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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. CHANGES IN ACCOUNTING METHOD ...

STILL THE HOT TOPIC. This entire issue of the *LIFO Lookout* is devoted to one major topic ... ***changes in accounting methods*** (CAMs) that are being made to eliminate trade discounts and advertising fees and expenses from inventory costs.

Although our discussion is in terms of automobile dealers, these CAMs can be beneficially made for a variety of other inventory-intensive clients.

We have included extensive discussions and illustrations to reflect the many considerations where LIFO inventories are involved with these changes in accounting method. Also, to demonstrate some actual results, we've included two cost effectiveness–benefit analyses on pages 27 and 30. From these, you'll see the size of the benefits that some dealers are garnering from making these changes.

For auto dealers using LIFO, the benefits of making these changes can be significant. The Section 481(a) adjustments required to implement these changes will be ***negative*** adjustments. The great news is that the entire amount of the adjustment is 100% deductible in the year of change.

Even better is the fact that these deductions (i.e., the reductions of LIFO valuation of opening inventory in the year of change) are permanent deductions. They are locked into, or embedded, in the LIFO layer valuations. As a result, the amount of the Section 481(a) deduction for a LIFO taxpayer will only be paid back or offset in the future under certain circumstances. See *LIFO Bonanza* on page 13.

This more permanent aspect of the Section 481(a) adjustment for LIFO taxpayers needs to be distinguished from the more obvious year-to-year offsetting effect of the year-end differences in the amounts of trade discounts (and/or ad fees) in successive years. These year-to-year differences will wash or more directly offset from year to year ... unless inventory levels and program dollars included in vehicle costs generally increase over the years.

LOOKOUT LOOKS INTO

A word of caution to CPAs: You probably should not attempt on your own to undertake the necessary year-by-year, invoice-by-invoice, manufacturer-by-manufacturer analyses that are necessary to determine the amounts to be eliminated from ending inventory. These determinations really require specialized databases and familiarity with program variations that few CPA firms already have. For more on this, see page 15, *Issues / Perils for CPA Firms Undertaking the "Do-It-Yourself" Approach.*

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#2. YEAR-END PARTS INVENTORIES VALUATIONS. You might want to review Revenue Procedure 2002-17 with your dealers to be sure that they are in compliance with its safe-harbor provisions.

This Rev. Proc. allows dealers to use replacement cost, instead of actual cost, for valuing parts inventories ***but only if*** the replacement costs (1) are determined as of the year-end date and (2) reflect the inventory mix on hand as of that date. So, be careful in this regard. Our suggestion is that you might want to check to see if your dealers are really doing this.

#3. TREATMENT OF CASH DISCOUNTS. In April 2003, the IRS released a Proposed Coordinated Issue Paper describing its position on the treatment of cash discounts. The Service said cash discounts must be determined on an invoice-by-invoice basis in order to clearly reflect income.

Although this proposed CIP only discusses ***cash discounts***, it would appear that the IRS will apply (approximately) the same reasoning with respect to trade discounts, advertising fees and/or to dollar-value LIFO inventory situations. Accordingly, we have included a summary of the proposed CIP on pages 38-39.

Changes in Accounting Methods to Eliminate Trade Discounts (Floorplan Assistance Payments) & Advertising Fees & Expenses from Inventory Costs

CHANGES IN ACCOUNTING METHODS TO ELIMINATE TRADE DISCOUNTS (FLOORPLAN ASSISTANCE PAYMENTS) AND ADVERTISING FEES & EXPENSES FROM INVENTORY COSTS

BACKGROUND

In recent years, many CPA firms have been filing Forms 3115 for their auto dealership clients in order to change their accounting treatment for certain Factory floorplan assistance payments and advertising fees and expenses. These changes in accounting methods (CAMs) have been made to eliminate these items from previously capitalized inventory costs. As a result of making these changes, by reducing ending inventory valuations, the dealerships have reduced their taxable income.

These changes in accounting methods are extremely beneficial for taxpayers who value their inventories using the LIFO (Last-In, First-Out) inventory method.

However, the fact should not be overlooked that these changes can also be beneficial for non-LIFO taxpayers if the absolute amounts of the year-end inventories are large and the compliance costs are not bloated by excessive conversion compliance costs.

Gathering momentum. In addition to the obvious, immediate reduction of taxable income effect, three recent developments have contributed to the "popularity" of these CAMs. ***First***, it used to be that making changes to eliminate *trade discounts* from inventory costs required advance permission from the IRS. However, in Revenue Procedure 2002-9 this change was elevated to "automatic change after year-end" status.

Second, under more recent Procedures, when a taxpayer changed an accounting method and the result was to reduce taxable income in the year of change, the effect of that change was required to be spread over four years. This meant that only 25% of the net adjustment was allowed as a deduction in the year of change. Thereafter, 25% was allowed in each of the 3 succeeding years.

However, shortly after the issuance of Rev. Proc. 2002-9 (which mandated a 4-year spread), it was superseded by Rev. Proc. 2002-19 which allowed taxpayers who had a *negative adjustment under Section 481(a) resulting from a voluntary change in method to deduct the entire amount of the adjustment from income 100% in the year of change.*

Third, the IRS made this whole area even more attractive by issuing Revenue Procedure 2002-54 (2002-35 I.R.B. 432). In Rev. Proc. 2002-54, the IRS "clarified" Rev. Proc. 2002-19 regarding the application of the 1-year negative Section 481(a) adjustment period to pending or recently approved change applications under both Rev. Proc. 97-27 and Rev. Proc. 2002-9.

Rev. Proc. 2002-54 allowed companies with Form 3115 applications filed for a year of change ending before Dec. 31, 2001 (and pending on March 14, 2002) to modify their applications so that they could take advantage of the 1-year spread by deferring the year-of-change to the first tax year ending after December 31, 2001. This Revenue Procedure also allowed most companies that had already received consent agreements to make similar elections. This "rollover of the year-of-change" permission basically required the taxpayer to simply notify the National Office of its desire to do so by December 13, 2002.

At the October 2002 AICPA Dealership Conference in Orlando last year, these CAMS were the biggest tax topic discussed. For a long time, many of the Big 8 ... Big 6 ... Big 4 accounting firms had been making similar changes in accounting methods for their clients. More recently, the "trickle-down" or copy-cat effect finally started reaching smaller CPA firms and their dealership clients.

CURRENTLY STILL (SOMEWHAT) CONTROVERSIAL ... AND A GREAT PLANNING AND/OR MARKETING OPPORTUNITY

As a result of these developments, more and more CPA firms began taking advantage of these beneficial changes. Other firms, not already aware of these developments, gradually woke up and were somewhat defensively forced to take "a closer look" at these potential CAMs.

In addition to being discussed at last year's AICPA Auto Dealership Conference in Orlando by two speakers, the subject of eliminating floorplan assistance payments and/or ad fees from inventory costs comes up in almost every tax discussion at Dealer 20 Group meetings and at other CPA/dealership group meetings.

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Trade Discounts & Ad Fee CAMs

(Continued from page 3)

It is not an exaggeration to say that the discussion of these changes is currently still a somewhat controversial or hot topic. In addition to being a significant year-end tax planning opportunity for many clients, some firms also see it as a significant new business development opportunity.

The ability to intelligently discuss and evaluate the ramifications of these changes in accounting method separates CPA firms that are more aggressively marketing to dealers ... from more passive CPA firms that are less growth/marketing oriented. Some firms that are lesser informed on this subject have found themselves on the defensive when called upon to respond to pressure coming from dealers who are returning from presentations to their 20 groups and other meetings where they heard about these new ideas from other CPA speakers

By demonstrating competence in this planning area, many CPA firms have been able to secure a "foot in the door" in discussions with prospective dealership clients. And finally, where these CAMs have been made and the dealerships have secured significant tax benefits, that cannot help but enlarge a sense of dealership-to-CPA-firm loyalty.

DIVIDED OPINIONS ... DIFFERENT SCHOOLS OF THOUGHT

In discussions with many CPAs regarding the desirability and mechanics of these accounting method changes, it becomes evident that there are many analytical approaches, with differing weights or emphases assigned to different factors.

In general, CPAs who are not familiar with the issues and these changes tend to initially react in a negative way toward them. Often the reaction is more emotional and defensive than analytical. Hopefully, this article will make a persuasive case for these CAMs by letting the analyses and results speak for themselves.

Typical negative reactions include... "It's just a timing difference." ... "Not really worth it." ... "My dealers don't see the benefit." Often, these reactions simply reflect the fact that the CPAs really didn't see the numbers! Or, more accurately, they weren't able to understand all of the underlying issues and think through their ramifications.

It is true that there can be a huge difference in the CAM benefits for dealers using LIFO as compared to dealers who are not using LIFO (i.e., dealers using specific identification). For dealers on LIFO, the larger the LIFO valuation of their inventories, the larger the amount of benefit that becomes permanent because it will not "turn around" or be a wash in the next year.

For dealers not on LIFO, although the net effect of the change is a timing difference, if the absolute dollar amount of the inventories is large, the benefit of a year-to-year deferral can be significant even without the further benefit of the more permanent or "built-in" benefit for LIFO inventories. After all ... Why should any dealership–on LIFO or not–prepay its taxes if the changes can be made in a cost-efficient way?

It has been generally accepted for many years that LIFO, which depends on inflation (over which the dealer has no control), is attractive for dealership new vehicle inventories. Why shouldn't CAMs to eliminate trade discounts and advertising fees and expenses, which depend on the continuation of Factory programs (over which dealer has no control), also be attractive?

TWO DIFFERENT CAMs & TWO DIFFERENT FILING PROCEDURES

It is important to keep in mind that although this article may, for convenience, refer to these CAMs in the singular, or collectively, these CAMs involve two completely different sets of change procedures.

Trade discounts (floorplan assistance payments, etc.). Rev. Proc. 2002-9 makes changes involving trade discounts attractive in four ways.

- IRS grants automatic permission to change,
- Decision to change does not have to be made before year-end,
- Form 3115 filing procedures are simplified and basically involve filings after year-end, and
- Payment of a user fee is *not* required.

Advertising fees and expenses. In contrast to the above, Rev. Proc. 2002-19 and Rev. Proc. 97-27 provide that changes in accounting methods involving advertising fees and expenses must meet different, and comparatively more restrictive, requirements.

- IRS ***does not*** grant automatic permission for ad fees and expenses CAMs,
- Decision to make an ad fee/expense CAM must be made *before* year-end,
- Form 3115 must be filed with the IRS *before* year-end,
- Payment of a user fee ... recently changed to $1,500 ... is required, and
- Form 3115 filing procedures are more complicated (see the Rev. Procs. for details).

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DISCOUNTS COMMON TO ALL DEALERSHIPS ... WHETHER USING LIFO OR NOT

There are several types of discounts that might be encountered in dealership inventory situations. These include (1) cash discounts, (2) trade discounts (including volume discounts and many floorplan assistance payments offered by manufacturers) and (3) programs involving certain advertising fees and expenses. These discounts are a fact of life for dealers and dealerships.

CASH DISCOUNTS

A cash discount is a reduction allowed by the seller in the invoice or purchase price that is granted for payment within a prescribed time period (i.e., 2/10 net/30). For tax purposes, cash discounts can be accounted for under one of two methods. A taxpayer may elect to use either method, but once selected, the method to reflect the timing of the earnings of the discount must be followed consistently from year-to-year.

Gross Invoice Method ... Price of the item purchased includes the cash discount allowed. Under the gross invoice method, the purchase price of merchandise is recorded at the full invoice price when the inventory is received. A corresponding dollar amount entry is credited to accounts payable, again at the full invoice price. When payment is made in time to take advantage of the discount, the accounts payable account is debited for the full invoice price, the cash account is credited for the amount of cash actually paid, and an income account is credited in order to report the amount of the cash discount that is earned as income.

Net Invoice Method ... Price of the item purchased does not include the cash discount. Under the net invoice method, the purchase price of merchandise is reduced at the time of purchase by the amount of the potential cash discount. This reduction is made irrespective of whether the discount offered is actually taken. Under the net invoice method, only the net invoice price is charged to inventory. Any cash discount not taken advantage of is recorded as an expense item.

IRS Coordinated Issue Paper on cash discounts. In April 2003, the IRS released a Proposed Coordinated Issue Paper on the treatment of ***cash*** discounts. This Issue Paper provides insights into the IRS' position on the proper determination of cash discounts.

According to this Paper, "A taxpayer may allocate its cash discounts to ending inventory only in the situations where it knows the items, on an invoice-by-invoice method, to which such discounts are attributable." A taxpayer's method of accounting for cash discounts is not permissible and does not clearly reflect income if it estimates the cash discounts relating to ending inventory through an allocation method based on a pro-rata or average basis.

For an *At A Glance* summary of this Issue Paper, see pages 38-39.

TRADE DISCOUNTS

A trade discount is a reduction allowed by the seller in the invoice or purchase price that is allowed or granted regardless of when the payment is made. Generally, trade discounts are allowed for volume or quantity purchases. In order to be treated as a trade discount, the reduction in price must not be contingent on the purchaser providing any services.

In contrast with the choice or election that taxpayers have for how to account for ***cash*** discounts, the Code (and the IRS) do not give taxpayers a choice in how they may account for ***trade*** discounts. A taxpayer ***must*** reduce the cost of inventory by a trade (or quantity) discount.

In other words, the taxpayer must take the deduction for the trade discount sooner (under the net invoice method) ... rather than later (as results from the gross invoice method).

For more specifics on this ***mandatory*** requirement for trade discounts and Rev. Rul. 84-41, see pages 6-7.

There is, however, one important qualification: Consistently following an erroneous method of accounting constitutes a method of accounting for the improper treatment of that item. This erroneous method cannot be changed–or corrected–without first securing permission from the IRS to make this change by filing Form 3115.

FLOORPLAN ASSISTANCE PAYMENTS AS *"TRADE DISCOUNTS"*

Auto dealerships are unavoidably drawn into involvement with a variety of programs that manufacturers establish in connection with the purchase of their vehicles by franchised dealers. These programs are different in terms of when dealers may become entitled to reductions in the cost of the inventory items/vehicles purchased.

In processing Forms 3115 filed requesting changes in accounting method, the IRS National Office considers most of the floorplan assistance programs offered by the manufacturers to be trade discounts within the technical meaning of that term.

There are, however, some CPAs who prefer the interpretation that these payments should be more properly treated under GAAP as reductions of interest expense. See page 11 for more on this.

see **TRADE DISCOUNTS & AD FEE CAMs**, page 8

Rev. Rul. 84-41	TRADE DISCOUNTS MUST BE RECORDED AT "NET" ... NOT "GROSS" ... INVOICE
Issue	Is it proper for an automobile dealer to record the cost of new automobiles in inventory (and cost of goods sold) without reduction of a manufacturer's rebate under the following circumstances?
Facts	X, an automobile dealer, uses an accrual method of accounting and files its Federal income tax returns on a calendar year basis. X is entitled to a 2% rebate (the "rebate") from the automobile manufacturer, which is based on the cost to X of new automobiles purchased during the taxable year. The rebate is based solely on the total cost of dealer purchases, and does not relate to sales volume, length of time that the dealer holds the automobile in inventory, or other incentives that the manufacturer may offer. Pursuant to the agreement with the manufacturer, X is entitled to the rebate in the taxable year of purchase; however, the rebate is actually received by X in the taxable year subsequent to the year of purchase. Under X's method of accounting at the time new vehicles are purchased from the manufacturer the purchases are recorded in inventory at X's cost with no reduction for the 2 percent rebate. As vehicles are sold, the inventory is reduced by the cost of the vehicles (which becomes the cost of goods sold), without any recognition of the 2% rebate that will be received. With respect to automobiles on hand at the end of X's taxable year, such automobiles are valued at cost with no reduction for the rebate. When X actually receives its 2% rebate on new vehicle purchases in the following year, the cost of goods sold for that year is reduced by an amount equal to the rebate received. That is, the 2% rebate is recorded on a cash basis in the year of receipt, even though it relates to and is derived from new vehicle purchases made in the prior taxable year.
Reg. Sec. 1.471-3(b)	Section 1012 of the Code provides, generally, that the basis of property shall be its cost. Reg. Sec. 1.1012-1(a) provides that cost is the amount paid for such property in cash or other property. Section 471 of the Code provides that whenever in the opinion of the Secretary the use of inventories is necessary in order clearly to determine the income of any taxpayer, inventories shall be taken by such taxpayer on such basis as the Secretary may prescribe as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting income. Reg. Sec. 1.471-3(b) provides that ***cost*** means, ... "***in the case of merchandise purchased since the beginning of the taxable year, the invoice price less trade or other discounts***, except strictly cash discounts approximating a fair interest rate, which may be deducted or not at the option of the taxpayer, provided a consistent course is followed." (Emphasis added)
Law & Analysis	Generally, there are two types of discounts available: trade (or quantity) discounts and cash discounts. Trade discounts represent adjustments to the purchase price granted by a vendor. The discount may vary depending upon volume or quantity purchases, or other factors established by the vendor. If a discount is always allowed irrespective of time of payment, it is considered to be a trade discount. (See *Thomas Shoe Co.*, 1. B.T.A. 124 [1924], acq., IV-1 C.B. 3 [1925]). The amount that a dealer will pay for an item is the net price after the trade discount. *(Continued)*

Law & Analysis (Continued)

Cash discounts, on the other hand, represent a reduction in the invoice or purchase price attributable to payment within a prescribed time period. The discount is only available if the purchaser makes payment within such time period.

Rev. Rul. 76-96, 1976-1 C.B. 23, concerns the Federal income tax treatment of rebates paid by an automobile manufacturer to qualifying retail customers who purchased its automobiles. Rev. Rul. 76-96 holds that the receipt of the rebate by a qualifying retail customer does not result in the receipt of gross income. However, Rev. Rul. 76-96 holds that the rebate represents a reduction in the purchase price of the automobile, requiring a downward adjustment to the basis of the automobiles in the hands of the purchasers under Section 1012 of the Code.

Although the present case involves rebates to an automobile dealer rather than to retail purchasers, the rationale expressed in Rev. Rul. 76-96 is applicable to the instant case. It supports a conclusion that a cash rebate paid to an automobile dealer should be treated as a reduction in the cost of the automobile purchased, and not as an item of gross income. This result is consistent with Reg. Sec. 1.471-3(b).

In the present situation, X has a fixed right to reimbursement in the taxable year of purchase with respect to the amount of the rebate. Income is distorted in cases in which the rebate is not subtracted in calculating cost of goods sold. That is, under X's present method of reporting rebates, cost of goods sold is overstated and income is understated where X sells an automobile in the same taxable year in which it is purchased. X cannot deduct the rebate in a later year (through an adjustment to cost of goods sold) when it has fixed right to reimbursement from the manufacturer in the year a car is purchased. (See *Wolfers v. Commissioner*, 69 T.C. 975, 983-985 [1978]). That is, X's cost of new automobiles is the amount paid to the manufacturer, less the amount of the rebate for which it has a fixed right to reimbursement.

Holding

It is not proper for an automobile dealer to record the cost of new automobiles in inventory (and cost of goods sold) without reduction of manufacturer's rebate. In this case, the manufacturer's rebate received by an automobile dealer represents a trade discount and, therefore, must be treated as a reduction in the cost of the automobile in the year of purchase.

Any change in a taxpayer's method of accounting, from recording the cost of new vehicles in inventory at cost with no reduction for the 2% manufacturer's rebate, to the method described in this revenue ruling is a change in method of accounting to which the provisions of sections 446 and 481 of the Code apply.

This ruling is identified as a designated ruling pursuant to Section 5.12 of Rev. Proc. 80-51, 1980-2 C.B. 818.

Citation

Revenue Ruling 84-41 ... 1984-1 C.B. 130

(Continued from page 5)

In this regard, CPAs should be careful to watch their terminology because these trade discounts are technically not ***"earned."*** According to the IRS, if the dealer is required or obligated to do anything in order to ***"earn"*** a discount (price reduction), that requirement would disqualify the cost reduction from being treated as a trade discount.

The all events and economic performance tests. Another tax technicality related to trade discounts is that they are subject to satisfying the *all events* and the economic performance tests under Section 461. For an accrual basis taxpayer, a liability is incurred and generally is taken into account for tax purposes in the taxable year in which

- all of the events have occurred that establish the fact of the liability,
- the amount of the liability can be determined with reasonable accuracy, and
- economic performance has occurred with respect to the liability (Reg. Sec. 1.461-1(a)(2)(i)).

The all events test is not treated as met any earlier than the taxable year in which economic performance occurs with respect to the liability (Reg. Sec. 1.461-4(a)(1)). The Regulations contain a maze of challenging exceptions and examples.

In addition, in certain circumstances, accrual basis taxpayers may adopt "the recurring item exception" treatment described in Reg. Sec. 1.461-5(b) by making appropriate elections in their tax returns.

A detailed discussion of Section 461(h) and the underlying regulations is beyond the scope of this article. However, a summary appears on the facing page. See also the discussion of Letter Ruling 9416004 on page 10 in the context of advertising fees and expenses.

For our purposes in connection with these CAMs, three observations related to the all events and economic performance tests are sufficient.

- ***First***, the application of the all events test may produce results that differ from those regarded as appropriate under Generally Accepted Accounting Principles (GAAP). In this regard, some practitioners feel more theoretically restricted than others.
- ***Second,*** the IRS recognizes that the all events and economic performance tests ***must*** be taken into consideration and satisfied in determining the proper year-end treatment for trade discounts and advertising fees and expenses.
- ***Third,*** because of the multitude of different arrangements in the automotive industry, each Factory program must be evaluated on a case-by-case basis.

What complicates matters in terms of treating different manufacturers' floorplan assistance payments as trade discounts is the fact that under some plans ...

- Some discounts attach at the time when the vehicle is purchased.
- Some discounts attach at the time when the vehicle is sold ... or, if sooner, after the passage of a number of days from the date of purchase.

These differences result in multiple fact patterns that have to be taken into consideration and properly reflected because ***if the vehicle is not sold as of the end of the year (or if the specified passage of time has not elapsed), the dealer's reduction in cost for the discount has to be deferred to the succeeding year.***

This also has to be considered in computing the Section 481(a) adjustment to the opening inventory for the year of change, as well as at the end of each succeeding year.

The receipt of the discount in the *following* year by the dealer will affect that year's computation of the cost of goods sold, and thus, it will result in a shift of income via the valuation of the ending inventory between years. This consequence is sometimes referred as the "deferred income" or "earning" of a discount that is associated with the manufacturer's program.

Another complication is that different programs...

- Have started and ended at different times over the years,
- Have been in effect for different time durations, depending on economic circumstances, and
- May have been available only for *specifically designated* vehicles, rather than available for *all* vehicles, purchased.

As a result, vehicles (goods) in ending inventory may have been acquired at different times and subject to the terms of many different programs. Nevertheless, as emphasized above, for these trade discounts, the reduction of the inventory acquisition cost by the amount of the trade discount is ***mandatory***.

What comes as a real shocker to some CPAs is that if the trade discounts are not subtracted from inventory costs, then Form 8275-R, Regula-

see **TRADE DISCOUNTS & AD FEE CAMs**, page 10

Reg. Sec. 1.461	***THE ALL EVENTS & ECONOMIC PERFORMANCE TESTS ... HOW SOON CAN THE TAX DEDUCTION BE CLAIMED?***
"All Events" Test	• For an accrual basis taxpayer, a liability is incurred and generally is taken into account (for tax purposes) in the taxable year in which ... ♦ all of the events have occurred that establish the fact of the liability, ♦ the amount of the liability can be determined with reasonable accuracy, and ♦ economic performance has occurred with respect to the liability. • *Reg. Sec. 1.461-1(a)(2)(i)*
Year in which Deduction Is Allowed ... Timing of Economic Performance	• For purposes of determining whether an accrual basis taxpayer can treat the amount of any liability as incurred, the all events test is not treated as met any earlier than the taxable year in which economic performance occurs with respect to the liability. (Reg. Sec. 1.461-4(a)(1)) • Reg. Sec. 1.461-4(b) lists exceptions to the economic performance requirement (i.e., situations where liabilities can be taken into account under Rules that operate without regard to the all events test [including economic performance]). • Reg. Sec. 1.461-4(d) through (m) and Reg. Sec. 1.461-6 provide rules for determining when economic performance occurs.
Recurring Item Exception	• An accrual basis taxpayer may adopt recurring item exception treatment for certain liabilities, if all four tests are met. • A liability will be treated as incurred for a taxable year if 1. At the end of that taxable year, all events have occurred that establish the fact of the liability, and the amount of the liability can be determined with reasonable accuracy, 2. Economic performance with respect to the liability occurs on or before the earlier of ♦ the date the taxpayer files a timely (including extensions) return for that taxable year, or ♦ The 15th day of the 9th calendar month after the close of that taxable year 3. The liability is recurring in nature, and 4. Either ... ♦ the amount of the liability is not material, or ♦ the accrual of the liability for that taxable year results in a better matching of the liability with the income to which it relates than would result from accruing the liability for the taxable year in which economic performance occurs. • Taxpayers are required to include a statement of election for recurring item exception treatment in their income tax returns.
Observations	• The application of the all events test may produce results that differ from those regarded as appropriate under Generally Accepted Accounting Principles (GAAP) ... and, in this regard, some practitioners feel more restricted than others. • The IRS recognizes that the all events and economic performance tests ***must*** be considered in determining the proper year-end treatment for trade discounts and advertising fees and expenses. • There is a multitude of different arrangements in the automotive industry. Therefore, each Factory program must be analyzed on a case-by-case basis.
Selected Bibliography	• Nellen, Annette & Kris Marucheck. ***Economic Performance (Parts I & II)***, *The Tax Adviser*. April & May 1994, pgs. 195-210 & 259-276. • Schneider, Leslie J. & Michael F. Solomon. ***Final Regs. on Economic Performance Requirement Resolve Most Issues***, *The Journal of Taxation*. July 1992, pgs. 12-16. • Smith, Annette B. ***When Can an Accrual-Method Taxpayer Deduct Liabilities?*** *Taxation for Accountants*. October 1995, pgs. 196-203. • MacNeil, C. Ellen, Marc D. Levy and Paul D. Prescott. ***Economic Performance - The Final Regulations under Section 461(h)***, *Tax Notes*. May 4, 1992, pgs. 671-687. • Schneider, Leslie J. & Michael F. Solomon. ***Do New Proposed Regs. on Economic Performance Mean End of Accrual Method?*** *The Journal of Taxation*. September 1990, pgs. 132-137.

(Continued from page 8)

tion Disclosure Statement, is required to be included with the income tax return. See page 21, "Where Do You Stand .... and Why?"

ADVERTISING FEES AND EXPENSES

Auto dealerships are also unavoidably involved with a variety of programs that manufacturers have established in connection with advertising activities. Again, these manufacturers' programs are different in terms of when, for how long, and to what extent, dealers may become entitled to reductions in cost of the inventory items/vehicles purchased.

As discussed on the facing page, there are some CPAs who debate how these advertising fee payments should be treated in accordance with GAAP.

Manufacturers have various plans and programs related to advertising and some are administered through dealer advertising associations. These involve the placement of charges on the vehicle invoices for advertising. Actual placement of advertising before or after the end of the year, rebates of unused amounts, etc., all tend to vary under different manufacturers' plans.

In this regard, dealers submitting IRS requests for changes in accounting method related to advertising fees and expenses must analyze the specific manufacturers' programs. In addition, they must demonstrate to the IRS that all of the technical requirements for satisfying the all events and economic performance tests have been met.

In processing Forms 3115 filed requesting CAMs with respect to eliminating advertising fees and expenses from inventory costs, the IRS National Office has been willing to allow dealers to make a change in accounting method with respect to *local and regional* advertising expenditures. ***However, the IRS will not allow a change in method with respect to advertising at national levels.***

As indicated previously, the CAM request for ad fees is subject to significantly different procedural Form 3115 filing requirements.

LETTER RULING 9416004

There is an older Letter Ruling that involves this area in connection with a taxpayer who manufactured consumer products and distributed them through dealers to the public. Some of the facts in LTR 9416004 illustrate how plans might vary.

"Taxpayer [a manufacturer] provides advertising support to its dealers, often through dealer association cooperative advertising programs. The dealers and dealer associations are wholly independent of Taxpayer. Under the cooperative advertising programs at issue, Taxpayer reimburses a portion of advertising costs incurred by dealers or their associations.

"To qualify for reimbursement under the programs, advertising must be run during a specified period of time, usually not exceeding two weeks. Taxpayer announces its advertising programs by sending letters to the dealers or their associations explaining the programs. If the dealers or their associations wish to participate, they sign the advertising agreement enclosed with the letter announcing the program. The agreement indicates the type of the advertising required and the amount of the reimbursement that Taxpayer will pay. The dealers or their associations return the signed agreements to Taxpayer. Taxpayer accepts all agreements if they are signed and returned to Taxpayer before the specified period for the program has lapsed.

"The agreements require participating dealers or their associations to submit claims for reimbursement after the advertising has run. The claims must be accompanied by invoices and supported by station affidavits in the case of radio or television advertising, or tear sheets in the case of newspaper or magazine advertising. The agreements also require that claims for reimbursement be submitted within a certain time period, usually two or three months, after the advertising has run. Taxpayer represents that, under state law, it is liable to pay for the advertising services once the dealers perform the advertising services, rather than when they submit claim forms."

In this LTR, the IRS framed the issue as follows ... "For purposes of the 'all events test' of Reg. Sec. 1.461-1(a)(2), is Taxpayer's liability to the provider of 'cooperative advertising' services fixed by (i) performance of the advertising services or (ii) the dealer's submission of the claim for reimbursement and documentation verifying performance?"

The Service held that, "... for purposes of the 'all events test' ..., Taxpayer's liability to its dealer association for 'cooperative advertising' services is fixed by the dealer association's submission of its claim for payment. Thus, Taxpayer may not accrue a deduction for cooperative advertising expenses prior to the year in which the claim is submitted."

Caution. LTR9416004 contains considerable discussion of the Service's analysis and other plan specifics. It appears that the National Office currently does not place great weight on this LTR in connection with currently filed Forms 3115 for advertising fees. Accordingly, if this Letter Ruling is going to be cited in a Form 3115 for an ad fees CAM, applicants should provide a comparison of the spe-

see **TRADE DISCOUNTS & AD FEE CAMs,** page 12

In processing Forms 3115 filed requesting changes in accounting method, the IRS National Office generally considers most of the floorplan assistance programs offered by automobile manufacturers to be trade discounts within the technical meaning of that term. This treatment by the IRS depends upon satisfactory analysis and reasoning provided by the taxpayer in the Form 3115 file.

There are, however, some CPAs who prefer the interpretation that these payments are more properly treated (under GAAP) as reductions of interest expense. The following is taken from *Thompson/PPC (Practitioner's Publishing Company), Guide to Dealerships*, Volume I, Eighth Edition (August 2003).

302.11 FLOOR PLAN ASSISTANCE PAYMENTS

"In a typical arrangement, when a vehicle is shipped to the dealership, the manufacturer issues a credit on the manufacturer's account equal to the floor plan interest that the dealership would be charged for the vehicle for a certain number of days. Therefore, if the dealership sells the vehicle within those days, which generally is a reasonable holding period, it will have no floor plan interest.

"That arrangement recognizes that dealerships will resist increasing inventories because of the additional floor plan interest that will be incurred. Accordingly, subsidizing interest reduces the risk to the dealership of increasing inventories.

"Since floor plan interest is not capitalized as a cost of inventory, the authors believe that in this type of arrangement the assistance should be deferred and amortized through credits to interest expense over the assistance period. As a practical matter, however, if the deferral is not material, the assistance may be credited directly to interest expense. If that results in negative interest expense, the excess of floor plan assistance payments over interest expense should be credited to cost of sales, following the guidance in EITF Issue 02-16. The financial statements would therefore report no interest expense."

Disclaimer: Although I am listed as a contributing author to *Thompson/PPC (Practitioner's Publishing Company), Guide to Dealerships*, I do not agree with the above positions.

302.21 SUPPLEMENTAL ADVERTISING FEE

"Manufacturers sometimes add a fee to the price of new vehicles to cover the cost of regional advertising. The manufacturer remits the fees collected to a regional group of dealerships called an advertising association. A portion of the money received by the advertising association may be remitted to the dealership for local advertising purposes.

"The authors believe that, for both financial statement and income tax reporting (see paragraph 402.18), the fee should be recorded as advertising expense in the year the manufacturer ships the vehicle to the dealership. The amount refunded by the advertising association may be recorded either as other income or as a reduction of advertising expense, which is the authors' preference.

"Some dealerships have capitalized the advertising fee as an inventory cost. Nevertheless, the IRS views the fee as an advertising expense, and those manufacturers with vehicle invoices that show which accounts the dealership should use to record new vehicle costs charge the fee to advertising expense."

 (Continued from page 10)

cific applicant dealer's advertising arrangements with those comprising the fact pattern in LTR 9416004 so that they may be properly differentiated.

Advertising allowances. Finally, a point made by the IRS in connection with ad fee/expense CAMs involves the distinction between advertising fees and expenses and ***advertising allowances***. It is important to distinguish advertising fees from allowances or reimbursements that some manufacturers provide for dealers.

An advertising allowance results when a manufacturer agrees to reimburse a dealership for advertising that has been placed, usually subject to definite parameters insisted upon by the manufacturer. For example, the manufacturer might have to approve the advertising, or approve the volume of advertising. Under these conditions, advertising ***allowances*** would not be regarded by the IRS as eligible for a change in accounting method. Instead, these allowances would appear to be more properly treated as expense reductions.

Other sources. In connection with these advertising fees and expenses, see also Reg. Sec. 1.461-4(d)(7), example 5, *Services or property provided to the taxpayer.* Also, see Letter Ruling 9243010, issue 5, regarding the mandatory "advertising fees" listed on manufacturers' invoices.

AD FEE SUMMARY

In summary, although the IRS will not allow a CAM for ***national*** advertising expenses, it will allow a CAM for ***local and regional*** advertising expenses.

If the money comes back to an association or to some third party and it is used for regional or local advertising, then the IRS' (evolving) requirements are likely to be met for allowing the CAM. However, the deduction for advertising will only be allowed when the advertising has been placed ... or when it has been deemed to have been placed ... in satisfaction of the all events and economic performance tests.

PLAN-BY-PLAN, INVOICE-BY-INVOICE ANALYSIS IS REQUIRED

The April 2003 IRS Proposed Coordinated Issue Paper dealing with the treatment of cash discounts expressed the position that a taxpayer's method of accounting for cash discounts is not permissible and does not clearly reflect income if it estimates discounts applicable to ending inventory through some allocation method based on a pro-rata or average basis. Instead, the taxpayer is required to allocate/determine its cash discounts with respect to ending inventory on an invoice-by-invoice method.

Although the Service has provide no guidance other than this relating to cash discount treatment, it seems reasonable to expect that the Service would require the same level or degree of specificity in connection with CAMs involving trade discounts and advertising fees and expenses. Accordingly, it appears that the IRS will not accept any other generalized calculations or estimates with no underlying detail computations.

Where dollar-value LIFO inventories are involved, one might argue that this position of the IRS is in conflict with, or contradicts, the underlying concept of dollar-value LIFO, which treats the entire ending inventory as an investment of dollars. However, it seems unlikely that this argument would get very far with the IRS.

As the IRS emphasized at the 2002 AICPA Auto Dealership Conference, these CAM determinations require a dealership-specific facts and circumstances analysis. Furthermore, this analysis must reflect the fact that the manufacturers' programs are constantly changing and that each year-end inventory has a different mix of vehicles to which all, some or none of the plans apply.

For the CPA or the controller trying to contend with all the details, the work can be tedious and even overwhelming. Not only do year-end invoices for several years have to be analyzed, but other dealership information including floorplan and other reports must be reviewed in the course of making these determinations. Incentive programs vary by manufacturer and, in some cases, by year. Many dealerships have several franchises. This means that the CPA has to be knowledgeable in the programs offered by all of the manufacturers whose vehicles are (bought and) sold by the dealership.

CPAs who, on their own, attempt to make an invoice-by-invoice determination generally will not have a comprehensive database of manufacturer programs (varying terms, durations, etc.). Furthermore, reliance only on invoices will not result in an accurate determination, since all of the information needed often does not appear on the invoices. For more on this, see "Issues / Perils for CPA Firms Undertaking the 'Doing It Yourself' Approach", on page 15.

The good news ... it's painlessly doable. What some CPAs and dealers may not be aware of is that, despite the underlying technicalities, *these overall changes in accounting methods can be made on a cost effective, turn-key basis.* They just have to find the right provider.

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YEAR-END RECONCILIATIONS ARE PERMITTED

Another area of discussion has centered around whether it is necessary for a dealer changing to, or using, the net invoice method to record *at the time of purchase* the cost of every vehicle purchased net of the applicable (trade) discount.

The question commonly asked is, "Is it permissible to compute only the discount applicable to vehicles in the ending inventory and to employ year-end reconciliations of carrying values net of trade discounts, etc., with inventory at cost (including trade discounts, etc.)?"

The IRS has indicated that it will allow year-end reconciliations to the net-of-discount results if the reconciling amounts are based upon detailed invoice-by-invoice determinations.

As part of the "terms and conditions" of IRS consent to a CAM, the National Office letters of consent have indicted that permission to change methods will be granted, provided that ... "the taxpayer keeps its books and records for the year of change and for subsequent taxable years ... on the method of accounting granted in this letter. ***This condition is considered satisfied if the taxpayer reconciles the results obtained under the method used in keeping its books and records and the method used for Federal income tax purposes and maintains sufficient records to support such reconciliation.***"

As far as GAAP considerations are concerned, many dealerships reflect the CAMs for both financial reporting/book and for tax purposes, without a Schedule M adjustment in the tax return.

On a related LIFO point, there should be no violation of the LIFO financial statement reporting conformity requirement if one method is used for financial statement purposes (i.e., the gross method), while a different method (i.e., the net method) is used for LIFO tax purposes. Different cost determinations under Section 263A are allowable without resulting in a LIFO conformity violation.

EACH YEAR, AN INVOICE-BY-INVOICE ANALYSIS MUST BE MADE

Another consideration worth emphasizing is that if these trade discount and ad fees CAMs are made, it will be necessary each year to track the qualification status and reduction amounts that are attributable to each vehicle in inventory at the end of each succeeding year.

This requrement for ongoing invoice-by-invoice analysis also supports the argument for using an outside service bureau, rather than relying on the dealership's CPA, to make these annual determinations.

SECTION 481(a) TRANSITION ADJUSTMENTS

In the case of both kinds of CAMs, the taxpayer's taxable income for the year of change is required to include an adjustment to reflect what the results (i.e., taxable income) would have been if the new accounting method had been applied in prior years. Accordingly, there are two adjustments to be considered.

Section 481(a) adjustment... An adjustment under Sec. 481(a) is required to compute the effect as if the change in method had been used in valuing prior years' inventories ... The simplified cut-off method is not allowed for this CAM. There must be a recomputation of all prior year inventory amounts as determined under the new method.

Section 263A corresponding adjustment... It is also necessary to compute the corresponding change in inventory capitalized costs under Section 263A. This change will be a reduction in previously capitalized Sec. 263A costs because the ending inventory carrying values have been reduced. The corresponding Sec. 263A reduction usually is a very, very small component of the Section 481(a) adjustment described above.

LIFO DEALERSHIPS ... SPECIAL BENEFITS & IMPLICATIONS

Huge benefits for LIFO inventories. Generally, the Section 481(a) adjustments that are required to be computed to implement most CAMs for trade discounts and advertising fees will be ***negative*** Section 481(a) adjustments.

LIFO BONANZA

- The entire deduction (100%) is allowable in the year of change.
- ***This deduction (i.e., the reduction of the LIFO valuation of the opening inventory in the year of change) is a permanent deduction.***
- As such, the negative Section 481(a) adjustment for a LIFO taxpayer will only be paid back or offset in future years to the extent that
  1. Subsequent years' LIFO inventory levels fall below and invade the revised beginning-of-the-year base dollar inventory amount,
  2. If the taxpayer goes off of LIFO, or
  3. If the taxpayer disposes of all the LIFO inventory.
- If the maufacturer stops the program(s) in a later year, the 481(a) benefit will still remain.

see **TRADE DISCOUNTS & AD FEE CAMs**, page 14

The more permanent benefit of the negative Section 481(a) adjustment for a LIFO taxpayer making these CAMs should be analyzed separately from the more obvious year-to-year offsetting effect of the net differences in the amounts of trade discounts (and/or ad fees) in successive years-end inventories. These year-end to year-end reductions of inventory cost will be more directly offsetting from year to year, unless inventory levels and program dollars generally increase over the years.

One minor offset. Finally, as a result of making these CAMs, **all** of the year-end inventory levels will reflect lower carrying values as these trade discounts and advertising fees are eliminated (i.e., are subtracted) from inventory costs. Accordingly, the LIFO computations for the year of change will show a resulting net increase in the LIFO reserve (assuming inflation) that will be less than the amount of increase in the LIFO reserve that would have been computed if the CAM had not been made and the inventories were left at higher levels. In other words, if the CAM had not been made, the LIFO reserve *increase* in the year of change generally would have been (slightly) greater.

In most cases, this difference is so small that it is more academic than financially significant. This has been borne out where we have actually made these LIFO calculations for the year of change both reflecting and not reflecting the new method.

To see some numbers on the relative insignificance of this factor, see the discussion in the sample letter (pages 28-29) where the total of this amount was $837 for both pools.

These amounts are reflected as separate line items even though they are relatively small in the "cost effectiveness–benefit analyses" on pages 27 and 30. For all practical purposes, these amounts are so small as to more likely hinder, rather than illuminate, a discussion of their origin with the client.

ADJUSTING LIFO INVENTORIES TO REFLECT THE CAMs

Since the cut-off method cannot be used for these CAMs and a Section 481(a) adjustment is required, there are additional LIFO ramifications to address.

It is impractical, if not impossible, to undertake a specific computation of the amount of year-end inventory reductions for all prior years. Furthermore, where LIFO is used, there may not be a LIFO increment for each of the preceding years. Fortunately, a more practical and reasonable approach to the Section 481(a) requirement is available. This is based on Reg. Sec. 1.263A-7.

(Continued from page 13)

Three-year (weighted) average factor. In determining the lower revalued carrying values for prior years' inventories, taxpayers making these CAMs are permitted to look at the specifics of the three years preceding the year of change and from that data, compute a ***three-year (weighted) average factor***. This factor may then be applied to the LIFO valuations of all the layers in the ending LIFO inventory for the year before the year of change.

The Regulations under Section 263A provide that the three-year average (weighted) method is available for dollar-value LIFO inventories as an alternative to the almost-unattainable precision required by the so-called "facts and circumstances" revaluation procedure. Under the "facts and circumstances" revaluation, the dollar-value inventories would have to be redeveloped for *all LIFO* years, regardless of whether or not layers or increments were shown to exist under the pre-Section 263A calculations.

The three-year average method is available as an alternative regardless of whether sufficient data exists from which a full "facts and circumstances" revaluation could be made. If the three-year average method is employed, the revaluation factor is based on the weighted average percentage change in the current costs of inventory for each LIFO pool ***based on the three most recent years for which the taxpayer has sufficient information.***

Generally, the three-year revaluation factor is applied to all LIFO layers for each pool in the beginning inventory of the year of change. If a taxpayer lacks sufficient information to otherwise apply the three-year average method, it may use reasonable estimates and procedures to apply the three-year average method.

It should be noted that under the three-year average method, if sufficient data is available to calculate the revaluation factor for more than three years, data from such additional years may be used in determining the average percentage increase only if the additional years are consecutive years prior to the year of change. The requirement to use data from consecutive years may result in using information from a year in which no LIFO increment occurred.

For more specifics on the three-year average method, see pages 16-17. The detailed example from the Regulations appears in a more understandable format which also "proves out" the composition of the LIFO reserves before and after on pages 18-19.

In order to have the proper correspondence with the revised lower carrying value of the inventory at cost (i.e., net of trade discounts), one further LIFO →

recomputation either must be made or usually is made even though it is not required (as discussed below) in order to simplify future LIFO calculations. ***This relates to the rebasing or restating of cumulative indexes to 1.0000 as of the beginning-of-the-year of change.***

Reg. Sec. 1.263A-7 (see pages 16-17) provides that for purposes of determining future indexes, generally ***the year of change becomes a new base year, and all costs are to be restated*** in new base year costs for purposes of extending such costs in future years. The Reg. further provides that costs associated with old layers retain their separate identity within the base year, with such layers being merely restated in terms of the new base year index.

The schedules on pages 24-25 show the Sec. 481(a) calculations and the index restatements and rebasing for the new auto and the new light-duty truck pools for one dealer implementing a CAM for its LIFO inventories. A sample letter explaining the results of making the changes in accounting method appears on pages 28-29.

SECTION 263A COST CAP & THESE CAMs

Most taxpayers using the Last-In, First-Out (LIFO) method start by making the calculations of a particular year's LIFO index and LIFO reserve without regard to the uniform capitalization rules. Then, after the LIFO computations for the year are completed, any additional costs required to be capitalized by Section 263A are determined under a "simplified resale method election, or some variation thereof (which may be with or without the historic absorption ratio election)." The resulting amounts are added to the LIFO layer for that year or are separately kept track of by year with reference to the LIFO layer.

For most dealers, the additional inventory costs capitalized under a simplified resale method are superimposed upon the LIFO computations which, in turn, are superimposed on the conventional accounting system. For these dealers, the rebasing/restating of indexes to 1.000 is technically not mandatory. However, we would not proceed without doing this and recommend that it be done in all cases.

If the LIFO calculations do not result in an inventory increment in any given year (i.e., if there is no current year increment), then there are no costs required to be capitalized under Section 263A for that year. Where a decrement is computed, the result is the *"freeing up"* or reversal of previously capitalized Section 263A costs.

What all this means is that costs capitalized in LIFO inventories under Section 263A become *"locked in"* until some future year when a liquidation occurs in that specific inventory pool. When that happens, the effect of the liquidation is carried back to *"unlock"* a corresponding portion of the Section 263A costs that were capitalized with reference to the earlier year. In other words, costs capitalized under Section 263A for LIFO inventories (in theory) get locked in for much longer periods of time than costs capitalized for non-LIFO inventories (which generally are offset in full in the following year if the inventory turns over at least once).

As a result of these Section 263A relationships, where trade discounts and ad fee CAMs are involved, there is an additional component to the Section 481(a) adjustment. This component involves the effect of the CAM reducing prior year LIFO increments which comprise the opening inventory in the year of change.

Accordingly, the Section 481(a) adjustment should include a corresponding decrease in the previously capitalized Section 263 costs proportionate to the reductions in the LIFO carrying values of those increments. This makes the overall Section 481(a) negative adjustment ***larger.***

ISSUES / PERILS FOR CPA FIRMS UNDERTAKING THE "DO-IT-YOURSELF" APPROACH

In discussing the possibility of making a change in accounting method for trade discounts, the dealer often assumes that the CPA is, or should be, able to make the analysis, and that the CPA has all of the necessary information if he or she has the prior years-end inventory invoices. More often than not, both assumptions are incorrect.

DO-IT-YOURSELF PERILS

- Extensive databases are required to keep track of all the different Factory programs.
- Not all items shown on the invoice are what they appear to be.
- Another myth: "It's already on the invoice." According to Todd Boren, of Green Financial Outsourcing Solutions (214-350-8197), "That's not true because if you rely only on what's stated on the invoice, your determinations are likely to be incorrect."
- Trade vehicles may present problems because in some instances the trade discount monies follow the vehicle, but in other instances, they do not.
- Some dealers don't get all of the benefit that they are entitled to because their CPAs' oversimplified (and/or inaccurate) analysis is not thorough enough.

see **TRADE DISCOUNTS & AD FEE CAMs**, page 20

WHAT THE SECTION 263A REGULATIONS SAY ABOUT REVALUING DOLLAR-VALUE (OPENING) LIFO INVENTORIES

REG. SEC. 1.263A-7(c) Inventory - (2) Revaluing beginning inventory - (v) 3-year average method - (A) In general. A taxpayer using the dollar-value LIFO method of accounting for inventories may revalue all existing LIFO layers of a trade or business based on the 3-year average method as provided in this paragraph (c)(2)(v). The 3-year average method is based on the weighted average percentage change (the "3-year revaluation factor") in the current costs of inventory for each LIFO pool based on the three most recent taxable years for which the taxpayer has sufficient information (typically, the three most recent taxable years of such trade or business).

The 3-year revaluation factor is applied to all layers for each pool in beginning inventory in the year of change. The 3-year average method is available to dollar-value taxpayers who comply with the requirements of this paragraph (c)(2)(v) regardless of whether such taxpayers lack sufficient data to revalue their inventory costs under the facts and circumstances revaluation method prescribed in paragraph (c)(2)(iii) of this section. The 3-year average method must be applied with respect to all inventory in a taxpayer's trade or business. A taxpayer is not permitted to apply the method for the revaluation of some, but not all, inventory costs on the basis of pools, business units, or other measures of inventory amounts which do not constitute a separate trade or business.

Generally, a taxpayer revaluing its inventory using the 3-year average method must establish a new base year. See paragraph (b)(2)(iii)(A)(2)(i) of this section. ***However, a dollar-value LIFO taxpayer using the 3-year average method and either the simplified production method or the simplified resale method to revalue its inventory is permitted, but not required, to establish a new base year.*** See, paragraph (b)(2)(iii)(A)(2)(ii).

[Note: The Proposed/Preliminary Section 263A Regs. did not distinguish between situations where simplified 263A methods were used and required all taxpayers to establish a new base year.]

If a taxpayer lacks sufficient information to otherwise apply the 3-year average method under this paragraph (c)(2)(v) (e.g., the taxpayer is unable to revalue the costs of any of its LIFO pools for three years due to a lack of information), then the taxpayer must use reasonable estimates and procedures, as described in the facts and circumstances revaluation method under paragraph (c)(2)(iii) of this section, to whatever extent is necessary to allow the taxpayer to apply the 3-year average method.

REG. SEC. 1.263A-7(c) Inventory - (2) Revaluing beginning inventory - (v) 3-year average method - (B) Consecutive year requirement. Under the 3-year average method, if sufficient data is available to calculate the revaluation factor for more than three years, the taxpayer may use data from such additional years in determining the average percentage increase or decrease ***only if the additional years are consecutive to and prior to the year of change.***

The requirement under the preceding sentence to use consecutive years is applicable under this method regardless of whether any inventory costs in beginning inventory as of the year of change are viewed as incurred in, or attributable to, those consecutive years under the LIFO method. Thus, the requirement to use data from consecutive years may result in using information from a year in which no LIFO increment occurred.

For example, if a taxpayer is changing its method of accounting in 1997 and has sufficient data to revalue its inventory for the years 1991 through 1996, the taxpayer may calculate the revaluation factor using all six years. If, however, the taxpayer has sufficient data to revalue its inventory for the years 1990 through 1992, and 1994 through 1996, only the years consecutive to the year of change (i.e., 1994 through 1996) may be used in determining the revaluation factor. Similarly, for example, a taxpayer with LIFO increments in 1995, 1993, and 1992 may not calculate the revaluation factor based on the data from those years alone, but instead must use the data from consecutive years for which the taxpayer has information.

263A COST CAP

WHAT THE SECTION 263A REGULATIONS SAY ABOUT REVALUING DOLLAR-VALUE (OPENING) LIFO INVENTORIES

REG. SEC. 1.263A-7(b)(2)(iii) Base year - (A) Need for a new base year. Certain dollar-value LIFO taxpayers (whether using double-extension or link-chain) must establish a new base year when they revalue their inventories under Section 263A.

(1) ***Facts and circumstances revaluation method used.*** A dollar-value LIFO taxpayer that uses the facts and circumstances revaluation method is permitted, but not required, to establish a new base year.

(2) ***3-year average method used - (i) Simplified method not used.*** A dollar-value LIFO taxpayer using the 3-year average method but not the simplified production method of the simplified resale method to revalue its inventories is required to establish a new base year.

3-year average method used - (ii) Simplified method used. ***A dollar-value LIFO taxpayer using the 3-year average method and either the simplified production method or the simplified resale method to revalue its inventory is permitted, but not required, to establish a new base year.***

REG. SEC. 1.263A-7(b)(2)(iii) Base year - (B) Computing a new base year. For purposes of determining future indexes, the year of change becomes the new base year (that is, the index at the beginning of the year of change generally must be 1.00) and all costs are restated in new base year costs for purposes of extending such costs in future years.

However, when a new base year is established, costs associated with old layers retain their separate identity within the base year, with such layers being restated in terms of the new base year index. For example, for purposes of determining whether a particular layer has been invaded, each layer must retain its separate identity. Thus, if a decrement in an inventory pool occurs, layers accumulated in more recent years must be viewed as invaded first, in order of priority.

REG. SEC. 1.263A-7(c) Inventory - (1) Need for adjustments. When a taxpayer changes its method of accounting for costs subject to Section 263A, the taxpayer generally must, in computing its taxable income for the year of change, take into account the adjustments required by Section 481(a). The adjustments required by Sections 481(a) relate to revaluations of inventory property, whether the taxpayer produces the inventory or acquires it for resale.

REG. SEC. 1.263A-7(c) Inventory - (2) Revaluing beginning inventory - (i) In general. If a taxpayer changes its method of accounting for costs subject to Section 263A, the taxpayer must revalue the items or costs included in its beginning inventory in the year of change as if the new method (that is, the method to which the taxpayer is changing) had been in effect during all prior years. ...

The difference between the inventory as originally valued using the former method (that is, the method from which the taxpayer is changing) and the inventory as revalued using the new method is equal to the amount of the adjustment required under Section 481(a).

263A COST CAP

REVALUING DOLLAR-VALUE (OPENING) LIFO INVENTORIES

EXAMPLE from REG. SEC. 1.263A-7(c)(2)(iv)(C)

The Regulations provide that when changes in methods of accounting are made for inventories subject to Section 263A cost capitalization requirements, for purposes of determining future indexes, the year of change becomes the new base year (that is, the index at the beginning of the year of change generally must be 1.0000). They further provide that all costs are restated in new base year costs for purposes of extending such costs in future years. When a new base year is established, costs associated with old layers retain their separate identity within the base year, with such layers being restated in terms of the new base year index. ***Reg. Sec. 1.263A-7(b)(2)(iii)(B).***

The Regulation cited above consists of one example involving a dollar-value, double-extension LIFO taxpayer who was not using either the simplified production method or the simplified resale method. Accordingly, the taxpayer is required to revalue its inventory establishing a new base year.

The example contains three tables. The first shows the LIFO inventory layers as of the beginning of the year of change. The year of change was calendar 1997; therefore, the LIFO inventory layers as of December 31, 1996/January 1, 1997 reflected base costs totaling $34,000 and corresponding LIFO carrying value (i.e., LIFO valuations) totaling $42,000. This table can be seen in the upper left-hand quadrant of the schedule on the facing page.

The recomputation of inventoriable costs under the new method of accounting ***for the three preceding taxable years*** is shown below. Note that the average revaluation factor is .28.

	Current Cost as Recorded (Former Method)	*Current Cost as Adjusted (New Method)*	*Percentage Change*
1994	$ 35,000	$ 45,150	.29
1995	43,500	54,375	.25
1996	54,400	70,720	.30
Total	$ 132,900	$ 170,245	.28

Applying the revaluation factor of .28 to each layer, results in restated base year costs totaling $43,520 and corresponding restated LIFO carrying values totaling $53,760. This table can be seen in the upper right-hand quadrant of the schedule on the facing page.

Section 481(a) Adjustment. The adjustment required by Section 481(a) is $11,760. This amount may be computed by multiplying the average percentage of .28 by the LIFO carrying value of the inventory valued using its former accounting method ($42,000). This amount ($11,760) can be seen in the separate (second) column shown for it in the table in the upper right-hand quadrant of the schedule on the facing page.

Alternatively, the Regulation states that the 481(a) adjustment may be computed by/as the difference between the inventory as originally valued using the former method (that is, the method from which the taxpayer is changing ... $42,000) and the inventory as revalued using the new method of accounting ($53,760). This difference is also equal to $11,760 (53,760 - 42,000).

The final table in the Regulation, which corresponds to the table in the lower right-hand quadrant of the facing page, shows the restated base year costs aggregating $70,720 (i.e., the current cost under the new method as of the beginning of the year of change) and the restated LIFO carrying value of the respective layers totaling $53,760.

The restated indexes in the example in the Regulations are carried to only 3 decimal places; they are carried to 6 decimal places in the schedule on the facing page.

What the example in the Regulations does not show is the LIFO reserve (which is $12,400) before the change in method and after the change in method, it has become $16,960. The compositions of the LIFO reserves both before and after the change in method are shown in the schedule on the facing page.

This format has been used to reflect all of the LIFO-related Section 481(a) computations in connection with the dealer changing accounting methods for trade discounts and advertising fees in the examples on the following pages.

REG. SEC. 1.263A-7(c)(2)(v)(C) EXAMPLE

RECOMPUTATION OF LIFO VALUATION & LIFO RESERVE TO REFLECT CHANGE IN ACCOUNTING METHOD

DOLLAR-VALUE POOL AS OF BEGINNING OF YEAR OF CHANGE: DEC. 31, 1996 / JAN. 1, 1997

	Before Change in Method			To Reflect Change in Accounting Method for the Year Beginning January 1, 1997							
					Sec. 481(a) Adjustment						
Analysis of Year-End LIFO Inventory Layers	Base Dollars	Valuation Factor	LIFO Valuation	Increase Factor	Increase in LIFO Valuation	Valuation of LIFO Layers ... as Revised	Valuation Factor (Unchanged)	Base Dollars ... as Revised*	Ratio of Revised Base Dollars	Original Base Dollars	Increase in Base Dollars
Base Layer	14,000	1.00000	14,000	0.28000	3,920	17,920	1.00000	17,920	0.411765	14,000	3,920
1991 Layer	4,000	1.20000	4,800	0.28000	1,344	6,144	1.20000	5,120	0.117647	4,000	1,120
1992 Layer	5,000	1.30000	6,500	0.28000	1,820	8,320	1.30000	6,400	0.147059	5,000	1,400
1993 Layer	2,000	1.35000	2,700	0.28000	756	3,456	1.35000	2,560	0.058824	2,000	560
1994 Layer	-	1.40000	-	0.28000	-	-	1.40000	-	0.000000	-	-
1995 Layer	4,000	1.50000	6,000	0.28000	1,680	7,680	1.50000	5,120	0.117647	4,000	1,120
1996 Layer	5,000	1.60000	8,000	0.28000	2,240	10,240	1.60000	6,400	0.147059	5,000	1,400
Totals	34,000		42,000		11,760	53,760		43,520 *	1.000000	34,000	9,520
Ending Inventory at LIFO Valuation			42,000			53,760					
Less: Ending Inventory at Current Cost			54,400	16,320		70,720					
LIFO Reserve at End of Year			12,400			16,960					

Rebasing/Restatement of Adjusted Base Dollars as of Dec. 31, 1996 and Composition & Proof of LIFO Reserve Before and After Rebasing/Restatement

				A	B	C	D = C/B	E	F = D	G=(E-F)	H = B	I=(G x H)
	Base Dollars	Proof Factor	Composition of LIFO Reserve by Layer	Ratio of Revised Base Dollars ... Per Above	Current Cost (New Method) Dec. 31, 1996	Valuation of LIFO Layers ... as Revised	Valuation Factor ... as Recomputed	LIFO Reserve Layer Proof Factor (1.0000 - Revised Valuation Factor)			Restated Base Year Costs	Composition of LIFO Reserve by Layer
Base Layer	14,000	0.60000	8,400	0.411765	29,120	17,920	0.615385	1.000000	0.615385	0.384615	29,120	11,200
1991 Layer	4,000	0.40000	1,600	0.117647	8,320	6,144	0.738462	1.000000	0.738462	0.261538	8,320	2,176
1992 Layer	5,000	0.30000	1,500	0.147059	10,400	8,320	0.800000	1.000000	0.800000	0.200000	10,400	2,080
1993 Layer	2,000	0.25000	500	0.058824	4,160	3,456	0.830769	1.000000	0.830769	0.169231	4,160	704
1994 Layer	-	0.20000	-	0.000000	-	-		1.000000	-	1.000000	-	-
1995 Layer	4,000	0.10000	400	0.117647	8,320	7,680	0.923077	1.000000	0.923077	0.076923	8,320	640
1996 Layer	5,000	-	-	0.147059	10,400	10,240	0.984615	1.000000	0.984615	0.015385	10,400	160
Totals	34,000		12,400	1.000000	70,720	53,760					70,720	16,960

Current cost of Pool #1 inventory as adjusted (New Method) as of Dec. 31, 1996 is $70,720. This amount ($70,720) becomes restated base year cost as of December 31, 1996.

Reconciliation of Net Change in LIFO Reserve

LIFO Reserve at Dec. 31, 1996 before Change in Method	12,400
Less: Sec. 481(a) Positive Adjustment	(11,760)
Add: Additional Sec. 263A Costs Required to be capitalized ($70,720 - 54,400)	16,320
LIFO Reserve at Dec. 31, 1996 after Change in Method	16,960

* Base Dollars as Revised: Determined by multiplying each base dollar layer before change (totaling $34,000 times (x) 1.2800 revaluation factor.

** Per Reg. Sec. 1.263A-7(c)(2)(v) ... "The current year cost of [the taxpayer's] inventory, as adjusted is $70,720. Such cost must be apportioned to each layer in proportion to the restated base year cost of that layer to total restated base year costs ($43,520).

(Continued from page 15)

However, some CPA firms don't want to admit to their dealer clients that they don't understand or are unable to do the necessary detailed analysis. So they just bluff their way through it by using oversimplified spreadsheet routines.

One example of a botched "do-it-yourself" attempt. This involved a Chrysler dealer where his CPA "did it himself with spreadsheets prepared from invoice information." According to Todd Boren of Green Financial Outsourcing Solutions, in this case, both DAA (Dealer Advertising Association expense, local–not national) and PPA (labeled Prepaid Advertising, but in reality a ***trade*** discount) were claimed as advertising expenses. This treatment is obviously incorrect, as separate 3115s are required, one for trade discounts and one for ad fees.

What was far more detrimental to the dealer was that in his CPA's erroneous analysis, the CPA missed all of the finance credits ... i.e., the floor plan assistance trade discounts ... which also should have been included as part of the trade discount CAM. There were big dollars left on the table because of this. And, now what?

Guess what the CPA's reaction was when his errors were pointed out to him.

**DOING THE MATH ...
A T/D & A/F CAM CASE STUDY**

The schedules on pages 24 through 30 show the Section 481(a) calculations and other information relating to a "typical" dealer making the CAMs for its new vehicle LIFO inventories. The amount of trade discounts and advertising fees to be eliminated from inventory cost were determined by Green Financial Outsourcing Solutions, Ltd.

The schedules on pages 27 and 30 reflect a "cost effectiveness–benefit analysis" approach for discussing the overall results for two dealership groups for whom we jointly made these CAMs. In both instances, the dealers decided to outsource (i.e., have a service bureau do) all of the invoice-by-invoice and plan-by-plan analysis detail work. In addition, the service bureau also prepared all of the necessary Forms 3115.

Several important "messages" are conveyed by the analyses on pages 27 and 30. One is that the dollar amounts of the Section 481(a) adjustment and year-end cost removed from inventory are shown in relation to the absolute dollar amount of the pre-change inventory cost levels. This information provides a "ballpark estimate" or range of benefit that is fairly typical based on the inventories involved.

Second, these schedules show the very large permanent benefit for the LIFO users resulting from the negative Section 481(a) adjustments. The effect of reducing the LIFO valuation of the beginning-of-the-year inventory ***does not turn over and will not be repaid in the next year. The Sec. 481(a) adjustment benefit will remain locked into the valuation of the LIFO layers, and it will remain until those layers are invaded ... and then, any invasion that occurs will be computed in a horizontal slice, rather than a vertical slice, manner.***

(Note: For a thorough discussion of the horizontal vs. vertical slice difference, see *LIFO Lookout, June 1999,* pages 4-7, "Sale of Excess Capacity Inventory Does Not Require Vertical Slice Faster LIFO Recapture".)

Finally, you may want to consider the Recommendations and Suggestions on the facing page and refer to the Practice Guide Checklist that follows on pages 22-23. ✻

SUPPLEMENTARY SCHEDULES & ANALYSES

CAMs ... RECOMMENDATIONS & SUGGESTIONS

WHERE DO YOU STAND ... AND WHY? Regardless of how you feel about the treatment of trade discounts, CPAs should read the Regulations and determine their Firm's position, liability and/or responsibility for not changing to the correct method/treatment for trade discounts ... It is clear that it is incorrect to include trade discounts as inventory costs. See Reg. Sec. 1.471-3(b).

If your CPA firm, or your dealer client, is adamantly against changing accounting methods for trade discounts (floorplan assistance payments, etc.) ... If trade discounts are being accounted for at "gross invoice" ... the Regulations require that you "disclose positions taken on a tax return that are contrary to Treasury Regulations." Accordingly, Form 8275-R, *Regulation Disclosure Statement,* should be attached to every dealer income tax return where the trade discount change has not been made if the method that the dealer is using is not the ***net invoice method.***

ACQUIRED NEW CLIENTS. Every time you acquire a new dealer client, if changes in accounting method for trade discounts and/or advertising fees have not been made, inquire why and document the reasons.

NEED FOR LEAD TIME. If you are going to discuss the possibility of making these changes in accounting method with dealers, it is advisable to have these discussions at least 6 to 8 weeks before year-end. This much lead time is needed in order to allow enough time to determine costs and projected benefits and to incorporate the anticipated results into other year-end planning for the dealer.

Fairly accurate preliminary estimates of the benefits can be made. Our schedules show and explain many of the key relationships, especially the size of the negative Section 481(a) adjustment. As an alternative, you can simply go to the web site of Green Financial Outsourcing Solutions and enter the "ballpark" amount of inventory by manufacturer. (www.greenoutsourcing.com)

CONSIDER USING A SPECIALIZED SERVICE TO DO THE DETAILED ANALYSIS.

- Obtain a preliminary, but somewhat tailor-made, estimate of the possible benefits.
- Also, you'll want to negotiate the cost of outsourced services
  1. There may be a wide disparity in the cost of services offered to do detailed invoice analysis, etc.
  2. Where possible, to avoid fee surprises, try to secure *"capped cost protection."*
  3. Often, the preparation of the necessary 3115s, LIFO layer restructuring and calculation of Section 481(a) adjustment will be included as part of the overall services provided ... thus making the CAM activity a simple "turn-key" process.
  4. Also, lock in the cost for ongoing program analysis for subsequent year-end inventories, as that should be considered as part of the overall compliance costs.

BOTH CHANGES AT ONCE ... OR SPLIT THEM OVER TWO YEARS? It will usually be desirable to make both changes in accounting methods (i.e., for both trade discounts and for ad fees and expenses) at the same time / in the same year.

The practical reason is that it makes more sense to analyze the same batch of 3-year ends' invoices at the same time, and this also avoids rebasing and 3115 filings in two successive years.

However, there may be situations where making the changes over 2 years (i.e., a "split change") may produce better tax benefits for the dealer. For example, it may be more advantageous to take part of the overall negative Section 481(a) adjustment attributable to one of the changes in one year and the corresponding negative Section 481(a) adjustment attributable to the other CAM in a later year.

This decision may be based on such considerations as the availability of net operating loss carrybacks and tax refund potential, the absolute dollar amounts of the negative Section 481(a) adjustments, and other tax planning elements either present or absent in the current year (such as large investments in depreciable property eligible for 30% or 50% special depreciation deductions).

REVIEW THE PRACTICE GUIDE checklist for trade discount and advertising fees CAMs on pages 22-23.

And remember ... these CAM benefits can be applied to any inventory-intensive clients.

Practice Guide	ELIMINATING TRADE DISCOUNTS (FLOORPLAN ASSISTANCE PAYMENTS) & ADVERTISING FEES FROM INVENTORY COSTS
Client Management Issues ❐ **Section Complete**	1. ❐ Have the ramifications and benefits of the change in accounting method been explained to the dealer/client? ❐ If possible changes in accounting method have been discussed, but dealer has decided not to make the changes, is there a memo in the file documenting discussion and rationale for not making changes at this time? 2. ❐ Regardless of how the client/dealer feels about the accounting for trade discounts, what is the Firm's position, liability and/or responsibility for not changing to the correct method/treatment for trade discounts? ... It is clear that it is incorrect to include trade discounts as inventory costs. ***(Where do you stand ... and why?)*** 3. ❐ If the CAMs are going to be made, who is going to be responsible for the accuracy of the determination of the amounts of floorplan assistance payments and/or advertising fees and expenses to be removed from prior and current year inventory costs? ♦ Dealership controller and/or dealership personnel ♦ (Our) CPA firm will make the determinations ♦ The determinations will be outsourced to a specialized service bureau ❐ Is there a memo in the file documenting responsibility in this area and for the conclusion to not rely on an outside service bureau to do this work? 4. ❐ Will both changes in accounting method be made at the same time? ❐ Or, will the changes in accounting method be split over two years?. If split over two years, why?
Timing of Filings ❐ **Section Complete**	1. For trade discounts, including floorplan assistance CAMs (filed under Rev. Proc. 2002-9)... ❐ Attach the original Form 3115 to the income tax return when it is filed. ❐ Send a copy of Form 3115 to IRS National Office in Washington, D.C. when the income tax return for the year of change is filed. 2. For advertising fees and expenses CAMs (filed under Rev. Proc. 97-27)... ❐ Form 3115 must be filed with the IRS National Office ***before year end***. ❐ Copy of consent letter received from IRS is required to be attached to the return for the year of change (possibly necessitating filing amended return with copy of consent letter attached?)
LIFO Issues & Adjustments ❐ **Section Complete**	1. ❐ Is restatement of opening (beginning) inventory layers based on an analysis of the new vehicle invoices in the year-end for each of the 3 preceding years? ❐ If no, explain why 3-year analysis of invoices had not been undertaken. ❐ If no, has disclosure of less than 3 years as the basis for adjustment been included in Form 3115 narrative? ***Note: Separate analysis must be made for vehicles in each pool.*** ***It is not permissible to use the same rate for both pools as a short-cut.*** 2. ❐ Has opening (beginning) inventory for the year of change been restated to reflect net discount method for determining inventory cost? 3. ❐ Does opening (beginning) inventory for the year of change reflect restatement/rebasing of LIFO indexes to 1.0000? 4. ❐ Do the LIFO computations as of the end of the year of change reflect the appropriate beginning of the year & end of the year (net) cost levels and the rebased LIFO indexes? 5. ❐ After the LIFO transition calculations were completed, was there a proof of the composition of the LIFO reserve so that future years' computations will not misstate LIFO valuations?

Practice Guide	*ELIMINATING TRADE DISCOUNTS (FLOORPLAN ASSISTANCE PAYMENTS) & ADVERTISING FEES FROM INVENTORY COSTS*
Analysis & Computations ❒ **Section Complete**	1. ❒ Has determination of costs to be removed from ending inventory been made on an invoice-by-invoice basis? ❒ If not, why not? Is there a memo in the file? 2. ❒ Has appropriate adjustment been made for difference in timing of allowance of discounts (i.e., some accrue at date of purchase, others do not accrue until a later date which may fall beyond the end of the year)? 3. ❒ Have appropriate corresponding adjustments been made to the payables accounts at the beginning of the year and at the end of the year? 4. ❒ If necessary, have you prepared ... ❒ (1) reconciliations to cost for tax purposes, **and** ❒ (2) adjusting entries to be recorded on dealership books to reflect the CAMs?
Advertising Fees & Expenses CAMs ❒ **Section Complete**	1. ❒ Has a distinction been made between ***local and regional*** advertising (for which the IRS will permit a change in method) and ***national*** advertising (for which it will not permit a CAM)? 2. ❒ Will the tax return for the year of change be filed before the dealership receives permission from the IRS to make the change in method? If so, ❒ Will a statement be included in the tax return with respect to its being filed before permission to change has been granted? ♦ ... "Taxpayer has taken all steps to file Form 3115 requesting a change in accounting method for advertising fees and expenses before the end of the year and to secure consent from the Commissioner to make this change. This change will result in a clear reflection of income and is in accordance with Generally Accepted Accounting Principles. At the time of filing its tax return, Taxpayer has not yet received notification from the National Office in connection with the application it has filed. As a result, Taxpayer is filing its income tax return for the year end December 31, 200__ reflecting the new, proposed method of accounting for advertising fees and expenses." 3. ❒ Will Form 8275-R, with explanation, be attached to the income tax return filed?
Cost Cap Sec. 263A ❒ **Section Complete**	1. ❒ Has the appropriate Sec. 263A computation been reflected as part of the Sec. 481(a) adjustment? 2. ❒ Has the taxpayer properly elected to use a simplified Section 263A method? ❒ If so, which simplified election has been made? ❒ If the dollar-value LIFO method has been elected, has the opening (beginning) inventory for the year of change been restated/rebased?
Tax Return Disclosures & Attachments ❒ **Section Complete**	1. For trade discounts (including floorplan assistance payments) CAMs ... ❒ Has original of Form 3115 been attached to the timely filed income tax return? ❒ Has a copy of the Form 3115 (included with the timely filed income tax return) been mailed to the IRS National Office in Washington, DC? 2. For advertising fees and expenses CAMs ... ❒ Before the end of the year, was the original of Form 3115 filed with the IRS National Office in Washington, DC? ❒ Has permission to change been received before the tax return is filed? ❒ If yes, attach copy of consent letter to timely filed income tax return. ❒ If no, see above re: explanation to be attached to tax return and/or Form 8275-R 3. ❒ Have the inventory questions on page 2 of Form 1120/1120-S been answered in the affirmative to indicate that changes in method have been made? 4. ❒ ***State returns*** ... Have corresponding CAM disclosures been made in all state and other income tax returns being filed?

SAMPLE DEALERSHIP

RECOMPUTATION OF LIFO VALUATION & LIFO RESERVE TO REFLECT CHANGE IN ACCOUNTING METHOD

POOL #1 - NEW AUTOMOBILES - AS OF BEGINNING OF YEAR OF CHANGE: DEC. 31, 2001 / JAN. 1, 2002

	Before Change in Method			To Reflect Change in Accounting Method for the Year Beginning January 1, 2002							
					Sec. 481(a) Adjustment						
Analysis of Year-End LIFO Inventory Layers	Base Dollars	Valuation Factor	LIFO Valuation	Reduction Factor	Reduction in LIFO Valuation	Valuation of LIFO Layers ... as Revised	Valuation Factor (Unchanged)	Base Dollars ... as Revised*	Ratio of Revised Base Dollars	Original Base Dollars	Reduction in Base Dollars
Calendar year 1979 Increment	200,307	0.58445	117,069	0.00653	764	116,305	0.58445	198,999	0.042628	200,307	1,308
Calendar year 1980 Increment	13,305	0.59744	7,949	0.00653	52	7,897	0.59744	13,218	0.002831	13,305	87
Calendar year 1984 Increment	216,463	0.76797	166,237	0.00653	1,086	165,152	0.76797	215,049	0.046066	216,463	1,414
Calendar year 1985 Increment	119,973	0.85271	102,302	0.00653	668	101,634	0.85271	119,190	0.025532	119,973	783
Calendar year 1986 Increment	129,660	1.02168	132,471	0.00653	865	131,606	1.02168	128,813	0.027593	129,660	847
Calendar year 1987 Increment	57,722	1.02551	59,194	0.00653	387	58,808	1.02551	57,345	0.012284	57,722	377
Calendar year 1996 Increment	1,451,737	1.20638	1,751,346	0.00653	11,436	1,739,910	1.20638	1,442,257	0.308950	1,451,737	9,480
Calendar year 1997 Increment	73,147	1.21075	88,563	0.00653	578	87,984	1.21075	72,669	0.015567	73,147	478
Calendar year 1999 Increment	510,129	1.21905	621,873	0.00653	4,061	617,812	1.21905	506,798	0.108563	510,129	3,331
Calendar year 2000 Increment	604,675	1.22682	741,827	0.00653	4,844	736,983	1.22682	600,726	0.128683	604,675	3,949
Calendar year 2001 Increment	1,321,815	1.23800	1,636,407	0.00653	10,686	1,625,721	1.23800	1,313,184	0.281301	1,321,815	8,631
Totals	4,698,933		5,425,239		35,427	5,389,813		4,668,249 *	1.000000	4,698,933	30,684
Ending Inventory at LIFO Valuation			5,425,239			5,389,813					
Less: Ending Inventory at Current Cost			5,817,279	(36,698)		5,780,581					
LIFO Reserve at End of Year			392,040			390,768					

Rebasing/Restatement of Adjusted Base Dollars as of Dec. 31, 2001 and Composition & Proof of LIFO Reserve Before and After Rebasing/Restatement

				A	B	C	D = C/B	E	F = D	G=(E-F)	H = B	I=(G x H)
	Base Dollars	Proof Factor	Composition of LIFO Reserve by Layer	Ratio of Revised Base Dollars ... Per Above	Current Cost (New Method) Dec. 31, 2001	Valuation of LIFO Layers ... as Revised	Valuation Factor ... as Recomputed	LIFO Reserve Layer Proof Factor (1.0000 - Revised Valuation Factor)			Restated Base Year Costs	Composition of LIFO Reserve by Layer
Calendar year 1979 Increment	200,307	0.65355	130,911	0.042628	246,416	116,305	0.471987	1.000000	0.471987	0.528013	246,416	130,111
Calendar year 1980 Increment	13,305	0.64056	8,523	0.002831	16,368	7,897	0.482477	1.000000	0.482477	0.517523	16,368	8,471
Calendar year 1984 Increment	216,463	0.47003	101,744	0.046066	266,291	165,152	0.620193	1.000000	0.620193	0.379807	266,291	101,139
Calendar year 1985 Increment	119,973	0.38529	46,224	0.025532	147,590	101,634	0.688627	1.000000	0.688627	0.311373	147,590	45,955
Calendar year 1986 Increment	129,660	0.21632	28,048	0.027593	159,506	131,606	0.825083	1.000000	0.825083	0.174917	159,506	27,900
Calendar year 1987 Increment	57,722	0.21249	12,265	0.012284	71,009	58,808	0.828176	1.000000	0.828176	0.171824	71,009	12,201
Calendar year 1996 Increment	1,451,737	0.03162	45,904	0.308950	1,785,913	1,739,910	0.974242	1.000000	0.974242	0.025758	1,785,913	46,002
Calendar year 1997 Increment	73,147	0.02725	1,993	0.015567	89,985	87,984	0.977771	1.000000	0.977771	0.022229	89,985	2,000
Calendar year 1999 Increment	510,129	0.01895	9,667	0.108563	627,556	617,812	0.984474	1.000000	0.984474	0.015526	627,556	9,744
Calendar year 2000 Increment	604,675	0.01118	6,760	0.128683	743,865	736,983	0.990748	1.000000	0.990748	0.009252	743,865	6,882
Calendar year 2001 Increment	1,321,815	0.00000	-	0.281301	1,626,084	1,625,721	0.999777	1.000000	0.999777	0.000223	1,626,084	363
Totals	4,698,933		392,040	1.000000	5,780,581	5,389,813					5,780,581	390,768

Current cost of Pool #1 inventory as adjusted (New Method) as of Dec. 31, 2001 is $5,780,581. This amount ($5,780,581) becomes restated base year cost as of December 31, 2001.

Reconciliation of Net Change in LIFO Reserve

LIFO Reserve at Dec. 31, 2001 before Change in Method	392,040
Add: Sec. 481(a) Negative Adjustment	35,427
Less: Trade Discounts + Ad Expense in 12/31/01 Inventory before Change in Method	(36,698)
LIFO Reserve at Dec. 31, 2001 after Change in Method	390,768

* Base Dollars as Revised: Determined by multiplying each base dollar layer before change (totaling $4,698,933) times (x) [1-.00653 = .99347] adjustment percentage.

SAMPLE DEALERSHIP

RECOMPUTATION OF LIFO VALUATION & LIFO RESERVE TO REFLECT CHANGE IN ACCOUNTING METHOD

POOL #2 - NEW LIGHT-DUTY TRUCKS - AS OF BEGINNING OF YEAR OF CHANGE: DEC. 31, 2001 / JAN. 1, 2002

	Before Change in Method			To Reflect Change in Accounting Method for the Year Beginning January 1, 2002							
					Sec. 481(a) Adjustment						
Analysis of Year-End LIFO Inventory Layers	Base Dollars	Valuation Factor	LIFO Valuation	Reduction Factor	Reduction in LIFO Valuation	Valuation of LIFO Layers ... as Revised	Valuation Factor (Unchanged)	Base Dollars ... as Revised*	Ratio of Revised Base Dollars	Original Base Dollars	Reduction in Base Dollars
Calendar year 1980 Increment	32,752	0.90968	29,794	0.01301	388	29,406	0.90968	32,326	0.029432	32,752	426
Calendar year 1981 Increment	12,013	0.92491	11,111	0.01301	145	10,966	0.92491	11,857	0.010795	12,013	156
Calendar year 1982 Increment	97,372	0.93553	91,094	0.01301	1,185	89,909	0.93553	96,105	0.087502	97,372	1,267
Calendar year 1983 Increment	70,753	1.11735	79,056	0.01301	1,029	78,027	1.11735	69,833	0.063581	70,753	920
Calendar year 1997 Increment	431,619	1.17052	505,219	0.01301	6,573	498,646	1.17052	426,004	0.387868	431,619	5,615
Calendar year 1999 Increment	295,847	1.18361	350,167	0.01301	4,556	345,612	1.18361	291,998	0.265858	295,847	3,849
Calendar year 2000 Increment	82,591	1.20768	99,743	0.01301	1,298	98,446	1.20768	81,516	0.074219	82,591	1,075
Calendar year 2001 Increment	89,853	1.27311	114,393	0.01301	1,488	112,905	1.27311	88,684	0.080745	89,853	1,169
Totals	1,112,800		1,280,577		16,660	1,263,917		1,098,322 *	1.000000	1,112,800	14,478
Ending Inventory at LIFO Valuation			1,280,577			1,263,917					
Less: Ending Inventory at Current Cost			1,416,717	(19,943)		1,396,774					
LIFO Reserve at End of Year			136,140			132,857					

Rebasing/Restatement of Adjusted Base Dollars as of Dec. 31, 2001 and Composition & Proof of LIFO Reserve Before and After Rebasing/Restatement

	Base Dollars	Proof Factor	Composition of LIFO Reserve by Layer	A Ratio of Revised Base Dollars ... Per Above	B Current Cost (New Method) Dec. 31, 2001	C Valuation of LIFO Layers ... as Revised	D = C/B Valuation Factor ... as Recomputed	E LIFO Reserve Layer Proof Factor (1.0000 - Revised Valuation Factor)	F = D	G=(E-F)	H = B Restated Base Year Costs	I=(G x H) Composition of LIFO Reserve by Layer
Calendar year 1980 Increment	32,752	0.36343	11,903	0.029432	41,110	29,406	0.715307	1.000000	0.715307	0.284693	41,110	11,704
Calendar year 1981 Increment	12,013	0.34820	4,183	0.010795	15,079	10,966	0.727283	1.000000	0.727283	0.272717	15,079	4,112
Calendar year 1982 Increment	97,372	0.33758	32,871	0.087502	122,220	89,909	0.735633	1.000000	0.735633	0.264367	122,220	32,311
Calendar year 1983 Increment	70,753	0.15576	11,020	0.063581	88,808	78,027	0.878604	1.000000	0.878604	0.121396	88,808	10,781
Calendar year 1997 Increment	431,619	0.10259	44,280	0.387868	541,763	498,646	0.920413	1.000000	0.920413	0.079587	541,763	43,118
Calendar year 1999 Increment	295,847	0.08950	26,478	0.265858	371,344	345,612	0.930706	1.000000	0.930706	0.069294	371,344	25,732
Calendar year 2000 Increment	82,591	0.06543	5,404	0.074219	103,667	98,446	0.949633	1.000000	0.949633	0.050367	103,667	5,221
Calendar year 2001 Increment	89,853	0.00000	-	0.080745	112,782	112,905	1.001082	1.000000	1.001082	-0.001082	112,782	(122)
Totals	1,112,800		136,139	1.000000	1,396,774	1,263,917					1,396,774	132,857

Current cost of Pool #2 inventory as adjusted (New Method) as of Dec. 31, 2001 is $1,396,774. This amount ($1,396,774) becomes restated base year cost as of December 31, 2001.

Reconciliation of Net Change in LIFO Reserve

LIFO Reserve at Dec. 31, 2001 before Change in Method	136,140
Add: Sec. 481(a) Negative Adjustment	16,660
Less: Trade Discounts + Ad Expense in 12/31/01 Inventory before Change in Method	(19,943)
LIFO Reserve at Dec. 31, 2001 after Change in Method	132,857

* Base Dollars as Revised: Determined by multiplying each base dollar layer before change (totaling $1,112,800) times (x) [1-.01301 = .98699] adjustment percentage.

SAMPLE DEALERSHIP

NEW VEHICLE LIFO INVENTORIES - COMPUTATION OF SECTION 481(a) ADJUSTMENTS

AS OF THE BEGINNING OF THE YEAR OF CHANGE IN ACCOUNTING METHOD (CALENDAR 2002)

	Pool #1 - New Automobiles					Pool #2 - New Light-Duty Trucks					Combined Pools - All New Vehicles				
	1999	2000	2001	Total	2002	1999	2000	2001	Total	2002	1999	2000	2001	Total	2002
Adjustment of Inventory Cost															
End-of-Year Inventory at Cost, Before Change in Accounting Method (CAM)* (A)	3,379,747	4,143,116	5,817,279	13,340,142	6,994,547	1,113,015	1,235,393	1,416,717	3,765,125	1,577,502	4,492,762	5,378,509	7,233,996	17,105,267	8,572,049
Less: Reduction for Trade Discount & Advertising Expense Adjustments** (B	(21,107)	(29,267)	(36,698)	(87,072)	(74,996)	(12,392)	(16,643)	(19,943)	(48,978)	(28,742)	(33,499)	(45,910)	(56,641)	(136,050)	(103,738)
End-of Year Inventory at Cost, As Adjusted for CAM (C)	3,358,640	4,113,849	5,780,581	13,253,070	6,919,551	1,100,623	1,218,750	1,396,774	3,716,147	1,548,760	4,459,263	5,332,599	7,177,355	16,969,217	8,468,311
Ratio of A to B (D)	0.00625	0.00706	0.00631	0.00653	0.01072	0.01113	0.01347	0.01408	0.01301	0.01822	0.00746	0.00854	0.00783	0.00795	0.01210
Ratio of C to A – Adj. % Adjustment Percentage (E)	0.99375	0.99294	0.99369	0.99347	0.98928	0.98887	0.98653	0.98592	0.98699	0.98178	0.99254	0.99146	0.99217	0.99205	0.98790
Sec. 481(a) Net Change in LIFO Reserve															
LIFO Valuation at 12/31/2001 Before CAM Adjustment* (F)			5,424,238					1,280,577							
LIFO Valuation at 12/31/2001 After CAM Adjustment (G)			5,389,813					1,263,917							
Net Change in LIFO Valuation Due to CAM Adjustment (H)	-	-	34,425	-	-	-	-	16,660	-	-		-	-	-	-
Alternative Calculation (Line F x Line D: 3-year avg.)			35,404					16,658							

Notes: **Change in Accounting Method effective for the year 2002 made to eliminate trade discount & advertising expenses from year-end inventory costs.**

For Pool #1 - .99347 is the 3-year average reduction factor computed in accordance with Reg. Sec. 1.263A-7(c)(2)(v). The Section 481(a) negative adjustment for Pool #1 is **$35,425**.

For Pool #2 - .98699 is the 3-year average reduction factor computed in accordance with Reg. Sec. 1.263A-7(c)(2)(v). The Section 481(a) negative adjustment for Pool #2 is **$16,660**.

This schedule does not reflect any recomputation of capitalized Section 263A costs. The net change in Section 263A capitalized costs must be computed separately as an element or component of the net Section 481(a) adjustment as of the beginning of the year of change.

* Per LIFO Inventory Report for the year indicated prepared by Willard J. De Filipps, CPA, P.C. (Mt. Prospect, IL).

** Per Inventory Adjustment Summary included in Report prepared by Green Financial Outsourcing Solutions, LLC (Dallas, TX).

JKL DEALERSHIP GROUP

COST EFFECTIVENESS - BENEFIT ANALYSIS FOR CHANGES IN ACCOUNTING METHODS

FOR CHANGES MADE TO LIFO INVENTORIES EFFECTIVE FOR CALENDAR YEAR 2002

	#1	#2	#3	#4	#5	#6	All 6 Dealerships Combined
	Both LIFO Pools Combined	Both LIFO Pools Combined	Both LIFO Pools Combined	Both LIFO Pools Combined	Both LIFO Pools Combined	Both LIFO Pools Combined	Totals
Adjustments							
Section 481(a) negative adjustment to reduce opening inventory LIFO valuation	151,882	52,087	44,571	50,143	62,008	37,267	397,958
Net decrease in year of change increase in LIFO reserve	(3,537)	(837)	(162)	(140)	1,115	(608)	(4,169)
Net decrease in year of change in ending inventory for trade discounts and ad fees	206,175	103,738	78,612	64,847	79,393	52,158	584,923
Subtotal (Net Adjustment Before Sec. 263A)	*354,520*	*154,988*	*123,021*	*114,850*	*142,516*	*88,817*	*978,712*
Section 263A adjustment to reduce previously capitalized Sec. 263A costs resulting from decrease in LIFO inventory layer valuations	139	18	96	59	63	57	432
Memo: Increase in LIFO reserve at Dec. 31, 2002							
Before method change	128,984	109,355	5,723	4,999	(95,422)	22,584	176,223
After method change	125,447	108,518	5,561	4,859	(94,307)	21,976	172,054
Net decrease in increase in LIFO reserve for the year because of change in accounting method	3,537	837	162	140	(1,115)	608	4,169
Net Income Effect / Benefit @ end of year-of-change	*354,659*	*155,006*	*123,117*	*114,909*	*142,579*	*88,874*	*979,144*
Less: Conversion & Compliance costs / fees paid							
Invoice analyses for discounts & ad fees							
Sec. 481(a) computations & yr. of change LIFO recalcs							
Internal tax & accounting staff costs							
User fees paid to IRS for Form 3115 filings (Ad fees)							
Total Conversion & Compliance Costs							
Net Benefit After Conversion & Compliance Costs							
Applicable effective rate of tax							
Net Benefit After Considering All Conversion & Compliance Costs and Tax Effects							
Dec. 31, 2001 Inventory (Before 3115 change)	5,477,246	7,233,996	1,712,508	1,636,772	4,222,982	1,571,412	21,854,916
Dec. 31, 2002 Inventory (Before 3115 change)	6,277,198	8,572,049	2,547,305	2,469,062	3,272,199	2,084,533	25,222,346
Average Inventory (Before 3115 change)	5,877,222	7,903,023	2,129,907	2,052,917	3,747,591	1,827,973	23,538,631
Net Adjustment as a % of Average Inventory	*6.03%*	*1.96%*	*5.78%*	*5.59%*	*3.80%*	*4.86%*	*4.16%*

Month __, 2003

Mr./Ms. Dealership Controller
Sample Dealership
123 Any Street
Any City, State Zip Code

Re: Sample Dealership ... Sample Letter Explaining CAM Results
New Vehicle LIFO Inventories - Change in Accounting Method
Effective for Calendar Year 2002

Dear Mr./Ms. Dealership Controller:

In accordance with the changes in the method of accounting for trade discounts and advertising fees and expenses effective for the calendar year 2002, enclosed are the LIFO inventory valuations for the New Vehicle LIFO Inventories Pool #1 - New Automobiles - and Pool #2 - New Light-Duty Trucks.

These computations reflect the reduction of ending inventory costs to eliminate from each pool the floorplan assistance payments and advertising fees and expenses which are subject to the changes in accounting method. These reductions from inventory cost are the amounts computed by Green Financial Outsourcing Solutions, LLC.

Adjustments to Inventory Valuations as of December 31, 2001

In connection with making these changes for calendar 2002, the valuations of the LIFO inventories and the corresponding LIFO reserves as of December 31, 2001 have been recomputed to reflect the necessary transitional adjustments as of January 1, 2002 (the beginning of the year-of-change). These adjustments are reflected in the schedules attached.

The recomputed LIFO reserves at December 31, 2001 reflect the effects of (1) the Section 481(a) adjustment and (2) the adjustment to the year-end inventory to reflect the dollar amount of the trade discounts, etc., in inventory as of that date. The changes in the LIFO reserves as of December 31, 2001 are summarized below.

December 31, 2001	***Pool #1 New Autos***	***Pool #2 New Light-Duty Trucks***	***Combined***
LIFO Reserve at Dec. 31, 2001 ***Before*** Change in Method	392,040	136,140	528,180
Add: Sec. 481(a) Negative Adjustment	35,427	16,660	52,087
Less: Trade Discounts & Advertising Fees in Dec. 31, 2001 Inventory ***Before*** Change in Method	(36,698)	(19,943)	(56,641)
LIFO Reserve at Dec. 31, 2001 ***After*** Change in Method	**390,769**	**132,857**	**523,626**

Adjustments for Section 263A Capitalization of Certain Inventory Costs as of Dec. 31, 2001

The enclosed schedules only relate to the LIFO inventory valuation adjustment. A separate Section 481(a) adjustment is required to correspondingly reduce the previously capitalized Section 263A costs with respect to each LIFO layer. This adjustment is based on proportional reduction of the amounts previously capitalized under Section 263A. Your CPA should compute this adjustment and include it as part of the overall Section 481(a) adjustment.

Recomputation of LIFO Inventory Valuations as of December 31, 2002

As a result of the change in method effective for the calendar year 2002 and the related transition adjustments that apply to the December 31, 2001 inventories, the LIFO valuations of the new vehicle inventories and of the LIFO reserves as of December 31, 2002 have been recomputed to reflect these transition adjustments. This resulted in a net increase in the LIFO reserves for the calendar year 2002 that was less than the increase would have been if these changes in accounting method had not been made.

(Continued)

December 31, 2002	***Pool #1 New Autos***	***Pool #2 New Light-Duty Trucks***	***Combined***
LIFO Valuation of Inventory ***Before*** Method Change	6,512,569	1,421,944	7,934,513
LIFO Valuation of Inventory ***After*** Method Change	6,439,412	1,396,755	7,836,167
Net Decrease in LIFO Valuation	73,157	25,189	98,346
Increase in LIFO Reserve at Dec. 31, 2002 ***Before*** Method Change	89,937	19,418	109,355
Increase in LIFO Reserve at Dec. 31, 2002 ***After*** Method Change	89,370	19,148	108,518
Net Decrease in Increase in LIFO Reserve for 2002	567	270	837

In addition to the above, the trade discounts relative to floorplan assistance and the advertising fees and expenses that would have been included in the ending inventory if no change had been made total ***$103,738*** and will be deducted in the tax return for calendar year 2002.

December 31, 2002	***Pool #1 New Autos***	***Pool #2 New Light-Duty Trucks***	***Combined***
Current Cost of Inventory ***Before*** Method Change	6,994,547	1,577,502	8,572,049
Current Cost of Inventory ***After*** Method Change	6,919,551	1,548,760	8,468,311
Net Decrease in Ending Inventory	74,996	28,742	103,738

The net decrease in the current cost of ending inventory equals the trade discounts and advertising fees excluded from ending inventory as a result of the changes in accounting method.

In summary, the net effect of reflecting the changes in accounting method for the dealership for the calendar year 2002 is shown below. This excludes the very small net effect of any Section 263A adjustments.

December 31, 2002	***Pool #1 New Autos***	***Pool #2 New Light-Duty Trucks***	***Combined***
Section 481(a) Negative Adjustment to Reduce Beginning Inventory LIFO Valuation	35,427	16,660	52,087
Net Decrease in Year of Change Increase in LIFO Reserve	(567)	(270)	(837)
Net Decrease in Year of Change in Ending Inventory Cost for Trade Discounts and Advertising Fees	74,996	28,742	103,738
Net Adjustment, before Sec. 263A	109,856	45,132	154,988

If you have questions on any of this, please call at your earliest convenience.

Sincerely,

Encl.

Willard J. De Filipps, CPA

ABC DEALERSHIP GROUP

COST EFFECTIVENESS - BENEFIT ANALYSIS FOR CHANGES IN ACCOUNTING METHODS

FOR CHANGES MADE TO LIFO INVENTORIES EFFECTIVE FOR THE YEAR ENDED JUNE 30, 2003

	#1	#2	#3	#4	#5	#6	#7	All 7 Dealerships Combined
	Both LIFO Pools Combined	Both LIFO Pools Combined	Both LIFO Pools Combined	Both LIFO Pools Combined	Both LIFO Pools Combined	Both LIFO Pools Combined	Both LIFO Pools Combined	Totals
Adjustments								
Section 481(a) negative adjustment to reduce opening inventory LIFO valuation	173,612	273,755	223,304	72,563	65,977	124,159	218,844	1,152,214
Net decrease in year of change increase in LIFO reserve	(9,416)	(6,174)	(5,904)	(2,590)	(1,964)	28,167	(6,192)	(4,073)
Net decrease in year of change in ending inventory for trade discounts and ad fees	253,052	637,921	369,218	115,964	134,684	97,111	366,634	1,974,584
Subtotal (Net Adjustment Before Sec. 263A)	417,248	905,502	586,618	185,937	198,697	249,437	579,286	3,122,725
Section 263A adjustment to reduce previously capitalized Sec. 263A costs resulting from decrease in LIFO inventory layer valuations	141	250	249	162	301	125	302	1,530
Net Income Effect / Benefit @ end of year-of-change	*417,389*	*905,752*	*586,867*	*186,099*	*198,998*	*249,562*	*579,588*	*3,124,255*
Less: Conversion & Compliance costs / fees paid								
Invoice analyses for discounts & ad fees								
Sec. 481(a) computations & yr. of change LIFO recalcs								
Internal tax & accounting staff costs								
User fees paid to IRS for Form 3115 filings (Ad fees)								
Total Conversion & Compliance Costs								
Net Benefit After Conversion & Compliance Costs								
Applicable effective rate of tax								
Net Benefit After Considering All Conversion & Compliance Costs and Tax Effects								

	#1	#2	#3	#4	#5	#6	#7	Totals
Autos	2,112,054	1,854,617	5,228,328	662,336	793,314	3,601,581	3,283,272	17,535,502
L/D Trucks	4,755,635	9,886,678	5,075,618	3,092,019	2,743,397	3,374,740	5,514,258	34,442,345
June 30, 2002 New Vehicles	6,867,689	11,741,295	10,303,946	3,754,355	3,536,711	6,976,321	8,797,530	51,977,847
Autos	1,743,774	6,224,949	4,573,930	1,190,844	1,100,684	1,968,166	2,709,708	19,512,055
L/D Trucks	5,489,374	18,312,819	9,389,233	4,415,181	3,569,606	1,990,336	8,836,262	52,002,811
June 30, 2003 New Vehicles	7,233,148	24,537,768	13,963,163	5,606,025	4,670,290	3,958,502	11,545,970	71,514,866

* Due to the unusual facts in the case of Dealership #6, the amounts shown as the "net decrease in the increase in the LIFO reserve for the year of change" (i.e., $17,228 for autos and $10,939 for light-duty trucks) are actually positive numbers. In all of the other dealerships, the corresponding figures were net decreases.

At A Glance	VOLUME-RELATED TRADE DISCOUNTS
Overview	• Many dealers have recently changed their accounting methods for volume-related trade discounts. This CAM has become increasingly common over the last few years. • Some CPAs oppose making these changes because they are concerned that if certain cost elements are excluded from inventory where LIFO inventories are involved, the exclusion of costs from inventory could be a violation of one of the eligibility requirements to use LIFO. (This does not seem to be a problem in the eyes of the IRS.) • Other CPAs oppose making these changes because of GAAP concerns. • In fact, the Regulations and Rev. Rul. 84-41 clearly state that trade discounts are ***not*** to be included as inventoriable costs. • Accordingly, where trade discounts are not recorded net (i.e., where the improper method of accounting of recording trade discounts as part of inventory costs is being followed), Form 8275-R should be completed and attached to the income tax return.
Changes in Accounting Methods Involving Trade Discounts Are Automatic	• ***Appendix*** Section 9 of Revenue Procedure 2002-9 (2002-3 I.R.B. 327) refers to changes involving inventories under IRC Section 471. • Includes changes for taxpayers who want to change their methods of accounting to treat qualifying volume-related trade discounts as reductions in the cost of merchandise purchased at the time the discount is recognized in accordance with Reg. Sec. 1.471-3(b). • Automatic change treatment only applies to discounts that satisfy the criteria/definition below.
Definition of "Qualifying Volume-Related Trade Discount"	• The taxpayer receives or earns the discount solely as the result of the purchase of the merchandise to which the discount relates; • The taxpayer is neither obligated nor expected to perform or provide any services in exchange for the discount; and • The discount is not a reimbursement of any expenditure incurred or to be incurred by the taxpayer.
Specifics of Automatic Change	• The net Section 481 adjustment attributable to the change is computed in a manner similar to the computation of a net Section 481 adjustment in the case of a change to the net invoice method of accounting for cash discounts. See section 9.01(2) of the ***Appendix***. • Text of cross-referenced section (9.01(2)): ***Computation of Section 481 adjustment for changes to net invoice method.*** In the case of a taxpayer changing from the gross invoice method to the net invoice method, a negative adjustment must be made to prevent duplications arising from the fact that the gross invoice method reported income upon timely payment for some or all of the goods that remain in inventory, and a positive adjustment must be made to prevent omissions arising from the fact that the gross method included the invoice price, unadjusted for the cash discounts, of some or all goods in cost of goods sold and the discount will be earned by payment in a subsequent taxable year. The net Section 481 adjustment can be computed by deducting the "Applicable Discount" at the beginning of the year of change from the "Available Discount" at the beginning of the year of change. The Available Discount is equal to the difference between the accounts payable balance under the gross invoice method and the net invoice method. The Applicable Discount is equal to the difference between the beginning inventory value under the gross invoice method and the net invoice method. • Example included in the ***Appendix*** ... Taxpayer's accounts payable balance at the beginning of the year of change was $1,000x under the gross invoice method and $980x under the net invoice method. Taxpayer's inventory value was $3,000x under the gross invoice method and $2,955x under the net invoice method. The Available Discount is $20 ($1,000x - $980x) and the Applicable Discount is $45 ($3,000x - $2,955x). Thus, Taxpayer's net § 481(a) adjustment is a negative $25 ($20 - $45).

IRS FILING PROCEDURES TO FOLLOW
IN MAKING AUTOMATIC CHANGES IN METHODS OF ACCOUNTING

R.P. 2002-9
Section 6

Consent (Sec. 6.01)	• Pursuant to Section 1.446-1(e)(2)(i), the consent of the Commissioner is hereby granted to any taxpayer within the scope of this Revenue Procedure to change its method(s) of accounting as described in the *Appendix* to this Revenue Procedure. Such consent is granted only for the change(s) of accounting method and the affected item(s) that are clearly and expressly identified in the taxpayer's application. • Such consent is granted only to the extent that the taxpayer complies with all the applicable provisions of this Revenue Procedure and implements the change in method of accounting for the requested year of change.
Applications (Sec. 6.02)	• ***Form 3115 is to be used.*** Ordinarily, a taxpayer applies for consent to change a method of accounting pursuant to this Revenue Procedure by completing a Form 3115. • ***Separate applications.*** Ordinarily, a taxpayer must submit a separate application for each change in method of accounting. • ***A complete and accurate application must be submitted*** The application must clearly and expressly identify the method(s) of accounting to be changed and the item(s) to which the change(s) applies.
No User Fee (Sec. 6.02)	• A user fee is not required for an application filed under this Revenue Procedure. • Ordinarily, the IRS will not acknowledge receipt of an application filed with it under R.P. 2002-9.
Filing after Year-End Is Permitted (Sec. 6.02)	• The Rev. Proc. waives the taxable year filing requirement. • The requirement to file a Form 3115 ***within*** the taxable year for which the change is requested is waived for any application for a change filed pursuant to this Rev. Proc. (Note: the filing requirement is found in Reg. Sec. 1.446-1(e)(3)(i) and (ii).)
Timely Duplicate Filing Requirement (Sec. 6.02)	• A taxpayer filing for a change in method of accounting under this Rev. Proc. must complete and file an application (Form 3115) ***in duplicate***. • The original of Form 3115 must be attached to the taxpayer's timely filed (including extensions) original Federal income tax return for the year of change. • In addition, a duplicate/copy (with signature) of the application must be filed with the National Office. • The duplicate/copy must be filed no earlier than the first day of the year of change and no later than when the original is filed with the Federal income tax return for the year of change.
Special Coding to Be Put on Top of Form 3115 (Sec. 6.02)	• In order to assist in processing an application under this Revenue Procedure, the section of the *Appendix* of this Revenue Procedure describing the specific change in method of accounting should be included in the application. For example, a phrase such as "Section 1.01 of the *Appendix* of Rev. Proc. 2002-9" should be included on the appropriate line on the Form 3115. • If a taxpayer is authorized under the *Appendix* of this Revenue Procedure to file a statement in lieu of a Form 3115, the taxpayer must include the taxpayer's name and employer identification number (or social security number in the case of an individual) at the top of the first page of the statement underneath any other required label.
Filing Address for Copy of Form 3115 (Sec. 6.02)	• The copy of the application Form 3115 must be addressed to the: *Commissioner of Internal Revenue* Attention: CC:IT&A (Automatic Rulings Branch) P.O. Box 7604 Benjamin Franklin Station Washington, D.C. 20044 • In the case of a designated private delivery service, the filing address is: Commissioner of Internal Revenue Attention: CC:IT&A (Automatic Rulings Branch) 1111 Constitution Avenue, NW Washington, D.C. 20224 • Special procedures are included for taxpayers who want to hand-deliver the copy of their Form 3115 to the IRS. • Remember: The *original* of the Form 3115 is to be included with the timely-filed Federal Income Tax Return for the year of change. The above addresses are only for filing the ***copy*** of Form 3115.

FORM 3115 ... SAMPLE NARRATIVE TEXT
TRADE DISCOUNTS (FLOORPLAN ASSISTANCE PAYMENTS)

Form 3115, Page 2, Part II, *Description of Change,* Item 9 states: "If the applicant is ***not*** changing its overall method of accounting, attach a description of each of the following:

A. The item being changed.
B. The applicant's present method for the item being changed.
C. The applicant's proposed method for the item being changed.
D. The applicant's present overall method of accounting (cash, accrual, or hybrid)."

Item 10 states: "Attach an explanation of the legal basis supporting the proposed method for the item being changed. Include all authority (statutes, Regulations, published Rulings, court cases, etc.) supporting the proposed method. The applicant is encouraged to include a discussion of any authorities that may be contrary to the proposed method."

The wording below offers a general proforma that should be expanded to fit the facts and circumstances of the change being requested for trade discount treatment.

Part II, Item 9: Item Being Changed

The taxpayer seeks to change its method of accounting, using the guidelines provided for automatic consent under Revenue Procedure 2002-09, regarding the treatment of Trade Discounts associated with the purchase of a vehicle.

When the taxpayer purchases new automobiles and/or light-duty trucks from the vendor/manufacturer(s); [insert manufacturers' names here], the taxpayer receives (i.e., becomes entitled to) unconditional trade discounts, from some manufacturers, and previously has been including the trade discounts in gross income in the year they are received. The taxpayer's present method of accounting does not reduce the base cost of the vehicle by the amount of the trade discount as provided by Section 471 - General Rule for Inventory.

When the taxpayer purchases a new vehicle, it receives trade discounts which it is eligible to receive are identified on the vehicle invoices. The taxpayer represents the trade discounts are received as income from the vendor/manufacturer. In no event, nor in any case, does the taxpayer receive any payments for trade discounts in advance or prior to purchasing the vehicles. All trade discounts are generally received by the taxpayer in the month following the purchase of the vehicle.

Receipt of the trade discounts is not contingent on (1) the number of vehicles purchased, (2) the number of purchased vehicles that are sold, (3) the price or amount for which the purchased vehicles are sold, or (4) whether or not the purchased vehicles are sold. The taxpayer has determined that its vendor/manufacturer's trade discounts must be reduced from the base cost of the vehicle as required by Regulation Section 1.471-3(b).

The taxpayer represents that trade discounts offered by the vendor/manufacturers from whom it purchases automobiles and light-duty trucks are received solely as the result of the purchase of the merchandise to which the discounts relate. The taxpayer further represents that it is neither obligated nor expected to perform or provide any services to or for the manufacturer in exchange for (or in order to receive) the trade discounts.

The taxpayer further represents that trade discounts offered by the manufacturer are not a reimbursement of any expenditure incurred or to be incurred by the taxpayer. The taxpayer receives the trade discount from the manufacturer for each new vehicle purchased irrespective of whether the taxpayer finances the purchase and incurs interest expense, pays cash, and does or does not finance the vehicle with any other third party financial institution. The taxpayer is not required to and it does not submit any form of conditional evidence to the manufacturer.

Accordingly, the sole activity or mechanism which qualifies the taxpayer to receive the trade discounts is the taxpayer's purchase of the vehicle.

R.P. 2002-9 Trade Discounts

FORM 3115 ... SAMPLE NARRATIVE TEXT TRADE DISCOUNTS (FLOORPLAN ASSISTANCE PAYMENTS)

Present Method

The taxpayer purchases new automobiles and light-duty trucks from the vendor/manufacturer. As an incentive to purchase vehicles for inventory, the vendor/manufacturers provides to the taxpayer a discount to defray some of the interest cost of vehicles purchased at the time of purchase.

Under its present method of accounting for trade discounts, the taxpayer the taxpayer, includes any trade discounts received from the vendor/manufacturers in gross income in the taxable year in which the discounts/reimbursements are received. The taxpayer does not apply the discounts/reimbursements to reduce the inventory cost of the vehicle by the amount of the trade discount. In other words, under its present method of accounting for trade discounts, the taxpayer is employing the gross invoice method, rather than the net invoice method for recording trade discounts.

Proposed Method

As authorized by Revenue Procedure 2002-9 - Appendix Section 9.05, the taxpayer proposes to change its accounting method for trade discounts. Under its proposed new method, the taxpayer will no longer include present and future trade discounts from the vendor/manufacturer in gross income in the year they are received.

Instead, the taxpayer will reduce the inventory cost by the trade discount amount of the purchased units to which they relate. This is the treatment as prescribed in by Regulation Section 1.471-3(b).

Regulation Section 1.471-3(b) provides that ***cost*** means, ... "***in the case of merchandise purchased since the beginning of the taxable year, the invoice price less trade or other discounts***, except strictly cash discounts approximating a fair interest rate, which may be deducted or not at the option of the taxpayer, provided a consistent course is followed." (Emphasis added)

The taxpayer's proposed method of accounting for the trade discounts received from vendor/manufacturers is also consistent with Revenue Ruling 84-41 (1984-1 C.B. 130). This Revenue Ruling states that it is not proper for an automobile dealer to record the cost of new vehicles in inventory (and cost of goods sold) without reduction of a manufacturer's rebate. The manufacturer's rebate received by the automobile dealer represents a trade discount and, therefore, must be treated as a reduction in the cost of the automobile in the year of purchase. An automobile dealer must record the cost of new automobiles in inventory reduced by the amount of a manufacturer's rebate which represents a trade discount.

The taxpayer has previously elected to value its new vehicle inventories using the safe-harbor dollar-value Alternative LIFO Method. In implementing the proposed change in accounting method, the taxpayer will revalue and rebase its opening inventory in the year of change in accordance with the Regulations under Section 263A.

In determining the amount of the Section 481(a) adjustment, the taxpayer has determined the appropriate reduction factor based on an invoice-by-invoice analysis for all vehicles in the ending inventory of the three years previous to the year of change. This three-year look-back, identifiable by Vehicle Identification Number (VIN), has resulted in the determination that the amount that inventory carrying value of each year was overstated. From the three-year analysis, a cumulative weighted average was used to recalculate all LIFO layers prior to the year of change. A summary of the Section 481(a) LIFO recalculation is attached.

Also included as part of the Section 481(a) adjustment is a corresponding adjustment with respect to inventory costs capitalized with respect to the LIFO layers.

FORM 3115 ... SAMPLE NARRATIVE TEXT
TRADE DISCOUNTS (FLOORPLAN ASSISTANCE PAYMENTS)

Overall Method of Accounting

The taxpayer uses the accrual method as its overall method of accounting.

Part II, Item 11

The taxpayer is a franchised automobile dealer, selling and servicing new and used automobiles and light-duty trucks.

Part II, Item 13

The taxpayer is changing its method of accounting to reduce inventory cost, by the trade discount(s) amount received from the vendor/manufacturer, at the time the vehicle is purchased. The reasons for this proposed change are set forth above.

Part II, Item 14

The taxpayer will use the proposed method of accounting for both tax and financial accounting purposes. The proposed method of accounting conforms to Generally Accepted Accounting Principles and to the best accounting practice in the taxpayers trade and business.

SEC. 263A INVENTORY COST CAPITALIZATION QUESTIONS

Schedule C - Change in the Treatment of Inventories and Section 263A Assets
Form 3115, Page 6, Part II, Item 1

The taxpayer is requesting permission to change its method of accounting for trade discounts for new automobiles and new light-duty truck inventories.

Form 3115, Page 6, Part II, Item 2

The taxpayer is not proposing to change any method of accounting for used automobiles, used light-duty trucks, parts, accessories and any other miscellaneous inventories.

Form 3115, Page 6, Part III: Method of Cost Allocation

The taxpayer does not propose to change its method used to capitalize direct and indirect costs properly allocable to property that it acquires for resale. The taxpayer allocates costs in accordance with Regulation Section 1.263A-1 and will continue to allocate costs on that basis. The taxpayer allocates service costs using the labor based simplified service cost method. Additional 263A costs are allocated in accordance with the simplified resale method. The taxpayer applies the combined absorption ratio in accordance with Regulation Section 1.263A-3(d).

R.P. 97-27
Ad Fees

FORM 3115 ... SAMPLE NARRATIVE TEXT ADVERTISING FEES & EXPENSES

Part II, Item 9: Item Being Changed

The taxpayer is requesting permission to change its method of accounting for all present and future Local (Dealer Contribution) advertising expenses and Association Type (Group Contribution) advertising expenses that are incurred with the purchase of a vehicle. When the taxpayer purchases new automobiles and light-duty trucks from the manufacturer(s), [insert manufacturers name here], advertising expenses are incurred in the year the vehicle is purchased.

The taxpayer, per vehicle, pays the pre-determined advertising expense amount, by model, as identified by the Vehicle Identification Number (VIN). The manufacturer(s) establishes the amount of advertising expense to be paid by the taxpayer. The Association Type (Group Contribution) advertising expenses are identified on the invoice as [insert manufacturers name & region and identifying descriptions here] and included in the base cost of the vehicle. Association Type Advertising funds are pooled and distributed by the manufacturer, generally monthly, to a Local Advertising Association for the purchase of local advertising media.

Additionally, the taxpayer represents the payment of Local (Dealer Contribution) advertising expenses as identified on the vehicles invoice as [insert manufacturers name & region and identifying descriptions here] advertising. The manufacturer charges the taxpayer [Group] advertising expense upon the purchase of a new vehicle, by model, a predetermined amount identified by the Vehicle Identification Number (VIN). The [Group] Advertising funds are deposited into an open account generally on a bi-monthly basis. The taxpayer purchases local advertising from varying media outlets, submits a form for approval by the manufacturer's advertising representative and receives 100% reimbursement of the expense the taxpayer paid upon the purchase of the vehicle. The taxpayer also represents all funds are used upon their availability, are pooled and unidentifiable by Vehicle Identification Number.

The taxpayer's change in accounting method for advertising fees and expenses is not related to, and does not involve, any advertising fees payable for national level advertising. The taxpayer's change in accounting method for advertising fees and expenses relates only to advertising fees payable for local and/or regional area dealerships.

Present Method

The taxpayer purchases new automobiles and light-duty trucks from the manufacturer(s). A predetermined amount, established by the manufacturer and identified by Vehicle Identification Number, of advertising expenses, Local (Dealer Contribution) advertising expenses and Association Type (Group Contribution) advertising expenses is added to, and included in, the base cost of the vehicle at the time of purchase.

Proposed Method

The taxpayer represents that the Local (Dealer Contribution) advertising expenses and Association Type (Group Contribution) advertising expenses have not been properly recorded (under the method of accounting which it has been previously employing) when the expenses are incurred, which is at the time the vehicle is purchased. Under the proposed method of accounting, the taxpayer will no longer include the local advertising expenses as part of the inventory cost of the vehicle. Instead, the taxpayer will identify the advertising expense by Vehicle Identification Number and record the base cost of the vehicle net of the advertising expenses paid to the manufacturer upon the purchase of the vehicle.

FORM 3115 ... SAMPLE NARRATIVE TEXT
ADVERTISING FEES & EXPENSES

The taxpayer represents that all funds paid for Association Type (Group Contribution) Advertising are "pooled" with other taxpayers, and that no more than ten (10%) percent of the total amount collected from all members can be retained at any given time, economic performance occurs and the all events tests are satisfied. In addition, the taxpayer represents the use of all Local (Dealer Contribution) advertising expenses generally within the month available and the expenses are unidentifiable by Vehicle Identification Number, thus economic performance occurs and the all events tests under Regulation Section 461-1 are satisfied in the year the expenses are incurred, upon the purchase of the vehicle.

The taxpayer has previously elected to value its new vehicle inventories using the safe-harbor dollar-value Alternative LIFO Method. In implementing the proposed change in accounting method, the taxpayer will revalue and rebase its opening inventory in the year of change in accordance with the Regulations under Section 263A.

In determining the amount of the Section 481(a) adjustment, the taxpayer has determined the appropriate reduction factor based on an invoice-by-invoice analysis for all vehicles in the ending inventory of the three years previous to the year of change. This three-year look-back, identifiable by Vehicle Identification Number (VIN), has resulted in the determination that the amount that inventory carrying value of each year was overstated. From the three-year analysis, a cumulative weighted average was used to recalculate all LIFO layers prior to the year of change. A summary of the Section 481(a) LIFO recalculation is attached.

Also included as part of the Section 481(a) adjustment is a corresponding adjustment with respect to inventory costs capitalized with respect to the LIFO layers

Overall Method of Accounting

The taxpayer uses the accrual method as its overall method of accounting.

Part II, Item 11

The taxpayer is a franchised automobile dealer, selling and servicing new and used automobiles and light-duty trucks.

Part II, Item 13

The taxpayer is proposing the change in method of accounting to expense advertising charges in the year the charges are incurred, which is at the time the vehicles are purchased.

Part II, Item 14

The taxpayer will use the proposed method of accounting for both tax and financial accounting purposes. The proposed method of accounting conforms to Generally Accepted Accounting Principles and will clearly reflect income.

Schedule C - Change in the Treatment of Inventories and Section 263A Assets

Narrative text for Schedule C disclosures for advertising fees changes in accounting method is basically the same as that for trade discount CAMs, with the exception that ***Form 3115, Page 6, Part II, Item 1*** would state, "The taxpayer is requesting permission to change its method of accounting for advertising expense charges for new automobiles and new light-duty truck inventories."

Coordinated Issue Paper	***TREATMENT OF CASH DISCOUNTS*** ***IRS REQUIRES INVOICE-BY-INVOICE ANALYSIS***
Issue	• Is the taxpayer's method of accounting for cash discounts a permissible method of accounting when it allocates cash discounts on a pro-rata or average basis?
Holding	• Because the taxpayer's method of accounting for cash discounts estimates the cash discounts relating to ending inventory through an allocation method based on a pro-rata or average basis, it is not permissible and does not clearly reflect income.
Facts	• The taxpayer regularly purchases merchandise either for resale or for use in the production of inventory. The vendors from whom the taxpayer acquires its merchandise offer the taxpayer cash discounts that approximate a fair interest rate. In other words, these vendors offer the taxpayer a reduction in the purchase price of its goods in exchange for the taxpayer's prompt payment. For example, the terms may be listed on an invoice as "2/10 net/30." This means that the taxpayer will receive a 2% cash discount if payment is made to the vendor within 10 days of the invoice date. If payment is not made within 10 days, the total invoice amount must be paid within 30 days. • The taxpayer values its inventories at the gross purchase price and allocates cash discounts to ending inventory on a pro-rata basis. Thus, the taxpayer first determines ending inventory without considering cash discounts. The taxpayer multiplies this amount by the ratio of cash discounts taken during the year to total purchases. Ending inventory is reduced by this result to arrive at the amount used in computing the taxpayer's cost of goods sold.
Example	• The taxpayer purchases item A with an invoice price of $100, 2/10 net/30. Thus, if the invoice is paid within 10 days, the taxpayer can deduct a 2% cash discount from the gross invoice price. The taxpayer records the inventory value of item A at $100 and records a liability for payment of the invoice also at $100. When payment is made within 10 days of the invoice date, the liability is reduced by $100, cash is reduced by $98 and a cash discount received account is increased by $2. At the end of the year the taxpayer determines that the gross invoice price of the inventory on hand is $2,000, the total cost of purchases during the year was $10,000 and the total cash discounts received during the year was $250. The taxpayer determines its average amount of cash discounts paid during the year is 2.5% ($250 divided by $10,000). The taxpayer then multiplies this amount by the $2,000 in ending inventory to determine the amount of cash discounts relating to its ending inventory ($2,000 times 2.5% equals $50) and reduces its ending inventory by this amount.
Two Methods ***Gross vs. Net*** ***Invoice Method***	• ***Gross Invoice Method.*** Under the gross invoice method the purchase price of merchandise is recorded at the full invoice price when the inventory is received and a corresponding accounting entry is made for accounts payable, again at the full invoice price. When payment is made in time to take advantage of the discount, accounts payable are debited for the full invoice price, cash is credited for the amount actually paid, and income is reported for the cash discount earned. • Under the ***Net Invoice Method***, the purchase price of merchandise is reduced at the time of purchase for the amount of the potential cash discount. This reduction is made irrespective of whether the discount offered is actually taken. Under the net invoice method only the net invoice prices are charged to inventory. Any cash discounts not taken advantage of are recorded as expense items.
Analysis	• The taxpayer is attempting to use a net invoice method of accounting for its cash discounts. The taxpayer's method of accounting is subject to I.R.C. Section 446(b), which requires it to clearly reflect income. In this case, the taxpayer allocated its cash discounts on a pro-rata or average basis. • Generally, allocating cash discounts to ending inventory on a pro-rata basis will not provide for a clear reflection of income because the cash discounts will be allocated to items in inventory for which cash discounts were either not offered or offered at a different rate. • For example, if all the cash discounts were taken on item A and ending inventory only included item B, then ending inventory should not be reduced for cash discounts because the cash discounts were not taken on any of the items remaining in ending inventory. • This is consistent with the holdings of Rev. Rul. 69-619 and Rev. Rul. 73-65. In Rev. Rul. 73-65, the Service recognized that Reg. Sec. 1.471-3(b) defers to generally accepted accounting principles, which permit the reduction of inventory by an amount for cash discounts. • Accordingly, Rev. Rul. 73-65 holds that accounting for cash discounts under the net purchase price method is a permissible method of inventory valuation that clearly reflects income. • Rev. Rul. 69-619 provides a taxpayer may not value inventories by deducting the average or estimated amount of cash discounts received from the invoice price of the merchandise on hand at the end of the year. • Thus, although Rev. Rul. 73-65 allows taxpayers to use the net invoice method of accounting for cash discounts, Rev. Rul. 69-619 limits its use to situations in which the reduction to ending inventory for cash discounts is determined on an other than average or estimated basis. • Under the facts in this situation, the taxpayer's method of accounting is not permissible.

Coordinated Issue Paper	***TREATMENT OF CASH DISCOUNTS*** ***IRS REQUIRES INVOICE-BY-INVOICE ANALYSIS***
IRS Position	• In order clearly to reflect income, Rev. Rul. 69-619 and Rev. Rul. 73-65 do not permit taxpayers accounting for cash discounts under the net invoice method to allocate cash discounts to ending inventory on a pro-rata or average basis. Consequently, the Service does not follow *Warfield-Pratt-Howell Co.* and its progeny to the extent they provide otherwise. • Rev. Rul. 69-619 and Rev. Rul. 73-65 require cash discounts be allocated to individual items on an invoice-by-invoice basis. At the close of a taxable year in which a taxpayer has received cash discounts one of three situations may exist: ♦ All of the discounts received are attributable to items on hand at the end of the year ♦ None of the discounts received are attributable to items on hand at the end of the year ♦ A portion of the discounts received is attributable to items on hand at the end of the year
Key Statements	• If all of the cash discounts received are attributable to items on hand at the end of the year, then all of the cash discounts should be allocated to ending inventory. Similarly, if none of the discounts received during the year are attributable to items on hand at the end of the year, then none of the cash discounts should be allocated to ending inventory. • If, however, a portion of the discounts received during the year is attributable to items on hand at the end of the year, then the ***taxpayer must know, on an invoice-by-invoice basis,*** the items in ending inventory and the amount of cash discounts attributable to each item. • In the situation where a taxpayer does not know, on an invoice-by-invoice basis, the discounts attributable to items in ending inventory, the taxpayer must treat the discounts as if none of them are attributable to items on hand at the end of the year. Thus, in such a situation, a taxpayer may not allocate cash discounts to ending inventory. • In the situation described above, the taxpayer received cash discounts on purchases of particular items that were paid within a time period specified by the invoice. The discounts, however, were not assigned to the invoices and items purchased. Rather, the ***taxpayer has attempted to make an after-the-fact allocation*** to items remaining in ending inventory. Such an allocation does no attempt to match the cash discount with the particular items on which they were received. Instead, the allocation is based on an estimate and as such the taxpayer is unable to substantiate that the discounts allocated to ending inventory relate to items in ending inventory. • Accordingly, ***a taxpayer may allocate its cash discounts to ending inventory only in the situations where it knows the items, on an invoice-by-invoice method, to which such discounts are attributable.*** This treatment is mandated by I.R.C. Section 446(b), Reg. Sec. 1.471-3(a), Rev. Rul. 73-65 and Rev. Rul. 69-619.
Retail Method	• Taxpayers who make their returns on the retail method of pricing inventories, in order to appropriately allocate cash discounts, must assign cash discounts ***at the same level of specificity*** as that used in determining the taxpayer's cost complement. • Many taxpayers who use the retail method compute a separate cost complement for every department. In this situation, the taxpayer must determine its cash discounts on a department-by-department basis.
Citations	• Industry Specialization Program ... Inventory Issue Specialist ... *Proposed Coordinated Issue* ***Treatment of Cash Discounts*** ... April 2003 • Revenue Ruling 69-619 (1969-2 C.B. 111) • Revenue Ruling 73-65 (1973-1 C.B. 216)
Pub. 538 Cash Discounts & Trade Discounts	• Publication 538, *Accounting Periods and Methods* (March 2003) includes the following definitions. • ***Cash discount*** ... "A cash discount is a reduction in the invoice or purchase price for paying within a prescribed time period. You (i.e., the taxpayer) can choose to deduct cash discounts or include them in income, but you must treat them consistently from year to year." • ***Trade discount*** ... "A trade discount is a discount allowed regardless of when payment is made. Generally, it is for volume or quantity purchases. You (i.e., the taxpayer) ***must reduce the cost of inventory by trade (or quantity) discount(s).***"

De Filipps' *LIFO LOOKOUT*
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