Willard J. De Filipps, CPA, PC
www.defilipps.com
A Quarterly Update of LIFO - News, Views and Ideas

LIFO LOOKOUT

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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. IT'S BEEN A PRETTY QUIET SUMMER. Quiet, at least as far as LIFO matters are concerned. Not much new IRS audit activity to report, nor apparent activity on LIFO matters in the Courts ... at least for now.

Maybe one way of looking at things is that there was a lot of excitement earlier in the year, and it was time for some rest. After all, the Service has been pretty busy adjusting to its massive restructuring, issuing revised procedures on accounting method changes, chasing huge tax shelter schemes, and, lest we forget, conceding its victory in *Mountain State Ford* by issuing Rev. Proc. 2002-17. (Sorry ... I just couldn't resist that last one.)

Nevertheless, there are two significant developments that we are focusing on in this issue. It's almost like there's some good news to share, and there's some bad news to go along with it. The good news relates to *Coggin Automotive's* surprising (to some) reversal of the Tax Court by its victory at Appeals. But even this good news has a significant downside. See #2 below.

The second development featured in this issue of the *Lookout* is the publication earlier this year by the IRS of some *Appeals Industry Specialization Program Settlement Guidelines.* These concern LIFO taxpayers who are using earliest acquisition / dual index methods. The *Appeals Guidelines* apply to all industries and to all LIFO cases. See #3 on page 2.

#2. HUGE LIFO RESERVE RECAPTURE AVOIDED IN DEALERSHIP ESTATE PLANNING RESTRUCTURING. In a series of transactions culminating in 1993, an auto dealer sought to accomplish a number of estate planning objectives. He involved his consolidated group of corporations in a sophisticated restructuring involving his holding company and several limited partnerships with C to S status changes.

LOOKOUT LOOKS INTO

After the IRS audit, the next stop was the Tax Court. When all was said and done, the IRS smelled almost $5 million worth of LIFO reserve recapture.

In October 18, 2000, the Tax Court held in *Coggin Automotive Corporation* that the IRS was right about the LIFO recapture. The IRS threw two arguments at the taxpayer. The IRS first challenged the overall corporate group restructuring as a sham, having no independent economic motives. The Tax Court did not agree with the IRS on this point.

However, the Tax Court did agree with the IRS's second attack which was based on the application of Section 1363(d). This case was analyzed in the December 2000 *LIFO Lookout*, and its predecessor TAM / Letter Ruling 9716003 was analyzed in the June 1997 *Lookout*.

Coggin next appealed the Tax Court decision and in June 2002, the Tax Court was reversed by the U.S. Court of Appeals for the 11th Circuit. The Appeals

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Court didn't support the notion that just because Coggin was getting a huge break, that made it necessary to stretch the IRS' rationale in "quantum leap fashion."

The Appeals Court was brief and to-the-point in reversing the Tax Court. It said that Coggin was a holding company. It only held the stock of the other C corporations. It was not engaged in the sale of automobiles. Under plain language of the statute, it had no LIFO inventory requiring recapture when it elected to become an S corporation. Therefore, it was not necessary to resort to legislative history. Any potential windfall to holding companies must be cured by Congress, not by the judiciary or by the IRS. ...End of story ...End of case.

Before you light any Autumn bonfires to dance around in celebration with your dealers ... wait just a minute. There is at least one fly in the ointment. It's in the form of the so-called anti-abuse partnership Regulation added shortly after Coggin made its S election. For more details, you'll have to read the article which begins on page 3.

#3. IRS APPEALS SETTLEMENT GUIDELINES FOR LIFO CASES INVOLVING DUAL INDEX METHODS. In February 2002, the IRS's Industry Specialization Program (ISP) published *Appeals Guidelines* that involve some LIFO taxpayers. These apply at the Appeals Conference level for all industry cases that involve LIFO taxpayers who are using the earliest acquisition or dual index method for valuing increments for dollar-value LIFO purposes. This sub-election is made on Form 970, item/question 7(a) on the new version ... it was item/question 6(a) on previous 970 versions.

The *Guidelines* reinforce the generally negative, some would say hostile, attitude the Service has displayed in the past toward taxpayers using these LIFO sub-election methods. The *Guidelines* seem to pick up where the IRS's 1995 Coordinated Issue Paper on this subject left off and they are very harsh on taxpayers who simply apply the previous year's cumulative inflation index as the factor for valuing the current year's increment.

In discussing short-cut and turnover methods as earliest acquisition approximations, the *Guidelines* state, "These ... methods utilized by taxpayers may subject the methodology to closer scrutiny under the clear reflection of income standard." They further warn that taxpayers must provide "proofs or studies that their methodology emulates the Regulatory method elected."

Taxpayers may now encounter greater difficulty in substantiating the correctness of their use of short-cut methods, especially if the results differ significantly from those obtained by the use of a single overall index. Taxpayers using dual indexes in their LIFO computations would be well-advised to review their LIFO computations to see how close or how far their results are from what the IRS would expect.

These *Appeals Guidelines*–which may embolden some Agents to become even more aggressive–are analyzed beginning on page 16. Our analysis includes supplementary discussions explaining why taxpayers might want to use dual indexes in the first place (pages 20-21) and giving some background on the computation technicalities for dollar-value method LIFO pools (pages 22-23).

COGGIN AUTOMOTIVE CORPORATION
DEALERSHIP RESTRUCTURING ESCAPES LIFO RECAPTURE DESPITE CHANGES FROM C TO S STATUS

In October 2000, the Tax Court upheld the IRS in its assertion that Coggin Automotive Corporation must pay tax on $4.8 million of new vehicle LIFO reserves that were on the books of its subsidiaries. This LIFO reserve recapture, the IRS maintained, was required by Section 1363(d) after the consolidated group of dealership corporations went through a rather complicated restructuring involving the creation of limited partnerships, and after the holding company changed its tax status from C to S in 1993.

In challenging the taxpayer's position that there should be no recapture of the LIFO reserves, the IRS raised two arguments in the Tax Court. The Service's first argument was that the overall corporate group restructuring did not have a legitimate business purpose and that it was a tax-motivated sham transaction. On this point of disagreement, the Tax Court found that there was economic substance underlying the restructuring, and it did not support the IRS.

The IRS's second challenge was based on its interpretation that Code Section 1363(d) should apply. The Tax Court agreed with the IRS and upheld the deficiency it had assessed against the parent corporation, based on the recapture of the LIFO reserves on the subsidiaries' books. (115 T.C. 349 [2000])

COGGIN ON APPEAL

Coggin appealed the decision of the Tax Court, and it prevailed in avoiding the LIFO recapture. In June 2002, the U.S. Court of Appeals for the Eleventh Circuit reversed the Tax Court's decision (292 F.3d 1326, 89 AFTR2d 2002-2826 [CA-11, 2002]). The Appeals Court opinion is remarkably succinct and to-the-point in saying that the Tax Court was not correct in its interpretations in support of the IRS.

The Appeals Court didn't support the notion that just because the taxpayer was getting a huge break, that justified stretching the IRS' rationale as far as the Tax Court was willing allow. The Appeals Court said that the Tax Court, while paying lip-service to the statutory scheme of Section 1363(d), relied entirely upon the legislative history of that Section and the line of cases using the "aggregate" partnership theory of taxation. The result, the Appeals Court said, provided an interpretation favorable to the Commissioner in ***"quantum leap fashion."*** It added, "It is unclear from the Opinion exactly how the Tax Court concluded that Congress intended this result."

Finding no ambiguity in the language of the statute, it concluded that the Tax Court's analysis should have ended with the statute's plain language. After making the observation that "...perhaps the Tax Court is straining to extend its interpretation of the legislative histories ... in order to close what it perceives to be a loophole in the case of holding companies that own no inventory yet elect S Corporation status," the Appeals Court said that if this were an inequity, only Congress or the Secretary has the authority to ameliorate it.

The Appeals Court summarized it all in six short, simple sentences: "Coggin was a holding company. It held stock in other C corporations. It was not engaged in the sale of automobiles. Under plain language of the statute, it had no LIFO inventory requiring recapture upon its election to become an S corporation. It is not necessary to resort to legislative history. Any potential windfall to holding companies must be cured by Congress, not the judiciary."

WHAT WAS THE IRS THINKING?

In finding fault with the IRS' technical arguments, the Appeals Court noted several inconsistencies and it expressed reluctance to "trust the IRS" that certain computational difficulties could be worked out ... if only the IRS were allowed to prevail.

In referring to basis adjustment ***nightmares***, the Appeals Court said,

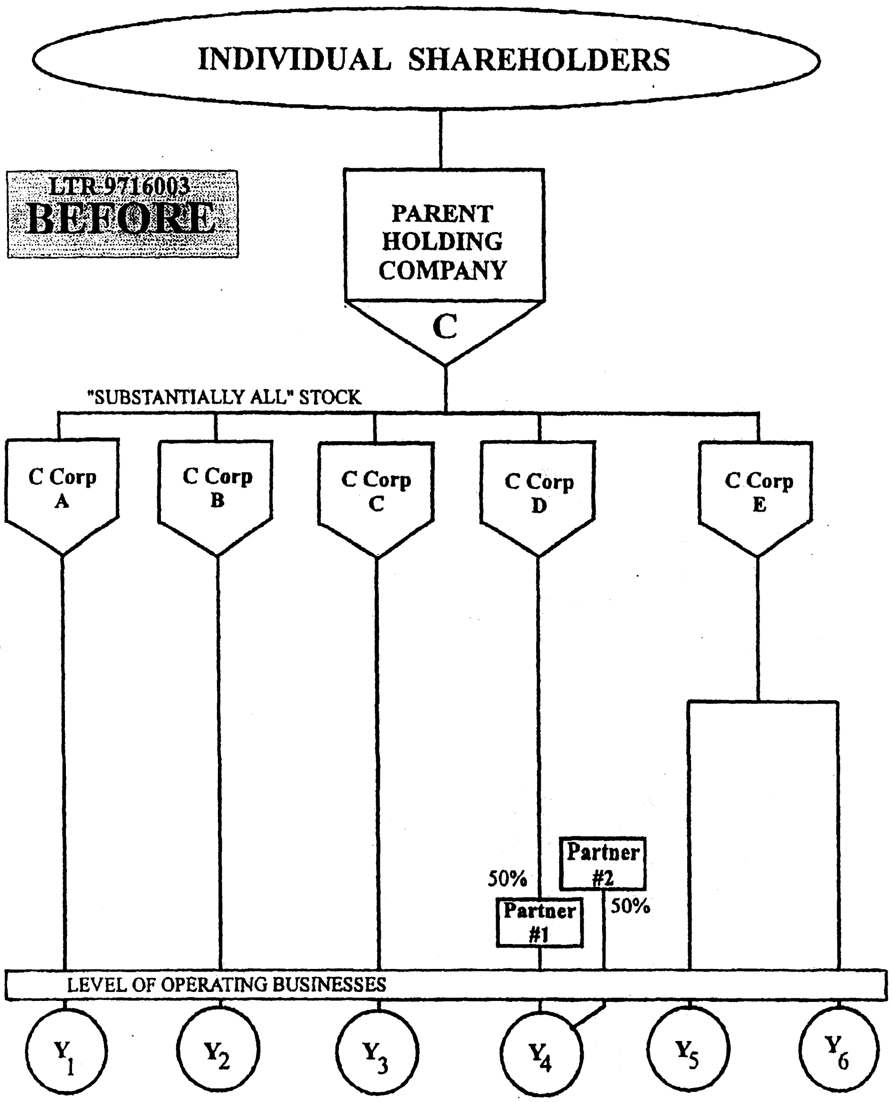
"... Practically speaking, the Tax Court holding results in ***basis adjustment nightmares*** not contemplated by the Internal Revenue Code or its regulations. Coggin did not actually own inventory when it converted to S status. Therefore it had no inventory basis to increase. The Commissioner concedes that if the Tax Court result is affirmed, there is no guidance in the Internal Revenue Code as to how to implement the basis adjustment requirements of Section 1363(d). ... Neither we nor the taxpayer receive much comfort from the Commissioner's response to this impracticable consequence that "we can work this [basis problem] out." [Emphasis added.]"

Some readers of the *Lookout* who have followed our consistent opposition to the (unrealistic) position taken by the IRS and supported by the Tax Court in *Mountain State Ford* may note a similar cavalier style exhibited in this case by the IRS in proceeding first with technical arguments before thinking about the

see **COGGIN**, page 10

Section 1363(d)	**COGGIN AUTOMOTIVE CORPORATION** ***FACTS & BACKGROUND***
The Consolidated Group	• The taxpayer, Coggin Automotive Corp. initially was a regular C corporation d/b/a Coggin O'Steen Investment Corp. • This corporation was a holding company that owned 80% of the stock of 5 subsidiary auto dealership corporations operating 6 dealerships in Florida. ♦ Coggin Pontiac-GMC ♦ Coggin Honda ♦ Coggin Nissan ♦ Coggin Acura (initially d/b/a Coggin Imports) ♦ Coggin Motor Mall (initially Coggin-O'Steen Motors) ♦ Coggin-Andrews Honda • Coggin Automotive Corp., in its role as a holding company, did not own or operate any business. It owned stock in the subsidiary C corporations. The subsidiaries, in their role as the operating companies of the Coggin holding company, ran the automobile dealerships. • The subsidiaries directly owned their inventories of automobiles and light-duty trucks. • The subsidiaries had made elections to use the dollar-value LIFO method of accounting for their new vehicle inventories. • Coggin did not own any inventory, and consequently, it had never made a LIFO inventory election.
Ownership	• For almost 20 years through early June 1993, Luther Coggin had a 55% ownership interest and a 78% voting interest in Coggin Automotive, the holding company. • Harold O'Steen and Howard O'Steen each owned a 22.5% ownership interest and an 11% voting interest in the holding company throughout the same period. • General managers of certain of the dealerships were given the opportunity to buy stock in the dealerships over a period of time. • Usually, the price paid for a dealership's stock was based on the corporation's book value, with little or no value being assigned to the franchise rights.
Consolidated Return Status	• The parent/holding company and its subsidiaries/operating companies had filed consolidated returns for almost 20 years through early June 1993. • After 20 years, the corporations underwent a restructuring resulting in new S corporations and assorted limited partnerships operating the 6 dealerships.
Benefits Sought By Restructuring	• To facilitate sale of stock through buy-sells to various managers...some of whom were frustrated by their inability to acquire more stock. The new arrangement was intended to allow them to buy-out Luther Coggin's stock ownership interests. • To assist the principal owner in his estate planning. At the time, Mr. Coggin was sixty-two years old. • The restructuring assisted Mr. Coggin in his succession planning, yet supported his efforts to retain qualified general managers of the automobile dealerships, key employees, by providing them with ownership incentives. • The stand-alone partnership form also afforded the general managers greater flexibility than the corporate form.

Section 1363(d)	COGGIN AUTOMOTIVE CORPORATION FACTS & BACKGROUND
Benefits Sought By Restructuring **(Continued)**	• Legal counsel for one of the buy-in parties suggested that the overall arrangement resulting from creation of limited partnerships would provide several advantages: ♦ Limited liability protection ♦ Ability to make disproportionate distributions ♦ Single level of taxation ♦ Lower Federal income tax rate ♦ Ability to avoid Florida State income tax on distributive share of profits ♦ Ability to exercise greater control over the potential sale or liquidation of partnership assets • Mr. Coggin agreed to have dealership assets held by a limited partnership.
Factory Approval	• The approval of manufacturers was required and was received before the restructuring transactions were initiated.
Restructuring Steps (In General)	• ***First***: Establishment of 6 new corporations, with each new corporation electing S corporation status. These 6 corporations were incorporated for the purpose of being the general partners in 6 new limited partnerships that would be formed to operate the dealerships. • ***Second***: Creation of Florida limited partnerships, resulting in permitting entry of several dealerships' general managers. • ***Third***: Assorted redemptions of general managers' stock with payment in the form of promissory notes. • ***Fourth***: Formation and capitalization of partnerships by three simultaneous events: ♦ Cash contributions to the limited partnerships by the newly formed S corporations in exchange for 1% ***general*** partnership interests in the limited partnerships. ♦ Contributions of operating assets, including LIFO inventories, and liabilities of the dealerships by the subsidiaries in exchange for the ***limited*** partnership interests in the limited partnerships. ♦ Contribution of promissory notes by general managers for partnership interests after which notes were cancelled. • ***Fifth***: The old subsidiaries were liquidated into Coggin after the transfer of assets to the partnerships so that Coggin (the parent/holding company) obtained the limited partnership interests. • ***Sixth***: Coggin (the parent/holding company) elected S corporation status. This was the event that the IRS said triggered the Section 1363(d) LIFO recapture. Note: this entity had not undergone any changes in capital structure nor any changes in ownership interests in its stock. • The foregoing is slightly generalized and certain other subsequent transactions have been omitted. • See diagram of *Before, During & After* restructuring.
Citations	• ***Coggin Automotive Corporation v. Commissioner*** • Tax Court ... 115 T.C. 349 (2000) ... date of decision Oct. 18, 2000, Dkt. No. 1684-99 • United States Court of Appeals for the Eleventh Circuit, (292 F.3d 1326, 89 AFTR2d 2002-2826 [CA-11, 2002]) ... date of decision June 6, 2002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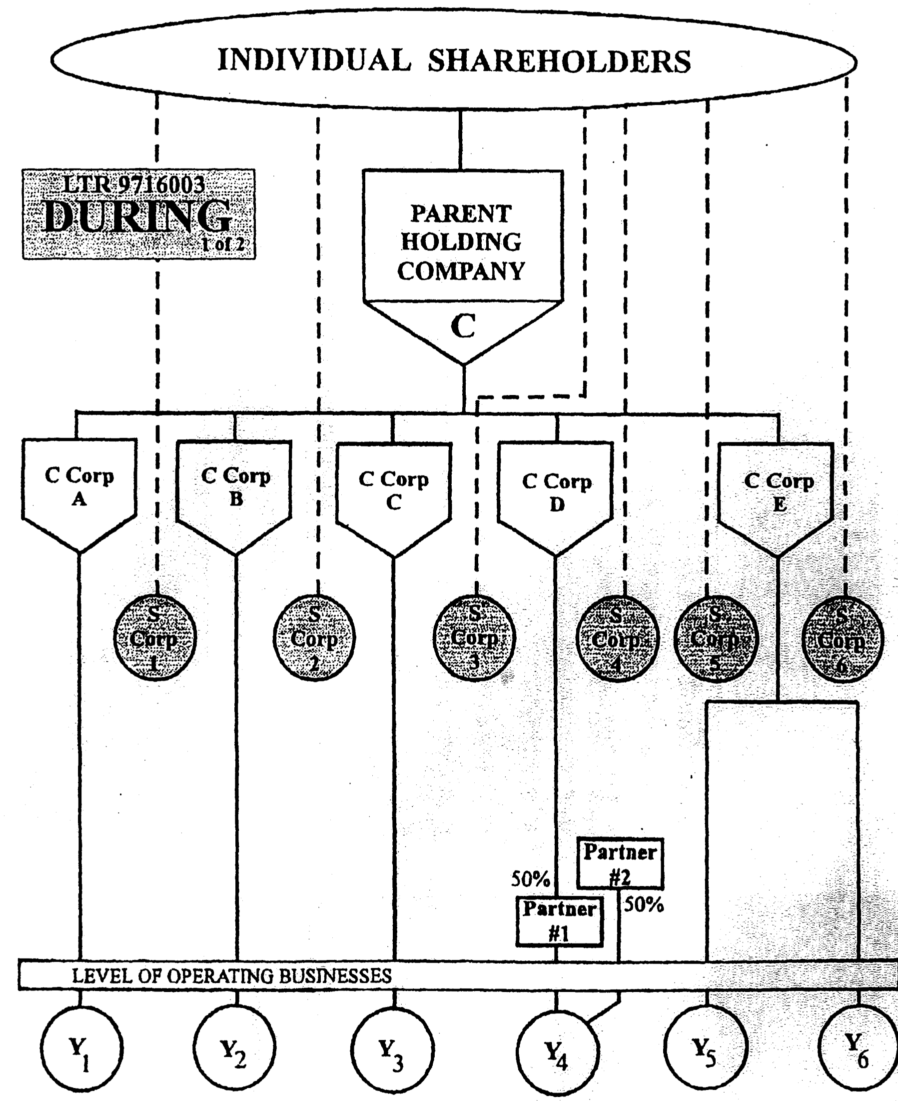
LTR 9716003
BEFORE
PARENT HOLDING COMPANY
C
"SUBSTANTIALLY ALL" STOCK
C Corp A
C Corp B
C Corp C
C Corp D
C Corp E
Partner #2
50%
Partner #1
50%
LEVEL OF OPERATING BUSINESSES
Y_1
Y_2
Y_3
Y_4
Y_5
Y_6


INDIVIDUAL SHAREHOLDERS
LTR 9716003
DURING
1 of 2
PARENT HOLDING COMPANY
C
C Corp A
C Corp B
C Corp C
C Corp D
C Corp E
S Corp 1
S Corp 2
S Corp 3
S Corp 4
S Corp 5
S Corp 6
Partner #2
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LEVEL OF OPERATING BUSINESSES
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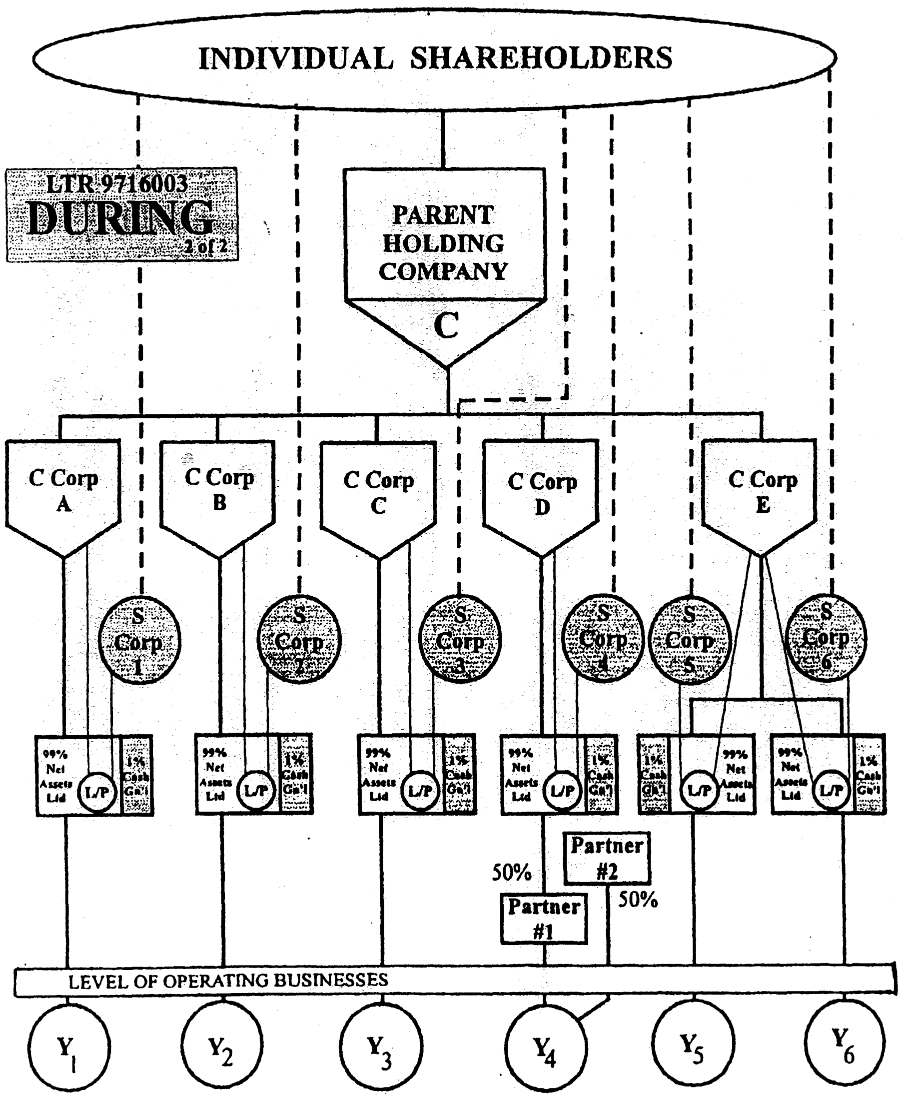

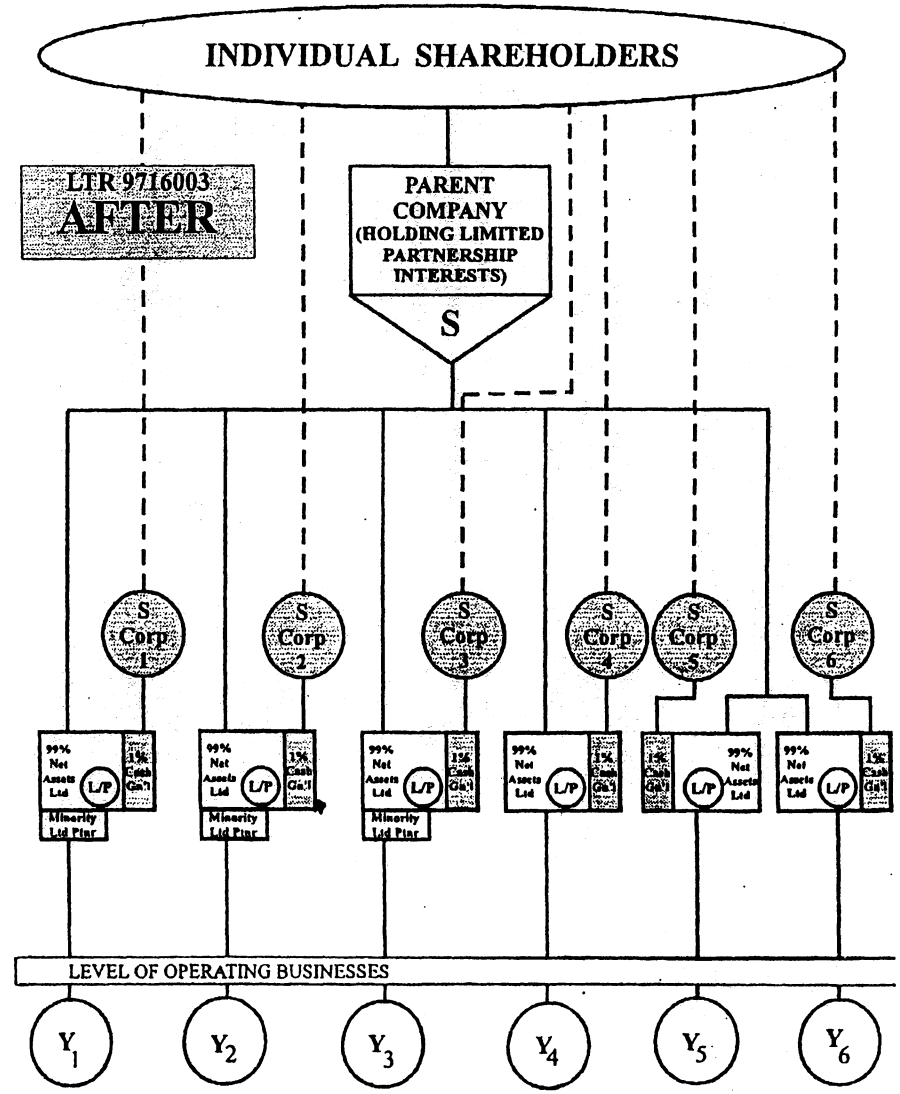

(LIMITED PARTNERSHIPS IN PLACE & ALL OLD C CORP SUBS LIQUIDATED)

<table>
<tr><td>Section 1363(d)</td><td><u>COGGIN AUTOMOTIVE CORPORATION</u>
<u>ISSUES & HOLDINGS</u></td></tr>
<tr><td>The Issue</td><td>• Under Section 1363(d), should the operating subsidiaries' new vehicle LIFO inventory reserves be recaptured by the parent holding company (Coggin Automotive Corporation) when it changed from C to S status in 1993?</td></tr>
<tr><td>Historical Note</td><td>• In September 1996, Coggin's LIFO recapture was the issue in National Office Technical Advice Letter Ruling 9716003 which held that the subsidiaries' LIFO reserves should be recaptured by the parent.
• For analysis of LTR 9716003, see LIFO Lookout, June 1997, pages 7-13.
• In this LTR, the IRS did not challenge the taxpayer's restructuring as being solely tax-motivated.
• See also Letter Ruling 9644027 for a contrasting result.</td></tr>
<tr><td>FIRST ISSUE...

Nature of the Transactions

Was Coggin's Restructuring Solely Tax Motivated
... Or Were There Bona Fide Business Purposes?</td><td><u>IRS ARGUMENTS</u>
• The restructuring should be disregarded because it had no tax-independent purpose.
• Coggin's restructuring was essentially a sham, motivated by tax avoidance.
• According to the IRS, "The 1993 restructuring was conceived and executed for the principal purpose of permanently escaping corporate level taxes on the LIFO reserves built into the LIFO inventories of petitioner's former consolidated subsidiaries."
• IRS cited Frank Lyon Co. v. U.S., 435 U.S. 561 (1978).
<u>TAXPAYER PROVED FOR THE RECORD</u>
• General managers were vital to the successful operation of the automobile dealerships.
• Providing incentives to attract and retain quality general managers was essential in the success of the automobile dealerships.
• Operating the automobile dealerships in stand-alone partnership form afforded the general managers flexibility greater than that offered by operating the dealerships in corporate form.
• Mr. Coggin and the general managers never discussed recapture of the LIFO reserves.
<u>TAX COURT</u>
• Agreed with Coggin that its restructuring was bona fide.
• "It is axiomatic that (1) tax considerations play a legitimate role in shaping a business transaction, and (2) tax planning does not necessarily transform an event otherwise non-taxable into one that is taxable."
• Held that the overall restructuring was a "genuine multi-party transaction with economic substance, compelled by business realities, imbued with tax-independent considerations and not shaped solely by tax avoidance features."

<u>APPEALS COURT</u>
• Not an issue ... The IRS did not appeal the Tax Court's finding that Coggin's restructuring was bona fide.</td></tr>
<tr><td>Citation</td><td>• Coggin Automotive Corporation v. Commissioner
• Tax Court ... 115 T.C. 349 (2000) ... date of decision Oct. 18, 2000, Dkt. No. 1684-99
• United States Court of Appeals for the Eleventh Circuit, (292 F.3d 1326, 89 AFTR2d 2002-2826 [CA-11, 2002]) ... date of decision June 6, 2002</td></tr>
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COGGIN AUTOMOTIVE CORPORATION

ISSUES & HOLDINGS

Theories of Partnership Taxation …	• For tax purposes, a partnership may be viewed either as ♦ An ***aggregation*** of its partners, each of whom owns a direct, undivided interest in the assets and operations and activities of the partnership. Under this aggregate or conduit approach, each partner would be taxed on his/her pro rata share of each item of the partnership's income, expense, deduction, gain/loss and/or credit. ♦ A ***separate entity***, which stands apart from its owners and in which the separate interests are owned by the partners. • The provisions of Subchapter K contain a mixture or blend of both approaches/theories.
SECOND ISSUE… *Application of Section 1363(d)* ***Does the Aggregate Theory of Partnership Taxation Result in Coggin's Recapture of its Subsidiaries' LIFO Reserves?*** ***… Or*** ***Does the Entity Theory of Partnership Taxation Prevent LIFO Recapture?***	***IRS ARGUMENTS*** • The ***aggregate*** (as opposed to the ***entity***) partnership approach/theory should be applied to the to the pre-S election LIFO reserves attributable to the taxpayer. • Section 1363(d) requires Coggin to include the pre-S election LIFO reserves. • Outside of Subchapter K (i.e., in a situation involving Section 1363(d)), the approach to be applied depends upon whether the aggregate or the entity approach "more appropriately serves the Code provision in issue." • The legislative intent underlying Sec. 1363(d) requires the application of the aggregate theory…"in order to ensure that the corporate level of taxation be preserved on built-in gain assets (such as LIFO reserves) that might fall outside the ambit of Section 1374." • Failure to apply the aggregate approach to Section 1363(d) would allow the taxpayer to completely escape the corporate level of tax on a C corporation's election. of S status and would eviscerate Congress' suppression of the *General Utilities* doctrine. ***TAX COURT*** • Agreed with the IRS that there should be Section 1363(d) LIFO recapture. • Supported the IRS analysis of the legislative histories of Sections 1363(d) and 1374 that "the application of the ***aggregate*** approach (as opposed to the entity approach) of partnerships in this case better serves Congress' intent." • Held that Section 1363(d)(4)(D) does not prohibit attribution of the subsidiaries' inventory and LIFO reserves to the parent holding company in this case. • Accordingly, upon Coggin's election to change from C status to S status, it was required to pay tax of $1,633,200 on $4,792,372 (its pro rata share of recapture). ***APPEALS COURT*** • Reversed the Tax Court … the Appeals Court held that Coggin Automotive was not subject to LIFO recapture. • "The general rule is that unless there is some ambiguity in the language of a statute, a Court's analysis must end with the statute's plain language. • "Perhaps the Tax Court is straining to extend its interpretation of the legislative histories of Section 1373 and Section 1363(d) in order to close what it perceives to be a loophole in the case of holding companies that own no inventory yet elect S corporation status. • "If this is an inequity in the United States Tax Code … only Congress or the Secretary … has the authority to ameliorate it. • "Coggin was a holding company. It held stock in other C corporations. It was not engaged in the sale of automobiles. Under plain language of the statute, it had no LIFO inventory requiring recapture upon its election to become an S corporation. • ***"It is not necessary to resort to legislative history. Any potential windfall to holding companies must be cured by Congress, not the judiciary."***

 (Continued from page 3)

implementation consequences if it prevails in Court. After winning in *Mountain State Ford*, the IRS could only find its way out of the imbroglio of its own making by issuing a Revenue Procedure reversing its technical victory many years after the fact.

Coggin Automotive had previously taken the LIFO recapture issue to the National Office. It was the taxpayer in IRS TAM / Letter Ruling 9716003 in which it was identified only as a *diversified holding company* subject to tax as a regular C corporation. In our analysis of this Letter Ruling in the *LIFO Lookout*, June 1997, we had guessed that automobile dealerships were involved.

In that LTR, the National Office had been asked to rule only on the LIFO recapture issues arising under Section 1363(d). However, when the Coggin decided to contest the LIFO recapture, the IRS threw it a curve and challenged the *bona fides* of the restructuring arrangement as its primary position in the Tax Court.

The Tax Court's decision in *Coggin Automotive* was discussed in the December 2000 *LIFO Lookout*. Our analysis here of the Appeal Court's reversal updates some previously published materials. In *What the Appeals Court Said*, we have integrated several explanatory notes from the decision with that text to provide a more complete analysis.

THE CODE SECTION MAZE

Coggin's LIFO recapture issue involves several sections of the Internal Revenue Code. First, there is Section 1363(d). Next, there is Section 1374, which had resulted in the enactment of Section 1363(d) in order to create more LIFO recapture situations. Finally, there is all of Subchapter K which addresses partnership taxation issues, and the underlying rationale for applying the various provisions of this Subchapter, particularly in terms of whether an aggregate or an entity approach or theory of taxation should be applied in settling this case.

Section 1363(d)(1) provides that if (1) an S corporation was a C corporation for the last taxable year before the first taxable year for which the S election was effective and (2) the corporation used the LIFO inventory method, then the LIFO recapture amount must be included in the gross income of the C corporation for its last taxable year.

Section 1363(d)(3) defines the LIFO recapture amount as the amount by which the C corporation's inventory under the First-in, First-out (FIFO) method exceeds the inventory amount under the LIFO method. The LIFO recapture amount is determined at the close of the C corporation's last taxable year before the first taxable year for which the S election is effective.

In general, under Section 1374 a corporate-level tax is imposed on built-in gains recognized by former C corporations within 10 years of the first day of the first taxable year for which the corporation was an S corporation.

Coggin involved the attribution of LIFO recapture from the operating subsidiaries to their passive holding company parent.

CAN RECAPTURE BE AVOIDED TODAY? ... THE ANTI-ABUSE REGULATION

Coggin's victory and its avoidance of LIFO reserve recapture is undeniably attention-grabbing and exhilarating for everybody (except the IRS). However, although *Coggin* is clearly a victory for the taxpayer, it could be more a relic of the past than a gateway to the promised land. Dealers and practitioners considering (similar) restructuring transactions should not necessarily assume that they will be able to avoid LIFO recapture in similar situations today. Unfortunately, there is a hitch–and a big one at that. It's more like the Sword of Damocles.

Buried deep in the notes to the Appeals Court Opinion–in fact, it's the very last one–there's a real downer. In this note, the Appeals Court mentions Regulation Section 1.701-2(e). This Regulation had not been promulgated at the time when Coggin underwent its restructuring in the years prior to 1994.

Reg. Sec. 1.701-2(e)(1) provides ... "***General Rule:*** The Commissioner can treat a partnership as an aggregate of its partners in whole or in part as appropriate to carry out the purpose of any provision of the Internal Revenue Code or the Regulations promulgated thereunder." This Regulation is referred to as the so-called anti-abuse Regulation, and it is effective for all transactions involving a partnership that occur on or after December 29, 1994.

There is more to the Regulation, and it is followed by a series of examples in Reg. Sec. 1.701-2(f), none of which specifically refer to Section 1363(d). However, these examples indicate the broad anti-abuse reach intended. The Regulation cautions that the examples included "do not delineate the boundaries of either permissible or impermissible types of transactions."

Finally, Reg. Sec. 1.701-2(i) provides that "The Commissioner can continue to assert and to rely upon applicable non-statutory principles and other statutory and regulatory authorities to challenge transactions. This Section does not limit the applicability of those principles and authorities."

→

OTHER RULINGS INVOLVING RESTRUCTURINGS & SECTION 1363(d)

Over the years, there have been a few Letter Rulings involving the potential application of LIFO recapture to various restructuring transactions. In addition to, and in light of, the uncertainty created by the "abuse of entity treatment" regulation (effective for transactions involving partnerships occurring after December 29, 1994), the following Letter Rulings should be considered. It is also unclear to what extent the IRS may raise comparable arguments and/or consequences if a current restructuring involves limited liability companies instead of partnerships.

Letter Ruling 9644027. In this Letter Ruling (July 1996), the IRS held that there would be no LIFO recapture upon the conversion of several dealerships to limited liability company status. This involved Section 721 partnership contributions under which neither a partnership nor any of its partners recognize gain or loss when property is contributed to a partnership in exchange for a partnership interest.

In Letter Ruling 9644027, the auto dealerships involved contributed assets to each LLC in exchange for a membership interest in that LLC. After the formation of the LLCs, the taxpayers who contributed the net assets of the dealerships remained in existence and maintained a majority ownership interest in the profits and capital of each LLC. Letter Ruling 9644027 is discussed at length in the December 1996 *LIFO Lookout.*

In this LTR, the IRS National Office seemed to place strong reliance on (1) the expectation that the success of the motor vehicle dealerships depended largely upon the effectiveness of the general manager and (2) the belief that vehicle manufacturers commonly insisted that general managers be allowed to acquire an incentive ownership interest in the dealerships they manage. The taxpayer's "need" to accommodate the manufacturers on this point may have been given more weight in LTR 9644027 than it might warrant elsewhere.

Letter Ruling 200050043. This Letter Ruling (September 2000) briefly addressed a spin-off situation involving S Corporations and held that because of the timing of the various S elections, there would be no LIFO reserve recapture under Section 1363(d) to any of the Corporations involved.

Letter Ruling 2000123035. In this Letter Ruling, the IRS ruled that the S Corporation would not trigger the recapture of the dealerships' LIFO reserves when it contributed the net assets of those dealerships to a newly formed LLC (Limited Liability Company) in exchange for a membership interest. (See June 2001 *LIFO Lookout*, page 3.)

After contributing the assets of the three dealerships to the LLC, the S Corp. stayed in existence and maintained a majority ownership interest in the profits and capital of the LLC. It also continued to operate the remaining auto dealerships as separate divisions.

The Ruling states "The contribution of the LIFO inventory property to the LLC formed to qualify for partnership tax treatment will not trigger recapture of the LIFO reserve." It added, "In order to adopt the dollar-value LIFO inventory method, the transferee LLC must file a Form 970 and otherwise comply with the provisions of Section 472 and the Regulations thereunder."

The Service also held that the LIFO inventories contributed to the LLC constituted Section 704(c) property, and any built-in gain or loss attributable to the inventories contributed by the Company must be allocated back to the Company when the LLC recognizes that gain or loss. The S Corp. agreed that the LLC would make necessary elections under the Section 704 Regulations to aggregate each item of inventory for purposes of making allocations under that Section.

CONCLUSION

Clearly, Coggin Automotive Corporation greatly benefited by boldly taking action in the early '90s and then by taking an aggressive position before the partnership regulations were "tightened up" with an anti-abuse provision. But can this "anti-abuse provision" really do what the Appeals Court in *Coggin* said should be left to Congress or to the Secretary?

Where inventories with significant LIFO reserves are involved, taxpayers would be foolhardy to proceed without advance assurance from the IRS that there will be no LIFO recapture.

Taxpayers should consider the advisability of obtaining an advance ruling from the IRS to find out whether the Service will take the position that there is LIFO reserve recapture under Section 1363(d) in connection with any restructuring transactions that are being contemplated. Where partnerships, LLPs and/or LLCs are to be involved, the Ruling request should specifically address the interpretation and/or application of Reg. Sec. 1.701-2(e) in the context of potential LIFO reserve recapture.

Finally, the details of the restructuring undertaken by the Coggin Group are impressive in their sophistication and their complexity. Dealers considering similar "rearrangements" should be sure that their attorneys and advisors are experienced in handling transactions of this magnitude.

LEGISLATIVE HISTORY

Section 1363(d) was added to the Internal Revenue Code by Congress in 1986 to supplement and strengthen the built-in gains tax provisions of Section 1374.

[...*Note 13 to the Opinion of the Appeals Court adds the further explanation*... "Under Section 1374(a), a built-in gains tax is imposed upon an S corporation's net recognized built-in gain attributable to appreciated assets held at the time that S corporation status is elected. An S corporation must pay a separate corporate level tax on any net recognized built-in gains recognized through a sale or distribution of assets within 10 years following the effective date of the corporation's election of S corporation status ... . A C corporation using FIFO would be covered by Section 1374. A C corporation using LIFO would not. Recognizing that LIFO method C corporations electing S status could easily avoid Section 1374 tax on the built-in gain attributable to LIFO inventory (as long as they did not have a decrement in pre- election LIFO layers during Section 1374's 10-year recognition period), Congress added Section 1363(d). ...]

As the Conference Committee explained:

> Thus, a C corporation using the Last-In, First-Out (LIFO) method of accounting for its inventory which converts to S corporation status is not taxed [under Section 1374] on the built-in gain attributable to LIFO inventory to the extent it does not invade LIFO layers during the ten-year period following the conversion. (H.R. Conf. Rep. No. 100-495 at 974 [1987], reprinted in 1987-3 C.B. 193, 254.)

TAX COURT OPINION

There are two approaches to partnership treatment. The so-called ***"entity"*** approach treats partnerships as separate entities in and of themselves, with separate interests being treated as owned by each of the partners. An ***"aggregate"*** approach treats partnerships as mere aggregates of their partners, each of whom directly owns an interest in the partnership's assets and operations. As cited below, from time to time, the Commissioner and the Tax Court utilize one and then the other in analyzing the tax consequences of partnership activity.

Here, relying upon the legislative histories of Sections 1374 and 1363(d), the Tax Court reasoned that the application of an ***aggregate*** approach better served Congress' intent to prevent corporations from avoiding a second level of taxation on built-in gain assets by converting to S corporations. Its rationale was that the line of cases applying the aggregate approach would prevent Coggin from using the LIFO method of accounting to permanently avoid gain recognition on appreciated assets. See *Holiday Village Shopping Ctr. v. United States*, 773 F.2d 276, 279 (Fed. Cir. 1985); *Casel v. Commissioner*, 79 T.C. 424, 433 (1982); *Unger v. Commissioner*, 936 F.2d 1316 (D.C. Cir. 1991).

[...*Note 14 to the Opinion of the Appeals Court adds the further explanation*... "On the other hand, the Tax Court found that the ***entity*** approach would potentially allow Coggin to permanently avoid paying a second level of tax on appreciated property by encouraging transfers of inventory between related entities. While acknowledging the line of cases applying the entity approach, the Tax Court found them factually restricted to the specific code provisions at issue and their respective legislative histories. See *Brown Group, Inc. & Subs. v. Commissioner*, 77 F.3d 217 (8th Cir. 1996), rev'g 104 T.C. 105 (1995) (regarding Subpart F income); *Madison Gas & Elec. Co. v. Commissioner*, 72 T.C. 521, 564 (1979), aff'd 633 F.2d 512 (7th Cir. 1980) (regarding ordinary and necessary expenses under Section 162); *P.D.B. Sports, Ltd. v. Comm.*, 109 T.C. 423 (1997) (regarding Section 1056)." ...]

* ***Coggin Automotive Corporation v. Commissioner***
Tax Court ... 115 T.C. 349 (2000) ... Docket No. 1684-99 ... October 18, 2000
United States Court of Appeals for the Eleventh Circuit, 292 F.3d 1326, 89 AFTR2d 2002-2826 (CA-11, 2002) ... June 6, 2002

The Tax Court recognized that Subchapter K of the Internal Revenue Code (Partners and Partnerships) blends both approaches. [...*Note 15 to the Opinion of the Appeals Court adds the further explanation*... "In certain areas of Subchapter K, the aggregate approach predominates. See Sections 701 (partners, not partnership, subject to tax); 702 (income and credits of a partner). On the other hand in other areas of Subchapter K, the entity approach predominates. See Sections 742 (basis of transferee partner's interest); 743 (optional adjustment to basis of partnership property)." ...]

Outside of Subchapter K, the Tax Court concluded it to be a tossup, whether the aggregate or the entity approach was to be applied appears to have depended upon which approach more appropriately served the Code provision at issue.

Without further analysis, the Tax Court concluded that "both the legislative history and the statutory scheme of Section 1363(d) *mandate* the application of the aggregate approach," and deemed Coggin to own a pro rata share ($4,792,372) of the dealerships' inventories (emphasis added). ***We disagree.***

The Tax Court, while paying lip service to the "statutory scheme of 1363(d)," relies entirely upon the legislative history of Section 1363(d) and the line of cases using the aggregate approach, to provide an interpretation favorable to the Commissioner in ***quantum leap fashion. It is unclear from the opinion exactly how the Tax Court concluded that Congress intended this result.***

Most notably, no where in the opinion does the Tax Court address the plain meaning of the statute itself. Therefore, that is where we must start.

ANALYSIS ... THE STATUTORY SCHEME OF SECTION 1363(d)

Under its plain language, Section 1363(d) will apply and recapture of LIFO benefits will be triggered if two conditions are met:

(1) a C corporation elects S corporation status under Section 1363(a); and

(2) the C corporation "inventoried goods under the LIFO method" in the "last taxable year before the first taxable year for which the election under Section 1362(a) was effective."

Here it is clear that the first prong is met. However, it is apparent that, by definition, the second prong is not met. Coggin never owned any inventories. Accordingly it never made an election to use the LIFO method. In fact, the Commissioner concedes in its brief that the plain language of Section 1363(d) "does not literally apply to the facts of this case."

[...*Note 16 to the Opinion of the Appeals Court adds the further explanation*... "Indeed the Commissioner acknowledges that the Tax Court finding that the aggregate approach applies only "in the circumstances of this case" and concedes that treating a partnership as an aggregate in all instances will not achieve the purpose of Section 1363(d)." ...]

Continuing on with the plain language of the statute, a C corporation converting to S corporation status need only recapture its "LIFO recapture amount." *[Section 1363(d)(1)]*. LIFO recapture amount is defined as the difference between the value of an inventory asset as it would have been valued using the FIFO method and its value using the taxpayer's LIFO method. *[Section 1363(d)(3)]*. An inventory asset is defined as the "stock in trade ***of the corporation***, or other property of a kind which would properly be included in the inventory ***of the corporation*** if on hand at the close of the taxable year." *[Section 1363(d)(4)(B)]*.

Here it is undisputed that Coggin held no stock in trade. Neither did it hold property of a kind which would properly be included in its inventory at the close of its taxable year. ***Therefore under the plain meaning of the statute, there is no LIFO recapture amount that can be attributed to Coggin.***

ANALYSIS ... THE PLAIN MEANING RULE

The general rule is that unless there is some ambiguity in the language of a statute, a Court's analysis must end with the statute's plain language. *Caminetti v. United States*, 37 S.Ct. 192 (1917). "[W]hen the terms of a statute are clear, its language is conclusive and Courts are not free to replace that clear language with an unenacted legislative intent." *United States v. Morrison*, 844 F.2d 1057, 1064 (4th Cir. 1988). "[W]hen the import of the words Congress has used is clear ... we need not resort to legislative history, and we certainly should not do so to undermine the plain meaning of the statutory language." *Harris v. Garner*, 216 F.3d 970, 976 (11th Cir. 2000) (en banc).

Perhaps the Tax Court is straining to extend its interpretation of the legislative histories of Section 1373 and Section 1363(d) in order to close what it perceives to be a loophole in the case of holding companies that own no inventory yet elect S corporation status. In *Gitlitz v. Commissioner*, 121 S.Ct. 701 (2001), in a case dealing with a potential double windfall to S corporation shareholders due to a discharge of indebtedness, the Supreme Court held that "[b]ecause the Code's plain text permits the taxpayers here to receive these benefits, we need not address this policy concern." Id. at 710. "[T]he result is required by statute." Id. at n.10.

If "this is an inequity in the United States Tax Code ... only Congress or the Secretary (as the holder of delegated authority from Congress) has the authority to ameliorate" it. *Hillman v. Internal Revenue Service*, 250 F.3d 228, 234 (4th Cir. 2001); see also *Brown Group, Inc. v. Commissioner*, 77 F.3d 217, 222 (8th Cir. 1996)(where the Eighth Circuit reversed the Tax Court's use of the aggregate method of partnership taxation to close what it perceived to be a loophole in the Internal Revenue Code in that "such a tax loophole is not ours to close but must rather be closed or cured by Congress.").

In *Petroleum Corp. of Texas, Inc. v. United States*, 939 F.2d 1165 (5th Cir. 1991), the issue presented was whether a corporate partner in a partnership was subject to depreciation and depletion recapture under Sections 1245, 1250 and 1254 upon its liquidating distributions to shareholders of its interests in three partnerships. While acknowledging that the transactions had a valid business purpose, the Commissioner argued that the aggregate theory of partnerships should be applied to protect the recapture provisions. *Petroleum Corp.*, 939 F.2d at 1166.

The Fifth Circuit rejected the Commissioner's position, instead finding that the language of the statute was unambiguous and that, under the statute, partnership interests were not among the specific properties listed as being subject to recapture upon distribution. Id. at 1168. The *Petroleum Corporation* Court concluded that the aggregate theory could not be used to circumvent the clear language of the Internal Revenue Code:

> [T]here [is no] Code authority extant that would have authorized ignoring or "looking through" the partnership to conclude, fictitiously, that the corporations were distributing assets then held in partnership solution as distinguished from distributing interests in the partnerships themselves. Federal income tax law is replete with examples of applying the entity theory of partnerships on some occasions while applying the conduit or aggregate theory on others. It suffices that there is no authority for the government's expedient position that use of the conduit theory is authorized and that such use should somehow override the clear language of the Code. (*Petroleum Corp.*, 939 F.2d at 1168-69.)

[...*Note 17 to the Opinion of the Appeals Court adds the further explanation...* "Practically speaking, the Tax Court holding results in basis adjustment nightmares not contemplated by the Internal Revenue Code or its regulations. Coggin did not actually own inventory when it converted to S status. Therefore it had no inventory basis to increase. The Commissioner concedes that if the Tax Court result is affirmed, there is no guidance in the Internal Revenue Code as to how to implement the basis adjustment requirements of Section 1363(d). See e.g. *P.D.B. Sports, Ltd. v. Commissioner*, 109 T.C. 423 (1997)(where in Section 1056 it was not appropriate to apply the aggregate approach due to enormous basis complexities that would result, such that had not as yet been addressed or explained by Congress). Neither we nor the taxpayer receive much comfort from the Commissioner's response to this impracticable consequence that 'we can work this [basis problem] out.'"...]

Although the Federal Circuit reached a contrary conclusion on the recapture issue in *Holiday Village*, 773 F.2d at 279, the Fifth Circuit in *Petroleum Corporation* distinguished *Holiday Village* on the basis that there was no legitimate business purpose present in *Holiday Village*, therefore the application of substance-over-form principles was appropriate. *Petroleum Corp.*, 939 F.2d at 1167 n.1. We agree.

It is undisputed that the 1993 Coggin restructuring transaction had economic substance and a valid business purpose. The aggregate theory does not override the clear language of the statute. In accordance with *Petroleum Corporation*, we must follow the statute and not extend it, by using judicially-created, look-through principles. Id.

ANALYSIS ... IN SUMMARY

Reading the clear and unambiguous wording of the statute, applying recognized rules of statutory interpretation, Coggin is entitled to know what the tax consequences of its restructuring will be with reasonable certainty at the outset. Indeed its own accountants advised Coggin prior to the transaction that LIFO inventory should not be recaptured since it did not inventory any goods under the LIFO method.

[...*Note 12 to the Opinion of the Appeals Court adds the further explanation...* "The legal opinion rendered by the law firm engaged by Mr. Coggin did not address the issue of LIFO recapture. The talking points paper prepared by accounting firm KPMG made the following statement ... 'LIFO inventory should not be recaptured on conversion of [Coggin] from a C corporation to an S corporation ***since [Coggin] does not inventory any goods under the LIFO method*** for its last tax year as a C corporation (I.R.C. Section 1363(d))(some degree of IRS risk which is being reviewed by our Washington National Tax practice).' (Emphasis added)." ...]

It is worrisome to think that a taxpayer may not know in advance whether this would be the day that the fictional aggregate theory or the fictional entity theory of partnerships will be applied on an ad hoc basis. Relying upon the plain meaning of the statute, in a legitimate business transaction, a taxpayer deserves the right to be able to predict in advance what the tax consequences of such transaction will be with reasonable certainty. Here the statute just does not do what the litigation position of the Commissioner would have it to do.

[...*Note 18 to the Opinion of the Appeals Court adds the further explanation...* "Although not present in the regulations when Coggin undertook its restructuring, and, prospective in nature, the so-called anti-abuse regulation, Reg. Sec. 1.701-2(e), now specifically states that the Internal Revenue Service 'can treat a partnership as an aggregate of its partners in whole or in part as appropriate to carry out the purpose of any provision of the Internal Revenue Code or the regulations promulgated thereunder.'" ...]

Coggin was a holding company. It held stock in other C corporations. It was not engaged in the sale of automobiles. Under plain language of the statute, it had no LIFO inventory requiring recapture upon its election to become an S corporation. It is not necessary to resort to legislative history. Any potential windfall to holding companies must be cured by Congress, not the judiciary. See *Gitlitz*, 121 S.Ct. at 710.

CONCLUSION ... WE REVERSE THE DECISION OF THE TAX COURT.

IRS PUBLISHES APPEALS SETTLEMENT GUIDELINES FOR LIFO CASES INVOLVING DUAL INDEX METHODS

In February 2002, the IRS's Industry Specialization Program (ISP) published the *Appeals Guidelines* that would apply at the Appeals Conference level for all industry cases that involve LIFO taxpayers who are using the earliest acquisition or dual index method for valuing dollar-value LIFO increments. In general, the *Guidelines* reinforce the generally unreceptive attitude the Service has displayed in the past toward taxpayers using these methods. They also repeat and emphasize the generally unfavorable positions in the IRS Coordinated Issue Paper on this subject a few years ago.

In this article, the terms "dual index method" and "earliest acquisition method" will be used interchangeably, although this might not satisfy some LIFO purists or theoreticians. Also, the February 2002 document will be referred to simply as the *Appeals Guidelines*.

Given the complexity of the technicalities involved, our analysis of the *Appeals Guidelines* includes two supporting discussions for readers with varying practice backgrounds. On pages 22-23, there is more detail on the dollar-value method technicalities. On pages 20-21, there is an illustration of the obvious advantage (i.e., having a larger LIFO reserve) as a result of employing a dual index *method*.

The use of the word *"method"* in connection with the dual index discussion is intentional. The word *"method"* is used in the technical sense to convey the fact that ***an election must be made to use this method*** and that any change to, from, or in the use of the dual index method generally requires the advance approval of the IRS.

Prior articles in the *LIFO Lookout* on the use of the dual index method include analyses of the IRS Coordinated Issue Paper (CIP) on this subject released in a preliminary or draft form in July 1994 and in its final form in 1995. The final version of the CIP retained all of the restrictive language from the preliminary draft, and it discussed the tests that users of short-cut methods based on turnover will have to satisfy.

The 1995 CIP stated that "a taxpayer electing the earliest acquisition method must compute the layer valuation index by determining the ***quantity of each item*** (or a representative portion) in the ending inventory, including new items, and by comparing that quantity of items purchased or produced during the year, starting with the first day of the year and working forward until the number of units which are priced equals the quantity of such items in the taxpayer's ending inventory."

It is evident from the February, 2002 *Appeals Guidelines* that this is still the approach that the IRS prefers to see taxpayers take in their calculations.

The 2002 *Appeals Guidelines* state that the Examining Division position on the use of dual indexes is that taxpayers may ***NOT*** do the following:

- "Use a prior year's cumulative index in determining current year cost (earliest acquisitions).
- "Use an inventory turn, short-cut approach unless the taxpayer can demonstrate to the satisfaction of the District Director that its method *consistently results in the clear reflection of its income.*

"Some factors that may support clear reflection are (1) the inflation rate is substantially the same throughout the year, and (2) the items are purchased or produced at a substantially constant rate and mix throughout the year. The combined variances in (1) and (2) above ***generally*** support an assumption that the application of the short-cut method produces substantially the same results as if the taxpayer had double-extended (i.e., repriced) each item at current year and base year cost (in the case of taxpayers using the double extension method) or current year and prior year cost (in the case of taxpayers using the link chain method)."

This is an exact restatement from the 1995 Coordinated Issue Paper except that in the Issue Paper the word ***"manifestly"*** appeared in the last sentence quoted above, and "manifestly" has been changed to ***"generally"*** in the *Appeals Guidelines* document.

The *Appeals Guidelines* document states the issue as follows:

"Whether a taxpayer, electing the earliest acquisition method of determining the current year cost of items making up a dollar-value LIFO pool, can determine the index used to value an increment without double-extending the actual cost of the goods purchased or produced during the year in the order of acquisition."

The *Appeals Guidelines* do not provide an absolute "yes" or "no" answer to this question.

The *Guidelines* discuss the use of short-cut methods, non-regulatory methods and turnover methods, and in their context provide that ... "These short-cut or non-regulatory methods utilized by taxpayers (to estimate earliest acquisition costs) may subject the →

methodology to closer scrutiny under the clear reflection of income standard."

The *Guidelines* do concede that ... "If properly applied, the use of a two index method or dual indexes may result in an inventory valuation method that is substantially the same as if the ending inventory was double-extended on an item-by-item basis in the order of acquisitions (proper regulatory method). ***In other words, the standard for clear reflection of income must be the use of a single overall index that one obtains through the regulatory method.***" This may require the taxpayers to provide "proofs or studies that their methodology emulates the regulatory method elected."

The *Appeals Guidelines* discuss two different Conference level approaches depending on the situation. One approach applies in situations where taxpayers have used the prior year's cumulative index without adjustment to determine (i.e., to value for LIFO purposes) the current-year cost for the earliest acquisition method. The other portion of the *Appeals Guidelines* applies to situations where the taxpayer has used dual indexes or inventory turn methods.

"SITUATION #1" ... PRIOR YEAR'S CUMULATIVE INDEX, WITHOUT ADJUSTMENT, USED TO VALUE CURRENT-YEAR INCREMENT

Apparently, many taxpayers have simply overlooked the technicalities (see pages 22-23) and made no effort at all to compute the second index to be applied to their increments. For these taxpayers, on audit and/or at the Appeals Conference level, there seems to be little hope and certainly no sympathy likely to be forthcoming from the IRS.

In discussing this situation, the *Appeals Guidelines* state ... "One common impermissible short-cut method is to use the *prior year's cumulative index* to value the current year increment. In other words, the ratio of the prior-year cost of the pool to the total base-year cost of the pool. This method would assume there is no inflation in the current year increment. ***Generally, such an assumption is unrealistic.*** Furthermore, this method is in direct violation of Reg. Sec. 1.472-8(e)(2)(iv) which requires that increments be valued using the ratio of the total current-year cost of the pool to total base-year cost of the pool. Further, use of the prior year's index squarely addresses the primary position of this coordinated issue of not allowing such prior year's index as an acceptable 'short-cut' methodology."

When caught in this scenario, taxpayers should expect the worst. The *Guidelines* provide, "Taxpayers using such methodology are not in compliance with the regulatory authorities ... and there should be little reason for its continued use or for some intermediate percentage settlement. It is an unallowable method. Such methods are not approved when taxpayers request a change in method of accounting with the National Office and should not be authorized at the field level (Exam or Appeals)."

Appeals Officers are directed to consider the facts and circumstances of each case, and they are provided with four alternative approaches for dealing with "Situation #1" cases:

- ***First,*** give the taxpayer an opportunity to properly reconstruct its increment valuation as technically required in the order of acquisition under Reg. Sec. 1.472-8(e)(2)(ii)***(b)***. This is the regulatory method the taxpayer elected and the standard to start with to determine ***clear reflection of income***.

- ***Second,*** compute the increment valuation under Reg. Sec. 1.472-8(e)(2)(ii)***(a)***. This is a regulatory method that uses the actual cost of goods most recently purchased or produced during the year, commonly called the "most recent purchases method." It does not follow the reverse flow of goods LIFO theory as well as the earliest acquisition method. A specific matters closing agreement under Code Section 7121 should be used if the resolution results in a permanent accounting method change to this acceptable regulatory method.

- ***Third,*** compute the increment valuation using the average cost method provided by Reg. Sec. 1.472-8(e)(2)(ii)***(c)***. The average cost method is another permissible method that is consistent with manufacturers' standard cost or burden rate method.

- ***Fourth & finally, the worst case scenario*** ... If the taxpayer does not have the records in the order of acquisition to properly compute its elected method and further does not have records to reconstruct under the alternative most recent purchases regulatory method, ***the viability of continuing the LIFO method must be analyzed thoroughly.***

This is IRS shorthand for terminating the taxpayer's LIFO election based on Revenue Procedure 79-23, (1979-1, C.B. 564), which is the Service's official position on termination or revocation of a taxpayer's LIFO method. In this case, consultation with the Appeals Inventory specialist is essential and required.

One Troublesome Issue. Neither the preliminary draft (1994) nor the final CIP (1995) indicated whether the Service would accept a ***cumulative*** earliest acquisition index that is the product of multiplying the prior year's ***cumulative*** deflator index by a separately computed Earliest Acquisition index for the current year in cases where the index for the current year might be 1.000.

see **DUAL INDEX METHODS** , page 18

A current-year earliest acquisition index of 1.000 when multiplied by the previous year's cumulative index, results in a cumulative index to value the current year's increment which, by identity, is the same as the previous year's cumulative index. If all items in the ending inventory were "new" items, that would produce an earliest acquisition index of 1.000 to be used to value the current year's increment since there is no inflation in new items according to the IRS.

The *Appeals Guidelines* state, "Generally such an assumption is unrealistic." In this case, the assumption refers to the use of the prior year's cumulative index *without adjustment.* But is it an absolute prohibition against the use of the prior year's cumulative index without adjustment as the factor for valuing the current year's increment? One could argue that this statement only should be interpreted as referring to situations where the prior year's cumulative index has been blindly used to value the computed increment. It would seem that this categorical statement should not automatically rule out situations where the result is supported by the facts and, therefore, by definition is not an assumption at all.

"SITUATION #2" ... DUAL INDEXES OR INVENTORY TURN METHODS

It appears the IRS may have a little more patience or tolerance with LIFO taxpayers who have tried, but obviously without success, to use a dual index method. The comments relating to short-cut and turnover methodologies appear on the facing page.

For LIFO taxpayers involved in these situations, the *Guidelines* state "...It is difficult to establish a firm cut-off percentage to delineate good cases from bad. If the taxpayer can reconstruct the items acquired in the first part of the year according to the Regulations, an informed decision can be made of this reconstructed data to the taxpayer's return position."

The *Guidelines* provide that "the acceptability of these and other similar approaches depends on whether the short-cut method produces results ***that approximate the methods prescribed in the Regulations***. This is a facts and circumstances intensive issue that requires careful review and study." Consultation with Inventory Issue Specialists for assistance, review and concurrence is mandated. It would appear that this zeroes in on the references elsewhere to the requirement that the standard for comparison should be the result obtained by the use of a single overall index.

The *Guidelines* recognize that it is difficult to give a pro-forma percentage or formula because of the many mitigating factors. In this regard, they provide, "Intermediate settlements based on a percentage

(Continued from page 17)

difference below the most recent purchases method ***(least advantageous to the taxpayer)*** may be a good starting point, since it is a regulatory method. This approach should only be used for intermediate settlements based on the hazards of litigation for the years under the jurisdiction of Appeals. It would not be an acceptable permanent accounting method to place the taxpayer on since it is a nonregulatory method."

Finally, the *Guidelines* acknowledge that they may not cover all fact situations and that different factual situations or variations may arise that cause them to be inappropriate.

ONE OTHER COMPUTATION MATTER

There's another computational matter that is not commented on specifically in either the final version of the IRS's 1995 CIP or in the 2002 *Appeals Guidelines.* Ironically, every taxpayer using a dual index method has to contend with it, and we've seen many different approaches employed.

This matter relates to the mechanics of computing the cumulative index factor to be applied to increments computed in years after the first LIFO year.

One would assume that in years *after the first LIFO year*, a 1% earliest acquisition factor for that current year would be multiplied by the **cumulative** inflation rate at the beginning of that year in order to derive the ***cumulative incremental*** (earliest acquisition) factor. This approach is consistent with the mechanics used by the taxpayer in Letter Ruling 8421010 which was specifically referred to in the draft version of the CIP (in 1994) but which was deleted in the final version in 1995.

CONCLUSION

Taxpayers should review their LIFO computations if they are using dual index methods to see how close–or how far–their results are from those obtained by the use of a single overall index.

If the dual index / earliest acquisition indexes have not been properly computed in prior years, there may be some relief. Protection from IRS audit adjustment because of "problems" in turnover calculations or underlying assumptions may be possible by filing Form 3115 to request permission to change increment valuation methods. If the taxpayer is not under audit when the Form 3115 is filed, LIFO changes requested usually are granted allowing the taxpayer to use the cut-off method and avoid a Section 481(a) adjustment.

Another possibility might be to change the overall LIFO method to the IPIC method now that the final IPIC Regulations do not require a 20% reduction in the inflation index for the pool.

COMMENTS FROM THE APPEALS SETTLEMENT GUIDELINES ON SHORT-CUT AND TURNOVER METHODS

When computing the increment valuation or secondary index, many taxpayers fail to double-extend the end of year quantities and earliest acquisition costs. Instead, they rely on various short-cut methods to estimate earliest acquisition costs. ...The Regulations require the taxpayer to use actual acquisition prices from the beginning of the year for the number of items acquired to develop the increment valuation index. Taxpayers with large complex inventories that use a standard cost system have difficulties in determining cost at the beginning of the year in order of acquisition so as to literally comply with the technical requirements ... . Generally, a perpetual standard cost system averages costs so that a taxpayer using a standard cost method will have the same book cost for all production of an item during the year. Therefore, taxpayers argue certain "short-cuts" may be necessary to emulate the earliest acquisition method. ***These short-cut or non-regulatory methods utilized by taxpayers may subject the methodology to closer scrutiny under the clear reflection of income standard.***

Tax accounting and inventory commentators discuss the fact that the dual index method can produce correct results, but warn that the earliest acquisition costs would not reflect the costs incurred by the taxpayer on any particular date, such as the first day or the last day of the first quarter of the taxpayer's year. Instead, such costs must be computed by determining the quantity of each particular type of item which is contained in the taxpayer's ending inventory and by comparing a sufficient number of the same items purchased or produced by the taxpayer during the year, commencing with the first day of the year and working forward until the number of units which are priced equals the quantity of such items in the taxpayer's ending inventory.

If properly applied, the use of a two index method or dual indexes may result in an inventory valuation method that is substantially the same as if the ending inventory was double-extended on an item-by-item basis in the order of acquisitions (proper regulatory method).

In other words, the standard for clear reflection of income must be the use of a single overall index that one obtains through the regulatory method. Verification of the result must be satisfactorily demonstrated by the taxpayer.

The inventory turn method is another short-cut methodology that may cause a potential distortion because of its treatment relative to new items entering the inventory. One of the reasons taxpayers elect the link-chain method is because they have a significant number of new items entering the inventory every year, but it causes difficulties in computing any increment under the earliest acquisition method or strict regulatory method.

This short-cut inventory turn method assumes that items are purchased at a constant rate and mix throughout the year. Under this method, if the inventory turned twelve times a year, the operative portion of the index would be divided by twelve. For example, if the current index were 1.12, the operative portion would be .12 (1.12 minus 1). This method would then assume the secondary index was 1.01 (.12 divided by 12 equals .01 and 1. plus .01 equals 1.01).

The possible distortion is based on the fact that ***the inventory turn method assumes a constant rate of inflation throughout the year.*** If inflation does not occur at a constant rate, the inventory turn method will not produce the same result, which the strict earliest acquisition regulatory method ... produces. The materiality difference can only be measured if the taxpayer has the records or means to compute the increment by the regulatory method. Essentially, it's an argument on an argument because their book or standard cost system for non-tax purposes is what caused them to use the short-cut inventory turn method in the first place. ***Some taxpayers cannot meet this required burden and adjustments are conceivably necessary for clear reflection of income.***

Whether there is a reasonable constant rate, including the first inventory turn, or whether the majority of new items would be purchased (or produced) after the first inventory turn must be reviewed. If new items make up a material portion of the overall inventory, and the new items are not considered in the computation of the increment valuation index, that index will be understated during periods of inflation thereby valuing the layer below the regulatory method and understating taxable income.

New items must be included in the computation of the LIFO increment indexes for income to be clearly reflected. The distortion is not limited to understatement of the index, but inventory turn method could result in an overstatement of the index. The amount and severity of the distortion is dependent upon the actual rate of inflation throughout the year, and at times of the year, compared to an assumed constant rate. It would be unusual for the distortion to be zero.

The taxpayers, in order to sustain their burden, must provide proofs or studies that their methodology emulates the regulatory method elected, otherwise adjustments may be required by the ... examiner for income to be clearly reflected.

Taxpayers may argue that if their short-cut method to determine the increment valuation is not an acceptable method under Reg. Sec. 1.472-(8)(e)(2)(ii)***(b)*** then it is an acceptable method under Reg. Sec. 1.472-8(e)(2)(ii)***(d)*** - any other proper method that clearly reflects income. In order to determine whether a method that is intended to emulate the earliest acquisition method is reasonable, the proposed method must be judged by comparing it to the earliest acquisition method. Therefore, if the taxpayer changed from the earliest acquisitions method to a short-cut method, the taxpayer has made an unauthorized change in its method of accounting. In that case, the Service may change the taxpayer back to the earliest acquisitions method and propose a Section 481(a) adjustment.

There is no case law directly on point with the various short-cut methods described above. The taxpayer clearly has the burden of proving its LIFO index is an accurate reflection of its inflationary price increases. The LIFO Regulations are legislative, which gives them the effect of law (and) these Regulations place a strong burden of proof on the taxpayer.

WHY TAXPAYERS PREFER TO USE DUAL INDEXES FOR VALUING LIFO INVENTORIES

Question: Why do many taxpayers *prefer* to use the dual index or earliest acquisition method?

Answer: ... To get larger LIFO reserves.

Generally, over a long-term period of rising prices, the dual index / earliest acquisition method will result in lower valuations of their LIFO inventories. This result will occur to the extent that the overall cumulative inflation rate at the end of the year is greater than the cumulative inflation rate that is being used to value that year's increment. Over many years with many increments, the differences in indexes could create a significantly larger LIFO reserve than if annual increments in any given year were multiplied by that year's cumulative primary or deflator index.

In one recent situation, the increase in the LIFO reserve for a pool where this method was employed was almost $3.9 million. Out of this amount, because of the very large current-year increment, slightly over $2 million of the LIFO reserve increase was attributable to the use of the dual index approach.

Example. The following illustrates the advantage using some smaller numbers in an initial LIFO year situation.

• *LIFO beginning-of-the-year "base" inventory*	*$ 650,000*
• *End-of-the-year inventory at cost*	*$ 838,056*
• *Current year inflation index (7.55% inflation)*	*1.0755*
• *End of the year inventory stated in terms of base date costs ($838,056 divided by 1.0755)*	*$ 779,225*

If prices had not increased during the year, the quantity of ending inventory that cost $838,056 would have *cost* only $779,225. In other words, the ending inventory restated at beginning-of-the-year costs has been "deflated" by dividing the actual cost at year-end ($838,056) by the inflation index of 1.0755. The resulting amount of $779,225 is then compared to the beginning of the year inventory amount ($650,000) to measure or determine if there has been an increase or a decrease in the investment of dollars (expressed in terms of constant purchasing power) in inventory.

Based on the 7.55% inflation index computed for the first year of this LIFO situation, since the inventory at the beginning of the year was $650,000, there has been a current year increase or increment of $129,225 ($779,225 - $650,000) and this increase or increment ***must*** be further valued for LIFO purposes.

Under the double-extension method, the current year increment would be multiplied by the cumulative index as of the end of the current year. Therefore, since the increment (expressed in base dollars) was $129,225, that amount is multiplied by the current year index - which is also the cumulative index in the first year - of 1.0755. This increases the current year increment for LIFO purposes to $138,981 which is its "current cost" for LIFO purposes (i.e., its LIFO valuation). The LIFO valuation of the inventory at the end of the year is simply the sum of the beginning-of-the-year (or base) inventory of $650,000 plus the current year increment of $129,225 as adjusted to its LIFO valuation of $138,981.

If a dual index/earliest acquisition approach were properly elected and employed in the initial year and it were determined (to the satisfaction of the Internal Revenue Service) that the earliest acquisitions - sometimes called "first purchases" - during the year for this purpose were made subject to price increases of only 2.6%, then the current year increment (expressed in base dollars) of $129,225 would be multiplied by 1.026% (instead of 1.0755%) in valuing it for LIFO purposes. This would produce a corresponding LIFO valuation for that increment of $132,585.

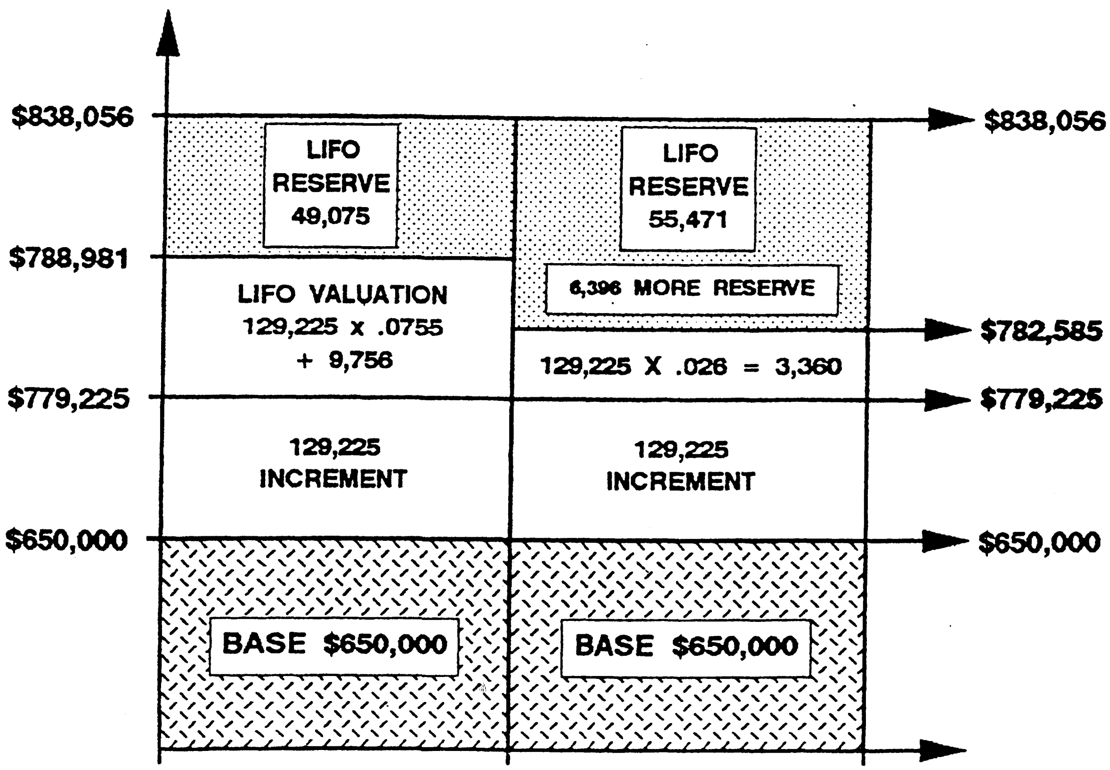
As a result of using this earliest acquisition index for valuing the current year's increment, the LIFO reserve would be approximately $6,400 greater. ($138,981 - $132,585 = $6,396.) This difference in LIFO reserve is simply the difference between the cumulative index at the end of the year and the index used to value the increment (1.0755 - 1.0260 or .0495) multiplied by the increment expressed in base dollars of $129,225.

As shown on the facing page, the LIFO reserves ... under either the single index or the dual index computation approach ... are the shaded uppermost portions of the respective tiers. Under the single index approach, the LIFO reserve is $49,075. Under the dual index approach, the LIFO reserve is $55,471. The amount of the difference in the LIFO reserves where the dual index / earliest acquisition approach is used is simply due to the difference in the factors that are used to value the increment (expressed in base dollars).

For taxpayers who want their LIFO reserves to be legitimately larger, this example shows why they are willing to undertake the extra effort required to use and justify the dual index method for valuing their LIFO inventory increments.

COMPARISON OF LIFO RESERVE RESULTS
DUAL LINK-CHAIN INDEXES FOR VALUING INCREMENTS

	SAME AS CURRENT YEAR (1.0755)	EARLIEST ACQUISITIONS (separate index=1.026)
LIFO base (beginning) Inventory	$650,000	$650,000
Current year increment, as adjusted		
$129,225 x 1.026 =	—	132,585
$129,225 x 1.0755 =	138,981	—
Ending Inventory at LIFO	788,981	$782,585
Ending Inventory at cost	838,056	838,056
LIFO Reserve	$ 49,075	$ 55,471
<u>Analysis of LIFO Reserve</u>		
Base Inventory ($650,000 x 7.55%)	$ 49,075	$ 49,075
Difference due to valuation of increment $129,225 x 4.95% (7.55% - 2.60%)	—	6,396
LIFO Reserve	$ 49,075	$ 55,471



Introduction. Generally, the *dollar-value method* is preferable to use in LIFO calculations because it treats the inventory as representing an investment of dollars rather than as an aggregate of individual items (unit method). The dollar-value method uses base year costs which are expressed in terms of total dollars invested in the inventory as its unit of measurement. This unit of measurement is applied to groupings, or categories, of inventory referred to as pools.

Reg. Sec. 1.472-8 prescribes the operating rules for the use of the dollar-value LIFO method of pricing inventories. Reg. Sec. 1.472-8(e)(1) is the basic provision, which outlines three methods to price dollar-value LIFO inventories:

(1) double-extension method;

(2) index method; and

(3) link-chain method.

These three methods apply different techniques to accomplish the following two objectives: (1) determine the base-year costs of current-year inventories; and (2) compute an index to price increments of base-year costs occurring during the current year. The use of the phrase "index method" can be misunderstood because each of the three LIFO pricing methods, i.e., double-extension, index and link-chain, are methods that apply price indexes. Reg. Sec. 1.472-8(e)(1) also states, among other things, that the appropriateness of the index must be demonstrated to the satisfaction of the district director in connection with the examination of the taxpayer's income tax returns.

The double-extension method requires that each item of inventory (100 percent) is priced at its base- year unit cost as well as its current-year unit cost. The sum of all extended base year costs is divided into the sum of all extended current-year costs to obtain a dollar-value index. The dollar value index is used to value increments.

The index method is an allowable method where indexes are developed by double-extending (*i.e., repricing*) a representative portion of the inventory in a LIFO pool(s) or by using other sound and consistent statistical methods. In contrast to the double-extension method, the index method divides the sample index into total current-year costs to obtain total base-year costs in the current inventory. This projection technique is necessary because the index method does not double-extend (*i.e., reprice*) the entire current-year inventory. This index is also used to value increments (increases) in inventory, which is the subject of this guideline.*

The link-chain index method is a cumulative index which considers all annual indexes dating back to the year of the LIFO election and must be computed every year to keep the cumulative index current. Each year, a taxpayer computes a new cumulative index and uses that index to determine the base-year cost of the ending inventory in a pool and to value the increment for the year, if any. *[Note: This third dollar-value LIFO method is referred to as "the link-chain **index** method ... which may be distinguished from the third DVM method previously identified as the "link-chain" method. Readers of the "LIFO Lookout" will note that a distinction has consistently been made between these two terms in all LIFO discussions.]*

The taxpayer's link-chain method may double-extend (*i.e., reprice*) all items in ending inventory ***or use a sampling technique***. The ending inventory must be priced at their beginning and end-of-year costs in order to obtain the annual index that is "linked" (multiplied) to the prior year cumulative index to arrive at the current year cumulative index.

In actual practice, it will be found that the procedures used by most large taxpayers are to double-extend (*i.e., reprice*) a representative portion of the inventory by some type of sampling technique, similar to what a taxpayer on the index method performs. The use of a sampling technique to compute the link-chain index is allowable, assuming it was properly elected, and the sampling methodology is statistically sound and consistently applied.

The Regulations also include examples as to how LIFO inventories should be computed under the double-extension method. There are no examples or other Regulations that relate specifically to the use of the index or link-chain methods, but it is commonly agreed that those methods are conceptually comparable to the double-extension method. See, e.g., *All Industry Coordinated Issue Paper, Dollar-Value LIFO Segment of Inventory Excluded from the Computation of the LIFO Index* (June 26, 1995).

Except for the requirement to double-extend (*i.e., reprice*) each item in ending inventory, the principles and operating rules in the double-extension Regulations are conceptually applicable to taxpayers on the index or link-chain methods. The double-extension Regulations are cited frequently to justify various methods and approaches used in conjunction with the link-chain method. For example, Reg. Sec. 1.472-8(e)(2)(iv), which describes the rules for determining layer increments and decrements, has been applied to the link-chain method.

Reg. Sec. 1.472-(8)(e)(2)(ii) provides that a taxpayer is allowed to determine the current-year cost of items making up the inventory by reference to:

(a) the actual cost of the goods most recently purchased or produced during the year;

(b) the actual cost of the goods purchased or produced during the year in the order of acquisition (the so-called, "earliest acquisition" method);

(c) the average cost of the goods purchased or produced during the year; or

(d) any other proper method which clearly reflects income.

(Continued)

Reg. Sec. 1.472-8(e)(2)(iv) states in part: "To determine whether there is an increment or liquidation in a pool for a particular taxable year, the end of the year inventory of the pool expressed in terms of base-year cost is compared with the beginning of the year inventory of the pool expressed in terms of base-year cost. When the end of the year inventory of the pool is in excess of the beginning of the year inventory of the pool, an increment occurs in the pool for that year. If there is an increment for the taxable year, the ratio of the total current-year cost of the pool to the total base-year cost of the pool must be computed. This ratio when multiplied by the amount of the increment measured in terms of base-year cost gives the LIFO value of such increment."

Paraphrasing this Regulation, an ***increment*** in a dollar-value LIFO pool occurs when the year-end inventory for the pool, expressed in terms of base year cost, exceeds the beginning-of-the-year inventory for that pool, also expressed in base year cost. To determine the ending inventory LIFO value for a pool, any increment is adjusted for changing unit costs by reference to a percentage or index, relative to base year cost, determined for the pool *as a whole*. This is the sub-election required when a taxpayer elects LIFO on Form 970 by question/item 7(a). Previous versions of Form 970 reflected this election at question/item 6(a).

This election is made by checking/selecting one of the four boxes appearing on Form 970, question/item 7(a):

1. Most Recent Purchases
2. Average Cost of Purchases During the Year
3. Earliest Acquisitions During the Year
4. Other - Attach Explanation

Generally speaking, the "earliest acquisitions" method is often referred to as either the "dual index" method or as the "first purchases" method.

The fourth box or "Other" category above really allows a number of other choices, so long as the method selected can be properly identified, described and justified. One example of an "Other" method is the "specific identification increment method" allowed by the Alternative LIFO Method for Automobile Dealers.

When dual indexes are used by taxpayers on the link-chain method, they must compute a "primary" index. The primary index measures current year inflation by double-extending (*i.e., repricing*) end-of-year quantities at most recent purchase or last acquisition (FIFO) costs in effect at the beginning of the year. Taxpayers then multiply this primary index by the prior year's cumulative index to arrive at a deflator index. The deflator index is used to compute inflation from the beginning of the taxable year for which LIFO was first adopted (the base year) to the current year. If the taxpayer's ending inventory stated at base-year costs is greater than the taxpayer's beginning inventory at base-year costs, an increment results. The increment, at base year cost, is then converted to current LIFO cost by applying the increment valuation index.

You should only use this type of dual index with a deflator index on a link-chain taxpayer. This secondary or increment valuation index is developed to value increments. This secondary index is computed by extending a representative portion of the current year ending inventory using earliest acquisition cost and then dividing this result by the base year cost of the same inventory. Taxpayers using the double-extension method do not need the deflator index, although they still need a proper index to value any increments.

Dual Indexes. In summary, two separate index calculations may be involved in connection with the use of the link-chain or link-chain, index methods:

1. The computation of the current year index of inflation, sometimes referred to as the primary, conversion or deflator index. This index is used to reduce or deflate the ending inventory from its actual current cost to its base dollar equivalent.
2. The computation of a second, separate index used <u>only</u> for purposes of valuing the actual increment, sometimes referred to as the secondary or incremental valuation index. This second index is used to raise any increment computed for the year from its expression in terms of base dollars to its equivalent in terms of current LIFO cost.

**** Source: Appeals Industry Specialization Program Settlement Guidelines***

Dollar-Value LIFO Earliest Acquisition Method ... Applicable to All Industries

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