De Filipps' LIFO LOOKOUT

A Quarterly Update of LIFO - News, Views and Ideas

Volume 6, Number 2 | Publisher: Willard J. De Filipps, C.P.A. | June 1996

# 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. LIFO FINANCIAL STATEMENT CONFORMITY REQUIREMENTS FOR AUTO DEALERS:**

**NO NEWS IS GOOD NEWS.** Still nothing solid on this to report, so again we will *temporarily* ignore the controversy surrounding the auto dealer financial statement LIFO conformity requirements. Peter Kitzmiller recently advised that the IRS and NADA are still trying to "work things out."

As we said last time: ...Expect something on this eventually...Expect it to be unpleasant.

In the meantime, enjoy your summer. We'll cover this development for you when it happens.

**#2. FORM 3115 REVISED.** Every change in a method of accounting involving LIFO inventories and computations requires advance approval from the IRS. This permission can only be obtained by first filing Form 3115, Application for Change in Accounting Method, before changing the method. This 7-page form bears a February, 1996 revision date...replacing the previous November, 1992 version.

In reviewing the new Form, I was pleased to note that one term—*link-chain, index*—that I have been using consistently for more than 20 years in describing my dollar-value LIFO computations finally appears by that name in an IRS publication. I've been looking, in vain, for this term for years, and I've never seen it in print in an official IRS publication until now.

When the LIFO election Form 970 was revised a few years ago, the IRS finally got around to using the term *link-chain*. But it never went any further. In introducing the term *link-chain, index* in Schedule B of the new Form 3115, the IRS failed to define or describe what these terms really mean. Is this what the IRS means by "paperwork simplification?"

Without official definitions, these terms leave taxpayers and their advisors on their own to guess what they mean. We have attempted to clarify the meaning of the term *link-chain, index* in our coverage of the revised Form 3115. In this regard, see especially the summary chart on page 8.

## LOOKOUT LOOKS INTO



**#3. DUAL INDEX / EARLIEST ACQUISITION APPROACHES.** The Service recently finalized its Coordinated Issue Paper on the use of a first purchase or earliest acquisition approach in connection with valuing increments in LIFO inventories. This ISP Paper applies to all industries.

Three terms—(1) dual index, (2) earliest acquisition and (3) first purchase—are synonymous and have been used interchangeably over the years by the IRS and many authors. The final IRS Paper reinforces the careful scrutiny the IRS gives to LIFO calculations valuing ending inventories using this method which usually produces lower LIFO valuations and, therefore, "better" results for the taxpayer.

As part of our coverage, we have provided some additional background and charts to help you understand why taxpayers are attracted to the use of dual indexes.

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**#4. TAX COURT PENDING CASE INVOLVING AUTO DEALER LIFO CALCULATIONS.** For some time, we have been following a case—*E.W. Richardson*—that was petitioned into the Tax Court quite some time ago. This case is a continuation of a 1981 case, *Richardson Investments, Inc.*, which gained some fame, along with *Fox Chevrolet*, when the Tax Court held that auto dealers should have one pool for automobiles and a separate pool for light-duty trucks.

As a followup to the Tax Court's decision, the dealer's new vehicle LIFO calculations were supposed to be revised to conform with the Court's holding that two pools should be used. Along the way, things went off the track resulting in a "weird and unusual"—to quote the comptroller— LIFO methodology. The petition and the related briefs provide an interesting look at some of the complications facing dealers who do not have the Alternative LIFO Method to fall back on.

The IRS technical arguments in *E. W. Richardson* should not be dismissed as applying only to auto dealer LIFO calculations. These arguments can be applied across the board to any type of business...and sooner or later they probably will be.

LEAR JET

Incidentally, the petition of *E. W. Richardson* in the Tax Court also involves the Service's challenge to the taxpayer's deductions of expenses in connection with owning and operating a **LEAR JET**. The June, 1996 issue of our sister publication, the *Dealer Tax Watch*, includes an analysis of the IRS' equally intense challenges to these airplane expenses.

**#5. SELECTED BIBLIOGRAPHY.** More than any other recent issue, this issue of the *LIFO Lookout* updates and incorporates portions of many articles that have appeared in prior issues over the years. In reading the articles in this issue, long-time readers of the *LIFO Lookout* may find it helpful to have some of the articles listed below on hand.

**REVISED FORM 3115**

| | |
|---|---|
| March, 1993 | Revenue Procedure 92-79: Tips, Traps, Tidbits and Some Questions That Could Use Answers: "Separate Trades or Businesses" - What Does This Really Mean? |
| June, 1993 | Terminating a LIFO Election: Procedures and Pitfalls |
| June, 1993 | Comparison of Rev. Proc. 88-15 and 92-20 |

(Continued from page 1)

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| June, 1994 | Acceptability of Replacement Cost Accounting for "Parts-Type" Inventories |
| September, 1994 | Replacement Cost Accounting for "Parts-Type" Inventories: In LTR 9433004, the IRS Says "No" |
| June, 1995 | Voluntary LIFO Change Requests: Revenue Procedure 92-20 Changing LIFO Methods |
| June, 1995 | Which LIFO Changes Require Advance Approval from the IRS? |
| June, 1995 | Form 3115: Filing Requirements and Mechanics |
| | Ten Suggestions for Form 3115 Filings |
| | During the Wait: What if Tax Returns are Due? |
| | Running Out of Time? File Late or Extend? |

**VALUING INCREMENTS UNDER THE EARLIEST ACQUISITION METHOD**

| | |
|---|---|
| September, 1993 | Dual Index Approaches for Valuing Increments |
| | Dual Index Approaches—In General |
| | Dual Index Procedures |
| | Start Up Dual Index Situation Comprehensive Example |
| June, 1994 | IRS/MSSP Templates for Dealer LIFO Calculations: Earliest Acquisitions Beware...We Think the IRS is Wrong |
| September, 1994 | Dual Index Approaches for Valuing Increments—an Update from the ISP |

***E. W. RICHARDSON*—AUTO DEALER ITEM DEFINITIONS**

| | |
|---|---|
| September, 1991 | IRS LIFO Audits and Issues: Theory, Practice and IRS Audit Issues: What's Going on Out There? |
| September, 1991 | What is an "Item?" Does Anybody Know? Vehicle Options and Accessories |
| March, 1993 | Revenue Procedure 92-79: How Far Do You Have to Go in Determining *Item Categories*? |

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# REVISED FORM 3115... FOR VOLUNTARY CHANGES IN LIFO METHODS

**FORM 3115**

February, 1996 ushered in the latest revision of Form 3115. According to the "Paperwork Reduction Act Notice," the good news is that the overall time for preparing and sending in the form for LIFO method changes has been substantially shortened from 7½ hours to 7¼ hours. The bad news is that the new form has had a substantial change in appearance, as well as in certain content respects, and asks for more information which may lead to more questions and discussion with the IRS.

**Changes on page 1**. Prominence is now given to the placement for the due date for filing Form 3115—which, by the way, is the 180th day of the year of change. This date must now be inserted at the very top right-hand corner below the taxpayer's identifying number. Taxpayers are asked to indicate whether the accounting method change requested involves either (1) Depreciation or amortization, (2) Financial products and/or financial institution activities or (3) Other. LIFO method and sub-method changes all fall within the "Other" category.

Overall, Form 3115 has been reduced from 8 to 7 pages. The first section consists of 34 questions, many of which have sub-parts. These questions are now more logically organized into the following four parts:

| | |
|---|---|
| Part I: | Eligibility to Request Change (Questions 1-6). |
| Part II: | Description of Change (Questions 7-19). |
| Part III: | Section 481(a) Adjustment (Questions 20-28). |
| Part IV: | Additional Information (Questions 29-34, which may be skipped by applicants filing under automatic change revenue procedures). |

These questions are followed by four schedules to be completed, only if applicable:

| | |
|---|---|
| Schedule A: | Change in Overall Method of Accounting. |
| Schedule B: | Changes Within the LIFO Inventory Method. |
| Schedule C: | Change in the Treatment of Long-term Contracts, Valuing Inventories (but not changes within the LIFO method) or Other Section 263A Assets. |
| Schedule D: | Change in Reporting Advanced Payments and Depreciation or Amortization. |

The User Fee is currently $900, as contrasted with $500 when the Form 3115 was revised 4 years ago. However, a special reduced User Fee of $500 is available to taxpayers whose gross income/receipts are less than $150,000. Also, user fees are waived entirely under many of the published automatic change revenue procedures. For example, Revenue Procedure 88-15, the expedited procedure by which certain taxpayers may voluntarily terminate their LIFO elections, requires no user fee.

## MORE INFORMATION REQUIRED

The latest revision of Form 3115 calls for more information. In connection with presenting their legal basis in support of proposed changes, applicants are "encouraged to include a discussion of any authorities that may be contrary to the proposed change in method of accounting." (How do you spell *oxymoron?*) In addition, item number 13 requires the attachment of "a copy of all documents directly related to the proposed change." The instructions indicate that true copies of all contracts, agreements, instruments, proposed disclaimers and any other documents directly related to the proposed accounting method change must be submitted with the request.

Question #15 asks whether the present method of accounting is a Category A method now requires that a statement be attached giving the legal basis for such determination. Watch out here!

A Category A method of accounting is a method of accounting the taxpayer is specifically not permitted to use under the Code, the regulations, or a decision of the Supreme Court of the United States. A Category A method is also a method of accounting that differs from a method the taxpayer is specifically required to use under the Code, the regulations, or a decision of the Supreme Court of the United States. In addition, a Designated B method of accounting will be treated as a Category A method if the taxpayer files a Form 3115 requesting to change from the Designated B method of accounting more than two years (or such other period provided in the designating document) after the date of designation. *Hamilton Industries*—Bargain Purchase type LIFO situations may fall into this Category A/Designated B classification.

Examples of "pure" Category A inventory methods include methods of inventory valuation listed in Reg. Sec. 1.471-2(f)(1) through (7), and various write-down practices. Also defined as a Category A method is the use of the LIFO method of accounting for inventories when there has been a termination event (as described in Rev.

see **REVISED FORM 3115...** , page 4

Proc. 79-23, 1979-1 C.B. 564, or any other applicable revenue ruling or revenue procedure) that occurred during a year not barred by the statute of limitations as of the date of the filing of a Form 3115 to request a change from the LIFO method. For purposes of Revenue Procedure 92-20 and LIFO terminating events, a termination event does not occur if the taxpayer first issues nonconforming financial statements during the taxable year for which the LIFO inventory method is discontinued (the year of change) and the nonconforming financial statements relate either to the year of change or to the year preceding the year of change.

### *SEPARATE* TRADES OR BUSINESSES

The prior Form 3115 asked for the principal business activity and business activity code used on the latest income tax return filed. It also asked if the applicant had more than one trade or business and, if yes, if each trade or business was accounted for separately. The instructions for the prior version Form 3115 indicated that if there was more than one trade or business, the taxpayer should show for each separate trade or business: "Type of business (manufacturing, retail, wholesale, etc.), employer identification number, overall method of accounting and whether, in the last six years, the business changed its accounting method or is changing its accounting method..."

The February, 1996 Form 3115 asks for "a description of the applicant's trade or business, operations, goods and services, and any other types of activities generating gross income." New question/item 17 clearly requires more than simply the principal business activity designated on the last filed income tax return.

The next question asks: "Does the applicant have more than one trade or business as defined in Regulations Section 1.446-1(d)?" If the answer to that question is yes, then question 18b asks: "Is each trade or business accounted for separately?" It then requires—as did the prior form—a description of the type of business, overall method of accounting, 6-year method change activity, etc. for each trade or business.

Comparison of the wording of these different versions of Form 3115 reveals that the current version cites the specific regulation under Section 446 and suggests that the term "trade or business" is defined in that regulation. In fact, Regulation Section 1.446-1(d) does not define the term "trade or business." It contains some qualifying information, but does not really provide a conclusive definition. As may be observed from the entire regulation in context (see page 6), the maintenance of a "complete and separable set of books and records" for a trade or business is set up as a minimum requirement to be satisfied before that trade or business will be recognized as "separate and distinct for purposes of this paragraph."

Without further discussion or qualification, the conduct of parts of the same business activity at different locations may be alleged to constitute the conduct of *separate* trades or businesses if separate sets of books and records are maintained for each location. This may present a problem for some taxpayers, especially automobile dealers, who conduct essentially the same overall business (i.e., retail) activities at different locations with separate accounting for each location and separate reporting to different manufacturers/franchisers.

### CHANGES WITHIN THE LIFO INVENTORY METHOD

Revised Form 3115 retains Schedule B for requests to change from one LIFO method to another LIFO method. These are referred to as "changes within the LIFO inventory method". The instructions indicate that Schedule B should not be used by taxpayers desiring to terminate their LIFO elections; instead, they must complete Schedule C. The Schedule B instructions indicate that taxpayers changing within their LIFO inventory method or sub-method must complete Part I and then only if applicable complete Part II (which deals with changes in inventory pools) or Part III (which deals with changes to the inventory price index (IPI) computation method involving Bureau of Labor Statistics' Consumer and/or Producer Price indexes).

The revised form and instructions refer to LIFO methods and **sub-methods**. The distinction appears to be that LIFO **methods** involve the broader areas of (1) valuing, (2) pooling, (3) pricing dollar-value pools and/or (4) valuing annual increments. Schedule B describes **sub-methods** parenthetically opposite each of the four main methods. For example, the unit method and the dollar-value method are described parenthetically opposite "valuing inventory."

Opposite "pricing dollar-value pools," the following sub-methods are identified: "Double extension, index, link-chain, link-chain index, IPI computation method, etc." Note that the appearance of the term "link-chain **index**" method on this revision of the Form 3115 is the first time that term "link-chain **index**" has appeared in any official document issued by the Internal Revenue Service in connection with LIFO inventories. See the discussion at the end of this article: "Link-Chain, Index...A New LIFO Method?" and the related summary chart on page 8.

see **REVISED FORM 3115...** , page 6

# WHEN DO YOU HAVE TO FILE FORM 3115?

## YES—LIFO CHANGES REQUIRING FORM 3115 FILING

1. Changing from specific goods (unit) method to the dollar value method...if pooling or other changes are also involved.
2. Decreasing the number of pools...combining or consolidating pools.
3. Increasing the number of pools (dividing, splitting or separating pools).
4. Changes in method of valuing LIFO layers or increments (Form 970, item 6).
5. Changes in composition of pools and miscellaneous LIFO related changes.
6. Change from double-extension method to index or link-chain, index method.
7. Change from index to link-chain, index.
8. Termination of LIFO election.
9. Reelection of LIFO after a recent previous termination of a LIFO election.
10. Change by an auto dealer already on LIFO for new vehicles to the Alternative LIFO Method for Automobile Dealers as set forth in Revenue Procedure 92-79.
11. Changes in item definition. It is evident from the *E. W. Richardson* discussion that the position of the IRS is that a change in the definition of an "item" for LIFO purposes constitutes a change in method of accounting within Section 446(e) and the regulations thereunder.

## NO—LIFO CHANGES NOT REQUIRING FORM 3115 FILING

1. The **initial election to use LIFO** requires filing Form 970 with the first income tax return on which LIFO is being used, along with other filing requirements...but it does not involve or require filing Form 3115.
2. The extension of the LIFO inventory method to additional classes of inventory goods. This is referred to as a "subsequent" election and it involves filing a new Form 970...and not Form 3115.
3. Corrections of mathematical or posting errors are not changes in accounting methods.
4. A change in method of accounting does not include a change in treatment resulting from a change in underlying **facts** (Regs. Sec. 1.446-1(e)(2)(ii)(b)).
5. A change from the unit (specific goods) LIFO method to the dollar value LIFO method **if** the taxpayer continues to use exactly the same pools as were used under the other LIFO method (Regs. Sec. 1.472-8(f)(1)).

## MAYBE... BUT FILE FORM 3115 TO BE SAFE

1. **CHANGES IN DETAIL COMPUTATIONAL TECHNIQUES AND/OR SAMPLING PROCEDURES:** Under the index and link-chain, index approaches, professional judgment needs to be exercised in determining the manner in which indexes are computed and in other qualitative analyses as to whether or not a "representative portion" of the inventory is being repriced **and** whether the overall results are reasonable and "clearly reflect income." This judgment (in theory) needs to be reevaluated every year taking into consideration changes in the inventory levels, inventory mix and other factors.

   The IRS position might be that under the Regulations these approaches or procedures, sampling techniques and judgments each in the narrowest sense involve "methods of accounting" requiring the filing of Form 3115 to obtain IRS permission to change. See Letter Ruling 8403009. However, the Regulations are not completely clear on this point and neither the IRS nor the accounting profession has produced any authoritative literature, guidance or published *suggestions* addressing these common LIFO sampling and related judgment issues.

## WHAT ARE "*SEPARATE* TRADES OR BUSINESSES?"

Below is the complete text of Regulation Section 1.446-1(d) which is cited by the IRS on Form 3115 as "defining" whether a taxpayer has more than one trade or business. Note the conjunctive requirement: *Separate* and distinct...and *distinct* means unlike another.

"(1) Where a taxpayer has two or more ***separate and distinct*** trades or businesses, a different method of accounting may be used for each trade or business, provided the method used for each trade or business clearly reflects the income of that particular trade or business. For example, a taxpayer may account for the operations of a personal service business on the cash receipts and disbursements method and of a manufacturing business on an accrual method, provided such businesses are separate and distinct and the methods used for each clearly reflect income. The method first used in accounting for business income and deductions in connection with each trade or business, as evidenced in the taxpayer's income tax return in which such income or deductions are first reported, must be consistently followed thereafter.

"(2) No trade or business will be considered separate and distinct for purposes of this paragraph unless a complete and separable set of books and records is kept for such trade or business.

"(3) If, by reason of maintaining different methods of accounting, there is a creation or shifting of profits or losses between the trades or businesses of the taxpayer (for example, through inventory adjustments, sales, purchases, or expenses) so that income of the taxpayer is not clearly reflected, the trades or businesses of the taxpayer will not be considered to be separate and distinct."

### IN THE CONTEXT OF LIFO POOLING, WHAT CONSTITUTES A "*SEPARATE* TRADE OR BUSINESS?"

In the March, 1993 *LIFO Lookout* article, "Tips, Traps, Tidbits, and Some Questions That Could Use Answers," the question was raised: "'Separate Trades or Businesses' What Does This Really Mean?" This question was asked in the context of the Alternative LIFO Method for Automobile Dealers. Section 4.02(1) of Revenue Procedure 92-79 indicates that all new automobiles (regardless of manufacturer) including those used as demonstrators must be included in one dollar value LIFO pool and that all new light-duty trucks (regardless of manufacturer and including those used as demonstrators) must be included in a separate dollar value LIFO pool. This requirement is preceded by the phrase, "for each *separate* trade or business."

Some view the "separate trade or business" limitation as suggesting that where an automobile dealership operates at different *geographic locations*, even though all activities may be reported by one taxpayer entity in one tax return, the conduct of business via separate locations and facilities, accounting and sales personnel warrants separate new auto and new truck pools *for each different location*. If the phrase "*separate* trades or businesses" in Rev. Proc. 92-79 doesn't mean anything, why is it there? If it does, clarification is needed.

**Revised Form 3115...** (Continued from page 4)

**PRACTICAL PROBLEM**: Part I, Schedule B requires taxpayers to attach a copy of all Forms 970 that were filed to adopt or expand the use of the LIFO method. What do you do if you cannot find or obtain a copy of the Form 970? If you cannot be positive that a Form 970 had not been filed, you might simply state that you have no reason to believe that Form 970 was not filed and attach a statement similar to that discussed below for comparable circumstances when terminating a LIFO election. On the other hand, the inability to produce a copy of Form 970 may require more immediate action under Revenue Procedure 92-85.

**TERMINATION (VOLUNTARY) OF LIFO ELECTIONS**

Where a taxpayer wants to voluntarily terminate its LIFO election, the filing of Form 3115 and Schedule C is mandatory. Recall that if a taxpayer wants to terminate its LIFO election, it may still be possible to do so in an uncontested, timely manner by filing under Rev. Proc. 88-15 before the 270th day of the year of change...and →

this is an exception to the general rule that requires the filing of a Form 3115 within the first 180 days of the year of change. For a discussion of the procedures and pitfalls in terminating a LIFO election and a comparison of Rev. Procs. 88-15 and 92-20 which control termination requests, see "Terminating a LIFO Election: Procedures and Pitfalls" in the June, 1993 *LIFO Lookout.*

Part II of Schedule C of the current Form 3115 requires the submission of the following information by a taxpayer that is voluntarily terminating its LIFO election:

1. Copies of Form(s) 970 filed to adopt or expand the use of the method.
2. A statement describing how the proposed method is consistent with the requirements of Reg. Sec. 1.472-6.
3. The termination event statement required by section 7 of Rev. Proc. 88-15, 1988-1 C.B. 683, or section 9.03 of Rev. Proc. 92-20 (whichever is applicable) **AND** an explanation if there has been a termination event.

The instructions point out that if an applicant (desiring to terminate its LIFO election) is subject to, but not in compliance with Section 263A, that applicant must first comply with Section 263A before changing an inventory valuation method. For LIFO taxpayers wishing to terminate their LIFO elections, this requirement means (1) they must first make adjustments to comply with the Inventory Cost Capitalization Rules of Section 263A before going off LIFO and (2) they are not eligible to use the expedited procedures under Rev. Proc. 88-15 to terminate their LIFO election.

**UNABLE TO PROVIDE A COPY OF FORM 970?** The instructions indicate that if an applicant desiring to terminate a LIFO election properly elected the LIFO method but is unable to furnish a copy of the Form 970, the following statement should be attached to Form 3115:

"I certify that to the best of my knowledge and belief (name of applicant) properly elected the LIFO inventory method by filing Form 970 with its return for the taxable year(s) ended (insert date(s)) and otherwise complied with the provisions of section 472(d) and Regulations section 1.472-3."

***TERMINATION EVENT* STATEMENT.** The third item of information required is a termination event statement. Revenue Procedures 92-20 and 88-15 parallel each other in the wording of this requirement, the essence of which is that a taxpayer must confirm that a terminating event has not occurred in an open year (i.e., a year not barred by the statute of limitations). This statement refers back to Revenue Procedure 79-23 (involving the cost, conformity and consent requirements) for which there is a limited exception for certain non-conforming financial statements.

The "Termination Event Statement" required by Revenue Procedure 92-20 is as follows:

"Under penalties of perjury, I hereby certify that to the best of my knowledge and belief, with respect to (Name of taxpayer)'s use of the LIFO inventory method of accounting, there (indicate either "has" or "has not") been a termination event (as described in Rev. Proc. 79-23, 1979-1 C.B. 564, or any other applicable revenue ruling or revenue procedure) for purposes of Rev. Proc. 92-20 that occurred during a year not barred by the statute of limitations as of the date of the filing of the Form 3115."

For purposes of Revenue Procedure 92-20, a termination event does not occur if the taxpayer first issues nonconforming financial statements during the taxable year for which the LIFO inventory method is discontinued (the year of change) and the nonconforming financial statements relate either to the year of change or to the year preceding the year of change. For example, if a taxpayer issues nonconforming financial statements for its 1991 calendar year on March 15, 1992, and properly files in 1992 a request to discontinue the LIFO inventory method for its 1992 taxable year, there has been no termination event for purposes of Revenue Procedure 92-20. Revenue Procedure 88-15 contains similar language.

## METHODS OTHER THAN COST (INCLUDING REPLACEMENT COST...FOR PARTS INVENTORIES)

Part I of Schedule B includes a new requirement (question/item 5) that a statement be attached "addressing whether the applicant values any of its LIFO inventory on a method other than cost." It provides an example of a situation where an applicant may value some of its LIFO inventory at retail and the remainder at cost. However, the wording would call for disclosure—where appropriate—if replacement cost is being used in connection with Parts inventories that are on LIFO.

The current controversy surrounding the use of replacement cost in connection with Parts inventories on LIFO has been discussed in connection with Letter Ruling 9433004 in the June, 1994 and September, 1994 issues of the *LIFO Lookout*. This controversy is far from resolved, as indicated by the petition filed by at least one taxpayer in the Tax Court.

see **REVISED FORM 3115...** , page 9

## SUMMARY OF
## METHODS FOR PRICING DOLLAR VALUE LIFO POOLS

| **Computation of LIFO Value of Dollar-Value Pool Form 970 - Item 9 <u>Form 3115 - Schedule B</u>** | **TWO DIFFERENT CHARACTERISTICS** <br> **<u>BASE DATE</u>** | <br> **<u>EXTENT OF REPRICING INVENTORY "ITEMS"</u>** (Regs. do not define the term "item"!) |
|---|---|---|
| **"Double Extension"** (Regulations) | Fixed (1) | <u>Every</u> "item" All items |
| **Index *** (Regulations) | Fixed (1) | Representative portion Less than every item (Sample) (4) |
| **Link-chain** (Regulations silent) (LTR 8437004) (LTR 8749005) (ISP 1989) | Self-Adjusts; Moves Forward every year ("Floats") (2) | <u>Every Item?</u> Regs. silence on this could be interpreted either way |
| **Link-chain, index **** (*<u>Richardson Investments, Inc.</u>*) (ISP Appeals 1993) | Self-Adjusts (2) Moves Forward every year | Representative portion Less than every item (Sample?) (4) |
| **Published Price Index (IPI)** | Fixed (3) | N/A (5) |

**NOTES:**

(1) "Fixed" means that the repricing reference date <u>is always the first day of the first year in which LIFO was adopted</u>.

(2) Every year moves up to become the first day of the current year so that repricing is over a one-year interval. Technically, the price used as the end of year price in the prior year becomes the price used as the beginning of year price in the next following year, thus "linking" the price "chain" together.

(3) Essentially fixed with reference to the first day of the first year in which the use of the Published Price Index/IPI computation method is elected.

(4) The term or word "Sample" is not mentioned by name nor defined in the regulations nor in the Tax Court's decision involving *<u>Richardson Investments, Inc.</u>* (76 T.C. 736 (1981)); instead, the reference is to an inflation index computation determined by repricing a "representative portion" of the inventory.

(5) Inventory items are not repriced <u>per se</u>; rather the equivalent of an index determined by a repricing process is arrived at by reference to Bureau of Labor Statistics published indexes using either the PPI (Producer Price Index) or the CPI (Consumer Price Index).

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* The <u>Key</u> to grasping the difference is that under **<u>the index method</u>**, as defined in the regulations, although less than every item is repriced, the base date **<u>point of reference</u>** for repricing those items which are selected **<u>is back to a fixed base date</u>** (i.e., the first day of the first year in which LIFO was adopted) and not to a comparatively more recent date.

** This term used in Form 3115, Schedule B, Part I (February, 1996 Revision).

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### *LINK-CHAIN, INDEX*...A NEW LIFO METHOD?

Many taxpayers for years have been using what I have always referred to as the "link-chain, index" method... even though this method has never been officially recognized by name—or style—by the IRS. The analysis of *E.W. Richardson's* LIFO computation difficulties (see pages 16-24) with the IRS takes us back to the original *Richardson Investments, Inc.* decision of the Tax Court filed May 11, 1981 which includes the following discussion of link-chain indexes:

"Respondent recognizes that in the link-chain method an index is computed by double-extending a representative portion of the inventory in a pool. We believe that as long as petitioner selects a representative portion of the inventory in a particular pool to compute an index for the pool under the link-chain method, the computation will be valid."

In more recent writings specifically involving auto dealer LIFO calculations, the IRS has stated that under the link-chain method, **every** item must be repriced...and the converse would be that no sampling may be employed in connection with a "true" link-chain method. In the ISP Motor Vehicle Industry Coordinated Issue Paper, July, 1989, on the definition of an "item" for dollar-value LIFO purposes, the statement is made "under the link-chain method, the quantity of **each** item in the inventory pool at the close of the taxable year is extended at both the beginning-of-the-year unit cost and the end-of-the-year unit cost." Note the emphasis on **each** item, thus precluding any sampling which might expedite the computation of the inflation index where there are thousands of items or in other situations where repricing every item is impractical or impossible.

In contrast, the ISP Coordinated Issue Paper (Appeals) dated June 21, 1993 states:

"The link-chain method uses a cumulative index which consists of the products of annual indexes dating from the year of the LIFO election. The cumulative index is used to restate current year inventory costs in terms of base-year costs. The cumulative index is also used to value increments stated at base-year cost. For example, if the year of the LIFO election is 1985, the 1987 link-chain index is computed as follows: 1985 index times 1986 index times 1987 index equals 1987 link-chain index.

"The link-chain method generally requires all items in ending inventory **(or a representative portion of the items in ending inventory)** to be priced at beginning and end of the year costs to obtain the current year annual index. In actual practice, taxpayers sometimes use sampling techniques to compute the link-chain index. These techniques must follow sound statistical methodologies."

In commenting above on the current revision of Form 3115, it was observed that Schedule B, Part I, Item 1(c) "Pricing dollar value pools" lists as examples the following: "...double extension, index, link-chain, **link-chain, index**, IPI computation method, etc." This is the first time anywhere that the Service has referred to the **link-chain, index** method, as such. It has always referred only to the link-chain method, and then patronizingly by adding the adjective "so-called" before using the words "link-chain." What does the Service now mean by its use of the term **link-chain, index**? Is this a *new* method?

The summary chart (page 8) "identifies" the two different characteristics essential to any method used in computing the LIFO value of a dollar value pool. One characteristic is shown in the "base date" column, referencing and emphasizing the fact that for computation purposes, the base date is either fixed, or it is adjusted forward every year. The second characteristic relates to the extent of the repricing required in connection with the overall population of inventory items falling within the pool: Either all items are required to be repriced (under the double extension method or under the link-chain method) or a representative portion may be repriced (under the index method or under the link-chain, index method).

**WARNING!**

The February, 1996 revision of Form 3115 is not quite in sync with the comparable listing of methods in item 9 on Form 970, which was recently revised December, 1995. The current Form 970 does not specifically refer to the "**link-chain, index**" method by name. If a taxpayer were electing LIFO using the link-chain, index method, on Form 970, item 9, the box for "Other Method" should be checked (as shown in the March, 1996 *LIFO Lookout* on page 22), followed by the explanation "link-chain, index method—see statement attached" and an explanation should be provided.

In conclusion, at the present time there is no official definition of what the IRS means by either *link-chain* or *link-chain, index*. Taxpayers proceed at their own peril in using these terms and in making their repricing computations. Practitioners and taxpayers should be careful to distinguish between these terms in filling out Forms 970, 3115 and in any other submissions to the IRS.

# EARLIEST ACQUISITION METHOD FOR VALUING INCREMENTS
# FINAL IRS ISSUE PAPER LIMITS USE OF DUAL INDEXES

Late last year, the IRS released its finalized Coordinated Issue Paper...covering all industries...on the use of the Earliest Acquisition Method in connection with dollar-value LIFO inventories. It states that a LIFO taxpayer electing an earliest acquisition/dual index method may **NOT** determine the index used to value an increment without double-extending (i.e., repricing) the **actual** cost of the goods purchased or produced during the year in the order of acquisition.

The draft of this ISP Paper was released in July of 1994 and it was summarized in the September, 1994 *LIFO Lookout*. Prior to that, the September, 1993 *LIFO Lookout* contained several articles addressing dual index approaches for valuing increments, including an extensive illustration relating to its use by aggressive taxpayers in start-up situations.

In its recently updated attack on the earliest acquisition/dual index method for valuing increments, the IRS tightened up its position even more while leaving the concerns expressed in our September, 1994 analysis about the validity of the IRS rationale essentially unaddressed. It is expected that the Service's revised and more restrictive discussion will make its way into revenue agent's reports in the near future.

### BACKGROUND TECHNICALITIES

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

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

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

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

The fourth box or "Other" category above really allows a number of other choices, so long as the method selected can be properly identified, described and justified. One example of an "Other" method is the "specific identification increment method" allowed by the Alternative LIFO Method for Auto Dealers in Section 4.02(2) of Revenue Procedure 92-79. According to an old LR7503130350B, another would be the use of current replacement cost for parts inventories.

In connection with the use of the **link-chain,** or **link-chain, index methods**(see pages 8 and 9), two separate index calculations may be involved:

1. The computation of the current year index of inflation, sometimes referred to as the primary, conversion or deflator index. This index is used to reduce or deflate the ending inventory from its actual current cost to its base dollar equivalent.

2. The computation of a second, separate index used only for purposes of valuing the actual increment, sometimes referred to as the secondary or incremental valuation index. This second index is used to raise any increment computed for the year from its expression in terms of base dollars to its equivalent in terms of current LIFO cost.

### THE ATTRACTION OF DUAL INDEXES

The ISP paper states that "historically, most taxpayers maintain their inventory records using the cost of items most recently purchased." This appears to mean that most taxpayers are using a FIFO, or First-In, First-Out ordering of costs so that their ending inventories reflect the cost of goods on hand that were most recently purchased. The ISP paper continues "...however, if they elect LIFO, they ***prefer*** to use the earliest acquisition method to determine their current year costs without changing their recordkeeping system. Therefore, they compute their LIFO inventory value using a dual index method. One index (the deflator index) is used to convert current year cost to base year cost and a second index (the increment valuation index) is used to value the increment."

Why do taxpayers ***prefer*** to use the earliest acquisition method? For many, it is because over a long-term period of rising prices, the earliest acquisition method will result in lower valuations of ending

see **VALUING INCREMENTS...**, page 12

# DUAL INDEX PROCEDURES

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

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

$$\text{ANNUAL INDEX} = \frac{\text{End of Year Prices} \times \text{End of Year Sample Quantities}}{\text{Beginning of Year Prices} \times \text{End of Year Sample Quantities}}$$

$$\text{INCREMENTAL INDEX} = \frac{\text{Earliest Current Year Prices} \times \text{End of Year Sample Quantities}}{\text{Beginning of Year Prices} \times \text{End of Year Sample Quantities}}$$

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

Cumulative ANNUAL Index = Current Year Annual Index x Previous Year's **CUMULATIVE ANNUAL** Index

Cumulative INCREMENTAL Index = Current Year Incremental Index x Previous Year's **CUMULATIVE ANNUAL** Index

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

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

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

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

(Continued from page 10)

inventory. This result will occur to the extent that the overall cumulative inflation rate at the end of the year is greater than the cumulative inflation rate that is being used to value that year's increment. Over many years with many increments, the differences in indexes could create a significantly larger LIFO reserve than if annual increments in any given year were multiplied by that year's cumulative primary or deflator index.

**EXAMPLE:** Consider the following initial LIFO year situation. (Some of the interpretative questions involving the use of dual indexes over multiple years are covered in the September, 1993 *LIFO Lookout* article.)

| | | |
|---|---|---|
| 1. | LIFO "base" inventory | $ 650,000 |
| 2. | End of the year inventory value | $ 838,056 |
| 3. | Current year inflation index (7.55% inflation) | 1.0755 |
| 4. | End of the year inventory stated in terms of base date costs ($838,056 divided by 1.0755) | $ 779,225 |

If prices had not increased during the year, the quantity of ending inventory that cost $838,056 would have *cost* only $779,225. In other words, the ending inventory restated at beginning-of-the-year costs has been "deflated" by dividing the actual cost at year-end ($838,056) by the inflation index of 1.0755. The resulting amount of $779,225 is then compared to the beginning of the year inventory amount ($650,000) to measure or determine if there has been an increase or a decrease in the investment of dollars (expressed in terms of constant purchasing power) in inventory.

Based on the 7.55% inflation index computed for the **first** year of this LIFO situation, since the inventory at the beginning of the year was $650,000, there has been a current year increase or increment of $129,225 ($779,225 - $650,000) and this increase or increment **MUST** be further valued for LIFO purposes.

Under the **double extension** method, the current year increment would be multiplied by the **cumulative** index as of the end of the current year. Therefore, since the increment (expressed in base dollars) was $129,225, that amount is multiplied by the current year index—which is also the cumulative index in the first year—of 1.0755. This increases the current year increment for LIFO purposes to $138,981 which is its "current cost" for LIFO purposes (i.e., its LIFO valuation). The LIFO valuation of the inventory at the end of the year is simply the sum of the beginning of the year (or base) inventory of $650,000 plus the current year increment of $129,225 as price adjusted to its LIFO valuation of $138,981.

If a dual index/earliest acquisition approach were properly elected and employed in the initial year and it were determined (to the satisfaction of the Internal Revenue Service!) that the earliest acquisitions—sometimes called "first purchases"—during the year for this purpose were made subject to price increases of only 2.6%, then the current year increment (expressed in base dollars) of $129,225 would be multiplied by 1.026% (instead of 1.0755%) in valuing it for LIFO purposes at $132,585.

As a result of using the earliest acquisition index for valuing the increment, the LIFO reserve would be approximately $6,400 greater. ($138,981 - $132,585 = $6,396.) This difference in LIFO reserve is simply the difference between the cumulative index at the end of the year and the index used to value the increment (1.0755 - 1.0260 or .0495) multiplied by the increment expressed in base dollars of $129,225.

This can be "seen" on page 13 which shows the LIFO reserves—under either a single index or a dual index approach—as the shaded uppermost portions of the respective tiers as $49,075 and $55,471, respectively. The difference in the size of the LIFO reserve where the earliest acquisition approach is used is simply due to the difference in the factor that was used to value the increment (expressed in base dollars). This explains the "preference" many LIFO taxpayers have for using an earliest acquisition approach in valuing increments.

**JULY, 1994..."PROPOSED" PAPER**

The conclusion expressed in the 1994 draft of the Coordinated Issue Paper was that:

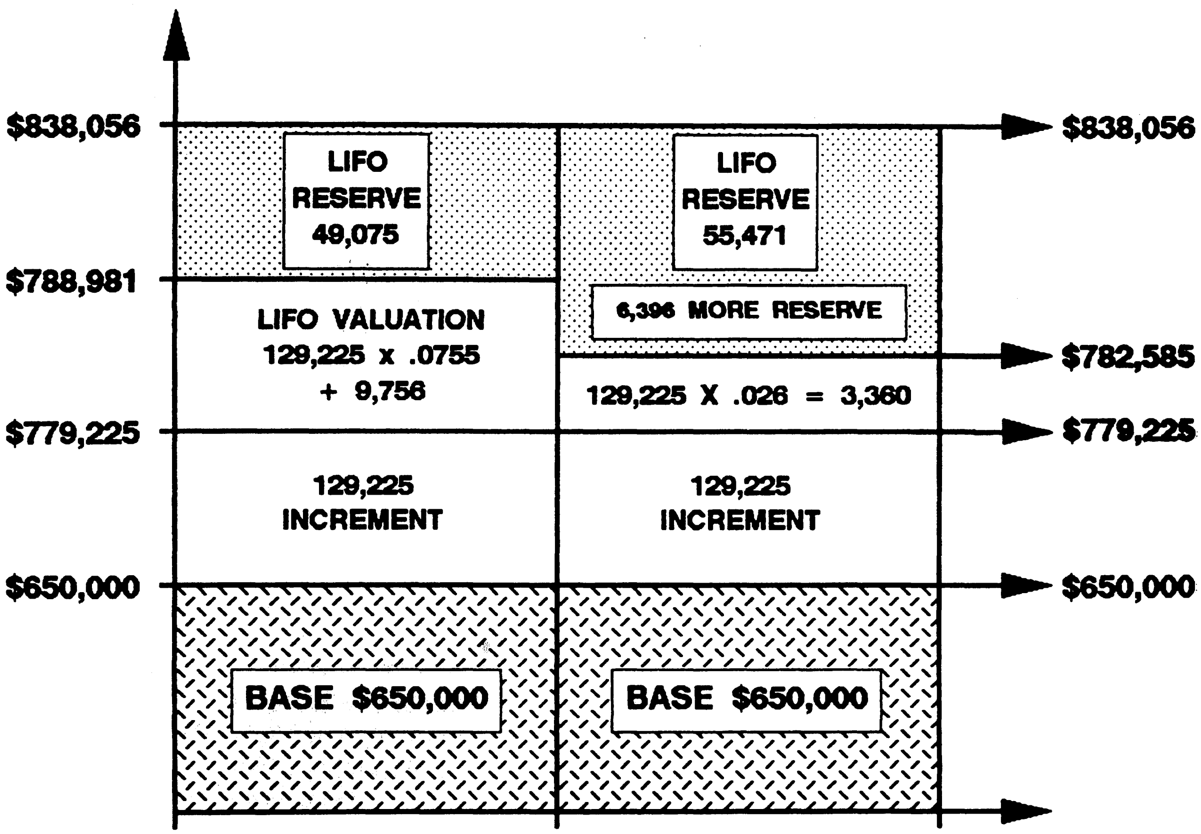
> "The "index" method of dollar-value LIFO does **not** permit the taxpayer to use two indexes determined as follows:
>
> (a) One index to restate year-end inventory to base-year cost using end of the year cost for "current year cost," and
>
> (b) A second index to value the increment in inventory quantity which is the prior year cumulative index or an index determined using a short-cut method."

The conclusion in the 1994 draft provided that "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."

see **VALUING INCREMENTS...**, page 14

# COMPARISON OF LIFO RESERVE RESULTS
# DUAL LINK-CHAIN INDEXES FOR VALUING INCREMENTS

| | SAME AS CURRENT YEAR (1.0755) | EARLIEST ACQUISITIONS (separate index=1.026) |
|---|---|---|
| LIFO base (beginning) Inventory | $650,000 | $650,000 |
| Current year increment, as adjusted | | |
| $129,225 x 1.026 = | — | 132,585 |
| $129,225 x 1.0755 = | 138,981 | — |
| Ending Inventory at LIFO | 788,981 | $782,585 |
| Ending Inventory at cost | 838,056 | 838,056 |
| LIFO Reserve | $ 49,075 | $ 55,471 |
| Analysis of LIFO Reserve | | |
| Base Inventory ($650,000 x 7.55%) | $ 49,075 | $ 49,075 |
| Difference due to valuation of increment $129,225 x 4.95% (7.55% - 2.60%) | — | 6,396 |
| LIFO Reserve | $ 49,075 | $ 55,471 |



(Continued from page 12)

## OCTOBER, 1995...FINAL VERSION

The conclusions in the IRS final paper—dated effective October 23, 1995—emphasize the tests that taxpayers using a short-cut method based on turnover will have to satisfy. The paper also retains all of the other limiting language from the draft.

The finalized paper concludes that a taxpayer electing the earliest acquisition(s) cost method of determining the current year cost of items making up a pool may not:

1. "Use a prior year's cumulative index in determining current year cost (earliest acquisitions).

2. "Use an inventory turn, shortcut approach unless the taxpayer can demonstrate to the satisfaction of the District Director that its method consistently results in the clear reflection of its income. Some factors that may support clear reflection are (1) the inflation rate is substantially the same throughout the year, and (2) the items are purchased or produced at a substantially constant rate and mix throughout the year. The combined variances in (1) and (2) above manifestly support an assumption that the application of the shortcut method produces substantially the same results as if the taxpayer had double-extended (i.e., repriced) each item at current year and base year cost (in the case of taxpayers using the double extension method) or current year and prior year cost (in the case of taxpayers using the link chain method)."

## POSSIBLE DISTORTIONS IN SHORTCUT TURNOVER CALCS

In discussing turnover tests, the IRS was considering a situation where if a 6% inflation rate had been computed for the year and the taxpayer's inventory had turned over 6 times, then a factor of 1% (6% divided by 6 turns) would be used under the taxpayer's earliest acquisition "convention" for purposes of valuing its LIFO increment expressed in base dollars.

Although not stated in the paper, one would assume that in years after the first LIFO year, a 1% earliest acquisition factor for that current year would be multiplied by the **cumulative** inflation rate at the beginning of the year in order to derive the **cumulative incremental** (earliest acquisition) factor... following the mechanics used by the taxpayer in Letter Ruling 8421010 which was specifically referred to in the draft version, but deleted in the final version.

The IRS paper expresses three concerns in connection with the use of "a short cut inventory turn method. One potential distortion is based on the fact that the inventory turn method 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 Reg. Sec. 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 potential distortion 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. The inventory turn method assumes 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 layer valuation index, that index will be understated during periods of inflation. New items must be included in the computation of the LIFO indexes." (But, how?)

## STANDARDS FOR TESTING DUAL INDEXES

The conclusion in the final version of the ISP paper suggests that where ersatz turnover tests are involved, a taxpayer's dual index approach or method should be allowed if it can be demonstrated that (1) the inflation rate is substantially the same throughout the year and (2) that the inventory goods—including new items—are purchased or produced at a substantially constant rate and mix throughout the year.

The "Discussion" includes a statement that may be regarded as establishing a "test" of sorts: "If properly applied, the use of a two index method or dual indexes should result in an inventory valuation method that is substantially the same as if the ending inventory was (sic) double-extended on an item by item basis in the order of acquisitions. In other words, *the standard must be the use of a single overall index.* Verification of the result must be satisfactorily demonstrated by the taxpayer to the District Director."

The root of this idea probably comes from many sources, including Letter Ruling 8421010: "Use of dual indexes....is not prohibited per se, by the regulations...; the use, however, must clearly reflect income with *the standard being the use of a single overall index."*

→

Neither the original draft nor the final version indicate 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)?

The final version deletes all references to Letter Rulings/Technical Advice Memoranda that appeared in the July, 1994 draft, including 8138005, 8421010, 8437004, 8749005 and 9332003. Taxpayers who want to see what the IRS has said previously in unpublished rulings will need to remember these numbers or save the draft version for reference purposes.

**AUTO DEALER LIFO APPLICATIONS & DUAL INDEXES**

The concerns expressed by the IRS in connection with the use of dual indexes may apply to some auto dealers' *used* vehicle inventories and/or *parts* inventories that are on LIFO.

For auto dealers using the Alternative LIFO Method for their *new* vehicle inventories, this is not a concern because the specific identification method for valuing increments is required by Revenue Procedure 92-79. The Alternative LIFO Method for Automobile Dealers requires the specific identification increment method in which the current-year cost of the items making up the pool must be determined by reference to the actual cost of the specific new autos or new light-duty trucks in ending inventory.

The finalized document retains the same statement from the draft version that earliest acquisition costs must be computed by determining the quantity of each particular type of item which is contained in the taxpayer's ending inventory and by comparing a sufficient number of the same items purchased or produced by the taxpayer during the year, commencing 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. This seems to be the IRS position for auto dealers who are using dual index approaches instead of the Alternative LIFO Method. As pointed out previously, this requirement seems to be unnecessarily pedantic and may be inconsistent with a broader interpretation of dollar-value LIFO concepts.

**WHAT IF EARLIEST ACQUISITION INDEXES HAVE NOT BEEN PROPERLY COMPUTED?**

The IRS is wary of possible taxpayer misuse.

**PROTECTION**

If you want protection from possible IRS audit adjustment because of "problems" in your turnover calculations or underlying assumptions, why not consider filing Form 3115 for permission to change increment valuation methods? If you are not under audit when the Form 3115 is filed, LIFO changes requested under Revenue Procedure 92-20 usually are granted allowing the taxpayer to use the cut-off method (Section 9.01). That may be a result to try for if your LIFO reserves are starting to look a little bloated. *

# LIFO PROBLEMS FOR DEALER ARBITRARILY CHANGING ITEM DEFINITIONS

E. W. RICHARDSON

Sometimes it takes many years before LIFO inventory issues get settled. One case we've been watching is *E. W. Richardson*, for which a petition was filed in the Tax Court back in 1992, but an opinion is yet to be issued. This case points out the difficulties that can arise when a taxpayer inconsistently uses "item definitions" in connection with its LIFO inventory computations.

The briefs filed by the Service reflect its continually expanding grasp of the technical issues and how they may be framed in terms of prior Tax Court precedents, including *Wendle Ford Sales, Amity Leather Products* and *Hamilton Industries.* The briefs also emphasize the Service's position that where Forms 3115 are required to be filed, but are not, the IRS is not bound by prior reviews or audits. Finally, they contain some very interesting comments on materiality and the fact that for IRS audit purposes, no amount of difference seems to be too small to ignore or adjust in the process.

The current petition filed by E. W. Richardson, arises out of the IRS' continuing audits of a taxpayer who was formerly the subject of a major Tax Court decision: *Richardson Investments, Inc. v. Commissioner*, 76 TC 736 (1981). In this case, the Tax Court held that the auto dealership in question was required to use two separate pools, one for new automobiles and a separate pool for new light-duty trucks because of the inherently different uses for which cars and trucks were intended. This opinion was released on the same day as *Fox Chevrolet, Inc. v. Commissioner*, 76 TC 708 (1981), which is the more often cited case for this proposition which has been continued in the now widely adopted Alternative LIFO Method for Automobile Dealers.

## BACKGROUND

Richardson Investments, Inc. in 1986 elected S corporation status and the Tax Court petition and briefs under review here are cited by the name of E. W. Richardson, the petitioner who is the sole shareholder of Richardson Investments, Inc. The case previously decided in 1981 involved the link-chain (not double extension) dollar-value LIFO computations used by one of the underlying Ford automobile dealerships. The IRS and the Tax Court agreed with the taxpayer's link-chain methodology, which is detailed on page 20. Note especially step 3...which involved the computation of average costs by body style/model code. Also note steps 7 and 8, which involved the use of a separately computed earliest purchase or earliest acquisition index for valuing increments: This was about the only thing the IRS agreed with!

Prior to 1986, Richardson Investments, Inc. owned three subsidiaries: Rich Ford Sales, Rich Ford Leasing and Richardson Properties. In 1986, these subsidiaries were liquidated into Richardson Investments and thereafter were operating divisions of that corporation. In 1974, the auto dealership had elected LIFO and its LIFO computations for that year were the subject of the Tax Court's opinion in *Richardson Investments, Inc.* which dealt only with the pooling issue.

After the opinion of the Tax Court was filed in May of 1981, the taxpayer restated its LIFO reserves for 1974 through 1980. The restatement computations were made by a newly hired comptroller who was hired about six months after the Tax Court decision. In the course of recomputing the LIFO reserves for 1974 through 1980 to reflect separate pools for new cars and for new trucks, the comptroller "did not apply step 3 of the LIFO inventory method approved by the Court in the prior case."

After proposing that the LIFO calculations for 1975, 1976 and 1977 be revised to conform to the "separate pool" Tax Court holding in 1981, the IRS did not examine the dealership's LIFO inventory methods until the present case. According to the IRS, these LIFO inventory valuation computations were not examined by it following the decision in the Tax Court case and, in the interim, the dealership never filed Forms 3115 nor otherwise requested the IRS to consent to changes in its methods of defining the items in its automobile and/or its light-duty truck pools. According to the Service, its actions in accepting the restatement of the LIFO reserves for 1974 through 1980 did not constitute a consent to the dealership's change in its method of accounting for item determination.

## AUTO POOL

The recomputations for 1974 through 1980 were based on grouping the dealership's inventory by vehicle size in order to determine an average beginning-of-the-year cost for all of the vehicles in each size category. This approach treated each of the vehicles within a given size category as the same ***ITEM*** of inventory as any other vehicle within that size category. In other words, under this approach, a full-size LTD II was a separate item with the mid-size LTD II included with the Granada as another item. The Thunderbird, Fairmont and Fiesta were

see **LIFO PROBLEMS...**, page 18

## WHAT THE IRS DIDN'T LIKE ABOUT *RICHARDSON'S* LIFO CALCULATIONS ...OR WHAT THE IRS ALLEGES *RICHARDSON* DID WRONG *

1. Taxpayer did not apply Step 3 of its own methodology in computing average costs *(see pages 19 & 20)*. Instead of using body style/model codes, it used vehicle size as its item definition in recomputing LIFO reserves for 1974 through 1980 after the Tax Court's decision in *Richardson Investments, Inc.*

2. Taxpayer did not apply Step 3 of its own methodology in computing average costs. Instead of using body style/model codes, it used model lines as its item definition for its 1981-1989 LIFO computations *(see pages 19 & 20)*.

3. Taxpayer used inconsistent item definitions for its "truck" pool. See detail analysis *(see page 19)*.

4. In using a dual index approach (i.e., one index to determine overall inflation, and a second index for purposes of valuing annual increments), the taxpayer used <u>inconsistent item definitions</u>. For purposes of computing overall inflation, the taxpayer used <u>vehicle size</u> (in its 1974 through 1980 recomputations) and <u>model lines</u> (in its 1981 through 1989 computations) as its item definition. However, for purposes of computing its increment valuation index under the earliest purchases method, the taxpayer used <u>body style/model codes</u> as its item definition *(see pages 19 & 20)*.

   **NOTE:** The IRS did <u>not</u> challenge the taxpayer's mechanics underlying its earliest purchase (i.e., the earliest acquisition / dual index) method for valuing annual increments.

5. "New items" slipped into the calculations without proper reconstruction.

6. In 1980, the Escort was treated as a continuing item, with reference to the prior Fiesta model. According to the IRS, the Escort was a "new item" in 1980.

7. In 1983, the Tempo was treated as a continuing item, with reference to the prior Fairmont model. According to the IRS, the Tempo was a "new item" in 1983.

8. The Ranchero was included in the car pool in 1975 and 1976, and it was included in the truck pool in 1977, 1978 and 1979. According to the IRS, the Ranchero should have been in the truck pool all along.

9. In making these (unauthorized) changes, taxpayer used a simple cut-off method; it did not restate prior LIFO indexes consistent with any subsequent changes it made.

10. All of the above changes were made without the Commissioner's consent...and Forms 3115 had not been filed in connection with any of them. These were unauthorized changes in item definition. Accordingly, they were unauthorized changes in accounting methods.

11. Even if the computed dollar amount of the effect of these changes were not material, adjustments were nevertheless required.

    According to the IRS, the taxpayer's LIFO computations *did not clearly reflect income*. Factors <u>*other than inflation*</u> had been allowed to enter into the computation of the annual and cumulative inflation indexes. Furthermore, the taxpayer had been inconsistent in applying its LIFO methodology over the years (1974-1989) involved.

* Tax Court Docket No. 27308-92, filed December 9, 1992.
Briefs and Reply Briefs filed September and November, 1994, respectively.

(Continued from page 16)

each separate items, while the Mustang and Pinto were included together as one item. For 1980, the Escort was defined as a separate item in place of the Fiesta.

According to the IRS, in attempting to comply with the Tax Court's decision, in doing the recomputation the definition of an item was changed by the dealership comptroller from "body style/model code" orientation to "vehicle size" orientation. The effect of this change in the definition of an item of inventory on the computations through 1980 for the auto/car LIFO pool was to overstate that index by one-third.

Further inconsistencies in the recomputation occurred insofar as the taxpayer determined its items by vehicle size for overall inflation purposes; but, it used a "body style/model code" item definition for purposes of computing its first purchase or earliest acquisition index for years when it had increments expressed in base dollars in the pool. According to the IRS, the same item definition should have been used for both purposes in the dual index approach.

In the opinion of the IRS, matters were made even worse when starting in 1981...and for the years 1981 through 1989...the dealership again changed its definition of an item in its car inventory from "vehicle size category" orientation to "model line" orientation. Thus, in the LIFO computations involved in *E. W. Richardson*, there are two changes in item definition: (1) from "body style/model code" as originally elected by the taxpayer and approved by the Tax Court in *Richardson Investments, Inc.* to "vehicle size" as employed in recomputations for the LIFO inventories for 1974 through 1980...and (2) then from "vehicle size" orientation or item definition to "model line" orientation beginning in 1981 and continuing through 1989. See summary on page 19.

For purposes of these discussions, "body style/model code" refers to 2-door, 4-door, sedan, station wagon, hatchback, convertible, coupe, etc. The term "vehicle size" classification refers to compact, subcompact, intermediate, standard (large/full-size) and/or luxury (specialty), with these latter size classifications being more prominent in the manufacturer's advertising efforts.

Several other inconsistencies troubled the IRS. FIRST, the broader grouping for item definition purposes in the recomputations for 1974 through 1980 resulted in an improper treatment of new items (especially with respect to Escorts and then later Tempos). SECOND, in changing its item definitions for the pools, the inflation indexes had not been similarly restated. In other words, the taxpayer, on its own, employed the cut-off method in making its changes.

**TRUCK POOL**

FINALLY, inconsistencies in item definition were also found in analyzing the LIFO computations for the truck pool. For 1979 through 1985, the dealership defined all of its vans (E Series) and extended body vans (S Series) as one item for average price computation purposes, while its full-size pickups (F Series), extended cab full-size pickups (X Series) and 4-door full-size pickups (W Series) were defined as separate items by load-carrying ability (i.e., ½ ton, 3/4 ton and 1 ton).

A change was made in 1986 and for 1986, 1987 and 1988 all full-size pickups (F, X and W Series) were defined as one item with one corresponding average cost being computed. Then, again, in 1989, the item definition was changed so that the dealership's E Series vans, its S Series vans, its F Series pickups, its W Series pickups and its X Series pickups were each defined as separate items for each series. In computing the average cost of its Ranger trucks (R Series) and Aerostar vans (A Series), each model line had been treated as one item regardless of any sub-models that were introduced...and this was inconsistent with the treatment accorded to Bronco trucks (U Series) wherein the full-size (U-15) was treated as one item while the Bronco II (U-12 and U-14) were combined and treated as a another combined item.

According to the Service, the effect of the changes in the definition of the items in the truck pool for 1986 through 1989 was an overstatement of the truck pool index "by almost 4%." Note: Although 4% might be considered by some to be immaterial or de minimis, the Service did not think it small enough to warrant being ignored.

Still another inconsistency that caught the eye of the Service was that the Ranchero in 1975 and 1976 was included in the car/auto pool; but for 1977 through 1979, it was included in the truck pool. It should have been in one pool or the other, and the Service felt the Ranchero should have been in the truck pool all along.

**KEY DIFFERENCES IN COMPUTATIONS**

The primary difference between the taxpayer's and IRS' inventory computations for the years 1981 through 1989 can be summarized as follows. The IRS multiplies the number of units in inventory of each body style/model code by the beginning-of-the-year average cost for that particular body style/model code to determine the total beginning-of-the-year cost for each body style/model code, which when added together, produces the total beginning-of-the-year cost for each pool. The dealership, on the other

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## *E.W. RICHARDSON V. COMMISSIONER* *

## DIFFERENT "ITEM" DEFINITIONS TAXPAYER USED FOR NEW VEHICLES FOR PURPOSES OF COMPUTING AVERAGE COST PER "ITEM"

### POOL #1: NEW CARS/AUTOS

| Years | Item Definition / Treatment | Manufacturer Classification Used for "Item" Purposes |
|---|---|---|
| 1974 - 1980<br>Per Taxpayer Original Election<br>on Form 970 | **BODY STYLE / MODEL CODES**<br>Which differentiate the different body configurations and interior styling packages within each model line | • 2-door<br>• 4-door<br>• Sedan<br>• Station Wagon<br>• Hatchback<br>• Convertible<br>• Coupe |
| 1974 - 1980<br>As Recomputed After Tax Court Decision<br>in *Richardson Investments, Inc.*<br>76 T.C. 736 (1981) | **VEHICLE SIZE CATEGORY** | • Standard (large / full-size)<br>• Compact<br>• Sub-Compact<br>• Intermediate<br>• Luxury / Specialty |
| 1981 - 1989 | **MODEL LINES** | • Pinto<br>• Mustang<br>• Maverick<br>• Torino<br>• Granada<br>• LTD<br>• Thunderbird<br>• Etc. |

### POOL #2: NEW TRUCKS (VANS, PICKUPS & SPORT UTILITY VEHICLES)

| Years | No. of Items | Item Definition / Treatment | | | | |
|---|---|---|---|---|---|---|
| 1979-1985 | 4 | **VANS** (E Series)<br>**VANS** (S Series) - Extended Body | 1/2 Ton **PICKUPS**<br>Full Size (F Series)<br>Extended Cab (X Series)<br>4-dr Full Size (W Series) | 3/4 Ton **PICKUPS**<br>Full Size (F Series)<br>Extended Cab (X Series)<br>4-dr Full Size (W Series) | 1 Ton **PICKUPS**<br>Full Size (F Series)<br>Extended Cab (X Series)<br>4-dr Full Size (W Series) | |
| 1986-87-88 | 2 | **VANS** (E Series)<br>**VANS** (S Series) - Extended Body | **ALL PICKUPS**<br>Full Size (F Series), Extended Cab (X Series) and 4-dr Full Size (W Series)<br>All 1/2 Ton, 3/4 Ton and 1 Ton Pickups treated as one item | | | |
| 1989 | 5 | **E Series - All** VANS | **S Series - All** VANS - Extended Body | **F Series - All** Full Size PICKUPS | **X Series - All** Extended Cab PICKUPS | **W Series - All** 4-door Full Size PICKUPS |
| Also | 1<br>1<br>2 | **RANGER (R** Series) - 1 item for entire model line<br>**AEROSTAR (A** Series) - 1 item for entire model line<br>**BRONCO (U** Series) - 2 items: Full size Bronco (U-15) 1 item and smaller Bronco II (U12 and U14) 1 item | | | | |

* Tax Court Docket No. 27308-92, filed December 9, 1992
Briefs and Reply Briefs filed September and November, 1994, respectively

## LINK-CHAIN LIFO METHODOLOGY ACCEPTED BY THE IRS IN *RICHARDSON INVESTMENTS, INC.*

1. List all items in new vehicle inventory as of year-end, including vehicles in transit, by body style (i.e., two-door, four-door, station wagon, sedan, etc.). The number of items for each body style and their aggregate costs are listed.
2. List all items in new vehicle inventory as of the beginning of the year, including vehicles in transit, by body style. In the year of changeover (i.e., the first year the LIFO election is in effect), calculations are made for both steps 1 and 2. For all subsequent years, the information obtained in step 1 of the prior year becomes step 2 of the current year.
3. Average cost of each new vehicle in the beginning and ending inventory is determined by dividing the total number of items *for each body style* into the total inventory cost *for each body style.*
4. Ending inventory quantity per category and body style is valued at beginning inventory price.
5. To determine the index to reduce current inventory to base year costs, a current to base year index is computed. The current year's ending inventory is valued at actual cost and at beginning inventory cost. The current to base year index is obtained by dividing ending inventory at actual cost by ending inventory at beginning inventory cost. Ending inventory valued at base year costs is the ending inventory at actual cost divided by the index. In years after the year of conversion, the current to base year index is obtained by multiplying the current index times the prior year's cumulative index.
6. Computation of increment (or decrement). The increment or decrement with reference to the base year costs is the difference between the ending inventory valued at base year costs and the previous year's ending inventory at base year costs.
7. The current year's inventory is then valued at earliest purchase cost (adjusted for cost increases between the first and the last purchases) .
8. The increment of inventory is then valued at earliest purchase value.
9. Ending inventory at LIFO value. The previous year's inventory at base year costs is added to the increment at earliest purchase value.
10. Total LIFO Reserve. The total LIFO Reserve is the ending inventory at actual cost less the ending inventory at LIFO value.
11. The term "LIFO Reserve" refers to the amount of increase in the petitioner's costs of sales resulting from its use of LIFO method of inventory valuation rather than specific identification lower of cost or market method.

## COMMENTS

- STEP 3 is where "item" definition is determined.
- STEPS 7 & 8 reflect *Richardson*'s use of a dual index/earliest acquisition method.
- STEP 9. The statement that "the previous year's inventory at base year costs is added to the increment at earliest purchase value" is technically correct only when taken as describing the first year LIFO valuation of the ending inventory. In fact, only the taxpayer's first year (1974) LIFO calculations were involved in *Richardson Investments, Inc.*

  For computations after the first year, Step 9 would read ..."the previous year's ending inventory at its LIFO valuation is added to the current year's increment, if any, at its earliest purchase LIFO value"...to determine the LIFO value of the ending inventory.

hand, multiples the total number of units in ending inventory within each broader model line times the average cost of all the units in that particular model line at the end of the previous year to determine a total beginning-of-the-year cost for each model line which, when added together, produces the total beginning-of-the-year cost for each pool.

Under the taxpayer's link-chain method, the multiplication of one year's current index times the cumulative index at the end of the preceding year results in the cumulative index at the end of the year which is used to deflate the ending inventory from actual cost—as determined by specific vehicle invoices—to express it in end-of-the-year "base dollars." Thus, the essential difference between the Service's and the dealership's LIFO calculations arises because of the manner in which they compute the corresponding beginning-of-the-year cost of the dealership's ending inventory.

The concerns of the IRS, of course, is that errors in the cumulative index keep moving forward from year to year with a cumulative or compounding effect.

**FOUR BROAD QUESTIONS**

The IRS brief raises four broad questions in terms of the LIFO calculations:

ISSUES

- Did the dealership change its method of accounting by changing the definition of the items in inventory for LIFO computation purposes?
- Does the Commissioner have the authority to place the taxpayer on a method of dollar-value LIFO when the method the taxpayer has been using does not clearly reflect income?
- Does the Commissioner's method of dollar-value LIFO valuation clearly reflect income?
- Was the dealership's handling of the Ranchero, Escort and Tempo model lines erroneous?

**IRS POSITION: "YES" TO ALL**

FIRST, the dealership did change its definition of items for LIFO computation purposes. The changes were from individual body style/model codes to vehicle size...and subsequently to model line and these changes constituted changes in methods of accounting under Code Section 446(e) and Regulation Section 1.446-1(e)(2)(i). SECOND, the taxpayer's changes in LIFO method were made without first securing permission from the IRS to make the changes. Consent was not requested nor given and, furthermore, the IRS action in accepting the restate-

(Continued from page 18)

ment of the LIFO reserves for 1974 through 1980 did not constitute a consent to the changes that had been made in item definition by the taxpayer.

THIRD, the Commissioner does have the authority to disallow changes that were made in the dollar-value methodology and the changes proposed by the Service are not significantly different from the LIFO methodology originally elected by the taxpayer. The inconsistent use of item definitions and treatment of new items by the taxpayer resulted in a "method of dollar-value LIFO inventory accounting that does not clearly reflect its income."

**FACTORS "OTHER THAN INFLATION"**

The essential technical thrust of the Service's arguments against the use of averages by the taxpayer in this case is that by broadening the definition of the items in its inventory from body styles/model codes to vehicle size...and then to model line...the taxpayer allowed factors other than inflation to enter into its computation of the annual rate of inflation.

Specifically, the factors "other than inflation" cited by the IRS are the (1) cost differential between vehicles of the same size category or model line and (2) the change in the mix of the vehicles in each size category or model line from year to year. According to the IRS, the effect of the change was to overstate the taxpayer's cumulative indexes which resulted in an understatement of the ending inventory valuation and, obviously, a consequent postponement of the recognition of income until some future date.

Under the LIFO method originally elected, the taxpayer defined the "items" of its inventory in its auto pool as the individual body styles/model codes in each of its vehicle size categories and it determined the beginning-of-the-year value of its ending inventory on the basis of the average cost of each of those separate body styles/model codes. When the taxpayer later restated its LIFO reserves on the basis of separate pools for autos and light-duty trucks, the taxpayer determined the beginning-of-the-year value of its ending inventory for each of the restated years on the basis of the average cost of all of the vehicles in each of its vehicle size categories as one item. Thus, it changed the definition of items in its inventory from individual body styles/model codes to vehicle size. Before that change, a full-size vehicle of one body style/model code, for example, was treated as an item of inventory different from a full-size vehicle of another body style/model code and each item had its own average beginning-of-the-year value. After the change, all of the dealership's full-size vehicles were treated as the same item of inventory, regardless of their different body styles, and all were aver-

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aged together to determine one beginning-of-the-year value for that vehicle size category. The effect of this change was to understate the beginning-of-the-year value of the ending inventory and the consequence of that understatement was to overstate the inflation indexes and thereby understate the ending inventory expressed in base dollar/base year cost.

### BROAD AVERAGES PRESENT PROBLEMS

In its brief, the Service cites *Fox Chevrolet*, *Hamilton Industries*, *Amity Leather Products* and Revenue Procedure 92-79 in support of its position that the use of averages by taxpayers must be carefully scrutinized to be sure that factors "other than inflation" are screened out of LIFO computations. It cites *Amity Leather Products* as follows: "For example, if a taxpayer's inventory experiences mix changes that result in the substitution of less expensive goods for more expensive goods, the treatment of those goods as a single item increases taxable income. Conversely, if changes in mix of the inventory result in the substitution of more expensive goods for less expensive goods, the treatment of those goods as a single item decreases taxable income... A narrower definition of an item within a pool will generally lead to a more accurate measure of inflation...and a clearer reflection of income."

The analysis included in the IRS brief is not unlike that contained in an article appearing in the *LIFO Lookout* March, 1993, entitled "How Far Do You Have to Go In Determining Item Categories" which was written in the context of Revenue Procedure 92-79.

However, the difference is that *Richardson* used an item definition based upon body style/model codes; whereas the Alternative LIFO Method goes into **greater** detail with its "item category" language... and this gets even more involved where *shared model codes* are involved.

### PERMISSION TO CHANGE NEVER RECEIVED

The taxpayer had not filed any Forms 3115—nor otherwise requested the IRS' consent—to the changes in its methods of defining the items in its new vehicle pools. According to the IRS, the Commissioner cannot be held to have consented to a change in accounting method without the filing of a Form 3115 ...and the actions of an IRS agent in accepting the restatement of the LIFO reserves for 1974 through 1980, after the filing of the Tax Court opinion in *Richardson Investments, Inc.*, cannot—according to the Service—be considered as having been a consent to the taxpayer's change in its method of accounting. Also, the change in item definition made starting with the taxable year 1981 from "vehicle size" to "model lines" should be regarded similarly as not having been made with the consent of the Commissioner.

### NEW ITEM "SLOPPINESS"

The position of the Service has been steadfast: For automobile dealers, new "items" must be repriced at

→

## MUSTANGS & WRANGLERS... ITEMS & POOLS... AND MISSED DISTINCTIONS

The taxpayer's expert witness testified that, in his opinion, a P-45 Mustang and a P-40 Mustang are the same item of inventory regardless of their difference in cost. As he put it, "A Mustang is a Mustang."

In its reply brief, the IRS picked up these comments and analyzed them extensively. The taxpayer's expert witness had said "If I have an extra large Wrangler shirt that is $49.99 and Wrangler also makes a shirt that is a $22 for a small, that doesn't mean I have got two different shirts there for purposes of items..."

The IRS (wanting the shirt off somebody's back?) disagreed: "Assuming the...taxpayer purchased both shirts during the year and sold one for $36 that year, a determination of which shirt was sold would be essential to a clear reflection of income (i.e., the proper matching of current revenues with current costs). If the... taxpayer sold the $49.99 shirt, he had a loss of $13.99. If he sold the $22 shirt, he had a gain of $14.

"If a taxpayer's inventory method allows the substitution of one type of good that is more expensive for a different type of good that is less expensive, the increase in cost is eliminated from the LIFO cost as if it were inflation."

The Service contended that the taxpayer's expert witness had "confused the composition of a pool with the definition and treatment of items within that pool... In *Fox Chevrolet*...the (Tax) Court held that the considerations applicable to the proper composition of *pools* are different than those which are required to answer the question of what constitutes an *item* within that pool...(the taxpayer's expert) has missed the distinction."

current cost, unless it's possible to reconstruct or otherwise establish a different cost to the satisfaction of the examining agent. *Richardson's* treatment of "new items" was, in general, not acceptable to the IRS because the broadening of the item definitions (from body styles to vehicle sizes to model lines) resulted in glossing over the impact of specific new models as they were introduced and these new items should have resulted in lower overall inflation indexes.

Specific problems over "new item" reconstruction are evident in the Escort, introduced in 1980, and the Tempo, introduced in 1983. When the Escort was introduced in 1980, although this was a new item, the average cost of the Fiesta at the end of 1979 was used as the corresponding beginning-of-the-year cost of the Escort for 1980 computation purposes. The Escort was a front wheel drive vehicle which had been introduced to replace the Pinto and all of the Escort's major components and systems (engine, transaxle, suspension and body) were specially designed for that car. The Escort was produced in the United States - whereas the Fiesta (also a front wheel drive vehicle) was an import built by Ford of Germany. (Recall the holding of the Tax Court in *Amity Leather Products* that even identical items manufactured in different countries should be treated as separate items because of different underlying cost characteristics.) The Service believed that using the 1979 average cost of the Fiesta as if it were equivalent to the average cost of the Escort at the beginning of 1980 produced an overstatement of the 1980 annual inflation index because it treated the Escort as if it were a continuing item, rather than attributing less—or no—inflation to it as a new item.

Similarly, when the Tempo was introduced in 1983, it was treated as if it were a continuing item by using the 1982 average cost of the Fairmont as the average cost of the Tempo at the beginning of the year. The Fairmont was a rear wheel drive vehicle in contrast to the Tempo which was a front wheel drive vehicle (which had been, in turn, introduced to replace the Granada). The Service disagreed with the treatment of these new models as new items in the car pool and took the position that in the absence of the reconstruction or establishment of a different cost, the beginning-of-the-year cost of those vehicles should have been based on their actual costs during the year in which they entered the dealership's inventory.

## MATERIALITY? NOTHING'S TOO SMALL TO BE IGNORED

The Service demonstrated that the taxpayer's inconsistencies in item definition between years produced results that do not clearly reflect income. The regulations provide that the term "method of accounting" includes not only the overall method of accounting used by a taxpayer, but also the accounting treatment of any item. In citing Regulation Section 1.446-1(e)(2)(ii)(a), the IRS brief states "a change in a method of accounting includes a change in the treatment of any material item used in such overall plan. A material item is any item which involves the proper time for the inclusion of the item in income or the taking of a deduction." The Regulations alsostate that a change in the treatment of any material item used in the overall plan for *identifying or valuing items in inventory* is a change in method of accounting.

In the prior *Richardson Investments, Inc.* 1981 Tax Court case, the Court found as a fact that the taxpayer elected a method of dollar-value LIFO in which it determined the average cost of each new vehicle in its beginning and ending inventory by dividing the total number of all items for each body style into the total inventory cost for each body style (see Step 3 on page 20.). Since the taxpayer neither requested nor obtained consent to change from the Commissioner, the IRS views its actions now as simply returning the taxpayer to the method it originally elected.

In separately arguing that the Commissioner has the authority to change the taxpayer's dollar-value LIFO method when the taxpayer's method does not clearly reflect income, the Service cites the inconsistent application of the inventory valuation methods. Even the comptroller and financial vice-president of the taxpayer is quoted as having described the taxpayer's method as "weird and unusual." The Service states that "once a taxpayer loses the mantle of protection afforded by an acceptable method of accounting, consistently applied, the materiality of the difference in results between the taxpayer's method and the Commissioner's method is irrelevant." In other words, under those circumstances, no amount is too small to be ignored.

The *All-Steel Equipment, Inc. v. Commissioner* case is cited for the proposition that "for tax purposes, there is no rule excusing a taxpayer from paying deficiencies which are relatively immaterial. Moreover, the doctrine of materiality in commercial accounting does not have the same significance it would have if applied to tax controversies." In that case, the Court noted that the amounts in dispute were substantial, even though they constituted only a small percentage of taxpayer's income (i.e., the difference in net income was less than 5% per year for 13 out of 14 years).

In *Ralston Development Corp. v. United States*, in 1991, the Tenth Circuit Court of Appeals held that a taxpayer arguing that the Commissioner has abused her discretion in selecting a method of accounting

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must demonstrate a substantial identity of results between his method and the method selected by the Commissioner. In *Wilkinson-Beane, Inc. v. Comm.*, in 1970, the Court held that there was not a substantial identity of results even though the difference in totals over a five-year period was less than two-tenths of one per cent.

The Court in *Wilkinson-Beane* noted that regardless of the accuracy of the taxpayer's method in the past, there was no guarantee that the stability of the factors which made for that result would continue in the future. Also cited was *All-Steel Equipment, Inc.*, where the Tax Court said in 1970 "...there is no legal basis for permitting the petitioner to continue to use an erroneous method...until a year in which it does result in the underreporting of larger amounts of income."

Consequently, the position of the Service is that the Commissioner has the authority in this case to disallow the changes which the taxpayer made to the definition of the items of its inventory and to place the taxpayer on a method of dollar-value LIFO inventory valuation which clearly reflects income.

### USE OF DUAL INDEXES NOT CHALLENGED

It is easy to observe from the description of the link-chain methodology employed by the taxpayer—steps 7 and 8—that it used a separately computed earliest acquisitions index. The IRS did not take exception to this approach even though it was obviously beneficial to the taxpayer. The first purchase cost was computed based on the actual number of units in each body style or model code in ending inventory.

This approach seems to conform with the approach elsewhere described by the IRS as acceptable. For example, in its Coordinated Issue Paper on the Dollar-Value LIFO, Earliest Acquisition Method, the IRS stated that "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...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." This approach takes into account the ending inventory mix and reflects it in the computation of the mix used in computing the earliest acquisition index.

Accordingly, the concerns expressed by the IRS in its Coordinated Issue Papers relative to dual index methods were not triggered in Richardson's situation. The most notable difference between Richardson's LIFO method and the Alternative LIFO Method is that Richardson used—with the IRS concurrence—a dual index/earliest acquisition approach for valuing increments... and this approach is specifically not allowed under Revenue Procedure 92-79.

### YOU BE THE JUDGE ...OR AT LEAST TAKE A GUESS

How do you think the Tax Court will rule in this case eventually? It will be interesting to find out, especially because the IRS may apply similar analyses to the use of averages where there are mix changes and items are not narrowly defined in the LIFO applications of many other types of businesses.

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*De Filipps' LIFO Lookout* format designed by *Publish or Perish, Inc.* (708) 289-6332.

De Filipps' LIFO LOOKOUT
Willard J. De Filipps, C.P.A., P.C.
317 West Prospect Avenue
Mt. Prospect, IL 60056

First-class postage paid at Mt. Prospect, IL