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. COMPONENTS-OF-COST: GODZILLA IS BACK. A glance at the Table of Contents will tell you what this issue of the *Lookout* is all about. Components-of-cost LIFO methods used by manufacturers for over 60 years are back in the spotlight. And still there is no certainty over whether or not they are legal.

In this issue we're attempting to present some balance, insight and practical advice on the C-O-C conundrum that the AICPA, the ABA and assorted other individuals and organizations have been struggling with for over half a century.

Just like the use of sampling and replacement costs, the C-O-C issue has been around since day one and lawyers and accountants toiling for decades just can't convince the IRS how wrong it is in tilting at these windmills. So what else is new?

It's sad to contrast the academic efforts IRS lawyers today are putting into discussions over the technical definitions of words like ***goods*** and ***merchandise*** ...with the practical understandings achieved by advisory committees that worked with the IRS some 50 years ago to help it gain a better understanding of just what the hell it was trying to audit.

As younger IRS attorneys become better trained in focusing on narrow legal precedents by looking in their dictionaries...they're getting farther away from applying common sense and regard for real world, decade-long accepted, practices. Interpretation of "the law" for its own sake has become paramount.

The dollars at stake over whether manufacturers can use components-of-cost methods with their LIFO calculations are even bigger than those involved in the controversy over whether dealers can use replacement cost for valuing parts inventories. But, there are similarities: Both involve long-standing, widely-used practices which the IRS has tacitly accepted for decades.

LOOKOUT LOOKS INTO

If a real test case involving C-O-C ever goes to court and the taxpayer loses, the shock waves will be enormous. But if the Service is going to rock the boat over replacement cost, why shouldn't it also rock the boat for C-O-C users?

Thirteen years ago I suggested and wrote about a ***LIFO USER SURTAX*** as a means of compromising the impossible-to-fathom problems with some of the ideas now being kicked around as ways to soften the blows for C-O-C users. I still think it was/is a good idea and a more practical alternative to the *status quo*...and everybody wins.

Some components-of-cost arguments may receive attention in the near future when the Tax

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Court's decision in *Consolidated Manufacturing, Inc.* is heard on appeal by the District Court in Denver. This case involved a core remanufacturer whose LIFO election was disallowed by the Tax Court because it had excluded certain inventory (used cores, used engines and other used parts) from its LIFO election.

As we reported in the last issue, Consolidated Manufacturing recently filed its appeal to the Tax Court's decision. Coincidentally, or ironically, its appeal was also filed to the 10th Circuit, and it seeks to overrule the decision which was made by the same judge who decided the *Mountain State Ford* (replacement cost) case.

The Appellate briefs filed by the taxpayer and by the IRS/Department of Justice make for some very interesting reading. *Consolidated Manufacturing, Inc.* is a key case to watch now, not only because of the significant issues it presents in terms of CMI's own fact pattern, but also because of its implications for all other manufacturers using components-of-cost methods and for all other taxpayers using replacement cost to value parts inventories. The C-O-C discussions in the briefs are so important that we have devoted a separate article to them.

But let's make one thing clear: the use of a components-of-cost LIFO method is not currently on trial in the Tax Court or anywhere else.

Another thing to keep in mind is that the Appeals Court, for whatever reason, may find a way to side-step the C-O-C issues and Consolidated's Appeal may provide no answers at all to any of the C-O-C questions. It could go either way.

In any event, you may want to fasten your seatbelt before you review the ***Practice Guide*** C-O-C Exposure Checklist coming in the next *Lookout*: it could leave you with a queasy feeling.

#2. IRS PROHIBITS ANOTHER MANUFACTURER'S USE OF THE COMPONENTS-OF-COST METHOD. In Field Service Advice 200010009, the IRS recently expressed its opposition to the use of a components-of-cost method which it said did not ***clearly reflect income.*** Why? ...Because the taxpayer's calculations did not take into account efficiency gains in labor and in overhead that it had experienced.

Many manufacturers use a variety of components-of-cost methods in their LIFO calculations. So this recent IRS pronouncement heightens tensions between the IRS–on one hand–and a large number of manufacturers, and the tax committees of the AICPA and the ABA–on the other. For more on the specifics of this FSA, see page 26.

#3. THE AICPA TRIES AGAIN. At this time, the AICPA's Tax Accounting Technical Resource Panel has formed a Task Force which hopes to provide input with respect to the portion of the Treasury's Year 2000 Business Plan that deals with components-of-cost inventory methods. Good Luck.

The Task Force will try to meet with the Treasury-IRS and provide some alternatives to the not so pleasant prospect of the loss of LIFO elections by countless manufacturers using a multiplicity of C-O-C methods. We're talking serious, big-time dollars here ... not the comparatively smaller amounts in the replacement cost squabble.

#4. "INADEQUATE BOOKS AND RECORDS." The requirement in Section 6001 that taxpayers must maintain ***adequate books and records*** has become a major issue that the Service is raising in a variety of ways in some of its current audits.

As this requirement relates to LIFO inventory calculations, one can readily recall taxpayers who have lost...or are on the verge of losing...their LIFO elections because they did not have adequate books and records. *Boecking Machinery, Inc.* and *Mountain State Ford Truck Sales* are typical examples.

In FSA 200010009 discussed above (#2), the IRS again threatened the loss of the LIFO election if the taxpayer had not maintained sufficient records to support alternative calculations. You can expect to see this ***books and records*** issue raised as an obstacle in even more situations in the future.

#5. *MOUNTAIN STATE FORD TRUCK SALES* & THE USE OF REPLACEMENT COST FOR PARTS INVENTORIES. At this time, there are no other new developments regarding the use of replacement cost for valuing parts inventories. As noted previously, Mountain State Ford has filed its appeal of the Tax Court's decision with the U.S. Court of Appeals for the Tenth Circuit in Denver.

If the AICPA can muster up enough enthusiasm and interest to form a Task Force to try and talk some sense into the IRS over components-of-cost issues, why can't it do the same thing...or at least pretend to...in connection with the replacement cost issue? Sorry, but I just had to ask.

#6. WILL THE IRS CHECK-UP ON THE SURPRISINGLY SMALL NUMBER OF AUTO DEALER LIFO CONFORMITY VIOLATION PAYMENTS? In her last presentation as "Motor Vehicle Industry Specialist" (now known as "Motor Vehicle Technical Advisor") before moving on to a new position in the IRS, Mary Baker reported that the IRS does plan to initiate some kind of follow-up to *account for* the

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relatively small number of dealers who actually made payments under the conformity violation amnesty provided by Rev. Proc. 98-44.

However, she did not provide specifics about what type of follow-up procedures the IRS will use. The last of these payments was due January 31, 2000. Please let us know if any of your dealers are contacted by the IRS about these payments... or the lack thereof. We'll keep you informed on what develops.

#7. TWO 1998 ISP GUIDELINES PUBLISHED. The IRS recently published two 1998 ISP Settlement Guidelines. These Guidelines are approved by IRS Appeals for purposes of allowing examining agents to settle issues, and their subject matter has already been covered in related *All Industry Coordinated Issue Papers*. The publication of these Settlement Guidelines now provides just a little more insight into the thinking of the IRS on these matters.

One Guideline addresses LIFO taxpayers involved with a bargain purchase of inventories. The second addresses taxpayers who construct LIFO indexes by using sampling techniques or other approaches that do not reprice representative portions of all of their inventory segments.

You don't have to be a genius to expect that

(1) the IRS does not want bargain purchase benefits to be locked into low-priced LIFO layers, and
(2) the IRS will not allow taxpayers to use an inflation index that is based on sampling less than all segments of their inventory.

The 1995 Coordinated Issues Papers to which these Settlement Guidelines relate were discussed in the September, 1995 *LIFO Lookout* at pages 20-24. Also, consult the index of articles appearing in the *LIFO Lookout* for other articles which refer to the IRS positions on these matters.

#8. BLS-IPIC REGULATIONS MAY BE CHANGED. On May 19th the IRS published ***proposed*** changes to the Inventory Price Index Computation (i.e., the ***IPIC***) method described in Reg. Sec. 1.472-8(e)(3).

In general, under the IPIC method, LIFO users are allowed to borrow the inflation or deflation indexes computed and published by the U.S. Bureau of Labor Statistics. Under the IPIC approach, taxpayers may elect to apply LIFO by referencing either the Consumer Price Index (CPI) or the Producer Price Index (PPI), whichever is the more appropriate. Taxpayers, of course, must pay a price for this convenience: The IRS allows most IPIC users to use only 80% of the appropriate CPI or PPI index. That's a 20% price tag.

These proposed changes to the regulations are intended to simplify and clarify certain aspects of the IPIC method. They are also intended to modify the computational methodology so that the IPIC method produces a more accurate and suitable inventory price index.

#9. IRS ALSO PROPOSES CHANGES IN LIFO TREATMENT FOR INVENTORIES TRANSFERRED IN CERTAIN SITUATIONS. At the same time as it proposed changes to the Regulations for the IPIC method, the IRS also proposed other changes. These changes would only apply to certain transferees, i.e., those using the dollar-value method for LIFO inventories that were received in a nonrecognition transaction to which Section 381 did *not* apply.

These transferees would be required

(1) to use the year of transfer as a new base year, and
(2) to use the transferor's current-year cost of the inventory received as its new base year cost for that inventory for purposes of determining future increments and liquidations.

#10. IRS UPDATES CERTAIN OF ITS NEW ITEMS LISTS. On June 12, 2000, the IRS Interim Motor Vehicle Technical Advisor released updates to the December 31, 1998, March 31, 1999 and June 30, 1999 new item categories lists under Revenue Procedure 97-36 which prescribes the Alternative LIFO Method for Automobile Dealers.

The IRS cover letter sent with the updated lists indicates that "since the list is not an 'Official List,' it does not reflect 'Service Position' and examiners are not required to follow it."

These IRS listings can easily be compared to the ***SUPERLIFO™*** new items lists which were published in previous editions of the *LIFO Lookout*. *

COMPONENTS-OF-COST METHODS IN MANUFACTURERS' LIFO CALCULATIONS... STILL NO CERTAINTY AFTER 60 YEARS

C-O-C OVERVIEW

One major issue popping in and out of our pages over the last 10 years has been the widespread practice by many large manufacturers of using components-of-cost methodologies in connection with their LIFO calculations.

Generally speaking, under components-of-cost methods, ***items*** of inventory are not the physical units as they are under the total product cost method. Instead, under components-of-cost methods, the physical units are exploded (or broken down) into their cost components which are generally:

(1) raw material,
(2) direct labor, and
(3) overhead.

As a consequence, one unit of a finished good is not inventoried as such. Instead, a taxpayer using a C-O-C method separately inventories the quantities of input of material, labor and overhead necessary to manufacture the number of physical units of the product in the ending inventory.

In its 1984 *LIFO Issues Paper,* the AICPA defined a C-O-C method as "a method of applying dollar-value LIFO in which changes in the LIFO index are measured by the weighted average increase or decrease in the component costs of material, labor and overhead that constitute ending inventory."

In the real world, there is no single or universally applied C-O-C method. Different manufacturers apply different components-of-cost techniques. But they all do essentially the same thing ... and that is to treat direct labor and overhead as separately distinguishable *items* which are repriced as such in their LIFO computations. Different strokes for different folks...***many*** different strokes!

Despite the differences in application, one statement can be made with certainty:

...THE IRS DISTRUSTS THEM ALL...!!

As the title of this article indicates, this controversy has been brewing for a long time. How long? Well, even further back than when the dollar-value LIFO regulations were first introduced in 1960.

Are these C-O-C methods legal? Guess what? Nobody knows! Maybe sometime during the next decade or so, we'll get answers taxpayers can understand and live with.

We have included a 60-Year Timeline on pages 6-9 for a quick overview of how various events fit together. This timeline includes relevant IRS pronouncements (in the shaded bars) with AICPA activities, court cases and certain other influential events (like the Blakely & Thompson article and the issuance of Revenue Procedure 92-20) to try to give a broader, more integrated view of the longstanding C-O-C controversy.

C-O-C DISTORTIONS ARE FACTORS "OTHER THAN INFLATION"

As the IRS sees it, ***if*** LIFO calculations reflect factors other than inflation, ***then*** those calculations can not, and do not, clearly reflect income...and that is the standard set by both Code Sections 471 and 472.

Starting with the *Wendle Ford Sales* decision in 1979, the IRS established significant precedents in cases where it challenged taxpayers' LIFO computations because the inflation indexes they had computed included factors ***other than inflation***.

According to the IRS, and as upheld by the courts, any changes other than pure price inflation in inventory costs are/were to be excluded from computations intended to measure and reflect LIFO results. In *Wendle Ford Sales*, *Amity Leather Products* and *Hamilton Industries*, to name but a few cases, the Tax Court and other courts agreed that only pure inflation should be included and reflected in the LIFO calculations.

FACTOR OUT OF LIFO

- Changes resulting from different inventory mix,
- Changes due to conducting manufacturing activities at different geographic locations,
- Changes in products resulting from technological innovations and production efficiencies
- Bargain-purchase benefit elements buried within lump-sum inventory acquisitions,
- ... And the list goes on.

The decisions above have added more support to the IRS arguments and to the power of the Commissioner to change (LIFO) accounting methods which do not clearly reflect income. It should be obvious from the 60-Year Timeline (pages 6-9) that

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the IRS is now in a much stronger position to challenge components-of-cost methods if it finds that they produce results that are unacceptable distortions.

As recently articulated in FSA 200010009, components-of-cost methods have to be watched very carefully because they may:

C-O-C DISTORTIONS

- Fail to reflect efficiency gains...***efficiency gain distortions***,
- Substitute one item for another within a cost component...***item-within-an-item distortions***, and/or
- Create improper linkage as a result of the interdependence between the overhead and the direct labor cost components...***double-dip or frozen burden distortions.***

Where such distortions as these occur, they are viewed as introducing factors ***other than inflation*** into the LIFO index computations. In so doing, they are proscribed by statute. Worst of all, FSA 200010009, in its last lines of print, says unmistakably that the Service can throw the user of an errant component-of-cost method off of LIFO.

Both Leslie J. Schneider (*Federal Income Taxation of Inventories)* and Stephen F. Gertzman *(Federal Tax Accounting*) argue at length–as have many others–that...

"Everyone's using the method,"
"C-O-C is the only practical alternative," and
"If the IRS didn't like it, it should have said so 40 years ago."

The article on page 10 offers a broad, general perspective and some insights for some of their arguments.

With the passage of (many) years and with the introduction of newer generations into the IRS workforce, the IRS seems to have forgotten the unselfish, generous cooperation it received from leading LIFO practitioners and the Bar during the 40's and 50's ... and it seems these "old arguments" are more easily cast aside. This seems evident from some of the Court decisions where all the lawyers and judges are looking in their dictionaries for answers to what are broader, tax administration policy questions.

We have attempted to pull together and summarize much of the IRS opposition to the use of components-of-cost methods. Readers desiring more detailed information on the components-of-cost method from an accounting and academic standpoint can find ample discussion in accounting texts, both old and new, and the references listed in the bibliography. Our focus in these articles will be on the IRS rationale as it has become more evident over time by the publication of documents made available only as a result of the Freedom of Information Act.

You can be sure that the IRS will very carefully select and challenge only a taxpayer fact pattern that it regards as giving it the best chance of winning ... when it decides to litigate C-O-C issues ... in Court. This should come as no surprise to anyone.

Somewhere, sometime, a real case testing head-on the IRS opposition to C-O-C will hit the courts. When it does, it will be a bombshell. Read these articles and you'll understand why.

AT A GLANCE	COMPONENTS-OF-COST ... A 60-YEAR TIMELINE
May 1941	• At an accounting conference in Chicago, Mr. Herbert T. McAnly was the first to suggest the concept of a ***dollar-value*** LIFO methodology for applying LIFO to any inventory, regardless of its complexity. • Prior to that time, only the ***specific goods*** LIFO approach was permitted by law when Congress first enacted LIFO for a limited group of taxpayers in 1938 and subsequently made the LIFO method available to all taxpayers in 1939.
May 1954 *April 1955*	• Tentative drafts of proposed rulings circulated between IRS and members of Commissioner's Advisory Committee composed of representatives from the AICPA, American Bar Association and Tax Executives Institute. • Small working group of five knowledgeable LIFO practitioners collaborated with IRS and Treasury representatives in developing what was to become the form and content of the dollar-value method LIFO regulations. • Component costing was recognized as an essential part of the dollar-value LIFO structure. • According to one of the five members of the advisory group, "Throughout our discussions of the Service's draft ruling of May 25, 1954, our proposed regulations of August 10, 1955 and the particular examples from actual taxpayers, it was abundantly clear to all involved that a component costing approach to LIFO was contemplated ***and considered to be acceptable.***"
January 1961	• Final regulations related to the dollar-value LIFO method as applied to manufacturers were adopted in lieu of the issuance of a more limited revenue ruling. • These regulations reflected the broad natural business unit concept of pooling. Therefore, it was unnecessary to include a multiplicity of examples that would be more specific about the treatment of labor and overhead cost components.
August 1969	• *BLAKELY & THOMPSON ARTICLE*, backed by scholarly research and mind-boggling formulae, appeared in *Management Accounting*. This article contained startling conclusions about the use of dollar-value LIFO methods. • "...Combining current technology with base-year cost achieves nothing rational (except, perhaps a lower tax bill) ...This index allowed by the Code is a ***meaningless conglomeration*** of both price and technological indexes." • "...The present Code allows a firm to use a method which may result in enormous tax savings...If it is mandatory to present this inventory method on financial statements to third parties without change, questions of ***material misrepresentation*** will arise, whenever significant technological advances have taken place."
February 1979	• *TAM/LTR 7920008* issued...disapproved taxpayer's use of components-of-cost method.
June 1979	• *WENDLE FORD SALES, INC. V. COMM.* (72 T.C. 447 (1979)). • This was the first LIFO case dealing with computational issues that arise when inventories reflect technological change/ improvements. It does not specifically mention components-of-cost issues. However, this case is cited frequently in discussions involving components-of-cost issues. • "The point at which a modification or modifications in a product are considered so substantial as to render it a new item for LIFO inventory purposes must, of necessity, be decided on a case-by-case basis from an examination of all the relevant facts. ...Dollar-value LIFO necessarily ignores ***minor*** changes in the design of a product from year to year."

COMPONENTS-OF-COST ... A 60-YEAR TIMELINE

August 1980	• *GENERAL COUNSEL MEMORANDUM (GCM) 38478.* • Disapproved two taxpayers' use of components-of-cost methods. • This GCM cites the 1969 Blakely & Thompson article.
May 1984	• *AMITY LEATHER PRODUCTS COMPANY V. COMM.* (82 T.C. 726 (1984)). • Held that the nature of *items* in a pool must be similar enough to allow a comparison between ending inventory and base-year inventory. "Because the change in the price of an *item* determines the price index and the index affects the computation of increments or decrements in the LIFO inventory, the definition and scope of an *item* are extremely important to the clear reflection of income." • "If factors other than inflation enter into the cost of inventory items, a reliable index cannot be computed." • "A narrower definition of item within a pool will generally lead to a more accurate measure of inflation (i.e., price index), and thereby lead to a clearer reflection of income." • In the IRS memo on components-of-costs dated July 31, 1992, this case is cited as "...strong authority that when substantial changes occur in the manufacturing cost of an item, for the LIFO index method to properly function, the item should be reclassified as a new item with its own base-year." • This was the second LIFO case dealing with computational issues that arise when inventories reflect technological change/improvements. It does not specifically mention components-of-cost issues. However, this case is cited frequently in discussions involving component-of-cost issues.
November 1984	• *LIFO ISSUES PAPER* released by AICPA Task Force on LIFO Inventory Problems. • This *Issues Paper* was submitted to the Financial Accounting Standards Board (FASB) in an attempt to provide financial reporting guidance on applying the LIFO method. • With respect to C-O-C, the Task Force reached the following advisory conclusion by a 9-0 vote: "...Either the unit cost or cost component method may be used for financial reporting purposes...in certain circumstances, such as those discussed in paragraph 4-47, the cost component method may be preferable to the unit cost method, unless base year costs are reconstructed." • Lists arguments in favor of ... and opposing ... the use of the components-of-cost method.
March 1985	• Securities and Exchange Commission issued *STAFF ACCOUNTING BULLETIN (SAB) No. 58*, which endorsed the AICPA LIFO *Issues Paper* and indicated that companies reporting to the SEC should reexamine their current LIFO practices and compare them the recommended LIFO methods such as the components-of-cost method in the *Issues Paper*.
July 1991	• *HAMILTON INDUSTRIES, INC. V. COMM.* (97 T.C. 120 (1991)) • Held that bargain purchase gains in inventory should not be reflected in LIFO calculations because of the material differences in cost characteristics between original inventory and later inventories. • *Hamilton Industries* is cited as precedent for requiring a Section 481(a) adjustment on an involuntary change involving dollar-value LIFO methods of accounting. • LIFO case dealing with computational issues presented when inventories reflect technological change/ improvements. Does not specifically mention components-of-cost issues. However, this case is cited frequently in discussions involving component-of-cost issues.

AT A GLANCE	COMPONENTS-OF-COST ... A 60-YEAR TIMELINE
March 1992	• *REVENUE PROCEDURE 92-20* issued by the IRS updating and modifying rules for requesting changes in accounting methods. Introduced "graded incentives" to encourage taxpayers to voluntarily request a change. • Taxpayers voluntarily changing from components-of-cost LIFO methods to the (total) product method received cut-off transition method (i.e., no recomputations required for prior years) with change effective for the current year and were given until September 18, 1992 to request permission to change. • Many manufacturers using C-O-C methods filed Forms 3115 to change. Special transition rules apply to taxpayers under audit. AICPA urged IRS to extend effective date beyond September 18, 1992 because of significance of C-O-C issue.
April 1992	• AICPA submitted lengthy Position Paper to IRS concerning propriety of using C-O-C method. • Strongly urged IRS to not prohibit use of components-of-cost method. • Alternatively, the AICPA urged that if the Service were contemplating such action, then "any changes in these procedures should be made prospective only, since companies will not be able to comply with new rules on a retroactive basis."
July 1992	• *TREASURY/IRS LETTER (DATED JULY 31, 1992)* in reply to AICPA stated IRS position on C-O-C. • "It is our conclusion that the LIFO regulations do not specifically permit the use of cost components as items in the computation of a LIFO price index under the dollar-value LIFO inventory method." • "Since...there is no standard methodology for computing indexes under the components-of-cost method, any particular application of the components-of-cost method must therefore be examined to determine whether it clearly reflects income."
July 1992	• *IRS MEMORANDUM DATED JULY 31, 1992* ... (note: same date as Treasury/IRS letter above) ... not released to the public until 1999 when it was released as *FSA 1999-622*. • Stated that this Memorandum required "consideration at the highest level in the Service and Treasury." • 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. • Held that (1) the components-of-cost method of valuing LIFO inventories is not authorized under the regulations, and (2) labor and overhead are not "items" - only tangible, physical units can be items.
October 1993	• *TAM/LTR 9405005* dated October 15, 1993. • Denied use of C-O-C method and held that a Section 481(a) adjustment would be required to effect the change. Taxpayer had requested that the ruling not be applied on a retroactive basis; its request was denied.
April 1994	• *TAM/LTR 9445004* dated April 25, 1994. • National Office permitted the extension of a LIFO election to include labor and overhead. However, it held that labor and overhead would have to be placed into the related raw material pool.

AT A GLANCE	COMPONENTS-OF-COST ... A 60-YEAR TIMELINE Page 4 of 4
August 1994	• Administration proposed to repeal the use of components-of-cost methods as a way to off-set some of the revenue loss from the ratification of the Uruguay Round of the General Agreement on Tariffs and Trade. Proposal was subsequently withdrawn. • Similar proposals for repeal of components-of-cost methods were raised and withdrawn in later years.
July 1998 *August 1998*	• *CONSOLIDATED MANUFACTURING, INC. V. COMM.* (111 T.C. No. 1 (1998)). • In this case, involving the LIFO election and application of a core remanufacturer, the Tax Court said that "...to the extent that (TAM 9445004) may be read to suggest that a taxpayer may validly elect the LIFO inventory method with respect to all of its labor and overhead, ***but not all of its raw materials***, that enter into production of a good or type of class of goods, we reject any such suggestion as contrary to Section 472 and the regulations thereunder." • Taxpayer argued that its facts and situation present issues very similar to components-of-cost issues. • Taxpayer (*Consolidated Manufacturing, Inc.*) filed Notice of Appeal with the United States Court of Appeals for the Tenth Circuit on August 31, 1998.
November 1999	• *FSA 200010009* dated November 12, 1999. • Held that the taxpayer's components-of-cost LIFO method did not clearly reflect income because it failed to take into account efficiency gains in labor and overhead which the taxpayer experienced. • Held that the productivity gains in the labor and overhead cost components should be factored out in arriving at a new method that is akin to the total product cost method. • Finally, held that if the taxpayer did not maintain sufficient books and records to support the change to the total product cost method, or an equivalent method, then the taxpayer should be taken off of the LIFO method and changed to the FIFO (First-In, First-Out) method.
July 2000	• AICPA's Tax Accounting Technical Resource Panel forms a Task Force to provide input to the Treasury and the IRS with respect to components-of-cost method included on the Treasury's Year 2000 Business Plan. • Task Force requests meeting with Treasury - IRS to discuss components-of-cost issues.

THE AICPA & THE BAR VS. THE IRS

AICPA + ABA *vs.* IRS

The IRS took its resistance to dollar-value LIFO to court...and lost in the *Hutzler Brothers* case in 1947 and the *Edgar A. Basse* case in 1948. After that, it became evident that the courts would not support the IRS in its resistance to the use of the dollar-value LIFO method. Accordingly in 1949, the LIFO regulations were amended to allow the dollar-value method. However, these regulations offered no guidance or rules relative to that application.

COOPERATION BEHIND THE SCENES

Shortly thereafter, a small number of LIFO practitioner attorneys and CPAs collaborated with the Treasury and the IRS in developing the guidelines for what was to become the dollar-value LIFO regulations. These dollar-value LIFO regulations were not published until 1961...some 12 years later.

Two facts should be understood in connection with this time frame.

- Many companies were already using the dollar-value LIFO method and
- A components-of-cost approach was the only practical way for many manufacturers to implement dollar-value LIFO.

In early 1954, the IRS circulated a draft of a proposed revenue ruling among the Commissioner's advisory group which consisted of representatives from the American Institute of CPAs, the American Bar Association, and the Tax Executives Institute. After receiving a generally negative response to the proposed ruling, the Commissioner abandoned the idea of addressing the use of components-of-cost through a revenue ruling at that time.

About a year later, a very select group of practitioners (five in all) submitted a proposed revision for the IRS tentative draft of a components-of-cost ruling. As one of the five members from private practice of that select group recalled (former Commissioner Randolph Thrower after he returned to private practice in a letter dated December 23, 1992 to the IRS): ***"Our group understood the concepts and methodology of dollar-value LIFO, and by this time component costing was recognized as an essential part of the fabric of dollar-value LIFO. This fact is reflected throughout our subsequent work with the government in this area."***

This brief era of collaboration and cooperation extended through a conference held with the IRS in January, 1956. Mr. Thrower recalls that "throughout our discussions of the Service's draft ruling of May 25, 1954, our proposed regulations of August 10, 1955, and the particular examples from actual taxpayers, ***it was abundantly clear to all involved that a component costing approach to LIFO was contemplated and considered to be acceptable."***

After supporting this statement with ten specific statements of fact, Mr. Thrower added: "Our group's activities received attention from the highest levels within the Service, and we understood they were given considerable weight in the regulation drafting process."

HOODWINKED

He adds that "given the expertise and composition of our group (as well as the interests of clients we were representing at that time), you can be assured that if we had believed the Service did not accept the use of component costing or was contemplating a challenge to the use of component costing, we would have strongly expressed our disagreement. However, none of us felt the need to address this as an issue on which there was any difference of opinion, either before or after the final dollar-value regulations were promulgated."

The final two paragraphs in Mr. Thrower's letter adequately summarize and reflect the actual experiences, and sentiments, of those groups which have opposed the IRS in its attempts to find a way to prohibit components-of-cost LIFO methods.

"...Similarly, the Service was well aware that taxpayers utilized component costing approaches and had done so for more than ten years before final dollar-value regulations were issued. ***The examples we presented and discussed with Service personnel included taxpayers who calculated and pooled inventories based on cost components.***

"If the Service had intended to challenge those practices, there is no reason to believe that such a challenge would not have been clearly announced.

"Indeed, any such challenge plainly would have been inconsistent with Congress' mandate that LIFO be made equally available to all businesses having inventories.

"In short, component costing was recognized and approved at the inception of the dollar-value LIFO method, and it was understood that the detailed dollar-value regulations were intended to confirm this approach.

see **THE AICPA & THE BAR VS. THE IRS**, page 12

IN A NUTSHELL	COMPONENTS-OF-COST
What is COMPONENTS-OF-COST?	• Under the components-of-cost approach, the cost of goods in process and finished goods is divided into three basic components or elements: (1) raw materials, (2) direct labor and (3) overhead. These separate components or elements are then treated as ***items***. • In contrast, under the total product cost approach, the total cost of each type of product in the taxpayer's inventory (i.e., raw materials, work-in-process and finished goods) is treated as a separate ***item***.
Diversity of Terms	• Components of Cost (C-O-C) • Cost Component • Component-of-Cost • Cost Components • All 4 terms refer to the same approach described above.
Diversity of Practices	• There is no single or universal "components-of-cost" method. • Different manufacturers use different C-O-C methods, depending on the nature of the business.
The Issue	• Whether or not taxpayers should be permitted to use various components-of-cost LIFO methods for Federal income tax purposes. • Note: It is not possible to compute Schedule M-1 adjustments for difference between C-O-C results used on financial statements and other C-O-C results used in arriving at taxable income on the Federal income tax return.
The Players	• IRS & Treasury • American Institute of Certified Public Accountants - (AICPA) • American Bar Association - (ABA) • Tax Executives Institute - (TEI) • Tax Court and other Courts • Other writers and authorities - (Blakely & Thompson)
Their Positions	• ***No ...*** IRS. Regulations do not authorize C-O-C methods. Therefore, they can be used only if taxpayer can demonstrate that the results produced "clearly reflect income." • ***Yes ...*** AICPA, ABA, TEI • ***Divided*** ... other writers and other authorities
Possibilities	• Terminate C-O-C - Prospectively, using the cut-off transition method Prospectively, with Sec. 481(a) adjustment ... no cut-off • Terminate C-O-C - Retroactively, using the cut-off transition method Retroactively, with Sec. 481(a) adjustment ... no cut-off • Continue to allow C-O-C, as is • Continue to allow C-O-C, with modification(s) to ***clearly reflect income***
Possible Solutions	• AICPA Tax Acctg. Technical Research Panel now formulating alternatives. • De Filipps ... ***LIFO User Surtax*** proposal, *Tax Notes* 1235 (June 22, 1987)

"Component costing was so basic to our discussions throughout the process of developing detailed dollar-value LIFO regulations, and to the actual cases that were used for illustrative purposes in the course of this process, that I feel confident in stating that ***it would have shocked those on both sides of the table if it had been suggested that the propriety of component costing was being left as an unresolved issue.***"

This background material quotes extensively from Mr. Thower's letter to Commissioner Peterson in 1992 shortly after her letter on C-O-C was issued. It is very interesting to note that before becoming Commissioner of the IRS, Mr. Thrower was in private practice and served on the 5-man Advisory Group in the '50s. Mr. Thrower was appointed IRS Commissioner from April 1, 1969 to June 22, 1971. After serving as Commissioner, Mr. Thrower returned to private practice and his letter was written some 21 years later.

Mr. Thrower's letter expresses quite clearly the seemingly unanimous agreement members of the AICPA, the Bar, and the Tax Executives Institute thought they had achieved with the IRS back in the mid-'50s.

Unfortunately, whatever implicit *understandings* were reached with the IRS in the '50s were never formally recorded for posterity, nor promulgated in a revenue ruling nor in the LIFO regulations.

These understandings as to the acceptability of using a cost-components approach in LIFO calculations ***are what the Treasury and IRS personnel now, half a century later, would conveniently like to forget.*** This memory lapse allows the IRS to accelerate its anti-components-of-cost position by going to the dictionary for definitions of *goods* and *merchandise,* instead of giving any recognition to the importance of precedent and rationality with which assistance was offered, and received, by the Commissioner nearly 50 years ago.

C-O-C ARTICLES

Over the years many articles have been written discussing and explaining the dollar-value LIFO application and various components-of-cost methodologies. These articles go back to the early '40s when Mr. Herbert McAnly and Mr. Carmen Blough wrote about dollar-value LIFO in its earliest forms.

Understandably, most articles have taken the approach of explaining how a C-O-C approach could be made to work with or in a given manufacturer's situation. In general, the "literature" consisting of articles and accounting textbooks explaining C-O-C methods would, occasionally, or as part of a more

(Continued from page 10)

complete discussion, explain various advantages and disadvantages of the application.

LOOK! THE EMPEROR HAS NO CLOTHES ON...

In 1969, an article appeared in *Management Accounting.* It was written by two professors from the University of Wisconsin. In it, the components-of-cost approach of applying dollar-value LIFO was soundly and unequivocally criticized as producing ***"a meaningless conglomeration of both price and technological indexes."***

Leaving little to the imagination (see page 13), the authors forcefully critiqued the real inadequacies of components-of-cost results and identified the "technological change factor" as being a factor other than inflation which should not be permitted to enter into the computation of a LIFO index. It was not until almost 15 years later, in *Amity Leather Products, Inc.* that the Tax Court made this same point in almost the same words. However, the article by Blakely and Thompson in 1969 left its mark, and no doubt a significant impression, upon all those in the Internal Revenue Service who read it.

According to the authors, when technological change is present, dollar-value LIFO ***always*** leads to a valuation of inventory which is less than that which would be obtained using specific identification LIFO (sometimes called *unit* LIFO). This is because specific identification LIFO does not permit technological improvement to be reflected in the LIFO base.

The authors pointed out that the index used to deflate the current year cost to a LIFO base dollar equivalent amount embodies both a price factor and a technological factor. As a consequence, the dollar-value LIFO method ***always*** understates the value of an inventory change when there is technological change and an inventory increase.

The illustrations in the article are straightforward and are supported by derivations, proofs and equations. The final formula breaks the overall index of change into its two components: (1) price inflation and (2) technology change effect. Unless you have a degree in statistics, you may have to call a statistician to help you understand the complex formulas, derivations and substitutions that are included in the Appendices to the article.

The authors stated that the cost component method is approved by both the AICPA ***and the Internal Revenue Code***. They then used this method "to illustrate clearly what LIFO ***is not***" and said, "The index, as defined by the Code, is the source of what is wrong with dollar-value LIFO." As an aside, does this not, in itself, add another degree of credibility to Mr. Thrower's statements regarding the *understand-*

see **THE AICPA & THE BAR VS. THE IRS**, page 14

LOOK ... THE EMPEROR HAS NO CLOTHES ON

One article cited frequently in the IRS writings about components-of-cost is an article written in 1969 by two professors at the University of Wisconsin (Madison) School of Business.*

FORCEFUL LANGUAGE: A WAKE-UP CALL THE IRS COULDN'T IGNORE

The authors did not mince any words in making the point that the components-of-cost method results in bad accounting. They said that the use of the components-of-cost method (which combines current technology with base year costs)...

- ***Produces "...a meaningless conglomeration of both price and technological indexes..."***
- ***"...Achieves nothing rational (except perhaps a lower tax bill)."***
- ***Produces a result that denotes "...nothing resembling an objective LIFO determination ... but rather what LIFO should not be. It does, however, result in a permanent tax savings to the going concern."***
- ***"...In many instances..., as presently applied, is BAD accounting."***

THE ESSENCE

The thesis of the article is found in its subtitle: "*CHANGES IN PRICE LEVEL CAN BE SEPARATED FROM THE EFFECT OF TECHNOLOGICAL CHANGES.*"

The C-O-C index should really be separated into its two components (price and technology). The separate price index and technology index are susceptible to independent computation.

Overall Index = Price Index + Technology Index

Overall Index (9 %) = Price Index (2 %) + Technology Index (7 %)

THE STUDY

Blakely and Thompson support their findings by illustrations in which "...the time period from 1940 to 1965 is considered one year. This is done to simplify the illustrations. ***But, this simplification has no effect on the results achieved. Exactly the same results would have been found if the inventory layer would have been computed for each and every intervening year.***"

The illustrations are fairly straight-forward and are supported by derivations, proofs and equations. The article shows the derivation of the final formula which breaks the overall index of change into its two components: (1) price or inflation and (2) technology change effect. Unless you have a degree in statistics, you may want to have a statistician handy to help you understand the complex formulae and substitutions in going from start to finish.

The authors state that "...a change in the inventory under dollar-value LIFO is understated to such an extent as to produce a final inventory figure which may be ***grossly lower than any actual cost ever experienced by the firm.***"

UNIVERSALITY OF THE FINDINGS

The authors state that the equations developed and included in the Appendix reflect the costing of the entire current year inventory at base-year prices. They state, "In practice, chain indices may be used to avoid costing (directly) current-year inventory at base-year prices. And, different techniques may be used to phase in new kinds of inventory items. ***However, the expediencies of practice in no way abrogate the proof.***"

AFTERMATH

Early in the article, the authors state, "LIFO is *not* a means to permit current productivity gains to replace original commodity cost in the base inventory; therefore, changes in value of the monetary unit should constitute the only difference between LIFO and other methods of inventory."

This is exactly what the later LIFO cases *Wendle Ford Sales*, *Amity Leather*, and *Hamilton Industries* concluded in their holdings to the effect that ***if factors other than the inflation enter into the computation of the index, the result will not clearly reflect income.*** Changes in the price of a product due to technological changes or production efficiencies are not the same as changes in the price due to fluctuations in the purchasing power of the dollar (i.e., inflation or deflation).

* Blakely, Edward J. & Howard E. Thompson. *Technological Change and Its Effects on Dollar-Value LIFO. Management Accounting*, August 1969, pg. 33-38. This article is an outgrowth of an earlier article by Blakely, Edward J. & Peter H. Knutson. *LIFO or LOFI - Which? The Accounting Review*, January 1963, pg. 75-86.

(Continued from page 12)

ings everyone thought they had with the IRS that assumed components-of-cost methods could be used in dollar-value LIFO applications?

Blakely and Thompson's conclusion should be read in the context of their statement (which was really an assumption) that the cost component method is approved by the Internal Revenue Code. Here is their conclusion which, undoubtedly, received significant attention within the IRS:

"As the illustrations show, the present Code allows a firm to use a method which may result in enormous tax savings. By understating the ending inventory, a firm deducts from revenue a cost of goods sold figure which ***in no way reflects the costs incurred to produce that revenue.***

"If it is mandatory to present this inventory method on financial statements to third parties without change, ***questions of material misrepresentation will arise, whenever significant technological advances have taken place.***

"Finally, it is generally understood that the only factor that should distinguish the results of one inventory computation from another is a change in the monetary unit. (i.e., a change in the purchasing power of the dollar.) The method allowed by the Code (i.e., components-of-cost) certainly allows more than just price changes to distinguish its result from other inventory methods" (emphasis added).

Blakely and Thompson's article is cited in GCM 38478, dated August 25, 1980. See the accompanying article, "IRS Ruling on C-O-C Methods," pages 20 to 25. The GCM simply references the Blakely and Thompson article at Note 11. This GCM incidentally was written in response to a request that a proposed revenue ruling on components-of-cost methods be issued. The GCM, at its conclusion, refers to a "revised draft of the ruling" which the GCM authors had prepared to modify the shortcoming of the original draft which had been submitted for their review. Obviously, this *revised* ruling was never published by the IRS either.

AICPA ISSUES PAPER IN 1984

In late 1984, after significant debate, the AICPA published an Issues Paper entitled *Identification and Discussion of Certain Financial Accounting and Reporting Issues Concerning LIFO Inventories* (dated November 30, 1984—File 3175). This document was prepared by the Task Force on LIFO Inventory Problems, Accounting Standards Division of the AICPA.

Two sections of the AICPA Issues Paper deal extensively with components-of-cost and unit cost LIFO. Paragraphs 4-38 through 4-49 (pages 28-34) of the Issues Paper provide examples and background discussion while Appendix II and III (pages 86-89) give examples of productivity increases and decreases.

Paragraph 4-47 contained "arguments favoring the cost component method." Arguments opposing the cost component method were presented in paragraph 4-48 of the Issues Paper. (See facing page.)

The *"Advisory Conclusion"* of the Task Force with respect to C-O-C is as follows: "The Task Force believes (9 yes, 0 no) either the unit cost or cost component method may be used for financial reporting purposes but that in certain circumstances, such as those discussed in paragraph 4-47, the cost component method may be preferable to the unit cost method, unless base year costs are reconstructed."

AICPA Issues Papers normally include *advisory conclusions* which represent the views of at least a majority of the Institute's Accounting Standards Executive Committee (AcSEC). Significantly, AICPA Issues Papers do not establish standards of financial accounting enforceable under Rule 203 of the Institute's Code of Professional Ethics. Accordingly, ***AICPA Issues Papers do not, per se, constitute or establish generally accepted accounting principles (GAAP).***

Whenever taxpayers have attempted to cite this 1984 AICPA Issues Paper in connection with their disagreements with the IRS over LIFO issues, the IRS is quick to point out the limitations of its applicability. For example, IRS writers generally dismiss the Issues Paper as "ambiguous" and without any authority.

OMINOUS RUMBLINGS IN 1991 & AICPA POSITION PAPER ON C-O-C

For many years, the AICPA and the ABA each have maintained committees addressing "tax accounting" matters. One such matter appearing over the years was, naturally, components-of-cost.

The minutes of the May 15, 1991 meeting of the Tax Accounting Committee, Tax Division of the AICPA, reported that "the IRS plans to issue a revenue ruling and revenue procedure on components-of-cost. The revenue procedure may impose Section 481(a) adjustment." This was a bombshell because historically manufacturers had been permitted to change from the cost components method prospectively without any Section 481(a) adjustments.

The following observations are included in the minutes of the May, 1991 meeting. "Because of the number of taxpayers that use cost components, this issue is one of the Committee's highest priorities.

see **THE AICPA & THE BAR VS. THE IRS**, page 16

AICPA LIFO ISSUES PAPER - 1984*
THE PROS & CONS OF COMPONENTS-OF-COST

ARGUMENTS FAVORING

a. "If the unit cost of finished product is not routinely developed as part of the cost accounting system, the cost component method is the only practical and reliable method to use to develop a LIFO cost index.

b. "If styles constantly change, it is impossible to develop comparable base year costs. However, the comparable base year cost of the underlying material, labor, and overhead components will generally be readily determinable. Thus the resulting LIFO index will be much more representative and reliable than an index developed on the basis of theoretical base year costs.

c. "The same rationale applies if the product line continually evolves, for example, with manufacturers of paints, plastics, and textile fiber yarns. For such manufacturers, makeups of finished products may have hundreds or even thousands of variations, but relatively few material ingredients, resulting in a greater degree of consistency and comparability in calculating the index if the cost component method is used.

d. "Manufacturers that have significant changes in purchased, as opposed to produced, material ingredients can experience significant fluctuations in unit cost unrelated to the effects of inflation. Use of the unit cost method in such cases would cause meaningless index fluctuations.

e. "The degree of utilization of manufacturing capacity can have a significant effect on the unit cost of finished products from period to period wholly apart from any change in underlying costs. Unit costs would generally decline when capacity utilization increases, and would generally increase when capacity utilization declines-even though the cost of material, labor, or overhead components remains unchanged. Use of the unit cost method under these conditions could produce a LIFO charge or a LIFO credit wholly unrelated to the effects of changing prices.

f. "The cost component method is well suited to use with the link-chain technique to avoid the problems encountered with identification of and accounting for "new products" or the reconstruction of base year cost for such products.

g. "Proponents also believe the principles of LIFO accounting are not violated by the index determination and LIFO adjustment resulting from eliminating manufacturing efficiencies. They believe the goal of LIFO is to factor the effect of price changes out of inventories and this can be accomplished best by factoring it out of the underlying cost components rather than the unit cost of finished product, which is influenced by many other factors such as capacity utilization, technological changes, manufacturing efficiencies, product styles, and so forth.

h. "Proponents also believe the cost component method is the only practical method to use if substantial work in process inventories exist. They cite the difficulties of double extending unit costs for in process inventories at various stages of completion."

ARGUMENTS OPPOSING

a. "Some believe the cost component method should not be used because labor and overhead are intangible and do not represent physical components of the finished product inventory. Those who disagree point out that the same elements of labor and overhead are integral parts of the unit cost of finished product and that if they are valid inventoriable costs under the unit cost method, they are equally valid inventoriable costs under the cost component method.

b. "Some believe the cost component method can cause ending inventory to be written down below its beginning of year cost as determined under the unit cost method.

c. "Some criticize the cost component method because it can theoretically cause writing down the ending inventory below its base year cost as determined under the unit cost method when manufacturing efficiencies occur (fewer inputs of material, labor, or overhead required to produce same number of finished products). Proponents of the cost component method believe such situations are likely to be exceptional and to have an immaterial effect. Also they point out that there are likely to be offsetting inefficiencies resulting from environmental requirements, union work rule changes, and so forth, that would negate the effects of technological improvements."

*AICPA Task Force on LIFO Inventory Problems. *Issues Paper: Identification and Discussion of Certain Financial Accounting and Reporting Issues Concerning LIFO Inventories*, November 10, 1984. File 3175, pg. 32-33 ... Paragraphs 4-47 and 4-48.

Further, because the IRS position on Section 481(a) adjustment could affect other LIFO changes, and because there is an implicit issue regarding definition of *item*, we believe ***this is the most substantive change proposed to LIFO since the 1961 dollar-value regulations. It is not clear the IRS understands the significance of the issue, and the underlying accounting issues."***

Did the IRS *really* understand the significance of the whole matter? Well, just in case it didn't, the AICPA submitted a report on the "Propriety of Using the Components-of-Cost Method of Computing a LIFO Price Index" just to help the Service *better* "understand" the significance of the issue.

This thirteen page Position Paper (dated April 13, 1992) was submitted by Leonard Podolin, Chairman of the Tax Executive Committee of the AICPA. Not surprisingly, the Position Paper concluded that the IRS should not seek to prohibit use of the components-of-cost method...or that if it did, "in no event should the application of any new rules be made retroactive" and "at a minimum, proposed regulations should be published so as to provide corporate taxpayers and others the opportunity to comment on this significant issue."

This AICPA Position Paper on C-O-C includes a lengthy historical perspective going back to Herbert McAnly's address in 1941. This perspective (on page 4) references a number of other IRS-practitioner group interactions in the mid-'50s, including the discussions of the draft of the proposed revenue ruling on C-O-C in May, 1954. In the context of the 1954 proposed revenue ruling, the AICPA Issues Paper states that "it was clear to both the Treasury and the Advisory Group that the components-of-cost method was appropriate for tax purposes."

It adds that in lieu of a revenue ruling, when the final dollar-value LIFO regulations were adopted in 1961, since the regulations reflected the broad natural business unit concept of pooling, certain examples involving components-of-cost issues were no longer appropriate, and, thus, were not contained in the regulations.

The AICPA strengthened its position on C-O-C by adding that in March of 1985, the Securities and Exchange Commission staff took the unusual step of endorsing the 1984 AICPA LIFO Issues Paper in Staff Accounting Bulletin (SAB) No. 58. Based on the acceptance by the SEC of the 1984 LIFO Issues Paper conclusions relative to C-O-C, the AICPA added that "if the components-of-cost method is permissible or even preferable under generally ac-

(Continued from page 14)

cepted accounting principles, then it ought to be equally acceptable for income tax purposes."

It added: "the link between tax and financial reporting is especially strong in the area of LIFO accounting because of the LIFO conformity requirement contained in the Code. Moreover, the use of either the product cost or components-of-cost method is so intertwined with the type of cost accounting system employed by the company, it is inconceivable that a company could use one method for tax purposes and the other method for book purposes." In other words, Schedule M-1 adjustments in tax returns were out of the question.

After referring to statements by the Administration and by the Internal Revenue Service that one of their goals was to simplify the administration of the tax laws, the AICPA added that the inability of companies to use the same underlying LIFO cost system for tax and financial purposes would introduce tremendous complexity into the system...exactly what the Administration and the IRS had publicly stated they hoped to avoid.

Here are the AICPA's reasons why the IRS should permit components-of-cost.

WHY THE IRS SHOULD PERMIT C-O-C

- C-O-C clearly reflects income.
- C-O-C represents the best accounting practice in many circumstances. It is permissible, if not preferable, under GAAP and the SEC SAB No. 58 has endorsed the 1984 AICPA Issues Paper.
- C-O-C has a long history of acceptability. ***Change after such a long period of acceptance would be fundamentally unfair.***
- Use of the C-O-C method was specifically provided for by the original drafters of the dollar-value LIFO Regulations.
- Disallowance of the C-O-C method will require massive and very expensive systems changes for the many manufacturing companies that use the method.
- Many companies may not be able at all to change to the total product cost method.

Summary: the AICPA Position Paper of April, 1992 urged moderation and toleration by the IRS in dealing with components-of-cost issues. It also urged a "soft landing" or at least one that would avoid the greatly-feared Section 481(a) adjustment which would fully tax C-O-C users on their LIFO reserves as part of their required transition. This brings us to the Commissioner's reply.

see **THE AICPA & THE BAR VS. THE IRS**, page 18

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

July 31, 1992

Mr. Leonard Podolin, Chairman
Tax Executive Committee
American Institute of Certified Public Accountants
1455 Pennsylvania Avenue, N.W.
Washington, D.C. 20004-1007

Dear Mr. Podolin:

Thank you for your letter of April 13, 1992, on behalf of the American Institute of Certified Public Accountants addressing the propriety of using the components-of-cost method of computing a LIFO price index.

As you know, we have given this issue considerable attention. In the summer of 1991, we invited representatives from the AICPA and the American Bar Association to discuss our specific concerns with the method. At that time, we shared our legal analysis of whether the method is specifically permitted by the LIFO regulations, and detailed our concerns about ways in which the method could distort the measurement of taxable income. The non-government participants were invited both to address our legal analysis and to suggest specific components-of-cost methods that would avoid the problems we discussed.

To date, your letter is the only response to the invitation. We have carefully reviewed your comments, as well as arguments made by specific taxpayers and at practitioner meetings. It is our conclusion that ***the LIFO regulations do not specifically permit the use of cost components as items in the computation of a LIFO price index*** under the dollar-value LIFO inventory method. ***Since ... there is no standard methodology for computing indexes under the components-of-cost method, any particular application of the components-of-cost method must therefore be examined to determine whether it clearly reflects income.***

After reviewing with our staffs the various possible applications of the components-of-cost method, we have concluded that the method has the potential to distort income by permitting a taxpayer to deduct as the cost of goods sold an amount greater than the current cost of creating the inventory sold. ***Some applications of the method can convert the changes in the component mix (often occasioned by technological advances) into apparent inflation in the cost of the inventory, even though overall product costs have not increased.***

This is not a new analysis of the issue. As you point out in your letter, the Service took the same position over a dozen years ago in a publicly released Technical Advice Memorandum. You also mention a number of other informal sources that taxpayers may have relied upon in the adoption or retention of the components-of-cost method. Those sources do not constitute official pronouncements of the Service that should engender reasonable taxpayer reliance. Moreover, we are convinced that ***taxpayer reliance on our failure to subsequently issue a revenue ruling would be misplaced and accorded no weight in judicial proceedings.***

We share your concern that some manufacturers may not have sufficient product-cost information to easily abandon the components-of-cost approach. ***And, in fact, it is not our position that all applications of the method will distort income.*** We would prefer to identify practicable applications of the method that will achieve acceptable results (even if these results are not identical in all cases to a product-cost approach). In the meantime, however, we believe it is appropriate to continue the examination of the method used by particular taxpayers to ensure compliance with the statutory requirement that income be clearly reflected.

We also appreciate your offer of substantial assistance in discussing the parameters of the components-of-cost issue and developing a definitive and workable solution. In fact, we hoped to begin such a dialogue last summer when we detailed our concerns. While we have yet to receive any specific suggestions on the methods or limits to be prescribed for components-of-cost, we are hopeful that your letter can be a springboard to a useful exchange of views and analysis. We are sending a copy of this letter to other practitioner groups and making it available to the press in the hope that other interested parties will join in this effort. ...

Sincerely,

Shirley D. Peterson, Commissioner

Abraham N. M. Shashy, Jr., Chief Counsel

(Continued from page 16)

THE COMMISSIONER REPLIES

Shortly after receiving the AICPA's Position Paper on C-O-C, the Commissioner and the IRS Chief Counsel jointly replied in a brief letter. (See previous page.) They said: ***"...it is our conclusion that LIFO regulations do not specifically permit the use of cost components as items" in the dollar-value LIFO computations.***

They added that since there was no standard components-of-cost methodology or application, any one taxpayer's use of a C-O-C method "must therefore be examined to determine whether it clearly reflects income." The clear reflection of income language reflects the statutory wording found in both Sections 471 and 472.

The letter expressed the IRS concern that the components-of-cost method has the potential to distort income in situations where changes in the component mix are translated into "apparent inflation in the cost of the inventory, even though overall production costs have not increased."

The IRS letter stated that the Service's analysis is not a new one: "The Service took the same position over a dozen years ago in a publicly released Technical Advice Memorandum." This would be TAM 7920008 dated February 12, 1979 which was subsequently followed by General Counsel Memorandum (GCM) 38478.

With respect to the AICPA's lament of "unfairness" if the IRS were to change its mind on this issue after so many years of acceptance, the Letter said simply that ***"we are convinced that taxpayer reliance on our failure to subsequently issue a revenue ruling would be misplaced and accorded no weight in judicial proceedings."*** So much for sympathy or thanks for all your help over the years!

Read my lips: The IRS letter says that it is not the position of the IRS that all applications of the C-O-C method will distort income. Rather, on a case-by-case basis, it will be necessary to look at each taxpayer's C-O-C methodology to determine whether it produces a distortion of income.

POST-LETTER AFTERMATH

In discussing the Commissioner's letter at a subsequent meeting of the American Bar Association Tax Section, an IRS representative (Kenneth Kempson) identified three concerns that the Service sought assistance from practitioners in working out.

The ***first*** concern related to when a component becomes a new or a different *item*. The ***second*** involved wrestling with how to separate production efficiencies out of the computational results. The ***third*** issue involved determining how units of inventory (i.e., overhead *items*) should be measured, especially when overhead is substituted for labor without an increase in product efficiency and when a variant of the components-of-cost method is used reflecting the assumption that there is a constant ratio of overhead to labor.

These concerns are discussed more fully on page 22 in the discussion of IRS Rulings on C-O-C.

Mr. Kempson placed one important qualification on his comments, lest they be understood to imply that if a taxpayer's accounting method satisfied Generally Accepted Accounting Principles (GAAP), then that method would automatically be accepted by the IRS. He observed that the regulations under Section 446 had just been amended to support the IRS position that even if a taxpayer's accounting method satisfied GAAP, it would not necessarily be acceptable for income tax purposes. As amended, the regulations mandate that "clear reflection of income" is the ultimate standard which must be met to the satisfaction of the Commissioner. For a more complete discussion of Mr. Kempson's remarks, see *Tax Notes*, September 7, 1992 page 1260 ("Official Details Service Concerns about Components-of-Cost Method").

In addition to Mr. Thrower's letter discussed on pages 10-12, another follow up to the Commissioner's letter was a letter from the AICPA requesting an extension of the transition rule deadline contained in Revenue Procedure 92-20 (which had been issued earlier in the year). The extension requested would have allowed manufacturers using C-O-C methods more time to consider the implications of the Treasury-IRS position expressed in the July 31, 1992 letter.

Since there was no clear guidance as to how the National Office would be handling requests for changes in C-O-C accounting methods, concern had arisen because of the difference in results involving a Section 481(a) adjustment. The Service declined to extend the transition rule deadline beyond September 18, 1992, the date originally set in Revenue Procedure 92-20.

SO...WHERE ARE WE NOW ...AFTER ALL THESE YEARS?

The last entry in the 60-Year C-O-C Timeline indicates where we are now. And that is just about where we started with the IRS in the mid-50s. A weeks ago, the AICPA Tax Accounting Technical Resource Panel formed a Task Force to provide input to the Treasury and the IRS on the components-of-cost issue. Great. As we have for the last 50 or so years, we'll just have to wait and see what comes along next. *

WHY THE IRS DISTRUSTS C-O-C METHODS

HOW TECHNOLOGICAL CHANGE CAN DISTORT LIFO RESULTS

A manufacturer of widgets adopts the dollar-value LIFO method in Year One, and elects to use the link-chain method to compute the LIFO value of its inventory in a single Natural Business Unit (NBU) pool. At the end of Year One, the taxpayer has a single widget in its inventory, composed of the following costs:

Material	1 unit	@ $ 2.00	=	$ 2.00
Labor	2 units	@ 5.00	=	10.00
Overhead	1 unit	@ 1.00	=	1.00
				$13.00

Because the taxpayer adopted the LIFO method for Year One, the Year One price index will be 100%.

In Year Two, the taxpayer manufactures another widget, but because of a more efficient production process needs only one labor unit to manufacture it. The Year Two costs to produce the widget are:

Material	1 unit	@ $ 2.50	=	$ 2.50
Labor	1 unit	@ 8.00	=	8.00
Overhead	1 unit	@ 1. 50	=	1.50
				$12.00

	Current-Year Cost *				Prior-Year Cost **			
Material	1	@	$ 2.50 =	$ 2.50	1	@	$ 2.00 =	$ 2.00
Labor	1	@	8.00 =	8.00	1	@	5.00 =	5.00
Overhead	1	@	1.50 =	1.50	1	@	1.00 =	1.00
				$12.00				$ 8.00

* Year Two Quantity times (x) Year Two Costs

** Year Two Quantity times (x) Year One Costs

The taxpayer's Year Two price index is 150% (determined by dividing the $12.00 current-year cost by the $8.00 prior-year cost). Under the link-chain method, the cumulative index is 150% (determined by multiplying the 150% Year Two price index by the 100% Year One price index). Accordingly, the taxpayer's ending inventory at base-year cost is $8.00 (determined by dividing the $12.00 current-year cost by the cumulative index of 150%).

When the taxpayer determined its total prior-year cost in Year Two, it multiplied the Year One costs by the Year Two quantity. Thus, to determine the prior-year cost of labor, the taxpayer multiplied the $5.00 Year One labor cost by the one unit of labor required to manufacture the widget in Year Two. The problem with this approach is that in Year One, it was not possible to manufacture a widget in a single hour. ***To the extent that the prior-year's labor cost is artificially low, the total prior-year costs, and thus the denominator used in calculating the price index, will be artificially low. This lower denominator results in a higher price index and a relatively lower ending inventory at base-year cost.***

In contrast, if prior-year labor inputs reflect the inputs at which the widget could have been produced in Year One, prior-year labor costs would be $10.00 (2 hours at $5.00), and the total prior year's costs would be $13.00. The Year Two price index would be 92% (determined by dividing current-year costs of $12.00 by prior-year costs of $13.00). The cumulative price index would be 92%. Accordingly, ending inventory at base-year cost would be $13.00 (determined by dividing current-year costs of $12.00 by the cumulative index of 92%).

In the above example, the taxpayer's ending inventory at base-year cost is $8.00, even though the taxpayer could not have produced a widget in the base year for $8.00. ***This result does more than merely alter the flow of costs; rather, it creates artificial costs. In effect, the possibility exists under the components-of-cost method for taxpayers to recover more costs on the sale of the item than it costs to replace such item. Taxpayer's method, which permits a matching of current revenues with costs higher than those incurred by taxpayer in the current period, is similarly improper. Consequently, it is our view that taxpayer's application of the components-of-cost method does not clearly reflect income.***

LETTER RULING 9405005: OCTOBER 5, 1993

IRS RULINGS ON COMPONENTS-OF-COST METHODS

IRS RULINGS

Some manufacturers have been using components-of-cost methods for about as long as LIFO has been around. And, in the real world beyond textbooks, there is no single or universally applied components-of-cost method. Different manufacturers apply different components-of-cost techniques. But they all do essentially the same thing ... and that is to treat direct labor and overhead as separately distinguishable *items* which are repriced as such in their LIFO computations. You can get a good idea of the kinds of C-O-C methods the IRS has challenged by reading the descriptions of the methods used by the taxpayers involved in the rulings below.

Given C-O-C's long and varied use, one might think that surely by now there would be an abundance of rulings by the IRS on the subject. The stark reality: There's nowhere to be found any official pronouncement setting forth the IRS position on C-O-C. The closest to any "official" or precedential guidance on the issue is in a letter sent by the IRS Commissioner to the AICPA on July 31, 1992.

As the summaries show, over the last 40 years there have been only a few assorted "rulings" by the IRS dealing with components-of-cost issues.

C-O-C RULINGS

- TAM/LTR 7920008–February 12, 1979
- GCM 38478–August 25, 1980
- Commissioner's Letter–July 31, 1992
- IRS Memo–July 31, 1992 (Released seven years later as FSA 1999-622)
- TAM/LTR 9405005
- TAM/LTR 9445004
- Field Service Advice 200010009

One *favorable* progression over time in the rulings relates to the acceptance of the idea that a taxpayer will be permitted to modify its C-O-C method so long as the modified C-O-C method does not distort income (i.e., as long as it clearly reflects income). This appears in both TAM/LTR 9405005 and also in FSA 200010009.

On the ominous side, one *disturbing* progression is that if a taxpayer does not have adequate books and records...which may be the case for many taxpayers...then the IRS can terminate the LIFO election and require a Section 481(a) adjustment to pick up the entire LIFO reserve as income.

INSIGHTS FROM OTHER IRS SOURCES

In addition to this handful of *rulings*, there are two other sources of information on the IRS position and concerns over C-O-C. One source is a record of some of the remarks made shortly after the Commissioner issued her letter on July 31, 1992.

In discussing the Commissioner's letter shortly after its release at a meeting of the American Bar Association Tax Section, an IRS representative (Kenneth Kempson) identified three questions or concerns troubling the IRS about C-O-C. The ***first*** concern related to when a component becomes a new or a different *item*. The ***second*** involved wrestling with how to separate production efficiencies out of the computational results. The ***third*** issue involved determining how units of inventory (i.e., overhead *items*) should be measured, especially when overhead is substituted for labor without an increase in product efficiency and when a variant of the components-of-cost method is used reflecting the assumption that there is a constant ratio of overhead to labor.

see **IRS RULINGS ON C-O-C METHODS**, page 22

SUMMARY OF HOLDINGS...FIVE SCARY THOUGHTS

- Components-of-cost methods are not authorized by the regulations, but they may be accepted by the IRS if the results they produce clearly reflect income.
- Prior acceptance by the IRS in earlier audits does not prevent the IRS from changing its mind at a later date in a later audit and questioning the validity of the C-O-C method used at that time.
- A taxpayer using a components-of-cost method may be allowed to stay on LIFO if it can modify its C-O-C method to one that does not distort income and that is acceptable to the Service.
- If the taxpayer is required to change from (or within) its C-O-C method, a Section 481(a) adjustment will be required.
- More recently, the IRS has introduced the importance of maintaining adequate "books and records" in support of LIFO calculations by taking the position that without adequate backup for alternative calculations, termination of the LIFO election is warranted and permissible.

AT A GLANCE

IRS RULINGS ON C-O-C METHODS

DATE	REFERENCE	COMMENTS OR HOLDINGS
January 1961	Reg. Sec. 1.472	• First issuance of regulations authorizing the dollar-value LIFO method. • No specific reference to C-O-C methods ... No examples or illustration of C-O-C.
February 1979	TAM/LTR 7920008	• Direct labor is not an "*item*." • If a components-of-cost method is used, the results must clearly reflect income. • "Clear reflection of income" is a question of fact. • Describes standards that C-O-C also must satisfy. • Can't value layers at less than the costs actually incurred. • Consistent use of method by the taxpayer or acceptance of its use in prior audits by IRS does not prevent IRS from questioning the use of this method in a later audit.
August 1980	GCM 38478	• Raw materials, labor and overhead are not "*items*." • Classification of raw materials, goods-in-process and finished goods are too broad for "*item*" determination purposes.
July 1992	Treasury/IRS Letter to AICPA July 31, 1992	• Only real "official" statement on C-O-C issued by Treasury, IRS. • Regulations do not specifically permit the use of cost components as "*items*." • Each C-O-C method must be examined based on its own facts and circumstances in order to determine whether or not the results *clearly reflect income*.
July 1992	IRS Memo July 31, 1992	• C-O-C method is not authorized under the Regulations. • Taxpayer's C-O-C application did not clearly reflect income; therefore, the taxpayer could not continue to use it. • Taxpayer should be changed to the total product cost method. • Section 481(a) adjustment is required ... ***Released in 1999 as FSA 1999-622***
October 1993	TAM/LTR 9405005	• Regulations do not specifically permit C-O-C. • Taxpayer's C-O-C method did not clearly reflect income because it did not take into account technological changes. • Alternative or modified C-O-C method could be used if it does not distort income; Otherwise, total product cost method would have to be used. • Various conditions and limitations. • Section 481(a) adjustment is required. Taxpayer can't avoid retroactive effect.
April 1994	TAM/LTR 9445004	• Involves the extension of a LIFO election from raw materials to include labor and overhead. • Labor and overhead can't be put in a pool separate from raw materials. • Somewhat favorable to taxpayers...but imposes other conditions regarding pooling.
November 1999	FSA 200010009	• C-O-C method used did not clearly reflect income because it did not account for efficiency gains in labor and overhead realized by the taxpayer. • Taxpayer can stay on LIFO using C-O-C if it can change to a method "akin" to total product cost method. • ***Alternatively***, if taxpayer does not have adequate books and records, then the IRS can terminate the LIFO election and change the taxpayer to FIFO.

 (Continued from page 20)

One interesting observation Mr. Kempson made was the possibility that in later years when a business has qualitatively better labor, perhaps as a result of substituting more skilled labor for semi-skilled labor, this newer class of labor might be identified as a ***new*** item. This would be consistent with *Hamilton Industries* and *Amity Leather Products* and perhaps that would solve the concern or issue over labor inefficiencies.

In connection with C-O-C concerns related to overhead computations, Mr. Kempson observed that rather than permitting a "burden theory of overhead" that winds up artificially inflating overhead by keying into labor costs, there might be a better alternative. This would be to more finely break down overhead into a series of subdivided computations. These subdivisions could involve square foot per lease, depreciation per machine, property tax allocations on a square foot basis, and other similar correlations.

IRS TRAINING MANUAL

The IRS Training Manual is another source of information on how the IRS views the use of components-of-cost methods. Training Manual 3127-01 (Chapter 5, Dollar-Value LIFO–Internal Index Methods) states:

IRS MANUAL ON C-O-C

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

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

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

NOTHING DIRECTLY ON POINT, BUT...

The accompanying summaries reflect the lack of anything precedential (except for the Regulations, over which disputed interpretations abound). The early rulings give warning that the IRS is skeptical about the use of C-O-C methods, to say the least. When one factors in the timing of several Tax Court cases involving LIFO computation issues (see pages 6-9), a more complete picture emerges. These cases are: *Wendle Ford Sales, Inc.* (1979); *Amity Leather Products* (1984); *Hamilton Industries, Inc.* (1991) and *Consolidated Manufacturing, Inc.* (1999).

The IRS has achieved precedents with these cases which can only be regarded as greatly supporting its opposition to the use of many components-of-cost methods being applied today. It should be remembered that not all C-O-C methods are categorically prohibited; only those which do not "clearly reflect income" are prohibited. That is a deliciously ambiguous fine line of distinction.

The timing of the issuance of Revenue Procedure 92-20 in March, 1992 also blends into the C-O-C controversy. This Revenue Procedure offered taxpayers "graded incentives" to encourage *voluntary* compliance and *voluntary* requests for changes from improper accounting methods to acceptable methods before an IRS audit started. When coupled with the July, 1992 IRS Letter and Memo, it is evident that 1992 (if not also the year leading up to it) was a year of significant activity by all parties concerned with the C-O-C issue.

Another piece in the C-O-C puzzle is the IRS Memo dated July 31, 1992–the same date as the Commissioner's letter to the AICPA. This was something the public did not find out about until it was forced out of the IRS *seven years later* under the Freedom of Information Act. At that time, it was designated as FSA 1999-622. An introduction to (i.e. in the first paragraph) the FSA/Memo states: "As you are aware the delay in our response was caused by the need for consideration at the ***highest level*** in the Service and Treasury."

The last paragraph of the FSA/Memo warns: "This document should not be disclosed to anyone outside the IRS, including the taxpayer involved, and its use within the IRS should be limited to those with a need to review the document in relation to the subject matter or case discussed herein."

In all of this, what is most obvious is the silence or less-than forthright reticence on the part of the IRS and the Commissioner to face this troublesome issue more directly either in a Revenue Procedure or by amending the LIFO regulations. However, on second thought, the secrecy with which the IRS has guarded its deliberations involving C-O-C should not be surprising given the enormous impact that its adverse position has on countless (unsuspecting?) taxpayers.

TAM / LTR 7920008 - FEBRUARY 12, 1979

ISSUES	*HOLDINGS*
1. Is direct labor an inventory item for the purposes of computing the LIFO value of a dollar?	1. *NO* ... Direct labor is not an inventory item as contemplated in Reg. Sec. 1.472-8 with respect to the computation of indexes in valuing a natural business unit dollar-value LIFO pool.
2. Does a dollar-value index computed on the basis of cost element of material, labor and overhead clearly reflect the income in accordance with Reg. Secs. 1.472-8(a) and 1.472-1(e)?	2. Whether a dollar-value index computed on the basis of cost elements of material, labor and overhead clearly reflect income in accordance with Reg. Sec. 1.472-8(a) and 1.472-1(e) is a question of fact. The taxpayer must establish to the satisfaction of the District Director that its use of the component cost concept will result in the same valuation of its inventories as the valuation it would otherwise derive if it extended physical inventory items or goods, taking into account only the material, labor and overhead content within each good.
3. May a taxpayer, through the use of a dollar-value index so computed, value its LIFO inventory layers at less than the cost it incurred in acquiring such LIFO inventory layers?	3. *NO* ... The unit base year cost concept must be maintained. Moreover, the taxpayer cannot use a dollar-value index which when computed will result in LIFO inventories layers being valued less than the costs incurred in acquiring such layers.
4. If the taxpayer has consistently used its present method of LIFO inventory valuation during the past twenty years and no examination by the District Director has challenged the use of such present method, can the District Director compel the taxpayer to change from that method to another method of LIFO valuation?	4. *YES* ... The District Director can compel the taxpayer to change the use of its present method of accounting notwithstanding the fact that such method has been used consistently over the past twenty years and notwithstanding the fact that such method has previously been accepted by the IRS during previous audits. Taxpayer's use of the component cost method is not clearly authorized in the regulations. Therefore, taxpayer must prove that the use of such method will clearly reflect income. Otherwise, the District Director is justified in requiring the taxpayer to change its LIFO method to a method consistent with Reg. Sec. 1.472-8.

GENERAL COUNSEL MEMORANDUM 38478 - AUGUST 25, 1980

ISSUES	*HOLDINGS*
1. Whether raw materials, labor and overhead constitute *items* for purposes of calculating the value of the taxpayer's inventory under the dollar-value LIFO method authorized by Reg. Sec. 1. 472-8.	1. Raw materials, labor and overhead do not constitute *items* for purposes of the dollar-value method. The taxpayer should not be permitted to mechanically use base year prices with current technology in reconstructing base year costs since it factors out the effect of technological advancement on the cost of a product.
1. Whether raw materials, goods in process, and finished goods constitute *items* for purposes of calculating the value of the taxpayer's inventory under the dollar-value LIFO method authorized by Reg. Sec. 1.472-8.	2. Raw materials, goods in process, and finished goods are too broad of a classification for the definition of *items* under dollar-value LIFO. The taxpayer should consider each type of raw material as a separate *item* rather than considering the different types of raw materials as one *item*.

IRS MEMORANDUM - JULY 31, 1992

ISSUES	*HOLDINGS*
1. Whether the regulations authorize the components of cost method of index calculation under the dollar-value LIFO method. Does the term *"item"* under the dollar-value LIFO method mean (1) raw materials, goods in process and finished products as used under the product cost method, or (2) raw materials, labor and overhead as used under the components-of-cost method?	1. The components-of-cost method of valuing LIFO inventories is not authorized under the regulations
2. If the regulations do not authorize the method, whether the taxpayer is precluded from using the method because it does not clearly reflect income.	2. The taxpayer's application of this method does not clearly reflect income. Therefore, it is not an appropriate method for valuing inventory under the LIFO regulations.
3. If the components-of-cost method is to be disallowed, whether the Service should impose a Section 481(a) adjustment.	3. The taxpayer's use of this method should be disallowed and the taxpayer should be required to change to the product cost method for valuing inventory. A Section 481 (a) adjustment should be required.

This Memorandum was not published until 1999 when it was released and designated FSA 1999-622

FSA 200010009 - NOVEMBER 12, 1999

ISSUES	*HOLDINGS*
1. Does the taxpayer's application of the last-in, first-out (LIFO) components-of-cost method clearly reflect income?	1. *NO* ... Taxpayer's components-of-cost LIFO method does not clearly reflect income because it fails to take into account efficiency gains in labor and overhead which the taxpayer experienced.
2. If not, what accounting method should the Service change the taxpayer to that clearly reflects income?	2. Possible remedial adjustments may be made. Otherwise, the Service should change taxpayer to a components-of-cost method that is akin to the total product cost method by factoring out productivity gains in the labor and overhead cost component *ALTERNATIVELY*: if the taxpayer does not maintain sufficient books and records to enable the Service to change the taxpayer to this method, ***the Service should terminate taxpayer's LIFO election.***

Note: This FSA contains the most current and consise IRS statements of opposition to C-O-C methods and it also discusses alternative remedies.

TAM / LTR 9405005 - OCTOBER 5, 1993

ISSUES	*HOLDINGS*
1. Does Reg. Sec. 1.472(8)(e)(2)(i) specifically permit the taxpayer to use a so-called "components-of-cost" method?	1. *NO* ... Reg. Sec.1.472-8(e)(2)(i) does not specifically permit the taxpayer to use the components-of-cost method to compute its LIFO price index under the dollar-value LIFO method.
2. Does the taxpayer's use of the components-of-cost method result in its income being clearly reflected?	2. *NO* ... Taxpayer's use of the components-of-cost method does not result in the clear reflection of its income ... because it does not properly take into account the technological changes which occurred during the years at issue. Accordingly, taxpayer's use of the components-of-cost method should be disallowed.
3. Is the taxpayer required to change to a so-called "product-cost" method or may it use a components-of-cost method that clearly reflects its income?	3. Unless the taxpayer is able to demonstrate to the satisfaction of the Appeals Officer that an alternative components-of-cost method does not distort income, the taxpayer will be required to change to a product-cost method of determining a price index. Although an accurate product cost method will result in the clear reflection of taxpayer's income, it is within the discretion of the Appeals Officer to approve any proposed mechanism of determining a price index, so long as it satisfies the concerns expressed herein.
4. If the taxpayer is not permitted to use the components-of-cost method, may this ruling be applied without retroactive effect?	4. *NO* ... the taxpayer may not apply this ruling without retroactive effect.
5. If the taxpayer is not permitted to use the components-of-cost method, is an adjustment required under Section 481(a) of the Code?	5. *YES* ... a Section 481(a) adjustment is required because a change from the components-of-cost method is a change in method of accounting.

TAM / LTR 9445004 - APRIL 25, 1994

ISSUES	*HOLDINGS*
1. May the taxpayer that uses the "raw materials content" last-in, first-out (LIFO) inventory method extend its LIFO election to include labor and overhead costs previously valued under the first-in, first-out (FIFO), inventory method by filing a Form 970, Application to Use LIFO Inventory Method?	1. *YES* ... the Taxpayer may extend its LIFO election from the raw materials content method to include labor and overhead costs previously valued under the FIFO method by filing a Form 970. As long as no other changes are made to the existing raw materials pools, the taxpayer is not required to obtain the prior consent of the Commissioner.
2. Are the taxpayer's labor and overhead costs eligible for inclusion in a different dollar-value LIFO inventory pool than its raw materials?	2. *NO* ... Under the principles for establishing multiple pools at Reg. Sec. 1.472-8(c)(3)(i), labor and overhead costs are not eligible for inclusion in a LIFO pool separate from its raw materials.
3. If the taxpayer's extension of its LIFO election to include labor and overhead costs results in an impermissible method of pooling, may the taxpayer change to a permissible method of pooling?	3. *YES* ... The taxpayer may change to a permissible method of pooling in the year under examination. If the taxpayer does not make appropriate changes to its pooling structure, then the District Director may determine as of the year under examination that the taxpayer's LIFO election for its labor and overhead costs may not be continued.

FSA 200010009: TAXPAYER'S USE OF COMPONENTS-OF-COST METHOD DOES NOT CLEARLY REFLECT INCOME

FIELD SERVICE ADVICE

Field Service Advice 200010009 dated November 12, 1999 sets forth the IRS' most recent denial of a manufacturer's use of a components-of-cost approach in its LIFO calculations.

In this FSA, there were two issues. The first was whether the taxpayer's application of the components-of-cost method clearly reflected income. If the taxpayer's use of a components-of-cost method did not clearly reflect income, the second issue concerned what accounting method the IRS should change the taxpayer to that would clearly reflect income.

The FSA held that the taxpayer's components-of-costs method did not clearly reflect income because ***it failed to take into account efficiency gains in labor and overhead*** which the taxpayer had experienced.

As to the second issue, the FSA held that the IRS should change the taxpayer to a components-of-cost method that is akin to, or more like, the total product cost method by factoring out productivity gains in the labor and overhead cost components.

Alternatively, the FSA held that if the taxpayer did not maintain sufficient books and records to enable the Service to change the taxpayer to a method more like the total product cost method, then the Service should change the taxpayer to the first-in, first-out (FIFO) method. In other words, in that case, the taxpayer should be taken off of LIFO.

TAXPAYER'S C-O-C METHODOLOGY

The taxpayer is a manufacturer and is the parent company of an affiliated group of corporations with many separate production plants or facilities. As part of its LIFO election, it adopted the natural business unit (NBU) method of pooling, the earliest acquisitions cost method of determining current-year cost, and the link-chain method of determining its annual price inflation or deflation indexes.

The taxpayer employed a components-of-cost method under which *"items"* of inventory were not the physical units in the stages of production, i.e., raw materials, work-in-process and finished goods. Instead, the taxpayer's *"items"* were defined by reference to the three cost components—raw material, labor, and overhead. As a consequence, one unit of a finished good is not inventoried as such. Instead, the components-of-cost method separately inventories the quantities of input of material, labor and overhead necessary to manufacture the number of physical units of the product in the taxpayer's ending inventory. This is consistent with the AICPA 1984 LIFO Issues Paper which defines the components-of-cost method as a method of applying dollar-value LIFO in which changes in the LIFO index are measured by the weighted average increase or decrease in the component costs of material, labor and overhead that constitute ending inventory.

The taxpayer's LIFO pool consisted of what it called "LIFO elements." These LIFO elements essentially were various categories of Raw Materials Labor and various categories of Overhead. In determining the appropriate price index for its pool, the taxpayer computed a separate index for each plant location. Although plant locations changed to some degree over the years, the taxpayer's component-of-cost methodology had remained substantially unchanged.

RAW MATERIALS. Each distinct raw material was double-extended, or repriced, at both end-of-the-year and beginning-of-the-year costs based on purchase costs during the last three months of the taxable year. The taxpayer used the resulting annual index in computing the cumulative index under its link-chain method.

LABOR. The labor element or component was further broken down into specific products at some locations. In determining its overall price index for the pool, the taxpayer separately measured its labor output per hour for each separate facility. The input data used to determine the amount of labor in the taxpayer's ending inventory was also based on the last three months of production. Ultimately, however, the taxpayer's labor component of its price index was based exclusively on the ratio of labor hours to labor dollars.

OVERHEAD. The overhead cost component was sub-divided into multiple "items," including indirect labor, depreciation, insurance, obsolescence, taxes and purchased utilities. The taxpayer determined a separate sub-index for each item based on the immediately preceding three months of relative through-put. These detailed overhead indexes were not derived by comparison of ratios, but were determined based on observed economic price changes.

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During the IRS audit, the Examining Agent used standard cost comparisons at one of the taxpayer's plants, the Production Facility, to establish that the taxpayer had incurred labor efficiencies. Although the taxpayer did not disagree that it had experienced labor efficiencies at the Production Facility, it contended that almost all of its labor efficiencies (that were, in the aggregate, minimal) occurred in one type of manufacturing operation and that the Production Facility was primarily engaged in that one type of manufacturing.

The taxpayer also contended that its primary manufacturing operations had remained substantially unchanged over the years because those operations were ***capital***, rather than ***labor***, intensive. Finally, the taxpayer contended that its Production Facility made up only a relatively small percentage of the total inventory in the taxpayer's natural business unit LIFO inventory pool.

Without further elaboration, the FSA indicated that there were some indications that the taxpayer may also have experienced some overhead efficiencies due to savings associated with utilities on newer equipment.

IRS CONCERNS OVER THREE POSSIBLE C-O-C DISTORTIONS

The IRS has traditionally identified three distortions that may arise as a result of using the components-of-cost method. See the discussion on page 22 of the expressions of these concerns in 1992 by the IRS.

Any or all of the distortions can occur depending on the taxpayer's particular facts and circumstances. These distortions can be the result of:

C-O-C DISTORTIONS

- Efficiency gain distortion; i.e., failing to reflect efficiency gains.
- Substitution of one item for another within a cost component (i.e., "item within an item" distortions).
- Improper linkage resulting from the interdependence between the overhead and direct labor cost components (i.e., "double dip" or "frozen burden" distortions).

FSA 200010009 points out that historically, some (i.e., mostly IRS employees) have questioned whether the components-of-cost method comports with the regulations. It cites the letter dated July 31, 1992 sent by then IRS Commissioner Shirley D. Peterson to Mr. Leonard Podolin, Chairman of the Tax Executive Committee of the AICPA.

In that letter, the IRS Chief Counsel and the Commissioner stated that the current regulations neither specifically permit nor proscribe the use of the components-of-cost method. The letter also stated that each specific application of the components-of-cost method would have to be evaluated as to whether or not it clearly reflected income.

For the text of the Commissioner's letter, see page 17.

In addition to citing this letter, the FSA referred to subsequent legislative proposals that have suggested eliminating or proscribing the use of the components-of-cost method, principally because of concerns over the possible distortions which might arise from its use. None of the legislative proposals to abolish the use of components-of-cost methods, however, has been enacted.

EFFICIENCY GAIN DISTORTION. The efficiency gain distortion occurs because component costing essentially reconstructs the base-year cost of products using technology available only in the current year.

Thus, for example, if two direct labor hours are required to produce good X in the base year and, due to technological change or other factors, only one direct labor hour is required to produce good X in the current year, the components-of-cost method produces the same result as if, under the total product cost method, one hour of direct labor was used to reconstruct the base-year cost of good X.

The problem with this approach is that it can result in base-year costs that are below what it actually cost to produce good X in the base-year. This is a natural consequence of using the components-of-cost method because the quantity of each cost component in ending inventory will invariably relate to current production. See the example on page 19 which is taken from TAM/LTR 9405005.

ITEM WITHIN AN ITEM DISTORTIONS. The "item within an item" problem arises where taxpayers using the components-of-cost method do not maintain different items of direct labor.

Thus, if unskilled and skilled labor are treated as the same item, a change in usage from one hour of unskilled labor to one hour of skilled labor will result in the wage differential ***between*** unskilled and skilled labor being improperly treated as inflation.

For example, if it currently takes two hours of unskilled labor, at $10/hr. to produce good X and the producer changes to using one hour of skilled labor at $20/hr. to produce good X, the total direct labor cost of producing good X has remained unchanged.

see **FSA 200010009: TAXPAYER'S USE OF C-O-C**, page 28

(Continued from page 27)

However, if the two classes of direct labor are treated as the same item, then the hourly wage differential would be improperly treated as 100 percent inflation ($20/$10).

DOUBLE DIP" OR "FROZEN BURDEN" DISTORTIONS. These problems arise because of the difficulty in independently quantifying and measuring the inflation factors inherent in overhead. Many cost accounting systems use direct labor hours or dollars as the basis for allocating indirect costs (i.e., overhead) to inventory items or goods.

Computing a price index for overhead based on the change in the relationship between overhead and direct labor will superimpose any direct labor efficiency gain onto the overhead cost component even where direct labor efficiency gains are achieved by increasing overhead (e.g., depreciation on high-tech equipment).

For example, if a taxpayer incurs $1 of overhead per direct labor hour in the base- year and now incurs $2 of overhead per direct labor hour (due to labor efficiency gains) and taxpayer uses this relationship ($2/$1) as the basis for computing its price index, it will be deemed to have incurred 100 percent inflation [($2/$1) = 2.0].

ISSUE #1: CLEAR REFLECTION OF INCOME

In zeroing in on the first issue, the FSA observed that there is a common thread in the Commissioner's July, 1992 letter to the AICPA, as well as in past legislative proposals to explicitly outlaw the use of the components-of-cost method. This common thread is simply that a components-of-cost method may not clearly reflect income if base-year cost is reconstructed using a different process or technology than actually existed in the base year.

Under these circumstances, the result is that the base-year cost reconstruction using the technology in the current year (and the labor hours required in the current year) coupled with the prices in the base year (e.g., the wage rate per hour) results in a base-year cost lower than what the taxpayer could have actually produced the particular product for in the base-year.

In this regard, the FSA directly quoted the following portion of the July, 1992 letter:

"After reviewing with our staffs the various possible applications of the components-of-cost method, we have concluded that the method has the potential to distort income by permitting a taxpayer to deduct as the cost of goods sold an amount greater than the current cost of creating the inventory sold. Some applications of the method can convert the changes in the component mix (often occasioned by technological advances) into apparent inflation in the cost of the inventory, even though overall product costs have not increased."

The FSA added that because the taxpayer's components-of-cost LIFO methodology ***"does not have a mechanism to eliminate in its LIFO valuation the efficiencies in labor or overhead it has experienced,"*** it fails to clearly reflect income. The fact that the taxpayer's component-of-cost methodology did not produce any so-called double dip (or frozen burden) distortions, was not relevant in arriving at this conclusion.

The FSA emphasized that the principal objective of, and underlying rationale for, the use of the LIFO method is to take into account ***only*** inflationary price increases (or deflationary price decreases) at the product level. (See *Amity Leather Products, Inc. v. Commissioner*, 82 T.C. 726 (1984); *Hamilton Industries Inc. v. Commissioner*, 97 T.C. 120 (1991).)

In this case, the taxpayer's components-of-cost method did not properly measure inflation because it included efficiency gains from the use of different processes and/or technology than actually existed in the base year as if those gains were factors in computing pure inflation.

The FSA also pointed out that there was evidence that for at least a portion of the taxpayer's total inventory (i.e., the inventory at the Production Facility), the taxpayer had incurred or experienced labor efficiencies. Finally, there were also some indications that overhead efficiencies were experienced, although these efficiencies had not been quantified.

Although the taxpayer agreed that there were efficiencies, it argued that the labor efficiencies were associated almost exclusively with the manufacturing process done at the Production Facility, which were different from the primary manufacturing processes carried on at other plants.

The taxpayer also unsuccessfully argued that the standard cost comparisons at the Production Facility were not representative of the entire natural business unit pool because the Production Facility represented only a small percentage of the NBU pool.

The FSA authors believed that the actual labor efficiencies which the agent demonstrated at the Production Facility were sufficient to illustrate, by example, the flaws in the taxpayer's overall use of its particular components-of-cost method of accounting.

In further support of its conclusion, the FSA authors noted that the Producer Price indexes pub-

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lished by the United States Bureau of Labor Statistics (BLS) reflected only modest productivity increases for the taxpayer's industry as a whole during the applicable period. This, they felt, provided some corroborative support for the position that the standard cost information from the Production Facility was sufficient to establish that the taxpayer's components-of-cost method did not clearly reflect income.

In citing authority for what it was about to conclude on this issue, the FSA stated that pursuant to Section 446, the Commissioner has broad powers to determine whether an accounting method used by a taxpayer clearly reflects income. (*United States v. Hughes Properties, Inc.*, 476 U.S. 593 (1986); *Commissioner v. Hansen*, 360 U.S. 446 (1959); *Ansley-Sheppard-Burgess Co. v. Comm.*, 104 T.C. 367 (1995).)

Additionally, the courts may not interfere with the Commissioner's determination under section 446 unless it is clearly unlawful or plainly arbitrary, i.e., an abuse of discretion. (*Thor Power Tool Co. v. Comm.*, 439 U.S. 522 (1979); *Cole v. Comm.*, 586 F.2d 747 (9th Cir. 1978), cert. denied, 441 U.S. 924 (1979).) In order to prevail against an IRS-proposed change in method, the taxpayer must prove that the Commissioner's determination is arbitrary and capricious or without sound basis in law or fact. (*Ansley-Sheppard-Burgess Co. v. Comm.*, 104 T.C. 367; *Ford Motor Co. v. Comm.*, 102 T.C. 87 (1994), aff'd, 71 F.3d 209 (6th Cir. 1995).)

SUMMARY: The FSA authors believed that the Examining Agent had established that the taxpayer had actually experienced labor and overhead efficiency gains. The taxpayer's components-of-cost method failed to take into account those labor and overhead efficiencies in computing its inflation indexes for the year. Accordingly, the FSA held that the taxpayer's components-of-cost method did not clearly reflect income.

ISSUE #2: WHAT CORRECTIVE STEPS SHOULD BE TAKEN?

The second issue concerned what corrective steps or action should be taken because the taxpayer used a components-of-cost method that did not clearly reflect income.

As precedent, the FSA stated that the Commissioner's determination with respect to clear reflection of income is entitled to more than the usual presumption of correctness, and the taxpayer bears a heavy burden of overcoming a determination that a method of accounting does not clearly reflect income. (*Hamilton Industries v. Comm.*, 97 T.C. 120 (1991).) Whether a particular method of accounting clearly reflects income is a question of fact which must be decided on a case-by-case basis. *Peninsula Steel Products & Equipment Co. v. Comm.*, 78 T.C. 1029 (1982). The Commissioner's determination as to the proper method of accounting for inventory must be upheld unless it is shown to be plainly erroneous. (*Lucas v. Kansas City Structural Steel Co.*, 281 U.S. 264 (1930); *Hamilton Industries*, 97 T.C. 120 (1991).) The Service may not, however, require the taxpayer to change to another method that does not clearly reflect income. (*Dayton Hudson Corporation v. Comm.*, 153 F.3d 660 (8th Cir. 1998).)

WHERE LIFO IS INVOLVED, THE COMMISSIONER HAS EVEN MORE DISCRETION TO FORCE METHOD CHANGES

The FSA pointed out that in issues involving LIFO, the Service appears to have more discretion in changing a taxpayer's method of accounting and/or proposing adjustments. Two arguments are advanced in this regard.

First, Reg. Sec. 1.472-3(d) provides that the taxpayer's continued use of the LIFO method and the propriety of all LIFO computations is to be determined by the Commissioner in connection with the examination of the taxpayer's return.

Second, Reg. Sec. 1.472-4 provides that the taxpayer is not even permitted to change to the LIFO method unless it agrees to adjustments incident to the use of such method in inventories of prior years or otherwise as the District Director may deem necessary in order to clearly reflect income. Reg. Sec. 1.472-3(d) permits the Service to condition a taxpayer's continued use of LIFO on making adjustments the Service reasonably believes are necessary in order for the taxpayer's method to clearly reflect income.

In this FSA case, several different courses of action are offered as being available to the Service. First, the Service could attempt to adjust the taxpayer's labor component index computation for productivity experienced at the Production Facility.

Another possibility is that the Service could make adjustments to the taxpayer's labor index based on some external measure of labor productivity. An acceptable external measure might be the "all manufacturers" labor productivity index published by the BLS or the specific labor productivity measured by the BLS for the 4-digit Standard Industrial Classification code for this industry. However, such an adjustment could only be made if the Examining Agent determined that the external index chosen was suitable, reliable, and accurate for the taxpayer.

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The FSA authors indicated their belief that the best course of action would be to request the taxpayer to provide ***internal standard cost information*** and the extent of productivity based on these costs that would fairly represent the efficiency gains applicable to the taxpayer's natural business unit pool. Based on this information, the taxpayer's price index would be decreased accordingly.

The FSA added that there is no established method for evaluating overhead efficiencies. One possibility is that the taxpayer's overhead could be reallocated based on direct labor hours and then adjusted by the same labor efficiency factor determined for the direct labor cost component.

The authors indicated that such taxpayer-specific adjustments would be reasonable and would directly remedy the specific problems associated with the taxpayer's components-of-cost method. The FSA authors believed this approach would be reasonable and legally sustainable. However, the creation of an internal index of efficiency or productivity gains may be very difficult for a taxpayer to implement to the satisfaction of an IRS examining agent.

WORST CASE SCENARIO: TAKE THE TAXPAYER OFF LIFO.

The FSA went on to state that if the taxpayer did not possess, or was unwilling to provide, the internal standard cost information from which "taxpayer-specific adjustments" could be made, then the taxpayer should be changed to the FIFO method.

(Continued from page 29)

REFERENCE TO *CONSOLIDATED MANUFACTURING, INC.*

The FSA concluded with a reference to the Tax Court case, *Consolidated Manufacturing, Inc.* In part, this case held that Section 446(b) would permit the Commissioner to terminate a taxpayer's method of accounting if that method does not clearly reflect income and to require the taxpayer to use a method that ***does*** clearly reflect income.

The FSA added that "Significantly, the Court also indicated that Reg. Sec. 1.472-3(d) gives the Service discretion to determine when a taxpayer's application to use LIFO should be approved or continued. In addition, the Court also noted that Rev. Proc. 79-23, 1979-1 C.B. 564, does not provide an exclusive list of situations in which the Service may terminate a taxpayer's LIFO election.

"Moreover, the Court held that one of the grounds enumerated for termination in Rev. Proc. 79-23 is a taxpayer's failure to properly elect the LIFO method and concluded that because the taxpayer did not elect LIFO for the entire good, its election was indeed improper because, when taken together, these costs do not represent earlier produced goods. Instead, they represent the cost component input quantities relating to the most recently produced goods."

In this regard, the FSA also cited *Mountain State Ford Truck Sales Inc. v. Commissioner,* 112 T.C. 58, 82 (1999) to the effect that it suggested that failure by the taxpayer to state its inventories at cost warrants the termination of its LIFO election under Sec. 3.01 (c), Rev. Proc. 79-23 ... even though the Service did not in fact terminate that taxpayer's LIFO election.

These references indicate that the IRS is looking to the favorable decisions in more recent cases to broaden its base of attack against LIFO elections, whether C-O-C is involved or not.

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