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. IRS PLANS TO CHECK UP ON AUTO DEALER CONFORMITY VIOLATION SETTLEMENT PAYMENTS. We previously reported that the IRS announced that it intends to check up on dealers who did–or didn't–make conformity settlement payments. Mary Burke Baker, the IRS Motor Vehicle Industry Specialist, repeated the message at our recent CPA Auto-Dealership Niche Conference in Las Vegas in May.

Based on recent direct experience, we know that the IRS will not accept a "late" payment from a dealer who thought it had passed its self-audit under Revenue Procedure 97-44, but who was later advised otherwise when a new CPA firm took over the account. When the dealership informally approached the National Office, it was told that the May 31, 1998 first payment deadline was absolute ... and that sending the penalty money in now, after the fact, would not save the dealer. It is now too late to do what should have been done over a year ago.

The Service suggested two equally bleak alternatives: pay the full tax on the entire LIFO reserve ... or file a Form 3115 to terminate the LIFO election. The Service is very serious about this issue and is not inclined to grant dealers any more relief.

#2. PARTS INVENTORIES & THE IRS VICTORY OVER THE USE OF REPLACEMENT COST. At present, there is nothing new in the way of additional developments or further clarification of the Tax Court's holding in *Mountain State Ford Truck Sales* that a dealer could not use replacement cost in connection with its parts inventory on LIFO. This decision–a victory for the IRS–was that use of the replacement cost method is contrary to both (1) the LIFO and (2) the general inventory Code sections and regulations because it does not reflect actual cost.

In holding that Mountain State's use of replacement cost does not clearly reflect income, the Tax Court has thrust the IRS in what could become a politically uncomfortable–or would it be an embarrassing?–situation. The Service got what it wanted in the lawsuit: it won. But all along, all it knew was that it didn't like replacement cost, and it still has no idea how to go about applying its victory in the real world.

Make no mistake about it: The Judge said that the only way to fix the "problem" is to have Congress change the law. Good. That being the case, however, the IRS certainly does not want strident car dealers or the NADA bringing Bill Archer and the rest of Congress into the picture by showing them just how illogical and absurd the result the IRS was pushing for–and got–really is.

Instead of helping the IRS get out of the mess it has potentially made for all dealers on this issue, NADA should be circulating petitions for dealers to sign objecting to the absurdity of this whole thing. NADA should be working to bring this matter to the attention of Congress so it can "fix" it, change or clarify the law, or otherwise put the IRS on a leash.

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LOOKOUT LOOKS INTO

(Continued from page 1)

Dealers apply many variations of replacement cost methods. Often they adjust replacement cost results to approximate actual cost results by a variety of techniques. NADA is ill-advised to try to help the IRS figure out what to do in the context of one single situation–that presented by *Mountain State* and its unfavorable ambiguous fact pattern. After all, the IRS probably chose to litigate *Mountain State* in the first place because the facts were so unfavorable to the taxpayer.

There is some interesting evidence from documents forced out of the IRS by the Freedom of Information Act. For almost 25 years, the IRS National Office and the Field Service Division have, in practice, allowed dealers to use the replacement cost method for parts inventories, knowing full-well this was not an actual cost method. So what has changed over all these years? Why all of a sudden this ruthless pursuit of perfection?

The Tax Court also said clearly that the IRS had no choice but to enforce a absolute actual cost standard ... as a result, the IRS should be held to that same 100% accuracy standard if the IRS really wants to pursue the determination of actual cost for all parts inventories.

Commissioner Rossotti should look into the enormous waste of time and effort, not to mention the distasteful confusion and industry gridlock, brought about by the IRS decision to pursue this case. Instead of pouring untold millions into Y2K and technology updating, why not invest a few dollars in a course like "Common Sense for Tax Collectors" for some top IRS managers?

For more on how we ***really*** feel about this, see page 20, followed by the three instances reflecting a far more sensible IRS "live and let live" administrative approach.

#3. WHAT CAN BE DONE ABOUT *MOUNTAIN STATE* IN THE MEANTIME? There's absolutely nothing that can be done at this time to avoid the gridlock that *Mountain State* has created.

Some dealers can't stand being told that they just have to wait a few years (more) before there's any real resolution of this issue. Remember: since the use of replacement cost involves a method of accounting, the IRS can always come back in a later year and attack it! All you can do is continue doing what you've been doing in the past...and just wait it out until the IRS makes up its mind and publishes something ***official.***

It's incredible just how childish some CPAs and dealers react when they're given this news. And some CPAs are afraid to be the messengers bringing this message, lest it appear that they're just not creative or intelligent enough to come up with something pleasing to satisfy their clients. We repeat: The right–and only–answer is that a dealer should continue to use its current accounting method (i.e., replacement cost) until it gets official permission from the IRS to change to an "acceptable" method.

Here's a thought for CPAs who don't want to sit idly by while the IRS decides what to do: Why not file 3115s for all dealers who have not elected LIFO for their parts since they have overvalued their parts inventories by using replacement cost? For the sake of simplicity, all these dealers have been overpaying their taxes all these years!

Here's the catch on this: Do they (i.e., the dealers) have *adequate* inventory books and records to support a negative Section 481(a) adjustment based on actual cost? Would they be using estimates based on turnover calculations to approximate actual cost? Just what will the IRS–at the National Office and/or the examination level–accept or require in this regard? See what we mean by calling it ***gridlock?***

#4. FORM 3115 FOR ACCOUNTING METHOD CHANGES REVISED AGAIN. The IRS has updated Form 3115 to reflect the recent issuance of Revenue Procedure 98-60 which superseded Revenue Procedure 97-37. The new form, bearing a May, 1999 revision date, should now be used for all applications for change in accounting methods, including LIFO methods, sub-methods and terminations. The new Form 3115 is still 8 pages long, and it really didn't get much of a fact-lift.

#5. RECENT TECHNICAL ADVICE FROM THE NATIONAL OFFICE. In recent technical advice, the IRS addressed the question of whether a company's sale of excess capacity inventory required a "vertical" slice (or accelerated LIFO recapture) approach. In TAM 199920001, the National Office overruled the IRS agent and held that the reduction in inventory should be treated just like any other and given the usual "horizontal" slice treatment.

The analysis in this TAM is very appropriate to consider in terms of dealer franchise consolidation and Project 2000 restructurings. This TAM is discussed on page 4.

In another situation–TAM 199911044–the National Office was asked to rule on whether a car dealer with multiple franchises and several locations ***all in the same city*** could use one pool for all new cars. The National Office said, "Yes."

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However, one should be careful because this favorable conclusion is based on the specific facts and circumstances in this case...and any half-awake agent may seek to distinguish more typical fact patterns from the one in this TAM. If anything, this TAM is a blueprint that shows an aggressive agent how to try to create multiple pools for new automobiles and/or new light-duty trucks for the far greater number of dealers who do not have such a simple fact pattern. See page 8.

6. FIELD SERVICE ADVICE PROVIDES INTERESTING INSIGHTS INTO IRS THINKING ON LIFO ISSUES. We are finally seeing new evidence of how certain LIFO issues are viewed by the IRS as more and more FSAs are being made available under the Freedom of Information Act. FSAs issued in prior years are being released, and so are some current year FSAs. We've summarized these FSAs which involve LIFO-related issues on page 12.

Here's an example of one of the interesting insights gleaned from these FSAs. ***One just happened to involve an auto dealer who had valued his parts inventories using replacement cost, and the Field Service Division (to its credit, we might add) did not take exception to this use of replacement cost.*** FSA 1999-501 is undated (unusual, since all other FSAs do not have dates redacted), but it appears to have been written shortly after the IRS issued Rev. Proc. 92-79 with the Alternative LIFO Method for Automobile Dealers.

From this, one might guess that 4 or 5 years ago the Field Service Division, at least, did not have a problem with the use of "replacement cost." Wouldn't it be interesting to know whether Field Service Advice was sought in connection with *Mountain State* before the decision to litigate was reached? And, if so, what did that Field Service Advice say? Maybe something like: "Go ahead and litigate, with the fact pattern this taxpayer has, you've got nothing to lose! Who knows, you might even win!" Did the IRS only have a "problem" with replacement cost because the taxpayer's Form 970 was so poorly worded? One can't help but wonder.

#7. JEWELRY RETAILER'S LIFO CALCULATIONS MAY LOSE THEIR GLITTER. Another of the FSAs was involved with how a jewelry retailer applied LIFO to his jewelry inventory and what the IRS liked–and didn't like–about what was done. We plan to cover this FSA, 199920002, more fully in a future issue of the *LIFO Lookout.*

#8. CORRECTION TO OUR NEW ITEM LIST. Please note the following corrections: the '99 Saturn SC1 and SC2 2-door coupe models were continuing models when they were first introduced on June 26, 1998. Production of the 2-door models ceased on October 30, 1998 and was replaced by a 3-door model as of November 1, 1998. The 3-door models should be considered ***new*** items because the manufacturer did change the model code number.

This more complete information was not available when our New Item Category List went to press in the last issue of the *LIFO Lookout.* ✱

SALE OF EXCESS CAPACITY INVENTORY DOES NOT REQUIRE "VERTICAL SLICE" ACCELERATED LIFO RECAPTURE

TAM 1999 20001

At one time or another, many businesses find it necessary to contract the scope of their activities and operations. In the course of this realization, excess capacity inventory is identified and disposed of as part of the streamlining process.

In Technical Advice Memo 199920001, dated January 13, 1999, the IRS National Office had to decide whether the examining agent should require an accelerated recapture of the LIFO reserve where a sale of inventory occurred as part of the organization's overall downsizing. The National Office rejected the agent's arguments and allowed the taxpayer to treat the sale of inventory as if it were made in the ordinary course of business.

FACTS

The taxpayer was engaged in the business of selling and storing a certain type of inventory. It had elected the ***specific goods*** LIFO inventory method. In one year, the taxpayer had sold 23% of its inventory in conjunction with the sale of storage facilities that it considered to be "excess capacity." The taxpayer's opening inventory was 149 units and its closing inventory was 115 units, hence the 23% contraction. In its LIFO calculations for that year, the taxpayer simply treated the inventory on hand at the end of the year as if it were made up entirely of inventory that was on hand at the beginning of the year. As a result, this treated the sale of the inventory that was sold as part of the downsizing as if that inventory sale had been a regular sale made in the ordinary course of business.

The IRS agent took the position that although Section 472 provides for the Last-In, First-Out or LIFO ordering treatment of inventories, Section 446 provides that if a method of accounting used by the taxpayer does not clearly reflect income, then the computation of taxable income shall be made under such method as does clearly reflect income. The Tax Court in *Hamilton Industries* in 1991 held that a taxpayer's inventory valuation method is subject to the requirement under Section 446 that it clearly reflect income, and that, for tax purposes, the clear reflection income is paramount.

VERTICAL SLICE OR HORIZONTAL SLICE? THE AGENT'S ARGUMENTS

The examining agent challenged the simple last-in, first-out treatment because the agent believe that the inventory sale that was made in conjunction with the sale of the storage facilities was ***not*** a sale of "inventory" because it was not a sale made in the ordinary course of business. The agent believed that the taxpayer was required to remove the cost associated with the inventory that was sold in conjunction with the sale of the storage facilities from its inventory ***prior*** to the sale.

The agent believed that in order to clearly reflect income the inventory sold should be removed as if the taxpayer were separating an existing LIFO pool into two or more pools. The means to accomplish this would be to remove the cost of the inventory sold from the total inventory costs pro-rata from the base-year units and from the subsequent yearly units of increment, thus removing the inventory as a so-called *vertical* slice.

The agent argued that the costs associated with the excess capacity inventory should be removed as a pro-rata vertical slice—rather than the usual *horizontal* LIFO slice—because the factual pattern represented a contraction of the taxpayer's business. The agent's view was that sales occasioned by a decision to reduce the level of operations or investment in inventory should be treated differently than sales occurring in the ordinary course of business.

The agent stated that the LIFO inventory method is predicated on the following theory: The operations of a business require that a certain level of inventory be maintained throughout the life of the enterprise, and the increasing costs associated with maintaining the level of inventory should be expensed during the year incurred.

However, in the situation of sales occasioned by a decision to reduce the level of operations or investment in inventory, exclusion from taxable income of the current cost associated with maintaining inventory levels is not a concern because the taxpayer does not contemplate replacement. The examining agent argued that, because the taxpayer had decided to reduce its investment in inventory, it should remove from inventory the historical cost of acquiring the inventory thereby recognizing the inventory profits previously deferred.

NATIONAL OFFICE RATIONALE

The National Office disagreed with the agent, stating that it believed that the excess capacity

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inventory sale in conjunction with the sale of the storage facilities was, nevertheless, "inventory." That the taxpayer ultimately sold the inventory in bulk in connection with the sale of storage facilities did not alter the fact. In support of its holding, the National Office cited three cases: *Grace Brothers v. Commissioner*, *Lawrie v. Commissioner*, and *Martin v. United States*.

The National Office said that "even if the LIFO inventory method is predicated on the theory that the operations of a business require that a certain level of inventory be maintained throughout the life of the enterprise (as the examining agent argues), we do not believe that the level necessarily is static. We believe that the required level of inventory could change with the growth or decline of a business.

The LIFO inventory method provides, through the use of increments and decrements, a methodology that appropriately accounts for the cost of inventory added or removed as a result of a growth or decline in the business. We believe that this methodology, which requires removing units in reverse chronological order, is consistent with removing from inventory the historical cost of acquiring the inventory when a taxpayer decides to reduce its inventory level.

"For example, assume that a taxpayer using the specific goods LIFO inventory method has an inventory in Year 1 of 100 widgets, that in each of the Years 2 through 10 the inventory of widgets increases by 10, and that in Year 11 the taxpayer decides to reduce its inventory of widgets by 50. Under these facts, we do not believe that there is any reason to conclude that the taxpayer is eliminating from inventory a pro-rata portion of its base-year widgets. In fact, in Year 11, the taxpayer's inventory of widgets numbers 140, 40 more than the taxpayer had in the base year. We believe that the LIFO inventory methodology contemplates that the taxpayer in this example is eliminating the widgets that were incrementally added in Years 6 through 10."

The National Office added that, "As a general matter, we do not believe that, for purposes of the LIFO inventory method, bulk sales of inventory should be treated differently than sales made in the ordinary course of business. Under the facts of this case, we do not believe that the inventory sold in conjunction with the sale of the storage facilities should be removed from inventory as a so-called 'vertical slice.' Instead, we believe that the taxpayer's treatment of the sale of the inventory that was made in conjunction with the sale of the storage facilities, which was the same as its treatment of sales of the inventory made in the ordinary course of business, clearly reflects the taxpayer's income."

REVENUE RULING 85-176 DISTINGUISHED

The National Office distinguished the fact pattern under consideration from the facts in Revenue Ruling 85-176. In that Ruling, it was held that a corporation that uses the ***dollar-value*** LIFO inventory method and transfers a portion of its inventories in a nontaxable exchange under Section 351 must compute its basis in the inventories transferred using a pro-rata (vertical) division of the base year and subsequent yearly incremental costs.

Revenue Ruling 85-176 involved a manufacturer using the dollar-value LIFO method and one natural business unit pool who transferred inventory seven years after its initial LIFO election. At that time, it transferred one-half of its production plant to a newly organized subsidiary in a non-taxable exchange under Code Section 351. Included in the assets transferred to that new subsidiary was one-half of the dollar-value LIFO inventory. The question presented in Rev. Rul. 85-176 was whether the basis of the transferred LIFO inventory was to be determined by reference to the current year costs (i.e., a horizontal slice) or on a pro-rata basis (i.e., a vertical slice) which takes into account a portion of the base-year layer and subsequent yearly increments.

In Revenue Ruling 85-176, the IRS held that the pro-rata division of the base-year costs and subsequent yearly increments (in accordance with Reg. Sec. 1.472-8(g)(2)) would be consistent with the underlying purpose of the LIFO inventory method. Thus, the concept of matching current income with current costs would be satisfied. The use of any other method to compute the portion of inventories transferred in a non-taxable Section 351 exchange would inappropriately treat the non-taxable transaction as if it were another sale of goods out of inventory.

WHAT ABOUT DEALERS WHO ARE RESTRUCTURING THEIR FRANCHISES?

One cannot help but wonder: Would the IRS require vertical slice or horizontal slice LIFO recapture treatment in situations where automobile dealerships are "required" to sell off one or several of their franchises—and the related inventory—in order to accomplish so-called *Project 2000* realignment or consolidation objectives of the various manufacturers.

We see dealers selling off—or otherwise disposing of—their franchises in transactions of this nature all the time! Where a dealer's inventory at the end of the year has been significantly reduced—because of the reduction in overall operations—is vertical or horizontal slice treatment appropriate?

see **"VERTICAL SLICE"**, page 6

"Vertical Slice"

(Continued from page 5)

These same questions are present–even though they lie a little farther below the surface–in common dealer situations less visible but, nevertheless, entirely consistent factually. For example, what if a dealer had three franchises at the beginning of the year, sold off one, and acquired another new franchise before the end of the year? In this case, perhaps the overall or total dollar amount of investment in inventory at the beginning of the year and at the end of the year would be approximately the same, despite the fact that one business component/franchise had been entirely eliminated or removed and replaced by a completely different franchise.

The computations accompanying this article illustrate the difference in result between a vertical slice and a horizontal slice treatment for a dollar-value LIFO taxpayer. Note that by removing earlier costs proportionally, the vertical slice approach results in more (i.e., it accelerates) LIFO reserve repayment or recapture. In contrast the horizontal slice obviously results in less.

COULD YOU BE A SWITCH-HITTER?

Perhaps in some planning situations, the taxpayer wants to or could benefit from an acceleration of income. In this case, the taxpayer might take the position that the vertical slice treatment would be appropriate even though in most other situations that come more readily to mind, the taxpayer would typically try to minimize reported income and generally would argue for the horizontal slice treatment. In a different overall fact pattern, a taxpayer might volunteer to vertically slice the LIFO layers in order to generate more income. Just a thought.

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LIFO LAYER HISTORY AS OF DECEMBER 31, 1997

				COMPOSITION & PROOF OF LIFO RESERVE AT 12/31/97				
YEAR	*Base Dollars 12/31/97*	*Valuation Factor*	*LIFO Valuation 12/31/97*	*Factor (A)*	*(B)*	*(C) = (A-B)*	*Base Dollars*	*LIFO Reserve (C) x Base $*
1974	778,915	0.39457	307,336	(1.21458 -	0.39457)	0.82001	778,915	638,718
1975	145,647	0.41706	60,744	(1.21458 -	0.41706)	0.79752	145,647	116,156
1981	240,456	0.67184	161,548	(1.21458 -	0.67184)	0.54274	240,456	130,505
1982	405,372	0.69050	279,909	(1.21458 -	0.69050)	0.52408	405,372	212,447
1984	253,488	0.74440	188,696	(1.21458 -	0.74440)	0.47018	253,488	119,185
1985	122,987	0.77983	95,909	(1.21458 -	0.77983)	0.43475	122,987	53,469
1987	174,073	0.86245	150,129	(1.21458 -	0.86245)	0.35213	174,073	61,296
1989	408,334	0.93237	380,718	(1.21458 -	0.93237)	0.28221	408,334	115,236
1991	638,083	1.00000	638,083	(1.21458 -	1.00000)	0.21458	638,083	136,920
1992	-	1.04160	-	(1.21458 -	1.04160)	0.17298	-	-
1993	-	1.07672	-	(1.21458 -	1.07672)	0.13786	-	-
1994	283,019	1.12908	319,551	(1.21458 -	1.12908)	0.08550	283,019	24,198
1995	96,701	1.16042	112,214	(1.21458 -	1.16042)	0.05416	96,701	5,237
			(1)					1
	3,547,075			*Total Base Dollars*			3,547,075	
			2,694,837	*Total LIFO Valuation*				
			4,308,206	*Actual Cost - 12/31/97*				
			1,613,369	*LIFO Reserve - 12/31/97*				1,613,369

SIGNIFICANT INVENTORY DECREASE AT DEC. 31, 1998

At December 31, 1998, Inventory Drops by $2 Million to $2,308,206 Actual Cost.
2% Inflation for 1998 Results in Cumulative Index at 12/31/98 of 1.23887 (1.21458 x 1.02).
$2,308,206 / 1.23887 = $1,863,154 in Base Dollars.
$3,547,075 - $1,863,154 = $1,683,921 Decrement for 1998 Expressed in Base Dollars.

LIFO LAYER HISTORY AS OF DECEMBER 31, 1998

REFLECTING INVENTORY REDUCTION OF $2 MILLION

HORIZONTAL SLICE

YEAR	Base Dollars 12/31/98	Valuation Factor	LIFO Valuation 12/31/98
1974	778,915	0.39457	307,336
1975	145,647	0.41706	60,744
1981	240,456	0.67184	161,548
1982	405,372	0.69050	279,909
1984	253,488	0.74440	188,696
1985	39,276	0.77983	30,629
1987	-	-	-
1989	-	-	-
1991	-	-	-
1992	-	-	-
1993	-	-	-
1994	-	-	-
1995	-	-	-
			(1)
	1,863,154		

COMPOSITION & PROOF OF LIFO RESERVE AT 12/31/98

Factor (A)	Factor (B)	Factor (C) = (A-B)	Base Dollars	LIFO Reserve (C) x Base $
(1.23887 -	0.39457)	0.84430	778,915	657,638
(1.23887 -	0.41706)	0.82181	145,647	119,694
(1.23887 -	0.67184)	0.56703	240,456	136,346
(1.23887 -	0.69050)	0.54837	405,372	222,294
(1.23887 -	0.74440)	0.49447	253,488	125,342
(1.23887 -	0.77983)	0.45904	39,276	18,029
-	-	-	-	-
-	-	-	-	-
-	-	-	-	-
-	-	-	-	-
-	-	-	-	-
-	-	-	-	-
-	-	-	-	-
				2

	Total Base Dollars	1,863,154
1,028,861	*Total LIFO Valuation*	
2,308,206	*Actual Cost - 12/31/98*	
1,279,345	*LIFO Reserve - 12/31/98*	1,279,345
1,613,369	*LIFO Reserve - 12/31/97*	
(334,024)	*Decrease in LIFO Reserve for 1998*	

VERTICAL SLICE

YEAR	Base Dollars 12/31/97	0.474735 Reduction Due to 1998 Decrement	0.525265 Remaining Base $ 12/31/98	Valuation Factor	LIFO Valuation 12/31/98
1974	778,915	(369,778)	409,137	0.39457	161,433
1975	145,647	(69,144)	76,503	0.41706	31,906
1981	240,456	(114,153)	126,303	0.67184	84,855
1982	405,372	(192,444)	212,928	0.69050	147,027
1984	253,488	(120,340)	133,148	0.74440	99,116
1985	122,987	(58,386)	64,601	0.77983	50,378
1987	174,073	(82,639)	91,434	0.86245	78,858
1989	408,334	(193,850)	214,484	0.93237	199,978
1991	638,083	(302,920)	335,163	1.00000	335,163
1992	-	-	-	1.04160	-
1993	-	-	-	1.07672	-
1994	283,019	(134,359)	148,660	1.12908	167,849
1995	96,701	(45,907)	50,794	1.16042	58,942
	3,547,075	(1,683,921)	1,863,154		

COMPOSITION & PROOF OF LIFO RESERVE AT 12/31/98

Factor (A)	Factor (B)	Factor (C) = (A-B)	Base Dollars	LIFO Reserve (C) x Base $
(1.23887 -	0.39457)	0.84430	409,137	345,434
(1.23887 -	0.41706)	0.82181	76,503	62,871
(1.23887 -	0.67184)	0.56703	126,303	71,618
(1.23887 -	0.69050)	0.54837	212,928	116,763
(1.23887 -	0.74440)	0.49447	133,148	65,838
(1.23887 -	0.77983)	0.45904	64,601	29,654
(1.23887 -	0.86245)	0.37642	91,434	34,418
(1.23887 -	0.93237)	0.30650	214,484	65,739
(1.23887 -	1.00000)	0.23887	335,163	80,060
(1.23887 -	1.04160)	0.19727	-	-
(1.23887 -	1.07672)	0.16215	-	-
(1.23887 -	1.12908)	0.10979	148,660	16,321
(1.23887 -	1.16042)	0.07845	50,794	3,985

	Total Base Dollars	1,863,154
1,415,504	*Total LIFO Valuation*	
2,308,206	*Actual Cost - 12/31/98*	
892,702	*LIFO Reserve - 12/31/98*	892,702
1,613,369	*LIFO Reserve - 12/31/97*	
(720,667)	*Decrease in LIFO Reserve for 1998*	

***VERTICAL SLICE**: The Dec. 31, 1997 Base Dollars Remaining in Each Prior Year's LIFO Layer as of Dec. 31, 1998 is Determined by the Ratio of $1,863,154 to $3,547,075 or 0.525265 Applied to Each Year's Layer.*

The Ratio of 1998 Decrement of $1,683,921 to the Dec. 31, 1997 Base Dollars of $3,547,075 Equals 0.474735.

AUTOMOBILE DEALER WITH MULTIPLE FRANCHISES & LOCATIONS CAN USE ONE POOL FOR ALL NEW CARS

TAM 1999 11044

For good reason, most automobile dealers using LIFO for new vehicles have elected to use the Alternative LIFO Method. This method was originally published in Revenue Procedure 92-79 and restated in Revenue Procedure 97-36. The Alternative LIFO Method is popular because it eliminates many of the controversies that would come up when IRS agents were examining car dealer's new vehicle LIFO calculations. Included as part of the Alternative LIFO Method, however, are a number of compensating sub-methods and a computational methodology that must be strictly followed.

The requirements that relate to LIFO pooling provide that "***for each separate trade or business***, all new automobiles (regardless of manufacturer) must be included in one dollar-value LIFO pool and all new light-duty trucks (regardless of manufacturer) must be included in another separate dollar-value LIFO pool." In the past, we have mentioned our concern over precisely what is meant by the preface wording, "for each separate trade or business." Recently, TAM 199911044 elaborated on this wording, giving an auto dealer permission to keep all new autos in one pool and all new light-duty trucks in a separate pool.

However, that dealer's fact pattern was really clean or simple. As such it may be significantly different from that encountered where a dealer has multiple franchises or operates in several different cities. Although the National Office overruled the examining agent and allowed the dealer's broader pool arrangement despite the dealer's multiple locations and franchises, the National Office left itself plenty of room to reach the opposite conclusion for a dealer with a more complex–and more usual–fact pattern.

The fact pattern presented by the dealer in the Technical Advice Request and the National Office comments are reported in greater detail on pages 9 and 10, respectively.

The dealer in the TAM held five franchises issued by two manufacturers. He conducted operations at three different locations, all within the same city. Not surprisingly, the applicable franchise requirements included conditions involving exclusivity and certification of personnel. The books and records, checking and payroll account activity were all centralized. There were some managerial employees, and there were other employees who worked when and as needed at all three of the locations. The dealer advertised each location and each franchise separately, and it also ran generic advertisements promoting the dealership as a whole. All of the inventory at all locations was financed through a "single line of credit ...secured by all of (the dealer's) vehicles."

The agent was looking to break down the broader single pooling permitted by the Alternative LIFO Method for new automobiles into three separate pools, one pool for the new cars at each geographic location. In other words, the agent thought the dealer should maintain separate pools for each geographical location and tried to justify this result.

Interestingly enough, only two cases are cited in the TAM analysis as bearing on this issue. In *Peterson Produce Co. v. United States*, a U.S. District Court held that the broiler division of the taxpayer was not a separate trade or business from the taxpayer's breeding farm operation. The Court's holding in *Peterson* was based in part upon its findings that the taxpayer's divisions were too interdependent and well-integrated to be considered separate and distinct, and there was not a sufficient separation of the books and records.

In the second case, *Burgess Poultry Market, Inc. v. United States*, the Court held that the taxpayer's poultry raising operation and broiler processing operation were separate and distinct trades or businesses. In *Burgess*, the Court considered the fact that the taxpayer maintained separate sets of books, had separate bank accounts for each operation, and had separate employees for each operation.

In TAM 199911044, the National Office discussed three factors: (1) separate geographical locations, (2) one complete set of books and records, and (3) separate sales force for new vehicle sales and service mechanics. However, it indicated that each factor ***alone*** was not a sufficient basis for requiring separate trade or business pooling treatment.

In allowing the single pooling arrangement to stand, the National Office said that it is reasonable to assume that the drafters of the Alternative LIFO Method recognized that most vehicle manufacturers do require in their franchise agreements terms and conditions similar to those present in the case. That may be true. However, other factors which the

see **TAM199911044**, page 11

THE DEALER'S FACTS IN TAM 199911044

TWO MANUFACTURERS...FIVE FRANCHISES, THREE LOCATIONS...ALL IN THE SAME CITY

The taxpayer is a franchised dealer for three divisions of A, an automobile and light-duty truck manufacturer, and two divisions of B, another automobile manufacturer. The taxpayer holds five franchises, one for each division of A and B. The taxpayer sells new and used vehicles at three different lots all of which are located in City Y. At one location the taxpayer sells used vehicles as well as new automobiles and trucks manufactured by A. The new vehicles sold at this location include vehicles covered by three separate franchise agreements between the taxpayer and A, an Al franchise, an A2 franchise and an A3 franchise. In addition, the taxpayer sells new automobiles manufactured by B, B1 and B2, as well as used vehicles at two other separate locations. The taxpayer operates a service department and a parts department at each location.

CENTRALIZED BOOKS, RECORDS, CHECKING & PAYROLL ACCOUNT ACTIVITY

The taxpayer maintains only one complete set of books and records, and its books treat each location as a division. The financial records of each location, at least the income statement items, can be retrieved and presented separately. The taxpayer has a single checking account. All payroll checks and other checks are issued from the central accounting office. Each location maintains a petty cash fund.

FINANCIAL REPORTING REQUIREMENT

The dealer's franchise agreements also obligate it to furnish monthly financial statements to A and B. These monthly financial statements require the dealer to present financial information with respect to new vehicles sales regarding each franchise separately. Although this information is listed separately, all of the financial information related to the dealer is presented on these forms.

ALL FLOOR PLAN LENDING FROM A SINGLE SOURCE

The taxpayer has one floor plan source in lieu of different sources for each location. All of the taxpayer's inventory is financed through a single line of credit that is secured by all of the taxpayer's vehicles.

ADVERTISING

In addition to advertising each location and each franchise separately, the taxpayer runs advertisements that promote its business as a whole (including all locations).

MANAGERIAL EMPLOYEES & OTHER NON-EXCLUSIVE EMPLOYEES

The corporate vice-president serves as the general manager for both locations that sell automobiles manufactured by B. In addition, each location has a manager for the sales department, a manager for the service department, and a manager for the parts department. The taxpayer has certain employees, aside from top management, accounting, and other administrative personnel that serve the taxpayer as a whole and are not limited to serving a particular location. Examples of employees that serve the taxpayer as whole include, (1) a single used car manager who purchases used vehicle inventory for all locations, (2) parts delivery personnel, (3) parts counter personnel who rotate locations to fill-in scheduling, (4) facilities maintenance personnel, and (5) used vehicle salespersons who may sell the used vehicle inventory of any location.

MANUFACTURER EXCLUSIVITY REQUIREMENTS

The franchise agreements between the taxpayer and B require the taxpayer to sell new B1 automobiles exclusively at one location and to sell new B2 automobiles exclusively at a separate location. No other types of new vehicles are permitted to be sold on the same lot as new B1 automobiles and new B2 automobiles. Originally, the taxpayer sold new B1 automobiles at the same location as new vehicles manufactured by A. However, at some time prior to the years in issue, B required the taxpayer to begin selling new BI automobiles at a separate location. Similarly, B would not grant a franchise to the taxpayer to sell new B2 automobiles unless such automobiles were the only types of new vehicles sold at a location. Accordingly, the taxpayer now sells (1) new automobiles manufactured by A at one location, (2) new B1 automobiles at a separate location, and (3) new B2 automobiles at another separate location.

CERTIFICATION REQUIREMENTS FOR NEW VEHICLE SALESMEN & SERVICE TECHNICIANS

The franchise agreements with both manufacturers require that (1) salesmen have certain certifications to sell a particular division's new vehicles, and (2) service technicians have certain certifications to work on a particular division's new vehicles.

WHAT THE NATIONAL OFFICE SAID IN TAM 199911044

The factors relied upon by the examining agent to establish the separateness of the geographical locations relate to the requirements of the different franchise agreements or derive from these requirements. Under its present franchise agreements, the dealer is required to maintain three separate geographical locations, submit monthly financial statements to two different manufacturers, and have certain certified new vehicle salesmen and service technicians.

In fact, the dealer sold all of its new vehicles from one geographical location until the dealer's franchise agreements began to require separate locations. Once required to establish separate locations, it was only reasonable that the dealer also have some degree of separateness of employees and employee supervision at each location. The dealer also wrote invoices, collected financial information from customers, approved sales, and collected sales proceeds at each location. We believe that a taxpayer may transact business from separate locations without each location being considered a separate trade or business; ***separate geographical locations alone are not sufficient to create separate and district trades or businesses***.

Each of the franchise agreements require the dealer to furnish monthly financial statements with respect to the division covered by the franchise agreement to either of the manufacturers wherein certain financial information with respect to that division's (franchise's) new vehicles sales is separately stated. The dealer fulfills these requirements by separating certain income statement items from its books. In this case, the dealer only maintains one complete set of books and records. ***Although this set of books and records is separable,*** at least with respect to income statement items as, noted above, that factor alone is not sufficient to require the dealer to treat each of its locations as a separate trade or business for purposes of the Alternative LIFO Method.

Another factor relied upon by the agent is that each location has its own new vehicle sales personnel and its own mechanics. That fact is, in part, dictated by the requirements in the franchise agreements regarding salesmen certification. Moreover, at the location where vehicles manufactured by A (one of the manufacturers) are sold, some of the salesmen exclusively sell only one division's new vehicles because of that franchise's certification requirements. Accordingly, even at a single location some salesmen only sell certain types of new vehicles.

Rev. Proc. 92-79 specifically recognizes that a trade or business could include different manufacturers. Furthermore, it is reasonable to assume that the drafters of this document recognized that most vehicle manufacturers require (in their franchise agreements) terms and conditions similar to those involved in this case. Accordingly, we believe that in considering the trade or business requirement in Rev. Proc. 92-79, controlling significance cannot be given to the factors discussed above. Otherwise, the pooling rules of Rev. Proc. 92-79, which recognize that different manufacturers can be included in a single pool, would tend to be frustrated.

Based upon the particular facts and circumstances of this case, we believe that the dealer is operating as a single trade or business at separate locations. Some of the factors we relied upon in reaching this conclusion include the following:

1. The dealer is engaged in the same type of activities (i.e., those related to new and used vehicle sales and service) at all three locations.
2. In addition to upper-level management, accounting personnel and administrative personnel, other employees work at more than one of the dealer's geographical locations; for example, the same employee is the general-manager of both locations that sell automobiles manufactured by B (one of the manufacturers) and the used car manager manages all used vehicle sales for all of the dealer's locations and purchases all used vehicles that are not acquired through trade-in sales, at all of the dealer's locations.
3. The dealer only has one checking account out of which all payroll and other expenses are paid.
4. The dealer has one line of credit that is secured by all of the dealer's inventory, regardless of location or manufacturer.

Under the particular facts and circumstances of this case, we believe that the dealer is operating as a single trade or business. Accordingly, ... the dealer must include all new automobiles in a single dollar-value LIFO pool and all new light-duty trucks in another separate dollar-value LIFO pool.

(Continued from page 8)

National Office cited/relied upon in reaching its conclusion included (1) common checking accounts for payroll and other expenses, (2) one line of credit secured by all of the dealer's inventory (regardless of location or manufacturer), and (3) "floating" employees who worked as needed at all three locations.

POINTS TO PONDER

Many dealers have fact patterns which, although they include the more generic or common manufacturer franchise requirements, also vary significantly from this TAM/dealer's fact pattern. This may be the case, especially with respect to multiple versus separate checking accounts, multiple lines of credit with different captive finance subsidiaries and/or other banks (rather than just one), and multiple locations that are more geographically diverse and not necessarily all within the same city.

Should auto dealers whose fact patterns are not as "simple" as this one expect trouble from IRS agents over their single pooling arrangements?

CONCLUSION

The Alternative LIFO Method has now been with us for seven years, and some agents are starting to see more ways to try to limit a dealer's LIFO benefits under it. For another example, consider the implications of TAM 199920001 discussed in the preceding article relating to vertical vs. horizontal slice LIFO recapture computations where a dealer disposes of the entire inventory from a franchise either voluntarily or involuntarily as a result of Project 2000 or other consolidation realignments. There are still many intriguing and unanswered questions out there for car dealers using the Alternative LIFO Method. *

FIELD SERVICE ADVICE PROVIDES INTERESTING INSIGHTS INTO IRS THINKING ON LIFO ISSUES

FSA ROUNDUP TO DATE

The IRS was recently forced to release Field Service Advice memoranda (FSAs) under the Freedom of Information Act. This was the result of a 5-year battle between the IRS and *Tax Analysts*, with numerous court showdowns, before the IRS finally gave in. For more on the fight with the IRS over public disclosure of FSAs, see *LIFO Lookout*, September, 1998, page 23.

Although FSAs have no precedential value, they are useful references because they provide (1) varied insights into how the IRS may interpret certain LIFO issues, and (2) evidence of what the IRS might be willing to accept in practice. Often this information is better learned from the sidelines as a bystander than as a contestant in the "heat of battle."

Fourteen FSAs involving LIFO issues have been released to date. Two were released in 1998, ten have been released so far in 1999, and two more have been both written and released in 1999. Prior-year FSAs involving LIFO issues have been designated by the prefix "*1998-*" or "*1999-*" followed by a three or four digit number as they were released. In addition, several FSAs actually authored in 1999 have also been released, and these current-year FSAs are designated by the full year 1999 prefix, "1999XXXXX," ahead of five digits, the first two of which refer to the week in 1999, and the last three of which refer to a numerical sequence beginning with 001.

FSAs INVOLVE

- Six auto dealers (with assorted pre- and post-Alternative LIFO Method issues for new vehicles, conformity and other issues),
- two bargain purchase or deep-discount inventory situations,
- two C-to-S mergers involving LIFO reserve recapture questions and the Section 1363 Regulation not finalized until 1994,
- one manufacturer using a component-of-cost LIFO method,
- three other taxpayers...a wholesaler/retailer, a wine maker and a retail jeweler...who had disagreements with the IRS over their LIFO computations.

This assortment of LIFO taxpayers and issues provides varied insights into IRS thinking on LIFO issues. They often explain how the Field Service Division factors the "hazards of litigation" into overall negotiation or settlement activity consideration. Overall, one might be tempted to conclude that overall there's not much new in them. However—depending on where your interests or vulnerabilities lie—at least one or two provide some very interesting information.

For example, FSA 199920002 discusses how one retail jewelry business applied LIFO to its inventory. FSA 1999-501 reveals that several years ago, the IRS was willing to accept the use of the replacement cost method for an auto dealer's parts inventory, despite that method's obvious limitations and shortcomings from a technical, actual cost, standpoint. Because this was the second of two issues discussed in FSA 1999-501, it almost past unnoticed.

The importance of the Tax Court's decision in *Hamilton Industries* is evident from its mention whenever the IRS examining agent or the Chief Counsel attorney brings up the "clear reflection of income" issue. It also is apparent that the IRS spent a considerable amount of time on automobile dealer (pre-Rev. Proc. 92-79) and conformity issues. Some of these FSAs even suggest interesting insights and ideas for proposing compromises to thorny LIFO computation issues to the IRS in real life situations. As good examples of this, consider FSA 1999-627 involving sampling issues and the jewelry retailer FSA.

FSAs IN GENERAL

Revenue agents and appeals officers often request special assistance to get a better understanding of potential tax issues and how they should be approached. Field Service Advice memoranda are written in response by the IRS Field Service Division to provide non-binding advice and analysis to help in developing an issue or in determining related litigation hazards of either a substantive or procedural nature.

Field Service Advice is not like Technical Advice, because the taxpayer is deliberately excluded from the Field Service Advice process. The taxpayer is not given an opportunity to submit its version of the facts nor to have a conference with the IRS officials concerning any potential adverse conclusion that might be reached. Accordingly, the FSA process affords the taxpayer no protection, and often the taxpayer is not even aware that the case has been given FSA treatment. →

Each Field Service Advice document states that it may contain confidential information subject to the attorney/client and deliberative process privileges. Each FSA also states that it may have been prepared in anticipation of litigation. Each FSA continues that "the document should not be exposed to anyone outside the IRS, including the taxpayer(s) involved, and its use within the IRS should be limited to those with the need to review the document in relation to the subject matter or case."

Field Service attorneys often will work with the agent requesting support to help that agent better develop the facts. 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 developing an issue. Some FSAs go so far as to state (as did FSA 1998-152) that, "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..." Other FSAs offer the agent advice on alternative issues that the agent may have overlooked.

In another FSA (1999-1121), where the link-chain dollar-value LIFO method was involved, the FSA author in a note prompted that "we found nothing in the facts presented to us which indicate that (the taxpayer) made such a showing and obtained the District Director's approval, and complied with other notification requirements of the regulation." This followed the recitation of the requirement that a taxpayer can use the link-chain method only when it demonstrates to the satisfaction of the District Director that the index method or double-extension method would be impractical or unsuitable because of the nature of the inventory pool.

Clearly, the sentence quoted would suggest to the reader that inquiry should be made into whether the taxpayer had made the requisite showing, obtained the District Director's approval and complied with the other "notification requirements." In this case, the oft-overlooked requirement of Reg. Sec. 1.472-8(e)(1) could present unexpected problems. Specifically, a taxpayer using a link-chain method is required to attach to the income tax return for the first year the method is used, a statement describing the particular link-chain method (or the method used in computing the index). Not only is the statement required to disclose "sufficient detail to facilitate the determination as to whether the method used meets the standards set forth." One further requirement is added: a copy of the statement that was attached to the tax return "shall be filed with the Commissioner of Internal Revenue in Washington, D.C." Some practitioners have had experiences with agents who have actually contacted the National Office in an effort to find out whether the taxpayer really did submit a copy of the required information to the National Office.

For a quick overview of the 14 FSAs, see pages 14-15. And read a little more about each in the following summaries.

FSA 1998-134

(date originally released: December 15, 1992)

The automobile dealer involved in this FSA did not file a Form 3115 either before or during audit, or while the case was being contested in Appeals. The taxpayer verbally requested permission to use a cut-off method in connection with attempting to adopt the Alternative LIFO Method when its new vehicle LIFO calculations under a different approach using a questionable item definition were disputed by the IRS.

The Field Service Division concluded that the auto dealer could not force the IRS to allow it to use the cut-off method in implementing the change in its LIFO calculation. The taxpayer's oral request could not make up for the failure to previously file Form 3115 or to employ other protective measures. As a result, a Section 481(a) adjustment would be necessary in connection with the change.

The FSA states that "a Section 481(a) adjustment is legally defensible in this case." However, it adds: "We leave it to the discretion of Appeals whether the adjustment should be waived as part of any overall settlement." Clearly, that left the door open for further negotiation with the taxpayer.

FSA 1998-152

(date originally released: January 28, 1992)

In this FSA situation, an examining agent was trying to deny an automobile dealer the right to use the dollar-value LIFO method because the taxpayer had a small inventory of large items and specific units could be tracked. In other words, the dealer could readily identify and use specific identification accounting for his new vehicle inventory.

The Field Service Division said that the agent could not disallow the use of the dollar-value method on the grounds that it did not clearly reflect income. The FSA states that "while dollar-value LIFO in the instant case might not reflect income as well as a specific identification method, we do not believe you should disallow the use of the dollar-value LIFO method on clear reflection grounds since the regulations firmly establish that ***any*** taxpayer may use the method despite the nature of its inventory."

The FSA author then offered an alternative strategy to the examining agent, suggesting that the

see **FSAs PROVIDE INTERESTING INSIGHTS**, page 16

FIELD SERVICE ADVICE SUMMARY

CITATIONS	• FSAs referenced 1998-XXX and 1999-XXX were written by the FS Division before 1999. • FSAs referenced 1999-XXXXX were written in 1999 and released in 1999.
1998-134	• An auto dealer could not force the IRS into allowing the dealer to use the cut-off method in changing accounting methods. A Section 481(a) adjustment was appropriate in this case.
1998-152	• The IRS couldn't prevent an auto dealer from using the dollar-value LIFO method for specifically identifiable goods. • The FSA said that the way to prevent distortive effects when the dollar-value method is used is by carefully looking at how the taxpayer defines the "items" in its inventory pools.
1999-501	• An auto dealer's LIFO calculations for new vehicles for the years before the election of the Alternative LIFO Method (i.e., pre-1992 years) could not be changed by the IRS since they were afforded "audit protection" by Revenue Procedure 92-79. • The auto dealer's LIFO calculations for parts inventories, however, were not afforded cut-off or audit protection. Therefore, they could be challenged and changed. • Neither Examination, nor the Field Service Division, took exception to the dealer's use of the replacement cost method for parts inventories. This FSA states: ***"While replacement costs are a noncost based inventory valuation method, we believe their use in this case is appropriate given the fact that (the taxpayer) does not have the records to value ending inventory at actual costs."***
1999-622	• A manufacturer was not allowed to use its components-of-cost LIFO method because it did not "clearly reflect income." Instead, the taxpayer should be changed to the product-cost method. • The components-of-cost method of valuing LIFO inventories is not authorized under the regulations. Labor and overhead are not "items" - only tangible, physical units can be items. • This FSA includes lengthy discussions on the C-O-C method.
1999-627	• A group of wholesale and retail businesses had problems with their LIFO computations in terms of "item" definition, pooling, reconstruction of base-year costs, the application of statistical sampling techniques and certain "spun-off" inventories. • These taxpayers used what may be described as a true link-chain, index LIFO method (i.e., year-to-year and repricing less than every item/sampling). • This FSA reveals surprising compromises that Examination and the FS Division were willing to make in lieu of exhaustive, perfectionistic 100% detail work.
1999-700	• An auto dealership's LIFO election for pre-Alternative LIFO Method years should not be revoked for those years because the dealership had adequate books and records from which "item" definition and computations could be made.

FIELD SERVICE ADVICE SUMMARY

1999-909	• Inventory acquired in a deep discount bargain purchase should be treated as a separate inventory item from similar, after-acquired goods in accordance with the *Hamilton Industries* principle and precedent.
1999-973	• An auto dealership's violation of the financial statement conformity requirement would justify the IRS Commissioner's termination/revocation of the dealer's LIFO election.
1999-997	• This FSA involves an auto dealer/IRS dispute (before Rev. Proc. 92-79 was applicable) over whether a vehicle model number - or a manufacturer's model name - should be used to define an "item" of inventory in the dealer's dollar-value LIFO pool.
1999-999	• The IRS tasted only sour grapes after testing a winemaker's LIFO calculations. They weren't right: either the "item" definition and/or the pooling should have been narrower. • This FSA analyzed what year would be the year of change, depending on what actions were taken by the taxpayer.
1999-1120	• A C Corporation that merged into an S Corporation before the effective date of Reg. Sec. 1.1363-2(a) should be left alone and allowed to not recapture its LIFO reserves as of the merger date because of the risk that a Court might hold against the IRS if the issue were litigated.
1999-1121	• Inventory ***originally acquired*** in a deep discount bargain purchase ***and subsequently transferred in a Section 351 transaction*** should be treated ***by the transferee*** as a separate inventory item from similar, after-acquired goods in accordance with the *Hamilton Industries* principle and precedent.
199920002	• The IRS should be allowed to take the glitter off of a retail jewelry businesses' LIFO calculations because of "item" definition, pooling, reconstruction of base-year cost, and other deficiencies. • Very interesting reading, in general ... and even more interesting if you're involved with a jeweler or jewelry business using LIFO.
199922011	• This FSA involves a C Corporation that merged into an S Corporation before the effective date of Reg. Sec. 1.1363-2(a) and whether it should be left alone and allowed to not recapture its LIFO reserves as of the merger date. • This FSA is very similar to FSA 1999-1120 because it concerns the risk that a Court might hold against the IRS if the issue were litigated. However, this FSA says that support exists in the legislative history for recapture treatment, even though the regulation applies prospectively. Possibly the \$3.3 million involved makes the IRS think there's more to be gained by litigating this case.

distortive effects of dollar-value LIFO may be reduced by looking carefully at how the taxpayer is applying the LIFO method. Specifically, this would involve looking into how the taxpayer defines "items" within its inventory pool or pools.

The FSA counseled that while the definition of a separate "item" is a factual matter, at that time the tentative position of the IRS National Office regarding the inventory of auto dealerships is that an "item" is a particular sub-model with option packages. This FSA involved an auto dealer before the Alternative LIFO Method was available. More significantly, it shows how the Field Service Division can help or "coach" an examining agent in developing LIFO issues in situations where the agent is less experienced in LIFO matters.

Although holding that the IRS can't prevent the use of the dollar-value LIFO method for specifically identifiable goods, the Field Service Division did illustrate how an agent could prevent unwarranted increases in the LIFO reserves by carefully monitoring the definition of the "item" or "items" constituting the goods in the pool. This careful attention to "item" definition and inventory substitution or mix has been increasingly more evident in IRS audits and in Tax Court analyses.

FSA 1999-501 (date originally released: Undated)

This FSA involved three S-Corporation automobile dealerships who had elected to use the Alternative LIFO Method for 1992 under Rev. Proc. 92-79. The first issue related to whether audit protection was available for the LIFO reserves under the cut-off method or whether a Section 481 adjustment would be required when the new vehicle LIFO calculations were changed to the Alternative LIFO Method. The FSA concluded that because the corporations elected to apply the provisions of Rev. Proc. 92-79 timely, the cut-off method would be available ***as to those new vehicle LIFO reserves***.

The second issue is this FSA involved one of the three auto dealerships also using LIFO for the parts inventory. The parts LIFO calculations involved the link-chain, dollar-value method in conjunction with the earliest acquisition method for valuing increments. One of the facts stated is that the taxpayer "calculates its physical (parts) inventory based on a representative selection of parts in the parts pool. It values the ending inventory using replacement costs (estimated actual cost)." Also, stated as a fact was that the records were insufficient to value the ending inventory at actual cost. The examining agent proposed to recalculate the LIFO layer using the cumulative index determined by reference to ***replacement costs***, along with computing a Section 481(a) adjustment.

It is clear from the other information in the FSA that the agent was simply recalculating the valuation of the part increments or layers. It is also clear that the agent was allowing the LIFO increment to be converted from base-year dollars to current-year dollars using the cumulative index based on the estimated actual costs (replacement costs). The FSA states that "use of the current replacement cost method generally produces the highest incremental value and lowest LIFO benefit in times of inflation. Although not precedential, issue #4 in TAM 8906001 provides an analysis of the impact that the current replacement cost method has on LIFO increments for automobile dealers."

Interestingly, the FSA states, "While replacement costs are a noncost based inventory valuation method, we believe their use in this case is appropriate given the fact that (the taxpayer) does not have the records to value ending inventory at actual costs. We also believe that the acceptance by the agent of a use of a representative sample is appropriate for similar reasons. The agent's proposed adjustments appear well within the Commissioner's discretion."

Note that the acceptance of the use of replacement cost for valuing the parts inventory by both the examining agent and the Field Service Division (FSD) was exactly the opposite of the position taken by the Internal Revenue Service in *Mountain State Ford Truck Sales*.

Finally, the FSA gently corrects the agent who was proposing to allow a three-year spread period for the Section 481(a) adjustment. Because this change was an involuntary change in accounting method, the FSA pointed out that no spread of the Section 481(a) adjustment is required.

FSA 1999-622

(date originally released: July 31, 1992)

In this FSA, the Field Service Division concluded that the components-of-cost method of valuing LIFO inventories is not authorized under the regulations. It also concluded that the taxpayer's application of this method did not clearly reflect income, and it was not an appropriate method for valuing inventory. Consequently, it should be disallowed and the taxpayer should be required to change to the product-cost method for valuing inventory. In the process, a Section 481(a) adjustment also should be computed for the change.

This FSA contains a lengthy discussion of why the components-of-cost method should be disal- →

lowed. According to the IRS, although neither the Code nor the regulations specifically define the term "item" as that term is used in the dollar-value LIFO regulations, the concept of an inventory "item" as used in the regulations presupposes a tangible, physical unit and not intangible units, such as direct labor and overhead.

For other related discussions, see TAM 9445004 and 9405005 which are summarized in "IRS Doesn't Like 'Components-of-Cost' LIFO Methods" in the September, 1998 *LIFO Lookout*, pages 20-21. Also see March, 1994 *LIFO Lookout* for a more detailed discussion of LTR 9405005. All in all, this FSA evidences what still seem to be the current positions of the IRS that labor and overhead are not "items" and that manufacturers should be using the product cost, and not a components-of-cost, LIFO method.

FSA 1999-627

(date originally released: August 31, 1992)

The taxpayers in this FSA operated wholesale and retail businesses that carried most of the same inventory items. The retail outlets did not share physical facilities with the wholesale divisions. The issues involved problems that came up in connection with the item definition, use of pools, absence of records necessary to reconstruct base-year costs, some of the statistical sampling techniques the taxpayers employed and other corrections the IRS wanted to make to the link-chain LIFO calculations.

The ultimate issue was whether the IRS could terminate the taxpayer's LIFO inventory election if the taxpayer refused to comply with the IRS' (suggested) corrective actions. Not surprisingly, the FSA agreed that termination of the LIFO election would be justified if the taxpayer would not agree to make certain adjustments.

The alleged shortcomings in the taxpayer's LIFO computations and the proposed remedial changes are discussed at some length in the FSA. Interestingly enough, although the taxpayer did not have adequate historic records for preparing valid samples for earlier years, the examining agent would accept the use of a sample of each pool for three most recent years and then weighting those results to recompute a cumulative index. This was said to be analogous to Reg. Sec. 1.263A-1T(e)(6)(iv)(a) which allows for a three-year average change ratio to restate all previous LIFO layers existing before the adoption of the Section 263A inventory capitalization rules.

A further interesting point in this FSA is that if the taxpayer would be able to demonstrate that one of its subsidiaries is representative of the consolidated group as a whole, then Examination would be willing to use the results of a three-year weighted sample of that subsidiary to correct the balance of the entire consolidated group's indexes. The FSA concluded that the treatment proposed by Examination was a reasonable approach to preparing valid samples for earlier years.

The taxpayer was using what might be described as a *true* link-chain, index method. It employed statistical sampling (i.e., an index approach) to determine the annual inflation index in conjunction with its link-chain or linking computations of these disparate annual indexes over a period of years. In connection with this approach, the taxpayer arbitrarily excluded new items from the computation of each annual index. This practice of excluding new items in determining the annual inflation index did not clearly reflect income. Accordingly, the taxpayer should be required to consider ***each*** item, including **all** the new items, in its dollar-value LIFO pools when computing the annual LIFO index under the link-chain method.

Another issue in this FSA was whether the beginning inventory of certain subsidiaries that were "spun off" from existing subsidiaries should be valued at average cost, and the FSA concluded that they should be.

FSA 1999-700

(date originally released: September 14, 1992)

This FSA involved an auto dealer's LIFO calculations for years before the Alternative LIFO Method was available. The issues essentially related to item definition and how minor changes in vehicles should be reflected in the computations. The Field Service Division said that it would not be appropriate or necessary to terminate the dealer's LIFO election since the books and records available were adequate for the IRS to calculate the LIFO inventory using a modified definition of an "item." This FSA gives some insight into the struggles that were involved in arriving at item definition for automobiles before the advent of Revenue Procedure 92-79.

The examining agent had proposed to use a mathematical model designed to eliminate from the LIFO calculations the added real value due to technological change, other quality improvements, government regulations, and market factors including those from the current-year government regulations. The Field Service Division was not inclined to accept the mathematical model approach for determining "added real value." It said that "it is our position that an index for added real value components is inappropriate. Referring to the Tax Court's holding in *Wendle Ford* that the term "item" refers to a finished good in inventory, and not to its component parts (or indi-

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(Continued from page 17)

vidual modifications), the index proposed/created by the agent "appears to be calculating LIFO in relation (to) components, rather than the whole."

In response to a disagreement over the reconstruction of base-year cost for new items entering a pool in later years, the FSA said that the regulations do not specifically state or give examples of reasonable means of reconstructing the base-year costs of new items.

The FSA did say that the taxpayer could use "engineering techniques and valid cost estimates" to create a hypothetical price in the base-year (or in any subsequent year). Otherwise, a new item would enter the pool with an assigned value equal to the current year cost, resulting in a value of 1.000 in the year of entry.

FSA 1999-909

(date originally released: January 29, 1993)

This FSA involved the question of whether a taxpayer should be required to create a separate item for inventory purchased at a discount in valuing base year costs for LIFO purposes. The FSA pointed out that combining inventory purchased at a substantial discount with inventory subsequently produced does not clearly reflect income as the Code and regulations have been interpreted by the Courts.

The Field Service Division said that the principle of *Hamilton Industries, Inc.* applied to this situation and that separate item treatment should be given to the bargain purchase inventory in the LIFO calculations. Furthermore, the Commissioner's determination concerning clear reflection of income is entitled to ***more than the usual presumption of correctness*** and, as a result, the taxpayer bears a ***heavy*** burden in order to show that the method of accounting proposed by the Commissioner does not clearly reflect income.

In one portion of the FSA, the author appears to be suggesting that the agent should look more closely at the allocation of the bargain purchase element to see how it related "not only to the goodwill and going-concern value, but also to the Class III assets."

FSA 1999-973 (date released: September 30, 1993)

In this FSA, the Field Service Division held that an auto dealer's violation of the financial statement conformity requirement would justify the Commissioner's termination of the dealer's LIFO election. Obviously, the situation in this FSA is one of many that subsequently inspired the IRS to issue Revenue Procedure 97-44 and, hopefully, put the dealer financial statement conformity controversy to rest.

FSA 1999-997

(date originally released: August 11, 1992)

This FSA involved another auto dealer dispute with the IRS over whether the vehicle model number or the manufacturer's model name should be used to define an "item" of inventory in the new vehicle LIFO inventory pool. Obviously, the *compromise* resulting in Revenue Procedure 92-79's "item-category" definition was inspired by situations like this one.

FSA 1999-999

(date originally released: September 18, 1992)

What is interesting in this FSA is that the taxpayer is a wine maker using the dollar-value, double extension method. That wine maker had divided his grape juice inventory into two items: (1) grape juice used to produce ***sweet*** wine, and (2) grape juice used to produce ***dry*** wine. In contrast, the Service determined that there were (numerous) varieties of grapes that go into juices in the LIFO pool and that due to substitutions of new types of grapes for old types, the taxpayer's use of certain prices for juice did not accurately reflect the base-year cost of the current inventory.

It was suggested that the wine maker should have possibly considered and/or treated the following in its item definition: (1) grapes differing in **price**; (2) the **location** in which certain grapes are grown; (3) **when** different grapes are used in production; or (4) **how** different grapes are used in production.

The subject or issue in this FSA was how to apply the now outdated transition rules for LIFO accounting method changes under Revenue Procedure 92-20. It was concluded that the year of change would depend on whether the taxpayer filed a Form 3115 before or after September 19, 1992.

FSA 1999-1120

(date originally released: October 4, 1993)

This FSA involved the application of Section 1363 and whether a C Corporation was required to recapture its LIFO reserves as a result of its merger into an S Corporation. The merger had occurred before the effective date of Reg. Sec. 1.1363-2(a)(2) and, accordingly, the Field Service Division recommended that the case be settled, if possible.

This FSA did say, however, that if the case could not be settled and went forward in litigation, the IRS litigating position in effect would be consistent with the proposed regulation, notwithstanding the fact that the regulation could be expected to have prospective application only. Apparently, the Field Service Division would have been willing to argue that Congress did not intend Section 1363(d) to be read →

together with Section 1374(d)(8). The regulation had been proposed on August 18, 1993. The FSA concluded that because the issue in this case arose before the Service published the proposed regulation, it believed that there is risk that a court might hold against the Service.

FSA 1999-1121

(date originally released: October 29, 1993)

This FSA also dealt with bargain purchase inventories transferred to a new entity in a Section 351 transaction. The discount in this case did not represent as large a bargain element as did the composite 64% discounts in *Hamilton Industries*. The Field Service Division believed that, in accordance with *Hamilton*, the inventory transferred in the Section 351 transaction must be segregated into a separate "item" within the appropriate pool or pools from after-acquired goods. By requiring separate item treatment of inventory contributed or transferred in the Section 351 transaction, the IRS would, in effect, be requiring the recapture of the built-in gain residing within the transferred inventory.

The FSA opined that the argument that the taxpayer might make would be that the Commissioner was abusing her discretion by extending the rationale of Section 1363(d) to a Section 351 transfer without a clear manifestation of Congressional intent. As a result, there was significant litigation risk attached to this case.

FSA 199920002

(date originally released: January 11, 1999)

The taxpayer in this FSA is a retail jewelry business that elected to use the dollar-value, double extension LIFO method. The business maintained manual inventory records for about ten years and then it installed a computerized accounting system, including an inventory function. After the new system was set up, the taxpayer no longer retained inventory listings, cards or invoices from the period when manual records were kept.

The IRS took exception to a change in accounting method that the jeweler initiated without first receiving approval. This new method applied a more narrow definition of "items" within the single pool the business was using for its jewelry inventory. In addition, the Service said that the taxpayer's manner of reconstructing many of the base year costs was unreasonable.

In this FSA, the Field Service Division also concluded that the IRS may terminate the taxpayer's LIFO election for failure to keep adequate records if the taxpayer maintained insufficient accounting data to support its LIFO calculations. The taxpayer argued that the accounting workpapers it had maintained were sufficient to meet the recordkeeping requirements. Furthermore, since its accountants had access to original books and records and used them to verify the taxpayer's LIFO computations, that should be sufficient. The agent disagreed because he was unable to verify the taxpayer's LIFO calculations and computations because of the lack of original inventory records. Specifically, the agent argued that the taxpayer should have retained invoices to verify its inventory.

Citing *Boecking v. Commissioner* (TC Memo 1993-497), the Field Service Division said that "failure to maintain ***all invoices*** since the first year of the LIFO election is not, by itself, sufficient to terminate an election. The failure to maintain original inventory ***records*** sufficient to enable the Service to verify LIFO calculations could fail the recordkeeping requirement and permit termination."

The discussions related to the change in accounting method, substitution of less expensive for more expensive products, and other facets of the LIFO computations will be very interesting to anyone who has ever considered LIFO for a jeweler.

But, don't overlook the more obvious fact: this jewelry retailer's use of a single pool for all items was permitted; it was the item definition and reconstruction of base year costs that received all the attention.

FSA 199922011

(date originally released: February 23, 1999)

Like FSA 1999-1120, this FSA also deals with the question of whether a C Corporation should be required to include the LIFO recapture amount in its gross income in the year the C Corporation merged with an S Corporation, where that Section 368 merger occurred in a year prior to the effective date of Reg. Sec. 1.1363-2(a)(2).

There is no question that for transactions covered by the regulation *after* its date of adoption (October 6, 1994), a C Corporation transferring its LIFO inventory to an S Corporation in a non-recognition transaction like a merger would be required to include its LIFO inventory reserve in income. But, does the regulation apply to such transactions that took place *before* the effective date of the regulation?

The FSA concludes that "although this conclusion is mandated by Reg. Sec. 1.1363-2(a)(2), this regulation applies prospectively. Nonetheless, support exists in the legislative history for this treatment." This FSA is brief, and the taxpayer's adjustment exceeds $3.3 million. Since this is a very current FSA, there is the possibility that this issue might be litigated.

ADIOS, COMMON SENSE ... HELLO, CONFUSION: ONE PERSONAL OPINION ON THE *MOUNTAIN STATE FORD* PARTS MESS

WHERE'S THE OUTCRY?

Now that the IRS insists on calling all taxpayers–including dealers–***"customers,"*** one thing's for sure: When you want satisfied customers, you shouldn't go around trying to fix things for them that aren't broken. Whatever happened to common sense?

With all due respect, I believe that NADA is making a huge mistake at this time in trying to help the IRS come up with some panacea software to finesse its way out of the mess it created because it couldn't leave replacement cost alone. Instead of helping the IRS get out of the situation it has stirred up over this issue, NADA should be circulating a petition to be signed by dealers objecting to the absurdity of this whole thing and working to bring Bill Archer and Congress in to "fix" it.

Documents forced out of the IRS by the Freedom of Information Act show that for almost 25 years the IRS National Office and the Field Service Division have, in practice, allowed dealers to use replacement cost for parts inventories, knowing full-well this was not an actual cost method.

Although it cannot be documented, everyone knows that over the years examining agents and appeals officers also accepted replacement cost, except for a few isolated cases including *Mountain State Ford.*

So what has changed over all these years? Why all of a sudden this pursuit of perfection? Commissioner Rossotti or Congress should look into the enormous waste of time and effort, not to mention confusion and gridlock, brought about by the IRS's decision to change its long-standing, unofficial policy that accepted replacement cost as a proper method of accounting for parts inventories.

CONGRESSIONAL INTENT: WHAT DID CONGRESS REALLY MEAN? WHO REALLY KNOWS?

The Court said that "If Congress had intended for the term "cost" in LIFO inventory tax accounting to have a meaning different from that regulatory definition (i.e., actual cost), it would have so stated." With all due respect, I do not agree with the Court's conclusion.

It is my belief that Congress never even remotely considered the ramifications of the application of an actual cost standard in the context of a typical parts inventory fact pattern for an entire industry that from its inception was unable to come up with a reasonable way to make those calculations. I believe that members of Congress were more pragmatic and flexible...and less perfectionistic and absolute...than the Court inferred them to be.

The issue addressed by the Court narrowed down to: Does *cost* mean ***actual*** *cost* in each and every instance, wherever that term is used? Without any clear manifestation of Congressional intent on this specific question, I believe the Court erred and that it should have given greater deference to a more reasonable assumption of Congressional intent that would permit the use of replacement costs under the circumstances.

UNREASONABLE ADMINISTRATIVE AND/OR COMPUTATIONAL BURDENS

In *Mountain State Ford Truck Sales*, the taxpayer tried to argue that in 1979, in *Wendle Ford*, the Tax Court declined to interpret the LIFO regulations in a way that would "impose undue administrative burdens on taxpayers attempting to use the LIFO method or in a way that will diminish or eliminate the availability of the LIFO method to a significant group of taxpayers."

This argument by *Mountain State Ford* was rejected based on the Court's conclusion that "cost" means "actual cost."

Let's assume the Court was wrong on this and that cost does not, in every situation...or at least in this specific situation...mean actual cost. If that were the case, the debate over undue or unreasonable administrative and computational burdens, and the IRS interpretation as a barrier to the use of LIFO by a large taxpaying population, would become relevant.

In that case, I would submit that if a taxpayer has to wait several decades for some software developer to be prodded into patching up some software that the IRS may eventually accept for tracking actual cost, that the taxpayer is not inventing or imagining some undue administrative or computational burden. In fact, an undue/unreasonable administrative burden clearly does exist for all taxpayers–including Mountain State Ford–trying to apply actual cost to a real life parts inventory situation the way the IRS says it should.

How can Mountain State or any taxpayer be blamed if nothing exists–or ever existed–sufficient to the task that the IRS and now the Tax Court require?

→

THREE INSTANCES WHERE THE IRS ACCEPTED REPLACEMENT COST

It has been generally accepted for many years by taxpayers, practitioners, and the IRS alike that one of the reasons the regulations allow taxpayers to choose from several alternative increment valuation methods is that ***such a choice simplifies the LIFO computations.*** It simplifies the LIFO computations by allowing the taxpayer to more closely coordinate its method of valuing increments with the method of determining current-year cost that is used in maintaining the underlying inventory records.

Until the *Mountain State Ford* case emerged, it is clear that over the past 25 years, the IRS generally found no reason to make a mountain out of a molehill over a dealer's use of the replacement cost method for parts inventories.

In 1975, it had no problem with replacement cost as evidenced by Letter Ruling 7503130350B. Almost 15 years later, it expressed the same acceptance in Technical Advice Memorandum 8906001. More recently (circa 1992), even the IRS Field Service Division would accept the use of replacement cost, as evident in Field Service Advice 1999-501. See the texts of these three IRS documents on pages 24-27.

SOME QUESTIONS WORTH ASKING

All of this raises questions that NADA–or anyone else with the gumption–should ask Congress to look into:

1. If the IRS was amenable–or at least not totally opposed–to the use of replacement cost for much of the past 25 years, knowing that it was the only generally accepted and applied industry-wide practice (and that software didn't–and couldn't–exist to track "actual" costs through the system), what has changed so radically in the meantime?

2. Was Field Service Advice requested by the IRS in connection with *Mountain State Ford Truck Sales*?. If so, what did it say? Does it shed any light on the about-face?

3. Given the IRS's new motto that "The Taxpayer is the customer," why can't the IRS employ a customer-friendly attitude and just back away gracefully from this issue?

4. If replacement cost is really going to become a industry-wide issue, what is to be done about the fact that all manufacturers' current accounting systems and financial statement reporting requirements call for dealers to use replacement cost for parts?

See *Why NADA Shouldn't Help the IRS Yet,* immediately following, for other issues and questions.

Note 12 of the *Mountain State Ford Truck Sales* decision puts the IRS in the Pandora's box that, all by itself, it chose to open. This Note says, in part, that the "Respondent" (i.e., the IRS Commissioner) has no discretion to deviate from the requirements of the Code and the Regulations even if such requirements were to impose administrative burdens on Mountain State Ford." Well, if that really is the case...by that I mean, if the taxpayer appeals and loses at Appeals, then wouldn't a more sensible, long-term course of action be for NADA or some other group of dealers to lobby Congress and request it to lessen these requirements?

To me, this makes more sense than forcing all taxpayers in many industries to wait for software to be developed which ultimately, at best, will come up with more refined <u>estimates</u> of actual costs under the pretense of really tracking actual costs. Besides, the business of developing software today consists of putting out a program that its creators hope will work and then debugging it later as complaints over what the program is not doing correctly come (pouring in) from the users.

Somehow the picture of many fine legal minds, IRS perfectionists and software techies huddled in committee meetings only to gloss over the unending complexities presented in different parts inventory situations conjures up no great expectations over how accurate the final result of the software product will be. A camel is said to be a horse that was put together by a committee. Newly developed software to track and compute actual costs–if it is ever developed–will have to be tested against the standard of ***perfectly*** computing the actual cost of a parts inventory. If the result is anything less than perfect, and the IRS is willing to accept that less-than-perfect result, then why did the IRS want to force dealers to change from replacement cost in the first place? Was it just so it could collect ***less*** revenue?

Note 12 in the *Mountain State Ford* decision also pointed out that when Mountain State Ford adopted the LIFO method, it made no attempt to determine whether it "could have" modified its perpetual inventory recordkeeping system so that it could have used invoice prices (i.e., actual cost) in valuing the parts inventory. Also, Mountain State Ford did not determine whether it could have created a new recordkeeping system. One of the Mountain State owners testified that replacement cost had been utilized by Mountain State previously, and that it did not consider using any other method than replacement cost when it elected the LIFO method.

If Mountain State Ford had initiated the inquiries suggested by the Court, it would only have been confronted with the obvious: no such method or software for determining actual cost existed at that time. Nor does it yet, some 20 years later. Since the technology and/or other means to do the job did not

see **ADIOS, COMMON SENSE...HELLO, CONFUSION**, page 22

exist, how can the taxpayer be faulted for not wasting time and money trying to find them?

NADA and the IRS in almost two years since the *Mountain State Ford* trial still have not been able to come up with a single situation where an automobile or a truck dealer used the actual cost method for parts inventories. This fact certainly vindicates Mountain State Ford–and all others like it–and that validates the only "decision" it could have reached was to continue to use replacement cost in connection with its LIFO election. It is interesting to note that the 1975 IRS Letter Ruling simply recognized the need for consistency in the application of the replacement cost method between the last non-LIFO year parts inventory valuation and the first LIFO year valuation.

The question or issue over whether the use of replacement costs under the LIFO method complies with Generally Accepted Accounting Principles, (GAAP) and conforms as nearly as may be to the best accounting practice in the industry, never really came out as an issue for resolution. Note 6 in the *Mountain State Ford* decision explains that "the Court's resolution of the disagreement between the parties about the *clear reflection of income* standard makes it unnecessary for us (i.e., the Court) to address the parties' and their respective experts' dispute over GAAP." In this case, replacement cost is the "only" accounting practice in the industry for parts inventories and this has been consistently and conclusively demonstrated over the last two years in all the discussions between the NADA and the IRS.

A PLEA, A PARABLE & A PARADOX

Former IRS Commissioner Fred T. Goldberg, Jr.–now in private practice–said in 1990 that "The IRS needs to build on, and...accommodate common commercial practice. We can't operate on the assumption that...small businesses...can be expected to modify and tailor their behavior to the world of taxes–it ought to run in the other direction...Many of the problems we have in the (tax) system right now are traceable back to an honest, genuine, but terribly misguided quest for theoretically pure answers...(we) really cannot live with theoretically pure answers...we need, instead, to be looking for simplifying assumptions."

I think that I've figured out at least one thing in connection with this whole *Mountain State Ford* mess. The substance of what Mr. Goldberg was talking about was certainly reflected as far back as 25 years ago and more recently in TAM 8906001 and in FSA 1999-501. What I can't figure out is: how can we bring back some of that common sense and apply it to this situation now? Can somebody help me out on that?

One sunny day in my youth, I was walking down the street and suddenly heard the wailing siren and screeching tires of a fire engine rounding the corner and roaring down the street at breakneck speed. Suddenly, from the yard across the street, an excited dog jumped the fence and dashed down the street, barking like mad and chasing the fire engine. When the fire engine abruptly stopped in front of the house on fire at the end of the block, the racing dog caught up with it. But the poor dog didn't know what to do with the engine once it stopped. So it just kept barking, running around in circles and getting tangled in the hoses. Mercifully, the dog's owner ran down the street, pushed through the crowd, grabbed the wet dog by its collar and pulled it away so that the firemen could get on with the business of putting out the fire. Everybody cheered...Long and loud...Common sense had prevailed.

Let's get real. Somebody needs to get Congress–and not NADA–to clean up this mess with the IRS over valuing parts inventories. A simple change to clarify the law would really be nice. And the sooner, the better. If not,...adios common sense...hello confusion. What's a little more added to what we have already? Then sooner or later, we'll all realize that *the owl of Minerva spreads its wings only with the setting of dusk.*

WHY NADA SHOULDN'T HELP THE IRS...YET

1. Action at this time is premature. The *Mountain State* decision may be appealed by the taxpayer, and if it is, there exists the possibility the taxpayer may prevail. So why is the IRS trying to come up with something before the taxpayer has even exhausted its available appeal procedures?
2. It is inadvisable to try to fix the "replacement cost problem" based on the peculiar facts and what is in the record in the *Mountain State Ford* case.
   a. The Court said it was not persuaded by *Mountain State* that the use of actual cost would result in an undue administrative burden ... is that a deficiency only in this case?
   b. The contradiction between the Form 970 stating actual cost and the taxpayer's use of replacement cost made Mountain State an easy target. There were many possible reasons for a holding against Mountain State's LIFO election, but not necessarily against its use of replacement cost.

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WHY NADA SHOULDN'T HELP THE IRS... YET (Continued)

c. Mountain State did not have adequate books and records (i.e., inventory records) to satisfy the Court that a proper reconstruction could be made. Some dealers may have adequate inventory records for their parts. Why should some piecemeal fix addressed to the specific facts in *Mountain State Ford* penalize those dealers who have adequate inventory records?

d. How does the holding in *Mountain State Ford* apply to dealers not using LIFO?

e. Why will the IRS accept a reasonable approximation of cost from taxpayers in many other inventory situations, but not from dealers for their parts inventories?

3. In practice, there are many variations in how ***"the replacement cost method"*** is applied. There is no single "replacement cost" method, although many dealers simply use the manufacturer's most recent price list without further adjustment (i.e., pure replacement cost).

   Since replacement cost typically exceeds actual cost, some dealers employ (a variety of) techniques by which they to try to approximate actual cost by applying various reductions to the "pure" replacement cost result. In attempting to adjust down to actual cost, these reduction factors can only be estimates, often based on turnover ratios or other computations either for the parts inventory as a whole, or for certain sections of the parts inventory where relatively greater price appreciation has been experienced...and these sections obviously will vary from year to year.

4. What are all dealers whose parts inventories are on LIFO going to be required to do? There's no point in having a so-called self-audit like the one involved with the conformity/Rev. Proc. 97-44 issue because all dealers' parts inventory valuations will not be in compliance–that's a given. Simply put, what is the IRS going to tell dealers they should or must do? ... Pay some kind of penalty and go on using replacement cost? ...Compute some type of pseudo-Section 481(a) adjustment and take it into income over a period of years? ...Or ???

5. The use of replacement cost generally overstates parts inventory valuations. Shouldn't all dealers not on LIFO be filing Forms 3115 and computing a negative Section 481(a) adjustment? This seems to logically follow but dealers filing the 3115 will run into roadblocks unless the National Office changes its present practice of denying requests involving parts because the underlying inventory must–in its view–be valued at actual cost.

6. If software tracking actual costs can be developed, unless it exactly computes actual cost, it will not be in compliance with the Tax Court's demand for actual cost results. Furthermore, the decision in Note 12 says that the IRS has no choice other than to enforce exact cost calculation requirements. Therefore, if any estimates or assumptions are made a part of the software programming, or if any adjustments based on inventory turnover (unless 100% computed and properly weighted) are employed, the software will not satisfy the requirements of the Tax Court's holding.

7. All of the manufacturers' accounting manuals and financial statement reporting directions require that replacement cost be used in valuing dealers' parts inventories. How will the use of an actual cost system, instead of the required replacement cost method, be worked out? How will these different requirements mesh for financial reporting, tax reporting, and LIFO conformity reporting purposes?

8. If the IRS is going to deal with the actual cost versus the replacement cost for parts inventory issue at this time, it should also address at least two other critical issues: (1) item definition in a typical parts pool, and (2) pooling. Many parts inventories contain parts of multiple franchises and/or parts that are manufactured in different countries. Since the IRS and the Tax Court insist on separating inventory items that have different cost characteristics, these issues are right around the corner and proper treatment should be clarified now so that if any overall changes from replacement cost are mandated, these "lesser details" involving LIFO sub-methods (which themselves are accounting methods) will not fall by the wayside.

9. Instead of helping the IRS attempt a partial fix based on *Mountain State Ford*, NADA should be circulating a petition among dealers to bring to the attention of Congress the inconsistent and incomplete actions the IRS has taken to date on this replacement cost matter. Congress should either change the law or impose a moratorium on any further IRS audit activity and on the release by the IRS of anything further until it has developed a comprehensive and rational plan for addressing ***all*** of the replacement cost related issues, and not just those more superficially present in the *Mountain State Ford* case.

IRS LETTER RULING

IRS Letter Ruling No. 7503130350B March 13, 1975

REQUEST

- This is in reply to your request for ruling, wherein ***you request permission to be allowed to use the current replacement value in computing parts and accessories inventory*** under the last-in, first-out ("LIFO") inventory method.

FACTS

- It has been stated that ... you propose to adopt the dollar-value LIFO inventory method for the parts and accessories inventory commencing with the taxable year ended December 31, 1974. You propose to utilize the double-extension method described in Reg. Sec. 1.472-8(e)(2).
- Under your present method, the parts and accessories inventory has been valued at the current replacement value as of the date the inventory was taken. This method was used so as to avoid the additional work involved if each item in inventory was separately costed from the vendor's individual invoices.
- You propose to adopt the dollar-value, LIFO inventory method for the parts and accessories inventory and you request permission to use current replacement cost in lieu of actual invoice cost in such computation.

DISCUSSION

- Reg. Sec. 1.472-8(e)(2)(ii) states that the current-year cost of items making up a pool may be determined:

  (a) by reference to the actual cost of the goods most recently purchased or produced;
  (b) by reference, to the actual cost of goods purchased or produced during the taxable year in the order of acquisition;
  (c) by application of an average unit cost equal to the aggregate cost of all the goods purchased or produced throughout the taxable year divided by the total number of units so purchased or produced; or,
  (d) ***pursuant to any other proper method which, in the opinion of the Commissioner, clearly reflects income.***

  Examples of (a), (b), and (e) above are described in Reg. Sec. 1.472-2 (d)(1)(iii).

HOLDINGS

- In accordance with Reg. Sec. 1.472-8(e)(2)(ii)(d), ***you may value your current year costs for the parts and accessories inventory utilizing the current replacement value.***
- ***With respect to your opening inventory of parts and accessories for the year in which the LIFO method is adopted, such inventory may be valued utilizing the current replacement value, providing such method was used to value your closing parts and accessories inventory for the year preceding the year in which the LIFO method is adopted.***
- Notwithstanding the use of the current replacement value in valuing the opening parts and accessories inventory for the year in which the LIFO method is adopted, Reg. Sec. 1.472-2(c) requires that a restoration must be made with respect to any write-down to market value resulting from the pricing of former inventories.

OTHER

- It should be understood that this ruling does not constitute a blanket approval for the use of the LIFO inventory method, since certain conditions and requirements must be fulfilled in accordance with Section 472 of the Code and regulations thereunder. This ruling merely directs itself to your inquiry concerning the use of current replacement value.
- Furthermore, it should be understood that the District Director will make the initial and continuing determination as to the appropriateness of your pool and the propriety of all computations incidental to the use thereof.

THE USE OF REPLACEMENT COST WAS ALLOWED

THE USE OF THE REPLACEMENT COST METHOD FOR VALUING PARTS WAS PERMITTED BY THE NATIONAL OFFICE IN 1975

FSA 1999-501 (ISSUE #2)	***DEALERS' PARTS INVENTORIES AND THE INDUSTRY-WIDE PRACTICE OF USING THE REPLACEMENT COST METHOD***
ISSUE	• Whether the taxpayer, one of three S Corporation automobile dealerships, correctly computed its parts inventory pool and LIFO layers.
FACTS	• Taxpayer elected the to use the LIFO dollar-value, link-chain method of valuing its parts inventory. Taxpayer elected to use the earliest acquisition method for determining the costs in its ending inventory parts pool. • As we (i.e., the author of the FSA) understand the facts, Taxpayer calculates its physical inventory based on a representative selection of parts in the parts pool. ***It values the ending inventory using replacement costs (estimated actual cost). Taxpayer records are in insufficient to value the ending inventory at actual cost.*** • In order to determine its value of the ending inventory in base year costs, Taxpayer divides the current year estimated actual costs determined under the latest acquisition method by the cumulative link chain index, after adjusting for inventory turnover. After determining that there is an increment (base year cost of the ending inventory exceeds the base year cost of the beginning inventory), the facts indicate that the valuation of the layers is not being calculated properly, if at all. • The agent's adjustment relates to the calculation of the LIFO layers. The agent proposes to calculate the LIFO layer using the cumulative index determined by reference to replacement costs. The agent treats the adjustment as a change in method of accounting recognized over a three-year spread period.
DISCUSSION	• Taxpayer has made errors affecting the propriety of its computations for the parts pool. First, it has used an estimated actual cost, apparently based on the replacement cost, to value the ending inventory at current year costs. Second, it effectively uses the latest acquisition cost method rather than the method it elected, the earliest acquisition method. Finally it apparently improperly computed its LIFO layers by using a cumulative index at variance with the cumulative index used as a deflator of current year cost to actual costs. • ***The agent has adjusted the parts inventory by recalculating the lifo layers.*** The increment would be converted from base year dollars to current year dollars ***using the cumulative index based on the estimated actual costs (replacement costs).*** Use of the current replacement cost method generally produces the highest incremental value and lowest LIFO benefit in times of inflation • Although not precedential, TAM 8906001, Issue 4, provides an analysis of the impact that the current replacement cost method has on LIFO increments for automobile dealers. • ***While replacement costs are a non-cost based inventory valuation method, we believe their use in this case is appropriate given the fact that the taxpayer does not have the records to value ending inventory at actual costs.*** • ***We also believe that the acceptance by the agent of the use of a representative sample is appropriate for similar reasons.***
CONCLUSION	• ***The agent's proposed adjustments to the parts LIFO layers*** (i.e., to recalculate or convert from base year dollars to current year dollars using the cumulative index ***based on the estimated actual costs [replacement costs]) appear well within the Commissioner's discretion*** under Reg. Sec. 1.472-3(d). • Calculation of the LIFO layers affects income and is thus a change in method of accounting and no spread of the Section 481 (a) adjustment is required.
NO CHANGE TO THE USE OF REPLACEMENT COST!	***THE USE OF THE REPLACEMENT COST METHOD FOR VALUING PARTS WAS UNDISTURBED BY BOTH THE EXAMINING AGENT AND THE FIELD SERVICE DIVISION IN THIS FSA CIRCA 1992.***

LTR/TAM 8906001 (ISSUE #4)	***DEALERS' PARTS INVENTORIES AND THE INDUSTRY-WIDE PRACTICE OF USING THE REPLACEMENT COST METHOD*** ***PAGE 1 OF 2***
ISSUE	• May the Taxpayer use the "replacement cost method" for valuing increments under the dollar-value LIFO method with respect to its parts ending inventories?
FACTS	• The Taxpayer is a corporation in the business of selling and servicing new and used cars and trucks. The Taxpayer uses the dollar-value LIFO method of valuing its inventories, and the "link-chain" method to compute base-year and current-year costs. The Taxpayer uses a single pool for all parts and accessories. Sampling techniques were used for computing the inventory price index for the...parts and accessories pool. • The Taxpayer has over 6,000 items in its parts and accessories pool. The Taxpayer sells both y and non-y parts and accessories. For the years under examination, the Taxpayer used an "index" method for computing the base-year and current-year cost of its parts and accessories pool. The Taxpayer computed an index for such pool by using a sample of items from the pool. The Taxpayer determined the sample size to be 5 percent based on a 95 percent confidence level with a 5 percent precision. The Taxpayer selected every 15th line item on its computer printout of parts and accessories items until the number of items needed to sample was recorded. The Taxpayer sampled only from the computer printout, however, the printout did not include the jobber and non-y parts. • These computer printouts, which are updated at periodic intervals and programmed into the Taxpayer's computer accounting system, consist of y parts and accessories at current prices established by y. At the time an index is computed, some of the sampled items have actually been purchased and, therefore, are sampled at actual cost. The other items are sampled at replacement cost. The Taxpayer has referred to this valuation process as current replacement cost. Obsolete items also were not subject to the sample. • In computing a LIFO index under the dollar value, link-chain method, the ending parts inventory for the current year is valued at current replacement cost (as described above) and is divided by the ending parts inventory for the current year valued at the prior year's replacement cost. This index is then divided into the current year's ending inventory valued at current- year replacement cost in order to arrive at a prior-year cost for such inventory. The prior-year replacement cost of the ending inventory is compared with the preceding year's ending inventory valued at prior-year replacement cost and any difference is treated as an increment or decrement. If an increment results, the increment is multiplied by the index computed as above to arrive at the LIFO carrying value of the increment. • With respect to the parts and accessories pool, the Taxpayer represents that a 100 percent double extension is impractical because of the frequency of technological change, the variety of items and the constant fluctuations in the variety of the items. In addition, the parts and accessories pool includes over 6000 items. Based on the Taxpayer's representations, and the facts and circumstances of this case, we conclude that a 100 percent double extension is impractical, however, since the Taxpayer excluded obsolete items and jobber and non-y parts from the sample, the Taxpayer did not meet the requirement of Reg. Sec. 1.472-8(e)(1) that it double-extend a representative portion of the inventory of the pool or use other sound and consistent statistical methods. Further, the Taxpayer has not shown that the index used is appropriate to the pool.
IRS AGENT'S POSITION	• The Agent contends that the use of replacement cost in valuing the parts and accessories is an impermissible non-cost-based inventory valuation method and that the failure to value a LIFO inventory at cost is grounds for terminating the Taxpayer's LIFO election.

DEALERS' PARTS INVENTORIES AND THE INDUSTRY-WIDE PRACTICE OF USING THE REPLACEMENT COST METHOD

DISCUSSION

- A taxpayer has a choice of three specific alternative methods of determining the current-year cost of its inventory under Reg. Sec. 1.472-8(e)(2)(ii). These alternative methods are:

  (1) the earliest acquisitions cost method,

  (2) the latest acquisitions cost method, and

  (3) the average acquisitions cost method.

- In addition to these three specifically-prescribed alternatives, Reg. Sec. 1.472-8(e)(2)(ii)(d) also provides that a taxpayer may use any other method of determining current-year cost that clearly reflects income. The regulations do not indicate what other type of increment valuation method might be acceptable.

- ***One of the reasons that the regulations permit several alternative increment valuation methods is that it simplifies the LIFO computations if the taxpayer is able to coordinate its method of valuing increments with the method of determining current-year cost that is used in maintaining the taxpayer's underlying inventory records.*** Thus, for example, if a taxpayer's underlying inventory accounts are valued at FIFO, the taxpayer might choose to value LIFO increments using the latest acquisitions cost method.

- The choice of any particular alternative will have no impact on the determination of whether an increment exists or on the determination of how large an increment or decrement is created when measured at base-year or current-year cost. A taxpayer's choice of increment valuation method affects only the determination of the LIFO carrying value of the increment. The earliest acquisitions cost method would produce the lowest incremental value and the greatest LIFO benefit in times of inflation, followed by the average acquisitions cost method and then the latest acquisitions cost method.

- ***The current replacement cost method would produce the highest incremental value and lowest LIFO benefit in times of inflation.***

CONCLUSION

- ***Although the taxpayer's use of current replacement cost, as described, may not in some instances represent "actual cost" incurred during the year, we conclude that, under the facts and circumstances of the case, the use of such method is not grounds for terminating the taxpayer's lifo election.***

HOLDING

- Although the Taxpayer's use of current replacement cost for valuing its parts ending inventory may, in part, be a non-cost-based inventory method, the use of such method is not grounds for terminating the Taxpayer's LIFO election because of the facts and circumstances involved.

NO CHANGE TO THE USE OF REPLACEMENT COST!

THE USE OF THE REPLACEMENT COST METHOD

FOR VALUING PARTS WAS UNDISTURBED

BY THE IRS NATIONAL OFFICE IN THIS TAM IN 1989.

Notes:

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

First-class postage paid at Mt. Prospect, IL