De Filipps' LIFO LOOKOUT

A Quarterly Update of LIFO - News, Views and Ideas

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LIFO UPDATE

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

#1. CORE REMANUFACTURER LOSES LIFO ELECTION BECAUSE IRS SAYS IT CAN'T "PICK & CHOOSE" WHAT GOES ON LIFO. The Tax Court recently upheld the IRS in disallowing the LIFO election of *Consolidated Manufacturing, Inc.* because it tried to "pick and choose" what it put on LIFO so that some cost components reflecting inflation increased the LIFO reserve, while other cost components–not on LIFO–created tax deductions through year-end write-downs to scrap value.

This case should be studied carefully by any taxpayer in a manufacturing or a processing mode who is using LIFO and believes that its placement of some goods on LIFO, while keeping others off, is giving it the "best of both worlds." This case is not about taxpayers who have elected natural business unit methods, nor is it about taxpayers who have elected "raw material content" pooling methods. The case is about LIFO elections for taxpayers who fall anywhere between those positions on the LIFO spectrum.

Our initial observations a few years ago in reporting the Tax Court decision in *Hamilton Industries, Inc.* were ... "In case you didn't hear it explode, the Tax Court did drop a bomb on LIFO calculations in July (1991) when it upheld the IRS in *Hamilton Industries, Inc.* ... Whether further damage to LIFO will be widespread depends on how aggressively the IRS tries to expand the significant leverage it now enjoys relative to **all** LIFO calculations (not just bargain purchases) and whether the taxpayer can get the IRS position reversed on appeal."

These strong statements about the precedential potential of *Hamilton*, we believe, can also be made about the Tax Court decision in *Consolidated Manufacturing, Inc.* (111 T.C. No. 1) filed July 28, 1998. There are at least two reasons for the significant impact of this case.

LOOKOUT LOOKS INTO

First, Consolidated attempted to justify its selection of some–but not all–of its costs on LIFO by bringing in a "components-of-cost" LTR/TAM from 1994 in its (unsuccessful) defense... and it is well known that variations on a components-of-cost LIFO methodology are commonly employed by many major manufacturing companies experiencing technological changes in their products and processes.

Second, Consolidated thought–and argued unsuccessfully–that if what it did was not proper in terms of including all costs, then the only remedy the IRS might have ... if it didn't agree ... would be to require "recalculations." Consolidated thought its LIFO election was safe under the "protection" thought to be afforded LIFO users by Revenue Procedure 79-23.

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The Tax Court did not see the Commissioner's remedy as being that limited. Instead, the Tax Court held that the Commissioner did not abuse her discretion in terminating the taxpayer's LIFO election.

Manufacturers and processors who have elected LIFO for some—but not all—of their ***costs*** will want to review this case carefully because all of the arguments and defenses that the taxpayer raised were rejected by the Court.

Accordingly, if any of these defenses are being relied upon by LIFO taxpayers with similar types of LIFO elections, at least they now know how the Tax Court will interpret the regulations and Revenue Procedure 79-23.

#2. MEDIUM- & HEAVY-DUTY TRUCK DEALERS GET CONFORMITY VIOLATION RELIEF. Last year, the IRS extended relief to auto and light-duty truck dealers who had LIFO conformity violations on their year-end Factory statements in any one of the six prior years. *Rev. Proc. 97-44* allowed them to keep their LIFO elections and reserves if they paid a 4.7% penalty tax based on their LIFO reserves at December 31, 1996. The 4.7% penalty was payable in three equal annual installments starting in 1998.

Now, the IRS ... in Rev. Proc. 98-46 ...has extended this conformity-violation relief to all medium- and heavy-duty truck dealers. Most of the same requirements and conditions for relief apply. They pay their three equal annual installments with the first one due January 31, 1999. If the dealer was under audit on September 8, 1998, the first installment payment date is accelerated to December 1, 1998. For more details, see page 17, 26-27.

#3. LIFO CONFORMITY CRACKDOWN... WHO'S NEXT? As we have observed before, there are significant implications from Rev. Rul. 97-42 and Rev. Proc. 97-44 that extend far beyond auto and now medium- and heavy-duty truck dealers. The portion of the LIFO regulations which the IRS has interpreted in providing relief for these NADA constituencies really applies to ***all*** taxpayers using LIFO ... every year. And, there's no way to go back and "cure" any conformity defects. The IRS has "forever" to go back and make you dig out all of the details and year-end financial statements that were issued.

The IRS offered relief only for conformity violations involving dealers' Factory income statements for years through 1996. The year 1997 is not included. Also, this relief is comparably narrow because it is granted **only** to automobile and truck dealers for **certain** conformity violations. How are countless other businesses on LIFO submitting similar formatted statements under similar circumstances to their manufacturers and credit sources going to be treated?

Advisors who feel aggressive about challenging the IRS in Court on terminating LIFO elections for this issue should ***carefully*** consider all of the implications of the Tax Court's holdings in *Consolidated Manufacturing, Inc.*

#4. FIELD SERVICE ADVICE TELLS AGENTS TO ATTACK ITEM DEFINITION BECAUSE THEY CAN'T PREVENT USE OF THE DOLLAR-VALUE METHOD. "Where you can't attack the overall LIFO method, attack the pooling and item definition." That's the essence of a 1992 Field Service Advice (FSA) Memorandum on the question of whether a taxpayer may use the dollar-value LIFO method, even though a specific identification method may reflect income more clearly or accurately.

The FSA holding was that dollar-value LIFO could be used despite the specific identification nature of the inventory. However, the FSA suggested that collateral challenges to the taxpayer's LIFO election should be directed at how items were defined within a pool and the pooling method. This FSA was recently made available under the Freedom of Information Act, and it is discussed on page 22.

#5. FIELD SERVICE ADVICE: PRYING MORE LIFO INFORMATION OUT OF THE IRS. In all of the prior years the *LIFO Lookout* has been published, there have never been any references or discussions of Field Service Advice Memoranda as a source of background information on LIFO. This is not because FSAs did not exist; rather, it is because the IRS refused to make them public under the Freedom of Information Act...until recently.

Many taxpayers and their advisors were not even aware that examining agents could "secretly" go "higher up" in the National Office for tax advice or direction, without ever directly involving the taxpayer in the process. That's right... we're not talking about the familiar request for technical advice proceedings, ...we're talking about an entirely different animal.

Thanks to *Tax Analysts* suing the IRS for disclosure of its Field Service Advice Memoranda, and persistently and doggedly staying with it—even after the IRS lost in court and tried several other end runs—this source of LIFO information in now trickling out.

Readers unfamiliar with the Field Service Advice process will find more information on page 23.

#6. A NEW WRINKLE FOR AUTO DEALERS TERMINATING LIFO ELECTIONS FOR PARTS INVENTORIES. A caller recently shared an experience its client is having with the IRS National

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Office in connection with trying to terminate its LIFO election for parts inventories. Apparently, the IRS is dragging its feet in allowing the dealer permission to terminate its LIFO election for parts because the IRS is saying that it is necessary to have the parts inventory on cost (i.e., actual cost)...rather than the more conventional ***replacement cost*** approach.

The dealer has its new vehicles on LIFO, and it only wants to take the parts inventory off of LIFO. The new wrinkle or glitch is simply that Section 10 of the Appendix to Revenue Procedure 97-37 specifies that in changing from the LIFO method, the taxpayer must change to "the permitted method as determined in Section 10.01(1)(b) of this Appendix."

The referenced requirements indicate how the taxpayer is to determine the inventory method to be used (which depends on whether or not all or some of the inventory will remain on LIFO) and defines what the Service means by "a permitted method." A permitted method is one in which the identification method is either the First-In, First-Out (FIFO) inventory method or the specific identification inventory method and the valuation is cost or cost or market, whichever is lower ... .

Apparently, the IRS is still very much alert to the use of replacement cost by automobile and truck dealers, as well as other taxpayers, for their parts inventories. This also ties in with the pending decision to be issued eventually by the Tax Court in the case of *Mountain State Ford Truck Sales*, to which we have referred in preceding *LIFO* "Update" columns.

If any readers have experienced similar situations with the National Office recently, we would like to hear more about them.

#7. IRS TELLS IPIC/LIFO USERS: JUST "BE REASONABLE" ... WHEN YOU'RE JILTED BY THE BLS. Many taxpayers use the CPI or PPI indexes published by the Bureau of Labor Statistics for their dollar-value LIFO computations by making the "IPIC" or "Inventory Price Index Computation" election. Despite the fact that most taxpayers are permitted to use only 80% of the BLS index results, there still is some attraction because of the "simplicity" and lesser likelihood of challenge of the results on audit by the IRS.

Alas... Even the smooth sailing anticipated by users of the IPIC method can sometimes run into glitches. For example, the BLS frequently makes changes to the categories included in the Consumer Price Index or the Producer Price Index results. When the BLS publishes a ***revised*** CPI or PPI index, the revision may be caused by:

BLS CHANGES

- Adding new index categories,
- Eliminating some previously reported index categories,
- Resetting the base year of some index categories, or
- Not reporting the relative weights of some index categories.

When a revised index is published, that obviously creates a lack of continuity with prior indexes...for which some adjustment is required.

In Revenue Procedure 98-49 (1998-37 IRB 1), the IRS told IPIC-LIFO users to "just be reasonable" when they cannot compute the LIFO indexes from year to year in strict conformity with prior year indexes because of BLS index revisions.

Actually, the IRS said that a taxpayer "may use any reasonable method of computing a percent change for each affected index category, as long as it is used consistently for all affected index categories within a particular taxable year." The Service also provided an example or safe-harbor computation that it would deem to be "reasonable" for these purposes.

Where the revised CPI or PPI includes new index categories or eliminates or resets old index categories, in the Service example, the year is broken into two portions using a procedure which computes the total percent change for the year as a combination of (1) the percent change for the second portion of the taxable year based on the revised index category and (2) the corresponding percent change for the first portion of the taxable year based on the old index category. Note: That seems pretty logical.

Where the CPI or PPI does not report the relative weights for one or more of the taxpayer's detailed index categories within a selected index category, the taxpayer will be deemed to use a reasonable procedure if it weights the detailed index categories actually present in its ending inventory... using the taxpayer's actual inventory weights. Note: That, too, seems pretty logical.

Rev. Proc. 98-49 provides that the selection of a new CPI or PPI index for a specific inventory item to compute an inventory price index as the result of revisions to the CPI or PPI will not be treated as a change in accounting method. However, any other change in the selection of a CPI or PPI index for a specific inventory item is a change in method requiring advance consent of the Commissioner.

The ***real*** question is: How often have BLS index users blown right past these discontinuities in the past, without even being aware they were there?

IRS TERMINATES *CONSOLIDATED MFG, INC'S* LIFO ELECTION MADE FOR SOME–BUT NOT ALL– *COSTS* THAT MAKE UP *GOODS*

CAN'T "PICK & CHOOSE"

OVERVIEW

Consolidated Manufacturing, Inc. is an auto parts remanufacturer in Hutchinson, Kansas engaged in the business of recovering, reconditioning, restoring and then selling used automobile parts, including engines, crankshafts, cylinder heads and transmissions. Used cores, generally acquired from customers, along with other new and/or used purchased parts collectively comprised the equivalent of the taxpayer's raw materials which were integral to its remanufacturing activities.

In 1980 when Consolidated elected LIFO, it included only ***new*** purchased parts and remanufacturing conversion costs (labor and overhead) in its LIFO election.

Consolidated deliberately excluded ***used*** customer cores, ***used*** engines, and other ***used*** parts... which comprised the major part of the product...from its LIFO election. For these ***used*** raw materials inventories, Consolidated continued the first-in, first-out (FIFO) method and the lower of cost or market basis for valuation purposes. The result was that the ***used*** raw materials inventories were almost all written-down to scrap or salvage value at year-end for tax purposes.

The IRS determined that Consolidated's method of reporting only ***new*** parts, labor and overhead (and excluding ***used*** parts which comprised substantially all of the product cost) did not clearly reflect income. According to the IRS, Consolidated's method was contrary to the requirements of Section 472 and the underlying regulations. As a result, the IRS terminated Consolidated's LIFO election and assessed roughly $1.3 million.

The IRS also challenged Consolidated's method of valuing its used customer core raw material inventory. The IRS took the position that the taxpayer did not reflect the proper amounts for customer cores under the first-in, first-out, lower of cost or market method of valuation. This issue was where the bigger dollars were, involving an assessment of roughly $2.4 million.

The Tax Court upheld the IRS on both issues in *Consolidated Manufacturing, Inc. v. Commissioner,* 111 T.C. No 1 (Tax Court Docket No 6176-96). The taxpayer has filed an appeal to the Tax Court's decision in the 10th Circuit.

In holding that the taxpayer's LIFO method did not clearly reflect income, the Tax Court held that a taxpayer may not elect LIFO for anything other than a ***good***. In other words, a taxpayer cannot elect LIFO for certain ***costs*** which constitute a portion of a ***good***. After reaching those conclusions, the Court held that the Commissioner did not abuse her discretion in terminating the taxpayer's LIFO election, interpreting Revenue Procedure 79-23 more favorably to the IRS than some (taxpayers) might have expected.

The Court observed that Rev. Proc. 79-23 does not contain an exclusive list of circumstances under which LIFO elections may be terminated, and that LIFO elections may be terminated under the Commissioner's discretionary power at least in this case where the taxpayer's method did not clearly reflect income. In the Court's view, the taxpayer's failure to apply LIFO to its entire ***good*** (i.e., it applied LIFO to only some of the cost components), constituted a <u>failure to properly elect LIFO</u>, which is one of the grounds for termination listed in Rev. Proc. 79-23.

Critical to the Company because it involved more dollars, but of less interest to LIFO followers, was the Court's holding that the inventories of used customer cores had to be valued at purchase cost, and not at either scrap prices or at amounts paid to core suppliers for cores of comparable quality. This holding will be of special importance to ***<u>all</u>*** taxpayers involved in similar-type remanufacturing operations involving cores.

IMPORTANCE OF THE LIFO HOLDINGS

LIFO cases are now coming out of the courts more frequently than they have been in the past. Some advisors tend to summarily dismiss reported LIFO cases based on the nature of the business the taxpayer is in, if that business is not one in which they are interested. The case involving *Consolidated Manufacturing, Inc.*, a core remanufacturer, should not be minimized or underestimated because there may be a relatively small number of core remanufacturers.

The three significant LIFO holdings of the Tax Court in this decision will be cause for concern if the taxpayer is unsuccessful in its appeal.

<u>First:</u> LIFO elections may not be made for cost components; LIFO elections may only be made for ***entire*** goods or products. This has great significance for taxpayers using various types of "components-of-

see **IRS TERMINATES *CONSOLIDATED MANUFACTURING's* LIFO ELECTION...**, page 6

ISSUES	TAX COURT HOLDINGS
1. Did the IRS Commissioner abuse her discretion in determining that the taxpayer's method of reporting only certain raw materials, labor and overhead in its LIFO election (while reporting certain other raw materials on the FIFO inventory method) does not clearly reflect income ...? ***LIFO issue: Section 472***	1. ***NO: The Commissioner did not abuse her discretion.*** The taxpayer's method of electing LIFO for only new purchased parts and remanufacturing conversion costs (labor and overhead) ... while excluding used parts which comprised substantially all of the product cost ... was contrary to the requirements of Section 472 and did ***not*** clearly reflect income.
2. If the taxpayer's method of applying LIFO did not clearly reflect income, could the Commissioner terminate the taxpayer's LIFO election under Revenue Procedure 79-23 or under any other authority? Note: The taxpayer's position was that the Commissioner could not terminate its LIFO election if the taxpayer agreed to "reform" its LIFO election to avoid termination by including its used core inventory in its LIFO election, valuing the cores at cost, & making any necessary adjustments. ***LIFO issue: Section 472***	2. ***YES: The Commissioner could terminate the taxpayer's LIFO method*** because it did not clearly reflect income. In this regard, the Commissioner did not abuse her discretion, either. The taxpayer's failure to apply LIFO to its entire ***good*** (i.e., it applied LIFO to only some of the cost components) constituted a failure to properly elect LIFO, which is one of the grounds for terminating a taxpayer's LIFO election, within the scope of Rev. Proc. 79-23. Sec. 446(b) and Reg. Sec. 1.472-3(d) both authorize termination by the IRS Commissioner.
3. Did the IRS Commissioner abuse her discretion in determining that the taxpayer's method of valuing certain raw materials (used customer cores) does not clearly reflect income ... because it did not reflect the proper amounts for those raw materials under the FIFO inventory method and the LCM (lower of cost or market) basis of valuation? ***Non-LIFO issue: Section 471***	3. ***NO: The Commissioner did not abuse her discretion.*** Customer cores should be valued at amounts paid as determined by transactions which were sales by the customers to the taxpayer...i.e., at invoice price. Accordingly, taxpayer should not value ending inventory at scrap value ... nor at prices paid by core suppliers to purchase similar cores from a salvage yard.

CORE INVENTORIES

The taxpayer's original LIFO election in 1980 and its subsequent election to use the IPIC method in 1982 were for "reconditioning costs and ***new*** part inventories, not including the cost of ***used*** core inventory." The LIFO elections were made as to the labor, overhead and ***new*** parts components of the taxpayer's *goods* (i.e., the remanufactured automobile parts) with the core component being excluded. Taxpayer acquired used cores from two sources for use in its remanufacturing process. These cores are referred to as (1) customer cores and (2) supplier cores.

Customer cores were acquired from customers at core amount and, if utilized in the remanufacturing process in the year acquired or in subsequent years, were valued at the supplier core amount. ***Consolidated*** valued its year-end inventory of used customer cores at scrap value, even though they were not subnormal goods.

Supplier cores were acquired on an as-needed basis from persons engaged in the business of selling cores (i.e., core brokers or core suppliers). Supplier cores were usually obtained only on a special order basis to satisfy a specific or temporary demand that had arisen for a particular remanufactured part. Accordingly, supplier cores were placed in production very soon after being acquired and were usually not present in year-end inventory. ***Consolidated's inventory valuation of supplier cores was not at issue or in dispute in this case.***

cost" approaches in their LIFO elections. So, if a taxpayer has a LIFO election from which–like Consolidated–it thinks it can enjoy "the best of all possible worlds" by "picking and choosing" what it has put on LIFO by selecting only partial cost components, the consequences in an IRS audit could be quite adverse.

Second: Revenue Procedure 79-23 has long been thought by many to be a sort of "Bill of Rights," protecting LIFO users from unwarranted loss of their LIFO elections on audit...except where cost, conformity, consent (i.e., the filing of Form 970 was overlooked or forgotten), or adequate books and records requirements were violated.

The Tax Court's interpretation of Revenue Procedure 79-23 in support of the Commissioner will come as a surprise to many. The Court's rationale upholding the IRS breaks new ground by stating that the so-called conditions for termination of a LIFO election set forth in Rev. Proc. 79-23 do not comprise an exclusive list. See page 18 for a more detailed discussion of Rev. Proc. 79-23.

Accordingly, two new or additional situations can be added to those listed in Rev. Proc. 79-23 as grounds for termination of a LIFO election:

1. Failure to elect LIFO with respect to ***an entire good or goods*** subject to inventory
2. Failure to use a LIFO method that ***clearly reflects income***.

Third: The Commissioner will be upheld in terminating LIFO elections or changing accounting methods that do not clearly reflect income in all cases except where the method selected by the Commissioner does not clearly reflect income. The taxpayer cannot challenge the new method selected for the taxpayer to use by the Commissioner, even though other alternatives more preferable to the taxpayer might be available.

Cases where the IRS challenges a taxpayer's LIFO methods/elections invariably involve changes in accounting methods. These are the opposite sides of the same coin. Absent a clear reflection of income, the method used by a taxpayer can readily be changed by the IRS/Commissioner...and a change in method by the Commissioner necessitates a termination of the improper method being used.

The presumption of correctness is with the Commissioner, and the burden of proof otherwise is on the taxpayer. Relatively few taxpayers are able to successfully navigate up that steep, slippery slope. In other words, the Commissioner has all the leverage while the taxpayer bears the entire burden of proof.

THREE SETS OF QUESTIONS

Not too long ago, in *E.W. Richardson* (T.C. Memo 1996-368), the Tax Court thoroughly examined three LIFO issues: (1) Whether the taxpayer made an unauthorized change in accounting method, (2) whether the method of inventory accounting clearly reflected income and (3) whether the IRS Commissioner abused her discretion in relation to the definition of certain *items* of inventory. This case was discussed at length in the September, 1996 *LIFO Lookout* and much of that general analysis also applies in the case of *Consolidated Manufacturing, Inc.*

Consolidated Manufacturing, Inc., like *Richardson*, involves three sub-sets of questions or issues. The briefs filed by the taxpayer and by the IRS framed the overall issues somewhat differently, perhaps because of the way in which the taxpayer was trying to structure its defense. And, the Tax Court boiled the whole case down to two issues or questions.

In analyzing this case, our discussion identifies three essential sets or sub-sets of questions.

First Set of Questions: Was Consolidated's LIFO election method correct or not? Was it using a proper LIFO method? Did that LIFO method clearly reflect income? Was there support for that method in the Code and in the Regulations?

Second Set of Questions: If Consolidated's LIFO election did not clearly reflect income, could the taxpayer simply be allowed to modify its LIFO results to reflect the inclusion of what the taxpayer originally left out? Or, was the Commissioner acting reasonably (and within the scope of Revenue Procedure 79-23 and/or the regulations) in terminating the taxpayer's LIFO election? Was the Commissioner acting unreasonably, or was the termination of the LIFO election an abuse of the Commissioner's discretion? Did Rev. Proc. 79-23 prevent the Commissioner from terminating the LIFO election?

Third Set of Questions: As for the non-LIFO issue involving FIFO-LCM inventory valuation...On a scale from the highest to lowest amounts: How should the inventory of used customer cores at year-end be valued? Should it be valued at:

- ***PURCHASE PRICE***...core amount...exchange deposit amount as determined by one-on-one transactions with individual customers who bought remanufactured parts (the highest amount),
- ***SUPPLIER CORE COST***...a lower amount based on prices paid to purchase used cores from businesses operating as core suppliers, or

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- ***SCRAP VALUE***...the lowest amount out of the three alternatives?

THE TAX COURT SAW ONLY TWO ISSUES

As streamlined by the Tax Court, there were only two issues and both were stated in terms of "clear reflection of income": the Section 472 LIFO issue and the Section 471 non-LIFO issue.

(1) Did the respondent (i.e., the IRS Commissioner) abuse her discretion in determining that ***Consolidated's method of reporting*** (certain raw materials, labor, and overhead on the LIFO inventory method and certain other raw materials on the FIFO inventory method) ***does not clearly reflect income*** because it contravenes the requirements of Section 472 and the regulations thereunder ***and that therefore*** Consolidated's election to use that method should be terminated? ... We (the Tax Court) hold that respondent did not.

(2) Did the respondent abuse her discretion in determining that ***Consolidated's method*** of valuing certain raw materials (used customer cores) ***does not clearly reflect income*** because it did not reflect the proper amounts for those raw materials under the FIFO inventory method and the LCM basis of valuation permitted by Section 471? ... We (the Tax Court) hold that respondent did not.

CONSOLIDATED'S METHOD OF APPLYING LIFO

Consolidated submitted Form 970, Application to Use LIFO Inventory Method, with its 1980 tax return electing to apply LIFO...to the following specified goods: Reconditioning costs (i.e., direct labor and overhead incurred for the production of remanufactured auto parts) and ***new*** parts inventories, <u>not including the cost of used core inventory</u>.

LIFO was not elected for used engines and parts (cores). As part of its dollar-value LIFO method, Consolidated (s)elected "one pool consisting of raw material, purchased parts and remanufacturing costs" ...and it stated that "the index method has been used by the company in computing the value of the dollar value pool."

Consolidated submitted another Form 970 with its 1982 tax return at which time it indicated that it was changing to Simplified LIFO and changing to two pools. On its 1982 Form 970, *Consolidated* stated ... "two pools are used: (1) motor vehicle parts; and (2) machine shop products. Pools include raw material, purchased parts and remanufacturing costs." (Note again the exclusion of *used* customer cores, *used* engines and other *used* parts from its LIFO election.)

The Form 970 stated that ... "due to changes made by the Economic Recovery Tax Act of 1981, which allows a change to the use of published indexes, taxpayer hereby elects to compute LIFO inventories by using such Government published indexes as prescribed in Reg. Sec. 1.472- 8(e)(3). Per Reg. Sec. 1.472-8(e)(3)(v), prior consent of the Commissioner is not required if the change is made for the first or second taxable year ending after 1981." Consolidated also elected to use the October Producer Price Index report as a representative month for selecting indexes.

Consolidated consistently applied the LIFO inventory method described in the 1980 Form 970, with the modifications for the change to the BLS/IPIC computation method, forward from 1982.

THE COMMISSIONER'S DISCRETION

In discussing Sections 446 and 471 and the regulations thereunder, the Court said that, collectively, they vest the Commissioner of the IRS with ***wide discretion*** in determining whether a method of inventory accounting should be disallowed because it does not clearly reflect income.

The Court said that...the Commissioner's interpretation of the clear reflection standard under Sections 446 and 471 may not be disturbed *unless it is clearly unlawful or plainly arbitrary...* The Commissioner's discretion under Sections 446 and 471 is not unbridled, however.

The only two cases cited by the Court in this discussion were (1) *Thor Power Tool Co.* (439 U.S. 522 (1979)) and (2) *Hamilton Industries, Inc.* (97 T.C. 120 (1991)).

The Court said that it had given due consideration to all of the parties, arguments and contentions with respect to those issues, even though it did not attempt to address each of them in its lengthy opinion.

ELECTING LIFO FOR *"COSTS"* INSTEAD OF ELECTING LIFO FOR *"GOODS"*

The Court's opinion includes a rather extensive history of (1) the inventory method of tax accounting, (2) the FIFO inventory method and (3) the LIFO inventory method. It noted that the use of inventories goes as far back as the Revenue Act of 1918 when use of inventories was first required whenever, in the opinion of the Commissioner, such use was necessary in order to determine clearly the income of any taxpayer. At that time, the use of FIFO was recognized as a necessary matter of convenience where goods taken in inventory were so intermingled that they could not be identified with specific invoices. LIFO, of course, did not come onto the scene until 20 years later in the Revenue Act of 1938.

see **IRS TERMINATES *CONSOLIDATED MANUFACTURING's* LIFO ELECTION...**, page 8

The IRS did not dispute that Consolidated's LIFO method conforms to Generally Accepted Accounting Principles (GAAP) and that it therefore satisfies the requirement of Section 471 and the regulations thereunder that that method conform "as nearly as may be to the best accounting practice in the trade or business." The IRS also did not dispute that Consolidated consistently applied that method.

But, compliance of the LIFO method with Section 471 is not enough here, because Section 472 is also involved. The Court said that the dispute between Consolidated and the IRS with respect to Consolidated's LIFO method is limited to whether the Commissioner abused her discretion "in determining that that method does not clearly reflect income because it contravenes the requirements of Section 472 and the regulations thereunder...and that, consequently, Consolidated's election to use that method should be terminated."

The Court observed that: Consolidated's remanufacturing business depended on a supply of two raw materials: cores and new parts. During the remanufacturing process, Consolidated incurred expenditures for labor and overhead and transformed those raw materials into its finished goods or products (i.e., remanufactured automobile parts). Thus, cores, new parts, labor, and overhead all entered into the production of those finished goods or products. Pursuant to Reg. Sec. 1.471-1, Consolidated maintained inventories for each of the two unprocessed raw materials that it used in its remanufacturing business, for partly finished goods (i.e., goods in process), and for finished (remanufactured) goods. Virtually all of the cores included in Consolidated's inventories were customer cores.

Consolidated had elected to use the LIFO inventory method with respect to new parts, labor, and overhead, but not customer cores. Thus, under Consolidated's LIFO method, it used (1) the LIFO inventory method for (a) new parts that were included in its inventories for unprocessed new parts, for goods in process, and for finished goods and (b) labor and overhead that were included in its inventories for goods in process and for finished goods and (2) the FIFO inventory method for customer cores that were included in its inventories for unprocessed customer cores, for goods in process, and for finished goods.

The IRS contended that a taxpayer who wants to elect the LIFO inventory method must (1) make that election with respect to a good or goods subject to inventory and specified in the application (i.e., on Form 970) and (2) make that election with respect to such entire good or goods and not a portion thereof.

In its brief the IRS had argued: "It is critical to note that the statute and the regulations specify that the election is to be made as to "goods". The ***goods*** produced by Consolidated are remanufactured automobile parts, such as remanufactured engines. Under the general rule, if Consolidated elected LIFO as to remanufactured automobile engines, the LIFO election would apply to raw materials, i.e. cores and new parts, and the reconditioning costs, i.e. labor and overhead. However, Consolidated elected as to only a portion of each type of good by excluding cores. For each type of goods, such as remanufactured engines, this left a portion of the goods (new parts and reconditioning costs) on LIFO, and a portion of the goods (cores) on FIFO."

The IRS had also indicated that a permissible variance to the inclusion of the total goods on LIFO is provided by Reg. Sec. 1.472-l(c) which allows the LIFO election to be restricted to raw materials.

It did not escape the Commissioner's eye that Consolidated was "picking and choosing" in its LIFO election. The IRS brief stated that ... "Consolidated has fashioned a method of accounting that factors out inflationary price increases for part of a particular good (labor, overhead and a secondary raw material –new parts) and takes into account inflation ***and*** changes in market value for the remaining portion of the goods (the principal raw material–the core). This is inconsistent with the plain language of Section 472 and the purpose of the LIFO method. A taxpayer must decide *in toto* for a type or class of goods whether it will use either the LIFO method to currently deduct inflationary price increases or the LCM method to currently deduct decreases in the market value of production costs. A taxpayer is not permitted to use a hybrid of these two methods for a single type or class of goods."

In support of its position, the IRS pointed out that Section 472(a) and Reg. Sec. 1.472-l(a) both use the specific word ***goods*** as the reference (antecedent) to which the use of a LIFO election is directed.

Consolidated had conceded that Section 472 and the regulations thereunder are worded in terms of electing to value ***goods*** under the LIFO method.

In trying to qualify its position, Consolidated had argued that the regulations made it clear that the "cost" of finished and partly finished goods consists of the "cost" of raw materials, labor and overhead. It further argued that "the finished and partly finished goods included in such an (LIFO) election necessarily consist of the cost attributable to raw materials, labor and overhead." In citing other regulations, Consolidated had argued that the cost of raw mate-

see **IRS TERMINATES *CONSOLIDATED MANUFACTURING's* LIFO ELECTION...**, page 12

IRS ARGUMENTS & CHALLENGES TO CONSOLIDATED MFG'S LIFO ELECTION

IRS BRIEFS

The Commissioner's decisions (1) to terminate the taxpayer's LIFO election and return it to FIFO and (2) to require it to value customer cores in year-end inventory at purchase cost ... must be sustained because they are not an abuse of discretion.

1. The taxpayer's initial LIFO election and its subsequent IPIC method election were in direct contravention to the statutory and regulatory directives that the ***LIFO election may only be used for goods, not selected costs pertaining to a good.***
2. Because the taxpayer's exclusion of its used customer cores from its LIFO election was contrary to statutory and regulatory authority, its reliance on GAAP was misplaced.
3. The dollar-value LIFO method makes LIFO available to virtually all taxpayers required to maintain inventories because it permits substitution among ***goods,*** not ***costs.***
4. The taxpayer elected to use the dollar-value LIFO method, not some "other method."
5. The fact that the taxpayer's LIFO method is not consistent with affirmative requirements in the regulations is a sufficient basis for disallowance.
6. The taxpayer's LIFO method is ***fundamentally incompatible*** with several requirements under IRC Section 472 and Reg. Sec. 1.472-8.
   - A. Section 472 requires LIFO to be applied to ***goods.***
   - B. The taxpayer's method is in contravention of all permissible pooling methods because, if labor and overhead are valued using LIFO, ***all*** underlying raw materials must be valued using the LIFO method.
   - C. The pooling rules under Reg. Sec. 1.472-8(b) are entirely consistent with the fact that only raw material content method and type or class of goods method elections are permitted under the regulations.
   - D. The taxpayer's example is misplaced because (1) under the raw material content method, the ***focus is on what is valued on the LIFO method,*** not what is valued on the FIFO method and (2) the example assumes the taxpayer is gratuitously foregoing a LIFO benefit for its cores.
   - E. The taxpayer's method is incompatible with acceptable methods of computing price indexes under dollar-value LIFO.
   - F. The taxpayer's method is inconsistent with base-year cost reconstruction under dollar-value LIFO because base-year cost reconstruction applies to "raw materials and products."
7. Taxpayer is not entitled to avoid termination of its LIFO election by now ***reforming*** the election.
8. The Commissioner did not abuse her discretion in requiring the taxpayer to value customer cores in year-end inventory based on the core amount. (Non-LIFO issue: Section 471.)
   - A. Taxpayer obtains cores from its customers by ***purchase***...(not by **exchange**).
   - B. Taxpayer's sales of remanufactured automobile parts are not subject to IRC Section 1001.
   - C. Reg. Sec. 1.471-3(d) does not apply to core acquisitions.
   - D. The cost of customer cores obtained by the taxpayer is not a "fair market value" issue.
   - E. The holding in Rev. Rul. 67-107 does not apply to the remanufactured automobile parts industry because remanufacturers do not customarily negotiate the selling price of their remanufactured parts.
   - F. Taxpayer's interpretation of the core valuation analysis in *Burrell v. Commissioner* is unpersuasive.
   - G. To the extent, if any, that "fair market value" is relevant, it is not the price paid by core suppliers to purchase a like core from a salvage yard.
   - H. No portion of the core amount is properly excludable from cost.
   - I. The core amount is not a deposit.
   - J. The taxpayer's ability to manipulate the core amount is limited.

TAXPAYER'S SEVEN UNSUCCESSFUL DEFENSES

TAXPAYER'S BRIEFS

Consolidated Manufacturing, Inc. *unsuccessfully raised a number of defenses in trying to avoid the termination of its LIFO election. These defenses should be a caution to others who might also be relying upon them to save their LIFO elections if their applications are similar to Consolidated's.*

1.) REVENUE RULING 60-321 SHOULD APPLY TO ALLOW THE ELECTION OF A LIFO METHOD FOR INVENTORIABLE COSTS CONSISTING OF LABOR AND OVERHEAD, WHICH ARE INTANGIBLES, EVEN THOUGH THEY ARE NOT "GOODS".

In Revenue Ruling 60-321, the IRS permitted a dealer in securities, which are intangibles, to use the LIFO inventory method for these securities. Consolidated argued that it should be permitted to elect LIFO for the inventoriable costs of its labor and overhead, which also are intangibles, even though they are not ***goods***. The Court said that Rev. Rul. 60-321 holds only that a taxpayer is permitted to elect the LIFO inventory method for the intangible goods, securities.

2.) EXAMPLES IN REGULATIONS AT REG. SEC. 1.472-1(c) SUPPORT TAXPAYER'S CONTENTION THAT ONE RAW MATERIAL MAY BE INCLUDED IN A LIFO ELECTION, WHILE ANOTHER IS NOT.

The Court said that the examples in the regulations in question "merely illustrate how the adjustments should be made under the ***raw material content LIFO inventory method***. Even if a taxpayer were to rely on those examples, in calculating the adjustments under such taxpayer's LIFO inventory method, that taxpayer would not be able to use such a method unless it were permitted by - or not inconsistent with - Section 472 and the regulations thereunder."

3.) LTR 9445004 SHOWING A "COMPONENTS-OF-COST" METHOD SUPPORTS THE TAXPAYER'S LIFO METHOD.

Notwithstanding the fact that Letter Rulings and TAMs have no precedential value, the Tax Court said that it is not at all clear from TAM 9445004 what, if any, of the labor and overhead in question ultimately were allowed to be on, or ultimately were disallowed from being on, the LIFO inventory method upon examination of the taxpayer's income tax returns.

The Court also said..."To the extent that (LTR/TAM 9445004) may be read to suggest that a taxpayer may validly elect the LIFO inventory method with respect to all of its labor and overhead, ***but not all of its raw materials*** that enter into production of a good or type or class of goods, we reject any such suggestion as contrary to Section 472 and the regulations thereunder."

4.) PREVIOUS TAX COURT DECISIONS EVIDENCE A WILLINGNESS TO ALLOW TAXPAYERS FLEXIBILITY WITH RESPECT TO THE DOLLAR-VALUE LIFO METHOD AND COMPUTATIONAL METHODS RELATING THERETO.

In support of these contentions, the taxpayer cited several "landmark" LIFO cases:

- *Hutzler Bros. Co.* (8 T.C. 14),
- *Richardson Investments, Inc.* (76 T.C. 736),
- *Fox Chevrolet, Inc.* (76 T.C.708), and
- *Amity Leather Products, Co.* (82 T.C. 726).

The Tax Court said..."In each of those cases (i.e., in *Richardson*, *Fox*, and *Amity Leather*), the taxpayer elected the LIFO inventory method as to a good or goods or a type or class of goods and as to such entire good or goods or type or class thereof. In none of those cases was the Court presented with the issue that we are now addressing."

The Tax Court also found *Hutzler Bros. Co.* to be distinguishable and it said that the Court's explanation in *Hutzler Bros.* of the "process envisaged by LIFO" actually supported the IRS position, rather than the taxpayer's.

(Continued)

TAXPAYER'S SEVEN UNSUCCESSFUL DEFENSES

TAXPAYER'S BRIEFS

5.) THE IRS MUST ESTABLISH THAT TAXPAYER DOES NOT HAVE BOOKS AND RECORDS ADEQUATE TO MAKE "ANY NECESSARY ADJUSTMENTS"... .

Consolidated Manufacturing conceded its willingness to make any necessary adjustments to perfect or reform its LIFO election. However, at trial, Consolidated did not produce any books or records that might be necessary to make "any necessary adjustments."

The Tax Court said that since it was Consolidated who was claiming that it should be permitted to modify its LIFO election to include customer cores provided that it established that it could, and did, make "any necessary adjustments," the burden of proof was on the taxpayer...and the taxpayer had failed to establish its ability to make such adjustments.

6.) LTR 7947001 SHOWS THAT IRS HAS PREVIOUSLY RECOGNIZED THAT A TAXPAYER MAY CONTEST THE IRS' DETERMINATION REGARDING LIFO INVENTORY MATTERS <u>WITHOUT THE THREAT OF HAVING ITS LIFO ELECTION TERMINATED</u>.

The Tax Court said ... Notwithstanding the fact that TAM 7947001 has no precedential value..."to the extent that it may be read to suggest that respondent (the IRS) does not have the authority in this case to terminate ***Consolidated's*** election to use ***Consolidated's*** LIFO method, such a reading is wrong." Section 446(b) and Reg. Sec. 1.472-3(d) authorized the Commissioner's action.

7.) REVENUE PROCEDURE 79-23 APPLIES ONLY TO PROCEDURAL REQUIREMENTS FOR ELECTING THE LIFO INVENTORY METHOD AND THE TAXPAYER'S EXCLUSION OF CUSTOMER CORES FROM ITS LIFO POOLS FITS WITHIN ONE OR BOTH OF THE ("NON-TERMINATION") SITUATIONS DESCRIBED IN SECTION 3.02.

The Tax Court rejected the taxpayer's suggestion that ***Consolidated's*** situation is described in Section 3.02 because the IRS was not taking the position that the taxpayer had selected too few or too many inventory ***pools,*** nor that the taxpayer had improperly included or excluded a specific ***item*** in a particular inventory pool.

The position of the IRS was that..."regardless of the different types of pools that a taxpayer may use if it elects the dollar-value LIFO method, that method must be used with respect to a ***good*** or ***goods*** subject to inventory and specified in a Form 970 and with respect to such ***entire good*** or ***goods***."

rials, the cost of labor, and the cost of overhead are expressly identifiable as inventoriable costs, and hence, it should have the right to elect the LIFO method for labor and overhead costs and not have its right to make such an election conditioned on its electing LIFO for the ***good*** produced by such labor and overhead.

The Court agreed with the IRS and found Consolidated's interpretations of the regulations to be "strained" and "its reliance on those regulations to be misplaced." The Court clarified the interpretation of these regulations, and the "lack of" significance in certain cross-referencing to which Consolidated had attached some importance in its arguments.

The Court added that the definition of the term ***"cost"*** in the regulations does not transform the latter two items in that definition (i.e., in the instant case, labor and overhead) into ***goods*** subject to inventory as to which a taxpayer may elect the LIFO inventory method under Section 472. "...Just because the costs of the labor and overhead are two of the three basic elements of cost that were reflected in Consolidated's inventories for goods in process and for finished goods, does not convert labor and overhead into goods themselves as to which Consolidated could have elected the LIFO inventory method."

The cost of Consolidated's ***new*** parts, one of the two raw materials employed by Consolidated in its remanufacturing business, is a third basic element of cost that also was reflected in Consolidated's inventories for goods in process and for finished goods. However, that did not mean that its labor and overhead, when combined with its ***new*** parts, become ***goods*** as to which Consolidated could have elected the LIFO inventory method under Section 472. As stated above, the ***goods*** produced by Consolidated are remanufactured automobile parts or a type or class of such goods (e.g., remanufactured automobile engines).

"Although Consolidated's new parts, labor, and overhead enter into the production, and thus are components, of those goods, another raw material, *indeed the principal raw material*, that enters into the production, and thus is a component, of the goods produced by Consolidated *is the customer cores*. The labor and overhead involved in this case are not goods."

The Tax Court said: "Section 472(a) allows a taxpayer to elect the LIFO inventory method in inventorying goods specified in the taxpayer's application. That section does not state that a taxpayer may elect the LIFO inventory method in inventorying ***other than a good***. Nor does that section state that a taxpayer may elect the LIFO inventory method in inventorying a ***portion of a good***.

THE KEY

"The ***new*** parts, labor, and overhead involved in this case, when taken together but without customer cores, do not constitute ***goods***.

"However, the new parts, labor, overhead, ***and*** customer cores involved in this case, ***when taken together,*** do constitute ***goods*** and are included in and comprise Consolidated's inventories for goods in process and for finished goods."

"The labor and overhead involved here are not a good, let alone the entire good, of Consolidated subject to inventory, even though they (1) enter into the production of Consolidated's finished goods (i.e., remanufactured automobile parts) by transforming Consolidated's customer cores and new parts into such goods and (2) are included, along with customer cores and new parts, in Consolidated's inventories for goods in process and for finished goods.

"Nor do the labor and overhead involved here become a good, let alone the entire good, of Consolidated subject to inventory when the new parts involved here are combined with them. The ***goods*** of Consolidated subject to inventory as to which it was permitted to elect the LIFO inventory method are: ...(1) the remanufactured automobile parts produced by Consolidated ...(2) a type or class of those goods (e.g., remanufactured automobile engines), and, ...(3) if Consolidated had made the election permitted by Reg. Sec. 1.472-1(c), which it did not, its raw material goods (i.e., customer cores and/or new parts).

"We conclude that Section 472(a) requires a taxpayer who wants to elect the LIFO inventory method (1) to make that election with respect to a ***good*** or ***goods***, which are subject to inventory and specified in a Form 970 and which could include one or more raw material goods used by a manufacturer or processor that will become part of the merchandise intended for sale, and (2) to make that election with respect to ***such entire good or goods***.

"***Section 472(a) does not permit***, and we do not construe it to allow, a taxpayer to make such ***an election (1) with respect to other than such a good or goods or (2) with respect to a portion thereof***. If Congress had intended to permit such an election under Section 472, it would have so provided in that section. It did not."

The Tax Court also reviewed and disposed of several of Consolidated's arguments relative to how it interpreted support for its position from (1) the raw material content LIFO method, (2) natural business unit pooling, (3) certain previously decided LIFO cases...i.e., *Hutzler Bros*.... and (4) a LTR/TAM on →

components-of-cost LIFO. These discussions, especially those relating to the raw material content LIFO method should be especially interesting to other manufacturers using, or considering using, LIFO.

After rejecting Consolidated's interpretations of several of the LIFO regulations, the Court added ..."The Court has no flexibility to rewrite Section 472. Our flexibility to reject the legislative regulations under Section 472 that are implicated here is quite limited; those regulations must be upheld unless they are arbitrary, capricious, or manifestly contrary to Section 472."

After briefly discussing the *Hutzler Bros. Co.* case in support of its point that costs (1) are components of ***goods*** and (2) taken alone—or in less than the entire aggregate—may ***not*** be the subject of a valid LIFO election, the Court turned Consolidated's reliance on *Hutzler* around and used it against the taxpayer, stating that ... "the following explanation by the Court in that case (i.e., *Hutzler Bros. Co.*) of the LIFO inventory method is instructive and rejects petitioner's position here:

"THE ***PROCESS ENVISAGED BY LIFO*** INVOLVES not so much the ascertainment of cost as THE ASCERTAINMENT OF WHAT IT IS OF WHICH WE ARE TO DISCOVER THE COST. The last in, first out formula assumes that the merchandise remaining in inventory is that which was first purchased ....

"IF WE WERE DEALING WITH A fabricator or MANUFACTURER, THE FIRST STEP WOULD BE TO DETERMINE WHICH ***MERCHANDISE*** IT IS TO WHICH A COST IS TO BE ATTRIBUTED, and the second, to determine that cost ... [Emphasis added.]

The Court added: "We see no reason to elaborate further on the foregoing succinct explanation in the *Hutzler Bros. Co.* case regarding what the *'process envisaged by'* the LIFO inventory method is."

REV. PROC. 79-23 DOES NOT PREVENT THE IRS FROM TERMINATING CONSOLIDATED'S LIFO ELECTION

Consolidated had contended that if the Court were to find that its LIFO method did not clearly reflect income, the IRS should not be permitted to terminate its LIFO election, provided that Consolidated agreed to account for its customer cores under the LIFO inventory method and to make any necessary adjustments resulting therefrom.

Consolidated argued that Rev. Proc. 79-23, "provides that a termination of a taxpayer's LIFO election may be warranted only where one of four specified circumstances exists". It maintained that its case did not involve any of those four situations. The Court noted initially that Rev. Proc. 79-23 does not provide an exclusive list of the only circumstances in which the IRS Commissioner will, in his/her discretion, terminate a taxpayer's LIFO election.

In any event, one of the four situations in which the Commissioner will, in his/her discretion, terminate such an election is found in Section 3.01(b) ... namely, "Failure by the taxpayer to properly elect the LIFO method". That situation (i.e., failure to properly elect the LIFO method) exists in the instant case.

The Court said: "We have held that, contrary to the requirements of Section 472 and the regulations thereunder, Consolidated's LIFO election did not apply to an entire good or goods subject to inventory and specified in a Form 970. Consequently, Consolidated failed *'to properly elect the LIFO method'* when it filed the 1980 Form 970 and the 1982 Form 970."

Consolidated also had relied on Reg. Sec. 1.472-3(c) which states that ... "As a condition to the taxpayer's use of the LIFO inventory method, the Commissioner ***may*** require that the method be used with respect to goods other than those specified in the taxpayer's statement of election if, in the opinion of the Commissioner, the use of such method with respect to such other goods is essential to a clear reflection of income." (Note: ***may*** does not equate with ***must*** here.)

Consolidated maintained that this regulation did not authorize the IRS to terminate its LIFO election. The Court held that the taxpayer's reliance was misplaced because that regulation authorizes the IRS to require a taxpayer who has elected the LIFO inventory method ***with respect to an entire good or goods*** subject to inventory and specified in a Form 970 to apply the LIFO inventory method to any other such good or goods but not specified in that form.

However, the catch here was that the regulation didn't apply because the IRS was not seeking to require Consolidated (which did not elect the raw material content LIFO inventory method) to apply the LIFO inventory method to a good or goods subject to inventory but not specified in the 1980 Form 970 and the 1982 Form 970. Consequently, that regulation is not applicable to Consolidated's situation.

The Court stated that the pertinent authority governing disposition of this issue (i.e., the IRS' termination of the LIFO election) is found in two places: Section 446(b) and in Reg. Sec. 1.472-3(d).

Section 446(b) provides that "... if the method used does not clearly reflect income, the computa-

see **IRS TERMINATES *CONSOLIDATED MANUFACTURING's* LIFO ELECTION...**, page 14

tion of taxable income shall be made under such method as, in the opinion of the Secretary, does clearly reflect income." This language permits the IRS to terminate a taxpayer's method of accounting that does not clearly reflect income (here, Consolidated's LIFO method) and to require the taxpayer to use a method (here, the FIFO inventory method) that does clearly reflect income.

Reg. Sec. 1.472-3(d) provides that "whether or not the taxpayer's application for the adoption and use of the LIFO inventory method should be approved, and whether or not such method, once adopted may be continued, and the propriety of all computations incidental to the use of such method, will be determined by the Commissioner in connection with the examination of the taxpayer's income tax returns." Under this regulation, it is within the Commissioner's discretion to determine whether or not a "taxpayer's application for the adoption and use of the LIFO inventory method should be approved ... and ... continued."

Based on the foregoing, the Tax Court held that Consolidated had not shown that the Commissioner abused her discretion in terminating Consolidated's LIFO election.

VALUATION OF USED CUSTOMER CORES IN ENDING INVENTORY...SECTION 471

On the non-LIFO inventory valuation issue, the Court had to decide whether the Commissioner abused her discretion in determining that Consolidated's FIFO-LCM (First-in, First-out, lower of cost or market) method...which valued used customer cores in ending inventory at scrap value...did not reflect the used customers cores in its inventories at the proper amounts.

Consolidated had argued that it acquired used cores from customers in ***exchange*** transactions (which were governed by Section 1001 and introduced "value" into the consideration equation). The IRS had contended that Consolidated acquired its used cores from customers in what were, in substance, ***purchase*** transactions (which involved Section 61 and the need for determination of income based on total sales less cost of goods sold and the taking of inventories in the process).

The Court held that the used customer cores should be valued at amounts paid as determined by transactions which were sales by the customers to the taxpayer, and reciprocally, constituted purchases by the taxpayer from its customers. Accordingly, the taxpayer's cost was invoice price, even though it was the party in the transaction who prepared the sales invoice.

The two cases Consolidated cited in support of its position that it acquired customer cores in *exchange*, and not in *purchase* transactions, were *Redwing Carriers, Inc. v. Tomlinson* and *Burrell v. Commissioner*. The Court held both cases to be distinguishable from Consolidated's fact patterns. Important considerations in the overall analysis were the presence or absence of *"indicia of transactional unity"* and "a *definite contractual interdependency* between the sale...and the trade-in...."

The position of the IRS stated in the September, 1989 *ISP Coordinated Issue Paper* was that "remanufacturers must value their inventory of cores for tax purposes at cost, unless they substantiate a lower inventory valuation in accordance with the provisions of the regulations."

Based on the entire record, the Tax Court held that Consolidated acquired its customer cores in an open market under ordinary, and not extraordinary, circumstances. In acquiring customer cores, Consolidated participated in the marketplace in which it purchased those cores from its customers, and not in the marketplace in which it purchased core supplier cores from core suppliers.

Accordingly, the Court found that Reg. Sec 1.471-4(a) applies in determining the ***market*** for Consolidated's customer cores for purposes of Section 471. Under that regulation, market is the *replacement* cost, and *replacement* cost...for each of the customer cores that were included in Consolidated's year-end inventories...is the core credit amount for a customer core of the same type that was prevailing at the end of each of the years in issue.

Under all of the circumstances, the taxpayer should not have valued its inventory of used customer cores at scrap value because that method did not reflect the proper amounts .

The Court found that Consolidated did not show that the Commissioner abused her discretion in determining that Consolidated's FIFO-LCM method does not clearly reflect income.

* * * * *

For related coverage, see the background articles on the following pages:

15..."More about Cores and the Nature of the Business",

18..."Rev. Proc. 79-23 and IRS Terminations of LIFO Elections", and

20..."IRS Doesn't Like 'Components-of-Cost' LIFO Methods."

MORE ABOUT CORES & THE NATURE OF THE BUSINESS

CORES REMFG.

SCOPE OF CONSOLIDATED'S ACTIVITIES

Consolidated was engaged in the recovery, reconditioning, and restoration to saleable condition of used and worn automobile parts, including engines, crankshafts, cylinder heads, transmissions, and various smaller parts, which it sold as remanufactured automobile parts to its customers. Consolidated was authorized by Ford Motor Company to produce specified remanufactured automobile parts and sell them within certain counties in Kansas, Missouri, and Arkansas to Ford-authorized dealers, who in turn, sold the remanufactured parts they had purchased from Consolidated to their own wholesale and retail consumers.

Consolidated also produced and sold remanufactured engines, crankshafts, and cylinder heads under its own private label to certain warehouse distributors and to Ford-authorized dealers. Consolidated did business with other segments of the industry in its capacity as a parts remanufacturer.

In actuality, the scope of Consolidated's activities was far broader than summarized above.

CORES: THEIR IMPORTANCE & WHERE THEY CAME FROM

The portion of a used and worn automobile part that Consolidated utilized to produce a remanufactured automobile part is known in the remanufacturing industry as a ***core.*** In order to recondition and restore to saleable condition a used and worn engine, transmission, cylinder head, crankshaft, or small automobile part, Consolidated needed a used and worn engine (engine core), transmission (transmission core), cylinder head (cylinder head core), crankshaft (crankshaft core), or small automobile part (small part core) to place into the remanufacturing process.

Consolidated's remanufacturing business depended on a supply of two materials: cores and new parts. It maintained inventories of cores (unprocessed cores raw material inventory) and new parts (unprocessed new parts raw material inventory) upon which it drew throughout the remanufacturing process.

During Consolidated's remanufacturing process, it incurred expenditures for labor and overhead and transformed those raw materials into its finished goods or products. These finished goods and products were all called remanufactured automobile parts. During that process for certain automobile parts, new parts were physically affixed to and incorporated into a core in order to produce a remanufactured automobile part. The new parts used by Consolidated in the remanufacturing process included pistons and rings, rockers and lifters, springs, bearings, chains, gears, plugs, pins, and other miscellaneous assembly parts. Consolidated purchased the new parts that it used in its remanufacturing business from the manufacturers of such parts.

Consolidated generally obtained cores from two sources. ***First,*** consistent with customary and established practice in the industry, Consolidated acquired most of its cores from its customers (customer cores), whose source for those cores was their own respective customers. ***Second,*** Consolidated also acquired cores, except small part cores, from persons engaged in the business of selling cores and known in the industry as core suppliers or core brokers (core suppliers). Consolidated obtained core supplier cores only on a special order basis in order to satisfy a specific or temporary demand that had arisen for a particular remanufactured automobile part. Although there were hundreds of individuals and businesses operating as core suppliers, Consolidated purchased core supplier cores from six major core suppliers, one of which was Bishop Engine and Automatic, Inc. (Bishop Engine).

Core supplier cores purchased by Consolidated entered into its production line almost immediately upon acquisition and remained in its **unprocessed cores raw material inventory** for only a brief period of time. As a consequence, that inventory **consisted almost entirely of customer cores**, and not core supplier cores.

THE REMANUFACTURING PROCESS

The following illustrates the remanufacturing process by which Consolidated produced reconditioned engines in saleable condition. Engine customer cores were torn down, stored in its unprocessed cores raw material inventory, and subsequently placed into production. If a customer had delivered to Consolidated a short-block engine customer core, which was an engine customer core without the heads, Consolidated's employees cleaned off the casting number, consulted the identification manual to determine the engine type and core lot number, wrote the core lot number on the top of that core, and wheeled it into the yard (core yard) where Consolidated stored its unprocessed cores raw material inventory.

see **MORE ABOUT CORES & THE NATURE OF THE BUSINESS**, page 16

More about Cores & the Nature of the Business

If a customer had delivered to Consolidated a long-block engine customer core, which was a short-block customer core with the heads, that core underwent some initial disassembly by Consolidated's employees in order to convert it into a short-block engine customer core (i.e., the cylinder heads, related valve train assembly, and the oil pump were removed), at which point it was marked and wheeled into the core yard. Short-block engine customer cores that were not sufficiently stripped down so as to permit detection of irreparable latent defects remained in the core yard until they were brought into production, at which time they were further disassembled, inspected for defects, and reconditioned into saleable condition.

During the disassembly and cleaning process, engine customer cores and engine core supplier cores were subjected to numerous visual and mechanical examinations and procedures. Only if an engine core passed all of those examinations and procedures could it become a remanufactured automobile engine.

During the disassembly process, the cylinder heads, the crankshaft, the camshaft, and rods were removed from the engine core, retained by Consolidated, and subjected to separate remanufacturing processes. These parts were, if in usable condition, remanufactured in separate areas of Consolidated's remanufacturing facility. Those remanufactured automobile parts were then incorporated into remanufactured engines and, in the case of crankshafts, heads, and rods, were sold as separate remanufactured automobile parts.

ACQUISITION & PRICING OF CORES ...SUPPLY & DEMAND DRIVEN

Consistent with standard and customary practice in the automobile parts remanufacturing industry, Consolidated sold each remanufactured automobile part for, and each of its customers was obligated to pay, an amount (sales price) that consisted of (1) an exchange amount and (2) a core amount. The remanufactured automobile part sales price was determined by market-related factors, including supply and demand. The exchange amount, the core amount, and the total of those two amounts for each remanufactured part sold by Consolidated were separately stated on each of Consolidated's sales invoices for each sale.

Each automobile parts remanufacturer established its own remanufactured automobile part sales price consisting of an exchange amount and a core amount. Consolidated determined the exchange amount that it charged as part of its sales price based on market-related factors.

(Continued from page 15)

The core amount included as part of the sales price charged for any given remanufactured automobile part also varied among remanufacturers. Consolidated determined that core amount based on several market-related factors, including the supply and demand of customer cores. One such factor was the location of the customer core within its anticipated life cycle as conceptualized by Consolidated.

Other market-related factors that Consolidated considered in determining the core amount (which was part of the sales price that it charged a customer for a remanufactured automobile part) included:

(1) the supply of a particular type of customer core in Consolidated's inventories,

(2) the probability that its customers would decide to provide it with customer cores,

(3) the ratio between sales of a particular type of remanufactured automobile part and acquisitions of the corresponding type of customer core, and

(4) the amounts that core suppliers were charging for certain types of core supplier cores that Consolidated anticipated purchasing in order to satisfy a specific or temporary demand for particular types of automobile parts.

At the time Consolidated sold each remanufactured automobile part to each of its customers, it offered to purchase from that customer (subject to the requirements established by Consolidated for its acceptance of a customer core), a customer core of the same type as each such part sold. Consolidated offered to purchase each such customer core for an amount (customer core purchase offer amount) that generally was equal to the core amount which was separately stated on the sales invoice as an element of the sales price for each such part.

The customer core purchase offer amount was, like the core amount, based on market-related factors, including supply and demand. The customer core purchase offer amount could have been less than the core amount shown on the sales invoice. That could have occurred because of the condition of the customer core upon its delivery to Consolidated. For example, Consolidated's customer core purchase offer amount for an engine core with a hole in it was equal to 50 percent of the core amount which was separately stated on the sales invoice as an element of the sales price for a corresponding remanufactured automobile engine. The customer core purchase offer amount for each customer core was set at an amount demanded by, or consistent

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LIFO CONFORMITY VIOLATION RELIEF EXTENDED TO MEDIUM- & HEAVY-DUTY TRUCK DEALERS

R. P. 98-46

Last year, the IRS extended relief to auto and light-duty truck dealers who had LIFO conformity violations on their year-end Factory statements in any one of the six prior years. *Revenue Procedure 97-44* allowed only auto and light-duty truck dealers to keep their LIFO elections and reserves if they paid a 4.7% penalty tax based on their LIFO reserves at December 31, 1996. This 4.7% penalty tax was payable in three equal annual installments on May 31, 1998 ... January 31, 1999 ... and January 31, 2000.

In Revenue Procedure 98-46, the IRS recently extended this conformity-violation relief to ***all medium- and heavy-duty truck dealers.*** Most of the same requirements and conditions for relief apply. They pay their penalty tax in three equal annual installments with the first one due January 31, 1999. The second installment is due January 31, 2000 and the last installment is due January 31, 2001.

If the truck dealer was under audit on September 8, 1998, the first installment payment date is accelerated to December 1, 1998, and the IRS agent has to be notified of the dealer's action by December 15, 1998.

It is important to note that if a violation occurred on a calendar year 1997 financial statement, the dealer is not entitled to any relief. Relief is extended only for years ending before October 15, 1997.

Medium- and heavy-duty truck dealers will need to do "self-audits" for 1991 through 1996 ...or fiscal '92 through '97... to see whether or not payments are necessary. All of the questions that auto dealers faced before their May 31, 1998 payments were due have to be considered by the medium- and heavy-duty truck dealers before their first installment date. And there still have been no answers to any of these questions.

We have updated the specifics of Revenue Procedure 98-46 for medium- and heavy-duty truck dealers on pages 26 & 27 in the previous summary formats for your convenience in tying all of this together. ✻

More about Cores & the Nature of the Business (Continued)

with, the marketplace in which Consolidated acquired customer cores.

At no time were Consolidated's customers under any obligation to accept Consolidated's offer to purchase customer cores from them or otherwise to provide such cores to Consolidated. However, most of those customers did decide to accept Consolidated's offer and provided it with customer cores.

ACCOUNTING FOR CORE TRANSACTIONS: ...DEBITS = CREDITS

At the time of a sale of remanufactured automobile parts to one of its customers, for each such part, Consolidated made an entry increasing (1) its "sales (exchange amount)" by the exchange amount that was part of the remanufactured automobile part sales price, (2) its "sales (core amount)" by the core amount that was the remaining part of that sales price, and (3) its "customer account receivable" by the remanufactured automobile sales price (i.e., the sum of those two amounts).

At the time at which that customer decided to and did deliver customer cores to Consolidated, for each such core, Consolidated made an entry decreasing its "sales (core amount)" and its "customer account receivable" by the core credit amount.

At the time Consolidated purchased a core supplier core, it charged the cost of that core directly to cost of goods sold.

FINANCIAL STATEMENT REPORTING

For financial reporting purposes, Consolidated calculated its inventories by using LCM and (1) the LIFO method for new parts, labor, and overhead and (2) the FIFO method for customer cores. For such purposes, Consolidated reflected customer cores in its inventories at the amounts (core supplier amounts) that core suppliers were charging for similar types of core supplier cores.

Both cores and new parts used by Consolidated to produce remanufactured automobile parts were treated as raw materials under generally accepted accounting principles (GAAP).

TAX RETURN TREATMENT OF CORES

For tax purposes, in determining its year-end inventories, Consolidated included (1) customer cores in its finished goods inventory at the core supplier amounts and (2) customer cores in its unprocessed cores raw material inventory and its goods in process inventory at scrap value (Consolidated's FIFO-LCM method). ✻

REVENUE PROCEDURE 79-23 AND IRS TERMINATIONS OF LIFO ELECTIONS

REV. PROC. 79-23

Revenue Procedure 79-23 (1979-1 CB 564) offers guidance in three areas that often come up in LIFO audit situations. These three areas are:

- What to expect an IRS agent to look at in connection with LIFO,
- What are grounds for holding that a LIFO election can be terminated or disallowed, and
- What are situations that do not warrant the disallowance or termination of a LIFO election.

REASONS FOR TERMINATION OF LIFO ELECTIONS

Section 3.01 of Rev. Proc. 79-23 provides that a LIFO election can be disallowed for any one of the following reasons:

1. Failure to value LIFO inventory at ***cost*** for the year preceding the year of LIFO election, the election year, and all subsequent years;
2. Violation of the financial statement reporting ***conformity requirements***;
3. Failure to ***properly elect*** the LIFO method, including a failure to make the necessary adjustments required by Section 472(d).
4. Failure to maintain ***adequate books and records*** with respect to the LIFO inventory and all computations incident thereto.

Even if one of these situations exists, the IRS has the discretion to allow the LIFO election to remain in effect–if it can be persuaded to exercise that discretion in favor of the taxpayer. However, taxpayers usually find it difficult, or impossible, to so persuade the IRS.

"PROPERLY ELECTING" LIFO

"Failure to properly elect the LIFO method" was more generally thought to encompass situations where a Form 970 was not filed (i.e., where the filing was overlooked by the taxpayer) or where some other filing-related defect existed which the IRS thought was significant enough to disallow the LIFO election.

The Tax Court in *Consolidated Manufacturing* has now significantly broadened the meaning of the words "Failure to ***properly elect*** the LIFO method."

ADEQUATE BOOKS AND RECORDS

Revenue Procedure 79-23 reflects the position of the Service that a LIFO election can be disallowed if the taxpayer fails to ***maintain adequate books and records***. However, if a taxpayer can reconstruct or otherwise provide satisfactory information necessary to calculate the LIFO inventory valuation properly, it ***may*** be possible to avoid termination of the LIFO election for this infraction by working out other computational adjustments to compensate for deficiencies in recordkeeping.

Detailed records which should already exist in the business must be analyzed and summarized, and various alternative sub-procedures and sub-elections must be interpreted and evaluated. All of the records supporting these analyses should be saved indefinitely because the IRS may want to see all detail records and verify the underlying reasoning, assumptions, procedures and methods. A taxpayer who can't produce this information can be at the mercy of the IRS...as were *Boecking Machinery, Inc.* and *Consolidated Manufacturing, Inc.*

While a taxpayer may attempt to raise technical defenses under Section 481 or under the statute of limitations when faced with a ***books and records*** issue, these defenses are *not* likely to be successful. Therefore, taxpayers generally look for reasonable and practical ways to compromise the matter with the IRS.

In attempting to defend its LIFO election after losing the "failure to properly elect" issue, *Consolidated Manufacturing, Inc.* argued that the IRS must establish that the taxpayer does not have books and records adequate to make "any necessary adjustments." Consolidated had conceded its willingness to make any necessary adjustments to perfect or reform its LIFO election. However, at trial, Consolidated did not produce any books or records that might support its ability to make "any necessary adjustments."

The Tax Court said that since it was Consolidated who was claiming that it should be permitted to modify its LIFO election to make "any necessary adjustments," ***the burden of proof was on the taxpayer*** ... and the taxpayer failed to establish its ability to make such adjustments.

It appears that the IRS will continue to aggressively interpret the ***adequate books and records*** section of Revenue Procedure 79-23 in situations where the facts (apparently including the inability of the taxpayer to submit alternative calculations) support a LIFO election termination position.

If a taxpayer has not retained detailed information for all prior years for which it used LIFO, it would be advisable to:

→

RECORD RECONSTRUCTION

- Immediately start saving all information for current year computations,
- Immediately attempt to save or acquire information relative to prior years, starting with the most recent years and moving back in time as far as possible, and
- Attempt to develop an information sharing capability through a trade association or peer group that might be able to fill in product and/or price information for prior years.

This information is usually available within the industry from many sources and should be documented as thoroughly as possible–sooner rather than later–to avoid guesswork, speculation or extrapolation in later years...and to counter a threatened termination of the LIFO election on a retroactive basis.

SITUATIONS NOT WARRANTING TERMINATION OF LIFO ELECTIONS

Section 3.02 of Revenue Procedure 79-23 provides that the following situations ***do not*** warrant disallowance or termination of the LIFO election:

1. Computational errors;
2. Selection of a lesser or a greater number of inventory pools that those the IRS thinks should be used;
3. Use of Bureau of Labor Statistics price indexes by non-department store taxpayers (Note: R.P. 79-23 predates the various Simplified Index IPIC Methods under which BLS CPI or PPI indexes may be used if properly elected.);
4. Improperly including (or excluding) a specific ***item*** in a particular inventory pool;
5. Differences in the level of costing inventories between financial statements and tax returns.

From the situations listed in Section 3.02 that do ***not*** warrant termination of a LIFO election, it seems clear that where a taxpayer has made a reasonable or good faith effort at applying the LIFO concept but has bungled the mathematics, pooling, or index conceptual applications, IRS agents are not supposed to disqualify the taxpayer from using LIFO or terminate the election. Is anybody perfect? ... Haven't we all, at one time or another, seen LIFO calculations that at best could only be generously described as rather sloppy, messy or hard to justify?

BOECKING MACHINERY, INC. INADEQUATE BOOKS AND RECORDS

On October 27, 1993, the Tax Court issued T. C. Memo Decision #1993-497 involving *Boecking Machinery, Inc.*, a Caterpillar machinery and equipment dealer. Boecking elected LIFO in 1970 and lost it in 1980 as a result of the IRS determination that the Company failed to maintain ***adequate books and records***.

One tax report summarized the *Boecking* case as follows: "The IRS properly terminated a corporations election to value inventory under the LIFO method where adequate records were not maintained, an index was not properly computed, and inventory was not computed using the specific LIFO method originally elected. Use of each prior years ending inventory value and each prior years corresponding base year cost in developing an index percentage, rather than the use of the value of the current quantities in ending inventories as the company had elected, resulted in an inaccurate cost calculation of the current-year ending inventory and a distortion of income."

The result in *Boecking* seems to be inconsistent with Section 3.02 of Revenue Procedure 79-23 which describes computational errors, etc. as **not** warranting the disallowance or termination of a LIFO election. Also related are LTR 9343001 and LTR 8851001, both of which seem to evidence a more liberal interpretation of the ***books and records*** provision. These LTRs contrast with the result that *Boecking* received in the Tax Court. For a more complete discussion of *Boecking* and these Letter Rulings, see the December, 1993 *LIFO Lookout*.

CONSOLIDATED MANUFACTURING, INC.

In *Consolidated Manufacturing, Inc.* (111 T.C. No 1), the Tax Court stated that the listing in Section 3.01 of Revenue Procedure 79-23 is not an exclusive listing of the ***only*** circumstances which will warrant termination of a LIFO election. As noted previously, the Tax Court held that Consolidated's LIFO election did not apply to "an entire good or goods subject to inventory and specified in a Form 970." Consequently, Consolidated failed "to properly elect the LIFO method" when it filed Form 970.

As a result of the Tax Court's opinion in *Consolidated Manufacturing, Inc.*, two additional situations can be added to those listed in Revenue Procedure 79-23 as grounds for terminating a taxpayer's LIFO election:

1. Failure to elect LIFO with respect to ***an entire good or goods*** subject to inventory
2. Failure to use a LIFO method that ***clearly reflects income***.

For many taxpayers, these will not be welcome additions.

Consolidated Manufacturing, Inc. attempted to use Letter Ruling/TAM 9445004 in support of its contention that it should be allowed to apply the dollar-value LIFO method in the manner it elected for labor and overhead (conversion costs) and only new purchased parts ... while excluding used customer cores.

In distinguishing its holding in *Consolidated Manufacturing, Inc.,* the Tax Court said that it is not at all clear from TAM 9445004 what, if any, of the labor and overhead in question ultimately were allowed to be on, or ultimately were disallowed from being on, the LIFO inventory method upon examination of that taxpayer's income tax returns. The Court said ... "to the extent that (TAM 9445004) may be read to suggest that a taxpayer may validly elect the LIFO inventory method with respect to all of its labor and overhead, ***but not all of its raw materials,*** that enter into production of a good or type of class of goods, we reject any such suggestion as contrary to Section 472 and the regulations thereunder."

One Letter Ruling/TAM relative to the "components-of-cost" LIFO methodology that Consolidated Manufacturing did not mention in its briefs was LTR 9405005. In this LTR, the IRS did not allow the taxpayer the use of a components-of-cost method. Both of these TAMs are discussed below.

IRS TRAINING MANUAL

The IRS Training Manual 3127-01 (Chapter 5, Dollar-value LIFO–Internal index methods) states:

"The components-of-cost method is a LIFO approach used by some taxpayers engaged in manufacturing. The components-of-cost method is not clearly authorized in the regulations and it is the Service's position that the components-of-cost method is not permissible.

"Consequently, a taxpayer who uses the method has the added burden of proving, to the satisfaction of the District Director, that the inventory value determined using the components-of-cost approach is the same as the inventory value determined by extending the physical inventory items by their unit cost."

The IRS Manual contains an example in which it shows the ending inventory for a taxpayer valued using (1) the components-of-cost method and (2) the dollar-value, double extension method ... where these two methods, when applied to the "same inventory data," produce the same ending inventory valuation.

AICPA ISSUES PAPER

Another very good reference for more information on components-of-cost is the AICPA's *Issues Paper: Identification and Discussion of Certain Financial Accounting Issues Concerning LIFO Inventories* (dated November 30, 1984–File 3175). This document was prepared by the Task Force on LIFO Inventory Problems, Accounting Standards Division of the AICPA.. Issues papers normally include advisory conclusions that represent the views of at least a majority of the Institute's Accounting Standards Executive Committee (AcSEC). Issues papers do not establish standards of financial accounting enforceable under Rule 203 of the Institute's Code of Professional Ethics." Accordingly, AICPA issues papers do not, per se, constitute or establish generally accepted accounting principles (GAAP).

LTR/TAM 9445004
... FAVORABLE TO THE TAXPAYER

In Letter Ruling/TAM 9445004 (April, 1994), the IRS permitted the extension of a LIFO election to labor and overhead, but held that that labor and overhead were required to be placed in the related raw material pool. In other words, labor was not a separate ***"item"*** that could be placed in a separate pool. This holding was consistent with earlier technical advice in Letter Ruling 9405005.

Specifically, LTR 9445004 involved three issues. ***First***, could a taxpayer that uses the "raw materials content" LIFO inventory method extend its LIFO election to include labor and overhead cost previously valued under the FIFO method? The Service held that the taxpayer could so extend its LIFO election by filing Form 970. As long as no other changes were made by the taxpayer to its existing raw materials pools, the taxpayer was not required to file Form 3115 to obtain prior consent of the Commissioner to make the change.

The ***second*** issue in LTR 9445004 was whether the taxpayer's labor and overhead costs were eligible for inclusion in a different dollar-value LIFO inventory pool than its raw materials. Based on Reg. Sec. 1.472-8(e)(3)(i), the IRS held that the taxpayer's labor and overhead were not eligible for inclusion in a dollar-value LIFO inventory pool separate from its raw materials.

The ***third*** issue in LTR 9445004 was:... If the taxpayer's extension of its LIFO election to include labor and overhead costs results in an impermissible method of pooling, may the taxpayer change to a permissible method of pooling? The National Office held that the taxpayer may change to a permissible method of pooling in the year under examination. The National Office also said that if the taxpayer did →

not implement appropriate changes in pooling structure to comply with these conclusions, then under Reg. Sec. 1.472-3(d), the District Director would have the authority to determine as of the year under examination that the taxpayer's LIFO inventory method for its labor and overhead costs may not be continued.

LTR/TAM 9405005
... *NOT* FAVORABLE TO THE TAXPAYER

The taxpayer in LTR 9405005 (October, 1993) used a dollar-value, link-chain, components-of-cost method to compute the current-year and prior-year cost of its LIFO inventory. Under its components-of-cost method, each of taxpayer's Natural Business Unit pools consist of only three types of items: raw materials, labor, and overhead. At the end of each taxable year, the taxpayer extends the quantity of each of its items on hand by their current-year unit cost and their prior-year unit cost. These extensions are then totaled to determine a total current-year cost and a total prior-year cost.

The taxpayer had filed its first LIFO election under Section 22(d) of the Internal Revenue Code of 1939 and it made numerous extensions of the original LIFO election to other inventories until the bulk of its inventories were on LIFO.

Taxpayer computes its index for the ***raw material component*** of work-in-process and finished goods by valuing the quantities of unprocessed raw materials in ending inventory at current-year unit costs and prior-year unit costs. Taxpayer computes its index for the ***labor component*** of work-in-process and finished goods by using average hourly labor rates. The index for the ***overhead component*** of work-in-process and finished goods is computed by comparing the overhead component of the work-in-process and finished goods in ending inventory (valued using the current overhead rate per labor dollar) with an amount equal to the labor dollar component of the work-in-process and finished goods in ending inventory, deflated by the labor index, and multiplied by the overhead rate per labor dollar for the prior year.

An annual price index is determined by dividing the current-year cost of the ending inventory by the prior-year cost of the ending inventory. The annual index is then multiplied by the prior year (cumulative) index to determine a cumulative index. Finally, the base-year cost is calculated by dividing the current-year cost of ending inventory by the cumulative index.

The Appeals Officer concluded that taxpayer's components-of-cost method is not permitted under Reg. Sec.1.472-8(e)(2)(i) and it does not clearly reflect income. The Appeals Officer proposed that taxpayer should change to a so-called "product-cost" method under which items used to compute the base-year and prior-year cost of its inventory would be individual products rather than individual cost elements or components (e.g., materials, labor and overhead). In effect, the IRS is holding that neither labor nor overhead is an "item" for LIFO purposes.

LTR 9405005 concludes, after lengthy analysis, that Reg. Sec. 1.472-8(e)(2)(i) ***does not specifically*** permit the use of the components-of-cost method (as applied by the taxpayer) to compute a price index.

Despite so holding, the IRS indicated that although the LIFO regulations do not specifically permit the taxpayer's components-of-cost method, the Regulations do not proscribe the components-of-cost method either. "Taxpayer's components-of-cost method may be appropriate to the extent it results in the clear reflection of taxpayer's income. However, based on the facts presented in this case, taxpayer's use of the components-of-cost method does not result in a clear reflection of its income."

Citing *Hamilton Industries, Inc.* (1991) and *Amity Leather Products Co.* (1984), the ruling states the position that the "correct standard by which to measure whether taxpayer's LIFO method clearly reflects income is whether the costs matched against sales revenue reflect the costs required to replace the inventory sold." The IRS noted that in certain circumstances, the taxpayer's components-of-cost method may result in a deduction greater than the cost required to replace the inventory sold.

The IRS softened the blow a little more by stating that "although we do not believe that taxpayer's present use of the components-of-cost method results in a clear reflection of its income, it is not our position that **all** components-of-cost methods necessarily fail to clearly reflect income. Accordingly, any particular method must be examined on a case-by-case basis." (Note: To date, the IRS has not issued any further guidelines on this.)

Finally, the IRS held that any change by the taxpayer in LTR 9405005 must be made on a prospective basis and the use of the cut-off method for certain LIFO accounting method changes was not applicable to the taxpayer's situation. Accordingly, an adjustment would be required under Section 481(a) of the Code.

For a more detailed discussion of LTR 9405005, see the March, 1994 *LIFO Lookout*.

IRS CAN'T PREVENT USE OF DOLLAR-VALUE LIFO METHOD FOR SPECIFICALLY IDENTIFIABLE GOODS

FIELD SERVICE ADVICE

FSA ALLOWS DVM, BUT TELLS IRS AGENTS HOW TO RESTRICT RESULTS

In a request for Field Service Advice issued in 1992, an IRS agent asked for technical research help on the use of the dollar-value LIFO method of valuing inventory. He asked whether the DVM can be disallowed to a taxpayer on the basis that such a method (i.e., the DVM) does not clearly reflect income where a small inventory of large items is maintained and specific units can be tracked.

The Field Service Advice (FSA) concluded that under the regulations, the taxpayer was permitted to use the dollar-value method. The second part of the FSA addressed an alternative issue ... not raised by "Examination" (i.e., the requesting IRS agent) ... of whether the taxpayer had appropriately defined the inventory "items" within each pool. This was brought out and suggested as a way the agent could reduce what might otherwise be a distortive use of the dollar-value method. (For a discussion of the FSA process and why FSAs are now available, see page 23.)

DOLLAR-VALUE METHOD COULD BE USED

The origin of the LIFO method is in the Revenue Act of 1938, where it was permitted only for raw material inventories in the leather tanning and non-ferrous metal industries. In the Revenue Act of 1939, however, Congress made LIFO available to ***all*** taxpayers. The Senate Finance Committee stated that "... Under the Bill, the option (to use LIFO) is extended to ***all*** taxpayers who use it, apply for it, and use it consistently, *regardless of the business in which the taxpayer is engaged*."

In the early years, the Commissioner only permitted the use of specific goods LIFO under which costs are measured in terms of physical units of individual items, such as pounds and feet. However, many taxpayers were unable to measure their inventory in such basis units. Consequently, they began using the dollar-value method, under which inventory is valued in terms of dollars, rather than in terms of physical characteristics. The dollar-value method was accepted by the Tax Court in *Hutzler Bros. Co. v. Commissioner*, (8 T.C. 14 (1947)).

Regulations under Section 471 (the inventory section) also provide that ***any*** taxpayer permitted or required to use inventory accounting may elect to use the LIFO method. Further, the regulation states that the LIFO inventory method is not dependent upon the character of a taxpayer's business, or upon the identity or want of identity through commingling of merchandise.

Regulations under Section 472 (the LIFO inventory section) also provide that ***any*** taxpayer may elect the dollar-value LIFO method, if such method is used consistently and clearly reflects the taxpayer's income "in accordance with the rules of this section." This ***clear reflection of income*** language refers to the manner in which a taxpayer applies the dollar-value LIFO method, i.e., how it groups types of goods in pools and how it computes the LIFO value of each pool. Thus, the FSA says that this "regulation allows any taxpayer to use dollar-value LIFO if it follows the specific rules established by the Service." (Note: Some may argue that the problem with this statement is that there aren't any specific rules established by the Service and the IRS develops its interpretations of the rules on a case-by-case basis as it goes along.)

The FSA discussed *Fox Chevrolet, Inc. v. Comm.*, (76 T.C. 708) which involved an auto dealership using the dollar-value LIFO method. The IRS attempted to divide *Fox's* inventory into several pools based upon the different car models in the inventory. Although the Service did not dispute the taxpayer's right to use the dollar-value method, the Tax Court in *dicta* stated that "while it may be arguable that Fox's inventory is small enough to match specific units, we find no limitation in respondent's regulations concerning the types of inventories which can be valued by the dollar-value LIFO method."

The FSA concluded that while the dollar-value LIFO method in the instant case might not reflect income as well as a specific identification LIFO method, the agent was advised not to disallow the use of the dollar-value method on ***clear reflection of income*** grounds, because the regulations firmly establish that *any* taxpayer may use the method despite the nature of its inventory. Moreover, it concluded that dollar-value LIFO, when properly applied, is designed to more clearly reflect income by matching current costs with current revenues. Thus, the examining agent was advised not to attack the

see **IRS CAN'T PREVENT USE OF DVM**, page 24

WHAT IS FIELD SERVICE ADVICE?

The accompanying article discusses a Field Service Advice (FSA) memo on whether any taxpayer can elect the dollar-value method for valuing LIFO inventories. This FSA was written in 1992, but it was just released this summer. Field Service Advice had not previously been available for public review, so readers looking in prior issues of the *LIFO Lookout* will not find any previous references to FSAs or the process by which they are issued.

FSAs AND THE FSA PROCESS

Field Service Advice memoranda are a means used by the IRS to provide IRS agents, attorneys and appeals officers with non-binding advice, guidance and analysis to assist them in developing an issue or in determining litigation hazards of either a substantive or procedural nature.

There has been an ongoing Field Service Advice ***process*** that may be unfamiliar to many taxpayers and their advisors. Revenue agents often request, and then rely on, non-binding guidance, known as Field Service Advice, to get a better understanding of potential tax issues and how they should be approached. Field Service Advice is not like Technical Advice, because the taxpayer is excluded from...and is deliberately *not* made a part of... the Field Service Advice process. Taxpayers have no opportunity to submit their version of the facts or to have a conference with the IRS officials concerning any potential adverse ruling that might be issued. Accordingly, the FSA process affords no protection to the taxpayer, who often may not even know that the case has been reviewed by a Field Service attorney.

It had been reported that there was a significant increase in the use of Field Service Advice procedures by agents and this possibly accounts for the reduced number of Technical Advice Memoranda issued by the National Office. One of the big concerns over Field Service Advice is that taxpayers who might eventually consider requesting technical advice might be at a significant disadvantage if their case has already been under review because (unknown to them) a revenue agent has already sought Field Service Advice on the issue.

In instances where formal Field Service Advice is sought, a revenue agent may actually submit documentation to IRS attorneys reviewing the request. The usual procedure is for the response to the examining agent to be in writing, hence, the name *"Field Service Advice"* memoranda. It has also been reported that Field Service attorneys usually will work with the agent requesting support to develop the facts, rather than return the request for advice unanswered. Field Service may also theoretically issue advice in a hypothetical format (i.e., "if the facts are thus, then it would follow that ..."). This "hypothetically speaking" format allows considerable flexibility which may help a revenue agent in seeking advice on how to develop an issue. In fact, the FSA memo analyzed in the accompanying article on dollar-value LIFO and item definition stated: "We will render further guidance on the separate item issue if you wish to pursue it and can furnish us with detailed information on how the taxpayer is computing its dollar-value LIFO inventory." As indicated in the article, the second half of the FSA was devoted exclusively to offering advice to the agent on alternative issues that the agent had not thought to request.

THE FIGHT OVER DISCLOSURE OF FSAs

FSAs have been made public under the Freedom of Information Act (FOIA) since early this year. Make no mistake about it, the IRS fought this disclosure tooth and nail. The activities of the IRS in resisting FOIA disclosure provides clear evidence that the IRS may be (collectively) characterized as expert at the strategy of recalcitrance, stonewalling and the creation of escalating defense measures when defeat at previous levels occurs. If this seems harsh or like an overstatement, consider this brief summary of the 5-year history by which FSA documents are now being made public.

Since 1993, *Tax Analysts*, the publisher of *Tax Notes*, and the IRS have actively been in the Courts litigating the disclosure of Field Service Advice memoranda and other undisclosed IRS documents. Their argument was whether FSAs constitute a secret body of law that should be made available to the public under the Freedom of Information Act. In July of 1997, a Circuit Court upheld the District Court that FSAs are subject to public disclosure. The IRS decided not to appeal the decision to the U.S. Supreme Court. Instead, the IRS attempted in late 1997 to get a statutory change into the IRS restructuring legislation that was then under consideration by the House Ways & Means Committee. The IRS characterized its legislative proposal as a "structured process for making certain FSAs available." This effort by the IRS was resisted by *Tax Analysts,* who took the position that the IRS was again maneuvering to negate its losses in court. The IRS attempt failed.

see **WHAT IS FIELD SERVICE ADVICE?**, page 25

taxpayer's ability to use dollar-value LIFO, but rather to closely scrutinize the manner in which the taxpayer used the dollar-value method.

KEEPING FACTORS OTHER THAN INFLATION OUT OF THE INDEX COMPUTATIONS

In guiding the agent on ways to look closely at how the taxpayer was applying the dollar-value method, the FSA first recited the basics of how the dollar-value LIFO method operates (base year costs, pooling, repricing mechanics, the use of current cost for each new item "entering" a pool for the first time after the base year, increments and liquidations). It then quoted the Tax Court's language in 1984 in *Amity Leather Products* to the effect that the more narrowly the taxpayer defines an ***"item"*** of inventory–that is, the more ***items*** it identifies–the more accurately income is reflected.

In stressing the importance of proper classification of ***items***, the Tax Court had said that ... the "The nature of ***'items'*** in a pool must be similar enough to allow a comparison between ending inventory and base-year inventory. Because the change in the price of an ***item*** determines the price index and the index affects the computation of increments or decrements in the LIFO inventory, the definition and scope of an ***item*** are extremely important to the clear reflection of income.

"IF FACTORS OTHER THAN INFLATION ENTER INTO THE COST OF INVENTORY ITEMS, A RELIABLE INDEX CANNOT BE COMPUTED.

"For example, if a taxpayer's inventory experiences *mix changes* that result in the substitution of less expensive goods for more expensive goods, the treatment of those goods as a single ***item*** increases taxable income. This occurs because any inflation in the cost of an ***item*** is offset by the reduction in cost resulting from the shift to less expensive goods. Conversely, if changes in mix of the inventory result in the substitution of more expensive goods for less expensive goods, the treatment of those goods as a single ***item*** decreases taxable income because the increase in inventory costs is eliminated from the LIFO cost of the goods as if such cost increase represented inflation." (Emphasis added.)

WHEN ARE ITEMS DIFFERENT FROM EACH OTHER? PHYSICAL SIMILARITIES VS. DIFFERENCES IN COST CHARACTERISTICS

The FSA then discussed how in 1979, in *Wendle Ford Sales*, the Tax Court focused on *physical similarities* of items in its holdings. The FSA observed that the Tax Court shifted its focus from physical similarities of the item to different *cost characteristics* in *Amity Leather Products* in 1984 and in *Hamilton Industries* in 1991.

(Continued from page 22)

The FSA said that the issue becomes: How should the taxpayer in the instant case be defining its specific ***items***? Neither the Code nor the regulations define the term ***"item."*** In *Fox Chevrolet*, the Service had raised the issue of whether an auto dealership should treat each model as a separate ***item*** in its inventory pool. The Court in *Fox* refused to address the issue because the IRS did not raise the issue in a proper procedural manner. However, a similar issue was raised in *Wendle Ford Sales, Inc. v. Commissioner*, 72 T.C. 447 (1979) where that auto dealer's base-year inventory pool was comprised of 1974 Ford automobiles. Some of the 1974 models were equipped with solid-state ignition. Beginning with the 1975 models, solid-state ignition became standard equipment. Also, beginning in 1975, some of the models had catalytic converters, a feature that was not found on any 1974 models. The Service asserted that the 1975 vehicles were separate ***items*** from the 1974 vehicles.

The Tax Court rejected the Service's rationale, stating that "the differences in the two models are (not) substantially sufficient to warrant the conclusion that the two vehicles are different ***items*** for dollar-value LIFO purposes." The Court also noted that the definition of the term ***"item"*** cannot be so narrow as to impose unreasonable administrative burdens upon taxpayers, thus rendering the use of the double extension dollar-value LIFO method impractical. The Court did state, however, that (eventually) some future model will be significantly different from the base year 1974 models and, as a result, that future model will warrant separate ***item*** treatment. Thus, at some point technological changes become so great that a subsequent model is no longer the same ***item*** as its predecessor model.

The Tax Court in *Wendle Ford* focused on the *physical similarities* between goods. However, the Tax Court also takes into account the difference in cost structures (i.e., cost characteristics) of items that are physically similar. For instance, in *Amity Leather Products*, the Tax Court found that billfolds produced by two different divisions of the taxpayer–one located in the United States and the other in Puerto Rico–were ***separate items*** due to their different cost structures even though they were substantially similar in all physical respects. In other words, a purchaser going into a store to buy a wallet and picking up two wallets made by Amity–one made in the U.S., and the other made in Puerto Rico–would see no physical difference between the two wallets, other than the tags that said "made in the USA" or →

"made in Puerto Rico." In all other respects, the wallets would be physically identical to each other.

The Court reached a similar holding in *Hamilton Industries, Inc.* (97 T.C. 120). Shortly after incorporation, the taxpayer acquired the assets of another company, including finished goods. It valued these purchased goods at a substantial discount from their market value and used them as its base inventory. The taxpayer then added raw materials and finished goods that it subsequently manufactured to the same pool without characterizing the discounted purchased finished goods as a separate *item*. Thus, the bargain element inherent in the taxpayer's base inventory remained buried in ending inventory, thereby inflating the cost of goods sold.

In holding that the purchased finished goods must be accounted for as a ***separate item,*** the Tax Court relied upon the fact that the purchased goods had substantially different ***cost characteristics*** from the raw materials and subsequently manufactured finished goods. The Court stated that the significantly large bargain purchase elements represented by the discounts (96% and 60%) caused the purchased inventories to assume a different character from inventory purchased or produced at market prices.

ELIMINATING DVM LIFO DISTORTION BY DEFINING *ITEMS* "WITH SPECIFICITY"

The FSA concluded while the definition of a separate *item* is a factual matter, the tentative position of the IRS National Office regarding the inventory of auto dealerships is that an ***item*** is a particular submodel with option packages. Thus, submodel A with option package X would be one ***item*** while submodel A with option package Y would be another ***item***. According to the FSA, "at the least, the Service should argue that each submodel is an ***item*** (without taking into account the various option packages). We believe that this position is supportable in light of cases such as *Amity Leather* and *Hamilton Industries* due to the varying cost structures among submodels with different option packages. As noted earlier, the objective of dollar-value LIFO is to eliminate the inflationary element of inventory costing from the computations of costs of goods sold. Thus, by defining items with such specificity in the instant case, the Service would be eliminating much of the distortion that results from the improper use of the dollar-value LIFO method."

In other words, although the Service cannot prevent a taxpayer from electing the dollar-value method, it can require the taxpayer to "narrowly define its items." By so doing, it can work toward a result under the dollar-value method that should "more clearly reflect income."

OBSERVATIONS

This document was written in 1992 shortly after the Tax Court's landmark opinion in *Hamilton Industries*. However, it was only recently released (in 1998) after a long struggle over whether FSAs were required to be disclosed under the Freedom of Information Act. The FSA concludes with the statements that the document *may* include confidential information subject to the attorney-client and deliberative process privileges, and that it *may* also have been prepared in anticipation of litigation.

It states further that the document should not be disclosed to anyone outside the IRS, including the taxpayer involved, and that its use within the IRS should be limited to those with a need to review the document in relation to the subject matter or to the case specifically discussed therein. It last asserts that the document is subject to nondisclosure under I.R.C. Section 6103 and requests further information from the IRS agent if help is desired to develop the separate ***item*** issue further.

The kind of business the taxpayer was in was deleted/"sanitized" from the FSA when it was released under the *FOIA*. However, it is obvious that the ideas expressed regarding ***item*** definition have very broad application to all DVM LIFO users.

What Is Field Service Advice? (Continued from page 23)

After some discussion between the IRS and *Tax Analysts,* a spokesman for the IRS indicated that the Service intended to take its legislative proposal—which had been rejected previously by the House Ways & Means Committee—to the Senate Finance Committee for consideration. Without belaboring this summary further, the IRS was ultimately unsuccessful in preventing the disclosure of FSAs under the FOIA.

Thanks to the efforts of *Tax Analysts,* as these FSAs are released we now have an additional source from which to better understand certain IRS overall positions and litigation challenges on various LIFO matters.

For more information on FSAs and the FOIA controversy, see: (1) "The Field Service Advice Process," *Tax Notes*, August 8, 1994, (2) "Field Service Advice—the IRS' "Star Chamber"?, *Tax Notes*, January 14, 1994, and (3) "*Tax Analysts* vs. the IRS—the Fight Over FSAs & Chief Counsel Stuart Brown's Remarks at ABA Tax Section Meeting," *Tax Notes*, February 23, 1998.

AT A GLANCE	RELIEF FOR MEDIUM & HEAVY-DUTY TRUCK DEALERS REV. PROC. 97-44 ... AS MODIFIED BY REV. PROC. 98-46
RELIEF "GOOD NEWS"	• Dealers with conformity violations "within the scope of Rev. Proc. 97-44" will not have their LIFO elections terminated for any year ending before October 14, 1997. • LIFO adjustments must appear in the income statement ... but they do ***not*** have to be made to the Cost of Goods Sold account. • LIFO adjustments may appear ***anywhere*** on the Statement of Income.
LOOK-BACK PERIOD	• 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.
PENALTY AMOUNT	• 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).
METHOD OF PAYMENT	• Three equal installments: January 31, 1999...January 31, 2000...& January 31, 2001. • Option for dealers not under audit to pay entire amount in one installment due January 31, 1999.
IRS ENFORCEMENT	• Dealer is required to do a "self-audit" of Factory statements submitted ***"for credit purposes."*** • 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.
DEALERS CURRENTLY UNDER AUDIT	• Allowed to obtain special relief if under audit on September 8, 1998. • Payment due date for first installment of settlement amount is accelerated to December 1, 1998. • Relief is also available to dealers at Appeals or in Federal Court.
SPECIAL RULES	• Transmittal memorandum ***MUST*** accompany each installment payment. • Permission to terminate LIFO will be held up if payments under Rev. Proc. are still due. • Payments are not accelerated by a change from C to S ... or by a change from S to C.
"BAD NEWS"	• Relief does not apply to years ending after October 14, 1997.
SOME QUESTIONS THAT NEED CLARIFICATION	• 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 Rev. Proc. apply? • What about multiple franchise dealers who had LIFO adjustments on some, but not on ***all***, of the statements that were sent to the various manufacturers? How does Rev. Proc. apply? • All the questions of interpretation raised by Rev. Proc. 97-44 are still unanswered. • See prior issues of *LIFO Lookout* for discussion of these questions.

MEDIUM & HEAVY-DUTY TRUCK DEALERS
CONFORMITY VIOLATION RELIEF UNDER REV. PROCS. 97-44 & 98-46

KEY TERMS	
PENALTY AMOUNT	• 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 ***Important Dates*** below.
SETTLEMENT AMOUNT	• The amount that a dealer with a LIFO conformity violation must pay. The ***Settlement Amount*** 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 FOR SELF-AUDIT	• 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")	• 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 amount due under Rev. Proc. 97-44.
REV. PROC. 97-44 **REV. PROC. 98-46**	• The designation of the Revenue Procedure that originally spelled out the terms and conditions and the steps that an auto and light-duty truck dealer can take to avoid having its LIFO election terminated because of certain financial statement conformity violations. • Relief extended to medium & heavy-duty truck dealers by Rev. Proc. 98-46.
REV. RUL. 97-42	• 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 FOR MEDIUM & HEAVY-DUTY TRUCK DEALERS	
1991 THROUGH 1996	• The ***six (6) year period*** 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	• Corresponding look-back or self-audit period for dealers with fiscal years ending January through September.
OCTOBER 14, 1997	• The cut-off date for Rev. Proc. 97-44 (and Rev. Rul. 97-42) determinations.
SEPTEMBER 8, 1998	• "Under Audit" date which accelerates the first installment due date to December 1, 1998.
DECEMBER 1, 1998	• For dealerships under audit on September 8, 1998, the date on or before which the ***first*** installment payment of one-third of the ***Settlement Amount*** is due. • If a dealer under audit elects to forego making installment payments, the entire ***Settlement Amount*** is due on December 1, 1998.
DECEMBER 15, 1998	• The date on which dealers under audit on September 8, 1998 must notify examining agents of their taking action under Rev. Proc. 98-46.
JANUARY 31, 1999	• Due date of the ***first*** installment of one-third of the ***Settlement Amount*** payment for dealers not under audit on September 8, 1998. • Due date for payment of the total ***Settlement Amount*** if a dealer not under audit on September 8, 1998 elects to make a single payment of entire ***Settlement Amount***.
JANUARY 31, 2000	• Due date for the ***second*** installment of one-third of the ***Settlement Amount*** payment.
JANUARY 31, 2001	• Due date for the ***third*** installment of one-third of the ***Settlement Amount*** payment.

SELECTED BIBLIOGRAPHY ON REV. PROC. 97-44 RELIEF

Below are all the articles discussing Rev. Proc. 97-44 relief in prior issues of the *LIFO Lookout*. The Practice Aid/Checklist on page 12 of the December, 1997 *Lookout* especially warrants another look, now that the IRS has extended conformity relief to medium- and heavy-duty truck dealers.

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