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. DUAL FOCUS. Unlike prior issues of the *LIFO Lookout*, this one has a dual focus. First, the materials on pages 3 through 10 complete the coverage started in our last issue on the components-of-cost LIFO method controversy.

The balance of this issue of the *Lookout* focuses on the changes recently proposed by the IRS and the Treasury to the Inventory Price Index Computation (i.e., the ***IPIC***) method. A bit more follows about each of these.

#2. COMPONENTS-OF-COST: GODZILLA'S OTHER BROTHER IS BACK. As the Table of Contents in the June issue indicated, there was more coverage coming on the components-of-cost controversy. Hopefully, you haven't been waiting for this in any great agony.

The article on page 3 discusses some of the *possible* implications of a case currently on appeal to taxpayers who are using components-of-cost LIFO methods. The Tax Court's decision in *Consolidated Manufacturing, Inc.* is on appeal to 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.

The Appellate briefs filed by the taxpayer and by the IRS/Department of Justice suggest that *Consolidated Manufacturing, Inc.* is a key case to watch for several reasons. ***First***, it is important because of the significant issues it presents in terms of its own fact pattern. ***Second***, it has implications for all other manufacturers using a components-of-cost LIFO methodology. And ***third***, *CMI* has other implications for all other taxpayers using replacement cost to value their parts inventories.

The *Practice Guide* on pages 8 and 9 is for C-O-C users to gauge their exposure if a sharp-eyed IRS agent were to come in and audit their methods and application.

LOOKOUT LOOKS INTO

#3. BLS-IPIC REGULATIONS: PROPOSED CHANGES. On May 19th, the IRS published ***proposed*** changes to the Inventory Price Index Computation (i.e., the ***IPIC***) method. This method is described in Reg. Sec. 1.472-8(e)(3). The IRS and the Treasury intend to simplify and clarify certain aspects of the IPIC method. They also want to modify the computational methodology so that the IPIC method produces a more accurate and suitable inventory price index.

By broadening the applicability of the IPIC method to additional taxpayers, and making the Regulations more user-friendly, hopefully everyone will benefit from a win-win result.

For the first time, we have included an article written by an guest author, Lee Richardson of Legend Software, Inc./LIFO-PRO, Inc. After giving the

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proposed Regulations a quick read-over in Mid-May, I concluded it would be in the best interests of our readers to provide an article written by someone with far more experience than I have in dealing with the IPIC Method. I could think of no one better to evaluate these proposed changes than Lee Richardson, CPA, whom I have known for many years.

As can be seen from the brief summary on page 17, his credentials are excellent and his clientele is an eye-popper.

In our discussion, Lee emphasized that his comments and testimony before the IRS on the proposed Regulations reflect the fact that his experience lies more in the areas of (1) practical application aspects of the mechanics of making LIFO calculations and (2) the problems that occur as companies try to implement IPIC LIFO. Although he professes not to be as expert on the ins and outs of LIFO method changes, inventory transfers, and LIFO-related TAMs, FSAs and court cases, I can assure you he is no slouch in these areas.

Our coverage on these IPIC changes includes a general overview article, a *Practice Guide* of sorts identifying some common errors in applying the IPIC method (borrowed, with permission, from Lee's web site) and Lee's article which evaluates many of the proposed changes from his vantage point as a practitioner who deals full-time exclusively with the intricacies of the IPIC method.

The Common Errors list (on pages 16-17) can be a very useful checklist in reviewing the IPIC work your own firm has done, as well as the IPIC work another firm has done when you take over a new LIFO account where the IPIC method has been used.

In this extraordinarily complex area, any one—or a combination—of these errors can significantly derail LIFO results from what they ought to be. Particular attention should be paid to the errors commonly found in applying the 80% limitation and to the blind use year-after-year of inappropriate procedures after the BLS simply stops compiling information that it was previously tracking. This latter problem was specifically discussed in our coverage of Revenue Procedure 98-49 on page 3 of the September 1998 *LIFO Lookout*.

It may become apparent after reading Lee's article and the related materials that if you are currently working (or struggling) with a client using the IPIC method, Lee could be a valuable consulting resource for your firm.

#4. *MOUNTAIN STATE FORD TRUCK SALES* & THE USE OF REPLACEMENT COST FOR PARTS INVENTORIES. Still nothing new to report on this...but, wait a minute. It's been said that "when you're a hammer, everything looks like a nail." We've been covering *Mountain State Ford* so long that it's hard to see some other new development without inferring some *MSFTS* influence. For example...

Tucked deep in the IRS/Treasury's proposed IPIC changes is a ***new*** Regulation. It says that if a taxpayer uses a LIFO method of accounting other than the IPIC method and the Commissioner determines that the method does not clearly reflect income, the Commissioner may require the taxpayer to change to the IPIC method.

Think about it... Does this sound like it could apply to taxpayers like *Mountain State Ford* and/or *Consolidated Manufacturing, Inc.*??? ...or any of your non-IPIC LIFO clients???

Proposed Regulation Sec. 1.472-8(e)(3)(iv)(C)(2) would give IRS agents even greater leverage to challenge non-IPIC LIFO applications which they believe do not clearly reflect income.

It also provides that "if a taxpayer is unable to provide a sufficient basis, including information from its books and records, to compute an adjustment under Section 481, and the Commissioner requires the taxpayer to change to the IPIC method, the Commissioner will require the taxpayer to change to the *double-extension* IPIC method and implement the change on a cut-off basis *without* a new base year."

Does this sound like it could be a way for the IRS to settle the *Mountain State Ford* issue involving replacement cost without resorting to a complete termination of the taxpayer's LIFO election???

This proposed Regulation gets even worse. (The devil's always in the details.) Do the references to the failure to "clearly reflect income" and to what happens when the taxpayer does not have sufficient books and records sound familiar?

One commentator on the proposed Regulations, Leslie Schneider, really took the IRS to task over this proposal.

There's a lot more to be said about this, and it will be interesting to see what this one looks like in its final form.

IMPLICATIONS FOR TAXPAYERS USING C-O-C METHODS MAY BE LURKING IN THE APPEAL OF *CONSOLIDATED MANUFACTURING, INC.*

The Tax Court's decision in *Consolidated Manufacturing, Inc. v. Commissioner* (111 T.C. No. 1) was discussed in some detail in the September 1998 *LIFO Lookout*. In that case, the IRS, with the approval of the Tax Court, disallowed Consolidated's LIFO election because it had excluded certain inventory from its LIFO election.

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

Consolidated included only ***new*** purchased parts and remanufacturing conversion costs (i.e., labor and overhead cost components) in its LIFO election. The IRS determined that Consolidated's LIFO method of including only ***new*** parts, labor and overhead...and excluding ***used*** parts which comprised substantially all of the total product cost...did not clearly reflect income.

Consolidated was trying to get around the prohibition in the Regulations against taking writedowns on inventory that should have been placed on LIFO. So the Service threw out the LIFO election entirely, and the Tax Court agreed.

Consolidated Manufacturing, Inc. is significant in its own right...because it requires the determination of the definition of the term "*goods*" as that term is used in the regulations. *Consolidated* also has broad significance in another area as it relates to the use of components-of-cost methods by a large number of manufacturers.

As if all of this were not enough, still another parallel exists between this case and *Mountain State Ford Truck Sales* because in *Consolidated,* as in *MSFTS*, the IRS challenged a long-standing, generally accepted industry practice, and the IRS was upheld by the Tax Court. It is neither understatement, nor pun, to say that there are many significant tax issues "consolidated" in *Consolidated Manufacturing, Inc.* And we have not heard the last of this case because Consolidated recently filed its appeal to the Tax Court's decision with the 10th Circuit.

WAS CONSOLIDATED USING A COMPONENTS-OF-COST METHOD?

In the Tax Court, *Consolidated Manufacturing* cited TAM/LTR 9445004 in an attempt to support its contention that it should be allowed to apply the dollar-value LIFO method in the manner it elected for labor and overhead (conversion costs) and only new purchased parts...while excluding used customer cores.

The Tax Court did not agree. In distinguishing its holding in *Consolidated Manufacturing,* the Tax Court said that it is not at all clear from TAM/LTR 9445004 what, if any, of the labor and overhead in question ultimately were allowed to be on, or ultimately were disallowed from being on, the LIFO inventory method when the IRS examined that taxpayer's income tax returns.

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

Recently, the taxpayer and the IRS filed briefs with the Appellate Court in which they argued the extent to which components-of-cost issues should be considered.

CONSOLIDATED'S APPELLATE BRIEF

In its Appellate brief filed in January of this year, Consolidated Manufacturing, Inc. presents four arguments that are related to the components-of-cost issue:

1. Interpretation of the term "goods" does not prevent Consolidated from doing what it did with its LIFO election.

2. The landmark Tax Court decision in *Hutzler Brothers* should be interpreted to support what Consolidated did with its LIFO election.

3. According to *Amity Leather Products* (and other cases), LIFO should be available to "all taxpayers" and the use of components-of-cost methods is widespread.

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4. What Consolidated did is a natural, logical and permitted extension of the method illustrated in the dollar-value LIFO regulations.

Each of these arguments is discussed below.

First, Consolidated attempts to argue that the LIFO methodology it employed should be regarded or considered as a components-of-cost method. Stating that "the components-of-cost method of measuring and valuing inventory is accepted for all financial reporting purposes," Consolidated argues that the widely-used "components-of-cost method is a permitted method of accounting under the Code." As a result, a taxpayer using the components-of-cost method is not precluded from electing the LIFO method for its labor and overhead costs. It argues that "there being absolutely no indication that the term *goods* should mean something different under Section 471 than under Section 472, application of the Tax Court's holding in this case would lead to the unavoidable conclusion that labor and overhead costs may not be inventoried under the FIFO cost flow assumption unless the good or goods resulting from the application of such labor and overhead to raw material are also valued under the FIFO method."

Consolidated argues the point this way:

"For example, if Consolidated elected LIFO for its core inventory only (including cores in raw material inventory, goods in process and in finished goods) under Reg. Sec. 1.472-1(j), its new parts inventory along with all of its labor and overhead would remain on FIFO. However, as made clear by the Tax Court, new parts and labor and overhead do not constitute a 'good' - the goods of Consolidated subject to inventory are the remanufactured automobile parts resulting from the application of labor and overhead to new parts and cores. Accordingly, under the Tax Court's interpretation of the word 'good,' although Consolidated's LIFO inventory under the foregoing example would be a permitted method of inventory accounting, under Reg. Sec. 1.472-1(j), its FIFO inventories (i.e., its new parts, labor and overhead) would not. Such a result is absurd; yet it is necessarily follows from the Tax Court's holding below."

Second, the taxpayer's brief offers the argument that the taxpayer in the LIFO landmark case *Hutzler Brothers Co. v. Commissioner* (8 T.C. 14, (1947)) used the components-of-cost method of measuring and valuing its inventories and that its use of this method eliminated the intermediate step of identifying specific goods and, instead, valued inventories in one step with reference to the units and costs of raw material, labor and overhead therein.

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Consolidated interpreted the Tax Court's action in *Hutzler Brothers* as follows:

"The question presented to the Tax Court for its decision was simply whether identification of specific articles in an inventory is the prerequisite for application of the Last-In, First-Out method. ...In holding that specific identification was not required, the Tax Court rejected as supported neither by logic nor legislative intent, the Commissioner's argument that the use of the term *good* in the predecessor of Section 472 precluded the taxpayer from electing LIFO for anything other than an identifiable good. ...In *Hutzler Brothers*, the Tax Court allowed the taxpayer to adopt the LIFO method for its dollar-value inventories even though the election did not apply to a good or goods and was not, therefore, expressly authorized by Section 472 or the regulations thereunder. The same rationale should be applied by this Court to reverse the decision of the Tax Court."

In developing its "*Hutzler*" analogy argument further, Consolidated's brief adds:

"In its opinion, the Tax Court dismissed the significance of *Hutzler Brothers* with reference to a passage from the opinion suggesting that a manufacturer using the LIFO method would first identify the goods in its inventory and then assign a cost to it using the LIFO cost flow assumption. The two step valuation process presumed to be applicable to the hypothetical manufacturer discussed in *Hutzler Brothers* does not, however, apply to a manufacturer using the components of cost method. A taxpayer who maintains inventories in terms of specific goods must convert those goods into dollars with reference to the number of units and cost of raw material, labor and overhead used to produce them before the inventory can be entered on its books and used in arriving at income. The components-of-cost method (the method used by the taxpayer in *Hutzler Brothers* and by Consolidated) eliminates the intermediate step of identifying specific goods and instead measures and values inventories in one step- with reference to the units and costs of raw material, labor and overhead therein. The significance of *Hutzler Brothers* for this case lies in the recognition by the Tax Court that the LIFO method does not require the specific identification of goods in inventory and, notwithstanding the use of the term "good" in Section 472 and the regulations thereunder, is equally applicable to inventories as to which ascertainment and valuation are a single process."

Third, Consolidated raises a more general argument, namely that it is Congressional intent that the

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LIFO method should be available to "all taxpayers." Here's what it says on this point, citing both *Amity Leather* and Stephen Gertzman's tax treatise:

"Congress intended that the LIFO method be available to all taxpayers required to maintain inventories. For this reason, the courts, and most notably the Tax Court, have allowed flexibility in LIFO inventory matters when to do otherwise would limit LIFO's applicability. The rationale underlying this flexibility is best summarized in *Amity Leather Products Co. v. Commissioner* (82 T.C. 726 (1984):

'...the method of inventory accounting must be administratively feasible and not unduly burdensome from the standpoint of each of the parties. Within limits of reasonableness, regulations governing LIFO inventory accounting have to be applicable across the board. Whether they achieve the best result in a particular fact situation is not controlling.'

"At the time the LIFO inventory method was adopted, 'taxpayers followed generally an inventory system which dealt with specific articles.' ...Today, the practice of measuring the quantity of inventory with reference to units of production (i.e., the amount of raw material, labor and overhead) is widespread. The Tax Court's interpretation and application of Section 472 will, if it stands, deny the availability of LIFO to manufacturers who maintain complex inventories under the component-of-cost method (Gertzman, Federal Tax Accounting, ¶ 7.04[3] at 7-57 (2d ed. 1993).) Consequently, and within limits of reasonableness, Section 472 and the regulations thereunder must be interpreted and applied in a manner to have it apply in general terms to all those coming within its provisions."

Finally, the last components-of-cost argument Consolidated makes in its brief is that its LIFO election to value its new parts inventory and all of its labor and overhead under LIFO "is a natural, logical and permitted extension of the inventory method" illustrated by Regs. Sec. 1.472-1(c) and 1.472-1(j). In support of this position, Consolidated argues that

"The purpose of the LIFO inventory method is to factor out inflationary price increases included in the value of a taxpayer's inventory. (The regulations cited) illustrate the manner in which a manufacturer may elect LIFO for one or more raw materials (including raw materials in goods in process and finished goods) and thereby factor out inflationary price increases with respect to one (and not even necessarily all of one) of three cost components that make up its inventory. Consolidated's LIFO election to value its new parts inventory and all of its labor and overhead under LIFO is a natural, logical and permitted extension of the inventory method illustrated (by the regulations cited)."

IRS' APPELLATE BRIEF

The Department of Justice/IRS filed its brief on March 1, 2000. In the portion of its brief addressing the components-of-cost related issues, the DOJ/IRS argued principally that "The labor and overhead involved in this case are not *goods*. The new parts, labor and overhead involved in this case, when taken together but without customer cores, do not constitute goods. However, the new parts, labor, overhead and customer cores involved in this case, when taken together, do constitute *goods* and are included in and comprise Consolidated's inventories for goods in process and for finished goods."

The Service argues further that ***"there is no provision that authorizes a taxpayer to elect to use LIFO as to merely a portion of a good that is not limited to raw materials.*** But, that is what Consolidated has done." It adds that "significantly, Consolidated cites no authority that would authorize its purported LIFO election. Rather, it relies on its unsupported assertion that its 'LIFO election' to value its new parts inventory and all of its labor and overhead under LIFO is a natural, logical, and permitted extension of the (raw material content) inventory method illustrated by Reg. Sec. 1.472-1(c) and 1.472-1(j)...Reg. Sec. 1.472-1(c) permits an election to apply the LIFO method to raw materials only, and ***we are unaware of any authority that permits the 'extension' of the raw materials content method beyond the parameters specified in that regulation."***

In addition, the IRS raises several other significant challenges to Consolidated's LIFO treatment and its component-of-cost related arguments. These IRS challenges reflect the most recently expressed IRS positions relative to components-of-cost, and accordingly, are worth careful review.

First, the IRS argues that the LIFO election that Consolidated Manufacturing, Inc. made in 1980 to use a natural business pool and its further election to use the IPIC or Inventory Price Index Computation simplified method required it to include all cost elements in that single pool. This "improper pooling" issue, simply stated, revolves around the fact that Consolidated's exclusion of its cores or materials from its LIFO elections violated the requirements that every item that would be properly includible in the natural business unit pool must be valued using the LIFO method.

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Implications for Taxpayers Using C-O-C

Consistent with that, the IPIC method (which is essentially a product-based measure of inflation) includes within the producer price indexes computed factors reflective of the cost changes of all raw materials, all labor and all overhead necessary to produce goods. Accordingly, Consolidated's 1982 LIFO election which specifically excluded used engines and parts, cores from the LIFO method render its use of the IPIC method inappropriate.

Second, the LIFO methodology employed by Consolidated was in violation of Code Section 472(b)(2) and Reg. Sec. 1.472-2 and 1.472-8. This was because under Consolidated's LIFO methodology, work-in-process and finished goods inventories included new parts and reconditioning costs that were accounted for using LIFO and were valued at cost. However, cores were accounted for using FIFO and valued at the lower of cost or market, a result which "is clearly impermissible under the LIFO method."

Third, relative to the disagreement over the interpretation of the term ***good*** or ***goods***, in its brief, the IRS argues that Consolidated ignores the reference in the regulation that concludes with the words "but, see Section 472 as to Last-In, First-Out inventories." This reference suggests that the rule is different where LIFO inventories are concerned and emphasizes that the raw material content method is a method of LIFO accounting authorized by the regulations under Section 472. In this regard, the IRS' brief states: "***The Code and regulations do not authorize the use of the FIFO method as to raw materials that are incorporated into work-in-process and finished goods inventories that are accounted for under the LIFO method. Consolidated may find this asymmetry to be irrational, but it nevertheless exists under the regulations.***"

Fourth, the IRS argues that "it is well established that an administrative agency's interpretation of its own regulations is entitled to substantial deference. ... The Commissioner interprets the regulations at issue here as, among other things, not permitting a taxpayer to elect to use the LIFO method of accounting for its inventories of specified goods while using the FIFO method to account for all or part of the raw materials that become part of such goods."

Fifth, the IRS brief states that it is the Service's position that Consolidated did not, as a procedural matter, properly raise the "components-of-cost" method argument before the Tax Court. Accordingly, the Tax Court did not specifically address the components-of-cost method issue because Consolidated Manufacturing, Inc. did not raise it for consid-

(Continued from page 5)

eration there. Having said that, the IRS adds the following: "Assuming arguendo, that labor and overhead may be deemed to be inventoriable 'goods' in their own rights, as Consolidated evidentially contends, such labor, overhead and new parts–i.e., the items that constitute part of Consolidated's inventories of work-in-process and finished goods as to which Consolidated elected the LIFO method–do not, in combination, constitute 'goods' without the cores to which the labor, overhead and new parts are applied. But, Consolidated excluded the cores from its LIFO election, and therefore, it did not elect LIFO as to 'goods.'"

The Service adds further that Consolidated could have elected to use the permissible raw material content method. However, it did not elect to do so. Accordingly, the Tax Court's opinion did not address what may or may not be required or permitted by the raw material content method. That should be considered as irrelevant in dealing with the *Consolidated* case on appeals.

Sixth, the IRS introduces or adds another interesting challenge. This is that Consolidated failed to show that using the components-of-cost method compels the use of the improper LIFO method that Consolidated seeks to use here.

Seventh, in arguing the irrelevancy of the *Hutzler Brothers* case, the IRS says tersely, "The authority upon which Consolidated principally relies provides no support for its position." In stating that "there's no longer any dispute about the permissibility of dollar-value LIFO," it says that "Consolidated evidentially attempts to make *Hutzler Brothers* seem similar to the instant case by repeatedly asserting" that both Consolidated and Hutzler Brothers "use the components-of-cost method in measuring and valuing inventories." The Service argues that this assertion is incorrect and adds, "as the Tax Court noted, the taxpayer in *Hutzler Brothers* in fact used a retail method of valuing its inventory, a method quite different from the components-of-cost method."

Finally, in its brief, the IRS points out that although Consolidated Manufacturing attempted to argue that the Commissioner should be prevented from changing its method, the Tax Court, in *Peninsula Steel Products & Equipment v. Commissioner* (78 T.C. 1029), held in favor of the taxpayer solely on the basis that the Commissioner's authority under Section 446(b) to determine whether an accounting method clearly reflected its income does not authorize the Commissioner to compel a taxpayer to change from a ***permissible*** method of accounting that clearly reflects income in accordance with the

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regulations to another permissible method that the Commissioner might prefer. The IRS brief notes that Consolidated's implementation of LIFO was not a permissible method and, accordingly, as such does not clearly reflect income in accordance with the regulations. Based on that logic, the Tax Court decision in *Peninsula Steel* would have no bearing on the issues being considered in the *Consolidated Manufacturing* appeal.

CONSOLIDATED'S REPLY BRIEF

In responding to the IRS' brief, Consolidated filed its reply brief on March 31, 2000. This brief essentially repeats its previous generalized arguments, with some minor adaptation to address some of the points in the IRS' brief.

In its reply brief, Consolidated argues that the Commissioner should not be able to limit or deny a taxpayer's right to make a LIFO election when, in so doing, it is attempting to promulgate a regulation adding provisions that he believes Congress should have included, but did not. Consolidated also argues that, in essence, it had selected a single miscellaneous pool, consistent with the dollar-value LIFO regulations, in an effort to counter the natural business unit pooling challenge raised by the IRS.

Citing the letter from former IRS Commissioner, Shirley Peterson to the AICPA in 1992, Consolidated contends that in light of "the Commissioner's public statements regarding the LIFO method used by Consolidated," it was an abuse of discretion for the Commissioner to refuse to exercise his authority under Reg. Sec. 1.472-3(c) to require Consolidated to include additional goods in its LIFO election, if, ultimately, the inclusion of cores in the LIFO election is found to be essential to the clear reflection of income.

In arguing that its LIFO election should not be terminated as a consequence of its adoption of an improper LIFO methodology, Consolidated states: "The penalty sought to be imposed by the Commissioner is in the form of requiring Consolidated to not only recalculate its income from 1980 with all of its information on FIFO but, in addition, requiring Consolidated to include all of the income resulting from such recalculation in one year. Whether intentionally or in the interest of what he considered to be sound tax administration, ***the Commissioner seeks to punish Consolidated for having made a good-faith interpretation of Section 472 that, depending on this Court's decision, may or may not turn out to be incorrect.*** Such a penalty is not authorized by the statute, and this Court should so hold."

In the final analysis, with respect to the jeopardy in which Consolidated's LIFO election now lies, Consolidated argues that the Appeals Court should find, as a matter of law, that its election to use the LIFO inventory method was valid and that the Commissioner abused his discretion in terminating Consolidated's LIFO election. Alternatively, it argues, if the Appeals Court affirms the Tax Court's interpretation of Section 472, then Consolidated argues that the Commissioner's determination to terminate its LIFO election without first allowing a "reformation of the election" should be found to be invalid as an abuse of the Commissioner's discretion.

WHILE AWAITING THE OUTCOME

The implications of the holding in this case by the Tax Court–and eventually in the Appeals Court–could have significant ramifications to taxpayers using various components-of-cost LIFO methods. However, it should be noted that ***one very simple possibility is that the confrontation over the components-of-cost method issue might simply be side-stepped by the Appeals Court*** if it accepts the IRS argument that the issue was not properly raised as a procedural matter before the Tax Court.

Similarly, there could be a number of reasons the Appeals Court might adopt to justify limiting its focus to issues *other than* the components-of-cost arguments that *Consolidated* has attempted to raise and the IRS has attempted to rebut.

Accordingly, one possibility is that there simply will be no showdown on the so-called components-of-cost issue as *Consolidated* moves further in the courts. For a thorough analysis of this case, in terms of its components-of-cost implications, the Selected References for C-O-C on page 10 include both Stephen Gertzman's treatise and Leslie Schneider's.

In this regard, the February 1999 issue of the *Journal of Accountancy* included an article by Professor W. Eugene Seago entitled "Scope and Viability of the Election Are the Focus of New LIFO Decision From the Tax Court." In his article, Professor Seago warns:

"It seems inevitable that the components-of-cost issue will heat up as a result of (*Consolidated Manufacturing, Inc.*). Those taxpayers currently using that method should prepare for a challenge and should consider a voluntary change in methods under Rev. Proc. 97-27. The change should be considered a change in LIFO methods and should not result in a Section 481 adjustment, but only if the change is made voluntarily. If the voluntary change is not feasible, the taxpayer should be prepared to convert the components-of-cost data into NBU pools with unit costing for the inventory items, and thus minimize the consequences of an involuntary change."

CONSIDERATIONS IN EVALUATING EXPOSURE WHERE COMPONENTS-OF-COST METHODS ARE USED

COMMENTS

1. In what year was the LIFO election made? ________
   - Are explanations and descriptions of the C-O-C methodology attached to the Form 970?
   - How complete and accurate were those explanations and descriptions of the C-O-C method then in use?
   - How accurate are those descriptions in terms of the C-O-C method currently in use today?
2. Under the taxpayer's Components-of -Cost LIFO election, are raw materials, labor and overhead treated as separate ***"items"*** in the dollar-value LIFO calculations?
3. When the C-O-C LIFO election was made, was the taxpayer/client advised that the use of C-O-C methods for tax purposes is a very controversial issue with the IRS?
4. At that time when the taxpayer/client made its C-O-C LIFO election, was the taxpayer/client advised of the IRS C-O-C position as expressed in GCM 38478?
5. When Revenue Procedure 92-20 was issued in March, 1992, was the taxpayer advised at that time to consider changing from its C-O-C method to the total product cost method?
   - If no, why not?
   - If yes, what action was taken?
6. Have there been any IRS audit examinations involving the taxpayer's use of the C-O-C LIFO method?
   - What year/years were involved?
   - How deeply did the IRS agent(s) investigate the specifics of the application?
7. Has the taxpayer/client been made aware that an IRS agent can come in at any time and not be bound by the fact that a previous IRS agent accepted the taxpayer's C-O-C method in an earlier audit (i.e., that an agent might now be able to require the taxpayer to change from its present C-O-C method)?
8. Have any of the following developments or/events occurred or been reflected in the taxpayer's inventory products since the year when the LIFO election was made (or the year since the last Form 3115 was filed)?
   - Technological changes
   - Production efficiencies
   - Changes in location of manufacturing operations
     - Relocation to another state within the United States
     - Relocation to other countries in the world

Describe these developments, events and/or changes in detail.

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COMMENTS

9. Has the base-year cost used in repricing a current-year inventory ***item*** ever been ***less than*** the base-year cost in the initial base year of the LIFO election?
Note: the IRS position is that this should not happen: i.e., the Service position is that base-year cost used in calculating the dollar-value of a LIFO pool should never be lower than the initial base-year cost.

10. Is the taxpayer/client able to demonstrate that the C-O-C method it is using produces ... or at least closely approximates ... the same result as the result that would be obtained if the ***total product cost method*** were used?

11. Does the taxpayer have ***adequate books & records*** to support the alternative LIFO calculations described above?
    - How do you know?
    - Are the taxpayer's books and records adequate for all (each of) those years?
    - If not, explain any shortcomings or deficiencies in detail

    ____

    ____

    ____

12. Has consideration been given ***recently*** to filing a Form 3115 requesting permission to change from the C-O-C method to the total product cost method?
    - If so when?______________________
    - What conclusions were reached?______________________

      ____
    - How, where and in whose files are these conclusions documented?______________________

      ____

      ____

13. Do the taxpayer's Component-of-Cost LIFO calculations follow the pattern below?
Note: If the LIFO inflation index for the later year reflects (earlier) base year costs ***(B)*** multiplied by that later year's units of production ***(A)***, the IRS may take the position that the result under this method does not ***clearly reflect income***.

BASE YEAR

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

LATER YEAR

Material	1 unit @	$ 2.50	=	$ 2.50
Labor	1 unit @	8.00	=	8.00
Overhead	1 unit @	1.50	=	1.50
	(A)			$ 12.00

PRICE-INDEX FOR THE LATER YEAR

1 unit	@	$ 2.00	=	$ 2.00
1 unit	@	5.00	=	5.00
1 unit	@	1.00	=	1.00
(A)		*(B)*		$ 8.00

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AN OVERVIEW OF THE PROPOSED CHANGES TO THE IPIC LIFO REGULATIONS

SOME BACKGROUND

In general, under the IPIC method, LIFO users are allowed to borrow the inflation or deflation indexes compiled and published by the U.S. Bureau of Labor Statistics. Under this 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.

However, most taxpayers 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 or haircut. This haircut has been a major deterrent to many taxpayers when they consider adopting the IPIC method as an alternative to computing their own (internal) price indexes.

Under the IPIC method, the inventory items in each pool are classified according to the detailed listings in the appropriate tables of either the Consumer Price Index or Producer Price Index. The inventory items are assigned to various categories, and index categories are assigned to a pool or pools. Published indexes and weights are used to compute the appropriate index ***for each index category***. After that, an index is computed for the pool.

The Commissioner will (1) accept the IPIC method as an ***appropriate*** method for computing LIFO indexes and (2) accept the results obtained under the IPIC method as being ***accurate, reliable and suitable***.

The key to properly using the IPIC method is that in computing the overall index for a pool, the taxpayer must weigh the appropriate indexes for the separate index categories comprising the pool according to the taxpayer's actual inventory weights for such separate index categories. Any practitioner working with the IPIC Regulations quickly finds that they are anything but "simple" to work with.

Generally speaking, many practitioners and IRS agents do not understand all of the nuances of the IPIC Regulations. Practical implementation problems are often approached from the standpoint of simply doing the best that one can working with the information available and the recordkeeping procedures currently in place in the business. Often, either or both of these could be—or should be—substantially improved.

Despite all of this, the IRS generally prefers that taxpayers on LIFO use the IPIC method. The reason for this IRS preference is that taxpayers can't bias or tinker with the computation of the inflation indexes because those are computed directly by the Bureau of Labor Statistics.

The recent proposed changes to the IPIC Regulations were published on May 19, 2000 and are found at 65 FR 31841(-853). Some corrections of a very minor nature were subsequently added.

The discussion of the proposed changes in the Federal Register provides an excellent primer on the intricacies of the IPIC method. These discussions explain and interpret what the Regulations in their present form now require. This is followed by a discussion of the proposed changes, along with reasons for proposing the changes.

When enacted, these changes to the proposed Regulations will become effective for taxable years beginning on or after the date they are published in the Federal Register as ***final*** Regulations.

ELEVEN MAJOR AREAS OF CHANGE

The proposed changes fall under eleven general categories. Each is briefly summarized below.

1. Elimination of Requirement to Use 10 Percent Categories and BLS Weights. The proposed Regulations would eliminate the current requirement to use 10% categories and BLS weights to determine an appropriate index. Instead, they would require a taxpayer to classify its inventory items into the most detailed index category listed in the *CPI Detailed Report* or the *PPI Detailed Report*. For purposes of computing a weighted average pool index, the weight assigned to each selected index category would be the relative current-year cost of the items in that category.

Some commentators on this proposed change felt that taxpayers should be allowed to continue to use the 10% categories if they have already been using them and have not found the current requirement to be onerous.

2. Weighted Harmonic Mean for Computing Pool Index. The proposed Regulations would require that the only acceptable method of computing a weighted average pool index using relative current-year cost of items in ending inventory would be a computation using the weighted *harmonic* mean. This is completely different from the weighted *arithmetic* mean approach that most taxpayers have been using for many years.

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 (Continued from page 11)

The new requirement to impose the weighted *harmonic* mean calculation is exactly the opposite of the holding in Field Service Advice 200004008 discussed in the March 2000 *LIFO Lookout*. In this FSA, the IRS allowed the taxpayer to use a weighted *arithmetic* mean developed from the end-of-the-year inventory values in its calculations.

Most commentators on this proposed change said that the difference between the results under the two methods usually is, or would be, immaterial. Therefore, they felt requiring a new procedure to replace one that almost everyone is already using was not necessary.

3. Double-Extension or Link-Chain Method of Index Computation. The proposed Regulations would specifically permit the use of either a *link-chain* or a *double-extension* methodology in connection with computations under the IPIC method. This proposed change would be consistent with a second holding in FSA 200004008, where this question had been raised.

The proposed Regulations include two examples that show how to compute these indexes.

4. Selecting Indexes as of an Appropriate Month. The proposed Regulations would clarify that, for each dollar-value pool, a taxpayer should either (1) annually determine the month most appropriate to its method of determining the current-year cost of the pool or (2) make a one-time election of a representative appropriate month for the pool.

The discussion in this case states that: "The principles of Revenue Ruling 89-29 continue to apply for purposes of determining whether a particular month is appropriate or representative." Under Rev. Rul. 89-29, a month is an appropriate representative month if there is a nexus between (1) the selected month, (2) the taxpayer's method of determining current-year cost, and (3) the taxpayer's historical experience of inventory purchases. This reference back to the principles of Rev. Rul. 89-29 unfortunately leaves the whole issue in a state of lesser clarity than would be achieved if some more definite rules were provided.

It would appear that what this change is really all about is whether taxpayers using the IPIC method can achieve further LIFO deferral benefits by using an earliest acquisitions approach (commonly resulting in a dual-index technique). This is what question 6(b) on Form 970 is all about.

5. Taxpayers Eligible to use "Department Store Inventory Price Indexes." The proposed Regulations would eliminate some of the eligibility restrictions which currently prevent certain taxpayers from using the IPIC method. They would allow a taxpayer eligible to use "Department Store Inventory Price Indexes" to elect to use those indexes for LIFO inventory items that fall within the 23 major groups listed in "Department Store Inventory Price Indexes" and to use the IPIC method for the remainder of its LIFO inventory items. Alternatively, the taxpayer could elect to use the IPIC method for all of its LIFO inventories.

This is a liberalization of the IPIC general requirement that a taxpayer using the IPIC method must apply it to all of its inventories on LIFO.

6. Selection From "CPI Detailed Report" or "PPI Detailed Report." The proposed Regulations would eliminate the need for a retailer to determine whether the "CPI Detailed Report" and the "PPI Detailed Report" contain *equally appropriate indexes*. Instead, the new IPIC Regulations would lay down a hard and fast rule: Retailers using the retail inventory method would select indexes from the "CPI Detailed Report," and all other taxpayers would be required to select indexes from the "PPI Detailed Report."

7. Elimination of Requirement to Convert Published Indexes into Retail Price Indexes or Cost Price Indexes. The IRS and the Treasury concluded that the administrative burden of converting published indexes into retail price or cost price indexes outweighs any benefit of increased accuracy from such a procedure. Therefore, the proposed Regulations would eliminate the current requirement to convert published price indexes into either retail price indexes or cost price indexes. Although this change eliminating the conversion requirement seems to be highly desirable, it could cause considerable transitional difficulties for certain taxpayers.

8. Relocation and Clarification of Special Pooling Rules. In general, the proposed changes in this area provide special, elective pooling rules for IPIC LIFO inventories. Although more detailed rulings are provided, there still exists a need for more clarification than is given.

9. Clarification of the Definition of "Eligible Small Business." This clarification would simply coordinate the language in the Regulations with the average annual gross receipts requirement of $5 million found in Section 474(b).

The real issue, of course, is that $5 million is far too small an amount to make this a meaningful benefit except for a handful of small businesses.

10. New Base Year for IPIC Method Changes. The proposed Regulations would address situations where taxpayers voluntarily requested permission to change to the IPIC method. They would also address →

situations where the change to the IPIC method was not voluntarily made by the taxpayer. Where the change to the IPIC method is not voluntary, examining agents would be given considerable latitude on how the change would be made. This could be a real concern for many taxpayers (i.e., those non-IPIC LIFO users who might be forced to change to the IPIC method by an aggressive agent.)

11. Inventories Received in a Nonrecognition Transaction. These changes are very important to practitioners involved with clients who are moving business assets around, or are involved with tax-free corporate mergers, reorganizations and Section 351 exchanges and/or transfers.

In this regard, the IRS has proposed a series of changes that would only apply to certain transferees, i.e., those using the dollar-value method for LIFO inventories that were received in a ***non***recognition 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 the new base year cost for that inventory for purposes of determining future increments and liquidations.

All of the commentators on this part of the proposed changes essentially felt that the IRS is "doing the right thing" with these changes. However, as one might expect, their comments suggested that the IRS could always be doing more.

PUBLIC HEARING & COMMENTS

A public hearing on these proposed IPIC Regulation changes was held on September 15, 2000 at the IRS Building in Washington, DC. At that hearing, five interested parties presented their views.

Lee Richardson of Legend Software, Inc. emphasized the contrast between defining simplicity in terms of IPIC calculation math versus creating additional data gathering burdens and requirements for existing IPIC users. For many of his retailer clients, simplifying the math would subject them to greater information gathering burdens. Therefore, he urged that the new Regulations allow current users the options of continuing to use their current approaches, since they already had adapted their internal record gathering procedures to these requirements. In short, he urged that the data gathering requirements not be made more onerous simply in order to make the IPIC calculations more accurate.

Leslie Schneider of Ivins, Phillips & Barker devoted most of his comments to problems taxpayers might face as a result of lack of guidance so far from the IRS on what constitutes "appropriate books and records" where LIFO inventories are involved. He expressed concern in both written and oral comments that the change proposed in Regulation Section 1.472-8(e)(3)(iv)(C)(2) could become a real nightmare for many LIFO taxpayers in surreal audit situations. (See Update item #4 on page 2.)

He surmised that this proposed change is designed to provide a less drastic alternative than termination of a taxpayer's LIFO election in circumstances where an agent might take the position that the taxpayer's current LIFO methodology fails to clearly reflect income. The broad grant of authority given to examining agents by the proposed Regulations under these circumstances could simply be an incentive to many agents to take a hard-line approach on audit in forcing LIFO taxpayers to change over to the IPIC method. Although not specifically mentioned by name, the recent Tax Court cases of *Mountain State Ford Truck Sales* and *Consolidated Manufacturing* readily come to mind as already-proven examples of disastrous situations for LIFO taxpayers.

The American Institute of Certified Public Accountants IPIC Task Force expressed concern that one year may be insufficient to allow a taxpayer to successfully make the necessary changes to comply with the new IPIC regulations in a timely and efficiently manner. Accordingly, the AICPA proposed that taxpayers be permitted to implement the final Regulations using a transitional rule that allowed a change for the taxpayer's first or second taxable year beginning after the Regulations' effective date under the automatic consent procedures under Revenue Procedure 99-49.

Another area the AICPA addressed was the requirement that a taxpayer that wishes to use the IPIC method must elect to do so to determine the value "of all goods for which the taxpayer has elected to use the dollar-value LIFO method." Although the proposed Regulations would allow a limited exception for certain department or specialty stores that used "Department Store Inventory Price Indexes," the AICPA felt that was not enough.

According to the AICPA, the "all-or-none" requirement is needlessly restrictive and it is inconsistent with Section 446(d) which allows a taxpayer engaged in more than one trade or business to use different methods of accounting for each trade or business. The AICPA pointed out that often taxpayers using dollar-value LIFO methods have several trades or businesses with significantly different types of inventory, and those taxpayers may want to volun-

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tarily change one trade or business to an IPIC method in order to avoid audit controversies, while retaining a non-IPIC method for inventories in a separate trade or business.

Deloitte & Touche expressed some sentiments echoed by most of the other commentators, as well: "There are several provisions in the proposed Regulations that may have unintended consequences. There are other provisions...that can be simplified in a manner that strikes a proper balance between increasing the accuracy of the IPIC method on the one hand and simplifying the method on the other."

PricewaterhouseCoopers' comments are of interest in at least three respects. First, PWC was the only one to urge that the proposed effective date for the Regulations be moved up to include, at the option of the taxpayer, taxable years "ending on or after" the date when the Regulations are published in the Federal Register as final Regulations.

Second, PWC urged the IRS and the Treasury to consider eliminating the 20% haircut which it cited as a major deterrent to using the IPIC method. Third, it submitted considerable comment on the provisions addressed to inventories received in certain nonrecognition transactions.

JK Holt & Associates. Finally, one written submission commenting on the proposed Regulations was more critical of the IRS than were the others. In Jeremy Holt's submission on behalf of JK Holt & Associates, he stated:

"While certain amendments provide much needed clarity, we believe that others make the method more difficult for many taxpayers. As a result, some taxpayers will be unable to comply with certain requirements and thus be unable to use the IPIC method." He added that "the proposed Regulations appear to conflict with the goal of simplicity by removing several simplified procedures that were included in the original Regulations."

According to Mr. Holt, the newly proposed Regulations would actually "revert back to the original proposals that were thought to be too difficult at the time."

He added: "We believe it is dangerous to assume that accounting systems have improved to such an extent that the difficulties no longer exist. While certain proposals may be attractive from a theoretical standpoint, they impose undue burdens the method was designed to remove."

WHAT SHOULD YOU DO?

For any serious IPIC LIFO practitioner, just reading the proposed Regulations and supplementary explanations in the Federal Register is only the starting point. Studying articles in current publications describing the proposed IPIC LIFO changes, such as the recent article by Eugene Seago (mentioned in the *Selected References*) will barely get you to first base.

Here's what else we think should be done. Obtain copies of all of the written submissions to the IRS on the proposed Regulations and obtain a copy of the transcript of the hearing on September 15. Then study those proposed changes which are most critical to your most specific IPIC LIFO clients. Study these proposed changes and all of the comments directed to them in light of the controversy and discussion each one generates. The written comments vary in length and in specificity with respect to sections of the proposed Regulations they are addressing. For example, the issue of work in process and how it should be related to finished goods could be critical for manufacturers, while being of absolutely no interest to retailers.

The views of those who testified at the IRS hearing on the proposed changes...or who submitted written comments...describe many of the practical problems that lie below the tip of the iceberg. While the proposed IPIC changes may provide some "welcome relief" for certain taxpayers, they might be onerous for others.

It may be advisable to hold off committing yourself to a client on any major decisions relative to these proposed changes, since some proposals may be modified along the way and finalized with different provisions based on input the IRS has now received.

IS THE GLASS HALF-FULL OR HALF-EMPTY?

The consensus seems to be that the proposed changes, as drafted, go a long way towards making the IPIC method more user-friendly to more businesses. However, as drafted, there are many areas where either further changes should be made or certain proposed changes should be modified.

Let's contrast the optimism towards these proposed changes, as expressed by Eugene Seago, with the pessimism as expressed by Jeremy Holt.

According to Mr. Seago, "The IPIC method as revised by the proposed Regulations should achieve wide-spread use. The changes should prove to be one of the most important developments in inventory accounting since the dollar-value LIFO Regulations were finalized in the early 1960s."

On the other hand, according to Mr. Holt:

"We believe a decision should be made to either make the rules simple or accurate because ***the proposed rules accomplish neither of these goals.***"

see **OVERVIEW OF PROPOSED CHANGES TO IPIC REGULATIONS**, page 24

AN EVALUATION OF THE CHANGES PROPOSED BY THE IRS TO THE IPIC LIFO REGULATIONS BY LEE RICHARDSON, CPA

IPIC GUEST AUTHOR

The IRS issued proposed IPIC LIFO Regulations (Reg.-107644-98) under Reg. Sec. 1.472-8(e)(3) on May 19, 2000. Our Company (Legend Software, Inc. d/b/a LIFO-PRO, Inc.) submitted written comments regarding these proposed Regulations and made oral comments at the IRS hearing in Washington, D.C. on September 15, 2000.

The purpose of this article is to provide a synopsis of the changes in IPIC LIFO Regulations proposed by the IRS and the reasons we believe the changes are being proposed. The article will also evaluate the desirability of these changes and other possible changes we believe should be considered consistent with the stated purpose for the proposed Regulations.

The stated purpose of these proposed Regulations is to "...simplify and clarify certain aspects of the IPIC method as well as to codify the computational methodology so that the IPIC method produces a more accurate and suitable inventory price index."

The current Regulations were issued in 1982 in an attempt to provide a means for many more dollar-value LIFO taxpayers to take advantage of tax savings afforded by use of the LIFO method. Rev. Proc. 84-57 was issued in 1984 to clarify several of the provisions of the IPIC LIFO Regulations. The primary attraction of this new method was that IPIC provided a vehicle for taxpayers other than those eligible to use the BLS Department Stores indexes to use external published indexes. Compilation of internal indexes is a daunting task for many companies and the work required to do this kept many companies, particularly small ones, from attempting to use LIFO.

The current Regulations are intimidating to taxpayers and CPAs not having extensive IPIC LIFO experience and are badly in need of improvement. The rate of error in using this method is so great that it is virtually impossible to find a taxpayer's IPIC LIFO calculations that do not contain errors. (Note: In this regard, see pages 16-17 for some of the *Common Errors in Applying the IPIC Method.*)

This situation provided the impetus for our Company's decision to spend a considerable amount of time to develop an IPIC calculation module within our LIFO-PRO LIFO calculation software. One could attribute many of these errors to the lack of experience of those making the calculations, but with such a high incidence of errors, much of the blame must be assigned to the lack of straightforward guidance provided by the current Regulations and Rev. Proc. 84-57.

The common critiques of the current Regulations and Rev. Proc. 84-57 include:

- Certain aspects of the Regulations are ambiguous,
- Issues involved in many calculations are not addressed,
- Comprehensive examples of calculation math are not provided and those included are poor, and
- Certain provisions make sense for companies in certain industries but not for others.

Given this situation, changes to the current IPIC LIFO Regulations are sorely needed and the IRS has taken an important step to address this problem. The LIFO inventory method is an important part of the U.S. tax code and hundreds of billions of dollars of inventory are valued using this method. It is important that the income tax Regulations for this method are comprehensive and address the stated purpose for the changes.

1. Elimination of Requirement to Use 10 Percent Categories and BLS Weights

The existing IPIC LIFO Regulations provide for the use of 10 Percent Categories and BLS Weights of Relative Importance to reduce the data gathering requirements of certain taxpayers, primarily retailers. There are over 200 CPI and over 3,500 PPI Table 6 index categories and many taxpayers have great difficulty in sorting their inventories by the most detailed index categories.

Retail grocers are a good example of this type of situation. Very few of these companies' inventory systems account for cost by item or stockkeeping unit (SKU) for store inventories. They have traditionally used variations of the Retail Inventory Method in which retail dollars are grouped by a dozen or so departments. Purchases at both retail and cost and markups and markdowns are accumulated for these departments and these departments' cost complements of the gross markon percentages are used to

see **CHANGES PROPOSED BY THE IRS TO IPIC**, page 18

COMMON ERRORS IN APPLYING THE IPIC METHOD

Lee Richardson, CPA reports that in his LIFO consulting for businesses using the IPIC/BLS Index Method, "We find errors in about 75% of our data conversions in the non-IPIC data for clients previously using (their own) LIFO spreadsheets...and we have yet to review an IPIC LIFO calculation that was done correctly in all respects." Below is a summary of the more common errors he has encountered.

INDEX & BLS WEIGHTS ERRORS

Wrong indexes or BLS weights looked up. The typical supermarket chain's IPIC calculation, when performed correctly, will make use of approximately 60 (30 current year & 30 prior year) CPI indexes and 20 BLS Weights. This is a total of 80 numbers to be looked up, and there is almost always at least one error in looking up these indexes.

Wrong indexes or BLS Weights categories used. An example of this error is use of the Alcoholic beverages CPI category. This category includes Alcoholic beverages away from home as well as Alcoholic beverages at home. The former is not a commodity only price index and should not be used.

Incorrect 10% test rollups. Spreadsheets cannot handle the logic necessary to deal with situations where category indexes are to be calculated based on the 10% test being met when this level changes in subsequent years because of inventory mix changes. As a result, category indexes are often calculated at the wrong level.

Incomplete accounting of items actually present in inventory. A good example of this error is often seen for supermarket chains in their Apparel commodities inventory. Because the Apparel dollars are substantially less than 10% of total inventory, only the total Apparel commodity dollars need be gathered. Most large supermarket chains carry only a few of the Apparel commodity categories in inventory, so only the CPI indexes and BLS Weights for those categories should be used for the Apparel commodities index category index calculation. The shortcut commonly used, in error, is to use the overall Apparel commodities index rather than the correct weighted average. For many companies, the proper accounting of items actually present in inventory and calculation of BLS weighted average indexes is made correctly for Food and beverages and other high dollar pools but is handled incorrectly for inventory classifications with relatively small dollar balances.

Use of Double-Extension Method. Virtually all retailers and wholesalers use the Link Chain method whereby cumulative indexes are calculated based on successive years' current inflation index calculations. Link Chain taxpayers' IPIC index calculations should be made using the current year index, for the index month, divided by the prior year index for that month. If the calculation is made using the new IPIC base year as the denominator, the result will be, in effect, the use of the Double-Extension Method which is not appropriate for a Link Chain Method taxpayer.

Changes in makeup of CPI or PPI categories. There was a substantial restructuring by the BLS to CPI categories in January, 1998. This change made it impossible for companies having year end months other than December to calculate annual inflation rates in the normal manner. Despite the fact that Rev. Proc. 98-49 was issued to specifically address this situation, very few taxpayers accounted for this situation correctly.

There are also frequent changes to the PPI Table 6 categories with new categories added and deleted on a monthly basis. Many taxpayers use the same categories year after year without determining whether indexes are still compiled for the categories used or whether they have inventories in categories added since the prior year end.

MATH ERRORS

Cost Complement application errors. Various spreadsheet formula errors are common. Using LIFO in conjunction with the Retail Inventory Method considerably complicates the calculations because the retail dollars must be reduced to cost using a cost complement calculated specifically for the LIFO calculations. Calculation of the LIFO provision also involves the stock ledger cost complement. These additional complications within the overall LIFO calculations make it very dangerous to attempt to do these calculations without using professional software.

Weighted average indexes. Various spreadsheet formula errors are common for both levels of index calculations, the BLS Weighted averages to calculate indexes for index categories and for the dollars weighted average pool indexes.

Reduction of indexes to allowable 80%. The IRS Regulations specify that the reduction of IPIC indexes to 80% of the CPI or PPI inflation is to be made to the cumulative amount of inflation (at 100%) since the adoption of the IPIC method. Many companies reduce the current year's inflation index to 80% instead. This causes an understatement of the IPIC cumulative indexes that is small at first (and there is no difference the first year IPIC is used) but grows to cause significant LIFO reserve understatements over time.

OTHER ERRORS

Errors commonly found in analysis of ad hoc "LIFO spreadsheets".

- Formulas are not set up correctly.
- Formulas are not applied consistently from year-to-year.
- Section 263A UNICAP costs are not correctly applied to the different years' LIFO layers.

Source: Legend Software, Inc., d/b/a LIFO-PRO, Inc., 337 S. 103rd Street, Omaha, NE 68154, Phone: (402) 330-8573

 (Continued from page 15)

reduce retail departmental inventories to their estimated cost.

The use of the 10 Percent Categories allows these companies to sort their inventory by less detailed CPI or PPI categories. For example, using the 10 Percent Categories, a retail grocer only needs to accumulate dollars for the less detailed *Meats, Poultry, Fish & Eggs* CPI category rather than for the 14 most detailed categories that comprise this less detailed category. This is because none of these 14 most detailed categories will exceed 10 percent or more of total inventory. Even if a company could accumulate their inventories for the 14 most detailed categories, the inventory mix used to calculated the weighted average category index is based on the BLS Weights of Relative Importance rather than the taxpayer's actual dollars.

If a taxpayer carries goods for all of these 14 most detailed categories, the aggregate *Meats, Poultry, Fish & Eggs* index is used. Even if the taxpayer did not stock goods in all of the 14 most detailed categories, they need not accumulate inventories for the most detailed categories for which they carry inventory because they will only use the BLS Weights and indexes for the CPI or PPI categories they carry in inventory. They simply need to make an accounting of which of the CPI or PPI categories are included in their inventories.

This method allows grocery retailers using CPI categories to accumulate their inventory dollars for approximately 20 less detailed categories rather than the 100 or more most detailed categories they typically carry inventory for. Under this provision of the IPIC LIFO proposed Regulations, these companies would have to accumulate their inventory dollars for the most detailed categories which would be a considerable challenge, especially for smaller taxpayers with less sophisticated accounting systems.

Under the existing Regulations, BLS Weights are not used entirely for the pool index calculations because the category indexes calculated using the BLS Weights are used in the second part of the calculations in which these indexes are weighted using the taxpayer's actual inventory dollars accumulated at the less detailed category levels to calculate the dollar weighted pool indexes.

This procedure produces a "happy medium" of accuracy and simplicity which has been well suited to retailers. While this methodology produces different pool indexes compared to indexes that would result from only using taxpayers' dollars by the most detailed CPI or PPI categories, our research shows that these differences tend to cancel out over time, at least for the grocery, drug and general merchandise retailers for which we made pro forma calculations using sample data available to us.

While the current Regulations have worked well for retailers, the use of 10 Percent Categories and BLS Weights is not as desirable for other taxpayers including manufacturers and wholesalers. This is because most of these companies have the ability to accumulate their inventory dollars by the most detailed CPI or PPI categories. For these companies, their IPIC LIFO calculations would be more accurate and simpler if they could only use their actual inventory balances to make the pool index calculations. The calculation math would be simpler because only actual dollars and not actual dollars and BLS Weights would be used and the indexes would be more accurate since the actual inventory mix would be used for weighted average pool index calculations.

An example of how greatly different results can result from using BLS Weights compared to actual taxpayer dollar to make IPIC LIFO calculations is described below.

In a recent IPIC LIFO calculation, gasoline represented approximately 3% of this particular pool's total FIFO inventory and less than 1% of total inventories. Since none of the actual inventory dollars for this pool was greater than the 10% of total inventory threshold, BLS Weights were used to calculate this pool's index. Using gasoline's BLS Weight of 2.476 for this year divided by the sum of the BLS Weights for all categories present in this pool of 3.025, the gasoline index was given 82% of the pool's total weight in calculating the pool index. This resulted in the pool index (at 100%) being 14.3%. The pool index would have been -.5% had the indexes been weighted using the actual dollars.

This large difference occurred because the gasoline index was 17.6% compared to -1.9% for the other goods. The pool index calculated using the actual inventory dollars would be considered by most to be more "accurate" than using BLS Weights and this is the type of situation that would be avoided if actual taxpayer inventory dollars were used instead of BLS Weights.

The comments our Company submitted to the IRS suggest that taxpayers be given the choice of using the 10 Percent Categories and BLS Weights or their actual inventory balances. Others submitting comments made the same argument. Some of those submitting comments suggested that use of the 10 Percent Categories should be optional but that BLS Weights should not be used because this is too complicated.

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Changes Proposed by the IRS to IPIC

(Continued from page 15)

We believe that use of 10 Percent Categories without using BLS Weights would produce less accurate indexes. The calculations would be simpler not using BLS Weights but the procedures for making calculations using BLS Weights have been used for over 15 years and adequate guidance exists for doing so. In 1983, the Food Marketing Institute published the *Handbook for LIFO Tax Valuations Inventory Price Index Computation Method (IPIC)*. This was the result of a collaborative effort coordinated by the FMI with considerable input from grocery retailer taxpayers, large CPA firms and the IRS. This handbook provides comprehensive instructions and calculation examples that have been used by numerous taxpayers and CPAs over the years and the underlying principles are applicable to all IPIC LIFO taxpayers, not just to grocery retailers.

2. Weighted Harmonic Mean for Computing Pool Index. Almost all companies using the IPIC Method now use the Weighted Arithmetic Mean weighting and this is the method used in the IPIC calculation examples in Rev. Proc. 84-57 and Rev. Proc. 98-49.

Using the Weighted Harmonic Mean always results in lower pool indexes than the Weighted Arithmetic Mean because the weighting is essentially done using the prior year's FIFO dollars (calculated using the current year's FIFO dollars deflated by the current inflation index) rather than the current year FIFO dollars. Lower indexes result from the use of this method because using the deflated prior year's FIFO dollars gives more weight to items with less inflation.

The examples below show the difference in the details of the indexes calculated using the two different methods.

These examples show that not only does the Weighted Harmonic Mean produce lower pool indexes but that pool indexes using this method will be less the more individual CPI or PPI category indexes vary from the average pool index.

The amount of the difference between the two methods cannot be consistently estimated because it will probably depend on the number of items included in the extensions which would usually in-

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WEIGHTED HARMONIC MEAN VS. WEIGHTED ARITHMETIC MEAN

HARMONIC ALWAYS PRODUCES A LOWER POOL INDEX

	(1) Current Year Inflation Index	*(2) Current Year-end FIFO Dollars*	*(3) Prior Year-end Deflated FIFO Dollars (Col. 2/Col. 1)*	*(4) Arithmetic Mean Weighted Extension (Col. 2 x Col. 1)*
EXAMPLE A				
Item X	1.02	$1,000,000	$980,392	$1,020,000
Item Y	0.98	1,000,000	1,020,408	980,000
Pool Total		$2,000,000	$2,000,800	$2,000,000

Arithmetic Mean Pool Index = 1.0000 = Column 4 sum/Column 2 sum
Harmonic Mean Pool Index = 0.9996 = Column 2 sum/Column 3 sum

	(1)	*(2)*	*(3)*	*(4)*
EXAMPLE B				
Item X	1.05	$1,000,000	$952,381	$1,050,000
Item Y	0.95	1,000,000	1,052,632	950,000
Pool Total		$2,000,000	$2,005,013	$2,000,000

Arithmetic Mean Pool Index = 1.0000 = Column 4 sum/Column 2 sum
Harmonic Mean Pool Index = 0.9975 = Column 2 sum/Column 3 sum

crease the amount of variance between the index category indexes and the pool average index.

The proposed Regulations state that "The IRS and Treasury Department have determined that a weighted arithmetic mean is mathematically inappropriate for averaging inflation indexes based on current-year costs. The mathematically correct method of averaging inflation indexes using current-year costs is a weighted harmonic mean."

Since we are not mathematicians nor statisticians, we cannot challenge these statements from that standpoint. We can, however, point out that this proposed change from the method now used by the vast majority of taxpayers will produce consistently lower LIFO indexes. This will also complicate LIFO calculations because many taxpayers would have to change their calculation methodology from that now being used.

The Harmonic Mean methodology is necessary to calculate internal indexes for taxpayers not using external indexes because this is the simplest way to make the calculations. The purpose of internal index calculations however is to calculate inflation indexes for a group of goods or products for which unit prices and number of units is known. For IPIC dollar weighting, inflation indexes for CPI or PPI categories are already known and need not be calculated. Pool indexes must be calculated using these categories' indexes and the normal means of calculating weighted average indexes for other purposes is to use multiplication, and not division, for extensions.

The comments our Company submitted regarding this provision stated that we were not in favor of this change since the new method will always produce less inflation and the change in method to one more complicated would cause confusion and errors in taxpayers' LIFO calculations.

3. Double-Extension or Link-Chain Method of Index Computation. The current IPIC LIFO Regulations do not indicate whether IPIC indexes should be computed using link-chain or double-extension methodology. In practice, some taxpayers use double-extension methodology, but the majority use the link-chain methodology. The proposed Regulations specifically permit either method.

We feel that is quite important that taxpayers adopting LIFO in initial elections where the IPIC method is elected select the link-chain method. This methodology is greatly preferable because CPI and PPI categories change over time and this creates far greater problems when the double-extension method is used.

4. Selecting Indexes as of an Appropriate Month. There has been confusion under the original IPIC LIFO Regulations about which months' CPI or PPI indexes could or should be used for index calculations. The proposed Regulations provide clarification of this issue.

5. Taxpayers Eligible to use "Department Store Inventory Price Indexes." The current Regulations prohibit the use of the IPIC method by taxpayers eligible to use the BLS Department Store Indexes. Retailers that have historically used the BLS Department Store Indexes include department stores, discount stores and general merchandise stores. These indexes are a subset of the CPI indexes that have been compiled by the BLS since the 1940s specifically for retailers using LIFO. The use of these indexes by these types of stores has been widespread because using these external indexes has proven to be far simpler than calculation of internal indexes.

The problem the prohibition of use of the IPIC method by taxpayers eligible to use the BLS Department Store Indexes has caused is that BLS Department Store Indexes are not compiled for all classes of consumer goods. The BLS Department Store groups for which indexes have been compiled has been the traditional department store departments. Three new groups were added in 1987 to cover merchandise common in discount chains. The groups, however, do not include food, candy and tobacco goods, and this has been a problem for some discount chains.

The best example of this limitation affecting taxpayers we have seen is for the so-called "superstores" which are essentially the marriage of the traditional discount store with a grocery store. Taxpayers with this type of store are eligible to use the BLS Department Store Indexes and have used these indexes for years when their stores were the traditional discount stores. As their store formats have changed so that they now carry grocery and tobacco goods, these taxpayers have either had to calculate internal indexes for the goods, use the BLS Department Store aggregate Soft Goods indexes or exclude these goods from the LIFO election. None of these are good options since calculation of internal indexes creates considerable unwanted work and the Soft Goods aggregate index inflation has been very low or even deflation for a number of years primarily because it is heavily weighted with apparel goods for which inflation has been low.

The proposed Regulations provides an excellent alternative to taxpayers facing this problem because

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they allow use of the IPIC method for goods for which BLS Department Store index groups do not exist. The only problem with this approach is the IPIC 80% limitation especially in light of the fact that no similar reduction in indexes has ever been made when BLS Department Stores indexes are used. Even with this limitation, the taxpayers facing this problem in the past now have a good alternative to deal with this situation.

6. Selection From "CPI Detailed Report" or "PPI Detailed Report" and

7. Elimination of Requirement to Convert Published Indexes into Retail Price Indexes or Cost Price Indexes.

These two provisions of the proposed changes to the IPIC Regulations are discussed together since they relate to each other very closely.

Under current Regulations, manufacturers, processors, wholesalers, jobbers and distributors may use only index categories from the "PPI Detailed Report." A retailer may select indexes from the "CPI Detailed Report" or "PPI Detailed Report," but if equally appropriate index categories could be selected from either publication, a retailer using the retail inventory method must select index categories from the "CPI Detailed Report" and a retailer not using the retail inventory method must select indexes from the "PPI Detailed Report."

The proposed Regulations would require that retailers not using the "retail inventory method" to select indexes from the PPI Detailed Report. Many retailers now using the IPIC method do not use the "retail inventory method."

We were informed by an IRS representative that the definition of "retail inventory method" as used in the proposed Regulations is the calculation of layer increments and decrements at base period prices using retail dollars. This definition is different from the common usage of this term in retail industries to describe the method of calculating cost complements of gross markup percentages by departments or classes of goods for use in converting retail FIFO inventory balances to cost balances.

Under the current Regulations, the published CPI or PPI indexes must be adjusted if the stage of production the price indexes selected represents is not the same as the taxpayer's purchase cost of their inventories. For example, retailers not using the retail inventory method who use CPI indexes must adjust the CPI indexes from their retail price basis to a cost basis by multiplying the CPI indexes by cost complements of the gross profit margins applicable to those goods. Another example is manufacturers using PPI indexes for finished goods inventories. The PPI indexes are a measure of inflation in selling prices of goods sold by manufacturers. Since manufacturers' finished goods inventories are stated at cost, the PPI indexes must be adjusted from their selling price basis to a cost basis by multiplying the PPI indexes by cost complements of the gross profit margins applicable to those goods.

The proposed elimination of the need to adjust CPI or PPI indexes using cost complements has been very well received because this requirement has caused many problems for taxpayers required to make this adjustment. It is particularly difficult for smaller retailers to accurately and consistently calculate cost complements, and if these are not calculated accurately, this can cause significant errors in their LIFO indexes.

This requirement also presents difficulty for larger companies. The fact that the accounts included in cost of sales may change from year to year makes calculation of consistent cost complements difficult. Most companies we are familiar with who have been required to make these adjustments to indexes using cost complements have faced these types of difficulties, and they often cause significant errors in pool index calculations.

This requirement is especially burdensome for small taxpayers for whom it is a challenge just to accurately calculate departmental cost complements let alone cost complements by CPI categories. We believe the application of cost complements to adjust indexes poses a greater possibility of distorting the indexes calculated than any increase in accuracy than may be gained from making this adjustment.

The problem we see with the provision of the proposed Regulations that cost complement adjustments be eliminated is that the means of accomplishing this for retailers is to require them to use PPI, rather than CPI, indexes if they do not use the retail inventory method.

The comments our Company submitted regarding these provisions applauded the elimination of the cost complement adjustments but stated that retailers not using the retail inventory method should be allowed to continue to use CPI indexes.

Apparently, the IRS's view of appropriateness of CPI vs. PPI indexes is based on the trying to match index prices' stage of production to taxpayers' purchase costs. We think appropriateness of CPI vs. PPI indexes should be determined by which list of categories more closely correspond to the taxpayer's

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inventory mix. Also, there is a flaw in the IRS's stage of production rationale. For example, many retail grocers' purchases, particularly for small companies, are from wholesalers and not from producers, manufacturers or food processors. This means that the retail selling prices reflected by CPI indexes are just as close to their purchase cost in terms of stage of production as PPI indexes which are selling prices of producers, manufacturers or food processors.

We believe that the elimination of the cost complement adjustment requirement is highly desirable, but we believe that it should not be tied to requiring use of PPI indexes for retailers not using the retail inventory method. While requiring the use of PPI indexes in these cases or making the cost complement adjustments is valid in theory, we don't believe that not making the cost complement adjustment would tend to consistently overstate or understate LIFO indexes over time. This is because profit margins of established companies do not tend to increase or decrease annually for a number of years. They typically may increase for a year or two and then decrease for a year or two in which case the effect of these cost complement adjustments tend to be minimal over time. This fact combined with the problems caused by the cost complements adjustment and the added complexity entailed is, we believe, a strong argument to eliminate the cost complement adjustment requirement regardless of whether CPI or PPI indexes are used.

8. Relocation and Clarification of Special Pooling Rules. The current Regulations state that retailers, wholesalers, jobbers and distributors using the IPIC method may establish pools using the CPI Table 3 (Consumer Price Index for all Urban Consumers (CPI-U)) general categories. While this made sense for these types of companies using CPI indexes, the current Regulations did not address whether these rules could be used for companies in these other industries when PPI indexes are used. Rev. Proc. 84-57 provides that inventory pools may be established for any group of goods included within one of the 15 PPI Table 6 general categories.

The proposed Regulations specify that a manufacturer, processor, wholesaler, jobber, distributor or retailer not using the retail inventory method using the IPIC method may establish inventory pools for any group of goods included within the 15 PPI Table 6 two digit major commodity groups. They also specify that a retailer using the retail inventory method may establish inventory pools for any group of goods included within one of the CPI Table 3 group of goods.

If the final Regulations permit companies to select CPI or PPI indexes based on their correlation to a taxpayer's inventory mix (as our Company and others have suggested), they will need to state that the CPI or PPI groups may be used to establish pools depending on which indexes are used.

9. Clarification of the Definition of "Eligible Small Business"

"Eligible Small Businesses" may use 100% of CPI or PPI inflation indexes, whereas those businesses not qualifying under this definition are limited to using 80% of CPI or PPI inflation indexes. Prior to 1986, "Eligible Small Business" was defined as a company whose average annual gross receipts that do not exceed $2,000,000 for the three year period ending with the taxable year. The proposed Regulations clarify that the gross receipts threshold has been $5,000,000 since 1986.

Comments our Company submitted stated that the threshold for the exception to this limitation is so low as to render it almost completely ineffective and that it also discriminates against companies with lower gross margins because they have to achieve higher levels of sales to generate net income.

10. New Base Year for IPIC Method Changes. Taxpayers switching to the IPIC method from another dollar-value LIFO method are required under the current Regulations to update their base year, a procedure commonly called "rebasing." The proposed Regulations clarify that the rebasing procedure applies only to voluntary changes to the IPIC method.

11. Inventories Received in a Nonrecognition Transaction. Under the current Regulations, many contributions of inventories valued using LIFO to newly formed entities resulted in partial recapture of LIFO reserves because of flaws in current Regulations. The proposed Regulations contain provisions intended to correct these flaws.

CONCLUSION

We believe the IRS has taken an important step in providing better guidance for taxpayers using the IPIC LIFO method. The few CPAs in the U.S. that have considerable experience assisting taxpayers using IPIC LIFO have submitted comments which we believe would improve the Regulations ultimately issued. We hope the IRS thoughtfully considers these comments so the final Regulations provide taxpayers and CPAs much needed improvement in the guidance for application of this important tax saving method.

–Lee Richardson, CPA

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IS THE GLASS HALF-FULL OR HALF-EMPTY ?

Mr. Holt continued: "If simplicity is truly a goal, we recommend the development of a methodology similar to the method used by department stores, which is truly simple and is widely viewed as an accurate method.

"...If more accuracy is desired, we recommend starting with the repeal of the 80% limitation on the published indexes. This limitation was originally adopted as an 'appropriately conservative estimate that the taxpayer can use without regard to the inflation rate actually experienced by the taxpayer.' ***With the proposed amendments, simplicity appears to have been abandoned in favor of greater accuracy.*** If accuracy has become the primary objective, the 80% index limitation should be removed because it is almost certainly not accurate. ...It appears that the validity of the centerpiece of the IPIC method, namely the CPI or PPI indexes, is in doubt. If that is the case, perhaps the entire methodology should be reconsidered. If the validity of the indexes is not in doubt, any barriers to use of the method should be removed."

It will be most interesting to see what changes, if any, are reflected in the final Regulations as a result of the written comments and testimony offered by practitioners on these proposed Regulations.

The *De Filipps' LIFO Lookout* newsletter is a quarterly publication of LIFO News, Views and Ideas by Willard J. De Filipps, CPA, P.C., 317 West Prospect Avenue, Mt. Prospect, IL 60056. It is intended to provide accurate, general information on LIFO matters and it should not be construed as offering accounting or legal advice or accounting or legal opinion on any specific facts or circumstances. The contents are intended for general information purposes only. Readers should consult their certified public accountant, attorney and/or other competent advisors to discuss their own situations and specific LIFO questions. Mechanical or electronic reproduction or photocopying is prohibited without permission of the publisher. Annual subscription: $395. Back issues available for $70 each. Not assignable without consent. Any quoted material must be attributed to *De Filipps LIFO Lookout* published by Willard J. De Filipps, CPA, P.C. Editorial comments and article suggestions are welcome and should be directed to Willard J. De Filipps at (847) 577-3977; FAX (847) 577-1073. **INTERNET**: http://www.defilipps.com.
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