



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?

Here's the answer: The IRS issued Revenue Procedure 97-44 and Revenue Ruling 97-42 on September 25, 1997. The Revenue *Procedure* tells dealers how to pay for their conformity violations. The Revenue *Ruling* defines what "conformity violations" are by using three examples or situations.

But watch out: the Revenue Procedure goes way beyond the Revenue Ruling and leaves many questions unanswered.

#2. IRS ISSUES MORE PROCEDURES FOR SPECIALIZED CHANGES IN LIFO ACCOUNTING METHODS.

As we reported in the last issue, Revenue Procedure 97-27 in May simplified many rules, terms and conditions involved when taxpayers request IRS permission to change accounting methods ... including various LIFO methods.

The IRS dropped the requirement that Form 3115 change requests be filed within the first 180 days of the year, and it eliminated difficult technical definitions along with the limited 90-day window relief for taxpayers coming under IRS audit. Also of significance: the 6-year spread period for reporting positive Section 481(a) adjustments in income has been shortened to four (4) years.

Recently, the IRS issued Revenue Procedures 97-36, 97-37 and 97-38. Collectively these deal with selected accounting method changes where taxpayers will be granted automatic consent by the Commissioner to make certain changes. These revenue procedures address (1) termination of LIFO elections, (2) republication of the Alternative LIFO Method for Automobile Dealers, (3) republication of the Service Warranty Income Method (SWIM) for dealer obligors in connection with their extended warranty or

LOOKOUT LOOKS INTO

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VSC contract sales, and (4) certain cost definition matters relating to used vehicle LIFO.

The republication of the Alternative LIFO Method in Revenue Procedure 97-36 and the republication of the SWIM method in Revenue Procedure 97-38 share common elements. First, each method is repeated word-for-word as it was in the originals, with no real modification or clarification of the original. Second, the revenue procedures they replaced (Rev. Proc. 92-79 and 92-98, respectively) contained cumbersome transition rules which the 1997 documents were able to delete. The final common element they share is that if an auto dealer previously elected to make these accounting method changes under the original revenue procedures, then no action by the dealer is required at this time.

These changes are summarized beginning on page 22.

see LIFO UPDATE, page 2

LIFO Update

#3. FORM 3115 TO BE REVISED. As a result of the changes made by all these mid-1997 revenue procedures, including the change allowing the filing of Form 3115 at any time during the year, the IRS is in the process of revising Form 3115. The revised Form 3115 is not yet available.

#4. USED VEHICLE LIFO. As part of Revenue Procedure 97-37, the IRS extended automatic approval change status to certain changes in cost definitions in connection with used vehicle inventories on LIFO. Some have erroneously concluded that this is tantamount to the IRS announcing an officially accepted LIFO methodology for used vehicles. This is not the case!

For used vehicle LIFO, many would seem to agree on *some* of the sub-elections: dollar-value method for valuing LIFO inventories and link-chain, index method for computing the LIFO value of the dollar-value pools.

However, other sub-elections (possibly even pooling) require an IRS "endorsement" before there is any "official," IRS-approved used vehicle LIFO method. Some of the unanswered questions relate to (1) item category definitions, (2) new item definitions, (3) price reconstruction, (4) increment valuation, and (5) whether (major) options and accessories and/or vehicle condition need to be repriced or otherwise taken into consideration in the process. Until these matters are "officially" clarified or covered in a revenue procedure by the IRS, there can be no official used vehicle LIFO method. Cut-off (audit) protection under Rev. Proc. 97-37 is not extended to prior years' *calculations* to the extent they are affected by all of these other considerations.

It should be stressed that the Revenue Procedure 97-36 (formerly 92-79) methodology for *new* vehicle LIFO that is automatically accepted by the IRS... *does not apply to used vehicles*. Accordingly, there is still no IRS-approved LIFO method for used vehicles at this time.

#5. RECORD RETENTION:

HOW LONG IS LONG ENOUGH? In Revenue Procedure 97-22, the IRS issued guidance for taxpayers using electronic storage systems to maintain their books and records. This includes various electronic retention alternatives to microfiche. An electronic storage system is one used to prepare, record, transfer, index, store, preserve, retrieve, and reproduce books and records. These may be done

(Continued from page 2)

either by (1) electronically imaging hardcopy documents to an electronic storage media, or (2) transferring computerized books and records to an electronic storage media using a technique that allows them to be viewed or reproduced without using the original program. If records in an electronic storage system comply with Rev. Proc. 97-22, they will be treated as being in compliance with the recordkeeping requirements of Section 6001.

An IRS District Director may periodically test a taxpayer's electronic storage system, but such "test" will not constitute an *examination, investigation, or inspection* of the books and records. See Rev. Proc. 97-22 for more particulars. Also, keep in mind that the statute of limitations basically does not expire on "books and records" used in support of LIFO calculations because of the ever-present possibility of a Section 481(a) adjustment where inventories are involved.

#6. INVENTORY TRANSFERS AND CARRYOVER BASIS.

In Letter Rulings 9730002 and -003, the IRS ruled that under the dollar-value LIFO method, corporations were not required to treat inventory received in a Section 351 exchange as separate items from otherwise identical inventory that was acquired later in the year. The IRS concluded in both LTRs that the corporations should not treat the goods received in the Section 351 transfers and physically identical goods later acquired as separate items solely because of the relatively low carryover basis of the inventories included in the Section 351 exchanges.

The National Office recognized that requiring separate item treatment would not tax the Section 351 exchange itself, even though that result would be contrary to the Tax Court's holdings in *Amity Leather* and in *Hamilton Industries*. Both of these decisions would have resulted in a tax on the built-in inventory gains almost immediately after the exchange.

In these LTRs, the National Office reasoned that Congress must have intended an incorporation to be treated as a mere change in the form of the underlying business and that it enacted Section 351 to encourage or facilitate business adjustments by allowing such businesses to incorporate without incurring the recognition of gain.

Accordingly, legislative intent underlying Section 351 was recognized as taking precedence here over the Tax Court's decisions in *Amity* and *Hamilton*. *



RELIEF FINALLY ARRIVES FOR AUTO DEALERS WITH LIFO CONFORMITY VIOLATIONS: REV. RUL. 97-42 & REV. PROC. 97-44

4.7 %
RELIEF
"TAX"

After many difficult deliberations with NADA, the Internal Revenue Service on September 25, 1997 finally issued its "official" relief plan for auto dealers with financial statement conformity violations.

The "good news" is that dealers with certain conformity violations will not be thrown off of LIFO or be forced to immediately pay back the tax on their entire LIFO reserves. The "not-quite-so-good news" is that those dealers will have to pay a non-refundable relief tax or "Settlement Amount" starting next year over three equal installments. The "bad news" is that many dealers and their CPAs are still left hanging because the IRS danced around too many very significant issues and questions and then finally and deliberately dodged them. This leaves taxpayers to draw their own conclusions... and possibly bring upon themselves what could be disastrous consequences if they guess wrong.

Revenue Ruling 97-42 holds that a franchised automobile dealer violated the LIFO conformity requirement if it provided to a credit subsidiary of its franchisor (i.e., of the Factory/manufacturer) an Income Statement for a full year that failed to reflect an adjustment for the change in the LIFO reserves in the computation of net income.

Revenue Procedure 97-44 provides the "relief" available to auto dealers who failed the conformity test. It sets out the terms and conditions by which dealers can still stay on LIFO by paying a penalty or "Settlement Amount". What is critical is that only a very limited fact pattern is addressed in Revenue Ruling 97-42. This involves the submission of statements, directly or indirectly, to an automobile manufacturer's credit subsidiary (i.e., GMAC, Ford Motor Credit Corporation, Chrysler Credit Corporation, etc.). But what if a dealer was not floorplanning through the manufacturers' affiliates and issued the Factory statement only to the Factory? This and other thorny questions cause some to wish the IRS had taken a little longer and really "gotten its act together" before releasing two documents addressing this highly visible and volatile issue. See: "Questions Needing Answers" on page 10.

CONFORMITY VIOLATIONS AS DEFINED IN REV. RUL. 97-42

Rev. Rul. 97-42 is limited to those dealers who provide financial statements "to the credit subsidiary"

of their franchisor (i.e., the Factory). The Ruling establishes that such statements are received by the financing subsidiaries or affiliates of the manufacturer "for credit purposes" because they were issued to a creditor with whom the dealerships "maintain continuing credit relationships." Thus, they are covered within the meaning of Sections 472(c) and (e)(2). The Revenue Ruling also provides that estimates may be used without violating the conformity requirement because the use of cost estimates is an example of a costing method that is not inconsistent with the LIFO inventory method. Three different dealership year-end Income Statement reporting situations are given as examples:

3 EXAMPLES

- The year-end statement reflects a LIFO adjustment in Gross Profit (i.e., in the Cost of Goods Sold section).
- A LIFO adjustment is reflected in the "Other Income" or "Other Expense" accounts in arriving at Net Income.
- A LIFO adjustment is not reflected anywhere or in any way in the Income Statement.

In the first two examples or situations, the IRS holds that the dealers have not violated the conformity requirement. This establishes that, on a prospective basis, dealers are not going to be required to include year-end LIFO adjustments in the Cost of Goods Sold section of the Income Statement in order to satisfy the conformity requirement. They will be allowed to reflect the change in the LIFO reserve elsewhere in the Income Statement... as long as it is reflected somewhere in the Income Statement.

In the third situation, because there was no adjustment for the change in the LIFO reserve reflected in the year-end Income Statement to the Factory ... which statement also went to the credit corporation ... there was a violation of the LIFO conformity requirement. Rev. Rul. 97-42 holds that this violation result would have occurred even if there had been some reflection of the LIFO reserve change or of the LIFO reserves in the Balance Sheet.

The full text of Revenue Ruling 97-42 is included beginning on page 13.

see RELIEF FINALLY ARRIVES FOR AUTO DEALERS..., page 8



**AT A
GLANCE**

**REV. PROC. 97-44 RELIEF FOR AUTO DEALERS
WITH LIFO CONFORMITY VIOLATIONS**

<p>RELIEF "GOOD NEWS"</p>	<ul style="list-style-type: none"> • Dealers with conformity violations "within the scope of Rev. Proc. 97-44" will not have their LIFO elections terminated. • LIFO adjustments must appear in the income statement ... but they do <u>not</u> have to be made to the Cost of Goods Sold account. • LIFO adjustments may appear <u>anywhere</u> on the Statement of Income.
<p>LOOK-BACK PERIOD</p>	<ul style="list-style-type: none"> • Six (6) most recent taxable years ending on or before October 14, 1997. • Calendar year taxpayers: December 31, 1991...1992...1993...1994...1995 & 1996. • Fiscal years (September or earlier): xx/xx/92...93...94...95...96 & 97.
<p>PENALTY AMOUNT</p>	<ul style="list-style-type: none"> • 4.7% times LIFO reserves on the last day of the last taxable year ended on or before October 14, 1997. • For calendar year dealerships: 4.7% times December 31, 1996 LIFO reserve(s).
<p>METHOD OF PAYMENT</p>	<ul style="list-style-type: none"> • Three equal installments: May 31, 1998... January 31, 1999... and January 31, 2000. • Option for dealers not under audit to pay entire amount in one installment due May 31, 1998.
<p>IRS ENFORCEMENT</p>	<ul style="list-style-type: none"> • Dealer is required to do a "self-audit" of Factory statements submitted "<u>for credit purposes.</u>" • District Director may verify accuracy of dealer's self-audit. • Special relief extends only to LIFO conformity violations; risk of termination exists for all others.
<p>DEALERS CURRENTLY UNDER AUDIT</p>	<ul style="list-style-type: none"> • Allowed to obtain special relief under Rev. Proc. 97-44 if under audit on October 14, 1997. • Payment date for first installment of settlement amount is accelerated to December 1, 1997. • Relief under Rev. Proc. 97-44 is also available to dealers at Appeals or in Federal court.
<p>SPECIAL RULES</p>	<ul style="list-style-type: none"> • Transmittal memorandum MUST accompany each installment payment. • Permission to terminate LIFO will be held up if payments under Rev. Proc. 97-44 are still due. • Payments are not accelerated by a change from C to S ... or by a change from S to C.
<p>SOME QUESTIONS THAT NEED CLARIFICATION</p>	<ul style="list-style-type: none"> • Many significant problems and unanswered questions remain. • Does IRS consider statements sent to the Factory as statements "for credit purposes"... possibly resulting in a conformity violation even though those statements were not sent to credit corp. because the dealer floorplanned elsewhere? • What about Factory statements that in prior years had no place on them for a LIFO adjustment and this was simply "overlooked" by the CPA? • What happens where used vehicles and/or parts are also on LIFO? How does RP 97-44 apply? • What about multiple franchise dealers who had LIFO adjustments on some, but not on <i>all</i>, of the statements that were sent to the various manufacturers? How does RP 97-44 apply?



KEY TERMS & DATES
DEALER CONFORMITY VIOLATION RELIEF UNDER REV. PROC. 97-44

KEY TERMS	
PENALTY AMOUNT	<ul style="list-style-type: none"> • 4.7% of the LIFO reserves on the last day of the last taxable year ending before October 14, 1997. • Payable in three equal installment payments ... see <i>Important Dates</i> below.
SETTLEMENT AMOUNT	<ul style="list-style-type: none"> • The amount that a dealer with a LIFO conformity violation must pay. The <i>Settlement Amount</i> is not a tax. It is not deductible as interest. It does not result in a basis adjustment to the LIFO inventories, nor does it affect prior LIFO layer increments or increment valuations.
LOOK-BACK PERIOD	<ul style="list-style-type: none"> • Six (6) most recent taxable years ending on or before October 14, 1997. For a calendar year taxpayer, the look-back period is the years ended December 31, 1991 through 1996.
MEMORANDUM ("ACCOMPANYING MEMORANDUM")	<ul style="list-style-type: none"> • This is a transmittal form the taxpayer is required to prepare, complete and send in with each installment payment so the IRS will be able to keep track of the payment status of the amounts due under Rev. Proc. 97-44.
REV. PROC. 97-44	<ul style="list-style-type: none"> • The designation of the Revenue Procedure that spells out the terms and conditions and the steps that an auto dealer can take to avoid having its LIFO election terminated because of certain financial statement conformity violations.
REV. RUL. 97-42	<ul style="list-style-type: none"> • The designation of the Revenue Ruling that describes the manner in which an adjustment for LIFO should be reflected in a dealer's year-end income statement.

IMPORTANT DATES	
1991 THROUGH 1996	<ul style="list-style-type: none"> • The <i>six (6) year period</i> with respect to which dealers are required to "self-audit" the year-end financial statements they submitted to the Factory for possible LIFO conformity violations.
FYE-92 THROUGH FYE-97	<ul style="list-style-type: none"> • Corresponding self-audit period for dealers with fiscal years ending January through September.
OCTOBER 14, 1997	<ul style="list-style-type: none"> • The cut-off date for Rev. Proc. 97-44 (and Rev. Rul. 97-42) determinations.
DECEMBER 1, 1997	<ul style="list-style-type: none"> • For dealerships under audit on October 14, 1997, the date on or before which the <i>first</i> installment payment of the <i>Settlement Amount</i> is due. • If a dealer under audit elects to forego making installment payments, the entire <i>Settlement Amount</i> is due on December 1, 1997.
DECEMBER 15, 1997	<ul style="list-style-type: none"> • The date by which dealers currently under audit must notify examining agents of their taking action under Rev. Proc. 97-44.
MAY 31, 1998	<ul style="list-style-type: none"> • Due date of the <i>first</i> installment of the <i>Settlement Amount</i> payment for dealers not under audit on October 14, 1997. • Due date for payment of the total <i>Settlement Amount</i> if a dealer not under audit on October 14, 1997 elects to make a single payment of entire <i>Settlement Amount</i>.
JANUARY 31, 1999	<ul style="list-style-type: none"> • Due date for the <i>second</i> installment of the <i>Settlement Amount</i> payment.
JANUARY 31, 2000	<ul style="list-style-type: none"> • Due date for the <i>third</i> and final installment of the <i>Settlement Amount</i> payment.



**AUTO DEALER LIFO REPORTING VARIATIONS IN
CERTAIN FACTORY-FORMATTED STATEMENTS
ISSUED "FOR CREDIT PURPOSES"**

REVENUE RULING 97-42

	<u>SITUATION 1</u>		<u>SITUATION 2</u>		<u>SITUATION 3</u>	
	LIFO REFLECTED <u>IN GROSS PROFIT (CGS) *</u>		LIFO REFLECTED <u>IN ADJ. TO NET INCOME **</u>		LIFO NOT REFLECTED <u>ANYWHERE ON THE INCOME STATEMENT</u>	
	INCOME STATEMENT <u>DECEMBER 1996</u>		INCOME STATEMENT <u>DECEMBER 1996</u>		INCOME STATEMENT <u>DECEMBER 1996</u>	
	<u>MONTH</u>	<u>YEAR-TO-DATE</u>	<u>MONTH</u>	<u>YEAR-TO-DATE</u>	<u>MONTH</u>	<u>YEAR-TO-DATE</u>
Sales of Automobiles	\$ 300x	\$3,600x	\$ 300x	\$3,600x	\$ 300x	\$3,600x
Cost of Goods Sold	<u>(255x)</u>	<u>(2,400x) *</u>	<u>(195x)</u>	<u>(2,340x)</u>	<u>(195x)</u>	<u>(2,340x)</u>
Gross Profit	\$ 45x	\$1,200x	\$ 105x	\$1,260x	\$105x	\$1,260x
Variable Expenses	(12x)	(144x)	(12x)	(144x)	(12x)	(144x)
Fixed Expenses	<u>(18x)</u>	<u>(216x)</u>	<u>(18x)</u>	<u>(216x)</u>	<u>(18x)</u>	<u>(216x)</u>
Operating Profit	\$ 15x	\$ 840x	\$ 75x	\$ 900x	\$ 75x	\$ 900x
Other Income & Expenses	<u>-0-</u>	<u>-0-</u>	<u>(60x)</u>	<u>(60x) **</u>	<u>-0-</u>	<u>-0-</u>
Net Income	<u>\$ 15x</u>	<u>\$ 840x</u>	<u>\$ 15x</u>	<u>\$ 840x</u>	<u>\$ 75x</u>	<u>\$ 900x</u>

NOTES

In Situations 1 and 2, A and B did not violate the LIFO conformity requirement in their statements to Y (a financing subsidiary of the Factory/manufacturer) because they used the LIFO method in inventorying goods to ascertain their net income in the Month and Year-To-Date columns of the December income statement. **The results in Situations 1 and 2 would be the same if the \$60x LIFO adjustment reflected in the Month and Year-To-Date columns of the December 1996 income had been a reasonable estimate of the change in LIFO reserve for the year.**

Further, if A or B had employed a fiscal taxable year, the results in Situations 1 and 2 would be the same if A or B made either (1) an adjustment for the change in the LIFO reserve that occurred during the calendar year in the Month and Year-To-Date column of the December income statement or (2) an adjustment for the change in the LIFO reserve that occurred during the fiscal year in the Month and Year-To-Date columns of the income statements provided for the last month of the fiscal year.

In Situation 3, C violated the LIFO conformity requirement in its statements to Y because C used a method other than LIFO (i.e., it used the specific identification inventory method) in inventorying goods to ascertain its net income in the Year-To-Date column of the December income statement. Further, C violated the LIFO conformity requirement because the January through November income statements can be combined with the December income statement to ascertain C's net income for the year using a single inventory method other than LIFO.

C used the specific identification inventory method to calculate its Cost of Goods Sold, Gross Profit, and Net Income for the year and month without adjusting for a \$60x increase in C's LIFO reserve for 1996. **Thus, the December 1996 income statement does not reflect C's use of the LIFO inventory method.** The result in Situation 3 would be the same even if C's December 31, 1996 Balance Sheet had reflected a 1996 adjustment to C's LIFO reserve.

WARNING: These examples can only be read and interpreted in the context of the entire discussions in Revenue Ruling 97-42 and Revenue Procedure 97-44 which relates to franchised automobile dealers who have provided monthly financial (income) statements "**FOR CREDIT PURPOSES**" to the credit subsidiary of the franchisor/automobile manufacturer.



ACCOMPANYING MEMORANDUM

**PAYMENT OF SETTLEMENT AMOUNT
UNDER REV. PROC. 97-44**

Name _____ EI # _____
Address _____

Taxpayer is "within the scope" of Revenue Procedure 97-44 and has calculated its *Settlement Amount* as set forth therein.

The amount of the taxpayer's LIFO reserve(s) calculated under Section 5.02(2) of Rev. Proc. 97-44 as of December 31, 1996 (or fiscal year ended _____, 1997) is\$ _____

The total *Settlement Amount* calculated under Section 5.02(2) of Rev. Proc. 97-44 is 4.7% (.047) multiplied by the amount above (insert amount _____) which equals\$ _____

The amount of installment payment enclosed herewith is\$ _____

Identification of payment: The enclosed payment is the:

- ___ First installment ... one-third of *Settlement Amount* ... (due on or before May 31, 1998).
- ___ Second installment ... one-third of *Settlement Amount* ... (due on or before January 31, 1999).
- ___ Third installment ... one-third of *Settlement Amount* ... (due on or before January 31, 2000).
- ___ The entire amount of the *Settlement Amount* pursuant to the taxpayer's election made hereby to pay the entire *Settlement Amount* in one installment ... (due on or before May 31, 1998).

Taxpayer agrees to all of the terms and conditions of Revenue Procedure 97-44 and executes this document under the penalties of perjury.

Signature _____ Title _____

Date _____

Mailing/Delivery Addresses:

Payments, together with the original memorandum, must be sent to the:

Internal Revenue Service
Cincinnati Service Center
201 W. River Center Blvd.
Stop 31, Unit 21
Covington, KY 41019

A copy of each memorandum must be sent to the National Office addressed to the:

Commissioner of Internal Revenue
Attention: CC:DOM:IT&A,
P.O. Box 7604, Benjamin Franklin Station
Washington, DC 20044

In the case of a private delivery service (a copy of each memorandum must be sent to):

Commissioner of Internal Revenue
Attention: CC:DOM:IT&A
1111 Constitution Avenue, NW
Washington, DC 20224



**SETTLING WITH THE IRS
WHERE CONFORMITY VIOLATIONS
HAVE OCCURRED IN THE PAST**

Revenue Procedure 97-44 is the settlement document which provides the terms and conditions by which *only* automobile dealers with a LIFO conformity violation in their past can pay a token amount now and go on with their businesses without having their LIFO elections terminated. Errant dealers are not paying a "tax" ... they are paying what is called a Settlement Amount.

The Settlement Amount is computed as 4.7% of the amount of the LIFO reserve(s) at December 31, 1996. Fiscal year taxpayers will pay 4.7% of their LIFO reserve(s) as of the end of their fiscal year ending in 1997 as long as their fiscal year ends with September or an earlier month. This amount is payable without interest in three equal installments. The first installment is due on or before May 31, 1998, and the two remaining installments are due on or before January 31 of the next two succeeding calendar years.

**DEALERSHIPS CURRENTLY
UNDER AUDIT OR BEYOND**

These special settlement rules also apply to dealerships who on October 14, 1997 are under IRS audit examination, or before Appeals or a Federal court. However, these dealerships must pay their first installment of the Settlement Amount on or before December 1, 1997. It appears that they must pay the remaining two installments on the same due dates as the dates set for payment by dealerships not currently under audit.

OPTION TO PREPAY

There is also an option available so dealerships can elect to pay the entire Settlement Amount in one payment which is due on May 31, 1998 if the dealership is not under audit on October 14, 1997 ...or due on December 1, 1997 if it is.

LOOK-BACK PERIOD

How far back is the IRS looking to see if a dealer has a conformity violation? The answer is simple: **SIX (6) YEARS**... a violation in **any one** of the six years triggers the penalty tax.

This look-back period consists of the taxpayer's six most recent taxable years ended on or before October 14, 1997. The October 14, 1997 magic date is simply the date on which Rev. Rul. 97-42 and Rev. Proc. 97-44 are scheduled to appear in the Internal Revenue Bulletin, 1997-41.

Accordingly, for a calendar year dealership, the look-back period will involve the year-end statements sent to the Factory for every year ended December 31, 1991, 2, 3, 4, 5, & 6. For taxpayers with fiscal years ending at the end of the month of September or before, the fiscal years involved in the look-back period will be those ending in 1992, 3, 4, 5, 6, & 7.

Query: Are short taxable years during the look-back period to be counted as "full" taxable years?

VIOLATION YEAR

If any one of the six preceding years in the look-back period is a "violation year," the Settlement Amount payment will be triggered. Rev. Proc. 97-44 provides the following: "A violation year is any taxable year for which a taxpayer violated the LIFO conformity requirement **under the facts described in Section 3 of THIS revenue procedure.**" Section 3 of **this** revenue procedure means Section 3 of Revenue Procedure 97-44... and 97-44 more broadly states that it applies to any dealer (auto or light-duty truck only) that violated the conformity requirement by providing, **for credit purposes**, an income statement prepared in a format required by the franchisor ..., covering any taxable year ending on or before October 14, 1997 that fails to reflect the LIFO inventory method in the computation of net income. In prior technical advice, the IRS has held that statements submitted to the Factory (without being extended to the financing subsidiary) also were deemed to be **for credit purposes**. Note that the Revenue Procedure does **NOT** limit its scope or reach by referring specifically to the use by the credit subsidiary Situation 3 in Revenue Ruling 97-42.

**LIMITED EXCEPTIONS FOR
CERTAIN 13th STATEMENT SITUATIONS**

The Revenue Procedure does appear to cut some dealers a little slack. But not much. It provides that a year during the look-back period will not be treated as a *violation year* if the dealership had a non-conforming twelfth (12th) monthly Income Statement **IF** all four of the conditions below are met:

1. That non-conforming twelfth statement was replaced by a "thirteenth" (13th) period Income Statement,
2. The replacement 13th period Income Statement covered the same period as the 12th monthly Income Statement,
3. The 13th period Income Statement reflected the LIFO inventory method, and
4. The 13th period Income Statement was provided to each creditor that received the 12th monthly Income Statement **before** the first

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Relief Finally Arrives for Auto Dealers...

monthly Income Statement for the following year was provided to creditors.

If the 13th Statement reflected the LIFO change by running the entire change through Retained Earnings—and not through the Income Statement—that would prevent this favorable-to-the-dealership exception from applying. Furthermore, the reality of dealership life is that many 13th Statements are not completed and issued before the next year's 1st monthly statement is sent out. All these dealer situations will be unable to qualify for relief.

USE OF ESTIMATES

Revenue Ruling 97-42... which is to be read in the context of Revenue Procedure 97-44... provides a little more relief of a different sort. Rev. Rul. 97-42 states that use of cost estimates is an example of a "costing method" that is not inconsistent with the LIFO inventory method. Therefore, if a dealership reflected a reasonable estimate of the year's LIFO reserve change in its year-end Income Statement, the use of that estimate instead of the actual amount computed later would not constitute a violation of the conformity requirement.

The discussion of Situations 1 and 2 in Revenue Ruling 97-42 says that the reporting which was acceptable to the IRS would result in the same acceptance by the IRS "...if the (x) LIFO adjustment in... income had been a **reasonable estimate** in the LIFO reserve for the year." However—and unfortunately—neither the Revenue Ruling nor the Revenue Procedure elaborate on what will constitute a "reasonable" estimate.

The text of Revenue Procedure 97-44 is included beginning on page 17.

HOW DO YOU GET RELIEF?

Revenue Procedure 97-44 does not use the term "self-audit" nor does it come right out and tell dealers they must audit themselves. It simply provides a date by which the first installment of the Settlement Amount **must be paid**, and it provides that if payment is not **timely** made, the dealership forfeits its eligibility for relief. As discussed elsewhere, if the result of a self-audit determines a violation year and payment is due, that payment is not to be made as part of the 1997 income tax return, nor is any disclosure required in the 1997 tax return.

Three requirements must be met to obtain relief:

1. The Settlement Amount must be paid at the time and in the manner prescribed in the Revenue Procedure,

2. A "Memorandum" must be prepared and submitted accompanying each installment payment

(Continued)

at the time when it is made and in the manner prescribed by the Revenue Procedure, and

3. The taxpayer must satisfy all of the additional requirements and special rules involving possible accelerations of the remaining installment payment dates under certain circumstances.

COMPUTING THE SETTLEMENT AMOUNT

The 4.7% penalty rate was intended to approximate the after-tax, time value of money benefit a dealership would receive or derive from being allowed to continue its LIFO election. It was computed by taking the AFR short-term rate at September 9, 1997 and reducing it by the flat 34% C corporation tax rate and then amortizing the result over four years, compounded semi-annually.

The Settlement Amount (i.e., the failure-to-conform penalty tax) does not affect the existing LIFO layers or valuations since it cannot be capitalized or deducted under any provision of the Internal Revenue Code. Also, it is not treated as deductible interest. The Revenue Procedure also provides that the Settlement Amount is not refundable or creditable against any Federal income tax liability. Therefore, if a dealership pays an amount by mistake or in good faith, but unnecessarily, there will be no refund or adjustment to the taxpayer.

The Settlement Amount is determined by multiplying the 4.7% penalty rate by the amount of the LIFO reserve(s) on the last day of the taxpayer's last taxable year ended on or before October 14, 1997. The term "inventory" includes "only inventory related to the purchase, sale and service of automobiles and light-duty trucks." What is to happen if a dealer has new, used and parts inventories on LIFO? See "Questions" on page 10.

The relief tax or Settlement Amount must be paid in three equal installments. If a dealer does not elect to prepay, the installment due dates for payment of each 1/3 of the Settlement Amount are: (1) on or before May 31, 1998, followed thereafter by (2) January 31, 1999 and (3) January 31, 2000. Payments are **not** to be sent to the usual address where the dealership income tax returns are filed or where the regular income tax deposits are made. Instead, payments—along with the "accompanying memorandum"—must be sent to a separate IRS processing address at Covington, Kentucky. In addition, a copy of each transmittal memorandum must be sent to the National Office at addresses specified in the document.

Dealerships not under audit on October 14, 1997 may elect to pay the entire Settlement Amount on or before May 31, 1998.

see **RELIEF FINALLY ARRIVES FOR AUTO DEALERS...**, page 27



SOME QUESTIONS IN NEED OF ANSWERS... RELIEF FOR CONFORMITY VIOLATIONS

R. R. 97-42
R. P. 97-44

After digesting the texts of Revenue Ruling 97-42 and Revenue Procedure 97-44, one starts to think about what they mean, what they have left unsaid and how all of this should be communicated to auto dealer clients. The conclusion: Very delicately. Although some have hailed these IRS pronouncements as generally beneficial to auto dealers, there are many unanswered questions. Some of them are discussed below.

WHAT ABOUT FACTORY USE (ONLY) OF THE DEALER FINANCIAL STATEMENTS?

Rev. Rul. 97-42 is predicated upon the use of the dealer financial statements by the credit subsidiary (i.e., GMAC, Ford Motor Credit, CCC.) This raises serious questions which the more broadly drafted Revenue Procedure entirely backed away from. The question arises: What happens if a dealership is not floorplanning its inventory through the manufacturer's credit corp.? In other words, what if the dealership is sending financial statements to the Factory only and not to the credit corp?

Is the Factory ever the only party that receives the financial statements? If it is, the position of the IRS in its 1995 Letter Rulings 9535009 and -010 that the use of the dealer's financial statements by the Factory constituted a use "for credit purposes" raises problems.

Apparently, NADA and the IRS wrestled over this issue. However, the IRS backed away from stating this position directly... as an example, or otherwise... in Revenue Ruling 97-42.

This creates great uncertainty because the IRS National Office has "left it to the taxpayer to decide" whether the receipt of the financial statements by the Factory constitutes a use "for credit purposes." Consequently, this deliberation would be part of the dealership's "self-audit." Will some taxpayers audit themselves more rigorously than others? Will some CPAs self-audit some of their clients more rigorously than others? And what about prior years where other CPA firms were involved?

If a dealer's self-audit concluded that the use by the Factory is a use "for credit purposes," then the dealer would pay the 4.7% relief penalty. At first blush, it might seem advisable for a dealer to "volunteer the payment" under these circumstances in the hope that such payment would foreclose the issue from being raised at a later date by the IRS, with the

more significant downside risk being the loss of the LIFO election.

Will a dealer lose either way? First: The relief penalty is non-refundable, and if it turns out the receipt or use by the Factory is held to be not "for credit purposes," then the penalty (Settlement Amount payments) would have been paid unnecessarily. Second: If the IRS (National Office in a Technical Advice or in some other audit scenario) concludes that the Factory use of the dealer's financial statement is a "credit use," then—not having already paid the penalty according to the schedule of dates for payment—the dealership could be subject to a far greater penalty: Termination of its LIFO election for a conformity violation which is not protected by Rev. Proc. 97-44... because of late payment.

This creates a further subset of questions and problems, including: What happens when the Factory provides a copy of the financial statement to the credit corp. even though the dealership is not floorplanning through the credit corp.? The prevailing practice of many, if not all, manufacturers is that they automatically provide the dealer's financial statement information to the credit corp., whether or not the dealer floorplans through it. Another variation is that, in many instances, the credit corp. may have simply called the dealership at some time during the year (perhaps at June 30) and requested a copy of the dealer's financial statements "for its records," even though the dealership was not financing its vehicles through the credit corp. at that time. Sometimes, a copy of the last calendar year's statement was mailed or otherwise provided gratuitously; in other instances (and less problematic), the copy provided was simply the most recently prepared statement which would report less than a full year's operations.

Multi-franchise dealers: What if a multi-franchise dealer properly reported LIFO in statements to one or two manufacturers, but not to all of them?

Recap: Neither Rev. Rul. 97-42 nor Rev. Proc. 97-44 specifically says that use by the Factory of the dealer's financial statements is a use for "credit purposes." It has been left up to the taxpayer to decide how it is going to interpret this in its "self-audits". Realistically, this means CPAs are going to have to decide this for their dealer clients. Regrettably, this will create debate and confusion. Theories will be a dime a dozen: Opinions letters, on the other hand, will be vastly more expensive.

→



IN PRIOR YEARS**SOME FACTORIES DID NOT EVEN HAVE A PLACE WHERE LIFO CHANGES COULD BE REFLECTED**

The financial statement formats for some manufacturers did not provide a place in the income statement for a dealer to reflect LIFO. Ford—prior to its recent change in 1995—may be one. And, there are others. This means that unless the CPA or the controller “forced” a LIFO adjustment into the manufacturers’ formatted statement, there could be no compliance with the LIFO conformity requirement.

Even though the Factory statement format did not separately prescribe where LIFO changes should be reported, many more cautious CPAs went ahead and recorded the LIFO reserve change as part of “Other Deductions” or “Other Additions to Income.” If this were not done, the facts would be identical to Situation (3) in Rev. Ruling 97-42 because the LIFO reserve was only on the Balance Sheet with the income effect run through Retained Earnings. The fact that there had been no reflection of LIFO in the Income Statement because “there was no place to put it anywhere” would be a weak reason to conclude, in a Rev. Proc. 97-44 self-audit, that there was no violation of the conformity requirement. What are some of the manufacturers going to do if a significant number of their dealers start calling them over this?

It would be advisable to compile a list of all manufacturers whose financial statements did not provide for reporting LIFO in the Income Statement during the six year look-back period beginning in 1991.

IMPLICATIONS FOR DEALERS WITH LIFO ELECTIONS FOR NEW, USED & PARTS INVENTORIES

Most of the attention is focused on the LIFO treatment of new vehicle inventories: Cars and light-duty trucks. When one carefully reads the Revenue Procedure, it says that all of the LIFO reserves (i.e., those for new, used and parts, if applicable) provide the basis for the computation of the Settlement Amount. See Section 5.02 of Rev. Proc. 97-44. Here again, different interpretations are likely to arise, and the failure of the document to address this more directly is likely to cause confusion.

Worse yet, the overall tenor of Rev. Proc. 97-44 really is one of overkill as to the dire consequences to a taxpayer that fails to follow all—and it emphasizes all—of the nitty gritty compliance details. If a taxpayer has new and used vehicles on LIFO and has a conformity violation in one of the six years, and it computes its penalty as 4.7% of only its new vehicle LIFO reserve(s) ... would that be a failure to comply with Rev. Proc. 97-44?

Another alarming possibility: If a dealer on LIFO for new and used vehicles recorded a LIFO adjustment for the new vehicles in its year-end financial statement, but failed to do so for its used vehicles on LIFO ... what are the consequences? Is the 4.7% penalty based on only the non-compliant used vehicle LIFO reserves at December 31, 1996? ... or is it based on the total of the new and the used vehicle LIFO reserves? And, if the parts and accessories inventories are on LIFO, do we have similar ramifications? Remember that the factory statement shows separate departmental breakdown before bringing all the operations together in the summary Income Statement report.

Might an argument be made for the proposition that a dealership should not have to pay a penalty on the LIFO reserves attributable to its used vehicles in cases where the dealership owns its used vehicle inventory and is not floorplanning it through the manufacturer’s subsidiary or affiliate (i.e., the credit corporation)? This is usually the case, isn’t it?

IMPLICATIONS FOR AUTO DEALERS USING BLS INDEXES

As a ramification of the above discussion, note that if a dealership is using BLS indexes (typically, Table 6 of the Producer Price Indexes) and that dealership has a conformity violation for any one of the six years during the 6-year look-back period, that dealership will pay its penalty tax based on the LIFO reserves for all of its inventories. The BLS in some years was slow in releasing its figures.

USE OF REASONABLE ESTIMATES

Neither the Rev. Rul. nor the Rev. Proc. sets forth a standard or a definition related to the IRS’ acceptance of a “reasonable” estimate in lieu of reporting the actual LIFO reserve adjustment in the statements. Some believe this situation arises only where the 12th statement has reflected no change in the LIFO reserve, and that statement is replaced by a “thirteenth” statement on or before the submission to the Factory of the financial statement for the first month of the following year (i.e., typically, February 10 for a calendar year dealer).

Under what circumstances might a zero amount be a reasonable estimate? Possibly if the amount of the LIFO reserve change for the year was relatively small? But, what is “relatively” small? Who will determine “reasonableness” on a case-by-case basis... the National Office or the IRS agents in the field?

Possible problems abound. A “thirteenth” statement may not have been filed with the Factory (replacing the previous “twelfth” statement). Also, all parties are required to have received a replacement

see **IRS RELIEF FOR DEALER STATEMENT LIFO...**, page 12



"thirteenth" statement. Further, in some situations where estimates are used on the twelfth statement, the adjustments computed for the "thirteenth" statement are simply washed through the financial statements and books in the following year outside the Income Statement (i.e., through retained earnings) and no "thirteenth" statement is ever really issued for the year.

**INCOME FROM LIFO RESERVE TURNAROUND
...WHAT HAPPENS?**

Does the requirement to reflect a LIFO adjustment in dealership Factory financial statements include situations where the LIFO reserve change actually created income for the year? In many instances, especially during the 6-year look-back period involved (1991 through 1996), LIFO reserves went down ... sometimes as a result of significantly lower year-end inventory levels. In some instances, dealerships may not have reflected a LIFO adjustment in the 12th statement thinking that it was unnecessary to do so because the LIFO reserve change was not an expense reducing net income.

DEALERSHIPS UNDER AUDIT

The revenue procedure provides that for dealers not under audit, the first installment of the relief penalty tax is due May 31, 1998. In the following sentence, Section 5.03 provides: "The remaining installments and memoranda are due on or before January 31 of the two succeeding calendar years."

For dealerships under audit, the first installment of the penalty tax is accelerated and becomes due on or before December 1, 1997. The question is: For dealerships under audit, are the second and the third installments accelerated to January 31, 1998 and 1999 ... or do they become due on the same dates as for dealerships not under audit (i.e., January 31, 1999 and 2000)?

Was there an intention to accelerate the second and third installment dates for dealers under audit? Or was the reason for accelerating the first installment date for dealers under audit to simply lessen the amount of paperwork and the need to keep existing IRS audits open any longer than necessary solely for the purpose of keeping track of the first installment payment?

HOW MANY DEALERS WILL RESPOND?

The "Paperwork Reduction Act" information included in Section 9 indicates that the IRS expects an estimated 5,000 "respondents" to be affected. What happens if only a few dealers or significantly less than 5,000 actually respond (because their CPAs' self-audits show them not to be in violation)? Can we expect a busy summer of '98... a rash of "compliance checks" or something else ...if the IRS doesn't clarify some of these questions real soon?

Many auto dealerships changed CPA firms during the past six years. The battle among CPAs for new clients in this niche market has been intense and often antagonistic. For some new dealer clients gained, there might be a new, unpleasant relationship created with the predecessor CPA firm. As a practical matter, will dealerships' self-audits really become audits by the current CPAs of the former CPAs? What if two (or more) different CPA firms were involved in violations during the six-year look-back period?

**IMPLICATIONS FOR
OTHER BUSINESSES ON LIFO**

The portion of the LIFO regulations which the IRS has interpreted in providing relief for automobile dealers applies to all taxpayers. The IRS has only offered relief for conformity violations involving "factory income statements" to auto dealers. How are hundreds... if not thousands... of other businesses on LIFO submitting similarly formatted statements under similar circumstances to their franchisors going to be treated? Are their LIFO elections also in jeopardy?

Most CPAs serving automobile dealerships also serve many of the other businesses. What does one do? What should these other businesses be told?

CONCLUSION

Some things are a long time in coming, but when they arrive, they turn out to have been worth the wait. In the case of Revenue Ruling 97-42 and Revenue Procedure 97-44, questions will flood into the minds of thoughtful and conscientious CPAs as they try to interpret these documents and advise auto dealers on how to react. As these questions multiply, some will conclude it would have been better if the IRS had taken more time to really think through more of the ramifications and find out more about the "real world" conditions in the dealerships which are the subject of these rulings.

It appears more attention was given to setting up the collection procedure so that the IRS could get its hands on "the money" than was spent in considering the implications of issuing documents that resemble Swiss cheese from a practical standpoint.

It should be kept in mind that payments of the conformity penalty tax are non-refundable and forever lost. Accordingly, it may be prudent for a dealer (not under audit) to think twice about electing to pay the entire Settlement Amount in one installment in the hope of having some clarification of some of these questions.

Where do we go from here? The next few months should be interesting. *



AUTO DEALER LIFO REPORTING VARIATIONS IN CERTAIN FACTORY-FORMATTED STATEMENTS ISSUED "FOR CREDIT PURPOSES"

REVENUE RULING 97-42

ISSUE

Whether a franchised automobile dealer that elected the last-in, first out (LIFO) inventory method for federal income tax purposes violates the LIFO conformity requirement of Section 472(c) or (e)(2) of the Internal Revenue Code by providing certain monthly income statements to the credit subsidiary of the franchisor (an automobile manufacturer).

FACTS

A, B, and C are franchised automobile dealers engaged in the purchase, sale, and service of automobiles manufactured by X. A, B, and C regularly finance their purchases of new automobiles through Y, a subsidiary of X.

For federal income tax purposes A, B, and C use the accrual method of accounting and a calendar taxable year. Each dealer elected to use the LIFO inventory method to account for its automobile inventory with its taxable year ended December 31, 1970.

Pursuant to the terms of the franchise agreements with X and the financing agreements with Y, X and Y must receive balance sheets and income statements from A, B, and C within 10 days after the end of each month. The income statements are prepared in a format required by X or on pre-printed forms supplied by X and present the dealers' operating results for both the month and the calendar year-to-date.

During 1996, A, B, and C's monthly financial statements were received by X and Y. In the January through November income statements, A, B, and C calculated their Cost of Goods Sold using the specific identification inventory method instead of the LIFO inventory method. Under the specific identification method, the cost of the dealers' beginning and ending inventories is determined by reference to X's actual invoice price for the automobiles on hand.

SITUATION 1 - LIFO REFLECTED IN GROSS PROFIT. A provided the following income statement to X and Y for the month of December:

	<u>INCOME STATEMENT</u>	
	<u>DECEMBER 1996</u>	
	<u>MONTH</u>	<u>YEAR-TO-DATE</u>
Sales of Automobiles	\$ 300x	\$ 3,600x
Cost of Goods Sold	(255x)	(2,400x)
Gross Profit	\$ 45x	\$ 1,200x
Variable Expenses	(12x)	(144x)
Fixed Expenses	(18x)	(216x)
Net Income	\$ 15x	\$ 840x



A calculated its Cost of Goods Sold for the year and the month as follows. First, A used the specific identification inventory method to calculate a tentative cost of goods sold for the year (\$2,340x) and the month (\$195x). Then, A made an adjustment of \$60x (representing a \$60 increase in A's LIFO reserve for 1996) to the tentative cost of goods sold to arrive at Cost of Goods Sold for the year (\$2,400x) and the month (255x), respectively.

SITUATION 2 - LIFO REFLECTED IN NET INCOME. B provided the following income statement to X and Y for the month of December:

INCOME STATEMENT
DECEMBER 1996

	<u>MONTH</u>	<u>YEAR-TO-DATE</u>
Sales of Automobiles	\$ 300x	\$ 3,600x
Cost of Goods Sold	<u>(195x)</u>	<u>(2,340x)</u>
Gross Profit	\$ 105x	\$ 1,260x
Variable Expenses	(12x)	(144x)
Fixed Expenses	<u>(18x)</u>	<u>(216x)</u>
Operating Profit	\$ 75x	\$ 900x
Other Income & Expenses	<u>(60x)</u>	<u>(60x)</u>
Net Income	<u>\$ 15x</u>	<u>\$ 840x</u>

B used the specific identification inventory method to calculate its Cost of Goods Sold and Gross Profit for both the year and month without adjusting for a \$60x increase in B's LIFO reserve for 1996. On the Other Income and Expenses line, B reduced Operating Profit in the year-to-date column by \$60x (representing the \$60x increase in B's LIFO reserve for 1996) and in the Month Column by \$60x to arrive at B's Net Income for the year (\$840x) and the month (\$15x), respectively.

SITUATION 3 - LIFO NOT REFLECTED ON THE INCOME STATEMENT: C provided the following income statement to X and Y for the month of December:

INCOME STATEMENT
DECEMBER 1996

	<u>MONTH</u>	<u>YEAR-TO-DATE</u>
Sales of Automobiles	\$ 300x	\$ 3,600x
Cost of Goods Sold	<u>(195x)</u>	<u>(2,340x)</u>
Gross Profit	\$ 105x	\$ 1,260x
Variable Expenses	(12x)	(144x)
Fixed Expenses	<u>(18x)</u>	<u>(216x)</u>
Operating Profit	\$ 75x	\$ 900x
Other Income & Expenses	<u>-0-</u>	<u>-0-</u>
Net Income	<u>\$ 75x</u>	<u>\$ 900x</u>



C used the specific identification inventory method to calculate its Cost of Goods Sold, Gross Profit, and Net Income for the year and month without adjusting for a \$60x increase in Cs LIFO reserve for 1996. **Thus, the December 1996 income statement does not reflect C's use of the LIFO inventory method.**

LAW AND ANALYSIS

Section 472(a) authorizes a taxpayer to use the LIFO inventory method in accordance with the regulations prescribed by the Secretary.

Section 472(c) provides that a taxpayer may not elect to use the LIFO inventory method unless it establishes to the satisfaction of the Commissioner that it used no method other than the LIFO method in inventorying goods to ascertain the income, profit, or loss of the first taxable year for which the LIFO method is to be used, for the purpose of a report or statement covering that taxable year to shareholders, partners, other proprietors, or beneficiaries, or for credit purposes.

Section 472(e) provides that a taxpayer electing to use the LIFO inventory method must continue to use the LIFO inventory method unless the taxpayer: (1) obtains the consent of the Commissioner to change to a different method; or (2) is required by the Commissioner to change to a different method because the taxpayer has used some inventory method other than LIFO to ascertain the income, profit, or loss of any subsequent taxable year in a report or statement covering that taxable year (a) to shareholders, partners, other proprietors, or beneficiaries, or (b) for credit purposes.

Reg. Sec. 1.472-2(e)(1) provides that a taxpayer electing to use the LIFO inventory method must establish to the satisfaction of the Commissioner that the taxpayer, in ascertaining the income, profit, or loss of the taxable year for which the LIFO inventory method is first used, or for any subsequent taxable year, for credit purposes or for purposes of reports to shareholders, partners, other proprietors, or beneficiaries, has not used any inventory method other than LIFO.

Reg. Sec. 1.472-2(e)(1) generally provides exceptions to the LIFO conformity requirement. Under Reg. Sec. 1.472-2(e)(1)(iv), a taxpayer is not at variance with the LIFO conformity requirement if it uses an inventory method other than LIFO in a report or statement covering a period of less than an entire taxable year.

However, Reg. Sec. 1.472-2(e)(6) provides that a series of credit statements or financial reports is considered a single statement or report covering an entire taxable year if the statements or reports in the series are prepared using a single inventory method and can be combined to disclose the income, profit, or loss for the entire taxable year. For this purpose a taxable year includes any one-year period that both begins and ends in a taxable year for which the taxpayer used the LIFO inventory method. Reg. Sec. 1.472-2(e)(2). Thus, income statements prepared on the basis of a calendar year may be subject to the LIFO conformity requirement even though the taxpayer employs a fiscal year for federal income tax purposes.

Under Reg. Sec. 1.472-2(e)(2)(vi), a taxpayer is not at variance with the LIFO conformity requirement if it uses costing methods or accounting methods to ascertain income, profit, or loss in financial statements for credit purposes if such methods are not inconsistent with the LIFO inventory method. **The use of cost estimates is an example of a costing method that is not inconsistent with the LIFO inventory method.** Reg. Sec. 1.472-2(e)(8)(ix).

The financial statement received by Y are "for credit purposes" within the meaning of Sections 472(c) and (e)(2) because they were issued to a creditor with whom A, B, and C maintain continuing credit relationships. Thus, under Reg. Sec. 472(c), 472(e)(2), and Reg. Sec. 1.472-2(e)(1), A, B, and C violated the LIFO conformity requirement if they used a method other than LIFO in inventorying goods to ascertain the income, profit, or loss for the taxable year the covered by the financial statements provided to Y.



In Situations 1 and 2, A and B did not violate the LIFO conformity requirement in their statements to Y because they used the LIFO method in inventorying goods to ascertain their net income in the Month and Year-To-Date columns of the December income statement. The results in Situations 1 and 2 would be the same if the \$60x LIFO adjustment reflected in the Month and Year-To-Date columns of the December 1996 income had been a reasonable estimate of the change in LIFO reserve for the year.

Further, if A or B had employed a fiscal taxable year, the results in Situations 1 and 2 would be the same if A or B made either an adjustment for the change in the LIFO reserve that occurred during the calendar year in the Month and Year-To-Date column of the December income statement or an adjustment for the change in the LIFO reserve that occurred during the fiscal year in the Month and Year-To-Date columns of the income statements provided for the last month of the fiscal year.

In Situation 3, C violated the LIFO conformity requirement in its statements to Y because C used a method other than LIFO in inventorying goods to ascertain its net income in the Year-To-Date column of the December income statement. Further, C violated the LIFO conformity requirement because the January through November income statements can be combined with the December income statement to ascertain C's net income for the year using a single inventory method other than LIFO. The result in Situation 3 would be the same even if C's December 31, 1996 Balance Sheet had reflected a 1996 adjustment to C's LIFO reserve.

HOLDING

A franchised automobile dealer that elected the LIFO inventory method for federal income tax purposes violates the LIFO conformity requirement of Section 472(c) or (e)(2) by providing to the credit subsidiary of its franchisor (an automobile manufacturer) an income statement for the taxable year that fails to reflect the LIFO inventory method in the computation of net income.

DRAFTING INFORMATION

The principal author of this revenue ruling is Jeffrey G Mitchell of the Office of Assistant Chief Counsel (Income Tax and Accounting). For further information regarding this revenue ruling, contact Mr. Mitchell on (202) 622-4970 (not a toll free call).

September 25, 1997



RELIEF FOR AUTO DEALERS IN VIOLATION OF LIFO CONFORMITY REQUIREMENT

REVENUE PROCEDURE 97-44

SECTION 1. PURPOSE.

This revenue procedure provides relief for automobile dealers that elected the last-in, first-out (LIFO) inventory method and violated the LIFO conformity requirement of Section 472(c) or (e)(2) of the Internal Revenue Code by providing, for credit purposes, an income statement prepared in a format required by the franchisor or on a pre-printed form supplied by the franchisor (an automobile manufacturer), covering any taxable year ended on or before October 14, 1997, that fails to reflect the LIFO inventory method. See, e.g., Rev. Rul. 97-42, 1997-41 I.R.B. (Situation 3). Automobile dealers that comply with this revenue procedure will not be required to change from the LIFO inventory method to another inventory method as a result of such LIFO conformity violation.

SECTION 2. BACKGROUND.

.01 Section 472(a) authorizes a taxpayer to use the LIFO inventory method in accordance with regulations prescribed by the Secretary.

.02 Section 472(c) provides that a taxpayer may not elect to use the LIFO inventory method unless it establishes to the satisfaction of the Commissioner that it used no method other than the LIFO method in inventorying goods to ascertain the income, profit, or loss of the first taxable year for which the LIFO method is to be used, for the purpose of a report or statement covering that taxable year to shareholders, partners, other proprietors, or beneficiaries, or for credit purposes.

.03 Section 472(e) provides that a taxpayer electing to use the LIFO inventory method must continue to use the LIFO Inventory method unless the taxpayer: (1) obtains the consent of the Commissioner to change to a different method; or (2) is required by the Commissioner to change to a different method because the taxpayer has used some inventory method other than LIFO to ascertain the income, profit, or loss of any subsequent taxable year in a report or statement covering that taxable year (a) to shareholders, partners, other proprietors, or beneficiaries, or (b) for credit purposes.

.04 Reg. Sec. 1.472-2(e)(1) provides that a taxpayer electing to use the LIFO inventory method must establish to the satisfaction of the Commissioner that the taxpayer, in ascertaining the income, profit, or loss of the taxable year for which the LIFO inventory method is first used, or for any subsequent taxable year, for credit purposes or for purposes of reports to shareholders, partners, other proprietors, or beneficiaries, has not used any inventory method other than LIFO.

.05 Rev. Rul. 97-42 holds that a franchised automobile dealer that elected the LIFO inventory method violates the LIFO conformity requirement by providing to a credit subsidiary of its franchisor (an automobile manufacturer) an income statement covering a taxable year that fails to reflect the LIFO inventory method in the computation of net income.

.06 Rev. Proc. 79-23, 1979-1 C.B. 564, provides that a violation of the LIFO conformity requirement warrants termination of a taxpayer's LIFO election.



SECTION 3. SCOPE.

This revenue procedure applies to any taxpayer engaged in the purchase, sale, and service of automobiles or light-duty trucks that violated the LIFO conformity requirement by providing, for credit purposes, an income statement prepared in a format required by the franchisor or on a pre-printed form supplied by the franchisor (an automobile manufacturer), covering any taxable year ended on or before October 14, 1997, that fails to reflect the LIFO inventory method in the computation of net income, regardless of whether the taxpayer is currently under examination, before an appeals office, or before a federal court. For this purpose, the term "taxpayer" has the same meaning as the term "person" defined in Section 7701(a)(1) (rather than the meaning of the term "taxpayer" defined in Section 7701(a)(14)). The term "taxpayer" includes a corporation that is included in an affiliated group of corporations as defined in Section 1504.

SECTION 4. RELIEF.

.01 A taxpayer within the scope of this revenue procedure that satisfies all the requirements for relief set forth herein is hereby granted the following relief: the district director will not terminate the LIFO election of the taxpayer because of a LIFO conformity violation described in section 3 of this revenue procedure.

.02 The relief granted under this revenue procedure extends only to LIFO conformity violations described in section 3 of this revenue procedure that occurred on or before October 14, 1997. Accordingly, the district director may, upon examination, terminate a taxpayer's LIFO election for:

- (1) Other LIFO conformity violations, including those described in section 3 of this revenue procedure that occur after October 14, 1997; or
- (2) Any other action that may warrant termination of a taxpayer's LIFO election.

.03 The district director may, upon examination, verify the accuracy of the taxpayer's settlement amount calculation and otherwise determine whether the taxpayer has fully satisfied the requirements of this revenue procedure. The district director may terminate a taxpayer's LIFO election for any violation year ended within the look-back period if the taxpayer failed to fully satisfy the requirements of this revenue procedure.

.04 Nothing in this revenue procedure will prohibit the district director from making adjustments to a taxpayer's LIFO inventory method of accounting.

SECTION 5. REQUIREMENTS FOR RELIEF.

.01 A taxpayer within the scope of this revenue procedure for which any violation year ended within the look-back period is entitled to relief only if the taxpayer:

- (1) Pays the settlement amount at the time and in the manner set forth in section 5.03 of this revenue procedure;
- (2) Submits the accompanying memorandum at the time and in the manner set forth in sections 5.03 and 5.04 of this revenue procedure; and
- (3) Satisfies the additional requirements set forth in section 7 of this revenue procedure.

A taxpayer within the scope of this revenue procedure that does not have a violation year that ends in the look-back period is automatically granted relief and is not required to satisfy any of the requirements of this revenue procedure.



5.02 SETTLEMENT AMOUNT.

(1) **IN GENERAL.** A taxpayer applying for relief under this revenue procedure must pay a "settlement amount," which is intended to approximate the after-tax, time value of money benefit that the taxpayer will derive from continuing to use the LIFO inventory method for a period of years. The settlement amount is not treated as interest under Section 163(a) and may not be capitalized or deducted under any provision of the Code. Moreover, the settlement amount is not refundable or creditable against any federal tax liability of the taxpayer.

(2) **CALCULATING THE SETTLEMENT AMOUNT.** The settlement amount equals 4.7% of the difference between the LIFO carrying value and the non-LIFO carrying value (for example, the value using the actual invoice cost or the first-in, first-out method) of the taxpayer's inventory (the "LIFO reserve") on the last day of the taxpayer's last taxable year ended on or before October 14, 1997. For this purpose, the taxpayer's inventory includes only inventory related to the purchase, sale, and service of automobiles and light-duty trucks. A taxpayer determines the LIFO reserve on the last day of its last taxable year ended on or before October 14, 1997, using the method of accounting that it used on its original federal income tax return for that taxable year.

5.03 TIME AND MANNER OF PAYMENT.

(1) **IN GENERAL.** The settlement amount must be paid in three equal installments. Except as provided in section 5.03(2) or (3) of this revenue procedure, the first installment and the memorandum described in section 5.04 of this revenue procedure, are due on or before May 31, 1998. The remaining installments and memoranda are due on or before January 31 of the two succeeding calendar years. Payments, together with the original memorandum, must be sent to the:

Internal Revenue Service
Cincinnati Service Center
201 W. River Center Blvd.
Stop 31, Unit 21
Covington, KY 41019

A copy of each memorandum must be sent to the National Office addressed to the:

Commissioner of Internal Revenue
Attention: CC:DOM:IT&A,
P.O. Box 7604, Benjamin Franklin Station
Washington, DC 20044

In the case of a private delivery service (a copy of each memorandum must be sent to):

Commissioner of Internal Revenue
Attention: CC:DOM:IT&A
1111 Constitution Avenue, NW
Washington, DC 20224



(2) TAXPAYERS UNDER EXAMINATION, BEFORE APPEALS, OR BEFORE A FEDERAL COURT. If any federal income tax return of a taxpayer is under examination, before an appeals office, or before a federal court on October 14, 1997, the first installment of the settlement amount and the memorandum described in section 5.04 of this revenue procedure are due on or before December 1, 1997. For this purpose, the terms "under examination," "before an appeals office," and "before a federal court" have the same meaning as provided in Rev. Proc. 97-27, 1997-21 I.R.B. 10. The taxpayer must notify the examining agent(s), appeals officer, or the counsel for the government, whichever is applicable, in writing on or before December 15, 1997, that it has applied for relief under this revenue procedure. Evidence that the first installment has been paid and a copy of the memorandum described in section 5.04 of this revenue procedure must be provided as part of this written notification.

(3) OPTION TO PAY SETTLEMENT AMOUNT IN ONE INSTALLMENT. A taxpayer may elect to pay the entire settlement amount in one installment. If a taxpayer makes this election, the entire settlement amount and the original memorandum described in section 5.04 of this revenue procedure are due on or before May 31, 1998, or, if any federal income tax return of the taxpayer is under examination, before an appeals office, or before a federal court on or before December 1, 1997. In addition, if applicable, the written notification required in section 5.03(2) of this revenue procedure must be satisfied. A copy of the memorandum must be sent to the National Office as required by section 5.03(1) of this revenue procedure.

5.04 ACCOMPANYING MEMORANDUM.

Each installment payment must be accompanied by a memorandum providing the following information:

- (1) the taxpayer's name, address, and EIN number;
- (2) the amount of the taxpayer's LIFO reserve calculated under section 5.02(2) of this revenue procedure;
- (3) the total settlement amount calculated under section 5.02(2) of this revenue procedure;
- (4) the amount of the installment being paid;
- (5) a statement identifying the payment as the first, second, or third installment (or a statement that the taxpayer elects to pay the entire settlement amount in a single installment); and
- (6) a statement that the taxpayer agrees to all of the terms of this revenue procedure.

Each memorandum must be signed under penalties of perjury by an individual with authority to bind the taxpayer in such matters.

The following language must be either typed or legibly printed at the top of the first page of each memorandum: "PAYMENT OF SETTLEMENT AMOUNT UNDER REV. PROC. 97-44."

SECTION 6. DEFINITIONS.

.01 VIOLATION YEAR. A violation year is any taxable year for which a taxpayer violated the LIFO conformity requirement under the facts described in section 3 of this revenue procedure. However, solely for purposes of this revenue procedure, a taxable year will not be treated as a violation year if it ended on or before October 14, 1997, and the taxpayer replaced the twelfth monthly income statement for that year with a "thirteenth period income statement" that:

- (1) covered the same period as the twelfth monthly income statement;
- (2) reflected the LIFO inventory method; and
- (3) was provided, before the first monthly income statement of the following year, to each creditor that received the twelfth monthly income statement.



.02 LOOK-BACK PERIOD. For purposes of this revenue procedure, the "look-back period" consists of the taxpayer's six most recent taxable years ended on or before October 14, 1997.

SECTION 7. ADDITIONAL TERMS OF RELIEF.

.01 A taxpayer that fails to pay each installment of the settlement amount timely, or to submit the memorandum timely, has not satisfied the requirements of this revenue procedure. Accordingly, the relief provided under section 4 of this revenue procedure is not available.

.02 A taxpayer that ceases to engage in the trade or business of purchase, sale, and service of automobiles or light-duty trucks or terminates its existence must pay the remaining balance of the settlement amount within 45 days of the cessation or termination. A taxpayer is treated as ceasing to engage in a trade or business if the operations of the trade or business cease, or substantially all the assets of the trade or business are transferred to another taxpayer in a taxable or non-taxable transfer. For this purpose, "substantially all" has the same meaning as in section 3.01 of Rev. Proc. 77-37, 1977-2 C.B. 568. No acceleration of the settlement amount is required under this section 7.02 when a C corporation elects to be treated as an S corporation, or an S corporation terminates its S election and is then treated as a C corporation. However, acceleration of the settlement amount is required if a sole proprietor incorporates and immediately elects to be treated as an S corporation.

.03 A taxpayer that makes one or more payments under this revenue procedure may not change from the LIFO inventory method pursuant to Rev. Proc. 97-37, 1997-33 I.R.B. 18, for a taxable year beginning before the date that the entire settlement amount is paid in accordance with this revenue procedure. A taxpayer requesting to change from the LIFO method for a taxable year beginning before the date that the entire settlement amount is paid, must file a Form 3115 in accordance with Rev. Proc. 97-27. The Commissioner will not grant consent to change from the LIFO method unless the taxpayer agrees to accelerate any remaining payments of the settlement amount.

SECTION 8. EFFECT ON OTHER DOCUMENTS.

Rev. Proc. 97-37 is modified.

SECTION 9. PAPERWORK REDUCTION ACT.

... The estimated total annual reporting burden is 100,000 hours.

The estimated annual burden per respondent will vary from 10 hours to 30 hours, depending on individual circumstances, with an estimated average of 20 hours. The estimated number of respondents is 5,000 ...

DRAFTING INFORMATION

The principal author of this revenue procedure is Jeffrey G. Mitchell of the Office of Assistant Chief Counsel (Income Tax & Accounting). For further information regarding this revenue procedure, contact Mr. Mitchell on (202) 622-4970 (not a toll-free call).

September 25, 1997



LIFO ACCOUNTING METHOD CHANGES: ADDITIONAL REVENUE PROCEDURES AMPLIFY & UPDATE REV. PROC. 97-27

**LIFO
METHOD
CHANGES**

The overall procedures for changing (LIFO) accounting methods and filing Forms 3115 that were included in Revenue Procedure 97-27 were reviewed and discussed in the June, 1997 issue of the *LIFO Lookout*. This Revenue Procedure was "the big one." It represented a major revision of, and it superseded, Revenue Procedure 92-20.

With Rev. Proc. 97-27 in place, during the following months the IRS continued to clean house by issuing several revenue procedures which amplified, modified and/or superseded other revenue procedures that were in place for dealing with specialized requests for LIFO changes. As a result, several old and familiar revenue procedures are no longer with us. Those which were superseded include:

<u>FORMER</u>	<u>SUBJECT</u>	<u>REPLACED BY</u>
Rev. Proc. 92-20	General Rules for Changing Methods	Rev. Proc. 97-27
Rev. Proc. 97-27	Alternative LIFO Method for Auto Dealers	Rev. Proc. 97-36
Rev. Proc. 88-15	Termination of LIFO Elections	Rev. Proc. 97-37
None	Used Vehicle Cost Determinations	Rev. Proc. 97-37
None	Determining Current Year Cost Under the LIFO Method	Rev. Proc. 97-37

(As an aside, but of special interest to auto dealers and their CPA advisors, the IRS also republished old Revenue Procedure 92-98 which described the Service Warranty Income Method (SWIM) for extended warranty/vehicle service contracts as Revenue Procedure 97-38. At the same time, the IRS folded old Rev. Proc. 92-97 (which described the proper treatment for deducting insurance premium payments made in connection with vehicle service contracts) into another part of Rev. Proc. 97-37. The September, 1997 issue of the *Dealer Tax Watch* contains extensive discussions of these and other current developments related to the taxation of vehicle service contracts.)

Revenue Procedure 97-37 is a very long and comprehensive document. It provides simplified and uniform procedures, terms and conditions for obtaining **AUTOMATIC** consent for a multitude of accounting changes, only some of which involve changes to, within or from the LIFO method. The effective date of Rev. Proc. 97-37 is August 18, 1997.

Because of its expanse, it includes various detailed procedural rules for LIFO method changes in Section 10 of an Appendix.

ALTERNATIVE LIFO METHOD FOR AUTOMOBILE DEALERS' NEW VEHICLE INVENTORIES ...

Republishes word-for-word the operative descriptions of the Alternative LIFO Method that auto dealers may use for new vehicle inventories ... Eliminates all of the former detailed transition rules that were necessary when the Alternative LIFO Method was introduced by Rev. Proc. 92-79 ... Changes may be made using the cut-off method (i.e., no Section 481(a) adjustment will be required).

TERMINATION OF LIFO ELECTIONS ... Requires 4-year spread period for recapture of LIFO reserves ...

This is the same as the general Section 481(a) spread for positive adjustments under Rev. Proc. 97-27.

DETERMINING THE COST OF USED VEHICLES PURCHASED OR TAKEN AS A TRADE-IN ... This does

not set forth an *official* or *IRS approved* LIFO methodology for used vehicles ... It only indicates that taxpayers agreeing to use the (somewhat restrictive) methods for determining cost of used vehicles *that it describes* are permitted to make *those* changes under the automatic consent provisions ... These changes are permitted to be made using the cut-off method (i.e., no Section 481(a) adjustment will be required).

DETERMINING CURRENT YEAR COST UNDER THE LIFO INVENTORY METHOD ... IRS now allows

changes involving the determination of current year cost to be made under the automatic consent provisions ... These changes are permitted to be made using the cut-off method (i.e., no Section 481(a) adjustment will be required).

INVENTORY PRICE INDEX COMPUTATION (IPIC) METHOD CHANGES ... Certain changes involving the

IPIC method are now allowed to be made under the automatic consent provisions.

More detailed information on each of the first four LIFO-related procedure changes is outlined on the following pages. *



ALTERNATIVE LIFO METHOD FOR NEW VEHICLES REV. PROC. 97-36 RESTATES REV. PROC. 92-79

R.P.
97-36

1. Republication of Alternative LIFO Method for Automobile Dealers ... for New Vehicles Only ... Previously Contained in Rev. Proc. 92-79.
 - A. Special Rules Contained in Section 10.03 of the Appendix to Rev. Proc. 97-37 Provide
 - (1) Change to the Alternative LIFO Method is Made Using a Cut-Off Method.
 - (2) Automatic Change Procedure Does Not Apply to Auto Dealer that Uses Inventory Price Index Computation (IPIC) Method for Goods Other Than New Automobiles, New Light-Duty Trucks, Parts & Accessories, Used Automobiles and Used Trucks.
 - (3) Special Rules are Provided for IPIC Method Changes.
2. Repeats Word-For-Word All Three Components of the Alternative LIFO Method.
 - A. Seven (7) Special Sub-Methods, Definitions and Rules.
 - B. Fourteen (14)-Step Computational Methodology.
 - C. Nine (9) Required Conditions of Consent.
3. All "Old" Interpretative Problems Under Rev. Proc. 92-79 Still Remain Unanswered.
 - A. *New Item* Determinations And IRS' "Unofficial" New Item Lists.
 - B. *Separate Trade or Business Issue*.
 - C. Treatment of Conversion Vans ... Definition of "Item."
 - D. Item Configuration ... i.e., Where Vehicle Contour Changes but Platform Doesn't.
4. Continues Warning to Dealers Who Are Electing LIFO and Also Electing to Apply the Alternative LIFO Method.
 - A. Be Sure Form 970 Filed with the Tax Return for the Year of Election is Clearly Marked to Indicate "Subsequent" Election to Use the Alternative LIFO Method.
 - B. All Related Sub-Methods Should Be Clearly Elected And Described.
5. Deletes "Old" Transitional Rules Provided Under Rev. Proc. 92-79 Which Have Become Irrelevant to Dealerships Currently Interested in Using the Alternative LIFO Method.
 - A. Dealerships Under Audit Mid-1992 When R.P. 92-79 Was Issued,
 - B. Or Making Alternative LIFO Elections Before the End of 1992 or After 1992 Under Rev. Proc. 92-20.
6. Effective Date: August 18, 1997 ... Modifies and Supersedes Rev. Proc. 92-79.



LIFO ELECTION TERMINATIONS

AUTOMATIC IRS APPROVAL-CONSENT

REV. PROC. 97-37 RESTATES REV. PROC.88-15

R. P. 97-37
LIFO
TERMINATIONS

1. Supersedes Rev. Proc. 88-15 ... Which Allowed Taxpayers a Filing Deadline as Late as 270 Days.
2. In Order to Qualify for Automatic Change, Taxpayer Must ...
 - A. Terminate LIFO Method for **ALL** LIFO Inventories, and
 - B. Change to the "Permitted Method" ... as Set Forth by the IRS.
3. Allows 4-Year Spread Period for Recapture of LIFO Reserve ... (Same as the General Section 481(a) Spread for Positive Adjustments Under Rev. Proc. 97-27).
 - A. Note, as Result of Rev. Proc. 97-27 Allowing the Filing of Form 3115 Any Time Before the End of the Year, Taxpayers Now Can Put Off a Decision to Terminate LIFO Almost to the End of the Year.
4. Provides Specific Rules for Determining What Inventory Method Must be Used by Taxpayer Based Upon One of Four Possible Scenarios.
 - A. If the taxpayer has inventoriable goods not included in its LIFO inventory computations (non-LIFO inventory) and, for all the taxpayer's non-LIFO inventory, the taxpayer uses an inventory method that is a permitted method, then the taxpayer must use that same inventory method for its entire inventory.
 - B. If the LIFO inventory method is used by the taxpayer with respect to all its inventoriable goods, then the taxpayer must use the same inventory method it used prior to the adoption of the LIFO inventory method, if that prior method is a permitted method.
 - C. If the taxpayer has only LIFO inventory and the method used by the taxpayer prior to the adoption of the LIFO inventory method is not a permitted method, then the taxpayer must use a permitted method.
 - D. If the taxpayer did not use an inventory method prior to the adoption of the LIFO inventory method and has no inventoriable goods other than its LIFO inventory, then the taxpayer must use a permitted method.
5. Defines "Permitted Method" Which Consists of...an Identification Method and a Valuation Method.
 - A. **Identification** Method Must be Either (1) First-In, First-Out (FIFO) or (2) Specific Identification.
 - B. **Valuation** Method Must be Either (1) Cost, (2) Cost or Market, Whichever is Lower ... (Market, Farm Price Methods and Retail Method are Provided for Other Taxpayers).
6. Other Specifics Regarding "Permitted Method."
 - A. Specifically Prohibits the Use of the Average Cost Method ("Rolling Average Method" Described in Rev. Rul. 71-234).
 - B. Clarifies that Whether an Inventory Method is a Permitted Method is Determined Only by the Taxpayer's Method of Inventory Identification (i.e., FIFO or Specific Identification) and Valuation (i.e., Cost or LCM) ... and Not by Which Types and Amounts of Costs are Capitalized Under the Taxpayer's Method of Computing Section 263A Inventory Costs to be Capitalized.
7. Requires the Completion and Attachment of Certain Statements to the Form 3115.
 - A. Essentially Confirming that the New Method Conforms With One of the Requirements of Section 10.01, With a Detailed Explanation of How the New Method Conforms to the Specific Subdivision.
 - B. Must Identify New Method of Identifying Inventory Goods and of Valuing Inventory Goods.
8. **Five (5)-Year Wait:** Taxpayer May Not Re-Elect LIFO for at Least Five Years, Unless, Based on a Showing of Unusual and Compelling Circumstances, IRS Grants Consent to Change Back to LIFO.
9. Discusses Effect of S Elections.
 - A. Effective for Year of LIFO Discontinuance.
 - B. Effective for Year after LIFO Discontinuance.
10. Effective Date: August 18, 1997.



USED VEHICLE LIFO CHANGES IN DETERMINING THE COST OF USED VEHICLES PURCHASED OR TAKEN AS A TRADE-IN

R. P.
97-37
USED

1. **WARNING:** This Section of Rev. Proc. 97-37 Does **Not** Set Forth an *Official* or *IRS Approved* LIFO Methodology for Used Vehicles. **SEE FURTHER DISCUSSION IN "UPDATE" COMMENT #4 ON PAGE 2.**
 - A. It Only Indicates That Taxpayers Agreeing to Use the (Somewhat Restrictive) Methods for Determining Cost of Used Vehicles Set Forth Are Permitted to Make That Change Under the Automatic Consent Provisions.
 - B. It Does Not Address How an Inflation Index for Used Vehicles Should be Computed in Terms of Whether Adjustments Should be Made for Comparability of Vehicles, Repricing of Options and (Major) Accessories, How Item Categories and/or "*New Items*" Should be Determined or Price-Reconstructed, etc. ...
 - C. All it Does is Provide a Glimpse of How the IRS (National Office) Thinks Cost for Used Vehicles Should be Determined.
2. Taxpayers Changing Their Method for Determining the Cost of Used Vehicles are Allowed to Make This Change Using a Cut-Off Method. This Change Applies to Used Vehicles Acquired During the Year of Change and All Subsequent Years.
3. This Change Applies to a LIFO Taxpayer That Wants to:
 - A. Determine the cost of used vehicles acquired by trade-in using the average wholesale price listed by an official used car guide on the date of the trade-in. See Rev. Rul. 67-107, 1967-1 C.B. 115. The official used car guide selected must be consistently used;
 - B. Determine the cost of used vehicles purchased for cash using the actual purchase price of the vehicle; or
 - C. Reconstruct the beginning-of-the-year cost of used vehicles purchased for cash using values computed by national auto auction companies based on vehicles purchased for cash. The national auto auction company selected must be consistently used.
4. Recap: For Vehicles Acquired by:
 - A. Trade-In ... Use Any Official Used Car Guide (i.e., *Black Book*, *Kelley*, *NADA*, etc.). Once Selected, the Official Used Car Guide Chosen Must be Consistently Used from Year to Year.
 - B. Cash purchase ... From Auction ... Use Values Compiled ("Computed") by National Auto Auction Company (i.e., *Manheim*, etc.). Once Selected, the National Auto Auction Company Chosen Must be Consistently Used from Year to Year.
5. Observations Regarding IRS Cost Determinations Above.
 - A. Many Dealers Who Purchase Used Vehicles Only From Local Auctions Might Have Significantly Different Price Factors Due to Local Conditions Which Would be Diluted by "National" or Other Region Price Factors.
 - B. Dealers Who May Acquire Used Vehicles Via Direct Dealer Trades Might Have Significantly Different Costs Than Those Determined by National Averages.
6. Revenue Ruling 67-107 Provides That a Car Dealer May Value His Used Cars for Inventory Purposes at Valuations Comparable to Those Listed in an Official Used Car Guide as the Average Wholesale Prices for Comparable Cars.
7. Effective Date: August 18, 1997.



CHANGES IN METHODS FOR DETERMINING CURRENT YEAR COST UNDER THE LIFO INVENTORY METHOD

**R. P. 97-37
CURRENT
COST**

1. Taxpayers That Want to Change a Method of Determining Current Year Cost for LIFO Purposes May Do So Under the Automatic Consent Provisions Using a Cut-Off Method.
2. This Applies to Taxpayers That Want to Change **TO** a Method of Determining Current Year Cost:
 - A. By reference to the actual cost of the goods most recently purchased or produced;
 - B. By reference to the actual cost of the goods purchased or produced during the taxable year in the order of acquisition; or
 - C. By application of an average unit cost equal to the aggregate actual cost of all the goods purchased or produced throughout the taxable year divided by the total number of units so purchased or produced. See Reg. Sec. 1.472-8(e)(2)(ii).
3. Effective Date: August 18, 1997



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

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ADDRESS: _____

CITY: _____ STATE: _____ ZIP: _____ PHONE: (____) _____

PAYMENT TRANSMITTAL MEMORANDUM

In order for the IRS to be able to properly keep track of a dealership's Settlement Amount payment status, each installment payment made must be accompanied by a memorandum containing the following information:

- | | |
|---------------------------|--|
| PAYMENT MEMORANDUM | <ol style="list-style-type: none">1. The taxpayer's name, address, and EIN number;2. The amount of the taxpayer's LIFO reserve calculated under Section 5.02(2);3. The total Settlement Amount calculated under Section 5.02(2);4. The amount of the installment being paid;5. A statement identifying the payment as the first, second, or third installment (or a statement that the taxpayer elects to pay the entire Settlement Amount in a single installment); and6. A statement that the taxpayer agrees to all of the terms of Revenue Procedure 97-44. |
|---------------------------|--|

The following language must appear legibly on the top of the first page of each memorandum: "PAYMENT OF SETTLEMENT AMOUNT UNDER REV. PROC. 97-44." The sample format "memorandum" on page 7 should be thoroughly reviewed with dealership counsel before its use is considered.

ACCELERATION OF PAYMENTS

If a dealership ceases to engage in its trade or business or terminates its existence, it must pay the remaining balance of the Settlement Amount within 45 days after its cessation of business or termination. A dealership is treated as ceasing to engage in a trade or business if the operations cease, or substantially all the assets of the trade or business are transferred to another taxpayer in a taxable or non-taxable transaction. Presumably, this would include many Project 2000 dealership corporate restructurings.

If a C corporation elects to be treated as an S corporation, or if an S corporation terminates its S election and is thereafter treated as a C corporation, there is no acceleration of the Settlement Amount. However, if a sole proprietor incorporates and immediately elects to be taxed as an S corporation, the remaining future installments of the Settlement Amount are accelerated.

If a dealership wants to terminate its LIFO election, under either the automatic consent procedures available in Rev. Proc. 97-37 or the regular procedures under Rev. Proc. 97-27, it will also be subject to special acceleration rules.

RELIEF ... AND SOME WARNINGS

A dealership that satisfies all of the requirements of Rev. Proc. 97-44 will not have its LIFO election

terminated because of a LIFO conformity violation described in Section 3 of the Revenue Procedure. As mentioned previously, the "scope" section refers to "any taxpayer" who is an automobile dealer who has violated the LIFO conformity requirement by providing **for credit purposes** an income statement in a Factory format that fails to reflect the change in LIFO inventory valuation in the determination of income in its year-end Income Statement.

The Revenue Procedure states that this relief—i.e., the IRS' waiver of the LIFO election termination sanction—will not apply if there are other LIFO conformity violations, including financial statement conformity violations that occur **after** October 14, 1997. Also, relief under Rev. Proc. 97-44 will not apply if the taxpayer has taken any other action that may warrant termination of its LIFO election under Rev. Proc. 79-23.

Furthermore: Taxpayers should not mistakenly conclude that the LIFO computations themselves during the look-back period are protected. Nothing in the Revenue Procedure prevents the IRS from auditing and adjusting the LIFO inventory calculations for any of the years during the look-back period that are still open; that is, of course, all of them insofar as inventory valuation matters and Section 481(a) adjustments are concerned.

DO IT RIGHT... AND PAY ON TIME... OR ELSE

The taxpayer's LIFO election may be terminated by a District Director for any violation year ended within the look-back period if the taxpayer failed "to fully satisfy the requirements of this revenue procedure." The language and the tone of the Revenue Procedure are heavy-handed in proclaiming loss of all chance of hope for relief if a dealership fails to comply in every respect with every requirement, no matter how minor it might be.

The Revenue Procedure states that if a taxpayer fails to pay each installment due on time, or fails to submit the transmittal memorandum, it has not satisfied the requirements for relief... and the penalty is that relief under the Revenue Procedure is not available!

CONCLUSION

For some dealerships that violated the conformity requirement, their fact pattern may be simple, and they may be very happy just to pay the 4.7% and get on with their lives. For them, Rev. Proc. 97-44 will be the best "break" to come along in a long time.

For other dealerships, and their CPAs, the questions left unanswered by the IRS—some intentionally, others by virtue of not even being considered—will result in still more uncertainty with a huge, almost intolerable downside risk. *



