LIFO applications equally... and in as much detail.

Even those who've avoided hassles by using the "simplified" BLS/CPI/PPI indexes for computing their LIFO reserves are in for a shock. They're also going to lose their LIFO elections if their 12th, 13th and fiscal year end statements don't satisfy all the conformity requirements.

Some accountants I've talked with recently have told me how glad they are they did not bother with the Alternative LIFO Method and how pleased they were that they were using the BLS indexes. It really blew their minds when I reminded them that their dealers →

are also subject to the financial statement conformity requirements for statements going to the manufacturer. Remember, no matter how you are computing LIFO indexes, the conformity eligibility requirement overrides the method of computation and applies regardless of whether you are using a BLS Consumer Price Index or Producer Price Index ...or any other computation method.

Finally, these interpretations killing auto dealer LIFO elections are just the start. Expect the IRS to apply its interpretation to any other business that is required to submit pre-formatted monthly statements to a franchisor or financing affiliate. This includes medium and heavy truck dealers, construction, agriculture and other equipment dealers.

#4. FORD AND HONDA FINANCIAL STATEMENTS BEING REVISED FOR LIFO PURPOSES ...TOO LITTLE...TOO LATE. As a side effect of all the conformity commotion, both Ford and Honda are revising their dealer financial statements to "agree" with what the IRS *seems to be saying* about reflecting LIFO in the Cost of Goods Sold section (and not Other Income / Deductions) in the Statement of Income.

Of course, this is far too little...far too late...as this will not cure conformity violations in prior years.

Both the Ford and the Honda revisions will provide a place for a separate directly identifiable charge in the Cost of Goods Sold section of the Income Statement. This will easily allow the manufacturer to simply "reverse it" and thus, work efficiently with all results to a non-LIFO basis.

The Ford financial statement will have a separate line on page 4 for the net LIFO adjustment for New and Used vehicles and on page 5 for Parts LIFO adjustments. Honda is suggesting that a "shared" account for after market sales and LIFO or for "inventory adjustments and LIFO" be used in its financial statements. In Honda's LIFO Conformity Bulletin #2, it cops out by saying "ultimately, you should discuss which Cost of Goods Sold Account(s) to use with your tax advisor(s) and follow their instructions." Who thinks they know the right answer?

Two observations: First, "why bother going through this charade?" If the real intention of the LIFO conformity regulations was to prevent a user from knowing the difference on a non-LIFO computation of income, doesn't the separate line item clearly identifying it - regardless of where it is placed in the Statement of Income - result in an inconsistency with the "intent of Congress"? Shouldn't the LIFO results be netted against the inventory amounts in Cost of Goods Sold in such a way that it is impossible by any means to pull out the LIFO impact and shouldn't there be no little "strings" to aid one's attempt to do so?

Second: The technicality in the Regulations (regarding what is or is not the "face of the Income Statement" and what are or are not "notes to the Income Statement" and "appendices and supplements to the Income Statement") supports the conclusion that to be "safe," a dealer must submit two full sets of financial statements: one totally on LIFO... and a completely separate NON-LIFO statement clearly marked as "supplemental" in all respects in order to comply with these regulations. Attempting to "do it all" on a single statement may be dangerous. So much for simplification of workloads and the elimination of paperwork!

Can Ford and/or Honda assure their dealers in writing that they have a current, binding, written opinion from the IRS that the disclosures now being accommodated in their financial statements will not violate the conformity requirements? I bet not. Wouldn't it be ironic if all of the Ford and Honda changes still turn out to be unsatisfactory when they are put under the microscope?

#5. YEAR-END PLANNING AND PROJECTIONS ARE STILL NECESSARY. Notwithstanding the jeopardy in which virtually all auto dealer LIFO elections are placed at the present time, LIFE and LIFO computations must go on.

You still need to be alert to planning opportunities for LIFO inventories and to the need to comply with the IRS' interpretations of the conformity requirements, as well as you can understand them. And there's also the matter of the "quality" or accuracy of preliminary estimates used when financial statements have to be released to the Factory before the LIFO calculations can be finalized.

Projections of LIFO reserve changes are still the order of the day, regardless of whether your clients are auto dealers, other retailers, distributors or manufacturers.

#6. SAMPLING AND LIFO INVENTORIES. In a now finalized ISP Paper for all industries, the IRS updated its views on statistical sampling in connection with LIFO index computations. This revision in June, 1995 updates the views expressed in its April, 1994 Proposed (or Draft) version. See page 20 for all the details.

7. HAMILTON INDUSTRIES AND BARGAIN PURCHASES. In another Industry Specialization Program (ISP) Coordinated Issue Paper for all industries, the IRS in September, 1995 finalized its views on bargain purchase/discount inventories. This

see **LIFO UPDATE**, page 24

LIFO ELECTIONS TERMINATED BY RECENT IRS LETTER RULINGS

In Letter Rulings 9535009 (dated May 10, 1995) and 9535010 (dated May 11, 1995), the IRS terminated the LIFO elections of two auto dealers for failing to comply with the Service's interpretations of the financial statement conformity requirements. See the accompanying "Issues and Holdings" for more specifics.

LTR 9535009 involved a fiscal year taxpayer who was caught in not only the calendar year reporting requirement, but also by the double-edged sword awaiting fiscal year taxpayers. LTR 9535010 involved an auto dealer who had not reflected LIFO in the statements sent to the Factory or Credit Corp., but instead hoped that his CPA's annual certified financial statements for the dealership would suffice to satisfy the conformity requirement. They had hoped the monthly statements sent to the Factory would be regarded as merely "supplementary" and, therefore, outside of the conformity requirement. Unfortunately, they were not.

Both taxpayers attempted to use the Alternative LIFO Method for Auto Dealers available under Revenue Procedure 92-79 as a shield or defense against the non-conformity attacks by the IRS. In both Letter Rulings, the National Office said, in effect, "what you bought ain't what you thought!"

To any reader of the ***LIFO Lookout,*** the IRS holdings in these Letter Rulings come as no surprise. For more background on the conformity requirement, see the December, 1994 ***LIFO Lookout***: "The Ultimate LIFO Traps: Financial Statement Conformity Requirements" and the "Catalog of Conformity Nightmares" also included in that issue.

Although these Letter Rulings state that they "may not be used or cited as precedent," we all know they will be.

The IRS employed a four-step analysis in both rulings to determine whether the dealerships violated the LIFO conformity requirements:

TESTS

1. The dealership used an inventory method other than LIFO in ascertaining its income in the monthly financial statements,
2. The financial statements ascertain income for the "taxable year,"
3. The financial statements are "for credit purposes," and
4. The financial statements are not within any of the exceptions to the LIFO conformity requirements that are provided in the Regulations.

From the wording in these Rulings, some readers have erroneously concluded that the financial statement conformity requirement applies to <u>each</u> monthly financial statement sent to the Factory. Of course, this is **not** the case. We are talking only about the monthly statement for the 12th month in any consecutive 12-month period that represents either the end of a fiscal year (for tax purposes) or December (where the calendar year is the full 12-month reporting period to the manufacturer).

In Letter Ruling 9535009, one of the Statements of <u>Fact</u> is that the manufacturer's Accounting Manual provided guidance for franchisees that use the LIFO inventory method. Consider the thousands of dealer financial statements filed over the years with manufacturers whose Accounting Manuals and reporting procedures did not and, in many instances, still do not provide any guidance for franchisees using the LIFO inventory method. In some cases in the past, the Factories actively prevented or hindered any dealer's CPA who tried to report on a LIFO basis!

Furthermore, in the case of fiscal year dealerships, many reflect the actual LIFO computation results made in connection with their fiscal year-end tax return in the corresponding month's financial statements and carry that forward until the next fiscal year-end. Letter Ruling 9535009 does not address what happens where this practice of recording LIFO in the statment occurs: LTR 9535009 simply refers (correctly or incorrectly) to the taxpayer's acknowledgment that it did not use the LIFO method in inventorying goods to ascertain its income in its monthly financial statements.

In connection with the second "test" related to whether the financial statement ascertained the taxpayer's income for the taxable year, the IRS noted that the year-to-date column information readily does this for the reader. Even without year-to-date accumulations on the face of the monthly income statement, any series of months could be added together to reflect a complete 12-month period of anyone's choice. LTR 9535009 states that the taxpayer issued a financial statement (in January, 19<u>xx</u>) that ascertained its income for the entire prior calendar year and that calendar year statement is considered a statement covering the "taxable year" because it covers a 1-year period that both begins and ends in a taxable year or years for which the taxpayer used the LIFO method.

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The IRS dismissed the taxpayer's arguments that the "Regulations do not harmonize with the plain language of the statute, its origin and its purpose" by abruptly stating that when the Service received comments 15 years ago to this effect, "those comments were considered then and rejected." (For more on this highly debatable issue, see the accompanying article on page 10 which urges Congressional intervention.)

STATEMENTS "FOR CREDIT PURPOSES"?

In connection with the third test, the IRS concluded that there was undoubtedly a debtor/creditor relationship between the dealership and the manufacturer and the Credit Corporation. In arguing that the financial statements had multiple uses and, therefore, were not statements "for credit purposes" alone, the taxpayer was fighting a losing battle because of the open accounts payable which the manufacturer has for the dealership's purchase of parts (notwithstanding the fact that a dealer's receivables from the Factory may often exceed its payables for parts).

The IRS held that the fact that the Factory and the Credit Corp. had multiple uses for these monthly statements is not determinative in the matter. In citing a letter submitted by the taxpayer, the IRS pointed out that the manufacturer and Credit Corporation were acknowledged to rely upon the equity position and working capital of the dealerships, as disclosed in these Factory-formatted financial statements. Two important observations on this: First, these equity position and working capital results upon which the Factory relies are those which it computes after eliminating the impact of LIFO. Second, both of these ratios are derived from **Balance Sheet** accounts and the only financial statement to which the conformity requirement applies is the Income Statement—not the Balance Sheet!

Another fact, obviously discounted by the IRS, is that most of the language in the dealer's agreement with the Credit Corp. underscores the importance of the fully secured nature of the Credit Corp. with respect to the inventories and the requirement that Balance Sheet accounts be prepared and reflected accurately. In Letter Ruling 9535009, the taxpayer acknowledged that the "credit sub may send a representative to a financially troubled franchisee to watch over its collateral." Should the fact that a Credit Corporation may do this be determinative in a specific situation if, in fact, such action never occurred in the past? The Factory and the Credit Corp.'s watchfulness over the Balance Sheet (not the Income Statement) is understandable. The collateralized status of the Credit Corporations explains its strong interest in the balance sheet, unadjusted for LIFO inventory valuations, so that it can determine more readily whether or not a dealer is "out of trust" at any time. Again, note that Balance Sheet determinations are immaterial in conformity considerations: only the Income Statement is important in this regard.

DO FACTORY STATEMENTS
MEET ANY OF THE EXCEPTIONS IN THE REGULATIONS?

The last test in Letter Ruling 9535009 reflects the IRS' position that the monthly financial statements are not "internal management statements and reports." With no substantive support, the IRS stated *ipse dixit:* "'Internal management reports' is not defined in the Regulations. Nonetheless, we believe that the term excludes reports provided to external parties such as franchisors and creditors."

LETTER RULING 9535010

Letter Ruling 9535010 was dated one day after LTR 9535009. As mentioned previously, the difference between these letter rulings is that 9535010 involves a calendar year dealership and raises the conformity question in the context of what happens when the monthly statements - including year-end - are not on LIFO but the CPA prepares annual audited financial statements for the dealership which reflect LIFO. Here, the taxpayer's argument was that these audited statements reflecting LIFO were the **primary** financial statements, while the monthly statements sent by the dealership to the manufacturer and to the credit corp. were "**supplementary** statements." The IRS concluded that a violation occurred by using the same four-part test that it used in 9535009.

With respect to the use of the financial statement "for credit purposes," the IRS found that a debtor-creditor relationship did exist between the dealership and the manufacturer and the credit corporation. The IRS stated that if the taxpayer's "operations began to deteriorate, it is doubtful that Corp. X (the manufacturer) and Corp. Y (the Credit Corporation) would ignore these reports and continue to extend credit to T (the taxpayer) as though nothing has changed." The IRS noted that the taxpayer was unable to provide any explanation of what purpose other than credit evaluation the credit subsidiary might have for requesting the dealer's financial statements. Furthermore, a letter from the credit corporation confirmed that it used the dealership's financial statements for credit purposes and it further stated that both the interim (non-LIFO) and the audited (LIFO) financial statements were reviewed by the credit corporation "to establish the financial status of the dealership in order to consider continuing credit lines." This obviously did not help the taxpayer.

see **LIFO ELECTIONS TERMINATED BY LETTER RULINGS**, page 8

LTR 9535009 FISCAL YEAR DEALERSHIP REPORTS SENT TO THE FACTORY CAUSE LOSS OF LIFO ELECTION

ISSUES	IRS HOLDINGS
Are the monthly financial statements issued to the franchisor and to its Credit sub *reports "for credit purposes"* within the meaning of Section 472 (e)(2)?	Yes
Are the monthly financial statements issued to the franchisor and to its Credit sub *"internal management statements and reports?"*	No
Whether a franchised automobile dealership that elected LIFO violates Section 472(e)(2) of the Internal Revenue Code (the "LIFO conformity requirement") when it issues to its franchisor, an automobile manufacturer, and to the franchisor's credit subsidiary twelve consecutive monthly financial statements that ascertain the dealership's income using an inventory method other than the LIFO inventory method. Note: These statements are prepared on forms provided by the manufacturer and are required to be submitted every month.	The dealership violated the LIFO conformity requirement when it sent out the last monthly statement for its fiscal year on a non-LIFO (i.e., specific identification) basis. See Regulation Section 1.472-2(e)(6) which specifically deals with a series of interim statements which can be combined to show overall results for a 12 month period. **THE LIFO ELECTION MAY BE TERMINATED.**
Whether a franchised automobile dealership that elected LIFO violates the LIFO conformity requirement when it issues to its franchisor, an automobile manufacturer, and to the franchisor's credit subsidiary a financial statement that ascertains the dealership's income using an inventory method other than the LIFO inventory method *for a twelve month period that begins and ends in taxable years for which the taxpayer used the LIFO method* for federal income tax purposes. Note: This addresses the issuance of financial statements reporting on a Calendar year (December 31) basis by a dealership that uses a fiscal year for income tax reporting purposes.	The dealership violated the LIFO conformity requirement when it sent out its December statement completing a calendar year reporting cycle to the manufacturer. See Regulation Section 1.472-2(e)(2) which specifically deals with "one-year periods *other* than a taxable year." **THE LIFO ELECTION MAY BE TERMINATED.**
Whether the Service may terminate the LIFO election of an automobile dealership that has violated the LIFO conformity requirement where the taxpayer has elected to use the Alternative LIFO Method for Automobile Dealers described in Revenue Procedure 92-79 (1992-2 C.B. 457).	**THE LIFO ELECTION MAY BE TERMINATED** notwithstanding the taxpayer's election under Revenue Procedure 92-79 to use the Alternative LIFO Method. **LTR 9535009**

LTR 9535010 CALENDAR YEAR DEALERSHIP REPORTS SENT TO THE FACTORY CAUSE LOSS OF LIFO ELECTION

ISSUES	IRS HOLDINGS
Whether, under the circumstances described below, a taxpayer violates the LIFO Conformity requirement in Section 472(e)(2) when it issues twelve consecutive monthly financial statements, prepared using a non-LIFO inventory method, to its franchisor/supplier and to the franchisor's credit subsidiary. The dealership issued financial statements to the manufacturer and to the Credit Corporation covering each month of its calendar year. The financial statements are prepared on forms provided by the manufacturer and are required to be submitted every month under the terms of the dealer's agreement. Each of these financial statements disclosed the dealership's income for the month and year-to-date calculated using the specific identification inventory method, i.e., gross profit was determined by deducting the actual invoice cost of each vehicle sold from total sales. When read together, the twelve financial monthly statements disclose the dealership's income, profit, or loss for the year calculated using an inventory method other than LIFO. Additionally, the twelfth statement, *standing alone*, disclosed the dealership's income, profit, or loss for the entire year calculated using an inventory method other than LIFO. Shortly after year-end, the dealership sent the manufacturer its CPA's audited financial statements on which the dealership's income for that prior year was calculated using a LIFO inventory method.	The dealership's presentation of income, calculated using a non-LIFO inventory method, on its monthly financial statements does *not* qualify as a "supplemental statement" within the meaning of Regulation Section 1.472-2(e)(1)(i) because the information the dealership seeks to classify as "supplemental" (i.e., the computation of income) appears on the face of the income statement. The monthly financial statements, *in their entirety*, are not supplemental to the audited financial statements ...nor are they "appendices or supplements" within the meaning of Regulation Section 1.472-2(e)(3)(iii) ...because they do not accompany the audited statements and they are not labeled as supplemental statements. ...Nor do the monthly financial statements qualify as "other reports" within the meaning of Regulation Section 1.472(e)(3)(iv). The definition of "other reports" does not include income statements; additionally, "other reports" must be clearly labeled as supplemental. **THE LIFO ELECTION MAY BE TERMINATED.** ***Note:* In LTR 9535010, the Taxpayer submitted a letter from the Credit Corp in which the Credit Corp confirmed that it used the financial statements for credit purposes. Therefore, there was no "issue" in this LTR over whether or not the financial statements were used "for credit purposes."**
Does an election under Revenue Procedure 92-79 (to use the Alternative LIFO Method) prevent the Service from terminating the dealership's LIFO election? The taxpayer contends that even if it violated the LIFO Conformity requirement, the Service is precluded from terminating its LIFO election because it elected the Alternative LIFO Method under Revenue Procedure 92-79 and that automatically gives auto dealers audit protection with respect to LIFO Conformity violations.	***The LIFO Conformity requirement is not a method of accounting, nor is it a LIFO sub-method. Rather, it is a condition upon the use of any LIFO method of accounting.*** Rev. Proc. 92-79 does not provide audit protection with respect to violations of the statutory LIFO Conformity requirement. **THE LIFO ELECTION MAY BE TERMINATED** ...notwithstanding the taxpayer's election under Revenue Procedure 92-79 to use the Alternative LIFO Method. **LTR 9535010**

As to the fourth test, the IRS found that CPA's audited financial statements which reflected LIFO were not really germane. The issue was with the monthly statements submitted to the manufacturer ...which the IRS held **not** to be "internal management statements and reports." The IRS did not agree that the audited financial statements were the dealership's **primary** financial statements and that the monthly statements were **supplemental** statements within the context of the regulations. The presentation of income in the dealership's monthly financial statements did not qualify as a "supplemental statement" for the reasons below.

NOT "SUPPLEMENTAL" BECAUSE...

1. The computation of income appeared on the face of the income statement,
2. The monthly statements, in their entirety, were not supplemental to the audited financial statements because they were not "appendices or supplements" within the meaning of the regulation,
3. The monthly statements did not accompany the audited financial statements,
4. The monthly statements were not labeled as supplemental statements, and
5. The monthly financial statements did not qualify as "other reports" under the Regulations.

ELECTING THE ALTERNATIVE LIFO METHOD UNDER REV. PROC. 92-79 DID NOT SAVE THE TAXPAYER

The dealerships in both Letter Rulings argued that the IRS should not be able to throw out the LIFO elections because of the anticipated "audit protection" available for dealers who changed to the Alternative LIFO Method. In denying this argument, Letter Ruling 9535010 stated that "the LIFO Conformity requirement is not a method of accounting, nor is it a LIFO sub-method. Rather, it is a condition upon the use of any LIFO method of accounting. Rev. Proc. 92-79 does not provide audit protection with respect to violations of the statutory LIFO Conformity requirement."

The IRS referred to **"published guidance** addressing this issue" alleged to specifically state that the provision of the monthly statements reporting income on a non-LIFO method by an automobile dealer to its franchiser and the franchiser's credit subsidiary results in a LIFO conformity violation and the termination of the LIFO election. This so-called "published guidance" is not identified. The IRS added that "despite the clarity and specificity of this guidance, T (*i.e.,* the taxpayer) made no attempt to comply with the LIFO Conformity requirement when submitting its 12th month financial statements..." →

COPING WITH CONFORMITY CONFUSION SYNDROME

There is not much anyone can do to dodge the pervasive reach of these IRS interpretations. The *oversimplified* flowcharts (pages 11-14) make that clear. A conformity violation is like a genetic defect—it cannot be ignored, cured or erased. It must be lived with. All this is compounded where dealerships have changed CPAs (many times) over the years and information for prior years may not be available.

The IRS' attitude seems to be "Sorry...you should have known this all along—and read our minds (and our Regulations) and asked for a written ruling from us a long time ago... GOTCHA!"

Will some dealers out there fight the IRS in Court over these issues? With so many varied fact patterns, what will one decided case establish either way? Does the IRS understand the practical implications of its interpretations ...except that they are intended to *drive* dealers off LIFO? Expect official "clarification"—when it comes—to be controversial and to raise more problems than it resolves.

Meanwhile, in the midst of all the attention given to Factory statements, don't overlook the many other common exposures to the loss of a LIFO election for conformity violations where copies of Factory statements are given to banks and other creditors. Often banks will call and ask for a copy of the dealer's year-end Factory statements just to put in their files! Before a copy is released to any bank, be sure it "properly" reflects LIFO. Also, be wary of situations where dealers are exchanging financial statements in connection with prospective dealership purchases and sales and other financing "deals." These could blossom into conformity violations if not carefully watched.

SOME QUESTIONS NOT ANSWERED IN LETTER RULINGS

1. Where should the LIFO adjustment be placed in the dealer's Income Statement? The controversy over the placement of the LIFO adjustment in the Cost of Goods Sold section versus Other Income or Deductions account is still open.
2. What happens in situations where the dealer subsequently issues a 13th statement to the Factory (which reflects LIFO) but the original 12th statement did not?
3. What happens when a fiscal year dealer reflects the LIFO adjustment at the end of the fiscal year but does not adjust that amount in the subsequent calendar year-end (*i.e.,* December) monthly statement?
4. Following from #3, how should a fiscal year taxpayer compute a LIFO estimate or is an actual recomputation at the end of the calendar year required? What type of "short period" adjustments will be required?
5. Where the dealer has multiple franchises, how does one allocate LIFO adjustments between or among the financial statements being reported to different manufacturers?
6. Where dealers have been audited for prior years by the IRS and no adjustments have been made, does a subsequent determination that a conformity violation occurred in a prior year allow the IRS to reach back and recapture LIFO reserves built up in what were thought to be "closed" years?
7. Accepting the IRS' conclusion in Letter Ruling 9535010 that "the LIFO conformity requirement is not a method of accounting, nor is it a LIFO sub-method," does that mean that there can be no Section 481(a) adjustments relative to "closed" years if a conformity violation is detected in a subsequent year? Or, equally obtuse, what happens if in a later year a conformity violation is detected in an earlier year?
8. What about all those situations where the manufacturers' accounting systems and reporting formats never allowed nor provided for reporting LIFO results in the monthly financial statements?
9. Is the taxpayer required to maintain proof of its compliance with the conformity eligibility requirement for all years as part of its "permanent books and records?" Is the taxpayer required to maintain copies of all financial statements disseminated in LIFO years as part of its "permanent books and records"...even though this has absolutely nothing to do with the computational aspects of its LIFO election? Or does the indefinite retention of "books and records" relate only to information supporting the LIFO computations? How is Revenue Procedure 79-23 to be interpreted on this?
10. If the taxpayer can't find or has "lost" copies of all financial statements for prior years, and the Factory and/or Credit Corporation cannot either, upon whom does the "burden of proof" fall? Note the language in *Commissioner v. Houston:* "the impossibility of proving a material fact upon which the right of 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 all other cases, as a result of a failure of proof."
11. If a dealer's LIFO election is terminated because of a LIFO conformity violation, how does that affect the prior payments of tax under Section 1363(d) where an S election was made? What about the "built-in gains" under Section 1374 and a step-up in basis for the LIFO inventories so affected?
12. Etc..etc...etc... We've only just begun!

LIFO Elections Terminated by Letter Rulings (Continued)

On this point, the IRS appears to have overlooked the fact that the taxpayer made more than a reasonable effort to comply insofar as it relied on professional advice! Auto dealers run the other way when LIFO is mentioned and rely exclusively on their CPAs for LIFO computations and advice. This is discussed in the next article in relation to unintentional and inadvertent non-compliance as a basis for requesting relief from the termination penalty.

It would appear that the so-called "published guidance" includes Technical Advice Memoranda which pre-date the change in the Regulations in 1981 and which, of course, state they are not to be used or cited as precedent (apparently, unless the IRS so chooses).

WHY CONGRESS OR THE COMMISSIONER SHOULD INTERVENE

The current Letter Rulings (9535009 and 9535010) on dealer conformity completely ignore broader issues and concerns which are important to the fair and consistent administration of the Internal Revenue Code and to the equitable treatment of all auto dealers. These issues are likely to be raised if a dealer has to go to court. If litigated, hopefully they would be favorably resolved for the taxpayer—as they were in *Powell* and *Insilco* .

In *Powell,* the (District) Court stated "We believe in a case such as this, where the IRS asserts that there is no room for interpretation, where there is no long-standing administrative interpretation and where there is little case law or legislative history to guide the Commissioner, we have an affirmative duty to determine the **rightness** of the interpretation, not just its reasonableness."

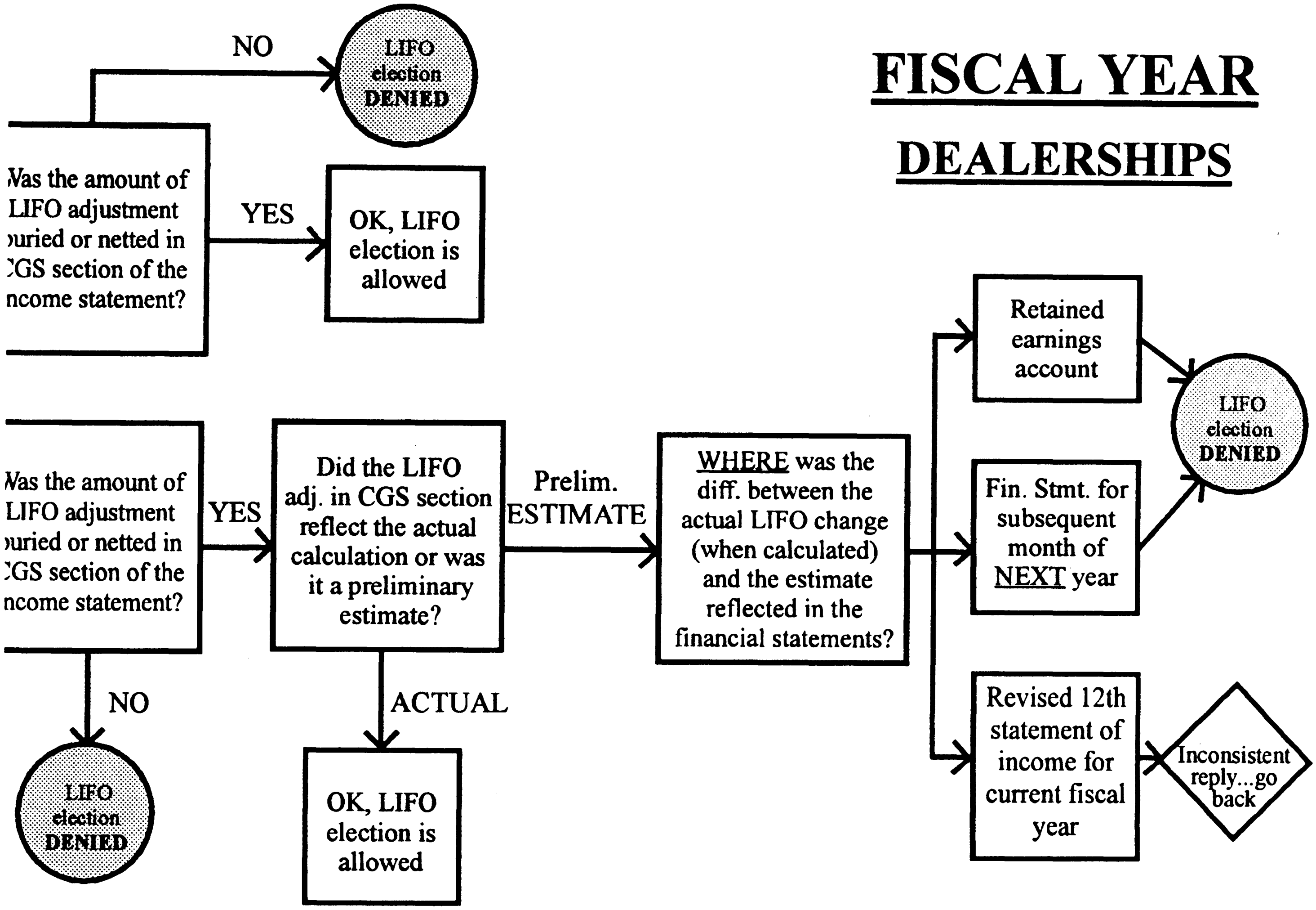
As the result of *Insilco*, Congress' ultimate response to the conformity controversy was to change the Internal Revenue Code (adding Section 472(g)) to eliminate on a prospective basis the conformity problems that were troubling the IRS and the interpretation it was stretching the law to make.

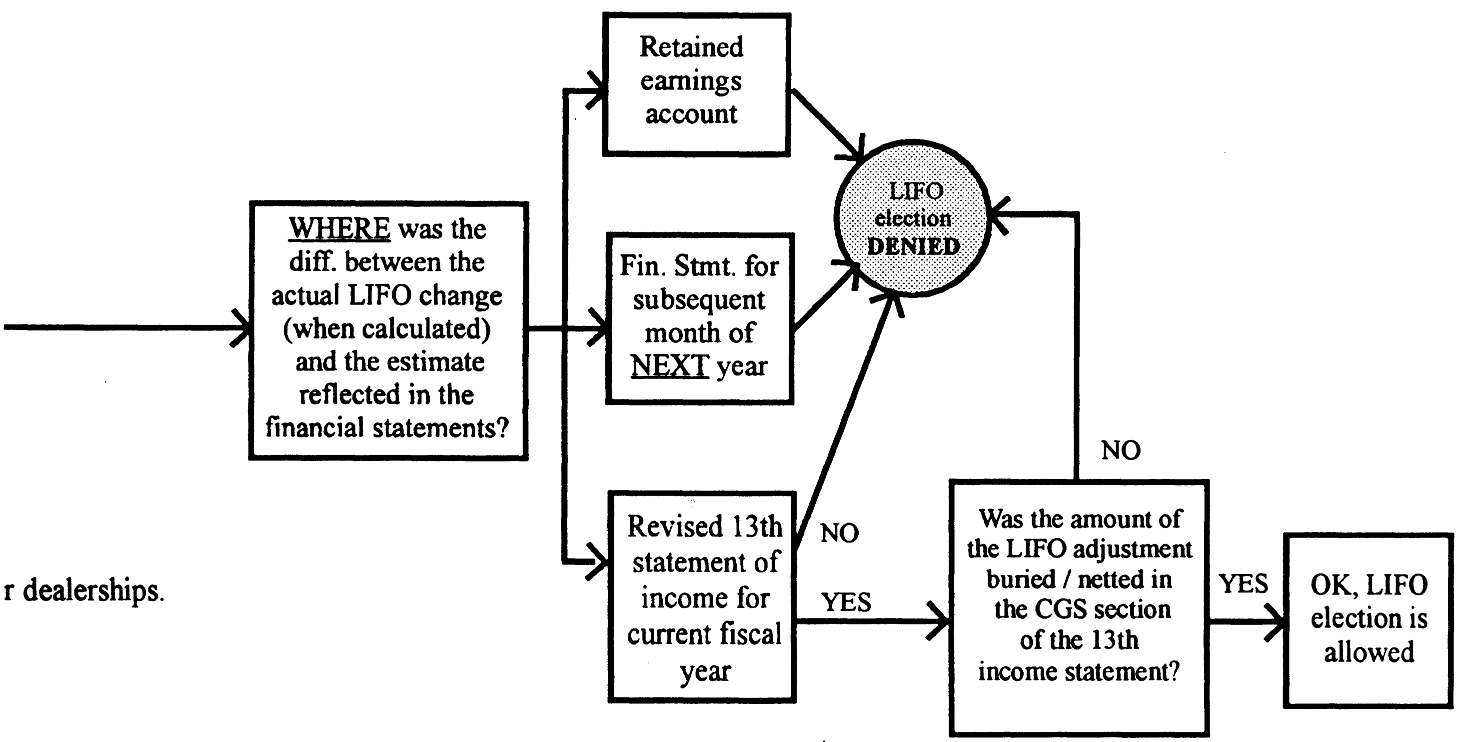
1. In almost all instances, violations of the conformity requirements are unintentional. If a dealership has violated a conformity requirement, does that unintentional and inadvertent violation warrant termination of the taxpayer's LIFO election? Many manufacturers statements did not ever allow for reporting LIFO results anywhere. Also, many auto dealers have relied exclusively on paid professional advisors, including their CPAs. Are those not reasonable causes to permit a more lenient sanction than termination of the election?
2. Revenue Procedure 79-23 specifically provides that the Commissioner may exercise discretion in remedying a LIFO conformity violation. If termination of a taxpayer's LIFO election is warranted, is the Commissioner justified in exercising authority/discretion to waive the dealer's (inadvertent) violation of the conformity requirement?
3. If exercised in the form of an **AMNESTY**, the discretion available to the Commissioner to waive termination of the LIFO election as the punishment for technical violation, (especially in light of the action taken by Congress resulting from *Insilco* to remedy the conformity 'problem' on a prospective basis) would evidence a reasonable and humane act consistent with the spirit of the *Compliance 2000* initiative, about which we hear so much... but see so little.
4. The regulations, as interpreted by the IRS, unreasonably expand the intention of Congress in these dealership situations. There should be a distinction between the intention of Congress relative to (a) reports to stockholders and to the public and (b) to the reports provided in franchisor-specified formats by automobile dealerships to their manufacturer/supplier/franchisors and, indirectly, to their affiliated credit corporations.
5. The lack of consistent interpretation of these regulations by IRS examining agents and the lack of consistent enforcement of these restrictive interpretations in various IRS districts currently and in prior years undermines the integrity of the system and the belief everyone would like to have that all taxpayers should be treated equally—even if that means *harshly.*
6. The IRS' interpretation and application of these regulations appears to be inconsistent with the policies expressed by various Treasury officials in explaining the intent underlying the liberalization of the LIFO Conformity regulations in 1981.
7. If termination of a LIFO election is the only penalty for a technical conformity violation, a penalty that harsh raises an issue involving the dealer's right to due process under the Fifth Amendment.
8. Finally, if the LIFO elections of countless dealers must be terminated, what is the proper year for the termination? How are prior years audited and closed by the IRS to be treated? What are the proper procedures, computations and terms and conditions—including the number of years over which the LIFO reserve is to be repaid—so that all dealers will receive the same treatment?

see **WHY CONGRESS OR THE COMMISSIONER SHOULD INTERVENE,** page 10

FISCAL YEAR

DEALERSHIPS





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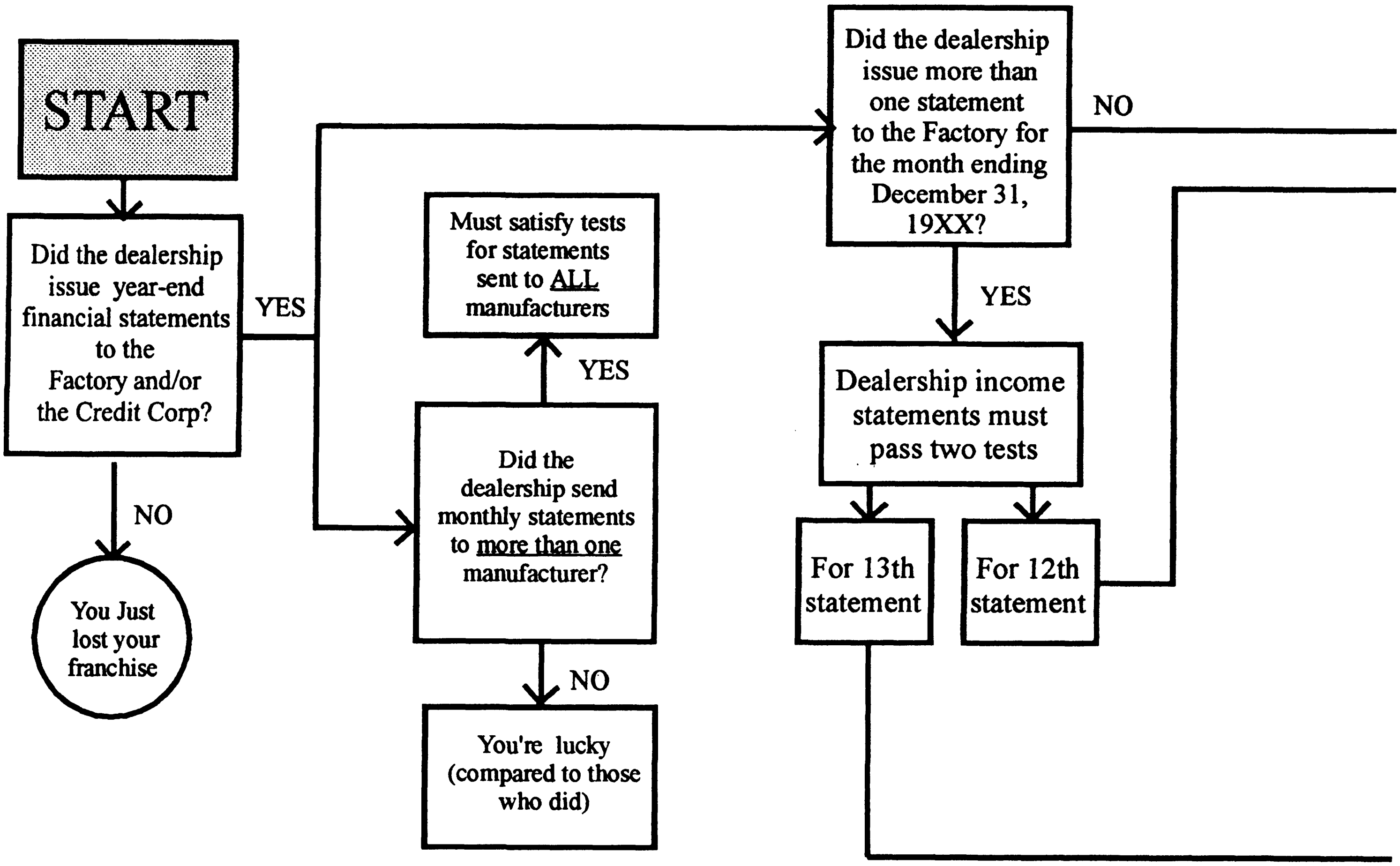
CALENDAR YEA

LIFO CONFORMITY REQUIREMENTS F



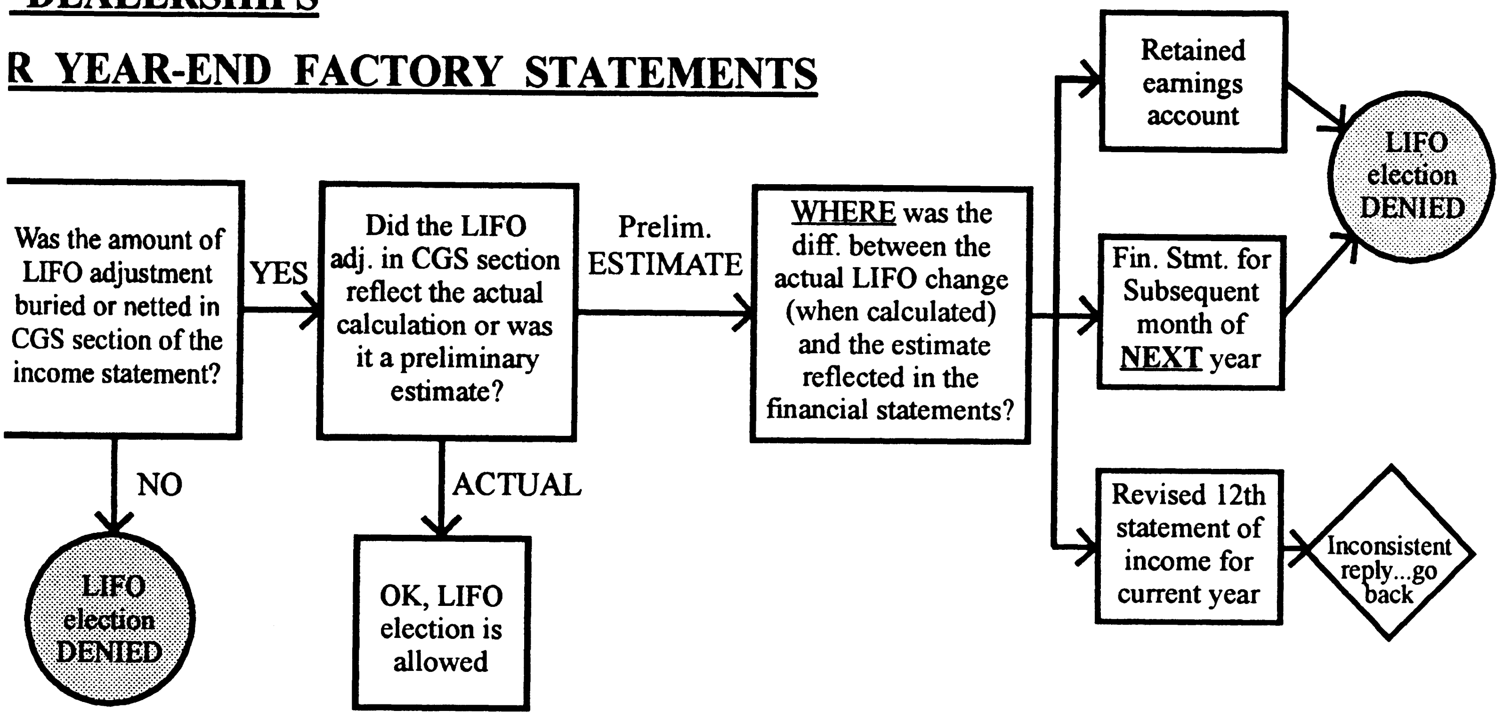
FATAL FLAWS FLOWCHARTS

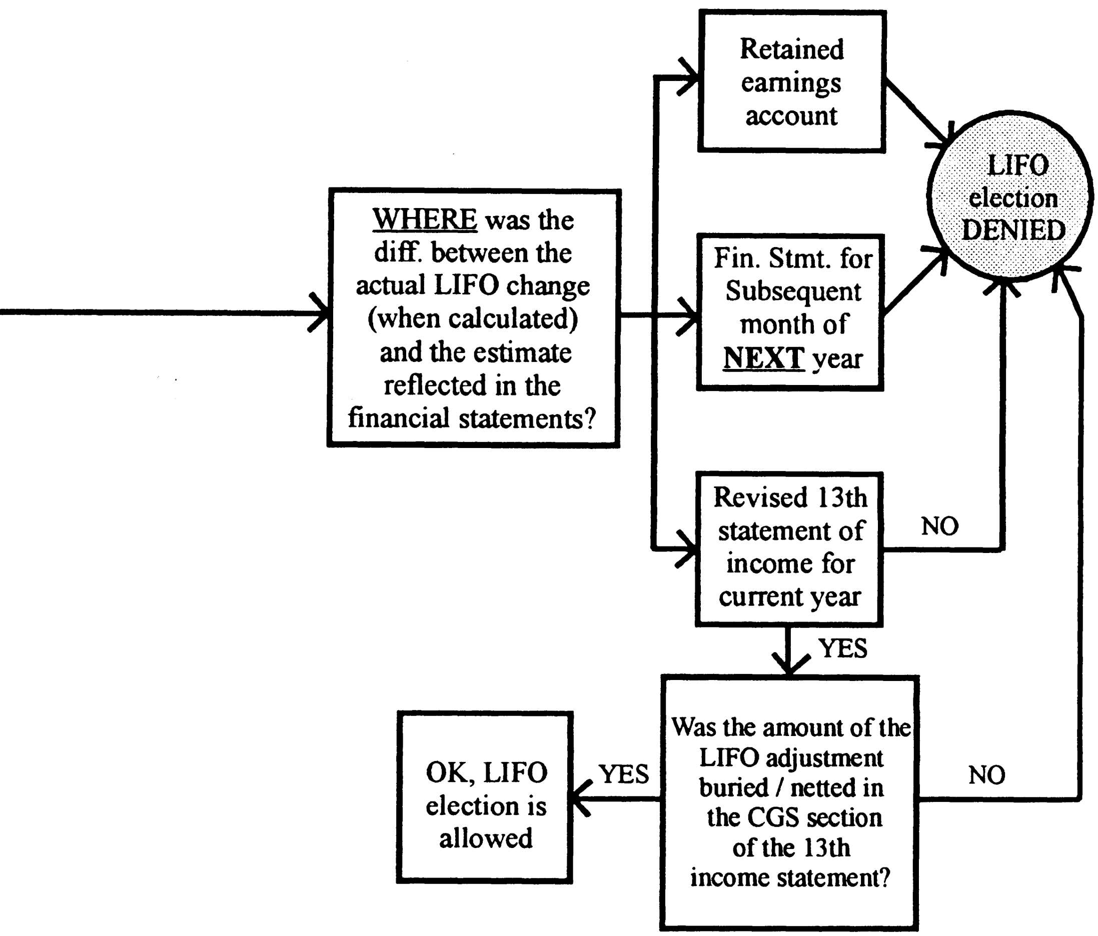
- **This side relates to calendar year auto dealerships.** See reverse side for fiscal year dealerships.
- **Multi-Franchise Dealers:** LIFO adjustments must be reflected in the year-end income statements submitted to each differe
- **New, Used and/or Parts** on LIFO: LIFO adjustments must be computed (or estimated) and properly reflected in the de **for each different class of goods subject to a LIFO election**.
- **Preliminary or Estimated calculations** should be based on reasonable assumptions, documented and saved for review.
- CAUTION: These flowcharts summarize the LIFO conformity requirements as the IRS appears to interpret them (as of financial statements prepared by auto dealerships on Factory-prescribed formats and sent to the manuf credit corporation affiliates. **IRS interpretations may change without notice at any time.**

  Although these flowcharts are intended to be helpful in determining the consequences of various] they may not be appropriate in all cases. You must have a thorough understanding of the LIFO conformi and unofficial interpretations of them, and of the dealership's specific reporting practices to the Factor reporting situation is within the scope of either flowchart summary.

DEALERSHIPS

R YEAR-END FACTORY STATEMENTS





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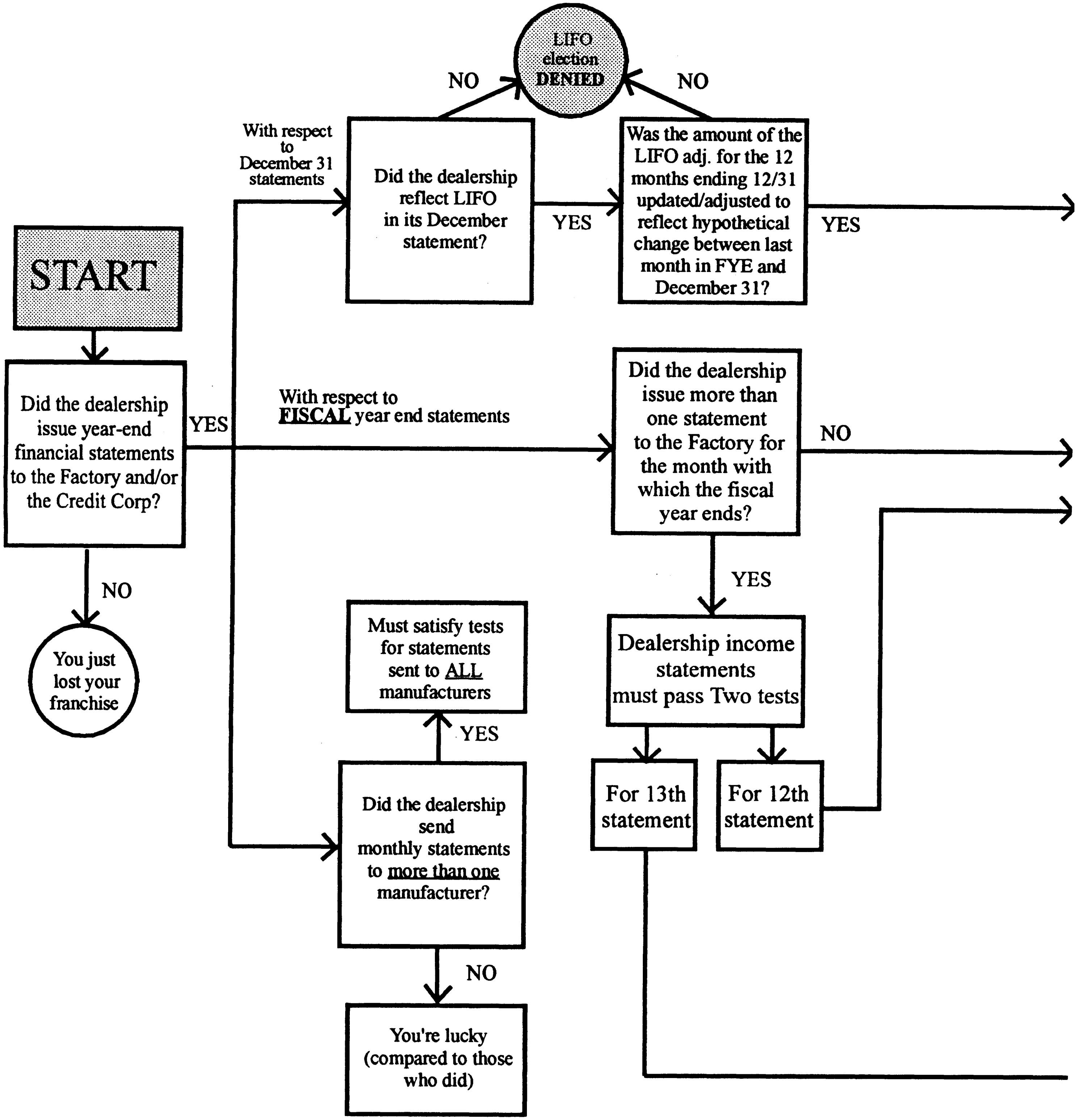

FATAL FLAWS FLOWCHARTS

- This side relates to auto dealerships reporting on a fiscal year basis for income tax purposes.
- See notes and cautions on reverse side for calendar year dealerships, all of which are equally applicable to fiscal y

DEALER-FACTORY INTERACTION IN THE REAL WORLD

Section 472(c) requires that LIFO be used in year-end financial reports: (1) to shareholders, partners or other proprietors, or to beneficiaries, or (2) for credit purposes. The reports issued by automobile dealers under their franchise agreements are not reports to shareholders, partners or other proprietors, ***or to beneficiaries***. The manufacturer/franchiser is not a beneficiary and the statutory language does not support an interpretation of the manufacturer as an ***other*** "beneficiary"

Any attempt by the Internal Revenue Service to attribute a preponderant use for "credit purposes" to an automobile dealer's financial statement—simply to support the termination of the dealer's LIFO election—is an unconscionable interpretation of Congressional intent and an abuse of the authority delegated to the Commissioner. Such an attempt fails to recognize that multiple uses are made of the financial information submitted by the automobile dealer on its statements.

Most dealers and CPAs believe that it cannot be said that the manufacturer and/or the credit corporations are using the dealer's "Factory" statements for "credit purposes" within the general meaning of that term or Congressional intent underlying the use of that term. Manufacturers and their credit corporations use the information on the financial statements to monitor their overall relationship with a given dealer, as well as with other competitive dealers within comparative geographical areas and for purposes of analyzing the products and product mix from the standpoint of the manufacturer's own activities, inventory levels and production schedules.

The overall relationship between the dealer and the manufacturer/supplier/franchiser and the manufacturer's affiliated credit arm is extremely sophisticated and not limited merely to a simple decision - purportedly based upon whether or not a LIFO reserve change occurs at year-end. To suggest otherwise is completely inconsistent with the extremely complex nature of the dealer-franchisor relationship and environment. It also completely disregards the fact that not all manufacturers or credit corporations use their dealers' financial statements in the same way or to the same extent.

As long as dealers can sell cars for the manufacturers, the manufacturers really don't care how profitable or unprofitable that activity is to the dealer; and the issuance of monthly statements to the credit corporations is simply a corollary by-product.

In litigated cases involving the application of the LIFO regulations—which really are very broad and general in nature—to complex dealership situations, interpretations advanced by the Internal Revenue Service have consistently been rejected by the Courts. *Wendle Ford*, *Fox Chevrolet* and *Richardson Investments...* ***all illustrate the consistent inability of the Internal Revenue Service to promulgate—or realistically interpret—LIFO "rules" in the context of automobile dealers***.

The unsupported statements contained in earlier Letter Rulings 7820004 and 7913001 that "...If these reports disclosed a significant change in taxpayer's financial operations, we cannot accept taxpayer's belief that the financier would be unaffected by such information..." are so broad and generalized as to be meaningless. To blindly carry these forward, as if with age they should gain credence, is absurd.

Despite what the IRS has ruled in these older letter rulings, as well as in the 1995 LTRs, most dealers and CPAs believe that their monthly financial statements to the Factory should be classified as ***internal management statements and reports***. Each department (new vehicle, used vehicle, service, body shop and parts & accessories) is analyzed in great detail from a "dollars" standpoint and from percentage and ratio standpoints. A review of these departmental analyses (whether by the dealer, the CPA, the manufacturer or the credit corporation) for comparability and consistency is completely frustrated by further efforts to record—on a detailed department level, by model or other activity—the results of using the LIFO inventory method. These five ...and sometimes more...departmental operating analyses are added together to produce an overall operating report (income statement) and the results of these operations also flow into the balance sheet. As such and as designed, ***the monthly reporting and year-end reports required by the manufacturer are not intended to be in the format of more conventional financial statements (typically released subject to an opinion by an independent Certified Public Accountant) which are clearly subject to the LIFO conformity rules***.

see **WHY CONGRESS OR THE COMMISSIONER SHOULD INTERVENE**, page 16

 (Continued from page 15)

DEALERSHIP CONFORMITY VIOLATIONS ARE INADVERTENT AND UNINTENTIONAL

If auto dealers have violated the conformity requirement, such violations have been inadvertent and unintentional and they have not been sufficiently egregious to warrant termination of their LIFO elections. Dealers have complied **to the extent practical and possible** with the intention of the LIFO conformity requirements and in a manner generally consistent with the manufacturers specifications for disclosure of changes in the annual LIFO reserves and intended to not jeopardize their franchise relationships.

Furthermore, dealers have relied on their CPAs' interpretations of the Regulations and such reliance constitutes a proper level of precaution by dealers under the circumstances. Any amount reflected for LIFO in the income statement—whether estimated or not and regardless of where placed or how disclosed—would not render a dealer's Factory statements any more useful or accurate for the limited credit purposes to the manufacturer or to the credit corporation. Accordingly, any violations of the conformity requirements were harmless, unintentional and not contrary to the intention of Congress in setting the conformity requirement.

WAIVER OF VIOLATIONS WOULD BE AN APPROPRIATE AND EQUITABLE REMEDY

Under the circumstances, the Commissioner would be justified in exercising authority and discretion in this matter by allowing dealers an **AMNESTY** to continue their LIFO elections with instructions on how to comply in all respects in the future.

Dealers' conformity "violations" were unintentional; caused no harm, misrepresentation, misstatement of net income for the year, nor miscalculation of the tax liability. Accordingly, they should be regarded as not sufficiently egregious to warrant termination of the LIFO election. To hold or conclude otherwise achieves the full perfection of absurdity when the least degree of infraction results in the same devastating penalty as the most gross, egregious infraction. Let's not add another example to the meaning of the term "Draconian."

Section 472(e) states that once a taxpayer elects to use LIFO, "then such method shall be used in all subsequent taxable years unless...(2) the Secretary determines. . .and requires a change." The statutory language clearly contemplates both a determination and a requirement, but it does not mandate that a change/termination must be made. It leaves to the discretion of the Commissioner any decision as to whether or not a change will be required if a determination is made that a violation has occurred.

The discretionary authority the Commissioner has over this matter is reinforced in Revenue Procedure 79-23 which provides that "termination in these situations is not automatic."

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Webster's Dictionary defines the word "warrant" as follows: "Justification or reasonable grounds for some act, course, statement, or belief." Haven't *reasonable grounds* including reliance on professional advisors and justification been demonstrated for the Commissioner to waive violation of the financial statement conformity requirement, if a violation has occurred?

The Commissioner has the authority and would be justified in exercising that authority to waive inadvertent violation of the conformity requirement. Termination of dealers' LIFO elections would be unwarranted, unduly punitive and—as discussed later—may even involve a violation of the Due Process Clause in the Constitution.

THE REGULATIONS AND/OR THE IRS' INTERPRETATIONS ARE INCONSISTENT WITH CONGRESSIONAL INTENT

The LIFO regulations are legislative (as contrasted with "interpretive") regulations. As such, they must be applied unless they are unreasonable and plainly inconsistent with the statute they implement. Most dealers, CPAs, and manufacturers and credit corporations using these statements believe that the IRS' interpretation of the regulations, as well as the failure to provide relief other than termination of the LIFO election, produce a result that is both "unreasonable and plainly inconsistent with the statute." If Congress were to look into this—and, hopefully, individual members will be urged to do so—woundn't it provide an exception for auto dealers if it thought that common sense already did not do so?

The amendment of the regulations in 1981 was intended to provide LIFO taxpayers with relief from the conformity requirement. This is evident from statements by several high ranking Treasury/IRS officials. Three such statements appear on the following page. The majority of the changes, and certainly all of the substantive changes, granted broad relief to large, publicly-held corporations, especially by providing for "supplementary information" reporting of non-LIFO information. In addition, these amendments to the regulations lacked specificity in their wording to apprise small, non-publicly held businesses such as automobile dealers and other retailers and wholesalers of the future interpretations that might be forthcoming.

Don't all of these statements evidence an intent to liberalize the conformity requirements by the amendments that were finalized in 1981? These statements were made by ranking Treasury/IRS officials to different members of Congress 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).

If the interpretations of the regulations to auto dealers suggested by the IRS today had been discussed in any of the 1980-81 exchanges between Treasury representatives and Congress, it seems reasonable to conclude that neither the Treasury nor Congress would have accepted the IRS' interpretations today that deprive auto dealers of their LIFO elections.

When published in final form on January 22, 1981, examples provided in the Regulations were not expanded to make clear the interpretation of the conformity requirements as they relate to automobile dealers' monthly statements, nor did any of the finalized regulations prescribe any disclosure patterns that must be followed "in ascertaining income, profit or loss."

Failure to clarify these important matters for thousands of retailers and wholesalers (not just for auto dealers) has precipitated the current dispute and evidences bad faith by the IRS in attempting to now enforce interpretations far more narrow or restrictive than those consistently accepted in prior years by examining agents in the field. Automobile dealers represent only one class of small business taxpayers who should be treated at least as fairly as large publicly-held corporations.

INCONSISTENT INTERPRETATION AND ENFORCEMENT

The interpretation and the enforcement of these regulations by IRS in automobile dealer audit situations all over the country has been inconsistent since the enactment of the regulations. This inconsistency over the years is well known within the industry and has been acknowledged informally many times by representatives of the IRS. Furthermore, at the present time, the interpretation and enforcement of these regulations is not consistently applied by different examining agents and by different District Directors throughout the country.

Accordingly, terminating auto dealers' LIFO elections abruptly and retroactively would be both unfair and discriminatory. The inconsistent interpretation and application of these regulations since 1981 should be taken into consideration in resolving the current situation on an industry-wide basis.

see **WHY CONGRESS OR THE COMMISSIONER SHOULD INTERVENE**, page 18

THREE EXAMPLES OF TREASURY'S STATED INTENTION TO "LIBERALIZE" THE LIFO CONFORMITY REGULATIONS IN 1981

DEPUTY ASSISTANT SECRETARY, TAX LEGISLATION DANIEL I. HALPERIN

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, 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."

ASSISTANT TREASURY SECRETARY FOR TAX POLICY RONALD C. LUBICK

On October 24, 1980, Assistant Treasury Secretary for Tax Policy, Ronald C. Lubick, 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."*

(Note: the reference to "repeal" of the LIFO conformity requirement appears to be a reference to the substance of the intention in the regulation, rather than to a legislative repeal *per se*.)

ASSISTANT SECRETARY (TAX POLICY) JOHN E. CHAPOTON

On September 25, 1981, John E. Chapoton, Assistant Secretary (Tax Policy), Department of the Treasury, stated the following before the Subcommittee on Taxation and Debt Management of the Senate Finance Committee 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, which I will discuss in more detail later,* ***have been significantly liberalized****."*

AUTO DEALERS ELECTIONS TO USE THE ALTERNATIVE LIFO METHOD AS PROVIDED BY REVENUE PROCEDURE 92-79 SHOULD PRECLUDE A TERMINATION OF THEIR LIFO ELECTION FOR ANY REASON, INCLUDING A CONFORMITY VIOLATION, FOR A YEAR PRIOR TO 1992.

Why did the IRS cooperate and exert great effort to work with the National Automobile Dealers Association in 1992 to fashion and promulgate Revenue Procedure 92-79...if now it seeks to completely terminate auto dealers' LIFO elections retroactively based on technicalities which do not even involve LIFO computations?

Why did the IRS even bother to get involved then—just to undo it all now?

Revenue Procedure 92-79 was intended to provide a mutually acceptable methodology for automobile dealers' LIFO computations for new vehicles. The whole idea was to provide a climate of certainty (for both auto dealers and for the IRS) with respect to the use of LIFO. All of this was provided within the broader framework of Revenue Procedure 92-20, which, in turn, was intended to encourage compliance with proper tax accounting principles and to minimize the expenditure of both IRS and taxpayer resources necessary to resolve audit disputes by trying to eliminate—or at least minimize—them in advance. This was accomplished by a gradation of incentives which included audit protection for prior years.

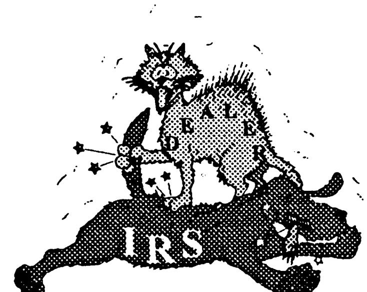
Unless substantial relief is granted for auto dealers' inadvertent and unintentional LIFO conformity violations, the failure of Section 10 (Protection For Years Prior To The Year Of Change) in Revenue Procedure 92-79 to more clearly warn or indicate that automobile dealers filing Forms 3115 would still be subject to LIFO conformity violation exposure ***represents a bad faith misrepresentation or effort at taxpayer entrapment by the Internal Revenue Service. That behavior is entirely inconsistent with all of the Compliance 2000 objectives expressed to date by the Office of the Commissioner of the Internal Revenue Service***.

IF UNAVOIDABLE, TERMINATION OF DEALERS' LIFO ELECTIONS SHOULD NOT BE RETROACTIVE

Finally, the excessive delay—almost 15 years since 1981—by the IRS in setting forth its current examining position in connection with auto dealer LIFO disclosure technicalities raises a Fifth Amendment issue insofar as the regulations are legislative regulations. The excessive delay in officially publishing and clarifying the real impact and interpretation of these legislative regulations should invalidate these regulations (if they are otherwise valid) as to prior years if the regulations are to be interpreted as requiring termination of LIFO elections.

In *United States v. Carlton* (No. 92-1941, February 28, 1994), the Supreme Court held that the excessive delay in issuing legislative regulations prevented the Internal Revenue Service from retroactively applying (an otherwise valid) regulation if such retroactive application would violate the taxpayer's Fifth Amendment right against the violation of due process. In this regard, *Tate & Lyle, Inc. vs. Comm.* (103 TC No. 37, Docket No. 740-92, November 15, 1994) also adds support.

P.S. All of this reminds me of a line from a song a few years ago: something about "holding out for a hero." Hopefully, a few dealers somewhere will fight this out in Court with the IRS. Better yet, maybe by some means Congress can be prodded to get involved before this goes much further and tell the IRS to back off and be reasonable about the whole thing. Any heroes out there?



SAMPLING AND LIFO INVENTORIES ... ISP PAPER ... JUNE, 1995

In April of 1994, the IRS released a proposed Coordinated Issue Paper on the use of sampling in connection with LIFO inventories. Recently (June, 1995), the IRS finalized its views in a statement applying to "ALL INDUSTRIES."

The April, 1994 version was discussed in the December, 1994 ***LIFO Lookout***. The recent finalization of the document deletes all references to Letter Rulings/Technical Advice Memoranda that appeared in the April, 1994 version. This includes references to LTR/TAM 8421010, 8437004, 8749005, 9210002, 9243010, 9251001 and 9332003. Accordingly, taxpayers who find themselves at odds with the IRS over sampling may want to look at these Letter Rulings to see if they suggest any useful material or arguments.

UNACCEPTABLE SHORTCUTS

- The double extension of only the large dollar items in the inventory, with the resulting index applied to the entire inventory.
- The exclusion of new items in the determination of an inflation index, with the resulting inflation index applied to the entire inventory dollars, including new items.
- The determination of an index for one segment of the inventory (for example, a warehouse) and the application of that index to all other segments of the inventory (i.e., other stores or other warehouse locations) where the inventory mix may be different.
- The use of samples that are not statistically valid which are applied to the entire inventory population.

The ISP document makes it a point to repeat the sad fate of the taxpayer in *Houston* in which the Supreme Court held that the impossibility of proving a material fact upon which the taxpayer depended for relief simply left the taxpayer who had the burden of proof with an unenforceable claim. Others in similar circumstances should consider themselves forewarned.

It is evident that the IRS is becoming increasingly more aware of...and less tolerant of... "sampling" approaches which are not thought out and documented. See the March, 1995 issue of the ***LIFO Lookout*** for a more complete discussion on sampling and LIFO inventories and a Sampling Documentation Report.

The conclusion in the April, 1994 draft that "the LIFO index cannot be applied to a portion of inventory which was not represented when the index was computed" has been expanded in the June, 1995 final version to include the qualifying language "...unless the taxpayer can demonstrate that the index is representative of the price movements of such segment (and clearly reflects income)."

WHAT DOES THE WORD *"OR"* REALLY MEAN?

The thrust of the ISP document relates to the wording in the regulations 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.

According to this IRS Paper, the use of the word "***OTHER***" in the regulations implies that a "representative portion" must be selected using sound and consistent statistical methods.

It would appear that the IRS ***LOST*** a similar argument involving the interpretation of a regulation where the disjunctive "or" was inartfully used by the drafter of the regulation. Specifically, see *Fox Chevrolet, Inc.* in which the IRS was challenging pooling based on the regulation wording "...by lines, types **OR** classes" of goods. In *Fox,* the Tax Court said that if it "were to accept each party's contentions at face value, petitioner's (*i.e.* the taxpayer's) method would be permissible since the regulatory standard is written in the disjunctive and appears to allow pooling by lines, types **OR** classes. Therefore, petitioner is as much entitled to pool by classes as by lines." (76 TC 708, at 725)

OTHER REACTIONS

One practitioner's comments of record on this ISP paper point out that a frequently used rule-of-thumb is that a sample should consist of 70% of the current cost of items in the LIFO pool. That writer stated "that in the absence of evidence that the representative portion index is not applicable to the LIFO pool, no statistical verification should be required of the taxpayer. To do otherwise would subject taxpayers to unnecessary and costly procedures that would provide little in the way of increased →

accuracy and would, in the case of many smaller taxpayers, limit their ability to use the LIFO method."

That practitioner also commented that the IRS statement that every item in the population must have an equal non-zero chance of selection is not reconciled to stratification techniques that are commonly employed which often enhance, rather than distort, the overall index result.

BASSE AS PRECEDENT

In *Basse v. Commissioner*, 10 T.C. 328 (1948), 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
- the application of the warehouse index to the goods at the various stores would not clearly reflect income.

The Court agreed with the Service on this point, 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.

The Tax Court reached its decision in *Basse* on the fact that the taxpayer failed to prove that the warehouse index applied to goods located at the stores. In current audit situations, taxpayers may claim that they "considered" all segments of inventory when they computed the pool index. According to the IRS, the regulations, however, require more than consideration: they require double-extension. Taxpayers will be required to 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.

BURDEN OF PROOF

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 Section 1.472-8(e)(1)).

HOUSTON

> "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."
>
> *Commissioner v. Houston,* 283 U.S. 223, 228 (1931)

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. 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.

CONCLUSION

The ISP Position Paper concludes that a LIFO index cannot be applied to a segment of inventory which was not represented when the index was computed unless the taxpayer can demonstrate that the index is representative of the price movements of such segment (and clearly reflects income).

BARGAIN PURCHASES OF INVENTORY ... ISP PAPER ... SEPT., 1995 *HAMILTON* GETS STRONGER

In April of 1994, the IRS issued a proposed Coordinated Issue Paper dealing with bargain purchase inventory and adjustments required by the IRS where LIFO elections are made right after the bargain purchase of inventory. In September of 1995, the IRS finalized its views which apply to "ALL INDUSTRIES." Apparently, the 1995 version incorporates the aftermath of the IRS' additional experiences in LTRs 9328002, 9446003 and *Hitachi Sales Corp.*

The final version deals more directly with whether the change in the definition of an item of inventory is a change of accounting method. Excess wording in the 1994 draft has been eliminated and the 1995 final document simply cites *Hamilton* and the regulations under Section 446. In addition, it more prominently refers to Announcement 91-173 by removing it from footnote status and states that the IRS will require taxpayers to compute and take into account a net Section 481(a) adjustment.

The discussion relative to the taxpayer's burden of proof in the final 1995 version deletes 1994's more passive reference to taxpayers "demonstrating" their position and substitutes stronger language placing the "burden of proof" squarely on the taxpayer.

BACKGROUND

A bargain purchase occurs when a taxpayer acquires a bulk quantity of inventory at a price significantly lower than the normal cost of production or purchase. If a taxpayer who has made a bargain purchase is on, or later elects, the LIFO method of valuing inventories, the taxpayer may attempt to retain the cost of those bargain purchase items in the end of year inventory whether or not such items are physically present.

Typically, a new corporation will be organized to acquire most or all of the assets of an existing business. If possible, the new/acquiring corporation will adopt a tax year that ends shortly after the date of the acquisition to ensure that all or most of the inventory purchased at bargain prices will be physically present and included in the LIFO valuation of ending inventory for the first (base) year. (Another method sometimes used by newly formed corporations involves an attempt to characterize the initial bargain cost inventory as opening inventory for the first taxable period. The IRS says this is not permissible. See Rev. Rul. 85-172, 1985-2 C.B. 151.)

By making a dollar-value LIFO election and filing Form 970 in the first taxable year and electing to use the earliest acquisition cost method to value increments, the taxpayer attempts to value its entire base-year inventory at bargain cost. The use of bargain cost as base-year cost ensures lower ending inventory values for subsequent years under the required LIFO index calculations and this (unless challenged) translates into higher deductions for cost of goods sold.

FACTORS OTHER THAN INFLATION ...CLEAR REFLECTION OF INCOME

In computing the value of the LIFO inventory, this issue usually arises because the acquiring corporation fails to account for the items purchased at the bargain price separately from other items subsequently purchased or manufactured. Separate **item** accounting can be distinguished from separate **pool** accounting (although, in this context, there is no prac- →

BARGAIN PURCHASES ISP PAPER CONCLUSIONS

- Inventories purchased in bulk at discounted amounts are separate *items* from goods purchased or produced subsequently for purposes of dollar-value LIFO inventory calculations.
- The significance or materiality of the discount is a question of fact to be determined on a case-by-case basis.
- Any change in the definition of an inventory item is a change in a method of accounting subject to Section 481. This follows from *Hamilton*, in which the Tax Court held (1) that a change in the method of valuing closing inventory constitutes a change in method of accounting to which Section 481 applies and (2) that the Commissioner's adjustments requiring separate *item* accounting for bargain purchase inventory constituted a change in method of accounting.

  Under Announcement 91-173 (1991-47 I.R.B. 29), the Service will require affected taxpayers to compute and take a net Section 481(a) adjustment into account.
- The taxpayer bears the burden of proving that the specific inventory items purchased at discount were on hand at the end of the year.

tical difference). The IRS doesn't need to argue for the establishment of separate **pools** in this context because separate **item** accounting is sufficient to segregate (and perhaps eliminate) the bargain cost inventory.

The bargain discounts in *Hamilton Industries* were 94 percent and 60 percent. *Amity Leather Products*, 82 T.C. 734 (1984), was the only precedential case—at that time—which dealt with the meaning of the term "item" as used in the dollar-value regulations in the context of a manufacturing business. In *Amity*, the Tax Court decided that "because the change in the price of an item determines the price index and the index affects the computation of increments and decrements in the LIFO inventory, the definition and scope of an item are extremely important to the clear reflection of income. The Court further stated that if factors other than inflation enter into the cost of inventory items, a reliable index cannot be computed. If the discounted cost is different from the cost of inventory acquired later, the discount represents a factor **other than inflation**.

The Tax Court in *Hamilton* determined that if the taxpayer were permitted to combine the bargain cost inventory with goods carried at higher cost, representing the current cost of production, the taxpayer could postpone recognition of the gain realized on disposal of the bargain cost inventory until such time as it decided to permit liquidation of the base layer of inventory. The Tax Court held that, **in order to clearly reflect income,** the taxpayer should be required to recognize the gain inherent in the bargain cost inventory at the time such gain is realized, rather than at a later time of the taxpayer's choosing.

Based on the rationale in *Hamilton*, gain in a bargain cost inventory should be realized when the actual bargain cost units are sold. Thus, separate item accounting (perhaps by physical segregation or by other means of specific identification) is required. When these actual bargain cost units are sold, the low costs associated with these units will flow through cost of goods sold and will no longer be included in inventory. More importantly, these bargain costs will no longer be used as base year costs in the LIFO index computations. Thus, future LIFO calculations will more accurately reflect true economic inflation.

The Tax Court in *Hamilton* recognized that not every purchase of inventory at a discount will require the creation of new items. Occasional purchases concluded on advantageous terms are to be expected in the course of normal business activity. (Example: a volume discount obtained by the purchaser and offered in the normal course of business by the seller.) However, these purchases differ materially from the case where a taxpayer attempts to value its entire base year inventory at bargain cost, as in *Hamilton*.

The Tax Court concluded that the bargain purchase inventory had to be treated as items separate from the inventory acquired or produced subsequent to such acquisitions. Such treatment avoids a distortion of the taxpayer's income and results in a clearer reflection of income. The Court ruled that the discounted items were different from other items purchased subsequently, even though physically identical, because the costs were very different. Therefore, to clearly reflect income, separate tracking of the bargain cost items was required.

GUESS WHO'S GOT THE BURDEN OF PROOF?

The Tax Court in *Hamilton* agreed with the IRS that, in a situation where a taxpayer purchases a bulk quantity of inventory at a discounted rate during the year and then manufactures or purchases similar inventory, the quantities on hand are assumed to be the quantities subsequently manufactured or purchased unless the taxpayer can show specifically that some or all of the items remain from the bulk purchase.

The Court held that the discounted acquisitions were separate items of inventory. It also held that the taxpayer has the burden of proving whether the bargain cost items were in the closing inventory. The Court was not persuaded by the taxpayer's claim that separate accounting for the different items imposed an undue burden. The Court stated "we find that eliminating the significant distortion in the petitioner's income which resulted from combining the two types of inventory warrants the burden that might be imposed on the petitioner."

The Service treated all of Hamilton's inventory acquired at discount as having been sold in the first full taxable year following the acquisition. This caused Hamilton to recognize the full amount of the gain from the bargain purchase in such year. Hamilton argued that not all of the inventory may have been sold in such year. The Court ruled, however, that Hamilton "must do more than suggest that respondent's method is less than perfect in order to carry its burden; rather, petitioner must show respondent's action to be arbitrary." Unfortunately for Hamilton, it had maintained no records to show the period over which the bargain purchase inventory actually was liquidated.

Once the Commissioner determines that a change in accounting method is required, the petitioner bears the burden, under Tax Court Rule 142(a), of proving that related Section 481 adjustments made by the Commissioner are incorrect. (*Hitachi Sales Corp. of America,* (T.C. Memo. 1994-159))

Watch for more repercussions from the twin terrors *Hamilton-Hitachi* as the IRS continues to challenge bargain purchase inventories.

 (Continued from page 1)

paper contains instructions and directions to Agents on what to look for, audit and adjust where taxpayers have benefited from bargain purchases of inventories and simultaneously elected LIFO. See page 22.

#8. CADILLAC REGIONAL DISTRIBUTION CENTER PROGRAM. The LIFO questions arising in connection with Cadillac's delivery system still remain unresolved while the test program continues in Florida. For all practical purposes, the plan seems to be good for dealers because it reduces their overall floor plan interest costs...notwithstanding a flat, but nominal, per unit delivery charge. Offsetting this benefit—in a substantial way in some cases—are the potentially adverse tax consequences as dealers under the program face the effect of LIFO reserve repayments resulting from significantly lower inventory levels eating into prior years' LIFO layers which are full of unrealized tax deferrals being triggered.

#9. LIFO FOR USED VEHICLES. Have prices dropped too much to consider a LIFO election for '95? Some reports indicate that used car prices are now increasing at a much slower rate than previously. This does not necessarily mean that used car prices have decreased; rather, they are not increasing as fast as they have in the past. This may suggest a second look at used car LIFO elections under consideration for 1995.

Also, it has been reported that the IRS requires vehicles purchased for cash at an auction or in a dealer trade to be treated differently for LIFO computation purposes than vehicles acquired by customer trade-in. For used vehicles acquired by trade-in, an index determined from average wholesale price comparisons seems to be allowable. However, for vehicles bought at auction or in dealer trades, the actual cash price paid for them—and not average wholesale price—must be used for LIFO inflation index computations.

#10. DEVELOPMENTS OF INTEREST TO MANUFACTURERS. In Letter Rulings 9528005 and 9535021, the IRS approved cost allocations and apportionments where exact or specific identification computations were not possible under the circumstances. Letter Ruling 9528005 approved the use of a sales ratio as the basis for determination of year-end LIFO inventories. Letter Ruling 9535021 approved an apportionment ratio computed over a representative period of time and, interestingly, the taxpayer was not required to make any additional adjustments in connection with the LIFO Cost requirement—notwithstanding the use of apportionment methods.

#11. AUTO DEALERS USING THE ALTERNATIVE LIFO METHOD. The IRS Motor Vehicle Industry Specialist in Grand Rapids, Michigan is now releasing quarterly updates of new item categories under Revenue Procedure 92-79. Each list, like earlier quarter revisions, is identified as not being an official list and states that IRS audit examiners are not required to follow it.

LIFO SEMINARS

Seminars have been scheduled at various locations around the country in December. The Day 1 - Basic course covers all aspects of making LIFO elections, eligibility requirements (Cost, Conformity and Consent/Form 970) and computation mechanics. Day 2 - Advanced Applications involves subjects which cannot be covered in the first day including understanding and reconciling LIFO reserves, changes in LIFO methods, rebasing indexes and other developments.

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