De Filipps' LIFO LOOKOUT
A Quarterly Update of LIFO - News, Views and Ideas
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LIFO UPDATE

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

#1. WHATEVER HAPPENED TO...CONFORMITY? Again, there is nothing new to report on dealer financial statement conformity. "Guidance Under Section 472 Regarding LIFO Conformity for Automobile Dealers" was included as the 12th of 14 Tax Accounting Priorities Items listed under the Office of Tax Policy and *IRS 1997 Guidance Priorities.*

Based on a recent meeting with the IRS, Peter Kitzmiller of NADA said that he is hopeful that the IRS may issue something by the end of the summer ... or at least before the AICPA Auto Dealership Conference in late October.

Lately, some dealers have come back from 20 Group meetings believing there already has been a conformity document released by the IRS. Many CPAs have also called under similar spells. *Wards Dealer Business* may have contributed to this confusion by recently reporting that "at last, according to the IRS' chief officer on auto dealer tax matters, a policy for determination of LIFO conformity issues is near the publication point." This could have been said a year ago, ... just before the only person who could have engineered a resolution left the IRS and the whole thing lapsed into a dormant state ... and it would have been accurate then, too.

Quite possibly, the confusion has been generated by the release of Revenue Procedure 97-27 which substantially revises some of the terms and conditions involved in changing accounting methods. These procedural changes affect all requests for permission to change methods. While this includes LIFO methods, it has absolutely nothing to do with dealer financial statement conformity issues (which involve the LIFO eligibility requirements).

So don't be confused: There is still nothing "official" out at this time on dealer conformity. And when it comes out, it will be issued in the form of a Revenue Procedure and/or as a Revenue Ruling - or both - by the IRS National Office. It will not come out as a position paper issued by IRS' Motor Vehicle Industry Group in Grand Rapids.

LOOKOUT LOOKS INTO

#2. IRS EASES RULES FOR CHANGING ACCOUNTING METHODS. Revenue Procedure 97-27 issued in May simplifies many rules, terms and conditions involved when taxpayers request IRS permission to change accounting methods ... including LIFO methods. The IRS has dropped the requirement that the Form 3115 request must be filed within the first 180 days of the year of change. Also, several difficult technical definitions have been eliminated ...along with the 90-day window for filing 3115s by taxpayers coming under IRS audit. The 6-year spread period for reporting positive Section 481(a) adjustments in income has been shortened to four (4) years. These and other details are discussed in coverage beginning on page 3.

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#3. FORM 3115 TO BE REVISED. As a result of the changes made by Revenue Procedure 97-27 and the change allowing the filing of Form 3115 at any time during the year of change, the IRS is in the process of revising the "old" Form 3115 (with a revision date of February, 1996). The revised Form 3115 is not yet available.

#4. NO LIFO BARGAIN IN BARGAIN PURCHASE INVENTORIES. In an interesting twist, the IRS attempted to use the *Hamilton Industries* case precedent to defeat an attempt by *LaCrosse Footwear, Inc.* to apply LIFO to obtain major tax deferral benefits from its bargain purchase of inventory. The Court held that the IRS was incorrect in the arguments it selected based on *Hamilton* and in the reasoning it suggested. However, the taxpayer still was not allowed to enjoy LIFO bargain purchase benefits because if it had been, the result would not clearly reflect income. For more on this, see page 14.

We have also included a "Practice Guide" questionnaire or checklist (pages 22-23) that may be helpful in quickly assessing exposure to IRS attack on bargain purchases. Also, to help keep the *LaCrosse Footwear* decision in perspective, we have included an article that covers pre-1996 bargain purchase developments - namely the Tax Court decision in *Hamilton Industries, Inc.*, the IRS Coordinated Issue Paper on bargain purchases of inventory in September 1995 and the *Kohler Co. & Subs.* Court of Federal Claims decision in November 1995.

The two pre-1996 cases (i.e., *Hamilton* and *Kohler*) were both decided in favor of the IRS. The recent decision in *LaCrosse Footwear* brings in even more "convincing" support for the denial of LIFO benefits in initial inventory bargain purchases by focusing on (1) the importance of the distinction between a ***new entity*** versus an entity already in existence that is making the acquisition and (2) the

USED CAR LIFO UPDATE

• **IRS AUDIT ACTIVITY.** We have received several calls reporting that some IRS agents have been looking into the specifics of used car LIFO computations. At the present time, the IRS has issued nothing "official" on how used vehicle LIFO computations should be made.

No one (except the IRS... or the Tax Court) can say for sure what the IRS will accept. CPAs should emphasize to their dealer clients that the Alternative LIFO Method for new vehicles in Revenue Procedure 92-79 does not apply to used vehicles.

• **WATCH THAT FORM 970.** In Letter Ruling 9723024, the IRS National Office recently granted a dealer an extension of time to file Form 970 to extend the LIFO method to used vehicles. What happened is that the dealership originally made a LIFO election to cover new vehicles. In a later year when the dealership wanted to extend LIFO to its used vehicles, it did not file a second Form 970, as required.

Apparently, the dealership's outside accountants "assumed" that the original election allowed LIFO for both new and used vehicles. This "assumption," of course, was incorrect. The instructions for the box in the upper right-hand corner of the Form 970 indicate that the "subsequent election" box should be checked when Form 970 is being filed to notify the IRS that the LIFO method is being extended to another class of goods.

In Letter Ruling 9723024, the IRS determined that the taxpayer had acted reasonably and in good faith, and it granted an extension of 30 days from the date of the ruling for the filing of the appropriate Form 970.

• **USED CAR LIFO ...STILL MORE ATTRACTIVE.** We commented in our last issue that several CPAs had reported negative LIFO reserves at December 31, 1996 for some of their auto dealer *used* vehicle LIFO elections. We also explained that some dealers had elected used car LIFO in 1995 and experienced only small (2%) price increases that year. Then, in 1996, they experienced equal or greater price decreases (3%), thus resulting in net negative LIFO reserves for their used vehicles at year-end 1996.

One publication aimed at the auto dealer niche recently reported that it had received "numerous requests for an article on opting out of used car LIFO in light of the sizable decrease in used car prices in 1996, threatening negative reserves. The Government published used car index declined from 158.2 to 155.6, or a decrease of 1.6% in 1996." Tsk! Tsk! What appalling logic!

Another consideration in connection with making a used car LIFO election for 1997 is prompted by the recent announcement by GM that it plans to raise its prices on '98 models by "only" an average of 1.5% on cars and 1.1% on trucks. Many dealers last year put off making a used vehicle LIFO election - for whatever reason - because they experienced fairly significant inflation in their new vehicle inventories and that was "enough for them." With the prospects of relatively flat inflation for new vehicles for 1997, perhaps the prospect of greater inflation for used vehicle inventories - coupled with the ability to spread the prior (Dec. 31, 1996) year-end writedowns over three years - may make a LIFO election for used vehicles for 1997 even more attractive.

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AT A GLANCE	SUMMARY OF REVENUE PROCEDURE 97-27 ACCOUNTING METHOD CHANGE REQUESTS
Time for filing Form 3115	• Any time before the end of the year of change. Old 180-day ... mid-year ... filing deadline eliminated.
Spread period for Section 481(a) adjustments	• Four (4) year spread period for all accounting method change adjustments, whether positive or negative, replaces old 3 or 6 year spread periods.
90-day window for changes after start of IRS audit	• ELIMINATED under new rules: The 90-day window that began with start of IRS audit for making changes under more favorable terms and conditions than those resulting if taxpayer were forced to change method has been removed. • LIFO taxpayers could be particularly disadvantaged by the change.
Not changed	• Cut-off method and audit protection for prior years still available for LIFO method changes "voluntarily" requested by taxpayers before the start of an IRS audit. • *Hamilton*-type changes require Section 481(a) adjustments. • Risk of termination of (entire) LIFO election (due to an eligibility violation) in a year prior to the year in which a LIFO sub-method is being changed. • $25,000 *de minimis* election allows taxpayers to take entire Section 481(a) adjustment into income if less than $25,000 in the year of change. • Ability to offset Section 481(a) positive adjustments against net operating losses. • Five (5) year wait to readopt LIFO.
Simplification	• Elimination of Category A, Category B, Designated A and Designated B classifications and distinctions. • For taxpayers under continuous IRS audit examination, expansion of old 30-day window to 90 days and reduction of consecutive months required to be under audit from 18 to 12 months. • Notification procedure replaces the consent requirement for taxpayers before an Appeals Officer or a Federal Court. • Clarification of the term "under examination."
Effective date	• May 15, 1997 ... Supersedes Revenue Procedure 92-20.
Special transition rules	• Forms 3115 filed and pending on May 15: May elect application of new Rev. Proc. 97-27 rules by notifying the IRS before IRS issues letter granting or denying change request(s) under pending applications. • Forms 3115 filed after May 15 and before December 31, 1997: May elect to use provisions of old Rev. Proc. 92-20 instead of new terms. • For taxpayers who came under audit recently (i.e., between Feb. 15 and May 15) and who could still make changes under the old 90-day audit window of Rev. Proc. 92-20: ... May be very favorable.
Future clarification	• Form 3115 (with Feb. 1996 revision date) to be revised immediately. • IRS to issue guidance (in near future) on • Automatic method changes. • Expedited method changes (For example, Rev. Proc. 88-15 dealing with LIFO Terminations).

NEW PROCEDURES FOR CHANGING (LIFO) ACCOUNTING METHODS AND FILING FORMS 3115... BOTH HELP AND HURT TAXPAYERS

REV. PROC. 97-27 FORM 3115

Revenue Procedure 97-27 changes the procedures, terms and conditions for requesting permission from the IRS to make accounting method changes after May 14, 1997. These changes have been described as a simplification of the previous rules, but whether the changes help or hurt taxpayers will depend on one's point of view.

Here's one way to look at the new changes: Would you rather have more time to file Form 3115 and not be stressed out by a 180 day filing deadline ... or would you rather have less time in which to pay the tax on any accounting method changes that result in income pick-ups? Changes in the new rules allow more time to file ... all the way to the end of the year of change ... but less time over which to spread the Section 481(a) adjustments ... a four year spread for <u>all</u> adjustments.

In the category of "somewhat-less painful" changes, many of the terms and conditions have been eliminated and/or significantly altered. Whether these changes either individually or collectively leave taxpayers better or worse off will depend upon the individual circumstances under which they are being evaluated.

It would appear that LIFO taxpayers have been significantly disadvantaged by the new changes, especially by the elimination of the old 90-day audit window.

For a quick summary, see the "At A Glance" table accompanying this article.

GRADATION OF INCENTIVES

Revenue Procedure 97-27 still maintains the emphasis of its predecessor, Revenue Procedure 92-20, which was to encourage taxpayers to voluntarily request permission to change from impermissible accounting methods before they are contacted by an IRS agent for an audit (i.e., before they come under examination). It does this by providing incentives to encourage prompt voluntary compliance with proper tax accounting principles.

Under this approach, a taxpayer generally receives **more favorable** terms and conditions if the taxpayer files its request for a change in accounting method **before** the Internal Revenue Service contacts the taxpayer for examination. These more favorable terms and conditions include, for example, a later year of change and a longer Section 481(a) adjustment period for a positive adjustment. A taxpayer that is contacted for examination and required to change its method of accounting by the IRS generally receives **less favorable** terms and conditions (i.e., an earlier year of change and no spread period for the Section 481(a) adjustment) ...and it may also be subject to penalties.

NEW FORM 3115 COMING

The changes in rules for method changes made by Rev. Proc. 97-27 will result in an immediate revision of Form 3115. Accordingly, until the revised Form 3115 is available, taxpayers should continue to use the old form which bears a revision date of February 1996.

MORE TIME TO FILE FORMS 3115

As of May 15, 1997, a Form 3115 requesting permission to change an accounting method may be filed at any time during the tax year for which the change is requested. This "doubling" of the number of days in the filing deadline is not easily found in Rev. Proc. 97-27. Rather, it is found in a simultaneous change made in the regulations under Section 446.

While this change will certainly cause many accountants to sigh with relief, common sense still suggests ... as do IRS officials ... that the earlier in the year the Form 3115 is filed, the better.

The IRS is on record as indicating that it may not be able to process all applications submitted during the later part of the year. As a consequence, that may mean that taxpayers requesting permission to change methods will not receive certainty regarding their requests until after the time for filing the tax return for the year of change. (In many instances, that's really not a change at all.)

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In this regard, see "During the Wait: What if Tax Returns are Due?" in the June 1995 *LIFO Lookout*. This article discusses the alternatives confronting practitioners when the request process takes so long that a tax return has to be filed for the year of change before you know whether or not permission to change will be granted. Technically, and according to the statute, until the taxpayer receives official permission from the IRS to change methods, it cannot unilaterally change from its current method. From this it follows that the taxpayer should file its tax return for the year of change using the old method(s) and then, when or if permission to change is eventually received, it should file an amended tax return for the year of change reflecting the new method. This creates many practical problems that are explored in the June, 1995 article.

Extensions of time to file Form 3115s will now be granted only in "unusual and compelling circumstances." This seems reasonable since the filing deadline has been effectively doubled to the end of the year and taxpayers would have less "workload compression" excuses to offer.

FOUR YEAR SPREAD PERIOD

In what might be regarded as a major "simplification" move, the varying spread periods previously available for Section 481(a) adjustments have all been combined. There is now a **single, four year spread period** for all Section 481(a) adjustments, whether they are positive (creating income) or negative (resulting in deductions). This is a significant shortening from the six year spread period that was previously available in connection with LIFO change requests made during the first 90 days of an IRS audit. Several other Section 481(a) adjustment periods under old Revenue Procedure 92-20 for Category B accounting method changes were six year spreads. On the other hand, certain Category A method changes under old Revenue Procedure 92-20 were spread over three years, for which the spread period has been lengthened to four years.

There are several special rules that operate to shorten or accelerate the 4 year spread. Essentially, these relate to situations where a taxpayer ceases to engage in the trade or business ... or to situations involving conversion to or from S corporation status. These are found in Section 7.03 of the Rev. Proc.

ELIMINATION OF 90-DAY IRS AUDIT WINDOW

Old Revenue Procedure 92-20 included a provision that allowed taxpayers a limited 90-day window period during which a taxpayer coming under IRS audit was permitted to file a Form 3115 requesting to change an accounting method without first obtaining IRS approval. If a taxpayer acted during that 90-day window period, the terms and conditions available to it were less favorable than those generally available for method changes voluntarily requested prior to contact for audit by the IRS... but they were less severe than if the taxpayer was unsuccessful in defending its method.

Rev. Proc. 97-27 eliminates that 90-day window that used to be available at the start of an IRS audit.

For LIFO taxpayers coming under IRS audit, this change has special importance. The elimination of the 90-day IRS audit window removes an often significantly favorable combination of terms and conditions that previously (under old Rev. Proc. 92-20) allowed taxpayers making LIFO method changes under the 90-day window to avoid having to go all the way back to their first LIFO year to make recomputations under the LIFO change required by the IRS on audit. The previously available "modified Section 481(a) adjustment" computation using only the prior ten (10) taxable years has been eliminated. And, as noted above, what previously was a six-year spread period for LIFO changes under these circumstances has been shortened to 4 years.

SIMPLIFICATION BY ELIMINATION

Under old Revenue Procedure 92-20, requests for permission to change accounting methods were grouped into those involving:

1. Category A methods,
2. Category B methods,
3. Designated A methods,
4. Designated B methods, and
5. Changes within the LIFO method.

Rev. Proc. 97-27 eliminates the distinctions between Category A, Category B, Designated A and Designated B classifications which were important in determining applicable terms and conditions under Rev. Proc. 92-20. Often some of these distinctions were difficult to make and the rules for handling changes in Designated A methods were particularly complex.

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LIFO METHOD CHANGES ... CUT-OFF METHOD STILL APPLIES

For LIFO taxpayers, Revenue Procedure 92-20 contained the first formal expression that taxpayers requesting changes in LIFO methods could use the cut-off method and avoid recomputations of prior year LIFO inventories. Under the cut-off method, only items arising **on or after** the beginning of the year of change are to be accounted for under the new LIFO method of accounting. Any LIFO computations arising prior to the year of change would be left undisturbed.

...EXCEPT FOR *HAMILTON*-TYPE CHANGES

As mentioned above, Rev. Proc. 97-27 continues to allow the use of the cut-off method in connection with most LIFO method changes. This is expressly provided for in Section 5.02(b)(3) of Rev. Proc. 97-27.

However, a Section 481(a) adjustment **will be required** for changes within the LIFO method of accounting for certain bulk bargain purchases of inventory to comply with *Hamilton Industries, Inc.* The Revenue Procedure cites Announcement 91-173 as "an example of other published guidance that requires a Section 481(a) adjustment."

...AND A LIFO CONFORMITY WARNING

In the Section granting "cut-off" protection, the Rev. Proc. (at Section 9.02(2)) contains the following disclaimer:

"The Service may change a taxpayer's method of accounting for prior taxable years if the taxpayer is changing a sub-method of accounting within the method. For example, an examining agent may propose to terminate the taxpayer's use of the LIFO inventory method during a prior taxable year even though the taxpayer changes its method of valuing increments in the current year."

WHAT DOES "UNDER EXAMINATION" MEAN?

One of the results of the changes made by Revenue Procedure 97-27 is to leave more taxpayers considering method changes in a "win-lose" or "winner-take-all" environment. The IRS has clarified the definition of "under examination" since this is the critical date before which taxpayers requesting changes in methods of accounting will receive the liberal terms and conditions afforded to those acting in the spirit of "voluntary compliance."

After the date on which a taxpayer comes "under examination," the terms and conditions are extremely harsh. It can be anticipated that any accounting method change, including LIFO method changes, forced upon the taxpayer by IRS audit will be made to the earliest open year with 100% of the Section 481(a) adjustment being taken into income entirely in that year. Furthermore, various penalties are also likely to be incurred as a result of waiting for the IRS to force the change in method.

An examination of a taxpayer begins ... "on the date the taxpayer is contacted in any manner by a representative of the Service for the purpose of scheduling any type of examination of the return. For an entity (including a limited liability company), treated as a partnership or an S corporation, that is subject to the TEFRA unified audit and litigation provisions for partnerships and S corporations, an examination begins on the date of the notice of the beginning of an administrative proceeding sent to the Tax Matters Partner/Tax Matters Person (TMP)."

TERMS LEFT UNCHANGED

Many of the terms and conditions in Rev. Proc. 92-20 have been left unchanged, and some of them are worth pointing out just to maintain a perspective:

1. If the Section 481(a) adjustment involves less than $25,000 - either as a positive or as a negative adjustment - taxpayers may elect to take the entire adjustment into income in the year of change. This *de minimis* rule has been carried over in Rev. Proc. 97-27 at Section 7.03(1).

2. Rev. Proc 97-27 cannot be used if a taxpayer is eligible to use an expedited procedure to obtain consent to change an accounting method. The IRS has indicated that later this year it will issue guidance on (1) automatic approvals and (2) expedited approvals to tie all of this together.

3. Form 3115 is still the form to be filed for requesting permission to change accounting methods. As noted above, a forthcoming new revision of Form 3115 will reflect all of these changes.

4. Five (5) year wait to readopt LIFO. If a taxpayer previously received permission from the Commissioner to change from the LIFO inventory method, the Commissioner will not consent to the taxpayer's readoption of the LIFO inventory method for five taxable years (beginning with the taxable year the taxpayer changed from the LIFO inventory method), in the absence of a showing of unusual and compelling circumstances.

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CORPORATE GROUP RESTRUCTURING CREATING S CORPS & LIMITED PARTNERSHIPS TRIGGERS LIFO RECAPTURE

LTR 9716003

SEC. 1363(d)

In Letter Ruling 9716003, the IRS looked through the form of a series of corporate restructuring transactions involving S Corporations and limited partnerships and held that the parent corporation was liable for the LIFO recapture tax under Section 1363(d). Although not referring specifically to the "substance vs. form" doctrine, the IRS held that allowing the parent to avoid the tax would circumvent the purpose of the statute.

BEFORE

The taxpayer requesting the ruling in this case was a diversified holding company subject to tax as a regular C corporation. This holding company held substantially all the stock of five Subchapter C corporations which were involved in the operation of six business activities. These companies had filed consolidated tax returns prior to the restructuring. Although the nature of the business activities is not specified, one possibility is that these were six different auto dealerships. Three of the C corporation subsidiaries each operated one (dealership) and one of the other C subsidiaries operated two (dealerships). The remaining C corporation subsidiary's only interest was a 50% partnership interest in a partnership that operated another (dealership) business. Each of the (dealership) businesses used the LIFO inventory method to value its inventories.

DURING

The shareholders of the parent corporation created six S corporations in which they held the same interests in the S corporations as they held in the parent. After the S corporations were created, on the same day, they and the parent's C subsidiaries created six limited partnerships ... one for each of the business activities (hypothetically referred to above as dealerships). Under the terms of the limited partnership agreements, each newly-formed S corporation contributed an unspecified amount of cash in exchange for a 1% general partnership interest. Each C subsidiary contributed all of the assets and liabilities associated with its operating business in exchange for a 99% limited partnership interest.

These contributions of capital upon the formation of the six limited partnerships did not occur on the same day as their creation ... they occurred at an unspecified later date. Immediately after the date on which the newly-formed S corps and the "old" C corp subsidiaries contributed their capital (cash for general interests and net operating assets for limited interests, respectively) to the six newly-formed limited partnerships, the "old" C corp subsidiaries were liquidated into the parent corporation.

As a result of these liquidations, the "old" parent C corporation was left holding the 99% limited interests in the limited partnerships who were conducting their business operations using the LIFO inventory valuation method ... and each of the newly-formed S corporations continued to hold their respective 1% general partnership interests. The original partnership agreements were amended and restated, and the new partnership agreements substituted the old parent corporation for each of the old C corporation subsidiaries as the holder of the limited partnership interests. At the same time, individuals who had been general managers in three of the "old" C corp subsidiaries (operating one dealership/business each) were admitted as minority limited partners to those three respective limited partnerships.

Finally, on that same date, the parent holding company elected to change its tax status from a C corporation to an S corporation. Each of the limited partnerships filed a Form 970, Application to Use LIFO Inventory Method, for its first taxable year ... to notify the IRS that the LIFO method was being continued in connection with its activities. The parent corporation did not include any LIFO recapture amount under Section 1363(d) in its gross income for its last taxable year as a C corporation ...and the IRS agent thought it should.

AFTER

As a result of this corporate consolidated return group restructuring, after all the transactions were completed, the six operating businesses (dealerships) were each controlled by a limited partnership. Each of the limited partnerships had a partnership capital structure consisting of a 99% limited partnership interest held by the parent corporation which had changed its previous C status to an S status ... and a 1% general partnership interest held by a newly created S corporation which was owned by the same individual shareholders who were the owners of the parent holding company.

To reflect the fact that originally the parent holding company held "substantially all of the stock" - and not 100% of all of the stock - of each of the original C corporation subsidiaries, the limited partnerships had

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admitted additional minority limited partners to the extent necessary to account for the full 100% ownership of the business operations.

THE ISSUES

One of the issues in Letter Ruling 9716003 was whether the parent corporation was required to include the LIFO recapture amount. The other issue was how the amount of LIFO recapture income should be calculated if Section 1363(d) applied.

APPLICABLE LAW

Section 1363(d)(1) provides that if (1) an S corporation was a C corporation for the last taxable year before the first taxable year for which the S election was effective and (2) the corporation inventoried goods under the LIFO method for such last taxable year, then the LIFO recapture amount must be included in the gross income of the C corporation for its last taxable year. Appropriate adjustments to the basis of the LIFO inventory must be made to take into account the amount included in gross income.

Section 1363(d)(3) defines the LIFO recapture amount as the amount by which the C corporation's inventory under the first-in, first-out (FIFO) method exceeds the inventory amount under the LIFO method. The LIFO recapture amount is determined at the close of the corporation's last taxable year before the first taxable year for which the S election is effective.

Section 1363(d)(4)(C) provides that, for this purpose, the inventory amount under the FIFO method is determined by the retail method under Section 472 if the taxpayer uses such (retail LIFO) method or by using cost of market, whichever is lower, if the taxpayer does not use the retail method. Section 1363(d)(4)(A) defines the LIFO method as "the method authorized by Section 472."

In general, under Section 1374 a corporate-level tax is imposed on built-in gains recognized by former C corporations within 10 years of the first day of the first taxable year for which the corporation was an S corporation.

SPECIAL COLLAPSED LAYER

Revenue Procedure 94-61 (1994-2 C.B. 775) provides that all of the prior LIFO layers are combined into a single layer that becomes the equivalent of a LIFO base layer as of the last day of the C corporation year/first day of the S corporation year. The LIFO election is not terminated upon a switch from C to S status. All prior C corporation LIFO layers are rolled up - or "collapsed" - into a single layer having an average weighted LIFO index valuation.

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

The index for the Special Collapsed Layer (for the last C corporation year) is relevant only for the purpose of computing the LIFO carrying value of a decrement in the event there is a decrement experienced in a later S year which has to be carried back to the LIFO inventory as of, or prior to, the last C corporate year. Thus, this adjusted index for the Special Collapsed Layer would be used only if the end-of-year inventory, expressed in terms of base-year cost, for a taxable year subsequent to the last C corporate taxable year (i.e., in an S year), is less than the base-year cost of the inventory as of the last day of the last C year. See page 12 for an example of the procedure for computing the Special Collapsed Layer resulting from Section 1363(d) adjustment.

METHOD OF REPORTING LIFO RECAPTURE TAX

The additional income tax attributable to the inclusion in income of the LIFO recapture amount is payable in four equal installments. The first installment must be paid by the due date of the income tax return for the electing corporation's last taxable year as a C corporation. The other installments are due by the respective due dates of the S corporation's returns for the three succeeding taxable years. No interest is payable on these installments if they are paid by the respective due dates.

An S corporation is <u>not</u> required to include the obligation to pay the installment of tax resulting from the LIFO recapture amount in its determination of its estimated tax payment under Section 6655. Should an S corporation file a final return before any unpaid installments of the increase in tax required under Section 1363(d) have been made, those unpaid installments become due and payable with the S corporation's final return.

IRS Announcement 88-60 (IRB 1988-15,47) spells out the special disclosure and computations to be made in the last regular C corporation tax return filed on Form 1120. For example, the LIFO recapture amount should be included in "other income" on line 10 of Form 1120, for the last tax year as a C corporation. To determine the additional tax due to LIFO recapture, the corporation must complete lines 1 through 9 of Schedule J of the Form 1120 based on →

income which includes the LIFO recapture amount. On a separate worksheet, using the Schedule J format, it is necessary to recalculate the entire worksheet based on taxable income excluding the LIFO recapture amount. The total of lines 1 through 9 of Schedule J must then be compared to the total tax on the worksheet. The difference is the additional tax due to the LIFO recapture.

Since the total included in Schedule J of the last C corporation return will include all additional tax attributable to the LIFO recapture amount, the amount which may be deferred (i.e., 3/4 of the additional tax) must be subtracted to arrive at line 10 total tax. This deferral amount should be shown on the dotted line to the left of the amount shown on line 10 of Schedule J as follows: "Sec. 10227 deferral - $(amount)." Note: The Sec. 10227 reference is to Sec. 10227 of the Revenue Act of 1987, which added Sec. 1363(d) to the Internal Revenue Code and is applicable to most S corporation elections made after December 17, 1987.

As noted previously, the S corporation must pay each of the remaining installments of the LIFO recapture tax with its tax return (Form 1120-S) for the three succeeding tax years. Each year's installment of LIFO recapture tax due should be included in the total amount to be entered on line 22c of Form 1120-S ...with the words "LIFO tax" written to the left of the box and the amount of the installment also indicated to the left of the line 22c box.

IRS RATIONALE FOR ASSESSING LIFO RECAPTURE TAX: "AGGREGATE PRINCIPLES" APPLY

The Service held that for purposes of Section 1363(d), "aggregate principles apply and (the parent corporation) is treated as owning directly its share of each partnership's LIFO inventory" ... even though it never directly held inventory as a "diversified holding company."

The IRS logic is as follows: The parent was a diversified holding company. As such, it has never directly held inventory. However, for purposes of Section 1363(d), aggregate principles apply, and the holding company is treated as owning directly its share of each partnership's LIFO inventory.

The parent corporation elected Subchapter S status effective for the taxable year beginning after the close of its last C year. Accordingly, pursuant to Section 1363(d), it must include the LIFO recapture amount in its gross income for its last taxable year as a C corporation if it inventoried goods under the LIFO method during that year.

Under the partnership provisions in Subchapter K of the Code, a partnership is considered to be either an **aggregate** of its members or it is considered to be a separate **entity**. Under the **aggregate approach**, each partner is treated as owning an undivided interest in partnership property and operations. Under the **entity theory**, the partnership is viewed as a separate entity in which partners have no direct interest in the partnership operations. Whether the entity or the aggregate principles apply depends upon the purpose and the scope of the particular Code section involved. Therefore, if for purposes of Section 1363(d) the concept of a partnership as a collection of individuals is more appropriate than the concept of a partnership as an entity, then aggregate principles (should) apply.

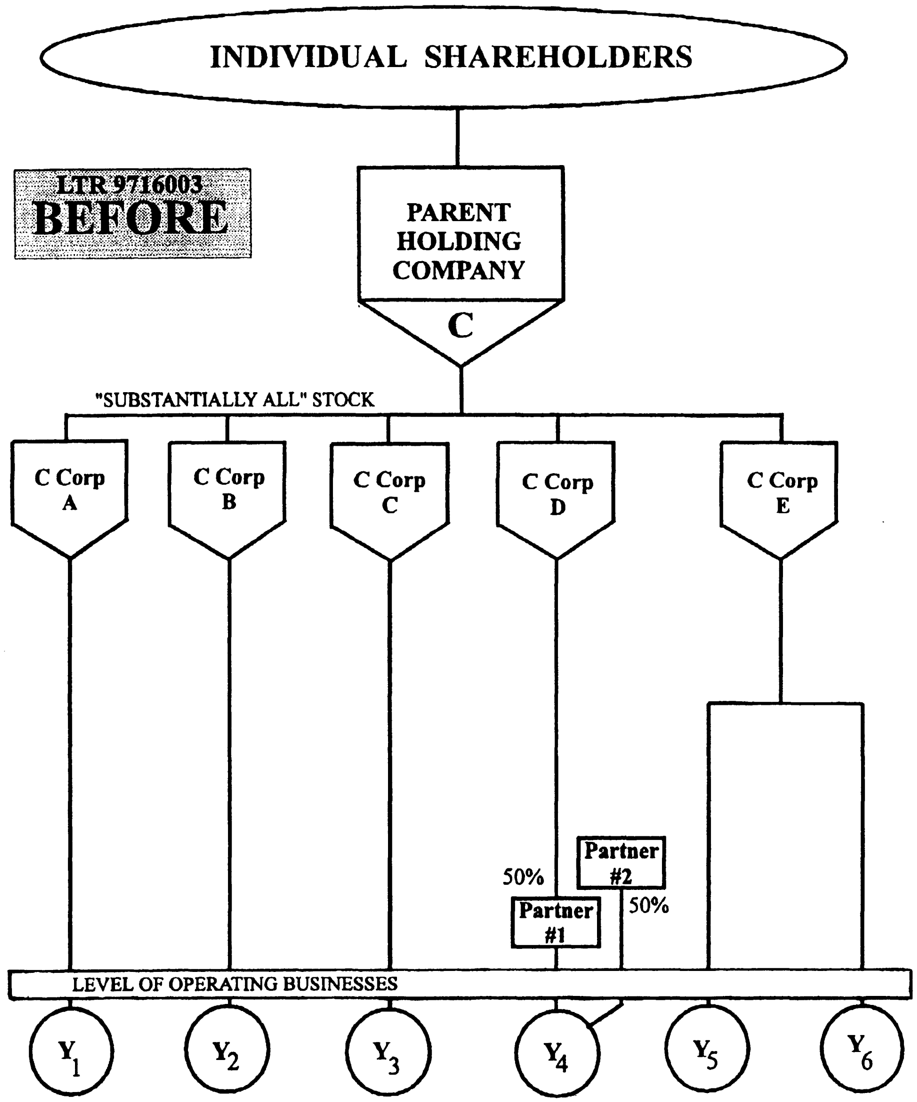
This line of reasoning necessitates a further inquiry into the legislative history underlying Section 1374 and 1363(d) which was added to the Code in 1987 to supplement Section 1374. Section 1374 imposes a corporate level tax on built-in gain recognized by former C corporations within 10 years of the effective date of the S election. The legislative history of Section 1363(d) indicates that Congress was concerned that taxpayers using the LIFO method could, or might, avoid Section 1374.

"The Internal Revenue Service has stated that the inventory method used by the taxpayer for tax purposes shall be used in determining whether goods disposed of following a conversion to S corporation status were held by the Corporation at the time of the conversion. Thus, a C corporation using the last-in, first-out (LIFO) inventory method of accounting for its inventory which converts to S corporation status will not be taxed on the built-in gain attributable to LIFO inventory to the extent it does not invade the LIFO layers during the ten-year period following the conversion."

To eliminate this advantage, Congress believed that it was appropriate to require LIFO taxpayers to recapture the deferral benefits of the LIFO method in the year that they converted to S corporation status. The recapture prevents LIFO taxpayers from being treated more favorably than their FIFO counterparts.

Congress added Section 1363(d) to the Code to prevent the disparate treatment of LIFO and FIFO basis taxpayers that make S elections. Allowing taxpayers to avoid LIFO recapture by holding LIFO inventory in a partnership would directly circumvent the purpose of the statute. Therefore, for purposes of Section 1363(d), it is appropriate to apply aggregate principles in determining the parent corporation's share of each partnership's LIFO inventory. Accordingly, the parent corporation which made the S election must include the LIFO recapture amount in its gross income for its last taxable year as a C corporation.

see **CORPORATE GROUP RESTRUCTURING**, page 13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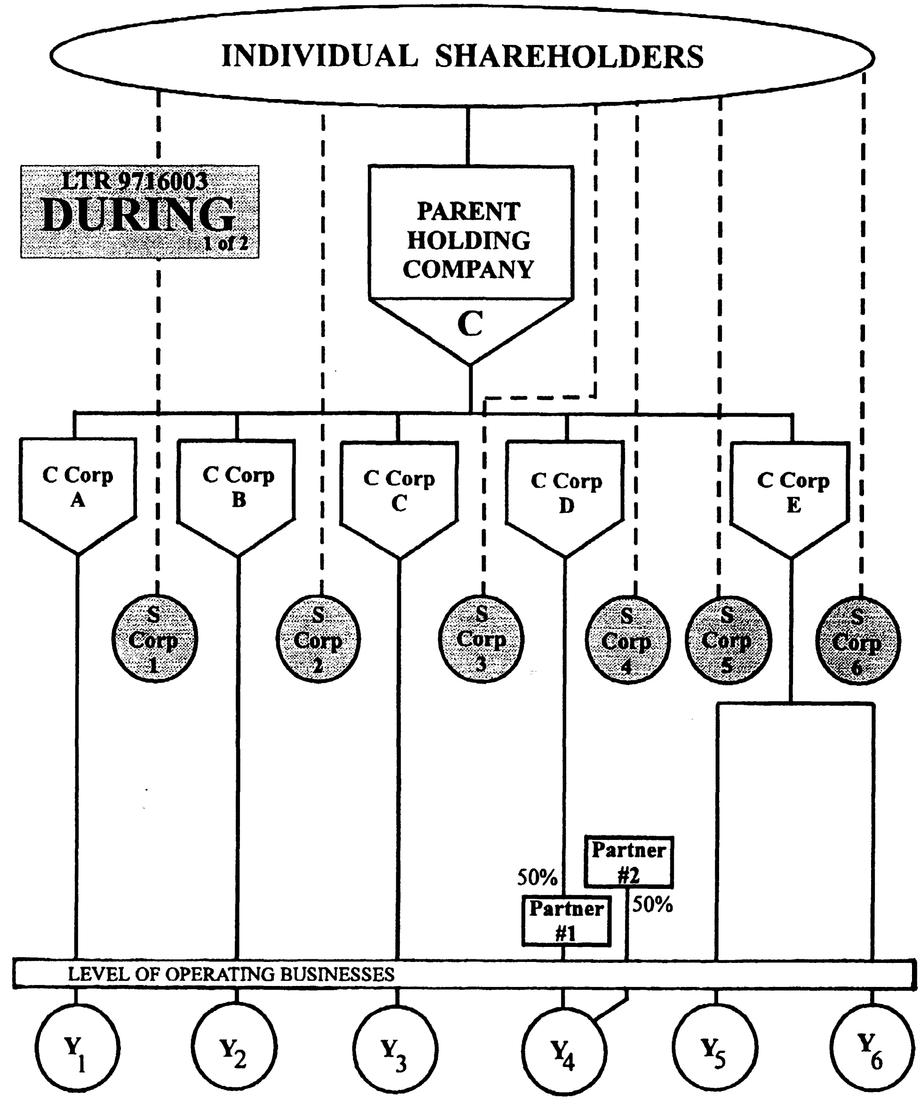
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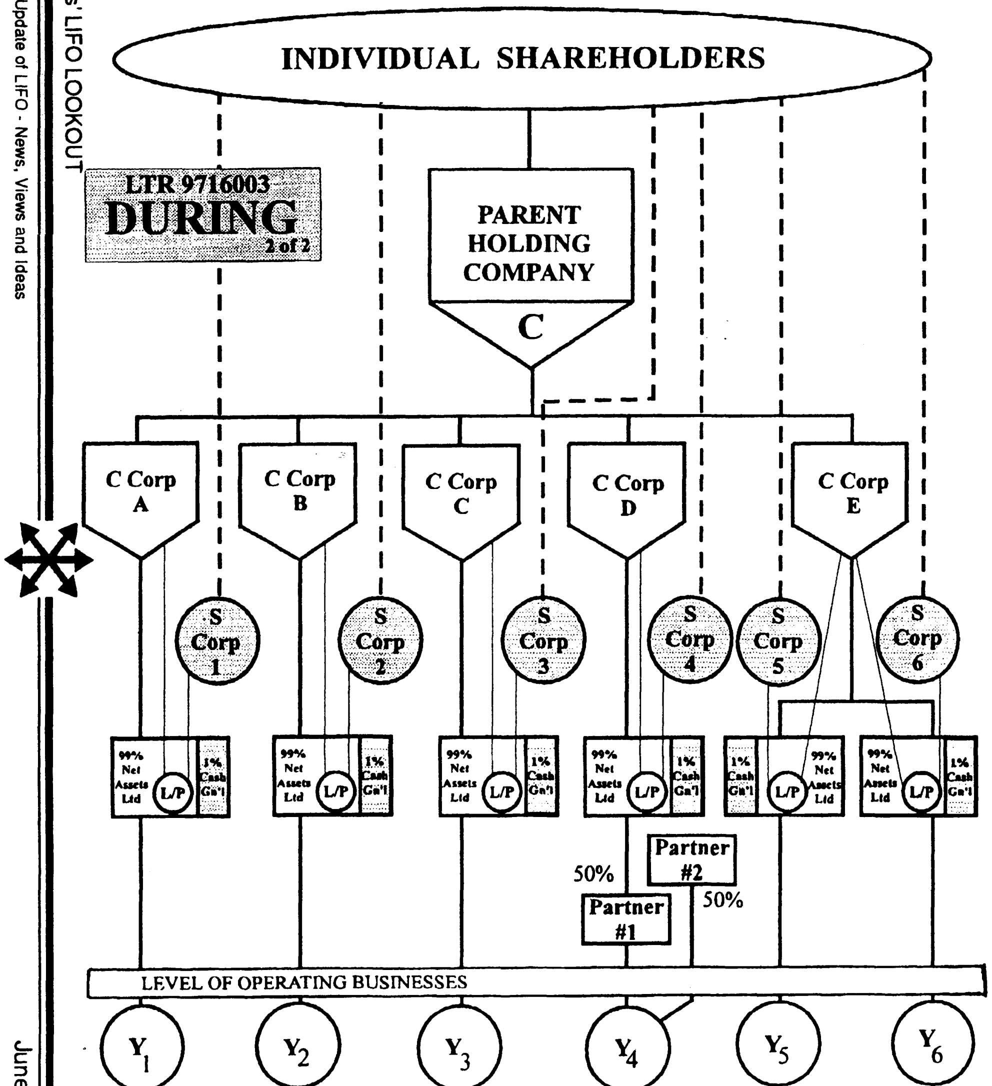

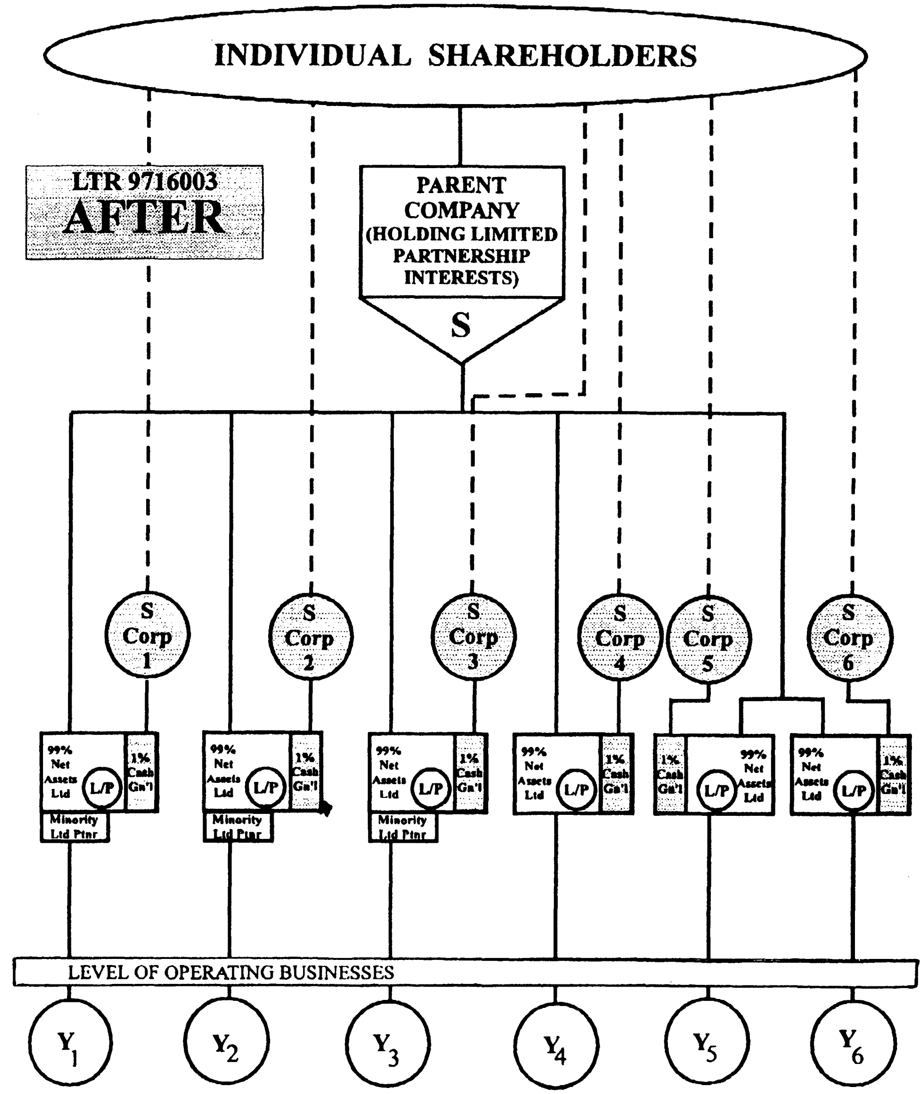

(LIMITED PARTNERSHIPS IN PLACE & ALL OLD C CORP SUBS LIQUIDATED)

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

REV. PROC. 94-61

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

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

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

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

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

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

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

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

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

 (Continued from page 9)

HOW TO COMPUTE THE LIFO RECAPTURE AMOUNT

The National Office also discussed how the computation of the LIFO recapture amount should be made. It held that in calculating the LIFO recapture amount, the LIFO amount of inventory on the last day of the last C corporation year is determined by reference to the LIFO amount of inventories in the partnerships' hands. This means that all inventory transactions that occurred at the level of the partnership after the transfers to the partnership are to be considered in calculating the first-in, first-out (FIFO) value of the inventory on that last C year-end date.

The LIFO amount to be recaptured is the amount by which the taxpayer's inventory under the FIFO method exceeds the inventory amount under the LIFO method, with the recapture amount determined as of the last day of the last taxable year before the S corporation becomes effective (i.e., the last day of the last taxable year for which a return is filed as a C corporation). The letter ruling goes on to state that the LIFO and the FIFO amounts for this last taxable year-ended date are determined, in part, **by using inventory transactions that occurred at the level of the partnerships after the transfers** on the date when the partnerships were funded by the partners' contributions to capital.

The Letter Ruling pointed out that the partnerships did file Forms 970 for their first taxable years. For purposes of Section 1363(d), the parent corporation inventoried goods under the LIFO method during that year "because the partnerships inventoried goods under the LIFO method." Accordingly, the LIFO amount of the inventory for purposes of Section 1363(d) as of the last day of the parent corporation's last C year is determined by reference to the LIFO amount of the inventories in the partnerships' hands. Under the FIFO method, the items remaining in ending inventory are considered to be the items most recently purchased or produced. Since the parent corporation continuously *"held"* an interest in the inventory throughout the taxable year, all inventory transactions that occurred during this year - including transactions during the time the inventories were held by the partnerships - are considered in calculating the FIFO value of the inventory for purposes of Section 1363(d).

The LIFO inventory layer history was inherited by the parent corporation under the carryover provisions of Section 381(c) because all of its C corporation subsidiaries were liquidated into it. The FIFO (First-In, First-Out) amount of such inventory equals the cost of the items most recently purchased during the parent's last taxable year as a C corporation.

PARTNERSHIP ADJUSTMENTS NECESSARY

The partnerships may make appropriate adjustments to the basis of their inventories to take into account the amount included in the parent's gross income.

This would be done following the guidelines provided in Revenue Procedure 94-61 for special collapsed layers ... see example on page 12.

LETTER RULING 9644027

Letter Ruling 9716003 is dated September 30, 1996. This should be compared with Letter Ruling 9644027 issued earlier on July 25, 1996. In LTR 9644027, the IRS held that there would be no LIFO recapture upon the conversion of several dealerships to limited liability company status. This involved Section 721 partnership contributions. Under Section 721(a), neither a partnership nor any of its partners recognize gain or loss when property is contributed to a partnership in exchange for a partnership interest.

In Letter Ruling 9644027, the taxpayers contributed assets to each LLC in exchange for a membership interest in that LLC. After the formation of the LLCs, the taxpayers who contributed the net assets of the dealerships stayed in existence and maintained a majority ownership interest in the profits and capital of each LLC. Letter Ruling 9644027 is discussed at length in the December 1996 *LIFO Lookout,* and it identified the taxpayers involved there as automobile dealerships. LTR 9644027 seems to place strong reliance on (1) the expectation that the success of the motor vehicle dealerships depended largely upon the effectiveness of the general manager and (2) the belief that vehicle manufacturers commonly insisted that general managers be allowed to acquire an incentive ownership interest in the dealerships they manage. The taxpayer's "need" to accommodate the manufacturers on this point may have been given more weight in Letter Ruling 96440027 than it might warrant elsewhere.

CONCLUSION

Letter Rulings 9716003 and 9644027 are now helping to fill in some of the gaps so taxpayers can know how the IRS is currently interpreting Section 1363(d).

LIFO & NEW BUSINESS BARGAIN PURCHASES NOT A "BARGAIN" FOR LIFO TAX PURPOSES FOR *LaCROSSE FOOTWEAR, INC.*

LIFO & BARGAIN PURCHASES

In *LaCrosse Footwear, Inc. v. U.S.* (79 AFTR 2nd 97-857), the U.S. Court of Federal Claims added new dimensions to the ongoing tensions between bargain purchases and LIFO elections. In a case in which the Court rejected both IRS arguments, the Court upheld the IRS noting that "the Service's action must be sustained even if it was right for the wrong reason" ...or reasons.

In other words, it seems unlikely that taxpayers still carrying bargain purchase benefits in their LIFO inventories will find any comfort from this case or any lessening of the threat of a major Section 481(a) adjustment should the IRS raise the issue.

The Court held that the Commissioner did not abuse her discretion in denying $3 million worth of locked-in LIFO bargain purchase benefits in a 1982 transaction. Obviously, the IRS audit and its initial objections took place well before the Tax Court decision in *Hamilton* in 1991. Accordingly, by contemporary standards, the arguments raised by the IRS appear to be a little awkward. Nevertheless, the Court addressed and defused the IRS' arguments and then handed the taxpayer its defeat on more general principles. Along the way, the Court wondered aloud why the IRS hadn't spared itself years of controversy by simply challenging the viability of the taxpayer's LIFO election for failure to meet the "conformity-of-reports requirements" in the regulations.

FACTS

In 1982, some of the members of the management and ownership group of Rubber Mills, Inc. formed a new tax entity, LaCrosse, which purchased all of Rubber Mills' assets for $7.5 million. The purchase transaction was consummated on June 21, 1982, effective as of May 1, 1982.

According to the seller's financial statements, the book value for the assets sold was approximately $10.6 million, of which approximately $4.1 million was inventory, $2.1 million was for plant, property and equipment, and the balance was principally for accounts receivable. As part of the overall transaction, the buyer and seller signed an "allocation agreement" providing that, for tax purposes, LaCrosse would assign to the cash and accounts receivable a tax basis equivalent to their full book value to Rubber Mills and, for tax purposes, $1.9 million would be allocated to inventory. The parties did not bargain over the allocation agreement.

For both tax and accounting purposes, LaCrosse elected the dollar-value, double extension LIFO inventory method for its first taxable year ending April 30, 1983. It also elected to use the "earliest acquisitions during the year" method for determining current year inventory cost when valuing closing inventory. It set up two LIFO pools: (1) a natural business unit (NBU) pool for manufactured goods and (2) a purchased goods pool.

After the acquisition, LaCrosse operated essentially as Rubber Mills had, using the same employees, plant and equipment to manufacture, purchase and sell the same types of footwear. Although both companies used LIFO, LaCrosse used two inventory accounting pools, a natural business unit (NBU) pool for manufacturing and another one for wholesaling; whereas Rubber Mills had used only one NBU pool.

LaCrosse placed in its manufactured pool two types of goods. The first was the goods used or produced in Rubber Mills' manufacturing process (raw materials, work-in-process, and a very large volume — representing $3.8 million of the $5.4 million FIFO book value of Rubber Mills' manufacturing pool — of finished manufactured goods). The second type was the (identical) goods LaCrosse subsequently manufactured, or used in manufacture.

In its purchased goods pool, LaCrosse placed (1) the finished goods purchased for resale by Rubber Mills (a small dollar quantity, $440,000) and (2) those goods purchased subsequently by LaCrosse for resale (also a relatively small amount).

In 1986, the IRS audited LaCrosse's 1983 return, challenging the valuation of the base-year cost of its inventories at the bargain purchase price. The Service's contention was that goods obtained in a bulk purchase immediately after a taxpayer's incorporation may not be treated as opening inventory, but rather they should be treated as the first acquisition. It also required LaCrosse to place the finished goods portion of the bargain bulk purchase inventory into LaCrosse's purchased pool. LaCrosse agreed to increase its base-year cost valuation by $1.5 million (from $1.9 million to $3.4 million) and, correspondingly, reduce its "cost of goods sold."

LaCrosse paid the tax and interest in 1987 and filed amended returns seeking a refund in 1989 based on the decision in *UFE, Inc. v. Commissioner*, 92 T.C. 1314 (1989), which upheld the taxpayer's

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position in similar circumstances. (The Service has never acquiesced to the Tax Court's position in *UFE.*)

The IRS raised two principal arguments to the use of LaCrosse's LIFO methods. The first argument was that the goods LaCrosse subsequently (after the purchase of Rubber Mills) purchased, whether for resale or for use in the manufacturing process, must be treated as different classes of goods ("items") from the identical goods acquired earlier from Rubber Mills, because of the significant price differential between the bargain cost of the acquired goods and the (market) cost of the goods it subsequently bought or manufactured. The second argument was that all of the inventory purchased at a bargain from Rubber Mills, including what would have been Rubber Mills' manufactured inventory, belonged in LaCrosse's purchased goods pool.

The IRS argued that LIFO accounting treatment is intended to compensate **only** for the effects of inflation on the out-of-pocket costs a merchant or manufacturer must incur each year in order to merely maintain his current inventory levels ... LIFO is not intended to permit a one-time bargain purchase price to shelter indefinitely a taxpayer's subsequent in-hand income unrelated to inflation. The IRS argued that LaCrosse's item and pooling treatments allowed it to defer, through each succeeding year that the goods comprising that "item" or pool of inventory were not liquidated (i.e., so long as LaCrosse kept its year-end inventories up to prior levels), any recognition and taxation of actual income or "profit" from this bargain purchase.

As discussed below, the Court rejected both of the IRS objections ... but it nevertheless concluded that disallowance of LaCrosse's method of accounting was proper because use of the bargain price for base-year LIFO inventory cost does not clearly reflect income.

COURT ASKS: WHY DIDN'T IRS THROW OUT LIFO BECAUSE OF CONFORMITY VIOLATIONS? ... ANOTHER TIME BOMB?

In its analysis, the Court observed that LaCrosse had used the bargain price ($1.9 million) of the inventory acquired from Rubber Mills to determine its tax liability, but that it had used the FIFO value of the inventory on its financial statement balance sheets. The Court said it also appeared that LaCrosse used the latter figure (i.e., the FIFO value) as its base-year cost to determine the cost of goods sold that appeared in its income statements and that ... "only in a note to the financial statements is it disclosed that the inventory had a much lower tax value."

The Court said: "This would seem to violate the requirement of I.R.C. Section 472(c)(1) and (e)(2) that a LIFO taxpayer use the same inventory accounting method to report its income (as opposed to its balance sheet assets) ... to its shareholders as it does to calculate its income for tax purposes. ... The Regulation permits a taxpayer to state its income to its shareholders under another method than its tax method, provided that the **TAX METHOD** calculation appears on the face of the income statement, and the **OTHER** calculation is presented only in a footnote ... This is the opposite of what LaCrosse apparently did. ... Plaintiff bears the burden of proving that its financial reports conform to its tax calculation ... (and) the Commissioner may require a taxpayer that violates the rule to change its tax accounting method to clearly reflect income."

In a footnote to its opinion, the Court said: ***"It is unclear to the court why defendant (i.e., the IRS) did not invoke its discretion to rule that plaintiff's LIFO election was invalid for failure to meet the conformity-of-reports requirements ..."***

IRS "ITEM" ARGUMENT ... WHAT THE COURT SAID

The IRS' first argument was that the goods LaCrosse acquired from Rubber Mills must be treated as different "items" from identical items that LaCrosse manufactured or acquired after the date of the bargain purchase. This was based on the substantially lower bargain price of the goods acquired from Rubber Mills.

LaCrosse disagreed with the IRS on the grounds that the result produced was inconsistent with:

1. ... the LIFO matching principle,
2. ... the AICPA LIFO Issues Paper: *Identification and Discussion of Certain Financial Accounting and Reporting Issues Concerning LIFO Inventories* (1984), and
3. ... industry practice.

LaCrosse unsuccessfully attempted to find a measure of protection in the AICPA LIFO Issues Paper. Apparently, the IRS' expert witness thoroughly thrashed this AICPA document which does not represent GAAP or any other authoritative source of accounting principles. The Court noted that APB opinions are the most authoritative pronouncements of the accounting profession. As such, only APB opinions provide a standard as to the most accurate method for clear reflection of income provided by accounting practice. LaCrosse's method was inconsistent with the most authoritative GAAP rules, as found in APB No. 16. Similarly, the Court found the

see **LIFO FOR NEW BUSINESS NOT A "BARGAIN",** page 16

evidence presented by the taxpayer of Industry practice to be "neither persuasive nor relevant."

The Court observed that bargain purchase LIFO inventory issues had previously been before other courts which held that bargain bulk purchase inventory must be treated as different items from identical goods acquired or manufactured afterward at greater cost. Referring to the *Kohler Co.* and *Hamilton Industries* cases, the Court recognized that neither constituted binding precedent on it.

The Court observed that the IRS result would require the creation of a new item based on increased cost only after *substantial* or *material* price changes, sufficient to cause the prices to be "greatly disparate." The Court was not persuaded by the taxpayer's references to industry practice or to the AICPA accounting profession Issues Paper. However, it did accept the taxpayer's "bottom line" position: "... based ... on the unworkability of defendant's (i.e., the IRS') standard, its inconsistency with LIFO principles and the absence of any support for that standard in the statute or regulations. Determining what is so 'substantial' that a new item must be created may appear easy when there is a 96% discount in base year cost, as in *Hamilton*, but (it) is difficult if not impossible, to specify in other cases. ... Delineating the extent of value change that constitutes a change in item classification is a project for the agency (i.e., the IRS) by regulations, not for a court."

The Court observed that such a standard should have been communicated to the taxpayer in advance so that it might plan its business, maintain proper records of sales and purchases, and calculate its taxes accurately. Without such a standard, the Court concluded the Service "may be branded as arbitrary." The decided cases - *Kohler* and *Hamilton* - use an *ad hoc* approach, looking at price as a factor creating the new item ... rather than setting forth criteria expressed in more specific terms.

LaCrosse argued that the IRS position was inconsistent with the LIFO matching principle. The Court agreed, stating that "creating and carrying on one's books a potentially limitless number of 'items' of the identical goods based upon price variations alone also would be administratively burdensome." Thus, that requirement would be "inconsistent with the purposes of the dollar-value, double extension LIFO inventory accounting rules, which are designed precisely to ***ELIMINATE*** the need to track or trace specific or particular goods, ... as would be necessary under this approach if there were frequent price fluctuations."

Another of the Court's comments was that ... "using increased unit cost **alone** as a basis for differentiating goods in inventory flies in the face of another purpose of dollar-value inventory accounting, which is to measure in inventory costs ***ONLY*** in the ***AGGREGATE***, from year to year." Interestingly, the Court referred to IRS Technical Advice Memo 9243010 in this respect.

Based on the foregoing, the Court held that the goods LaCrosse acquired from Rubber Mills may be placed in the same item category as the identical goods subsequently acquired for manufacture, manufactured or purchased for resale, as the case may be, by LaCrosse.

IRS "POOLING" ARGUMENT ... WHAT THE COURT SAID

The IRS' second/alternative argument was that all of the inventory LaCrosse had acquired from Rubber Mills should have been placed in LaCrosse's purchased goods pool ...and that none of it belonged in its manufactured goods pool.

The IRS cited Reg. Sec. 1.472-8(b)(2)(I), which states: "Where a manufacturer or processor is also ENGAGED in the wholesaling or retailing of goods purchased from others, the wholesaling or retailing operations WITH RESPECT TO SUCH PURCHASED GOODS shall not be considered a part of any manufacturing or processing unit."

According to the IRS, this regulation forbids a dual-function taxpayer from including bulk-purchased raw materials, work-in-process, or finished manufactured goods from another manufacturer in its own manufactured goods pool. Instead, it would require that ALL of the acquired goods be placed in the purchased goods pool, even in a one-time-only acquisition situation.

Application to purchased raw materials and WIP: As to the raw materials and work-in-process purchased from Rubber Mills, the Court found that, as a matter of fact, LaCrosse never intended to be - and never was - "engaged in the wholesaling or retailing" of "SUCH purchased goods" either before or after the bargain purchase transaction. The Court found instead that LaCrosse intended to use those purchased goods (i.e., RM and WIP) only in its manufacturing process. "That LaCrosse wholesales some goods does not convert other goods it purchases solely for use in the manufacturing process into goods purchased for wholesaling or retailing. Therefore, plaintiff's (i.e., LaCrosse's) pooling treatment as to those goods was correct. See *Hamilton Industries*, 97 T.C. at 134-35 and *UFE, Inc.*, 92 T.C.

see **LIFO FOR NEW BUSINESS NOT A "BARGAIN",** page 18

OBSERVATIONS ... AND POSSIBLE LIMITATIONS IN OTHER BARGAIN PURCHASE SITUATIONS

LACROSSE FOOTWEAR

Some of the underlying facts in *LaCrosse Footwear, Inc.* may present limitations to expanding the holding in this case - or its conclusion - to other LIFO/bargain purchase scenarios.

1. The taxpayer was a new (i.e., newly formed) entity. As such, it had no prior existence ... and the Court weighed heavily on this fact in disallowing the use of the "earliest acquisitions" method by a "new" taxpayer to determine current year cost for purposes of valuing a LIFO increment in its first year.

In its recitation of "Standards of Review," the Court said:

> " ... When 'no method of accounting has been regularly used,' as here, with a new corporation first electing a method of accounting, the computation or method 'shall be made under such method as, in the opinion of the Secretary, does clearly reflect income.' I.R.C. Section 446(b); see Treas. Reg. Section 1.446-1(b)(1). **Thus, the Secretary's discretion is even broader in the case of a new taxpayer**, and the issue raised by some courts, that the Secretary before imposing a new method must first consider whether the taxpayer's current selected method clearly reflects income, does not arise. See e.g., *Photo-Sonic, Inc. v. Commissioner*, 357 F.2d 656, 658 n.1 (9th Cir. 1966)."

2. The bargain purchase transaction was not undertaken by parties negotiating at arm's-length. LaCrosse was formed by certain members of the management and ownership group of Rubber Mills (the entity whose assets were purchased). There were extensive overlaps and numerous familial relationships between the directors, officers and owners of the two groups. The Court said that there is an assumption in the dollar-value LIFO regulations that costs used for inflation measurement purposes are based on arm's-length purchases.

The Court recognized that under Section 482 the IRS could reallocate payments between two corporations "owned or controlled directly or indirectly by the same interests" to clearly reflect income. It stated that "given this authority in the Commissioner, the court need not reach the question of whether the sale was a sham transaction."

3. The valuation which supported the acquisition price was based solely on Rubber Mills' liquidation value. Replacement cost, sales comparison and/or income analysis methods were not considered. The Court said "... absent all three methods, the appraisal may be viewed as highly questionable." Here the Court cited an IRS training manual and observed that the company had been on the market for less than a year at the time when the valuation report had been issued. Although referred to in the stipulation of facts as an asset purchase, in fact LaCrosse's purchase of Rubber Mills was as a going concern.

4. The Court stated that the only business justification given for the sale "appears weak." The "philosophical conflicts" maybe weren't so great, and the Court opined that a "simple buy-out" of one individual's interests might have done the job. The evidence presented was not sufficient to dispel the conclusion that the true purposes driving the sale were (1) to increase business in the more profitable purchased imported goods, (2) to obtain a tax benefit for Rubber Mills from the sale at a loss and, more importantly, (3) to write down the older inventory.

5. The buyer and the seller did not bargain over the "allocation agreement" which allocated $1.9 million to an inventory that had a market value of roughly $5.8 million and a (pre-sale) book value of $4.1 million. The cost to LaCrosse of Rubber Mills' inventory was only 33% of, or 67% less than, its market value ... and only 47% of, or 53% less than, its book value to the seller.

6. *LaCrosse Footwear, Inc.* is an unpublished decision. In general, this means that it is not to be treated as having precedented value. (But neither are Letter Rulings and TAMs, but they are referred to all the time by taxpayers, the IRS and the courts.)

at 1322, "holding that a taxpayer acquiring the assets of a manufacturing business that the taxpayer then carries on is a manufacturer, not a wholesaler, of the inventory."

There was no dispute that LaCrosse was "engaged in wholesaling or retailing" the goods that Rubber Mills had purchased for wholesaling or retailing, as well as those goods that LaCrosse subsequently purchased for wholesaling or retailing. Accordingly, the Court held that it properly placed those goods in its purchased goods pool.

Application to finished manufactured goods: The Court said that the situation with respect to the finished manufactured goods purchased from Rubber Mills was more difficult. It is hard to determine whether these goods are identical to those LaCrosse was (later) "engaged" in wholesaling or retailing, either as a matter of intent at the time of their purchase or as a matter of subsequent practice. No *evidence* was presented as to whether LaCrosse intended to (or did) engage in "wholesaling" any or all of such goods. It seemed unlikely to the Court that **all** of such goods were wholesaled. Witnesses had described the goods both Rubber Mills and LaCrosse were engaged in purchasing for resale as being athletic footwear, fashion boots and "moon boots." However, the goods both companies manufactured included only some of these categories (athletic shoes, but not "moon boots"). Only if there were an overlap between these two categories could the overlapping finished manufactured goods from Rubber Mills arguably be deemed the same as goods LaCrosse was engaged in purchasing for resale and, thus, allocable to LaCrosse's purchased goods pool.

In other words, only those finished goods manufactured by Rubber Mills that were identical to goods that LaCrosse intended to (or did) regularly engage in wholesaling belonged in LaCrosse's purchased goods pool. The Court distinguished *UFE, Amity Leather,* and *Hamilton Industries. Amity Leather*, 82 T.C. at 738 held that when there is a regular purchase of goods identical to its manufactured goods from a subsidiary for resale, the purchased goods belong in the purchaser's purchased goods pool. Neither *Hamilton Industries* nor *UFE* requires a contrary rule. In *UFE*, as in the instant case involving LaCrosse, there was a one-time purchase of the goods *that were* identical to those manufactured by the purchaser. The purchased goods were not required to be placed in a purchased goods pool. In *Hamilton Industries*, too, the purchases were "isolated," and they were "part of larger business acquisitions"; furthermore, the goods were not identical to the manufactured goods, as they were in *Amity Leather*.

WHAT THE COURT SAID ABOUT ISSUES THE IRS *DIDN'T* RAISE ... AND THE TAXPAYER HOPED WOULD BE IGNORED

After dismissing the two principal "item" and "pooling" arguments raised by the IRS, the Court concluded that the Commissioner did not abuse her discretion in determining that LaCrosse's application of LIFO inventory accounting methods to its first year's inventory, as carried through to succeeding years, did *not clearly reflect income*. Below is a somewhat paraphrased and edited summary - with most citations omitted - of the Court's analysis.

THE IMPORTANCE OF (NOT) BEING "NEW"

The question of how to set the base-year "cost" of items **first** entering the **new** *taxpayer LaCrosse's* opening inventory during its **first** taxable year is not answered by the tax rules. The general inventory regulation (Reg. Sec. 1.471-2(c)) states that the basis of valuing inventories is "(1) cost and (2) cost or market, whichever is lower." However, Reg. Sec. 1.471-2(c) is largely descriptive and it specifically excepts LIFO inventories and refers to Reg. Sec. 1.472 for the rules governing LIFO inventory accounting.

The general LIFO regulation which states that "inventory shall be taken at cost regardless of market value" specifically excepts computations under Section 1.472-8 "with respect to the 'dollar-value' method." This leaves Reg. Sec. 1.472-8(e)(2) as the specific rule for dollar-value, double-extension LIFO, and specific rules are to be given precedence over general rules.

Note, however, that the specific dollar-value, double-extension regulation measures only the cost of new items entering the pool ***AFTER*** the base date: it provides no express guidance as to how to set the base-year "cost" of items or other inventory entering the pool ***AT*** the beginning of the first taxable year **for a new taxpayer**. For such inventory, the regulation states that current-year cost is the measure of cost of a new item unless the taxpayer reconstructs its cost on the base date, i.e., the first day of the taxable year that the pool was created.

Purportedly relying on this rule, LaCrosse looked to the three measures for current-year cost and selected "first acquisition cost," i.e., the bargain purchase cost. However, this rule, by its terms, is not applicable to a new taxpayer's opening inventory on its base date; it is applicable only to new items entering an existing taxpayer's inventory after the base date.

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CERTAIN USEFUL PRESUMPTIONS

The specific dollar-value LIFO regulation does appear to incorporate certain useful presumptions:

1. One presumption is that base-year cost will be based either on an approximation of current MARKET value, determined by actual current-year purchase cost (whether first acquisition, average cost or latest purchase) or on an historical (reconstructed) MARKET value.

2. Another presumption is that the HIGHER cost (in a time of rising costs, such as would prompt a LIFO election in the first place) is the taxpayer's current-year cost. Furthermore, this (i.e., current-year cost) will presumptively be imposed in lieu of a lower cost, UNLESS the taxpayer is able to reconstruct the lower cost.

3. Finally, all the current-year cost measures reflect **actual** cost to the taxpayer as determined by actual purchases. Thus, these measures presumptively are intended to be **arm's-length purchases**. If so, they must reflect current-year fair market value. If the taxpayer wishes to use an even lower figure than its best actual arm's-length current-year cost measure to establish base-year cost, the taxpayer bears the burden of reconstructing the (market) cost on the base date. Thus, the regulation does not appear to contemplate the circumstance urged by LaCrosse, that the current-year cost — and thus the base-year cost — for a new item would be LOWER than a market historical (reconstructed) cost. (For this very reason, perhaps, no write-DOWN, even to market, is allowed by the LIFO rules.)

CAN'T CONDONE MANIPULATION

The assumption of the dollar-value LIFO regulation that both the (reconstructed) base-year cost and the current-year cost will reflect actual out-of-pocket costs, i.e., what it actually cost the taxpayer to obtain the goods in an arm's-length transaction, does not appear to envision that a taxpayer selecting dollar-value LIFO in its first year of operation may either (1) begin operations with an inventory priced at a non-market (bargain) cost or (2) select a current-year cost measure based on an inflated non-market (non-arm's-length) purchase.

Allowing base-year cost for dollar-value LIFO inventories by *a new corporation first electing LIFO* to be calculated as LaCrosse urges, i.e., based on an actual (but bargain) cost of a corporation's opening inventory that tax year, rather than on the market value of that inventory, **would permit manipulation**. For example, pricing a new item with a market value of $10,000 at $1 because of a fortuitous non-arm's-length purchase could set the taxpayer's base-year cost for that item at $1 in perpetuity. This would shelter $9,999 of the sales income as Cost of Goods Sold for that item in every succeeding year. **Such a reading of the LIFO regulations leads to a ludicrous, and thus presumably unintended, result.** The Court said that such a result would be similar to that produced by the "base stock method" under which artificially low base prices are used and costs above those amounts are carried into Cost of Goods Sold. These results are not permissible because they obscure the true gain or loss for the year and, thus, misrepresent the facts.

The Court observed that LaCrosse used the bargain price of the inventory acquired from Rubber Mills to determine its tax liability but used the Rubber Mills FIFO value of the inventory on its financial statement balance sheets. It also appeared that LaCrosse used the latter figure as its base-year cost to determine the cost of goods sold that appeared in its income statements. Only in a note to the financial statements was it disclosed that the inventory had a much lower tax value. The Court said that this would seem to violate the "conformity" requirement that a LIFO taxpayer use the same inventory accounting method to report its income (as opposed to its balance sheet assets) to its shareholders as it does to calculate its income for tax purposes.

LaCrosse's current-year cost-based tax accounting approach also was inconsistent with GAAP. Whatever basis rules LaCrosse relied upon squarely conflicted with the AICPA accounting rules, which require that the "fair value" at the acquisition date of such bargain-purchased goods be reflected on a company's financial statements and that, if the fair value exceeds the cost, negative goodwill (a deferred credit) must be recorded and amortized. See APB Op. No. 16. The negative goodwill is simply the difference between FMV and cost. Moreover, as previously noted, LaCrosse DID record the fair market value (i.e., the purchase price in an arm's-length transaction) of the bargain inventory for book, but not for tax, purposes. Therefore, the book value of the inventory recorded by LaCrosse for financial accounting purposes was higher than its tax value to LaCrosse. This conflicted with the rule in Section 446(a) that a taxpayer must compute taxable income under the method of accounting on the basis of which the taxpayer regularly computes its income.

A LIFO index that reflects price increases caused by factors other than cost inflation (such as bargain purchases) foils the purpose of LIFO inventory accounting. "The use of overstated inflation rates to value LIFO inventory pools should be reduced to the

see **LIFO FOR NEW BUSINESS NOT A "BARGAIN"**, page 20

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extent possible." An artificially low base-year cost is preserved in the LIFO index, and thus inflates Cost of Goods Sold ... and reduces taxes... by the deflated amount, year after year.

The assumption of the dollar-value LIFO regulations, which underlies the use of base-year cost as a component of calculating the LIFO layer value and, thus, the Cost of Goods Sold in inflationary circumstances, ***is that current-year cost exceeds base-year cost and that both are based on arm's-length purchases***. "We believe that the potential distortion of income resulting from locking in a bargain purchase as opening inventory ... is particularly great where the selling and acquiring corporations are related and/or the purchase includes a purchase of substantially all the assets ... such that a portion of the purchase price must be allocated to inventory" ... (General Counsel Memorandum 39,470 (Jan. 6, 1986)).

The evidence did not support LaCrosse's contention that it had engaged in a fully arm's-length transaction. There were extensive overlaps and numerous familial relationships between the directors, officers, and owners of the two buying and selling groups.

In addition, the company was on the market for only a relatively brief period of time when a valuation report, based on liquidating values, was issued. Absent consideration of other accepted valuation criteria such as replacement cost, sales comparison, or income analysis methods, the appraisal based on liquidating values only was viewed as highly questionable.

Finally, the only business justification LaCrosse offered for the sale appeared weak to the Court. Insufficient evidence was presented to dispel the conclusion that the true purposes driving the sales were other tax-related considerations.

Section 482 allows the IRS to reallocate payments between two corporations "owned or controlled directly or indirectly by the same interests" to clearly reflect income. Given this authority, the Court said it did not need to address the question of whether the sale was a sham transaction.

CONCLUSION

Accordingly, the Court concluded that the IRS may prohibit LaCrosse from using the bargain cost of the bulk purchase items as the base-year LIFO cost for those items in the year in which they were acquired. Instead, the IRS may require LaCrosse to use a market-based cost to measure the base-year LIFO cost of the goods acquired from Rubber Mills.

The purpose of the calculation of base-year and current-year costs is to approximate the INCREASED cost to the taxpayer due to inflation (general or in the cost of the relevant item) during the taxable year ...the purpose is not to REDUCE the item's base-year cost.

LIFO inventory must be taken at cost in the first LIFO year to prevent "windfall tax liability reduction."

PRE-1996 LIFO BARGAIN PURCHASE CASES: *HAMILTON INDUSTRIES, INC., KOHLER CO. & SUBS.*

BACKGROUND

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

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

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

Seasoned tax practitioners are aware of these "tricks of the trade." However, they are also aware that adhering to all of the formalities still will not guarantee that the IRS won't come along and upset the LIFO benefits frozen into the bargain purchase inventories. This article discusses the pre-1996 litigating activity by the Internal Revenue Service which is evidenced in three actions:

1. *Hamilton Industries, Inc.*, July 1991 Tax Court case, as followed up by IRS Announcement 91-173,
2. Coordinated Issue Paper on bargain purchases of inventory in September 1995, and
3. *Kohler Co. & Subsidiaries*, US Court of Federal Claims, November 1995.

The two pre-1996 cases were both decided in favor of the IRS.

The post-1996 decision also supporting the IRS in *LaCrosse Footwear, Inc.* is less dependent on precise technical item and pooling arguments. In denying LIFO benefits for a bargain purchase situation, *LaCrosse* emphasizes more the broader statutory requirement of clear reflection of income and underpins this by bringing in two observations - or arguments - not mentioned in the previous cases. These "new" observations relate to (1) the importance or distinction between a new entity versus an entity already in existence making the acquisition and (2) the presumption of arm's-length market prices being the factors that Congress intended as the measurements for inflation determinations.

HAMILTON INDUSTRIES, INC... 1991

In 1991, the Tax Court upheld the IRS in *Hamilton Industries, Inc.* (97 TC 120, Dec. 47,501). This is the leading case involving the election of LIFO immediately after a taxpayer makes a bulk bargain purchase of inventory. This decision was filed July 30, 1991, and on November 7, 1991, it was followed by IRS Announcement 91-173 (IRB 1991-47).

Hamilton Industries involved two bargain purchases of inventory, the earlier one at about 4 cents on the dollar and the later one at about 40 cents on the dollar. These bargain purchases were 'locked in' by double extension LIFO method elections in an effort to indefinitely postpone or defer the taxation of income resulting from the bargain elements. In its decision, the Tax Court held that:

1. The IRS could reach back to a year otherwise barred by the statute of limitations by requiring an adjustment under Section 481(a) to the earliest open year, and

see **PRE-1996 LIFO BARGAIN PURCHASE CASES,** page 24

CONSIDERATIONS IN EVALUATING EXPOSURE IN BARGAIN PURCHASE SITUATIONS

PRACTICE GUIDE

COMMENTS

TRANSACTION MECHANICS

1. Was the inventory acquired purchased from an unrelated seller or unrelated parties? (*LaCrosse Footwear*)
2. Was the purchase price an arm's-length price? (*LaCrosse Footwear*)
3. Was the purchasing entity a newly created entity? (*LaCrosse Footwear*)
4. Was the bargain purchase an isolated transaction in the course of an ongoing business?

LIFO MECHANICS

5. In the year of the bargain purchase, was Form 970 filed with the tax return?
   - In what year (or years) did the bargain purchase(s) occur?
   - Is there a copy of the Form 970 ...with all attachments ...in the file?
6. Were the appropriate LIFO sub-methods elected:
   - Dollar-value method,
   - Link-chain, index method,
   - Earliest acquisitions (i.e., first purchases) cost method for valuing increments?
7. Were two separate pools set up for (1) goods purchased for manufacture and (2) goods purchased for wholesaling and/or retailing? (*LaCrosse Footwear*)
8. Recordkeeping & Flow of Goods: Does the client have detailed records to show that the specific inventory items purchased at a (bargain) discount were on hand at the end of the year (...to rebut the **greater than usual presumption of correctness** that will attach to the Commisioner's/IRS agent's determination)? (*Hamilton Industries* & ISP 1995 Coordinated Issue Paper.)

MATERIALITY OF DISCOUNT AMOUNT

9. How large are the bargain purchase discounts? ...How do they compare with:
   - *Hamilton Industries* - 96% discount
   - *Hamilton Industries* - 60% discount
   - *Kohler & Subs.* - 50% discount
   - *LaCrosse Footwear* - 33% of market value
   - *LaCrosse Footwear* - 47% of net book value

MANIPULATION

10. In any of the years following the initial bargain purchase, have there been any attempts to manipulate the ending inventory level in order to avoid a penetration of the lower bargain cost inventory layer(s)?
11. In any of the years since the initial bargain purchase, have there been any manipulations or unauthorized changes in item determinations or pooling affecting the pools in which the bargain purchases are frozen? If so, explain.

FINANCIAL REPORTING & DISCLOSURE

12. Has the taxpayer issued (audited ...or any other) financial statements?
    If so, is there any disclosure of the bargain purchase inventories in the financial statements?
    In your opinion, is such disclosure adequate? Might there be a LIFO conformity issue?

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PRACTICE GUIDE

COMMENTS

PENALTY & PRACTICE EXPOSURE

13. Have you discussed with the client/taxpayer the potential exposure to a *Hamilton*-type bargain purchase LIFO adjustment if the Service raises the issue?
14. Have you discussed the merits or possibility of filing Form 3115 before an IRS audit commences (i.e., before the taxpayer comes "under examination")?

    Section 5.02(3) of Revenue Procedure 97-27 provides that a Section 481(a) adjustment will (usually) be required for *Hamilton*-type adjustments... because... "Announcement 91-173, 1991-47 I.R.B. 29 (regarding LIFO taxpayers changing their method of accounting for certain bulk bargain purchases of inventory to comply with *Hamilton Industries*...) is an example of other published guidance that requires a Section 481(a) adjustment."
15. If this client has not been a client of the Firm since it (i.e., the client) started in business, have you inquired or determined whether there have been any bargain purchases in prior years (or that were handled by predecessor CPAs) that are frozen in the LIFO pools?
    - Do you have a representation from management in this regard?
    - Have you discussed this with the predecessor CPA firm and obtained copies of relevant work papers?

WHAT THE TAX COURT SAID IN *HAMILTON INDUSTRIES*:

"We do not mean to suggest that every bargain purchase of inventoriable property will require the creation of new items within the dollar-value LIFO pool, as occasional purchases concluded on advantageous terms are to be expected in the course of normal business activities. Moreover, where a taxpayer uses LIFO, the gain realized upon sale of such goods probably will be recognized within a short time, unless an increase in closing inventory prevents such bargain cost from flowing into Cost of Goods Sold. Consequently, an isolated bargain purchase in the course of an ongoing business differs materially from the case where a taxpayer attempts to value its entire base-year inventory at bargain cost."

ADDITIONAL COMMENTS & EXPLANATIONS

Preparer's signature and date

Reviewer's signature and date

 (Continued from page 21)

2. The significantly large bargain elements represented by discounts as sizable as those enjoyed by *Hamilton* caused those inventories acquired to assume a different character from similar inventories purchased or produced at prevailing or market prices after the bargain purchases took place.

The bargain purchase price allocations resulted in artificially low values assigned to base year LIFO inventories as compared to the cost of subsequently purchasing or producing these inventories under normal conditions. According to the Tax Court, this, in turn, resulted in a **factor other than inflation** being introduced into the LIFO indexes and LIFO computations. Consequently, the Tax Court held that in order to avoid a distortion of income and in order to "clearly reflect income," the taxpayer, *Hamilton Industries*, should be required to recognize the gain inherent in the bargain cost of the inventory as soon as those goods were sold shortly after the purchase transactions.

In the earlier of the two bulk bargain purchases, the inventory acquired received an allocation of $79,028 - against which the seller's FIFO valuation would have been $2,034,680. That's a bargain of roughly $1,950,000 with the inventory being bought for about 4 cents on the dollar. In the second purchase, the bargain element was about $10 million - or the difference between the purchaser's allocated cost of $6,550,262 compared to the seller's FIFO value of $16,566,320.

In both purchases, the taxpayer further allocated the amount paid for the inventory down to each item in inventory in proportion to its relative FIFO value. After both purchases, the taxpayer also continued the business of manufacturing and selling goods that had been previously carried on by the seller. The products produced or manufactured after the acquisitions were identical to those previously produced by the sellers. LIFO elections to use the double extension, dollar value methods were made by filing Forms 970 in the initial income tax returns filed by the purchasing corporations.

SECTIONS 446 & 481: CHANGES TO EARLIEST OPEN YEAR

In *Hamilton Industries*, the Tax Court held that the substance of each IRS adjustment was a change in the purchaser's method of accounting for inventory. The Court held further that a Section 481(a) adjustment increasing the purchaser's income with respect to the earlier acquisition could be made to the earliest open taxable year (1981) even though that bargain purchase had taken place six (6) years earlier. The Tax Court pointed out that:

1. Adjustments to correct undervaluations of inventory constitute accounting method changes.

2. The use of a practice that results in an understatement of closing inventory postpones - and does not avoid - the inclusion of income... because the income not included due to such understatement in value eventually will be taken into account at such time as the closing inventory is correctly stated.

3. A change in the method of valuing closing inventory constitutes a change in method of accounting to which Section 481 applies.

4. Following from all of this, Section 481 permits an adjustment with respect to closed years to be made during the earliest open year under audit.

After ruling on the applicability of Section 481, the Tax Court looked to the interplay between Section 446 (which covers methods of accounting) and Section 471 (which covers inventories in general). Both Sections 446 and 471 grant the IRS broad discretion in matters of inventory accounting and permit the IRS wide latitude to adjust a taxpayer's method of accounting for inventory in order to clearly reflect income. The Tax Court noted that even if a method of accounting comports with generally accepted accounting principles, consistently applied, if that method does not clearly reflect income, then that method will not control for tax purposes. Here, among other decisions, the Court cited *Thor Power Tool Co.* Consequently, even though the principle of matching current costs and current revenues is involved under Section 472, it appears that Section 471 takes precedence because the "clear reflection of income" requirement/standard appears in both Sections 471 and 472.

BARGAIN PURCHASE IS NOT ATTRIBUTABLE TO INFLATION

"Petitioner seeks to fill its inventory with goods purchased at a steep discount, and then replace them with goods purchased and produced at higher cost. The difference between petitioner's base year inventory cost and inventory cost incurred after the acquisition is **not attributable to inflation,** but rather to the artificially low value assigned base year inventory as compared to the cost of subsequently purchasing or producing such inventory at prevailing market prices. The consequence of permitting such replacement is an increase in the cost of goods sold, resulting in an understatement of petitioner's income.

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"The disparity between the value assigned (to the bargain purchase inventory when compared to the seller's FIFO value for the same inventory) indicates that petitioner purchased such inventory at a substantial discount from its replacement cost or market value, and that such inventory therefore possessed **materially different cost characteristics** from inventory purchased or produced after the acquisitions. We hold that the significantly large bargain element represented by such discount caused inventory acquired to assume a different character from inventory purchased or produced at market prices as represented by the FIFO value of the inventory after the acquisition...

"We do not believe...that permitting a taxpayer to defer recognition of the gain realized on the disposal of such assets by means of accounting devices is appropriate under the circumstances of the instant case. If petitioner were permitted to combine the bargain cost inventory with goods carried at a higher cost, representing the current costs of production, petitioner could postpone recognition of the gain realized on disposal of the bargain cost inventory until such time as it decided to permit a liquidation of the inventory...

"In order to clearly reflect income, (taxpayer) should be required to recognize the gain inherent in the bargain cost inventory at the time such gain is realized, rather than at a later time of petitioner's choosing. Such a requirement is in harmony with the matching principle which is at the heart of the inventory accounting rules (under Section 471). To hold otherwise would permit petitioner to include the cost increases attributable to the replacement of bargain cost inventory with inventory produced at prevailing market prices in the cost of goods sold **as though such cost increases were attributable to inflation.** The LIFO method was not intended to permit taxpayers to include in cost of goods sold cost increases attributable to the replacement of goods with low cost characteristics with goods possessing higher cost characteristics.

"Thus, even though the two classes of inventory were physically the same, the great disparity in their cost warrants separating them. Accordingly, we hold that the inventory acquired (in the bargain purchases) should be treated as items separate from the inventory acquired or produced subsequent to such acquisitions. Such treatment avoids a distortion of petitioner's income, produces a better measure of inflation, and results in a clear reflection of petitioner's income."

(In a footnote, the Tax Court made an analogy between the result under the LIFO lock-in of the bargain purchase element and the **base stock** method of accounting. The **base stock** method is not a permissible method of tax accounting because it "obscures the true gain or loss of the year, and thus, misrepresents the facts.")

Other observations made by the Court were that the Commissioner's determination with respect to the **clear reflection of income is** entitled to **more than** the usual presumption of correctness, and that the taxpayer bears a **heavy** burden in trying to overcome an IRS determination that a particular method of accounting should be used by the taxpayer in order to clearly reflect income. Whether a particular method of accounting clearly reflects income is a question of fact, and that must be decided on a case-by-case basis. More ominously, the Court indicated that the taxpayer carries the burden of showing that the method selected by the Commissioner to clearly reflect income is incorrect and that this burden of proof is extremely difficult for any taxpayer to carry, since the Commissioner's determination as to the proper method of accounting for inventory must be upheld unless it is shown to be plainly arbitrary.

TAXPAYER'S TECHNICAL ARGUMENTS OVERRULED

The Tax Court overruled the taxpayer's three arguments that:

1. Isolated purchase transactions carried on by separate taxable entities did not establish a method of accounting.

2. The determination of when a new item comes into existence is so factual as not to rise to the level of an accounting method.

3. Inventory acquired from the sellers did not constitute an *"item"* within the meaning of the regulations.

As technical arguments, the IRS asserted that the bargain purchase inventory either should not have been included in the same pool or, alternatively, it should not have been included in the same item category as inventory manufactured by the taxpayer **after the** acquisition. Apparently the IRS learned from *Fox Chevrolet* the importance of introducing both **"POOLING"** and **"ITEM"** arguments in tandem against a taxpayer.

see **PRE-1996 LIFO BARGAIN PURCHASE CASES,** page 26

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On the **"POOLING"** issue, the IRS asserted that separate pools were required, but the Tax Court disagreed with the IRS and held for the taxpayer. The Court distinguished its 1984 decision in *Amity Leather Products Co.* (82 TC 726...Dec. 41,221) in which *Amity* was viewed as a 'dual-function entity' both (1) manufacturing leather goods and (2) regularly purchasing identical goods from a subsidiary for resale...a situation requiring separate pools for (1) manufactured goods inventory and (2) purchased goods inventory.

The Tax Court also distinguished its 1989 decision in *UFE, Inc.* (92 TC 1314...Dec. 45,793) in which the taxpayer was not required to have separate pools because it was not held to be a wholesaler or retailer of goods based on a single, isolated purchase occurring in the context of acquiring an ongoing manufacturing business where the taxpayer continued to manufacture identical items after the acquisition. *Hamilton Industries* was found to satisfy the *UFE, Inc.* fact pattern, and the Tax Court did not agree with the IRS on the pooling issue.

However, on the **"ITEM"** issue, the Tax Court examined relevant case law from which various factual patterns have produced isolated definitions of the term "item" on a case-by-case basis. It recognized that prior cases have held that the definition of the term "item" must not be so narrow as to impose unreasonable administrative burdens upon taxpayers, thus rendering impractical the dollar value LIFO inventory approach. On balance, however, it also recognized that the term "item" should be construed in a manner that most closely satisfies the "clear reflection of income" requirement found in the inventory provisions of the Revenue Code.

The Court noted that inventory goods may be in separate "item" categories because they have substantially dissimilar characteristics, whether in terms of their physical nature or whether in terms of their **cost characteristics.** The Court reanalyzed its holding in *Amity Leather Products Co.* where the fact pattern involved the substitution of less expensive goods (at year-end) for more expensive goods (at the beginning of the year), thus tending to overstate taxable income. The *Amity* fact pattern was just the opposite of that found in *Hamilton*, where less expensive goods (at the beginning of the year) were offset by more expensive goods (at the end of the year), thus tending to understate taxable income.

The Tax Court rejected *Hamilton's* arguments that requiring separate accounting for the different items of bargain purchased inventory would impose an undue record keeping burden. It noted that the taxpayer could have easily tracked this inventory as it was being sold off or liquidated by sales in the ordinary course of the conduct of its business. The Tax Court also said that eliminating the significant distortion in taxable income which otherwise would have resulted if the two types of inventory had been allowed to be combined actually justifies or warrants the extra record keeping burden that might be imposed on the taxpayer under these circumstances.

Hamilton, the taxpayer, further argued that the IRS method of correcting its inventories "might not be completely accurate," since the IRS treated all of the bargain purchase inventory as having been sold in the first full taxable year following each acquisition. The Court pointed out that the taxpayer had to do more than **suggest** that the IRS' method might be less than perfect...and the Court noted that since the taxpayer did not maintain any records, it therefore had no basis for demonstrating any alleged inaccuracy in the IRS' assumptions.

The Tax Court did say that "had the cost characteristics assigned to the inventory acquired in (the bargain purchases) not been so disparate from the cost of later acquired inventory, we would not have required their separation."

QUERIES: Are other bulk bargain purchase situations distinguishable from *Hamilton* if their bargain purchase elements are not as extreme as 4 cents on the dollar or 40 cents on the dollar? Where should the line be drawn? Where does a taxpayer or the IRS draw the line in light of Announcement 91-173?

IRS ANNOUNCEMENT 91-173... 1991

As a follow up to *Hamilton Industries*, the IRS issued Announcement 91-173 (IRB 1991-47) on November 7, 1991. This Announcement is intended to provide guidance to taxpayers involving certain voluntary accounting method changes for LIFO inventory pursuant to Section 446 and the Tax Court's decision supporting the IRS in *Hamilton Industries, Inc.*

IRS ANNOUNCEMENT 91-173 contains only three paragraphs. The first paragraph is a preface and the second is a brief summary of the Tax Court's opinion in *Hamilton Industries.* The third paragraph provides that:

1. Taxpayers requesting the advance consent of the IRS to voluntarily change their method of accounting for bulk bargain purchases of inventory to a method consistent with that required by the Tax Court in *Hamilton* are required to file a current Form 3115, Application for Change in Accounting Method.

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2. The IRS will require a Section 481(a) adjustment to implement this LIFO inventory method change for applications filed on or after November 7, 1991 - the date of Announcement 91-173.

3. The provisions relating to Category B methods of accounting described in Revenue Procedure 84-74, or any successor document (i.e., Revenue Procedure 92-20), will apply in determining the applicable Section 481(a) adjustment (spread) period. Note: As of May 15, 1997, Rev. Proc. 92-20 was superseded by Rev. Proc. 97-27 which eliminated all the distinctions between Category A, Category B, Designated A, and Designated B methods of accounting previously identified or established by Rev. Proc. 92-20.

4. If the taxpayer's books and records do not contain sufficient information to accurately compute the Section 481(a) adjustment and revalue LIFO inventories, the Service will **generally** permit the use of **reasonable** estimation procedures.

HAMILTON-TYPE LIFO METHOD CHANGES UNDER REVENUE PROCEDURE 97-27

The Tax Court decision in *Hamilton Industries* was a significant IRS victory, after which the Service immediately followed up with IRS Announcement 91-173. Because of the importance of the *Hamilton* decision, Section 9.01 of Revenue Procedure 92-20 specifically provided that the use of the cut-off method would **not** be allowed where the LIFO inventory issues involve *Hamilton Industries* - type bulk bargain purchases.

This policy of requiring a Section 481(a) adjustment has been continued in Revenue Procedure 97-27. Both Revenue Procedures state that Announcement 91-173 provides that the IRS will require taxpayers to compute and take a net Section 481(a) adjustment into account for a change in method of accounting for certain bulk bargain purchases of inventory required to comply with *Hamilton Industries, Inc. vs. Commissioner*, 97 TC 120(1991). See Rev. Proc. 97-27, Section 5.02(3)(b).

IRS COORDINATED ISSUE PAPER BARGAIN PURCHASES OF INVENTORY ... 1995

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

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

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

FACTORS OTHER THAN INFLATION ... AND THE "CLEAR REFLECTION OF INCOME" ISSUE

The IRS Coordinated Issue Paper comments that a bargain purchase occurs when a taxpayer acquires a bulk quantity of inventory at a price significantly lower than the normal cost of production or purchase. Typically, a new corporation will be set up to make the bargain purchase, and it will adopt a tax year that ends shortly after the date of purchase. This is to ensure that all or most of the inventory purchased at bargain prices will be physically present and included in the LIFO valuation of ending inventory for the first (base) year. By immediately making a dollar-value LIFO election and then by further electing to use the earliest acquisition cost method to value increments, the taxpayer attempts to value its entire base-year inventory at bargain cost.

In computing the value of the LIFO inventory after a bargain purchase, this issue usually arises because the acquiring corporation fails to account for the items purchased at the bargain price separately from other items subsequently purchased or manufactured. Separate **item** accounting can be distinguished from separate **pool** accounting (although, in this context, there is no practical difference). The IRS doesn't need to argue for the establishment of separate **pools** in this context because separate **item** accounting is sufficient to segregate (and perhaps eliminate) the bargain cost inventory.

see **PRE-1996 LIFO BARGAIN PURCHASE CASES,** page 28

The bargain discounts in *Hamilton Industries* were 96% and 60%. *Amity Leather Products*, 82 T.C. 734 (1984), was the only precedential case—at that time—which dealt with the meaning of the term "item" as used in the dollar value regulations in the context of a manufacturing business. In *Amity*, the Tax Court decided that "because the change in the price of an item determines the price index and the index affects the computation of increments and decrements in the LIFO inventory, the definition and scope of an item are extremely important to the clear reflection of income. The Court further stated that if factors other than inflation enter into the cost of inventory items, a reliable index cannot be computed. If the discounted cost is different from the cost of inventory acquired later, the discount represents a factor **other than inflation**.

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

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

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

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

ISP PAPER - 1995 CONCLUSIONS

- For dollar-value LIFO purposes, inventories purchased in bulk at discounted amounts are separate ***items*** from goods purchased or produced subsequently.
- The significance or materiality of the discount is a question of fact to be determined on a case-by-case basis.
- Any change in the definition of an inventory *item* is a change in a method of accounting subject to Section 481.
- The Service will require affected taxpayers to compute and take a net Section 481(a) adjustment into account.
- The taxpayer bears the burden of proving that the specific inventory items purchased at a discount were on hand at the end of the year.

TAXPAYER BEARS THE BURDEN OF PROOF

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

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

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

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

KOHLER CO. AND SUBSIDIARIES... 1995

In November 1995, the United States Court of Federal Claims upheld the IRS and overruled the use of LIFO by *Kohler Co. and Subsidiaries* in connection with a bargain purchase acquisition of initial inventory.

In 1978, Sterling Faucet bought all of the inventory of Rockwell International Corp. at a bargain purchase—50%—discount. In 1984, Kohler Company acquired Sterling Faucet. Many years later, the IRS attacked the use of LIFO in connection with the original acquisition of inventory in 1978. Readers are not burdened with the presentation of many facts in this case. About the only "pure number" presented is the 50% discount, with no further qualification. The cases cited as legal precedent are all familiar names, and the Court concluded that the taxpayer's method did not clearly reflect income where it used the LIFO method of accounting in connection with its original bargain purchase.

As the Court framed the issue, Congress has given the Commissioner of Internal Revenue discretion to change a taxpayer's accounting method if it does not clearly reflect income. The entire opening inventory of the taxpayer in its first year of existence consisted of goods that had been purchased at a substantial discount. The IRS determined that the taxpayer's LIFO accounting method did not reflect income from the sale of these items. Accordingly, the issue was whether those bargain-purchase goods may be grouped with physically similar goods manufactured or purchased at "normal" costs. The goods purchased at a bargain price were physically identical to goods later produced, and the taxpayer believed that the cost difference in the items should not affect the manner in which physically identical goods were accounted for under its LIFO method.

WHAT THE CLAIMS COURT SAID IN *KOHLER*

The Court pointed out that tracking bargain-purchase goods with manufactured goods produced at cost avoids or postpones relatively higher income from the sale of the discounted goods. Because of the LIFO assumption of cost flows, the goods purchased at a discount **might never be included in income**.

Under LIFO, goods that are not considered as sold in the year they are acquired are less likely to be considered as sold in subsequent years when unsold goods are "insulated" by another layer of inventory. This continues every year that the number (or the dollar value) of goods sold is less than the number (or the dollar value) of goods manufactured or purchased. Accordingly, income from the sale of bargain-purchase goods might never be realized...until the company liquidates. For that reason, the Court of Claims held that the Commissioner reasonably determined that the taxpayer's LIFO method of accounting did not clearly reflect income.

In its more detailed discussion, the Court observed that the goal of a taxpayer's (LIFO) accounting method should be to ensure that factors other than inflation do not affect the income calculation.

The Court observed that if a taxpayer were to use the First-In, First-Out (FIFO) method, it would realize greater income earlier because lower priced goods are considered to be sold first. However, that greater income would not account for the (higher, inflationary) cost of replacing goods in inventory. Under LIFO, the higher income from the sale of lower cost, earlier-produced or purchased goods is deferred until the business depletes its prior-year inventory. LIFO allows the taxpayer to match current costs with current revenues more accurately, but LIFO usually results in lower taxes. According to the Court, "this is acceptable because the lower taxes on lower income is *(sic)* attributable to inventory inflation."

To isolate the effect of inflation from other reasons that costs may increase from year-to-year, it is important to group like goods together and to separate dissimilar goods (citing *Amity Leather Products Co. v. Commissioner*, 82 T.C. 726, 731-34 (1984)). The more homogeneous that each inventory category can be made, the better it will screen out cost increases caused by non-inflationary factors, thus producing a clearer reflection of

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income than would be possible with categories containing heterogeneous agglomerations of goods (citing *Hamilton Industries v. Commissioner*, 97 T.C. 120, 132 (1991)).

These groupings are important under dollar-value LIFO because actual goods are not tracked; instead, inventory is tracked or monitored by dollar-aggregate costs. The dollar-value method measures increases or decreases in inventory in terms of total dollars - rather than units - invested in the inventory. The dollar-value LIFO method depends on grouping the inventory goods into "pools" (reflecting the taxpayer's natural business unit or major lines, types or classes of goods) and "items" (which are subdivisions of pools) that will meet this goal (citing *Wendle Ford Sales, Inc. v. Commissioner*, 72 T.C. 447 (1979)).

In *Kohler*, the parties agreed that the technical distinction between "items" and "pools" did not matter for purposes of their dispute. The Court felt that LIFO treatment in this instance was not consistent with the theory that income differences under LIFO accounting are attributable to only "inventory profits" or inflation. Where a taxpayer's inventory has a cost basis that differs from current-year costs for reasons other than inflation, the taxpayer avoids more than inflation; it avoids income attributable to these other factors (i.e., factors other than inflation).

The Court quoted liberally from the *Hamilton* decision, wherein that taxpayer had purchased the inventory assets of two companies at discounts of 96% and 60% of the value of the inventory in the hands of the sellers. The substantial discounts in *Hamilton* indicated that the purchased inventory "possessed materially different **cost characteristics**" from later-purchased or produced inventory, and treating the goods as the same "item" was contrary to the purpose of the LIFO method, which was "not intended to permit taxpayers to include in Cost of Goods Sold cost increases attributable to the replacement of goods with **low cost characteristics** with goods possessing **higher cost characteristics**."

The Tax Court in *Hamilton* pointed out that the "clear reflection of income" determination can only be made on a case-by-case basis. It stated that it did not mean to suggest that every bargain purchase of inventoriable property will require the creation of new items within the dollar-value LIFO pool. Where isolated bargain purchase transactions occurred in the course of an on-going business, those purchases might not be subject to a challenge by the IRS that LIFO was not appropriate.

Here's what the *Hamilton* Court said: "We do not mean to suggest that every bargain purchase of inventoriable property will require the creation of new items within the dollar-value LIFO pool, as occasional purchases concluded on advantageous terms are to be expected in the course of normal business activities. Moreover, where a taxpayer uses LIFO, the gain realized upon sale of such goods probably will be recognized within a short time, unless an increase in closing inventory prevents such bargain cost from flowing into Cost of Goods Sold. Consequently, an isolated bargain purchase in the course of an ongoing business differs materially from the case where a taxpayer attempts to value its entire base-year inventory at bargain cost."

In the *Kohler* situation, the subsidiary had purchased goods at a discount of roughly 50%. In addition, that bulk purchase constituted the subsidiary's entire opening inventory. Citing *Thor Power Tool*, the Court pointed out that "grouping these goods with later-purchased goods or manufactured goods under dollar-value LIFO accounting **would have prevented the income from the sale of these goods from being realized ... for an unknown period of time, perhaps forever.** ...While the deferral of higher income is an acceptable result of the LIFO method of accounting, we cannot find that the (LIFO) method was intended to defer the flow of lower costs that are not the result of inflation."

CHANGE IN ACCOUNTING METHOD—
NO STATUTE OF LIMITATIONS PROTECTION

The bargain purchase transaction in question occurred in 1978. Kohler claimed that the Commissioner's action was improper because the taxable years affected by the change in treatment were barred by the 3-year statute of limitations and that the adjustment was not consistent with Section 481(a).

The Court overruled this contention. It pointed out that "Section 481 would be virtually useless if it did not affect closed years. ...The purpose of Section 481 is to prevent a distortion of income and a windfall for the taxpayer as a result of a change in method that otherwise would be barred by the statute of limitations. ...Thus, Section 481 allows the Commissioner to make adjustments in an open year to closed taxable years and...is proper if it is necessary to prevent the omission of income because of the change in the method of accounting. ...An adjustment in the earliest open taxable year ensures that income will not be omitted. Thus, the adjustment is proper to prevent the omission of income."

 (Continued from page 6)

OTHER CHANGES, POSSIBLY OF LESSER SIGNIFICANCE

Some of the other changes made by Revenue Procedure 97-27 which may be of lesser significance - at least to smaller taxpayers - include:

1. For taxpayers under continuous examination, the window for making accounting method changes during audits that had been going on for at least 18 months has been extended from 30 days to 90 days ... and the minimum 18 month consecutive audit period has been shortened to 12 months.

Thus, a taxpayer may file a Form 3115 to request a change in accounting method during the first 90 days of any taxable year ("90-day window) if the taxpayer has been under examination for at least 12 consecutive months as of the first day of the taxable year. This 90-day window is not available if the method of accounting the taxpayer is requesting to change is an issue the examining agent(s) has placed in suspense at the time the Form 3115 is filed or is an issue under consideration at the time the Form 3115 is filed.

2. A window that previously existed for parent corporations acquiring new subsidiaries to request accounting method changes for those new members within the first 90 days after the acquisition has been eliminated. Therefore, when new members come into a consolidated return group, there is no initial "moratorium" during which accounting method changes can be requested.

3. A new notification procedure now allows taxpayers before an Appeals Officer or before a Federal Court to more easily initiate method changes.

4. A special provision which under the old revenue procedure accelerated the spread period if a taxpayer had a reduction of its inventory by 1/3 has been eliminated.

TRANSITION RULES

CURRENTLY PENDING FORM 3115. The new revenue procedure applies for changes requested as of May 15, 1997. Any application for a change (i.e., any Form 3115) already filed and pending on that date can request that the terms of the new revenue procedure be applied if the taxpayer notifies the IRS that it desires to have the new provisions applied before the IRS issues a ruling granting or denying consent to make the change. Otherwise, the "old" Revenue Procedure 92-20 terms and conditions will apply to Forms 3115 filed and pending on May 15, 1997.

POST-MAY 15, 1997 NEW FORMS 3115 FILED IN 1997. In addition, for applications filed after May 15 and on or before December 31, 1997, a taxpayer may affirmatively request in an attachment to the application that the IRS apply the terms of Revenue Procedure 92-20. Otherwise the terms of Rev. Proc. 97-27 will apply to Forms 3115 filed after May 15, 1997.

OPEN WINDOWS UNDER REV. PROC. 92-20. There is also a special transition rule if, on May 15, 1997, a taxpayer is still within a window period provided by Revenue Procedure 92-20. Note: this could be very important for taxpayers under IRS audits which began after February 16, 1997 ... in which case, for a limited time, they may still come under the old "90-day window" terms and conditions available under Revenue Procedure 92-20.

Whether a taxpayer should opt to be treated under the old rules ... rather than the new rules ... will depend on the spread period that might otherwise be available to it and/or whether the result of coming under a "window" application might be beneficial. As indicated previously, taxpayers under audit with potential LIFO adjustments might seriously consider electing to have the rules of Rev. Proc. 92-20 apply if they are eligible to do so.

CONCLUSION — REV. PROC. 97-27

One might say that the "gradation of incentives" for taxpayers to initiate accounting method changes has been "upgraded" by Revenue Procedure 97-27 as a result of its overall "simplification" approach by eliminating certain classifications, "window" periods and special rules.

However, that may not be the case for specific taxpayers in specific circumstances... especially once an IRS audit starts. Only time will tell. *

presumption that Congress intended that an arm's-length market price was to be used as the basis for measuring inflation for LIFO purposes.

#5. CORPORATE RESHUFFLINGS AND/OR PROJECT 2000 CHANGES MAY TRIGGER LIFO RECAPTURE. We recently mentioned that the IRS has apparently identified an issue regarding "separate trades or businesses" in connection with inventory dispositions and replacements, and this may include situations resulting from Project 2000 reshuffling. Does the disposition of one manufacturer's (line of) inventory collapse all of the existing layers related to that inventory to zero ... and does it prevent the replacement of that line of inventory by another line of inventory before year-end? Does the inventory of another manufacturer that replaces it create only new increment layers in the current year? In essence, if the answers are yes, this would require **separate** LIFO calculations (or prorations) by manufacturer even though under the Alternative LIFO Method *all* manufacturers' new vehicles are supposedly to be combined within the same LIFO pools.

Transfers of inventory, whether or not related to Project 2000 activity, will generate different LIFO ramifications depending on the overall nature of the restructuring and which code sections govern the tax consequences. Different LIFO consequences will be experienced depending on whether dealer rearrangements are structured as outright sales, mergers, other reorganizations under Section 368 and 381(a) or as Section 351 exchanges. Also, depending on the nature of the restructuring, it may be necessary to file new Forms 970 notifying the IRS of the continuation of LIFO elections by the successor entities.

This is also true of entity restructuring and creating done to implement estate and succession planning.

In Letter Ruling 9716003, the IRS looked through a series of steps by which a corporate group essentially changed from C to S status while creating limited partnerships to replace C corp subsidiaries to operate the underlying businesses which had been using the LIFO inventory method. The IRS held that the LIFO recapture tax under Section 1363(d) was triggered by all this maneuvering. This letter ruling is discussed on page 7.

#6. INVENTORY SHRINKAGE *ESTIMATION* METHODS CHALLENGED BY IRS. The IRS rarely hesitates when it comes to challenging the use of "generally accepted accounting principles" in the treatment of inventories for tax purposes by different industries. For example: the treatment of rotable parts, component-of-cost methods used by manufacturers, and replacement cost used by many industries for parts inventories ... have all been challenged in recent years.

Now, add to the list the use of various methods by retailers to estimate inventory shrinkage. Cases decided by the Tax Court this year involve Wal-Mart, Kroger and Dayton-Hudson. In fact, Dayton-Hudson was in the Tax Court a second time over this shrinkage issue.

These cases continue to emphasize the complex rules involved when the IRS challenges accounting methods (for example, see the flow chart for Accounting Methods, Changes & Approval Disputes in the September 1996 issue of the *LIFO Lookout*) and the extreme differences of opinion held by expert witnesses on what is appropriate in attempting to estimate (as contrasted with "measure" or "value") shrinkage in larger retail inventories.

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