



De Filipp's

# LIFO LOOKOUT

A Quarterly Update of LIFO - News, Views and Ideas

Volume 6, Number 3

Publisher: Willard J. De Filipp, C.P.A.

September 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 CONFORMITY: PENDING IRS REV. PROC. PUNISHING DEALERS FOR FINANCIAL STATEMENT CONFORMITY VIOLATIONS.

The last report from NADA was that IRS attorneys had completed drafting a Revenue Procedure that requires three levels of review and approval. The first level of approval had been completed; that left two remaining. Timetable for ultimate release: Anyone's guess. Contents and scope of pronouncement: Not revealed yet; apparently very confidential at this point. When the IRS releases its document, we'll analyze it thoroughly in the *LIFO Lookout*.

The recent case involving worker classification issues for a used car dealer in San Diego (*Martin L. Springfield d/b/a Douglas Motors*) reached the Ninth Circuit Court of Appeals. This case—which the taxpayer won—provides language that, in the right hands, might be helpful for auto dealers subject to the harsh IRS interpretation of the financial statement conformity requirement for year-end statements sent to the manufacturer/Factory.

Here's what the Appeals Court said in *Martin L. Springfield*: "When the Government ignores a taxpayer's contentions as to the real world conditions of the market place, despite the requirements of Congress that it consider them, it invites the result reached here."

In other words, when the IRS ignores what's going on in the "real world," some judges insist that the realities of the business world be taken into account. Hopefully, some auto dealers—particularly those in Southern California whose cases might ultimately wind up in Judge Hawkins' court—will resist the IRS on conformity, rather than cave in to its unrealistic demands, theories ... and even Revenue Procedures.

Perhaps the Appeals courts will be more inclined to take a hard look at the "real world" conditions in which the manufacturers have said time and time again, they really don't care about—or want—LIFO

## LOOKOUT LOOKS INTO

LIFO UPDATE .....	1
A CLASSIC LIFO SHOWDOWN:	
E. W. RICHARDSON, T.C. MEMO 1996-368	
THREE LIFO METHOD ISSUES ... ALL FALL DOWN ....	3
RICHARDSON AT A GLANCE .....	5
THE RICHARDSON TWINS .....	6
ITEM DEFINITION .....	7
THE TAX COURT'S PRIMER ON LIFO INVENTORIES .....	8
"VISUALIZING" HOW DOLLAR VALUE LIFO WORKS ...	10
WHAT THE TAX COURT SAID	
ABOUT THE DISPUTED LIFO CHANGE ISSUES .....	12
FLOWCHART FOR ACCOUNTING METHODS,	
CHANGES & APPROVAL DISPUTES .....	16
PLANNING AND PROJECTING	
FOR YEAR-END LIFO INVENTORIES	
IT'S NOT TOO EARLY TO START NOW .....	18
PROCEDURES & FORMATS FOR LIFO PROJECTIONS .	20
MULTI-YEAR LIFO RESERVE RECONCILIATIONS .....	24
PROJECTIONS PROFORMA	
SAMPLE PROJECTIONS WITH "PROOFS" .....	26
CLIENT TRANSMITTAL LETTER .....	30
PROJECTION DOCUMENTATION CHECKLIST .....	31

on their statements: They just want to know where it is—if it is there—so they can erase it before it distorts their analyses and composites.

Even one of the oldest cases in the Tax Court (*Latimer-Looney Chevrolet, Inc.*) said almost 45 years ago ... "As required by its franchise, petitioner (the auto dealer) followed the accounting system prescribed by the Chevrolet Division of General Motors, which system was designed by and for the benefit of General Motors. The system has been in effect for many years without major changes."

Do GM, Ford, Chrysler and the other manufacturers really need the IRS to tell them how they should evaluate their dealer networks? Seems pretty ridiculous, doesn't it? We shall see to what levels this conformity absurdity ascends.

see **LIFO UPDATE**, page 2

**DEALER TAX & LIFO SEMINARS**

Our Fall, 1996 Seminars are being scheduled around the country. These full day seminars will be presented on consecutive days at various locations:

- Orlando, FL ..... Oct 2-3
- Baltimore, MD ..... Oct 7-8
- Indianapolis, IN ..... Oct 10-11
- Dallas, TX ..... Oct 31 - Nov 1
- Burbank, CA ..... Nov 7-8
- Chicago, IL ..... Nov 25-26

**DEALER INCOME TAX ISSUES** ... a new full day seminar covering dealer tax cases, IRS activity and practice guides on all the hot tax issues affecting auto dealers, updating many articles previously appearing in the *Dealer Tax Watch*.

**LIFO for AUTO DEALERS** ... covering all aspects of making LIFO elections, eligibility requirements—Cost, **CONFORMITY**, and Consent/Form 970—and computation mechanics. This seminar will emphasize the LIFO conformity controversy and cover in depth any IRS revenue procedure or ruling that is issued between now and your seminar date.

## **#2. DOLLAR-VALUE LIFO PRIMER: AS AUTHORITATIVE AS IT GETS.**

In our last issue of the *LIFO Lookout*, we discussed the *E. W. Richardson* case, then pending in the Tax Court. In August, 1996, the Court issued its opinion as Tax Court Memo 1996-368.

This case should be read by all LIFO practitioners, and it should not be dismissed or discounted just because it involves the pre-Alternative LIFO Method computations of an automobile dealer. The LIFO issues in *Richardson* were the catalyst for the Tax Court to summarize—in its own words—how it has been interpreting IRS-taxpayer disputes over LIFO theory and practice. You won't find a more authoritative summary anywhere else ... coming right from the source.

The LIFO issues centered around the determination of what constitutes an "item" and the extent to which the taxpayer could use averaging techniques in its comparing beginning-of-the-year and end-of-the-year prices. In turn, these issues have blossomed lately into very potent IRS/Treasury attacks on virtually any accounting methods—and even on more isolated transactions—which the IRS uses to go beyond the statute of limitations every chance it

(Continued from page 1)

gets. This tricky triumvirate of issues is diagrammed on page 14:

1. Unauthorized change in method.
2. Clear reflection of income.
3. Action within (versus abuse of) Commissioner's discretion.

## **#3. LIFO INFLATION INDEXES FOR SOME DEALERS MAY BE LOWER AT YEAR-END THAN THEY WERE LAST YEAR.**

Cadillac and Lincoln have announced reduced prices on some of their vehicles and this may spread to other manufacturers as well. It's too early to tell, but these outright price reductions may result in overall lower LIFO inflation indexes for new vehicles.

Furthermore, some non-domestic manufacturers are reported to be "decontenting" their newer vehicles. If the manufacturers do not proportionately pass the reduced cost along to the dealers in lower base costs, they will be providing dealers—and ultimately, customers—with less product for the same amount of money. It's like ordering a dozen donuts for \$4.00 and having the clerk give you only 10 or 11 and still charging you the same \$4.00 price. That's ... inflation. How it may affect auto dealers' year-end LIFO indexes will depend on a number of factors, as discussed in the lead article in our coverage on Year-End Planning and Projections.

**#4. YEAR-END PLANNING AND PROJECTIONS.** It's not too early to start calendar year-end projections and we've included articles and examples that should be helpful as you undertake this process.

We've also mentioned some of the instances where taxpayers tried to do some "planning" but were foiled by the Internal Revenue Service. These cases provide good guides for what not to do and show just how perceptive and watchful the IRS and the Courts have become over year-end "transactions" intended to manage inventory levels. We plan to do a feature article on this in the next issue.

**#5. PETITIONS IN THE TAX COURT.** Two cases recently petitioned in the Tax Court caught our eye. The first one involves an auto dealer who, on December 29, transferred his dealership to a partnership, while keeping the corporation alive with other assets. He then elected S corporation status for that corporation effective for January 1 of the following year.

The IRS said the dealer should pay the LIFO recapture tax required by Section 1363(d). The dealer claimed that as of December 31, 19xx, he had no inventory and therefore, the Section 1363(d) recapture tax was not applicable. Will form triumph over substance? More on *Hub Chrysler Plymouth* (Docket No. 4464-96) as that case progresses.

see **LIFO UPDATE**, page 32

De Filippis' LIFO LOOKOUT



# A CLASSIC LIFO SHOWDOWN: THREE LIFO ISSUES, ALL FALL DOWN *E.W. RICHARDSON, T.C. MEMO 1996-368*

As pointed out recently, sometimes many years pass before LIFO issues get settled once and for all. We were watching the *E.W. Richardson* case, for which a petition had been filed in the Tax Court almost 4 years ago. The Tax Court recently filed its opinion (on August 12, 1996) in Tax Court Memo Decision 1996-368. This case involved two diverse issues: ... LIFO calculations ... and whether the expenses of owning and operating a corporate Lear Jet were deductible. The corporate aircraft expenses were allowed in full by the Tax Court and that part of the case has been discussed in the last two issues of the *Dealer Tax Watch*. The LIFO issues are the subjects for the *LIFO Lookout*.

One very important observation at the onset: The LIFO issues in *E. W. Richardson* do not involve calculations under the Alternative LIFO Method for Auto Dealers under Rev. Proc. 92-79. However, this case is still important because it is a primer on LIFO principles, accounting method changes and Commissioner authority, as summarized by the Tax Court itself. That's what makes *E.W. Richardson* (T.C.M. 1996-368) interesting reading and reference material.

Our detailed coverage in the June, 1996 *LIFO Lookout* provided most of the background related to (1) the various item definitions that Richardson used for its auto and for its truck pools, (2) the key differences in the computations, and (3) the IRS challenges to Richardson's LIFO calculations. In closing that article, readers were invited to guess how the Tax Court might rule. Well, if you guessed that the Tax Court would throw out Richardson's LIFO calculations and uphold the IRS' ... you guessed ... right!

## ISSUES

- Whether Richardson (i.e., the taxpayer) made an unauthorized change in accounting method ... The Tax Court said it did,
- Whether Richardson's (i.e., the taxpayer's) method of inventory accounting clearly reflected income ... The Tax Court said it did not, and
- Whether the IRS Commissioner (Margaret Richardson) abused her discretion in determining that Richardson (the taxpayer) should define its "items" of inventory (for dollar-value LIFO purposes) by model code ... The Court said Richardson (the IRS Commissioner) did not.

It is interesting to note that when Richardson filed its Form 970, it had checked the box on that Form for the "double extension method," even though it actually used a link-chain method in computing its LIFO values for its inventory. Apparently, the IRS chose to ignore this oversight or not to make a mountain out of a molehill over it. Also, it was interesting to read that the use of dual indexes by Richardson was not at all challenged by the IRS.

## RICHARDSON REDUX

This current Tax Court Memo decision, 1996-368, is really the second "Richardson" case to come before the Tax Court. The first was *Richardson Investments Inc. v. Commissioner*, 76 T.C. 736 (1981). In that case, the primary issue was whether the LIFO election made in 1974 had properly adopted the use of a single LIFO inventory pool in computing inventory values under the dollar-value, link-chain LIFO method. The Tax Court held that new cars and new trucks should be placed in separate pools. After that opinion, filed by the Tax Court in May of 1981, Richardson recomputed its 1974 LIFO inventories and those for succeeding years placing the new cars and new trucks in separate LIFO pools. These LIFO recalculations were submitted to the Tax Court under the Court's Rule 155 Procedure, and a decision was entered. The taxpayer and the IRS reached agreement on the LIFO calculations for the years 1975, 1976 and 1977, conforming those calculations to the decision that had been filed. For the years 1978, 1979 and 1980, Richardson amended its income tax returns to conform its inventory calculations to that previous decision.

The crux of the current *E. W. Richardson* litigation related to arguments over whether there were changes in the definitions of the "items" that Richardson used in making beginning-of-the-year and end-of-the-year repricing comparisons to determine the inflation rates for the pools.

When the taxpayer restated its LIFO reserves for 1974 through 1980, the restated computations were made by a comptroller who was newly hired about six months after the Tax Court decision. In the course of recomputing the LIFO reserves for those years to reflect separate pools for new cars and for new trucks, the comptroller did not follow one of the steps (step 3) of the LIFO inventory method approved by the Court in the prior case.

see A CLASSIC LIFO SHOWDOWN... , page 4



## **A Classic LIFO Showdown...**

According to the IRS, its actions in accepting the Rule 155 recalculation of the LIFO inventories and reserves for 1974 through 1980 did not constitute an affirmative consent to the dealership's change in its method of accounting for "item" determinations. Obviously, Richardson's position was to the contrary.

### **ITEM DEFINITION**

In the LIFO computations for new autos, there were 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 page 19 of the June, 1996 issue of the *LIFO Lookout*, and page 7 in this issue for more specifics on how this definition varied over the years. Initially, the IRS disputed the "item" definitions Richardson had used in both the car (autos) pool and in the light-duty truck pool.

The IRS had also determined that Richardson changed its method of accounting when it changed the definition of its items of inventory for its new truck pool. At trial and on brief, however, Richardson argued only that the change from body size to model line in its new car pool was not a change in method of accounting. In other words, Richardson did not specifically address the change in accounting method issue with respect to its new truck pool. As a result, the Tax Court held that Richardson had conceded the item definition change in that pool.

The IRS, and the Tax Court, saw that through it all, the essence was that Richardson was "averaging" at too broad a level. The technical thrust of the Service's arguments against the use of averages by Richardson was that by broadening the definition of the items in its inventory from body styles/model codes to vehicle size ... and then to model line ... Richardson had allowed factors other than inflation to enter into its computations of the annual rate of inflation. This line of attack brought the case into the precedents established by *Amity Leather Products* in 1984 and *Hamilton Industries* in 1991. Both cases spell "curtains" for LIFO calculations that do not "clearly reflect income."

Specifically, the factors "other than inflation" cited by the IRS and by the Tax Court 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. In *Fox Chevrolet* ... the (Tax) Court held

(Continued from page 3)

that the considerations applicable to the proper composition of pools are different considerations than those which are required to answer the question of what constitutes an item within that pool. The taxpayer's expert had missed the distinction. "Pooling" has to do with the grouping of like goods/items for overall computation purposes. "Item" nature of the goods goes to the degree of similarity (physically and/or from a cost characteristic standpoint) which may allow—or prevent—them from being similar enough to be averaged for repricing purposes in determining inflation indexes.

The portion of the Tax Court's Opinion that discusses the disagreement over the nature of the "items" also provides the most recent summary of its views on dollar-value LIFO accounting. (See page 8.) It further analyzes the three essential elements in most taxpayer disputes with the IRS over accounting method changes. These dispute elements involve (1) unauthorized changes in method, (2) clear reflection of income, and (3) alleged abuse of discretion by the IRS Commissioner in requiring changes in a taxpayer's method of accounting. Each of these is discussed beginning on page 12.

### **MATERIALITY**

The Service stated 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. Just how small is small? In its briefs, *Richardson* said that:

...The adjustments are not significant on a year-by-year basis and are not always in favor of the IRS.

...Its calculations result in a lower LIFO inventory in 8 of 15 years for cars and in 10 of 15 years for trucks. It argued that was not an indication that its method did not clearly reflect income.

...The average cumulative difference in inventories through 1989 was \$7,461 for cars and \$19,735 for trucks. This constituted only a .3 percent difference for 1989. A difference this insignificant is obvious proof that the IRS computation could not more clearly reflect income.

...The comparison of only one year fails to reflect the fact that, in the aggregate, a comparison of the differences between the two methods of computation over all years since 1974 through 1989, the last year in issue, reflects a cumulative difference of only .3 percent in the 1989 index computation, after taking into account all the individual years' variations be-

see **A CLASSIC LIFO SHOWDOWN...** , page 32

De Filippis' LIFO LOOKOUT



# E. W. RICHARDSON AT A GLANCE

## SIMPLE MATH: LIFO POOL FOR NEW AUTOS \*

6			DIVIDED BY 2			EQUALS 3		
INCONSISTENCIES			CHANGES IN ITEM DEFINITION			ISSUES FOR TAX COURT		
1. Arbitrary Changes in Definitions of Items			1. From "Body Style / Model Code" as originally elected by the taxpayer and approved by the Tax Court in <i>Richardson Investments, Inc.</i> to "Vehicle Size" as employed in recom- putations for the LIFO inventories for 1974 through 1980.			1. Did <i>Richardson</i> make an unauthorized change in method of accounting? (Tax Court said: Yes.)		
2. Escort (1980)						2. Did <i>Richardson's</i> method of inventory accounting clearly reflect income? (Tax Court said: No.)		
3. Tempo (1983)								
4. Ranchero (1975-76) vs. (1977-78-79)								
5. No Section 481(a) adjustment computed, Cut-off method used			AND THEN					
6. No Form 3115 filing; No IRS Permission Granted			2. From "vehicle size" orienta- tion or item definition to "Model Line" orientation beginning in 1981 and continuing through 1989.			3. Did the IRS Commissioner abuse her discretion in determining that <i>Richardson</i> should define its items of inventory for dollar-value LIFO purposes by model code? (Tax Court said she did <u>not</u> abuse her discretion.)		

SIMPLE MATH: SIX (6) DIVIDED BY TWO (2) EQUALS THREE (3).

\* Note: Richardson did not specifically address the IRS' challenge regarding the change in method of accounting with respect to its new truck pool. As a result, the Tax Court held that Richardson conceded that issue in favor of the IRS.



**De Filippis' LIFO LOOKOUT**  
 Willard J. De Filippis, CPA, P.C.  
 317 West Prospect Avenue Mt. Prospect, IL 60056  
 (847) 577-3977 FAX (847) 577-1073  
 INTERNET: <http://www.defilippis.com>

Published Quarterly  
 March, June, September  
 and December  
 \$325

Start my subscription for the next four issues of the **LIFO Lookout** with the \_\_\_\_\_ issue.

☐ **YES!** My check for **\$325** is enclosed for 4 issues.

**Back Issues** of the *LIFO Lookout* are available for \$70 each. Please send me:

1996:	<input type="checkbox"/> 1Q (Mar '96)	<input type="checkbox"/> 2Q (June '96)	<input type="checkbox"/> 3Q (Sep '96)	
1995:	<input type="checkbox"/> 1Q (Mar '95)	<input type="checkbox"/> 2Q (June '95)	<input type="checkbox"/> 3Q (Sep '95)	<input type="checkbox"/> 4Q (Dec '95)
1994:	<input type="checkbox"/> 1Q (Mar '94)	<input type="checkbox"/> 2Q (June '94)	<input type="checkbox"/> 3Q (Sep '94)	<input type="checkbox"/> 4Q (Dec '94)

Prior years 1991 through 1993 also available

NAME(S): \_\_\_\_\_

FIRM NAME: \_\_\_\_\_

ADDRESS: \_\_\_\_\_

CITY: \_\_\_\_\_ STATE: \_\_\_\_\_ ZIP: \_\_\_\_\_ PHONE: (\_\_\_\_) \_\_\_\_\_

# THE RICHARDSON TWINS

<b>RICHARDSON INVESTMENTS, INC. V. COMMISSIONER.</b>  76 T.C. 736 (1981)	<b>E. W. RICHARDSON V. COMMISSIONER</b>  T.C. Memo 1996-368 ... August 12, 1996
<b><u>POOL CONTENT</u></b>	<b><u>ITEM DEFINITION</u></b>
What goods go into the pool?	How are <u>items</u> to be defined in the pool?
<b><u>NARROW</u></b>	<b><u>NARROW</u></b>
Each model line goes in a separate pool	Body Style / Model Code
<b><u>EXPANDED</u></b>	<b><u>EXPANDED</u></b>
Cars / Autos in Pool #1 Light-Duty Trucks in Pool #2	Vehicle Size / Body Size Category
<b><u>VERY BROAD</u></b>	<b><u>VERY BROAD</u></b>
All new vehicles in single pool	Model Lines
<b><u>CRITERIA</u></b>	<b><u>CRITERIA</u></b>
Major Lines, Types or Classes of Goods	<ul style="list-style-type: none"> <li>• The more narrowly the item is “defined,” the more clearly income will be reflected.</li> <li>• Factors <u>other</u> than inflation should <u>not</u> enter into the computation of the inflation index (i.e., taxpayers need to factor these other elements out by treating as separate items):               <ul style="list-style-type: none"> <li>(1) Different cost characteristics, and</li> <li>(2) The effect of changes in mix in year-end inventory levels.</li> </ul> </li> </ul>
<b><u>TAX COURT HOLDING</u></b>	<b><u>TAX COURT HOLDING</u></b>
2 Pools: Cars / Autos in Pool #1 Light-Duty Trucks in Pool #2	“Item” should be defined more narrowly, by using Body Style / Model Code.
<p>* The Tax Court said: “The considerations applicable to the proper composition of POOLS (i.e., for retailers: lines, types or classes of goods) are <u>different</u> than those which are required to answer the question of what constitutes an ITEM (i.e., the smallest unit of goods within the pool used for end-of-the-year vs. beginning-of-the-year price/cost comparisons.”</p>	



**E. W. RICHARDSON \***

**DIFFERENT "ITEM" DEFINITIONS FOR NEW CARS / AUTOS: POOL #1  
FOR PURPOSES OF COMPUTING AVERAGE COST PER "ITEM"**

<u>YEARS</u>	<u>ITEM DEFINITION / TREATMENT</u>	<u>MANUFACTURER CLASSIFICATION USED FOR "ITEM" PURPOSES</u>
1974 - 1980 Per Taxpayer Original Election on Form 970	<b>BODY STYLE / MODEL CODES</b> Which differentiate the different body configurations and interior styling packages within each model line	<ul style="list-style-type: none"> <li>• 2-door</li> <li>• 4-door</li> <li>• Sedan</li> <li>• Station Wagon</li> <li>• Hatchback</li> <li>• Convertible</li> <li>• Coupe</li> </ul>
1974 - 1980 As Recomputed After Tax Court Decision in <i>Richardson Investments, Inc.</i> 76 T.C. 736 (1981)	<b>VEHICLE SIZE / BODY SIZE CATEGORY</b> ALSO REFERRED TO AS "BODY SIZE"	<ul style="list-style-type: none"> <li>• <b>FULL SIZE (STANDARD)</b> - included 8 model codes of full size LTDs</li> <li>• <b>LUXURY / SPECIALTY</b> - included 1 model code of Thunderbird</li> <li>• <b>MID SIZE (INTERMEDIATE)</b> - included 4 model codes of mid-size LTDs &amp; 2 model codes of Granadas</li> <li>• <b>COMPACT</b> - included 4 model codes of Fairmont</li> <li>• <b>SUB-COMPACT</b> - included 4 model codes of Mustangs &amp; 3 model codes of Pintos</li> <li>• <b>ESCORT</b> (all by itself because Escort model line was introduced for the first time in 1980)</li> </ul>
1981 - 1989	<b>MODEL LINES</b>	<ul style="list-style-type: none"> <li>• Pinto</li> <li>• Mustang</li> <li>• Maverick</li> <li>• Torino</li> <li>• Escort</li> <li>• Granada</li> <li>• LTD</li> <li>• Thunderbird</li> <li>• Fiesta</li> <li>• Etc.</li> </ul>
<p>* Note: Richardson did not specifically address the IRS' challenge regarding the change in method of accounting with respect to its new truck pool. As a result, the Tax Court held that Richardson conceded that issue in favor of the IRS.</p>		

# THE TAX COURT'S PRIMER ON LIFO INVENTORIES

E. W.  
RICHARDSON

Section 471 requires the use of inventories whenever necessary in order to clearly reflect income. Sec. 471(a); *Fox Chevrolet, Inc. v. Commissioner*, 76 T.C. 708, 719 (1981). The regulations define "necessary" as being whenever the production, purchase, or sale of merchandise is an income-producing factor. Reg. Sec. 1.471-1. When inventories are required, they must be maintained on a basis that conforms as nearly as possible to the best accounting practice in the taxpayer's trade or business and that most clearly reflects income. Sec. 471(a); *Fox Chevrolet, Inc. v. Commissioner*.

In a merchandising business, gross income from sales means total sales less cost of goods sold (COGS). Reg. Sec. 1.61-3(a). Cost of Goods Sold (COGS) for the year is determined by subtracting the value of ending inventory from the sum of the value of beginning inventory and the cost of purchasing or producing goods during the year. *Primo Pants Co. v. Commissioner*, 78 T.C. 705, 723 (1982). As a general rule, taxpayers will want to keep ending inventory as low as possible so that Cost of Goods Sold (COGS), which is an offset to gross receipts, is made as large as possible, thereby minimizing gross income. *Hamilton Industries, Inc. & Sub. v. Commissioner*, 97 T.C. 120, 129 (1991).

Section 472 permits taxpayers to value their inventories under the LIFO method. In contrast to the FIFO method of inventory valuation, which treats the first goods acquired as the first goods sold, the LIFO method of inventory valuation treats the last goods acquired as the first goods sold. Sec. 472(b); *Fox Chevrolet, Inc. v. Commissioner*. Accordingly, under the LIFO method, the earliest goods acquired are treated as the goods remaining in ending inventory. *Fox Chevrolet, Inc. v. Commissioner*. During a period of rising costs, the use of the LIFO method generally results in lower taxes because ending inventory will be lower, and therefore Cost of Goods Sold (COGS) will be higher. *Amity Leather Prods. Co. v. Commissioner*, 82 T.C. 726, 731 (1984). "The theory behind LIFO is that income may be more accurately determined by matching current costs against current revenues, thereby eliminating from earnings any artificial profits resulting from inflationary increases in inventory costs."

In computing LIFO inventory values, two basic approaches are used: The specific-goods method and the dollar-value method. *Hamilton Industries, Inc. & Sub. v. Commissioner*, see Reg. Sec. 1.472-2 and 1.472-8. We have (i.e., the Tax Court has) previously compared the specific-goods LIFO method with the dollar-value LIFO method:

"Under the specific-goods method, the physical quantity of homogeneous items of inventory at the end of the taxable year is compared with the quantity of like items in the beginning inventory to determine whether there has been an increase or decrease during the year. Because the specific-goods method requires the matching of physical units, practically speaking, it is only used as a method for valuing inventories in those industries with inventories which contain a limited number of items with quantities that are easily measured in units.

"In contrast to the specific-goods method, the dollar-value method measures increases or decreases in inventory quantities, not in terms of physical units, but in terms of total dollars. Thus, to determine whether there has been an increase or decrease in the inventory during the year, the ending inventory is valued in terms of total dollars that are equivalent in value to the dollars used to value the beginning inventory.

"Because it is not predicated upon the matching of specific items, use of the dollar-value method permits the application of the LIFO principle in those industries with complex inventories containing a vast number of items. \* \* \* [*Wendle Ford Sales, Inc. v. Commissioner*, 72 T.C. 447, 452 (1979)]"

Under the dollar-value method, inventory is grouped into "pools" composed of "items". *Hamilton Industries, Inc. & Sub. v. Commissioner*, supra at 131; Reg. Sec. 1.472-8(a). To determine whether there has been a change in inventory value from the prior year, the current year aggregate cost of the items in ending inventory for each pool is valued at "base-year cost." Base-year cost is the aggregate cost of all items in the pool at what they cost (or would have cost) as of the beginning of the taxable year for which the LIFO method was first adopted. Reg. Sec. 1.472-8(a). After converting the current year ending inventory from current-year cost to base-year cost, the value of the beginning and ending inventory in terms of base-year cost is compared to determine whether an increase or decrease in inventory value has occurred. Thus, to ascertain whether a taxpayer's ending inventory has increased or decreased in real quantity terms, it is necessary to compare the value of the beginning and ending inventories of a particular taxable year expressed in terms of the same dollar equivalent; i.e., base-year cost. (1 Schneider, "Federal Income Taxation of Inventories," sec. 14.01[1], at 14-4, 14-5 (1996)).

→





The regulations contain four alternative approaches to determine base-year cost: The double-extension method, the index method, the link-chain method, and the retail method. Reg. Sec. 1.472-8(e)(1). (The taxpayer, Investments)...used the "link-chain" method of computing the base-year cost of the inventory in its LIFO pools.<sup>2</sup>

More specifically, (the taxpayer, Investments) used the link-chain, dual-index method for the determination of quantity changes and for the valuation of increments in its LIFO pools. Under the dual-index method, a cumulative deflator index is used to value ending inventory at base-year cost, and a layer-valuation index is used to value increments in the pool. (Note: See "Earliest Acquisition Method for Valuing Increments", June, 1996 *LIFO Lookout*, pages 10-15 for further articles and a discussion of the IRS finalized Coordinated Issues Paper on Dual Indexes dated October 23, 1995.)

Each year (the taxpayer, Investments) calculates an annual and a cumulative deflator index for each pool in order to convert current year ending inventory at "actual cost"<sup>3</sup> to what it would be at base-year cost. To compute the annual deflator index, (the taxpayer, Investments) divides the ending inventory at actual cost by the beginning of the year value of ending inventory.<sup>4</sup> This results in a current year annual deflator index. The current year annual deflator index is then multiplied by the annual deflator index from all prior years to arrive at the cumulative deflator index. The ending inventory on the books at actual cost is then divided by the cumulative deflator index to arrive at the ending inventory expressed at base-year cost.<sup>5</sup>

Once ending inventory at base-year cost is computed, it is compared to beginning inventory at base-year cost. See Reg. Sec. 1.472-8(e)(2)(iv). If ending inventory valued at base-year cost exceeds beginning inventory at base-year cost, there is an increment in inventory. See *id.* The LIFO value of such increment is then computed, see *id.*, and the increment is added to beginning inventory for the pool to determine the current year's LIFO ending inventory for the pool, see *id.*; see also *Fox Chevrolet, Inc. v. Commissioner*, 76 T.C. at 733.

If ending inventory valued at base-year cost is less than beginning inventory at base-year cost, there is a decrement in inventory. See Reg. Sec. 1.472-8 (e)(2)(iv). When there is decrement, the current year's LIFO ending inventory is the beginning inventory reduced by the decrement.

Once the total LIFO ending inventory is calculated, the ending inventory figure is subtracted from the sum of the values for beginning inventory and purchases during the year to produce the Cost of Goods Sold (COGS) for the current year. *Fox Chevrolet, Inc. v. Commissioner*.

## NOTES

1. In the case of a retailer, such as (the taxpayer, Investments), the regulations provide that the inventory shall be grouped by "major lines, types, or classes of goods." Reg. Sec. 1.472-8(c). Investments, pursuant to *Richardson Invs., Inc. v. Commissioner*, 76 T.C. 736 (1981), used two pools, one for new cars and one for new trucks.
2. Although the regulations do not contain a specific description of the link-chain methodology, or an example of such methodology, the parties have stipulated that Investments' link-chain methodology was appropriate. For a more detailed description of the link-chain methodology, see Rev. Proc. 92-79, sec. 4, 1992-2 C.B. 457, 460 (describing Alternative LIFO Method for Automobile Dealers); see also [1 Schneider, "Federal Income Taxation of Inventories," sec. 14.02[3][b], at 14-96 (1996)].
3. In arriving at the actual cost of its ending inventory in its new car and new truck pools each year, Investments uses the actual invoice cost of each vehicle in inventory.
4. (The taxpayer, Investments) divided the total beginning of the year number of vehicles for each unit of inventory, e.g., model line, by the total beginning of the year cost for all the vehicles in that unit, resulting in an average cost for the unit. This average cost was then multiplied by the number of vehicles on hand and in transit at year-end for that particular unit to determine the beginning of the year value of ending inventory for the unit. The total for each unit was then summed to reach beginning of the year value of ending inventory.
5. Comparing the link-chain method with the double-extension method, one commentator has noted:

The basic approach of the link-chain method is comparable to the double-extension method, except that the base year is rolled forward each year. Thus, instead of referring back to a fixed base period for purposes of pricing items, each year's current costs are restated in terms of the prior year's costs. These costs may then [be] indexed back to the base year through the use of a cumulative price index. [1 Schneider, *supra* at 14-96.] \*



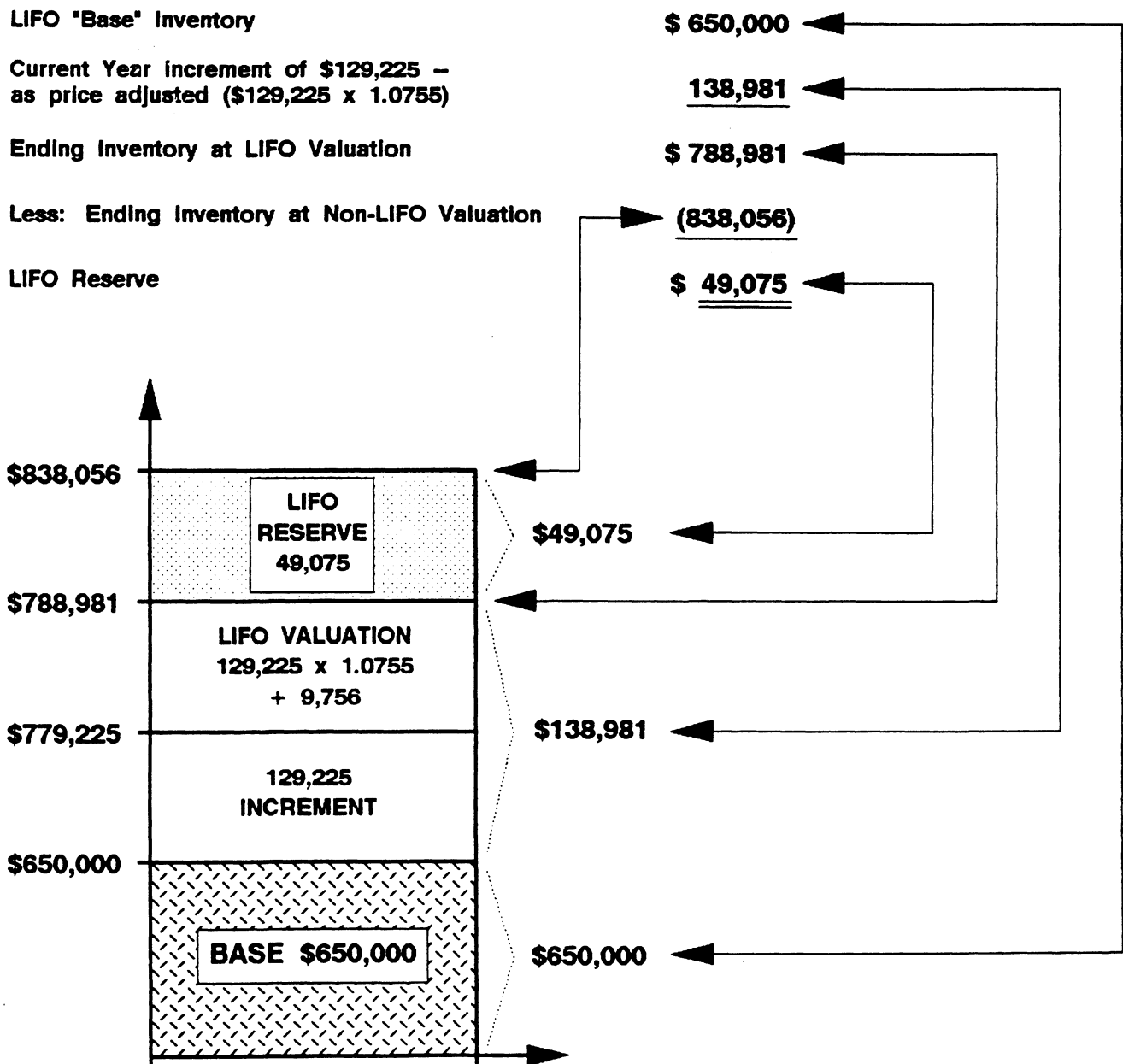
# **"VISUALIZING"**

## **HOW THE DOLLAR VALUE METHOD WORKS**

Assume the following for the initial LIFO year where the same (inflation) index is used to (1) deflate the ending inventory to express it in base dollars and (2) to "inflate" or value the increment to bring it up to LIFO cost.

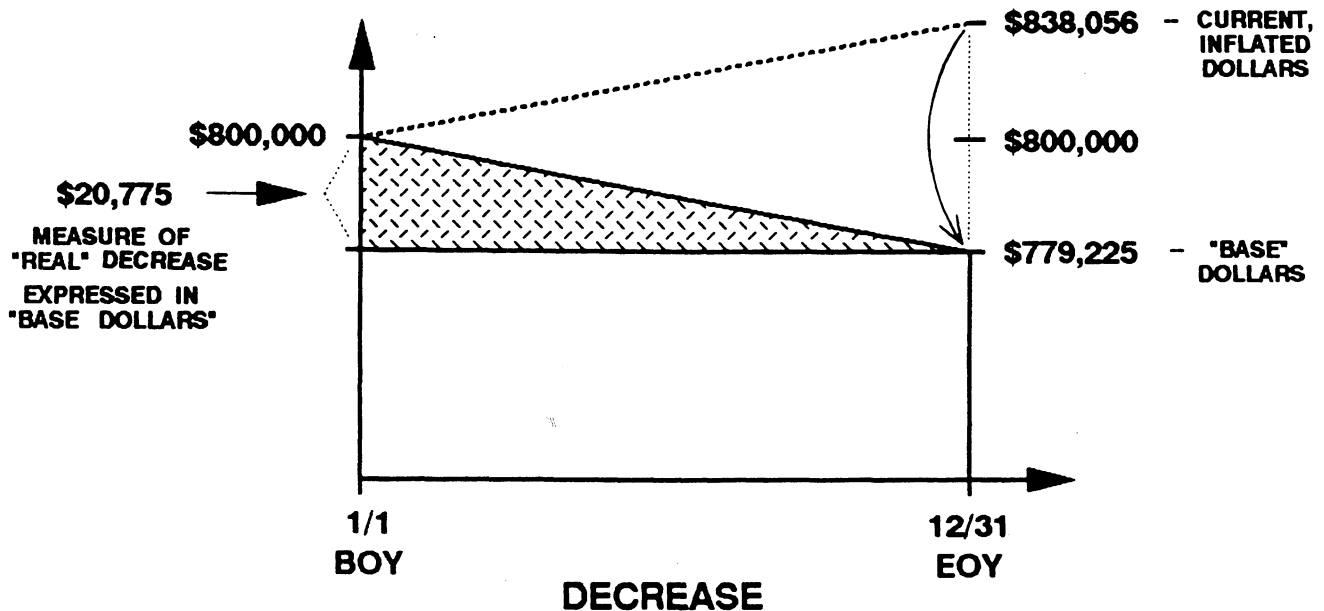
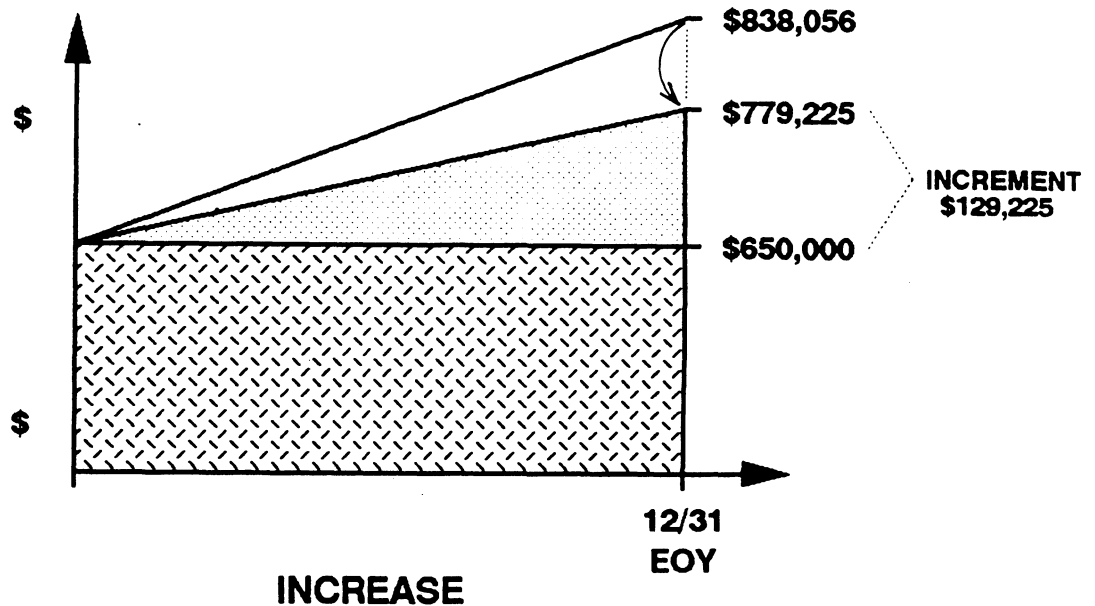
1.	LIFO "base" inventory	\$ 650,000
2.	End of the year inventory value	\$ 838,056
3.	Current year price index (7.55% inflation)	1.0755
4.	End of the year inventory <u>\$838,056</u> stated in terms of base date costs 1.0755	\$ 779,225

In tabular form, the LIFO reserve is calculated below:



Based on the 7.55% inflation index applying to the first year of a LIFO conversion, 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). This increase or increment must be further valued for LIFO purposes.

At the bottom is an alternative to illustrate a decrease situation: If the inventory at the beginning of the year had been \$800,000, there would have been a liquidation or decrease in inventory levels (expressed in terms of base dollars) of \$20,775 (\$800,000 - \$779,225) for the year. In this case, the LIFO reserve would have been \$58,831 (\$838,056 - \$779,225) and this equals the inflation rate of 7.55% multiplied by \$779,225.



# THREE BIG ISSUES IN DISPUTED LIFO METHOD CHANGES

## WHAT THE TAX COURT SAID

### 1. UNAUTHORIZED CHANGES IN METHOD

IRS took the position that Richardson made an unauthorized change in method of accounting when it changed the definition of its inventory units in 1981 from body size to model line.

Section 446(e) requires taxpayers to receive IRS consent before changing accounting methods.

Internal Revenue Code does not define the phrase "change in accounting method."

Regulations under Section 446(e) state that "... change in the method of accounting includes a change in the overall plan of accounting for gross income or deduction or a change in the treatment of any material item used in such overall plan."

A change in an overall plan or system of identifying or valuing items in inventory is a change in method of accounting.

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.

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. Reg. Sec. 1.446-1(e)(2)(ii)(c).

Certain changes do not "rise to the level of a change in method of accounting:"

1. Correction of mathematical or posting errors.
2. Adjustment of any item of income or deduction which does not involve the proper time for the inclusion of an item of income or the taking of a deduction.
3. A change in treatment resulting from a change in the underlying facts.

To determine the scope of a taxpayer's LIFO election, the facts and circumstances of the case must be examined and this requires analysis of scope of the taxpayer's business, the information provided on Form 970, the tax return and other business records.

Taxpayer has the burden of proof on this issue.

Taxpayer and taxpayer's CPA both testified that "model code" was never used to define new car pool inventory units.

Tax Court concluded that "the weight of the evidence ... suggested that taxpayer ... never defined its inventory units for new car pool by model code."

#### 1981 UNAUTHORIZED CHANGE

IRS took the position that *Richardson Investments* made an unauthorized change in the treatment of material items when it changed the definition of its inventory units for its new car pool from body size to model line in 1981.

Richardson argued that "the definition of the unit used to compute beginning of the year value of ending inventory did not serve to define its items" for dollar-value LIFO purposes.

Tax Court concluded that "when *Richardson* defined its units used in computing beginning-of-the-year values of ending inventory, it was in substance defining its items of inventory."

"... Beginning-of-the-year value of ending inventory served as the denominator in both the annual deflator index computation and the layer-valuation index computation. The annual deflator index and the layer-valuation index are indexes of price change between the prior year and the current year; therefore, the denominator of each index, computationally, represents the aggregate of all items in ending inventory at beginning-of-the-year value."

"When *Investments* (i.e., Richardson) changed the definition of its inventory units from body size to model line, it changed its definition of an item of inventory for purposes of ... Reg. Sec. ... (ii)(a) and (c)."

*Richardson* took the position that even if the units used in the computation are "items" for Section 446 purposes, ... such change was a permissible refinement or delineation of (its) existing item definition.

New or separate items may be created or arise in a taxpayer's dollar-value LIFO pool.

→



If goods or products have substantially dissimilar characteristics, whether in terms of their physical nature (i.e., *Wendle Ford Sales*) or whether in terms of cost (i.e., *Amity Leather Products*), these goods or products are properly treated as new or separate items (*Hamilton Industries*).

A reconstruction of base year cost for a new or separate item will not be treated as a change in method of accounting under Section 446(e).

*Richardson* did not allege that a physical character or cost of its new car inventory substantially changed between 1980 and 1981.

The Tax Court concluded that *Richardson* changed its definition of its item of inventory without the predicate change in facts required for the creation of a new or separate item.

Therefore, the Court held that *Richardson's* change in definition of its item of inventory was not due to the creation of a new or separate item.

*Richardson's* alternative argument was that the change it made "does not rise to the level of a change in method of accounting because such change was merely a change in valuation." This was a losing argument.

The Tax Court stated that the objective of inventory accounting is to value inventories. Accordingly, any change in inventory accounting can be characterized as a change in valuation. The Tax Court did not agree with *Richardson's* argument that "any change in inventory accounting could be characterized as a change in underlying fact and, therefore, not a change in method of accounting."

Having found that *Richardson* changed the treatment of an item of inventory and that the change did not meet the exception for a new or separate item, the Tax Court next had to examine whether the item change was "material."

A "material item" is any item which involves the proper time inclusion of the item in income or the taking of a deduction.

The essential characteristics of a material item is that it determines the timing of income or deduction.

A change in the method of determining both beginning and ending inventory is a change in the treatment of a material item and, therefore, constitutes a change in method of accounting.

*Richardson* changed the definition of items in its inventory... This change caused the annual and cumulative indexes to be lower than they would have been had the taxpayer continued using a body size definition of items.

For example, in 1980, the cumulative deflator index in the new car pool under a body size definition of item would be 2.090204; under a model line definition, that index would have been 1.970891.

Accordingly, the base year cost of *Hamilton's* year-end inventory (actual cost \$1,437,855) would have been \$687,890 under a body size definition of item and \$729,546 under a model line definition of item.

Although a higher base year cost of ending inventory will generally produce higher taxable income (i.e., the taxpayer's cost of goods sold will be lower), taxpayers may, nevertheless, desire a higher base-year cost of ending inventory in a given year to avoid liquidating a LIFO layer, causing a match of historical cost against current revenues. Thus, depending on a taxpayer's particular set of facts and circumstances, it may be advantageous to have a lower annual deflator index.

When *Richardson* changed its definition of an item in inventory (which resulted in lower annual and cumulative indexes and, therefore, affected the computation of beginning and ending inventory), the change was a change in the treatment of a material item.

After changing its definition of item for its new car pool from body size to model line in 1981, *Richardson* did not file Form 3115 or otherwise request the IRS' consent to change its LIFO method. Therefore, the Tax Court concluded that *Richardson* had changed its method of accounting without IRS consent.



## 2. CLEAR REFLECTION OF INCOME

The Commissioner can change the taxpayer's method when the existing method does not clearly reflect income.

The IRS determined that *Richardson's* method of accounting ... did not clearly reflect income; *Richardson* asserted that it did.

Inventory accounting is governed by Sections 446 and 471 which vest the Commissioner with wide discretion in matters of inventory accounting and give her wide latitude to adjust a taxpayer's method of accounting for inventory so as to clearly reflect income.

The Commissioner's determination with respect to a clear reflection of income is entitled to more than the usual presumption of correctness, and the taxpayer bears a heavy burden of overcoming a determination that a method of accounting does not clearly reflect income.

If a taxpayer establishes that a method of accounting clearly reflects income, the Commissioner may not disturb the taxpayer's choice.

Whether a taxpayer's method of accounting clearly reflects income is a question of fact, and the issue must be decided on a case-by-case basis.

Section 446(a) requires a taxpayer to compute taxable income using a method of accounting it regularly uses in keeping its books.

If ... the method used does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary, does clearly reflect income.

The Commissioner's authority under Section 446(b) reaches not only overall methods of accounting, but also a taxpayer's method of accounting for specific items of income and expense.

In regard to inventory accounting, an inventory must conform to two distinct tests:

### TWO TESTS

1. It must conform as nearly as may be to the best accounting practice in the trade or business, and
2. It must clearly reflect income.

To clearly reflect income, the inventory practice of the taxpayer should be consistent from year to year, and greater weight is to be given to consistency than to any particular method of inventory or basis of valuation.

Any taxpayer may elect to determine the cost of ... its LIFO inventories under the so-called "dollar value" LIFO method provided such method **is used consistently and clearly reflects income**.

Consistent application of a method of accounting is necessary for the method to clearly reflect income.

Accordingly, if a method of accounting is not consistently applied, this fact alone may cause the method not to clearly reflect income.

Case law has also recognized the significance of the consistency requirement when examining whether a method of accounting clearly reflects income.

"*Investments'* inconsistent definition of its items of inventory for both its new car and new truck LIFO pools strikes at the heart of the requirement that a taxpayer's inventory accounting must clearly reflect income."

"*Investments'* inconsistent definition of its items of inventory violates the clear reflection rules of Section 446(c), the regulation (citing Reg. Sec. 1.471-2(b) and 1.472-8(a)), and case law."

The Court concluded, "*Investments'* inventory practice was inconsistent from year to year and, therefore, its method of inventory accounting does not clearly reflect income."

*Richardson* had not specifically addressed the change in method of accounting issue with respect to its new truck pool. Accordingly, the Tax Court held that it had conceded that issue.



### 3. ABUSE OF DISCRETION BY THE COMMISSIONER

Once the Commissioner has determined that a taxpayer's method of accounting does not clearly reflect income, she may select for the taxpayer a method which, in her opinion, does clearly reflect income.

The taxpayer has the burden of showing that the method chosen by the Commissioner is incorrect, and that burden is extremely difficult to carry.

Accordingly, the Commissioner's determination will not be set aside unless shown to be clearly unlawful or plainly arbitrary.

The Code and the Regulations do not define the term "item."

In our (i.e., the Tax Court's) prior cases, we have found that the proper definition of an item for dollar value LIFO purposes depends on the specific facts and circumstances of the case. The facts and circumstances of the case must be examined in light of the objectives of the dollar value LIFO method.

A major objective of the LIFO method is to eliminate from earnings any artificial profit resulting from inflationary increases in inventory cost.

Consequently, the dollar value method is designed to insure that any increase in cost of property passing through the inventory during the year is reflected in the cost of goods sold.

To properly reflect increases attributable to inflation, goods contained in a taxpayer's item category must have similar characteristics, because a "system which groups like items together and separates dissimilar items permits cost increases attributable to inflation to be isolated and accurately measured."

Therefore, a "narrower definition of an item within a pool will generally lead to a more accurate measure of inflation (i.e., like indexes) and thereby, lead to a clearer reflection of income."

The dollar value LIFO method does not require the matching of specific goods in opening and closing inventories, but focuses on the total dollars invested in an inventory. Accordingly, minor modifications to an item should not cause the item to be treated as new or separate.

"This freedom from having to take into account minor technological changes in a product represents a major objective of the dollar value approach."

*THE DEFINITION OF AN ITEM OF INVENTORY MUST NOT BE SO NARROW AS TO IMPOSE UNREASONABLE ADMINISTRATIVE BURDENS ON A TAXPAYER, THUS RENDERING IMPRACTICAL THE TAXPAYER'S USE OF ... LIFO ... (Amity Leather Products Co.).*

In the first *Richardson* case, *Richardson Investments, Inc. v. Commissioner* (76 T.C. 736 (1981)), we did not address the proper scope of an item, i.e., whether items of inventory should be defined by model line; rather, we merely indicated that the taxpayer could use a combination of the link-chain method and the index method to price its LIFO inventory.

The Tax Court observed that the parties had stipulated that *Richardson* had never double extended a representative portion of its new car and new truck inventory, but had always double extended its entire inventory.

Requiring *Richardson* to use a model code definition of items is not tantamount to placing it on the specific goods method of LIFO, as the model code definition of an item does not require the taxpayer to match specific goods in opening and closing inventory.

Simply put, even though the definition of an item is narrower, *Investments, Inc.* is still free to use the dollar value LIFO method.

*Richardson* does not testify why the model code definition of an item is too narrow, and we have previously found that a narrower definition of an item more clearly reflects income ... citing *Amity Leather Products Co.*

*Richardson* had all of the data necessary to implement the model code definition of an item. Therefore, it cannot argue that the model code definition would be administratively burdensome to implement.

Based on the foregoing, taxpayer has failed to demonstrate that the method selected by the IRS for it to use was "clearly unlawful or plainly arbitrary."

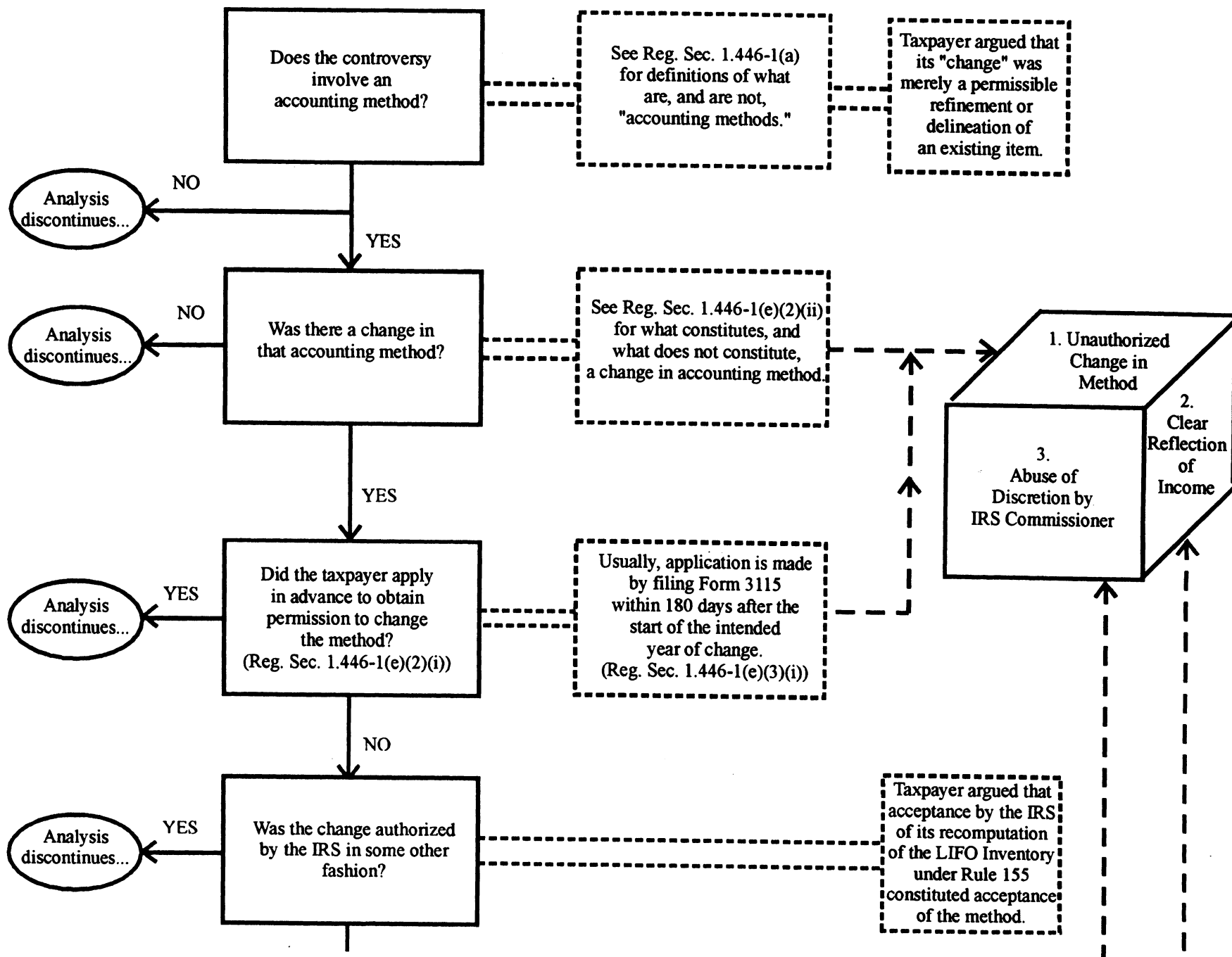
Therefore, the Tax Court held that the IRS' determination must stand and *Investments* must utilize a model code definition of an item.

The IRS' determination effects a change in *Richardson's* method of accounting.

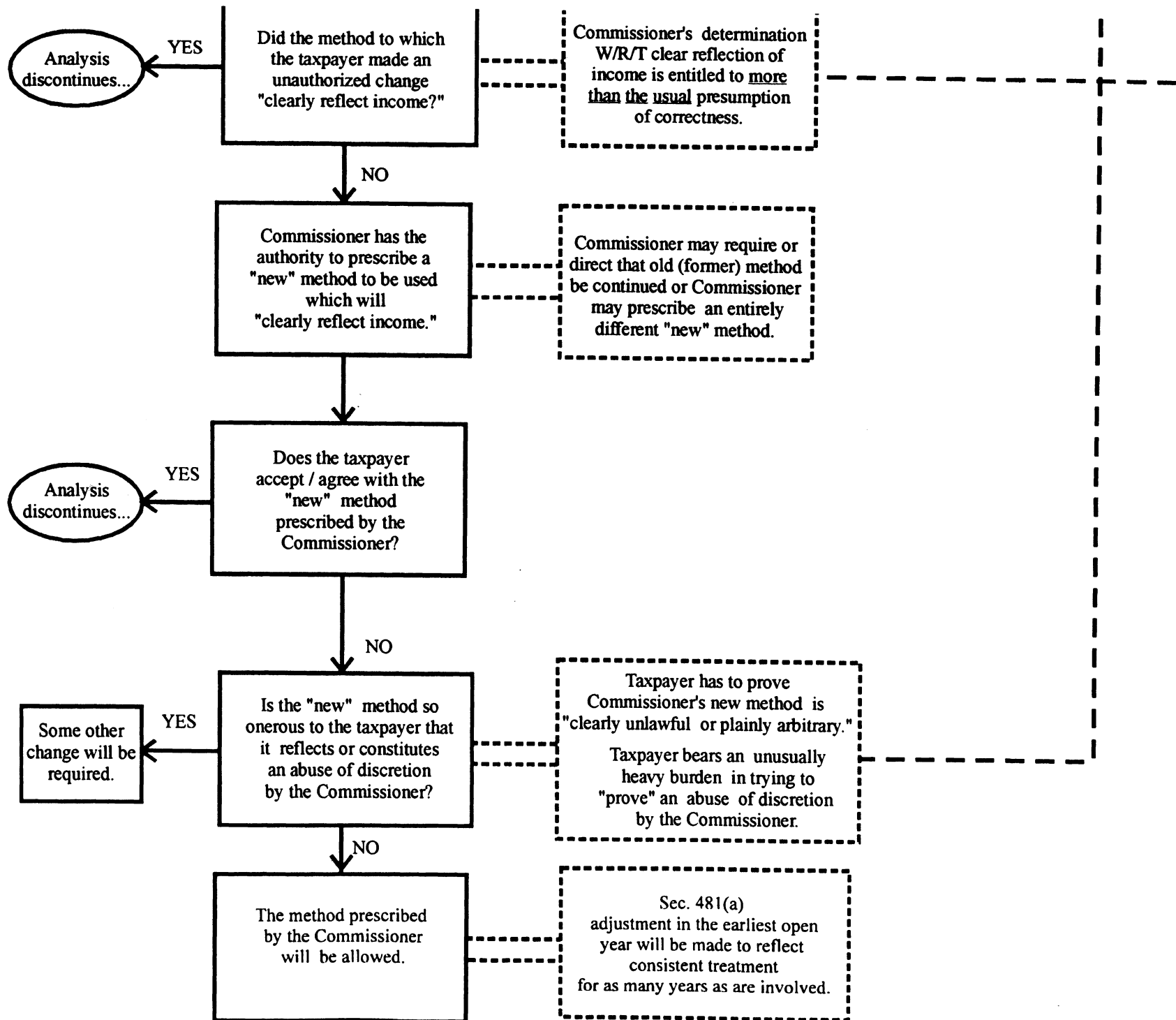
Accordingly, the IRS may make a Section 481(a) adjustment.



# ACCOUNTING METHODS, CHANGES AND APPROVAL DISPUTES







# LIFO YEAR-END PLANNING AND PROJECTIONS

## IT'S NOT TOO EARLY TO START NOW

## PROJECTIONS

LIFO is a great tax deferral. It allows businesses to deduct the impact of inflation in their inventories while the goods are still on hand at year-end ... instead of making those businesses wait until the next year when those inventories are sold. Over the years, in inflationary times, businesses build up substantial LIFO reserves and the ups and downs of their inventory levels produce situations that make it desirable—if not imperative—to know and keep track of how the total LIFO reserve is broken down, associated with or “locked into,” each different year’s layer in the ending inventory.

It is unrealistic to attempt any serious planning for a business using LIFO without having made projections of the change in the LIFO reserve for the upcoming year-end. Typically, projections should be made far enough in advance so that management may consider not only the impact of what is likely to happen, but also whether legitimate steps, motivated by sound business reasons, should be undertaken to produce a result different from that projected. One thing is certain: After year-end, it will be too late to change the results that might have been avoided by advance notice, proper planning and adequate timing.

Included as part of this discussion are several illustrations showing year-end LIFO projections in various formats and the associated analysis of the LIFO reserve components attributable to the underlying years’ increments. These reconciliations and proofs are indispensable in analyzing the true impact in terms of LIFO reserve paybacks and in advising business owners on projected consequences. All of the detail projections can be done manually, on various spreadsheets such as Excel, or using integrated software programs. All of the projections illustrated on pages 26 to 29 (and the related correspondence and documentation on pages 30-31) were prepared in a matter of moments—using integrated software.

Over the years, several articles in the *LIFO Lookout* have analyzed the nature of year-end changes and explained why LIFO reserves change the way they do. In this regard, see: “Why Do Some LIFO Reserves Go Up Even Though Inventory Levels Go Down?” in the March, 1992 *LIFO Lookout* and “Another Rebasing Example—With Proofs: Why LIFO Reserves Go Up Even Though Inventory Levels Go Down and Despite Rebasing Indexes to 1.000 in Between” in the June, 1993 *LIFO Lookout*.

Clients are often surprised ... and understandably skeptical ... when they are told that even though their inventory levels are projected to be lower at year-end, their LIFO reserves are expected to increase, ... and often these increases are very large. As the accompanying illustrations show, often the net change in the LIFO reserve for a year is the result of complementing or offsetting price and/or inventory investment payback factors.

### CHANGE FACTORS

**Upward** influences...causing increases:

1. Price increases ...inflation.
2. Quantity increases, if a dual index methodology/approach is used.

**Downward** influences...causing decreases:

1. Price decreases ...deflation.
2. Decreases in inventory investment levels —i.e., pay-backs of previously built-up LIFO reserves to the extent necessitated by the carryback of a current year quantity decrease (referred to as “decrements”) against increases (“increments”) built up in prior years.

If year-end LIFO projections show that the dollar amount of the ending inventory (expressed in terms of base dollars) is projected to be lower than the beginning of the year inventory amount (also expressed in base dollars), that means there is going to be a liquidation or decrement in a technical LIFO sense. However, that liquidation or decrement may not necessarily cause, or result in, any pay-back of some or any of the LIFO reserve at the beginning of the year. Whether or not there is a “pay-back” depends on how the prior year layers were (1) built up over time and (2) valued for LIFO purposes.

### DECREMENT CARRYBACKS

The general rule is that the LIFO liquidation or decrement for a given year is carried back against layers built up in prior years on a LIFO or reverse-chronological sequence. This means that the most recent/last layer built up is the first one eliminated, and then prior years’ layers are eliminated in reverse-chronological order. In other words, a decrement in 1996 is carried back first against any 1995 increment, then against 1994, then against 1993, then against 1992, etc. until the entire amount of 1996 decrement has been fully accounted for. In some instances, a

→



decrement may end up being carried all the way back to the original first LIFO year base layer.

## REASONS FOR PLANNING

Year-end LIFO projections may be necessary—or imperative—in the following situations:

1. Where the corporation—whether “C” or “S”—and the individual shareholders want to anticipate what's going to happen at year-end with their LIFO inventories and their own tax situations so that they can consider related cash flow needs and the desirability of engaging in other (or contrary) planning transactions.
2. If a tax return (or extension Form 7004 for C corporations) is required to be filed before the LIFO computations can be finalized, the balance of tax estimated to be due for the year must be paid in full at that time, and LIFO changes may be a major component in arriving at taxable income.
3. Where year-end financial statements must be issued before the LIFO computations can be finalized.
4. Where the last “interim” statement (or last monthly statement) required by a manufacturer or franchisor must be released before the LIFO computations can be finalized. In this regard, the IRS has recently become very aggressive in its interpretation of a provision in the regulations that would apply to the last monthly statement sent by automobile dealers to the Factory.

The IRS has issued two adverse Letter Rulings ... 9535009 and 9535010 ... and these are expected to be amplified in the near future by a Revenue Procedure penalizing auto dealers who have not placed LIFO estimates on the financial statements for the last month for their calendar year and any other fiscal year reports. (See “Guidance From The IRS—A Cure Worse Than The Disease?” in the December, 1995 *LIFO Lookout*.)

## THE MECHANICS OF PROJECTING YEAR-END LIFO RESERVES

Projecting changes in LIFO reserves at year-end usually is not too difficult or time-consuming. These projections involve two **estimates**:

- (1) the ending inventory level, and
- (2) the overall inflation percentage for the year.

All other factors necessary to compute projected year-end changes in the LIFO reserves for dollar-value LIFO pools are **known** at the time the projections are made because they are “**facts**” related to the beginning of the year.

## KNOWN FACTS

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

The computation of the projected change in a LIFO reserve is made by plugging in the estimates of the year-end inventory level and the current year's rate of inflation or inflation index, ... and then “working backwards” in the following order:

**DETERMINE** the cumulative index as of the end-of-the-year—this is the estimated current year inflation index times (i.e., multiplied by the) beginning of year cumulative index,

**DIVIDE** the end-of-the-year estimated (or, if known, actual) inventory dollars by the year-end cumulative index—to determine the end-of-the-year inventory stated or expressed in base dollars,

**COMPARE** the end-of-the-year inventory expressed in base dollars with the beginning-of-the-year inventory stated in base dollars to determine whether there is an increment or a decrement projected for the year,

**VALUE** the projected increment under the method already selected for valuing increments (Form 979, item 6(a)). Alternatively, if a decrement is projected for the year, carry back the decrement (expressed in base dollars) against prior years' increments (also expressed in base dollars) on a LIFO or reverse-chronological-order basis.

**ADD** all the resulting layers of inventory at their respective LIFO valuations to get the end-of-the-year inventory stated at its LIFO valuation,

**SUBTRACT** the ending inventory at its LIFO valuation from the ending inventory at its actual or estimated current non-LIFO cost to determine the projected LIFO reserve as of the end-of-the-year,

**FINALLY, SUBTRACT** the *actual* LIFO reserve as of the beginning-of-the-year from the *projected* LIFO reserve as of the end-of-the-year.

The result determined in the final step is the estimate of the change in the LIFO reserve for the year.

see **LIFO YEAR-END PLANNING....**, page 21



1. Set up a projection format consistent with the prior year's LIFO calculation and insert the last year's amounts for reference so that the process by which the projections are being generated is consistent. Note the projections included as illustrations show all the details of the prior year LIFO reserve computation. This greatly aids in understanding and explaining (not to mention "visualizing") the results of the projections.
2. Consider running projections using multiple (i.e., three or four) assumed inflation rates. From these multiple projections, you can easily spot the difference that an additional 1% more or less of inflation makes. For example, in the autos pool illustrated, a change of one percentage point in the assumed inflation rate results in a difference of roughly \$36,000 in the LIFO reserve (i.e., \$36,399 going from 3% to 4%... and \$35,708 going from 4% to 5% inflation).
3. Reconcile the changes in the LIFO reserve shown by the projections just as you would reconcile the final year-end changes in the LIFO reserve. By doing this you can be sure that your projection mathematics is accurate. Even though the projections involve estimates, the mathematics is always precise and easy to do once the amounts to be used as estimates are decided upon.
4. Reference points or estimated amounts for the year-end inventory level may be:
  - An actual projection, taking into consideration mix and purchases and sales anticipated between the date of the projection and year-end,
  - The inventory level from the preceding month's financial statement, or
  - Last year's actual inventory level.

Obviously, a more accurate overall projection will result if the current actual inventory levels are used with adjustments for anticipated deliveries and sales to year-end. For auto dealer LIFO computations, if the actual invoices of the vehicles on hand as of the estimate date can be input, with subsequent increases and decreases adjusted against that information, a series of revised estimates reflecting mix as well as total dollar amount can be made on a more frequent basis.
5. Don't rely too heavily on inflation percentages for the year reported in general newspaper articles because usually they only report the change as a percentage of—or with reference to—the last reported price. Often, that last reported price is one that has been already increased during the year from the beginning-of-the-year price.
6. If the projections show a decrement, be especially careful not to prejudge the impact of that decrement. Successive years' layers could have significantly different and greater costs in terms of "payback potential" as a current year decrement gets carried farther back into the older layers. The end result will depend specifically on the unique layer history or structure for that pool. In this regard, each pool's layer structure is like a "fingerprint" in that no two of them are alike.
7. In justifying or explaining the amounts of the projected changes in the LIFO reserve, don't attribute any part of the changes to (i.e., "don't blame it on") any rebasing of the indexes done in prior years due to the election of the Alternative LIFO Method or, generally, due to any other change in LIFO methods. When the Alternative LIFO Method was elected by a taxpayer already on LIFO, one of the requirements was that the previous LIFO indexes be restated to 1.000 as of the beginning of the year of the change to the Alternative Method. That rebasing process should have made no difference in any of the LIFO reserve additions or decreases. In this regard, see the comprehensive examples included in the June, 1993 *LIFO Lookout*.
8. If the projections are being made to support dealer-Factory 12<sup>th</sup> statements, be sure to save the projection worksheets and detail assumptions in case the Internal Revenue Service inquires at a later date where the "numbers came from" or about the integrity or quality of the estimate. See the *DOCUMENTATION CHECKLIST FOR PROJECTIONS* on page 31.
9. In making projections for automobile dealers on LIFO, be sure that the vehicles (for car dealer new vehicle inventories) in the projection are in the same pool as they will be at year-end. Otherwise, significant differences in projected results may be noticed when the actual results computed after year-end are compared against the projections. Also, consider using different estimated inflation percentages for the truck pool than for the car pool.
10. Consider reviewing the beginning of the year average item category cost calculations (since they are already known information) to see if there are any unusual average costs that might significantly affect the inflation rate for that item category.



The results of the year-end projections may show that under the assumed combination of inventory level and inflation rate, the business will experience a reduction in its LIFO reserves as of the end of the year. What this means is that it will be reporting income because the LIFO reserve at the end of the year will be lower than the LIFO reserve amount at the beginning of the year.

If the business wishes to avoid a LIFO reserve reduction or a layer penetration, it may consider a number of actions to increase its inventory level before year-end. These steps should be taken, completed and documented before the end of the year. They should be considered only if it makes sense from a business standpoint to increase the inventory level, after considering carrying costs, insurance and expected ability to sell the additional inventory.

### **SPECIAL AUTO DEALER PROJECTION CONSIDERATIONS**

Many manufacturers have announced price decreases in several of their models and these price decreases could result in significantly lower inflation indexes for the overall vehicle pools...possibly, even an inflation index of less than 1.000 indicating deflation in the pool. Cadillac (General Motors) and Lincoln (Ford Motor Company) both announced significant price decreases on many of their models in an attempt to compete with sport utility vehicles, minivans and European sedans.

Many Japanese manufacturers are reported to be reducing the content of some of their vehicles while leaving the prices unchanged. This "decontenting" may take the form of (1) using less complex technology, (2) the substitution of lower grade parts, or (3) the elimination of "quality" where it is not visible to the eye. Some decontenting changes recently mentioned are:

1. Drum brakes instead of disc brakes,
2. Lower technology suspensions,
3. Rigid — instead of flexible — side view mirrors that fold,
4. Tires that are thinner than standard width,
5. Substitution of cheaper fabrics for leather in upholstery,
6. Removal of cruise control as a standard feature,
7. Fixed speed windshield wipers, rather than variable or intermittent wipers, and
8. Different paint.

The impact of decontenting will vary depending on whether or not the quality reductions and their related cost reductions due to the substitution are passed along to the dealer by being reflected in lower base prices or whether the manufacturer retains the benefit or impact of its cost reduction—decontenting by not passing that cost savings along.

Technically, a reduction in quality or content is the equivalent of inflation (i.e., receiving less for the same dollar) if there is no reduction or a less than proportional reduction in the base cost of the vehicle.

Although it would be more "theoretically correct" to attempt to estimate/quantify some reduction in cost as created by the inflationary impact of decontenting, under the Alternative LIFO Method and specifically under the definition of what constitutes a "new item" in Section 4.02(5) of Revenue Procedure 92-79, that result does not happen in most cases unless the decontenting is accompanied by a (major) change in the vehicle and a change in its model code number or a change in its platform. That is simply one of the compromises made to try to achieve greater computational simplicity by Revenue Procedure 92-79 which uses only the base price to the dealer as its point of impact for measuring inflation.

Another somewhat common situation might arise from the sale of one or more of the franchises owned by the dealership. In a number of instances, dealers have sold off one franchise completely during the year and replaced it with a different franchise. Under the Alternative LIFO Method, all new automobiles are required to be placed in the same pool, regardless of manufacturer ... and this rule also applies to all new light-duty trucks.

It would appear that if an auto dealer sold off one franchise during the year and by year-end had replaced dollars in the respective pools with vehicles from a continuing or from a newly acquired franchise, the offsetting or substitution effect within the pool should be permitted. However, this might be challenged by the IRS which, of late, seems to have become more interested in trying to associate LIFO computations by franchise or by location under the somewhat ambiguous language in Rev. Proc. 92-79 relating to "separate trades or businesses."

This might also be a problem arising under "Project 2000" where a dealer "gets rid of" one franchise pursuant to the GM dualling guidelines or eliminates a non-GM franchise from its showroom, while acquiring other "more favored" brands before year-end. Although the literal language in Revenue Procedure 92-79 appears to allow the free substitu-

see **LIFO YEAR-END PLANNING....**, page 22

Vol. 6, No. 3



tion of vehicles of one franchise/manufacture for another, or even the replacement by year-end of additional dollars in connection with the inventory of a franchise on hand at the beginning of the year, the Service in some audit situations has attempted to prevent that result under a "vertical slice" replacement theory.

### STRIKES AND YEAR-END CHANGES

Occasionally, a taxpayer may fear the possibility of a strike directly or indirectly affecting its ability to maintain inventory levels at year-end. The strike may be either at the manufacturer level or at the delivery/teamster level. This concern may prompt the taxpayer to consider changing its taxable year-end, perhaps by switching from a calendar year to a fiscal year end. (This concern actually was very significant for many auto dealers a few years ago.)

Generally, a taxpayer desiring to change its accounting year-end must obtain approval of the Commissioner. Approval is requested by filing an application on Form 1128 on or before the 15<sup>th</sup> day of the second month following the close of the short tax year created by the change in its year.

However, Reg. Sec. 1.442-1(c)(1) and (2) allow a corporation to change its year-end without prior approval if it meets **ALL** the following conditions:

#### AUTOMATIC YEAR-END CHANGE

1. The corporation has not changed its annual accounting period within the last ten calendar years,
2. The corporation does not have a net operating loss for the short period created by the change,
3. The taxable income for the short period is, on an annual basis, 80% or more of the taxable income of the corporation for the taxable year immediately preceding the short period,
4. If the corporation has a special status (such as a personal holding company) for either the short period or the year preceding the short period, it must have that same special status for both years, **and**
5. The corporation cannot attempt to elect S corporation status for the year following the short period.

A corporation that meets these requirements may change its year-end merely by the filing of Form 1128 and by filing a statement with the District Director at or before the time (including extensions) for filing the return for the short period indicating that

the corporation is changing its annual accounting period confirming that all of these special requirements are satisfied.

A corporation that cannot meet these requirements has to request approval by filing Form 1128 and waiting for the Commissioner to act upon that request ... or else, it may try to qualify for a year and change under Revenue Procedure 92-13. This Revenue Procedure is specifically intended for a corporation that ... cannot satisfy all of the conditions of Reg. Sec. 1.442-1(c)(2) ... has not changed its annual accounting period at any time within the last six calendar years ... is not an S corporation ... and does not attempt to make an S corporation election following its short period effective for the taxable year immediately following the short period ... and satisfies certain other conditions.

Two special observations are warranted. First, a business attempting to change its fiscal year-end under Revenue Procedure 92-13 must be prepared, if it has a net operating loss in excess of \$10,000, to spread that net operating over six years, subject to certain exceptions and qualifications.

Second, if an auto dealer is considering taking action to avert an anticipated year-end inventory decrease situation, the current IRS positions relative to the dealer financial statement for the last month of its desired short taxable year may pose some hyper-technical interpretations with respect to the placement of LIFO estimates on the last month statement in the short taxable year.

Businesses contemplating switching to a fiscal year-end to avert adverse anticipated LIFO consequences may find the IRS attempting to block that maneuver, just as it has attempted to block other year-end maneuvers where it has become aware of them, as discussed below.

### "MANAGING" YEAR-END INVENTORY LEVELS TO PREVENT LIFO LAYER LIQUIDATIONS

As mentioned previously, if the business wishes to avoid a LIFO reserve reduction or a layer penetration (and the corresponding "paper income" pickup), it may consider steps to increase its inventory level before year-end. These steps should be taken, completed and documented before the end of the year and they should be considered only if they make sense from a business standpoint, after considering carrying costs, insurance and expected ability to sell the additional inventory.

Despite cautions that inventory purchasing decisions should be based on sound business judgment and not solely on the desire to minimize or reduce the

→



impact of projected LIFO pay-backs, some taxpayers may still wish to pursue more aggressive strategies and to take their chances in this regard.

The IRS and the Courts are very much aware of year-end planning "ploys." The most recent evidence of this is the observation by the Tax Court earlier in 1996 (see *E. W. Richardson*, Tax Court Memo Decision 1996-368) that taxpayers often "desire a higher base-year cost of ending inventory in a given year to avoid liquidating a LIFO layer, causing a match of historical costs against current revenues." This most recent remark comes against a back-drop involving several cases and Revenue Ruling 79-188.

Revenue Ruling 79-188 indirectly suggests some planning considerations:

AVOIDING REV. RUL. 79-188

1. Attempt to document that sales during the year are at levels that justify the purchase of year-end inventory levels in the ordinary course of business.
2. It helps if the inventory acquired at year-end can be sold to regular customers in due course or to a third party, rather than back to original supplier.  
This helps to avoid the "cast" as a resale.
3. The inventory acquired at year-end should be paid for before its subsequent sale, again in an effort to demonstrate an intent to receive and use the goods in the ordinary course of the business.
4. The specific mechanics of taking possession and title prior to reselling the inventory should also be considered.

But note, even doing all this legally did not stop the IRS in *Illinois Cereal Mills*, 46 TCM 1001 ... TC Memo 1983-469.

## SUCCESSFUL CHALLENGES BY THE IRS

IRS victories in the courts denying and penalizing year-end inventory transactions that were LIFO-benefit motivated have thwarted several eager "planners" ... , among them:

1. ***Ingredient Technology Corporation*** (Su Crest Corporation), 83-1 USTC 9140, January 5, 1983. Tax fraud convictions by means of LIFO inventory overstatements.

2. ***Illinois Cereal Mills***, 86-1 USTC 9371 affirming TCMemo 1983-469, Dec. 40,342(M), 46 TCM 1001, August, 1983. Legal ownership of the goods did not justify inclusion in the taxpayer's inventory because the taxpayer did not intend to use the corn in its milling business.

3. ***Miracle Span Corporation***, 82-1 USTC 9365, April 1982. False inventory values, inventory omitted, fraud penalties.

4. ***Ballou and Company, Inc.***, 85-1 USTC 9290, U.S. Claims Court, No. 247-82T; March 29, 1985. The Court upheld the IRS' removal of year-end gold purchases from LIFO inventory calculations because the IRS adjustments removed only the amounts of gold that the taxpayer had purchased in order to temporarily inflate inventory levels solely for income tax/LIFO purposes at year end.

## CONCLUDING THOUGHTS

Taxpayers aggressively planning to avoid year-end LIFO layer liquidations should realize that even satisfying the apparent "boundaries" set by Revenue Ruling 79-188 and other litigated cases may not be enough.

These aggressive planners may still find themselves coming up short even if year-end purchases are not structured to involve subsequent resales back to the same supplier shortly after year-end. \*



# **MULTI-YEAR LIFO RESERVE RECONCILIATIONS**

The concept of LIFO is geared to measuring future price increases in comparison with a "base inventory" amount. "Base inventory" is established and defined as the inventory at cost, i.e., actual cost after restoring any market or other writedowns, or previously omitted cost components or elements. Once this "base inventory" is established on the first day of the first year when LIFO is elected, then over a period of years, the cumulative LIFO deferral advantages (in the form of the LIFO Reserve) can be measured in terms of (1) the overall increase since the initial LIFO election, and (2) as interim changes in the LIFO Reserve from year to year.

LIFO involves a measurement process which in turn involves: ... Two points in time (two year-ends) ... One of which is fixed (the base date).

The base date, (i.e., first day of the first year in which LIFO is elected) provides that benchmark or fixed reference point for all subsequent LIFO computations. Although the base date is always fixed, subsequent measurements with respect to it may involve computations that either:

1. Reprice as of that specific date (i.e., double extension or index methods), or
2. Reprice as of that specific date by the use of a "splicing" or year-by-year index construction (i.e., link-chain or "link-chain, index" methods).

A link-chain method uses the beginning of each year as the measuring reference for determining change. In contrast, the double-extension method uses a fixed base date, which is defined as the first day of the first year for which LIFO is elected. An index method prices a representative portion of the overall inventory, rather than "every item" as required under the double-extension portion of the regulations. A "link-chain, index" method refers to a method that (1) uses a moving base date and (2) reprices a representative portion (rather than "every" item) of the inventory in determining the annual index.

## **PROJECTION & RECONCILIATION PRINCIPLES**

1. LIFO reserve benefits basically relate to inventory investment levels that have remained **INTACT** over a period of time, and
2. We must look at the difference or differential between cumulative inflation rates at the two given points in time (beginning of the year and end of the year) for which we are making the reconciliation.
3. The elements or the composition of the LIFO reserve as of the end of the year are analyzed in terms of amounts of inventory investment that remained constant throughout the years.
  - **Base Inventory** (i.e., LIFO reserve accumulated with respect to the base inventory "component" of the dollars in ending inventory.)
  - **Increments** - year-by-year, net of any subsequent years' decrements carried back to reduce that increment to a net, lower, level or amount.
4. The **change** in the LIFO reserve during the year is really the net increase or decrease in the LIFO reserve which may be the result of complementing or offsetting price and/or inventory investment pay-back changes.
  - **Upward influence** on LIFO Reserve, causing it to increase:
    - (1) Price increases (inflation)
    - (2) Quantity increases, if a dual index methodology is used (although theoretically this may be difficult to rationalize, it does seem to be reflected in the LIFO reserve reconciliations (where dual indexes are used) as a result of the time "lag" or delay represented by the timing of the indexes)
  - **Downward influence** on LIFO Reserve, causing it to decrease:
    - (1) Price decreases (deflation)
    - (2) Decreases in inventory investment levels - pay-back of previously built-up LIFO reserves to the extent quantified ("quantity decrease" factor)

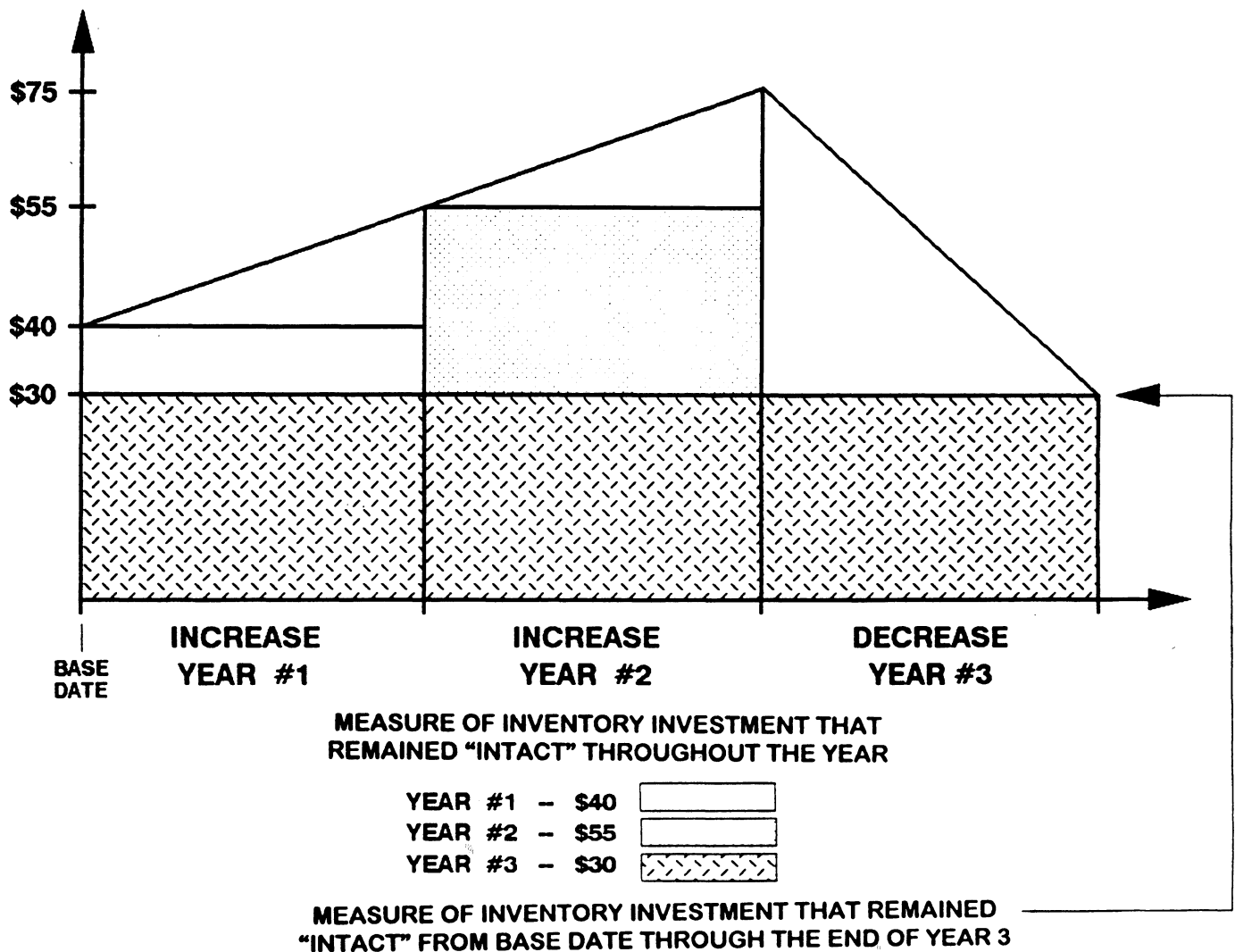




As inventory levels change in succeeding years, even if those levels fall below earlier levels during LIFO years, to the extent that the investment of dollars in inventory (i.e., dollars converted back to reflect a "constant" purchasing power, as measured by LIFO index techniques) remain intact throughout the year, the dollars that remained intact receive the "benefit" of current year price increases applied on a cumulative basis. In many cases, this consequence will prolong the LIFO deferral considerably even as inventory levels decline. This may be "visualized" as shown below.

As a result, the **cumulative** deferral advantages of LIFO in later years may be increased even more if an election has been made in an early year even though (or despite the fact that) inventory levels in that year are lower and the potential LIFO deferral for that year alone is relatively small. This occurs because under the link-chain method, the inflation index percentages carry forward in all later years' computations. And these are compounded over all the years the LIFO election is in effect.

Taxpayers using the LIFO method are simply in a position to deduct inflation as it is incurred, rather than carrying it as an inventory cost from one year to the next in their ending inventories.



LIFO INVENTORY RESERVE REPORT  
ALTERNATIVE LIFO METHOD PER REVENUE PROCEDURE 92-79  
FOR THE FISCAL YEAR ENDED JULY 31, 1996

PROJECTIONS OF INCREASE OR DECREASE IN LIFO RESERVES - NEW AUTOS POOL #1

	1995 ACTUAL POOL #1	1996 PROJECTED AT 3.00%	1996 PROJECTED AT 4.00%	1996 PROJECTED AT 5.00%
A. BEGINNING OF YEAR INVENTORY AT BASE DATE COST - AS REBASED	3,797,644	3,630,536	3,630,536	3,630,536
B. END OF YEAR INVENTORY AT END OF YEAR (CURRENT) PRICES	4,661,499	4,012,586	4,012,586	4,012,586
C. END OF YEAR INVENTORY AT BEGINNING OF YEAR (BASE) PRICES	NOT FULLY REPRICED	NOT FULLY REPRICED	NOT FULLY REPRICED	NOT FULLY REPRICED
D. CURRENT YEAR PRICE INDEX END OF YEAR INVENTORY PRICED AT END OF YEAR PRICES (DIVIDED BY) RATIO OF: $\frac{\text{END OF YEAR INVENTORY PRICED AT END OF YEAR PRICES (DIVIDED BY)}}{\text{END OF YEAR INVENTORY PRICED AT BEGINNING OF YEAR PRICES}}$	1.02912	1.03000	1.04000	1.05000
E. CUMULATIVE LINK-CHAIN INDEX CURRENT YEAR PRICE INDEX (LINE D) MULTIPLIED BY (X) PRIOR YEARS CUMULATIVE INDEX (LINE E OF PRIOR YEAR)	1.28397	1.32249	1.33533	1.34817
F. END OF YEAR INVENTORY AT BASE DATE COST (LINE B DIVIDED BY LINE E)	3,630,536	3,034,114	3,004,940	2,976,320
G. CURRENT YEAR INVENTORY INCREASE (DECREASE) - EXPRESSED IN BASE DOLLARS				
1. END OF YEAR INVENTORY AT BASE DATE COST (LINE F)	3,630,536	3,034,114	3,004,940	2,976,320
2. BEGINNING OF YEAR INVENTORY AT BASE DATE COST (LINE A)	<u>(3,797,644)</u>	<u>(3,630,536)</u>	<u>(3,630,536)</u>	<u>(3,630,536)</u>
3. CURRENT YEAR INCREMENT (G(1) EXCEEDS G(2)) OR DECREASE (IF G(2) EXCEEDS G(1))	(167,108)	(596,422)	(625,596)	(654,216)
4. LIFO VALUATION OF CURRENT YEAR INCREMENT (IF G(1) EXCEEDS G(2), MULTIPLY LINE G(3) BY LINE E)	N/A	N/A	N/A	N/A
H. ANALYSIS OF YEAR-END INVENTORY LIFO "LAYERS" - AS REBASED				
	BASE VALUATION DOLLARS FACTOR			
FYE JULY 31, 1985 INCREMENT	326,433 X 0.78047	254,771	254,771	254,771
FYE JULY 31, 1986 INCREMENT	1,214,961 X 0.80662	980,012	980,012	980,012
FYE JULY 31, 1987 INCREMENT	17,731 X 0.89414	15,854	15,854	15,854
FYE JULY 31, 1988 INCREMENT	1,179,324 X 1.01780	1,200,316	1,200,316	1,200,316
FYE JULY 31, 1989 INCREMENT	134,772 X 1.16600	157,144	157,144	157,144
FYE JULY 31, 1994 INCREMENT	<u>757,315 X 1.24764</u>	<u>944,856</u>	<u>200,737</u>	<u>164,338</u>
	<u>3,630,536</u>			<u>128,630</u>
ENDING INVENTORY AT LIFO VALUATION, TOTAL PER ABOVE	3,552,953	2,808,834	2,772,435	2,736,727
LESS: ENDING INVENTORY AT END OF YEAR PRICES (LINE B)	<u>4,661,499</u>	<u>4,012,586</u>	<u>4,012,586</u>	<u>4,012,586</u>
LIFO RESERVE AT END OF CURRENT YEAR	1,108,546	1,203,752	1,240,151	1,275,859
LESS: LIFO RESERVE AT END OF PREVIOUS YEAR	<u>976,649</u>	<u>1,108,546</u>	<u>1,108,546</u>	<u>1,108,546</u>
INCREASE (DECREASE) IN LIFO RESERVE AT END OF CURRENT YEAR	<u>131,897</u>	<u>95,206</u>	<u>131,605</u>	<u>167,313</u>



LIFO INVENTORY RESERVE REPORT  
ALTERNATIVE LIFO METHOD PER REVENUE PROCEDURE 92-79  
FOR THE FISCAL YEAR ENDED JULY 31, 1996

PROJECTIONS OF INCREASE OR DECREASE IN LIFO RESERVES - NEW AUTOS POOL #1

	1995 ACTUAL POOL #1	1996 PROJECTED AT 3.00%	1996 PROJECTED AT 4.00%	1996 PROJECTED AT 5.00%
<b>POOL #1 PROJECTED AT 3.00%</b>				
JULY 31, 1996 LIFO RESERVE CONSISTS OF:	BASE DOLLARS	INDEX FACTOR	COMPOSITION OF LIFO RESERVE	
FYE JULY 31, 1985 INCREMENT	326,433 X	0.54202	(1.32249 - 0.78047)=	176,933
FYE JULY 31, 1986 INCREMENT	1,214,961 X	0.51587	(1.32249 - 0.80662)=	626,762
FYE JULY 31, 1987 INCREMENT	17,731 X	0.42835	(1.32249 - 0.89414)=	7,595
FYE JULY 31, 1989 INCREMENT	1,179,324 X	0.30469	(1.32249 - 1.01780)=	359,328
FYE JULY 31, 1993 INCREMENT	134,772 X	0.15649	(1.32249 - 1.16600)=	21,030
FYE JULY 31, 1994 INCREMENT	160,893 X	0.07485	(1.32249 - 1.24764)=	12,043
ROUNDING				1
TOTALS	3,034,114			1,203,752
<b>POOL #1 PROJECTED AT 4.00%</b>				
JULY 31, 1996 LIFO RESERVE CONSISTS OF:	BASE DOLLARS	INDEX FACTOR	COMPOSITION OF LIFO RESERVE	
FYE JULY 31, 1985 INCREMENT	326,433 X	0.55486	(1.33633 - 0.78047)=	181,125
FYE JULY 31, 1986 INCREMENT	1,214,961 X	0.52871	(1.33633 - 0.80662)=	642,362
FYE JULY 31, 1987 INCREMENT	17,731 X	0.44119	(1.33633 - 0.89414)=	7,823
FYE JULY 31, 1989 INCREMENT	1,179,324 X	0.31753	(1.33633 - 1.01780)=	374,471
FYE JULY 31, 1993 INCREMENT	134,772 X	0.16933	(1.33633 - 1.16600)=	22,821
FYE JULY 31, 1994 INCREMENT	131,719 X	0.08769	(1.33633 - 1.24764)=	11,550
ROUNDING				(1)
TOTALS	3,004,940			1,240,151
<b>POOL #1 PROJECTED AT 5.00%</b>				
JULY 31, 1996 LIFO RESERVE CONSISTS OF:	BASE DOLLARS	INDEX FACTOR	COMPOSITION OF LIFO RESERVE	
FYE JULY 31, 1985 INCREMENT	326,433 X	0.56770	(1.34817 - 0.78047)=	185,316
FYE JULY 31, 1986 INCREMENT	1,214,961 X	0.54155	(1.34817 - 0.80662)=	657,962
FYE JULY 31, 1987 INCREMENT	17,731 X	0.45403	(1.34817 - 0.89414)=	8,050
FYE JULY 31, 1989 INCREMENT	1,179,324 X	0.33037	(1.34817 - 1.01780)=	369,613
FYE JULY 31, 1993 INCREMENT	134,772 X	0.18217	(1.34817 - 1.16600)=	24,551
FYE JULY 31, 1994 INCREMENT	103,099 X	0.10053	(1.34817 - 1.24764)=	10,365
ROUNDING				2
TOTALS	2,976,320			1,275,859
<b>PROOF / RECONCILIATION OF INCREASE (DECREASE) IN LIFO RESERVE AS OF JULY 31, 1996</b>				
		AUTOS AT 3.00%	AUTOS AT 4.00%	AUTOS AT 5.00%
AMOUNT OF BASE DOLLARS THAT REMAINED IN TACT THROUGHOUT FYE JULY 31, 1996		3,034,114	3,004,940	2,976,320
(X) MULTIPLIED BY CURRENT YEAR INFLATION		X 0.03862	X 0.05136	X 0.06420
INCREASE (DECREASE) IN LIFO RESERVE DUE TO INFLATION (DEFLATION) FACTOR		116,874	154,334	191,080
LESS PAYBACK DUE TO DECREMENT CARRIED BACK AGAINST PRIOR YEAR LAYER(S)		(21,668)	(22,728)	(23,768)
ROUNDING		0	(1)	1
INCREASE (DECREASE) IN LIFO RESERVE		95,206	131,605	167,313



LIFO INVENTORY RESERVE REPORT  
ALTERNATIVE LIFO METHOD PER REVENUE PROCEDURE 92-79  
FOR THE FISCAL YEAR ENDED JULY 31, 1996

PROJECTIONS OF INCREASE OR DECREASE IN LIFO RESERVES - NEW LIGHT-DUTY TRUCKS POOL #2

	1995 ACTUAL POOL #2	1996 PROJECTED AT 3.00%	1996 PROJECTED AT 4.00%	1996 PROJECTED AT 5.00%
A. BEGINNING OF YEAR INVENTORY AT BASE DATE COST - AS REBASED	2,502,627	2,440,216	2,440,216	2,440,216
B. END OF YEAR INVENTORY AT END OF YEAR (CURRENT) PRICES	3,232,823	2,454,993	2,454,993	2,454,993
C. END OF YEAR INVENTORY AT BEGINNING OF YEAR (BASE) PRICES	NOT FULLY REPRICED	NOT FULLY REPRICED	NOT FULLY REPRICED	NOT FULLY REPRICED
D. <u>CURRENT YEAR PRICE INDEX</u> END OF YEAR INVENTORY PRICED AT END OF YEAR PRICES (DIVIDED BY) RATIO OF: <u>END OF YEAR INVENTORY PRICED AT BEGINNING OF YEAR PRICES</u>	1.03383	1.03000	1.04000	1.05000
E. <u>CUMULATIVE LINK-CHAIN INDEX</u> CURRENT YEAR PRICE INDEX (LINE D) MULTIPLIED BY (X) PRIOR YEARS CUMULATIVE INDEX (LINE E OF PRIOR YEAR)	1.32481	1.36455	1.37780	1.39105
F. <u>END OF YEAR INVENTORY AT BASE DATE COST</u> (LINE B DIVIDED BY LINE E)	2,440,216	1,799,123	1,781,821	1,764,849
G. <u>CURRENT YEAR INVENTORY INCREASE</u> (DECREASE) - EXPRESSED IN BASE DOLLARS				
1. END OF YEAR INVENTORY AT BASE DATE COST (LINE F)	2,440,216	1,799,123	1,781,821	1,764,849
2. BEGINNING OF YEAR INVENTORY AT BASE DATE COST (LINE A)	<u>(2,502,627)</u>	<u>(2,440,216)</u>	<u>(2,440,216)</u>	<u>(2,440,216)</u>
3. CURRENT YEAR INCREMENT (G(1) EXCEEDS G(2)) OR DECREASE (IF G(2) EXCEEDS G(1))	(62,411)	(641,093)	(658,395)	(675,367)
4. LIFO VALUATION OF CURRENT YEAR INCREMENT (IF G(1) EXCEEDS G(2), MULTIPLY LINE G(3) BY LINE E)	N/A	N/A	N/A	N/A
H. <u>ANALYSIS OF YEAR-END INVENTORY LIFO "LAYERS" - AS REBASED</u>				
	<u>BASE VALUATION</u> <u>DOLLARS FACTOR</u>			
FYE JULY 31, 1985 INCREMENT	454,661 X 0.77870	354,045	354,045	354,045
FYE JULY 31, 1986 INCREMENT	601,374 X 0.78929	474,658	474,658	474,658
FYE JULY 31, 1989 INCREMENT	442,197 X 1.01560	449,095	449,095	449,095
FYE JULY 31, 1990 INCREMENT	432,615 X 1.02450	443,214	308,263	290,537
FYE JULY 31, 1993 INCREMENT	509,369 X 1.20390	613,229	0	0
	<u>2,440,216</u>			
ENDING INVENTORY AT LIFO VALUATION, TOTAL PER ABOVE	2,334,241	1,586,061	1,568,335	1,550,947
LESS: ENDING INVENTORY AT END OF YEAR PRICES (LINE B)	<u>3,232,823</u>	<u>2,454,993</u>	<u>2,454,993</u>	<u>2,454,993</u>
LIFO RESERVE AT END OF CURRENT YEAR	898,582	868,932	886,658	904,046
LESS: LIFO RESERVE AT END OF PREVIOUS YEAR	<u>795,323</u>	<u>898,582</u>	<u>898,582</u>	<u>898,582</u>
INCREASE (DECREASE) IN LIFO RESERVE AT END OF CURRENT YEAR	<u>103,259</u>	<u>(29,650)</u>	<u>(11,924)</u>	<u>5,464</u>



LIFO INVENTORY RESERVE REPORT  
ALTERNATIVE LIFO METHOD PER REVENUE PROCEDURE 92-79  
FOR THE FISCAL YEAR ENDED JULY 31, 1996

PROJECTIONS OF INCREASE OR DECREASE IN LIFO RESERVES - NEW LIGHT-DUTY TRUCKS POOL #2

	1995 ACTUAL POOL #2	1996 PROJECTED AT 3.00%	1996 PROJECTED AT 4.00%	1996 PROJECTED AT 5.00%
<b>POOL #2 PROJECTED AT 3.00%</b>				
<b>JULY 31, 1996 LIFO RESERVE CONSISTS OF:</b>	<b>BASE DOLLARS</b>	<b>INDEX FACTOR</b>	<b>COMPOSITION OF LIFO RESERVE</b>	
FYE JULY 31, 1985 INCREMENT	454,661 X	0.58585	(1.36455 - 0.77870)=	266,363
FYE JULY 31, 1986 INCREMENT	601,374 X	0.57526	(1.36455 - 0.78929)=	345,946
FYE JULY 31, 1989 INCREMENT	442,197 X	0.34895	(1.36455 - 1.01560)=	154,305
FYE JULY 31, 1990 INCREMENT	<u>300,891</u> X	0.34005	(1.36455 - 1.02450)=	<u>102,318</u>
TOTALS	<u>1,799,123</u>			<u>868,932</u>

<b>POOL #2 PROJECTED AT 4.00%</b>				
<b>JULY 31, 1996 LIFO RESERVE CONSISTS OF:</b>	<b>BASE DOLLARS</b>	<b>INDEX FACTOR</b>	<b>COMPOSITION OF LIFO RESERVE</b>	
FYE JULY 31, 1985 INCREMENT	454,661 X	0.59910	(1.37780 - 0.77870)=	272,387
FYE JULY 31, 1986 INCREMENT	601,374 X	0.58851	(1.37780 - 0.78929)=	353,915
FYE JULY 31, 1989 INCREMENT	442,197 X	0.36220	(1.37780 - 1.01560)=	160,164
FYE JULY 31, 1990 INCREMENT	<u>283,589</u> X	0.35330	(1.37780 - 1.02450)=	<u>100,192</u>
TOTALS	<u>1,781,821</u>			<u>886,658</u>

<b>POOL #2 PROJECTED AT 5.00%</b>				
<b>JULY 31, 1996 LIFO RESERVE CONSISTS OF:</b>	<b>BASE DOLLARS</b>	<b>INDEX FACTOR</b>	<b>COMPOSITION OF LIFO RESERVE</b>	
FYE JULY 31, 1985 INCREMENT	454,661 X	0.61235	(1.39105 - 0.77870)=	278,412
FYE JULY 31, 1986 INCREMENT	601,374 X	0.60176	(1.39105 - 0.78929)=	361,883
FYE JULY 31, 1989 INCREMENT	442,197 X	0.37545	(1.39105 - 1.01560)=	166,023
FYE JULY 31, 1990 INCREMENT	<u>266,617</u> X	0.36655	(1.39105 - 1.02450)=	<u>97,728</u>
TOTALS	<u>1,764,849</u>			<u>904,046</u>

<b>PROOF / RECONCILIATION OF INCREASE (DECREASE) IN LIFO RESERVE AS OF JULY 31, 1996</b>	<b>TRUCKS AT 3.00%</b>	<b>TRUCKS AT 4.00%</b>	<b>TRUCKS AT 5.00%</b>
AMOUNT OF BASE DOLLARS THAT REMAINED IN TACT THROUGHOUT FYE JULY 31, 1996	1,799,123	1,781,821	1,764,849
(X) MULTIPLIED BY CURRENT YEAR INFLATION	<u>X 0.03974</u>	<u>X 0.05299</u>	<u>X 0.06624</u>
INCREASE (DECREASE) IN LIFO RESERVE DUE TO INFLATION (DEFLATION) FACTOR	<u>71,497</u>	<u>94,419</u>	<u>116,904</u>
LESS PAYBACK DUE TO DECREMENT CARRIED BACK AGAINST PRIOR YEAR LAYER(S)	(101,146)	(106,342)	(111,439)
ROUNDING	(1)	(1)	(1)
INCREASE (DECREASE) IN LIFO RESERVE	<u>(29,650)</u>	<u>(11,924)</u>	<u>5,464</u>

Payback details @ 3%

509,369	x	.12091	=	61,588
<u>131,724</u>	x	.30031	=	<u>39,558</u>
Decrement Expressed in Base Dollars		<u>641,093</u>		<u>101,146</u>





*Willard J. De Filippis, CPA, P. C.*

LIFO REPORT SERVICES

DEALER TAX WATCH

DEALER/CPA 21 RESOURCE GROUPS

SEMINARS/CONSULTING

LIFO LOOKOUT

August 12, 1996

VIA FAX TRANSMITTAL,  
FOLLOWED BY MAILING

**RE: PROJECTED LIFO RESERVE CHANGES  
FOR FINANCIAL STATEMENTS SENT TO THE FACTORY**

Enclosed are the detailed projections we made of the estimated changes in the LIFO reserves at *July 31, 1996* so the dealership could complete its financial statements for the Factory without waiting for the completion of the more time-consuming actual calculations. These projections were based upon the number of units and the dollar amounts of ending inventory you provided.

The attached recap sheet summarizes the information for the dealership. It also shows the number of units and inflation rate for each pool last year for reference purposes. This is helpful in seeing how the final estimated amount fits into last year's actual experience as well as this year's projected inflation and inventory levels.

We have separate LIFO computations for each pool which reflect assumed inflation rates for the year of *3%, 4% and 5%*...as a general range of expected inflation. These projection computations are built upon the dealership's prior year LIFO history for the pool in terms of total dollars in inventory, base dollars and cumulative inflation experience. The computational format for these projections will also be used in our LIFO Inventory Reports when we do the final computations.

The LIFO reserve computations for last year (i.e., *July 31, 1995*) appear in the column immediately to the left of the three columns showing the current year's computation based upon the assumed inflation rates.

(continued)

WILLARD J. DE FILIPPS, CPA, PC

317 WEST PROSPECT AVENUE MT. PROSPECT, ILLINOIS 60056  
PHONE (847) 577-3977 FAX (847) 577-1073

- 2 -

August 12, 1996

Page three of each projection shows the composition of the LIFO reserve for that pool for each projected inflation rate. Immediately below that is a "proof/reconciliation" of the increase or decrease in the LIFO reserve at year end. Where a payback will occur due to the decrement being carried back against prior years, the program does not print all of the detail by layer - even though this has been computed - due to space limitations on the page. In other words, there is more detail underlying the reconciliations on page 3, but that data has not been printed out as part of the projections.

**YEAR-END LIFO FINANCIAL STATEMENT CONFORMITY REQUIREMENT**

Please remember that the year-end LIFO financial statement conformity requirement necessitates that a dealership reflect an estimate (or the actual amount, when computed) of the change in the year-end LIFO reserve on the last statement for the year issued to the Factory, as well as on any other year-end financial income statements.

The dealership's 12th monthly financial statement (sent to the Factory) should reflect a best-efforts estimate, and the 13th statement should adjust the estimate to the actual computed year-end LIFO reserve amount. The position of the IRS is that failure to satisfy these conformity requirements can result in the termination/loss of the entire LIFO election and reserves.

Any year-end financial statements with preliminary LIFO estimates on them should be adjusted to reflect the amount of the LIFO reserve changes once they are finalized for the year.

**SAVE THESE PROJECTIONS**

These projections should be retained as part of your permanent corporate income tax records because they document your attempt at compliance with the LIFO financial statement conformity requirements for dealership financial statements sent to the Factory.

**CALL IF YOU HAVE ANY QUESTIONS**

Please call me if you have any questions on these comments, or the detailed projections, or if we may be of any further assistance in advance of receiving your ending inventory invoices for processing.

Sincerely,

WILLARD J. DE FILIPPS, CPA

*Willard J. De Filippis, CPA, P. C.*

# YEAR-END LIFO PROJECTIONS DOCUMENTATION CHECKLIST

## PRACTICE GUIDE

NAME \_\_\_\_\_ CAL/FYE ENDING \_\_\_\_\_

### YEAR-END PLANNING PROJECTIONS

1. File Contents Listing is Shown Below.
2. RECAP of Projected LIFO Reserve Changes:  
\_\_\_\_ Individual Dealership ... or \_\_\_\_ Dealership Group
3. Detail Projections for Autos Pool #1.
4. Projection Proofs and Reconciliations for Autos Pool #1.
5. Detail Projections for L/D Trucks Pool #2.
6. Projection Proofs and Reconciliations for L/D Trucks Pool #2.
7. Letter to Client for Client's Files Transmitting Projections.
8. Input Worksheet Comparing Last Year & Current Estimated Inventory Levels by Make/Model.
9. Other Info and Correspondence with Client Re: Projections.

### POST-YEAR-END COMPARISONS

10. Letter to Client Transmitting Comparison of Actual LIFO Reserves With Projections.
11. Detail Schedule Comparing Year-End Actual Results With Projections.  
\_\_\_\_ Individual Dealership ... or \_\_\_\_ Dealership Group

### DOCUMENTATION OF PROJECTIONS WITH CLIENT

1. Projections requested by \_\_\_\_\_ (date) \_\_\_\_\_
2. Projections to be used for:  
\_\_\_\_ Tax payment purposes \_\_\_\_ Corporation \_\_\_\_ Shareholders (S Corps)  
\_\_\_\_ Compliance with Factory or other financial statement conformity requirements  
\_\_\_\_ Other \_\_\_\_\_
3. Did we provide a copy of the projections to the client? \_\_\_\_ Yes \_\_\_\_ No
4. Projections discussed with \_\_\_\_\_  
by \_\_\_\_\_ on (date) \_\_\_\_\_
5. Transmitted by: \_\_\_\_ Mail \_\_\_\_ Fax \_\_\_\_ In person review  
\_\_\_\_ Orally, not sent to client  
\_\_\_\_ Other \_\_\_\_\_
6. Importance of conformity requirement discussed with \_\_\_\_\_  
by \_\_\_\_\_ on (date) \_\_\_\_\_

The dealership's 12th monthly financial statement (sent to the Factory) should reflect a best-efforts estimate, and the 13th statement should adjust the estimate to the actual computed year-end LIFO reserve amount. The position of the IRS is that failure to satisfy these conformity requirements can result in the termination/loss of the entire LIFO election and reserves.

7. Next followup (date) \_\_\_\_\_ by \_\_\_\_\_ Cal \_\_\_\_\_ FYE \_\_\_\_\_
8. Time and billing comments re: Projection services \_\_\_\_\_



The second case involved a shoe manufacturer who had much of its inventory destroyed by fire. This inventory happened to be on LIFO and when it was subsequently replaced, the taxpayer tried to assign the lower LIFO valuation (that the inventory destroyed by fire previously had) to the replacement inventory.

The IRS said that the involuntary conversion basis carryover provisions were not supposed to apply to the LIFO inventory in this situation. There are several cases involving this issue docketed in the Tax Court as a result of this S corporation having a multiplicity of shareholders.



---

**A Classic LIFO Showdown...**

(Continued from page 4)

tween the two methods in issue. It is materially misleading to single out only one year when the issue is the cumulative effect of recomputing, not simply one additional year's differences. In its audit of 1988 and 1989, the IRS recomputed the indexes used back to 1975, and then carried forward the cumulative changes into a single adjustment for 1988, spreading the change over a three-year period; however, the IRS later changed its position to argue that the cumulative changes should all fall in 1988.

Although Richardson argued that ... "the difference here is so immaterial that it defies logic to claim that (the IRS) method more clearly reflects income than (Richardson's) method," the Tax Court saw things differently.

In its analysis, the Court observed that "... Since the annual and cumulative indexes would be lower under the model line definition of item, (Richardson's) ending inventory at base-year cost would be higher. Although a higher base-year cost of ending inventory will generally produce higher taxable income, i.e., Cost of Goods Sold will be lower, taxpayers may, nevertheless, desire a higher base-year cost of ending inventory in a given year to avoid liquidating a LIFO layer, causing a match of historical costs against current revenues. Thus, depending on a taxpayer's particular set of facts and circumstances, it may be advantageous to have a lower annual deflator index."

Most LIFO practitioners in the real world have to agree with this perceptive comment. After all, dear reader, how many times has a client said to you ... in so many words ... that their LIFO reserves are big enough and they aren't strongly motivated to make them any larger?



---

The *De Filippis' LIFO Lookout* newsletter is a quarterly publication of LIFO News, Views and Ideas by Willard J. De Filippis, CPA, P.C., 317 West Prospect Avenue, Mt. Prospect, IL 60056. It is intended to provide accurate, general information on LIFO matters and it should not be construed as offering accounting or legal advice or accounting or legal opinion on any specific facts or circumstances. The contents are intended for general information purposes only. Readers should consult their certified public accountant, attorney and/or other competent advisors to discuss their own situations and specific LIFO questions. Mechanical or electronic reproduction or photocopying is prohibited without permission of the publisher. Annual subscription: \$325. Back issues available for \$70 each. Not assignable without consent. Any quoted material must be attributed to *De Filippis LIFO Lookout* published by Willard J. De Filippis, CPA, P.C. Editorial comments and article suggestions are welcome and should be directed to Willard J. De Filippis at (847) 577-3977; FAX (847) 577-1073. INTERNET: <http://www.defilippis.com>. © Copyright 1996 Willard J. De Filippis. *De Filippis' LIFO Lookout* format designed by *Publish or Perish, Inc.* (630) 627-7227.

**PLEASE NOTE:** All articles and the entire contents of this publication are the proprietary intellectual property of the author and publisher, Willard J. De Filippis. No article, nor any portion of this publication, is to be reproduced or distributed without the express written authorization of Willard J. De Filippis. Any prior permission to reproduce and/or distribute, unless expressed in a written document, is null and void.

---

**De Filippis' LIFO LOOKOUT**

Willard J. De Filippis, C.P.A., P.C.  
317 West Prospect Avenue  
Mt. Prospect, IL 60056

First-class postage paid at Mt. Prospect, IL

