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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 METHODS FOR TRADE DISCOUNTS & FOR CERTAIN ADVERTISING FEES & EXPENSES. This issue of the *LIFO Lookout* contains Part II of our continuing coverage of this subject. Part I can be found in the September 2003 issue.

For a look at how the publicly-held dealership groups have handled the underlying change in GAAP effective for 2003, see page 14. We have included the results of our analysis of the consent letters received from the IRS by dealers who have requested permission to change their accounting method for advertising fees and expenses. Ordinarily, dealers have requested permission to make these changes at the same time as they have automatically changed (or more technically, ***"corrected"***) their methods of accounting for trade discounts ... floorplan assistance payments.

Our opinion is that CPAs are doing a disservice to their dealer clients if they have not encouraged and assisted them in complying with the Code and with GAAP on these matters.

We'd be happy to print rebuttals from CPAs who feel otherwise.

#2. LIFO RECAPTURE POTENTIAL IN PARTNERSHIP EXCHANGES WILL BE INCREASED BY CHANGES IN 1363(d) REGULATIONS. On August 13, 2004, the IRS published proposed changes that will extend certain rules involving the recapture of LIFO reserves in special situations involving C corporations converting to S corporations.

In part, these proposed changes are motivated by the IRS' dissatisfaction with the final outcome–which was its defeat upon appeal–in the *Coggin Automotive Corp. v. Comm.* case. Somehow or other, seeing a clever taxpayer avoid, escape or otherwise successfully dance around $4.8 million of LIFO recapture was just too much for the IRS. The

LOOKOUT LOOKS INTO

Coggin case and its reversal upon appeal were discussed in previous issues of the *LIFO Lookout*.

These changes will set forth the LIFO recapture requirements when a C corporation holds inventory accounted for under the Last-In, First-Out method indirectly through a partnership. The end result is that a C corporation holding an interest in a partnership that owns LIFO inventory must include the ***lookthrough LIFO recapture amount*** in its gross income if the corporation either elects to be an S corporation or transfers its interest in the partnership to an S corporation in a nonrecognition transaction. The proposed Regulations also prescribe corresponding basis adjustments under certain circumstances.

see **LIFO UPDATE**, page 2

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These changes are proposed to be effective for S elections and transfers made on or after August 13, 2004.

#3. IPIC LIFO METHOD'S POPULARITY IS INCREASING ... NOT NECESSARILY FOR AUTO DEALERS ... BUT FOR MANY OTHER KINDS OF TAXPAYERS. We are pleased to expand our coverage of the IPIC LIFO Method by including a portion of Lee Richardson's *IPIC LIFO Resource Guide for CPAs: Non-Auto Dealer LIFO*. Especially significant is the information on page 28 spelling out the advantages of using the IPIC method over other LIFO methods.

Success stories are included in Mr. Richardson's *IPIC LIFO Guide* starting on page 29. These warrant your careful attention since it is quite possible that you may encounter similar situations where similar results can easily be obtained.

To all of these, we would add the highest recommendation of Mr. Richardson's services, along with our own IPIC success story, which follows below.

In a recent situation, we became involved with the LIFO inventory computations for several ***motorcycle dealerships*** whose previous accountants had done a terrible and indefensible job in computing LIFO indexes for various pools of motorcycles, scooters, parts, watercraft and all-terrain vehicles. Both new and used vehicles were on LIFO. To preserve the LIFO elections and the LIFO reserves built up to date, we advised the client to initiate a voluntary change to the IPIC method in order to secure "audit protection" for the previous calculations.

With astonishing rapidity and at a very reasonable price, LIFO-PRO, Inc., handled the entire conversion to the IPIC method and the completion and filing of the Forms 3115 for this dealership group. The workpapers and documentation provided by LIFO-PRO, Inc., by the way, are impeccable. So, everything Lee says about the quality of his company's service on page 25 is true and, if anything, a tactful understatement.

LIFO-PRO, Inc., also has compiled a *Guide for Planning and Implementation of the IPIC LIFO Method for **Supermarket Chains***. Mr. Richardson handles all the big ones ... Wal-Mart, Kroger, Target, etc. He is a tremendous resource whenever the IPIC LIFO method should be considered and he can be reached at (402) 330-8573 or lifopro@cox.net.

#4. A HEADS-UP FOR AUTO DEALER INVENTORIES. It appears that year-end inventory levels may be higher and that inflation in some cases may be a little greater this year than it was last year.

We plan to have the December issue of the *LIFO Lookout* in your hands in early December so you can use our usual "one-of-each item category indexes" for projection and year-end planning purposes.

#5. YEAR-END DEALER SEMINARS. We will be presenting our *2004 Automotive Dealer Tax Update* seminars on November 9th, 10th and 11th. For content, location and registration specifics, visit any one of the following web sites ... (1) www.defilipps.com and/or (2) www.prochecknational.com and/or (3) www.greenoutsourcing.com.

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

PART TWO

As we have pointed out in the past, for auto dealers using LIFO, the benefits of making these changes can be significant because the Section 481(a) adjustments required to implement these changes will be ***negative*** adjustments, the entire amount of which is 100% deductible in the year of change. Although our discussion of these changes in method is in terms of automobile dealers, these CAMs can be beneficially made for a variety of other inventory-intensive clients ... whether or not they are on LIFO.

Part I of our coverage of this topic appeared in the September 2003 issue of the *LIFO Lookout*. This coverage included detailed examples of the benefits, sample calculations showing the Section 481(a) deduction, discussions of the related changes in method for certain advertising fees and expenses, Form 3115 procedures for filing requests with the IRS and a *Practice Guide* checklist.

This article ... Part II ... addresses several additional aspects. First, there are matters involving GAAP and the seemingly perplexing nature of the accounting/adjusting entries that have provoked significant debate among some CPAs. In addition, we have analyzed in more detail the change in method for certain advertising fees and expenses by looking at several IRS replies ("consent letters") that taxpayers have received from the IRS and a related earlier Technical Advice Memorandum (LTR 9243010) on a similar issue. (See page 12.)

GAAP IMPLICATIONS

It is important to consider the GAAP (Generally Accepted Accounting Principles) aspect of these changes, especially for trade discounts. We have done this by including, on pages 14-15, related discussions taken from the Annual Reports and/or SEC filings for 2003 of the publicly-held automobile dealership groups.

Note, however, that although none of these groups is using LIFO for valuing its new vehicle inventories, they all made these changes. The reason for this is because they all were affected by the fact that in January 2003, the Emerging Issues Task Force of the FASB reached a consensus on Issue No. 02-16 *Accounting by a Customer (Including a Reseller) for Certain Consideration Received from a Vendor*. All of these groups are currently using specific identification for new vehicles and, we might add, throwing away enormous amounts of money by failing to use LIFO.

We would also point out that in a recent *Dealer Development General Field Bulletin*, Ford Motor Company recognized that current Generally Accepted Accounting Principles now interpret Ford's finance cost reimbursement program as a reduction in the cost of the vehicle which must be recorded as such. As a result, all dealer development dealerships were required to reflect the change in method in operating results as of December 31, 2003.

In discussing these changes with CPAs, many of them still are unconvinced either of their benefits or the mandatory nature of at least the change for the treatment of trade discounts. For these still unconvinced CPA handling a typical auto dealership, not changing to the correct accounting treatment for trade discounts not only violates the Internal Revenue Code, but it also contravenes GAAP.

PERMANENT NATURE OF THE SEC. 481(a) DEDUCTION BENEFIT

What's best about these changes is the fact that the deductions required by Sec. 481(a) (i.e., the reductions of LIFO valuation of opening inventory in the year of change) are ***permanent*** deductions. They are locked into, or embedded pro-rata, in all of the prior years' LIFO layer valuations.

This is because the rationale for the Section 481(a) adjustment requires the taxpayer, in effect, to go back and to restate all of the prior years' LIFO layers as if the inventory costs for which the change in method is permitted had been removed year-by-year (i.e., layer-by-layer at the end of each year). That is the fiction. The reality is that the recomputation does not have to be made on a year-by-year basis for as far back in time as the LIFO election has been in place. The computations are permitted to be made on a short-cut basis and they are intended to approximate the result of a complete year-by-year analysis. This is done by looking at the results of the 3 preceding years as a representative period and

see **CAMs FOR TRADE DISCOUNTS, ETC.**, page 4

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adjusting all prior LIFO layers on the basis of the results of that 3-year look-back computation.

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, and then only to a limited degree. This is true even if all of the manufacturers were to eliminate all of their programs tomorrow ... the Section 481(a) benefit would still remain.

In LIFO layer liquidation situations, the strict Last-In, First-Out (LIFO) carryback sequence first removes the most recent (typically higher) LIFO layer valuations. Thus, prior year costs being removed are determined by reference to the more recent (generally higher) current year costs. This is known as the *horizontal slice* approach.

The alternative would be a *vertical slice* approach which takes into account (i.e., eliminates, where there is a LIFO decrement) a portion of the base year layer and each subsequent yearly increment pro-rata. In so doing, the vertical slice removes earlier costs proportionally, and it results in more LIFO reserve repayment or recapture.

Stated another way ... if, in a future year, there is a decrement in the LIFO pool, any repayment of the previously embedded Section 481(a) benefit, in effect, is made on the *horizontal slice* basis (removing first all of the higher, more current LIFO base dollars), rather than on the *vertical slice* basis (which alternatively, would remove LIFO base dollars from all layers on a pro-rata basis). For a more thorough discussion of, and a visual look at, these differences in approach, see the June 1999 *LIFO Lookout* in which TAM 199920001 and Revenue Ruling 85-176 are examined.

ACCOUNTING ENTRIES STILL PERPLEX SOME CPAs

One might speculate that the reason some CPAs have not instructed or recommended that their dealers comply with the requirement that trade discounts not be included as inventory costs is that these CPAs simply are not up-to-date on recent GAAP changes, and/or they are unable to prepare the accounting entries necessary to achieve the correct results and explain them to their dealer clients and to their controllers.

Basically there are four entries to be considered:

1. The entry to net the end of the year trade discounts and advertising expenses against new vehicle inventory,

2. The entry to record end-of-the-year trade discounts included in ending inventory not received until after the end of the year,

3. The entry to reflect the Section 481(a) adjustment related to the beginning-of-the-year restatement of the LIFO inventories, and

4. The entry to reflect the impact of the Section 481(a) deduction on the Section 263A previously capitalized inventory costs.

Here are some comments on our experience as it relates to the four entries above.

We believe that the typical CPA is ill-equipped and unprepared to do the necessary invoice-by-invoice analysis and coordinate that with the various programs that different manufacturers have in place. It should be kept in mind that once the change in accounting method has been made, similar analyses will have to be made at each succeeding year-end to determine the amount of cost reduction for trade discounts and advertising fees to be pulled out of ending inventory cost.

If the dealership uses a service bureau, such as we do, the development of the appropriate accounting entries becomes a non-issue. This is because suggested journal entries are provided as part of the overall services provided by the outside party doing the detail analysis. These adjusting entries are created automatically as a result of the information gathered from the invoice-by-invoice analysis process.

Assuming many CPAs simply want to be the bearer of "good news" to their dealers about the benefits of these method changes and that they really don't want to have to do any of the detail analysis or thinking underlying the accounting entries, what could be easier than having this work done as part of the overall outsourcing engagement?

Whether or not the second adjusting entry for the so-called Factory receivables at year-end will be required depends on the facts and circumstances of each situation. Basically, this entry applies only to those Factories with deferred income or Factory receivable adjustments.

Section 9.05 of the Appendix to Revenue Procedure 2002-9 (2002-3 IRB 327) deals with qualifying volume-related trade discounts. It states that computations concerning year-end receivable adjustments are to be made in a manner similar to the computation of a net Section 481(a) adjustment in the case of a change to the net invoice method of accounting for cash discounts which is found in Section 9.01(2) of the Appendix. This detail information was included on page 31 of the September 2003 *LIFO Lookout*.

Technically, the Section 481(a) adjustment consists of two components:

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1. The net result of the LIFO inventory restatement computation as of the beginning of the year of change, and

2. The net result of the effect of the LIFO inventory restatement computation on the amount of inventory costs previously capitalized under the taxpayer's previous Section 263A elections.

Typically, the Section 263A component of the Section 481(a) adjustment is computed on a percentage or pro-rata basis relative to the change in the LIFO valuation of the layers before and after the recomputation that reflects the removal of the inventory costs being eliminated. The IRS basically combines both the LIFO and the Section 263A components into one single amount, which it refers to as the net Section 481(a) adjustment.

In the majority of instances where we have been involved, the Section 481(a) adjustment has not been reflected in the books and records by the CPAs for the dealerships. Instead, it has been treated as a Schedule M-1 adjustment. So, in that regard, income reported for tax purposes is different from income reported for book or for financial statement purposes.

Note, however, that if the CPA is of the opinion that the change in method is material and mandated in order to comply with Generally Accepted Accounting Principles, that presents a strong argument that the net effect of the change should be recorded on the books and not carried as a reconciling Schedule M-1 adjustment.

The IRS does not require the taxpayer to adjust its underlying accounting records on a transaction-by-transaction or invoice-by-invoice basis where these changes in method are approved. Instead, the IRS consent letters received in connection with advertising method changes state that the condition that the taxpayer keeps its books and records for the year of change and for subsequent taxable years on the new method of accounting ... *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. (See Condition 2 on the second page of the IRS consent letter [i.e., page 7].)

Accordingly, all of the computations underlying the initial change and each subsequent year-to-year reconciliation can be contracted for as part of the ongoing engagement fees if the service bureau provides that as part of the services it offers.

IRS NATIONAL OFFICE LETTERS APPROVING CAMs FOR ADVERTISING FEES & EXPENSES

When the IRS National Office reviews a taxpayer's request for permission to change its method of accounting for advertising fees and expenses, it carefully reviews and inspects Form 3115 and all supporting information submitted along with it. This review may include telephone calls or written correspondence with the taxpayer and/or its representative if the IRS believes it needs more information.

The September 2003 issue of the *LIFO Lookout* includes (on pages 36-37) a sample or proforma narrative text that might typically be included as part of the information required by Form 3115. In this regard, two points should be keep in mind. The first is that complex analyses and schedules are required to support computations of the Section 481(a) adjustment. In all cases that we have been involved with, based on our recommendation, our dealer clients have preferred to leave all of this detail work to an outside service bureau.

The second important point is that the Form 3115 for this change in accounting method must be filed before the end of the year of change (i.e., before December 31 for a calendar year taxpayer) and this change is filed under Revenue Procedure 97-27. The procedures underlying this request for change in method and the time-for-filing-Form-3115 requirements are different from the procedures involving a request for changing the treatment of trade discounts (floorplan assistance payments).

In connection with Forms 3115 filed for method changes for advertising expenses where the year-of-change was 2002 or 2003, the IRS National Office originally was quite slow in processing these requests. More recently, the Service has been able to "turn these requests around" much more quickly. In all instances where we have been involved, we have been successful in receiving permission to make these changes as requested.

On pages 6 to 8, you will see a typical letter received from the IRS National Office granting permission to make the change in method for advertising fees and expenses. This letter has been modified only to highlight or emphasize certain aspects. After reviewing many letters, we find variations between them to be relatively small and/or insignificant. However, depending on the dealerships involved and certain other factors, occasionally the text of the letters received back from the IRS would vary.

see CAMs FOR TRADE DISCOUNTS, ETC., page 12

IRS Letter Granting Permission to Change Method of Accounting For Certain Advertising Fees & Expenses

Internal Revenue Service

Index No.: ________________

XYZ Dealership
Address
City, State, Zip

EIN: ________________

Attention: Mr./Ms. ________________
XYZ Dealership President

Department of the Treasury

Washington, DC 20224

Person to Contact: ________________
Identifying Number: ________________
Telephone Number: ________________
Refer Reply To: ________________

Date: __________, 2004

Dear Mr./Ms. ___________:

This letter refers to a Form 3115, *Application for Change in Accounting Method*, filed on behalf of the above-named taxpayer requesting permission to change its method of accounting for advertising expenses *[Note 1]*, for the taxable year beginning January 1, 2002 (year of change).

Facts

The taxpayer is franchised new car dealer, selling and servicing new and used vehicles *[Note 2]*. The taxpayer uses an overall accrual method of accounting and account for new vehicle inventories under the Last-In, First-Out (LIFO) method valued at cost.

The taxpayer is subject to the uniform capitalization rules under Section 263A of the Internal Revenue Code and the Income Tax Regulations thereunder *[Note 3]*. The taxpayer uses the simplified resale method to allocate additional Section 263A costs to ending inventory *[Note 4]*.

The taxpayer participates in various advertising programs in which the taxpayer pays the manufacturer(s) a predetermined amount that is based on the vehicle model. The manufacturer(s) establish the amount of advertising expense to be paid by the taxpayer *[Note 5]*.

In the Ford Motor Company (Ford) advertising program, Ford distributes the funds to the local Ford Dealers Advertising Association (FDAA). The FDAA establishes the amount of advertising expense to be paid by the taxpayers and it is added to the base cost of each vehicle. The FDAA pools the funds each dealer has paid to Ford, and the funds are used for the promotion of either the taxpayer's individual dealership, or limited to the specific dealerships in the taxpayer's region (area dealers). Part of the advertising expense is rebated to the taxpayer to help defray the taxpayer's costs of advertising.

The taxpayer also participates in an advertising program with General Motors Company (the manufacturer). The General Motors advertising program has two components. In the Cooperative Advertising (Co-op) portion of the program, the taxpayer pays a charge which is levied by the manufacturer and listed on the invoice of each new vehicle. The taxpayer is contractually obligated to perform advertising services in order for the manufacturer to return the levied amount to the taxpayer. The taxpayer is required to submit a claim for reimbursement in order to ensure compliance with the advertising requirements of the program.

In the second component of the General Motors advertising program, the taxpayer pays an amount listed on the invoice of each vehicle to the manufacturer at the time the taxpayer buys a vehicle from the manufacturer. The amount the taxpayer pays to the manufacturer is either a set fee per vehicle, or a set percentage of the invoice price. The manufacturer then pays part of this amount to a local advertising association for the promotion of either the taxpayer's individual dealership, or limited to the specific dealerships in the taxpayer's region (area dealers).

Under the present method, the taxpayer includes the advertising costs as part of the acquisition cost of the vehicle *[Note 6]*. The taxpayer includes advertising costs as Section 471 costs under the simplified resale method.

(Continued)

Note References indicated by [...] are not part of the official IRS correspondence.
Additional explanations and comments amplifying these notes appear on separate page(s).

IRS Letter Granting Permission to Change Method of Accounting For Certain Advertising Fees & Expenses

(XYZ Dealership - Permission to Change Method of Accounting) **Page 2 of 3**

Under the proposed method, the taxpayer will exclude advertising costs that are used for local and regional advertising programs from the cost of new vehicles *[Note 7]*. The advertising costs will be excluded in determining Section 471 costs under the simplified resale method. However, the taxpayer will continue to include any advertising costs that are not specifically for local or regional advertising in determining Section 471 costs under the simplified resale method. The taxpayer may deduct any advertising costs spent on local and regional advertising under Section 162 as the advertising services are provided to the taxpayer. See Reg. Secs. 1.461-4(d)(2)(i) and 1.263A-1(j)(2) *[Note 8]*.

The taxpayer has represented that, on the date the Form 3115 was filed, it was not under examination and was not before an Appeals Office or a Federal Court with respect to any income tax issue. See Sections 3.07, 3.08(2) and 3.08(3) of Rev. Proc. 97-27, 1997-1 C.B. 680, as modified by Rev. Proc. 2002-19, 2002-1 C.B. 696.

Section 481(a) Adjustment

The Sec. 481(a) adjustment for the year of change is ($100,000), which represents a decrease in computing taxable income.

Consent/Terms & Conditions of Consent

Based on the facts presented and the representations made, permission is hereby granted for the taxpayer to change its method of accounting from the present method to the proposed method, beginning with the year of change, provided that:

(1) ***The taxpayer takes into account the entire amount of the net negative Section 481(a) adjustment in computing taxable income in the year of change.*** See Section 5.02(3)(a) of Rev. Proc. 97-27 as modified by Rev. Proc. 2002-19 *[Note 9]*;

(2) ***The taxpayer keeps its books and records for the year of change and for subsequent taxable years*** (provided they are not closed on the date the taxpayer receives this letter) ***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***; *[Note 10]* and

(3) No portion of any net operating loss that is attributable to a negative Section 481(a) adjustment may be carried back to a taxable year prior to the year of change that is the subject of any pending or future criminal investigation or proceeding concerning (a) directly or indirectly, any issue relating to the taxpayer's Federal tax liability, or (b) the possibility of false or fraudulent statements made by the taxpayer with respect to any issue relating to its Federal tax liability. *See* Section 5.02(4) of Rev. Proc. 97- 27.

Effect of this Accounting Method Change

The accounting method change granted in this letter is a Letter Ruling pursuant to Section 601.204(c) of the Statement of Procedural Rules. See also Section 2.01 of Rev. Proc. 2004-1, 2004-1 I.R.B. 1, 6 (or any successor). The taxpayer ordinarily may rely on this Letter Ruling subject to the conditions and limitations described in Rev. Proc. 97-27.

The consent granted in this letter extends only to advertising expenses incurred for local or regional advertising that directly promotes either the taxpayer's individual dealership, or for advertising that is limited to the specific dealerships in the taxpayer's region (area dealers).

We express no opinion regarding the propriety of the computations relative to the taxpayer's LIFO inventory method, nor do we express an opinion regarding the use, accuracy, or reliability of any LIFO sub-methods. These determinations are to be made by the Director in connection with the examination of the taxpayer's income tax returns.

The Director must apply the ruling in determining the taxpayer's liability unless the Director recommends that the Ruling should be modified or revoked. The Director will ascertain whether (1) the representations on which this ruling was based reflect an accurate statement of the material facts, (2) the amounts of the Section 481(a) adjustment were properly determined, (3) the change *in* method of accounting was implemented as proposed in accordance with the terms and

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IRS Letter Granting Permission to Change Method of Accounting For Certain Advertising Fees & Expenses

conditions of the ***Consent Agreement*** and Rev. Proc. 97-27, (4) there has been any change in the material facts on which the ruling was based during the period the method of accounting was used, and (5) there has been any change in the applicable law during the period the method of accounting was used.

If the Director recommends that the Ruling (other than the amounts of the Section 481(a) adjustment) should be modified or revoked, the Director will forward the matter to the National Office for consideration before any further action is taken. Such a referral to the National Office will be treated as a request for technical advice, and the provisions of Rev. Proc. 2004-2, 2004-1 I.R.B. 83, (or any successor) will be followed. *See* Section 11.01 of Rev. Proc. 97-27.

Audit Protection

An examining agent may not propose that the taxpayer change the same method of accounting as the method changed by the taxpayer under this ruling for a year prior to the year of change provided the taxpayer implements the change as proposed, in accordance with the terms and conditions of this Ruling and Rev. Proc. 97- 27, and the Ruling is not modified or revoked retroactively because there has been a misstatement or an omission of material facts. *See* Sections 9.01 and 9.02(1) of Rev. Proc. 97-27.

However, the Service may change the taxpayer's method of accounting for the same item for taxable years prior to the requested year of change if there is any pending or future criminal investigation or proceeding concerning (a) directly or indirectly, any issue relating to the taxpayer's Federal tax liability for any taxable year prior to the year of change, or (b) the possibility of false or fraudulent statements made by the taxpayer with respect to any issue relating to its Federal tax liability for any taxable year prior to the year of change. *See* Section 9.02(4) of Rev. Proc. 97-27.

Consent Agreement

If the taxpayer agrees to the terms and conditions set forth above, an individual with the authority to bind the taxpayer in such matters must sign and date the attached copy and return it to Commissioner of Internal Revenue, *Attention:* CC:ITA:B06/B07, P.O. Box 14095, Benjamin Franklin Station, Washington, D.C. 20044, ***within 45 calendar days from the date of this letter***.

The signed copy constitutes an agreement regarding the terms and conditions under which the change is to be effected (herein referred to as the "***Consent Agreement***") within the meaning of Section 481(c) and as required by Reg. Sec. 1.481-4(b). The ***Consent Agreement*** shall be binding on both parties except that it will not be binding upon a showing of fraud, malfeasance, or misrepresentation of a material fact.

In addition, a copy of the executed ***Consent Agreement*** must be attached to the taxpayer's Federal income tax return for the year of change. For further instructions, see Section 8.11 of Rev. Proc. 97-27 (copy enclosed).

The accounting method change granted in this letter ruling is directed only to the taxpayer who requested it and may not be used or cited as precedent.

In accordance with the provisions of a power of attorney on file with this Office, we are sending the original ruling letter to the taxpayer with a copy to the taxpayer's authorized representative.

* * *

Sincerely yours,

IRS Representative ***[Note 11]***
Office of Associate Chief Counsel
(Income Tax & Accounting)

Enclosure:
Section 8.11 of Rev. Proc. 97-27

Explanatory Notes	***Explanations & Comments Amplifying Notes in IRS Consent Letter for Change Method of Accounting For Certain Advertising Fees & Expenses*** **Page 1 of 3**
General	• Regarding the wording used to describe the change in method requested as being for "certain advertising fees and expenses," the most important observation is that the IRS will permit changes in method only for advertising which is not ***national*** in scope. In other words, the change is permitted only for (certain) advertising costs that are used for local and regional advertising programs. • In submitting Forms 3115 to the IRS, our preference is to include the following statement to give the IRS a "heads-up" on the fact that we are not trying to sneak in a change that involves the treatment of national advertising expenses. ♦ "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." ... See *LIFO Lookout*, September 2003, page 36.
Note 1	• Some IRS letters refer to the change in method as being for advertising "expenses," ... Other letters use the word "fees." As a matter of style, we have tried to consistently refer to the change as being for advertising "fees and expenses."
Note 2	• Some letters refer to the dealership as selling "cars and trucks," ... Other letters refer to "vehicles." The more recent letters appear to be using the word "vehicles," perhaps since this term includes all variety of SUVs and other vehicles that do not more readily fall into either category.
Note 3 ***(Sec. 263A)***	• In connection with Section 263A (inventory cost capitalization requirements), some IRS personnel have inquired more deeply than others. In this regard, in some letters, the IRS includes as part of its recitation of facts, the following ... ♦ "The taxpayer ***represents that it is in compliance with Section 263A***, except as to the advertising fees to which the taxpayer now seeks to change." ♦ Note: This is different than the statement of facts in the "more typical letter" that ... "The taxpayer is subject to the uniform capitalization rules under Section 263A."
Note 4 ***(Sec. 263A)***	• Typically, the IRS letters state, "The taxpayer uses the simplified resale method to allocate additional Sec. 263A costs to inventory." • As further evidence of different levels of inquiry into Section 263A, here is another variation included in the statement of facts portion of the letter... ♦ "The taxpayer uses the simplified resale method ***with the historic absorption ratio election*** to allocate additional Section 263A costs to inventory." ♦ As a further follow-up to this, after describing the proposed method, the statement of facts includes the following ... ▪ "The taxpayer will continue to use the simplified resale method with the historic absorption ratio election to allocate additional Section 263A costs to ending inventory. The taxpayer must use its proposed method(s) of accounting to revise its historic absorption ratio. To determine its revised historic absorption ratio, the taxpayer must apply its proposed method(s) of accounting during the test period as defined in Reg. Sec. 1.263A-3(d)(4)(ii)(B)(1), during recomputation years, and during updated test periods to determine the Section 471 costs and/or additional Section 263A costs that were incurred. That is, the taxpayer will recompute its actual absorption ratios for the test period, the recomputation years, and the updated test period(s). Moreover, the taxpayer will determine the amount of Section 471 costs that are remaining on hand at year-end by using the method(s) of accounting granted in this letter ruling. This recomputation must also be accounted for in the taxpayer's Section 481(a) adjustment."

Explanatory Notes	Explanations & Comments Amplifying Notes in IRS Consent Letter for Change Method of Accounting For Certain Advertising Fees & Expenses Page 2 of 3
Note 5	• There are many different manufacturers, and they all have different types of programs. Some manufacturers do not have any … So, be careful. • The dealer in the "typical" letter was involved with both Ford and General Motors. • The recitation of dealer-specific advertising program facts in this regard varies from letter to letter, and in some cases, is surprisingly brief. Some examples are … ♦ "The taxpayer participates in advertising programs in which the taxpayer pays the manufacturer(s) a pre-determined amount that is based on the vehicle model. The manufacturer establishes the amount of advertising expense to be paid by the taxpayer. There are two types of programs: Group Contribution and Dealer Contribution. Group Contribution expenses are identified on the invoice and included in the base cost of the vehicle. These advertising funds are pooled and distributed by the manufacturer, generally monthly, to a local advertising association for the purchase of local advertising that benefits either the taxpayer's individual dealership or specific dealerships in the taxpayer's region. Dealer Contribution advertising expenses are also pre-determined amounts charged by the manufacturer and based on the vehicle model. The 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 percent reimbursement of the expenses the taxpayer paid upon the purchase of the vehicle." ♦ "The proposed change applies only to the Daimler Chrysler program. … The taxpayer pays a mandatory advertising charge which is levied by the manufacturer on of each vehicle purchased by the taxpayer. The manufacturer uses these advertising charges to purchase advertising from local dealers." (Possibly the word "from" should be "for"?) ♦ "The proposed change applies only to the Ford Motor Company advertising program. … The taxpayer pays a mandatory advertising charge which is levied by the manufacturer on of each vehicle purchased by the taxpayer. The manufacturer uses these advertising charges to purchase advertising from local dealers." (Possibly the word "from" should be "for"?) ♦ It is interesting to compare the brevity of the reference to the Ford program above to the reference to the Ford program in the "typical" letter.
Note 6 *"Present Method" Language*	• In describing the "present method," the "typical" letter used the following wording … "The taxpayer includes the advertising cost as part of the acquisition cost of the vehicle." • In this regard, other letters have stated that … "Under the present method, the taxpayer includes in inventory the amount listed on the invoice for the mandatory advertising program as part of the acquisition cost of the vehicle." • This highlights the fact that some advertising costs appear directly on the invoice; others do not.
Note 7 *"Proposed Method" Language*	• In describing the "proposed method," the "typical" letter used the following wording … "Under the proposed method, the taxpayer will exclude advertising costs that are used for local and regional advertising programs from the cost of new vehicles." • In this regard, other letters have stated that … "Under the proposed method, the taxpayer will exclude the amount listed on the new vehicle invoices for the Ford advertising program from the cost of new vehicles. The taxpayer may deduct any advertising costs spent on local and regional advertising under Section 162 as the advertising services are provided to the taxpayer. See Reg. Secs. 1.461-4(d)(2)(i) and 1.263A-1(j)(2)."

Explanations & Comments Amplifying Notes in IRS Consent Letter for Change Method of Accounting For Certain Advertising Fees & Expenses

Note 8 ***Economic Performance ... In General***	• Section 461 provides the general rules for the taxable year of deduction. Section 461(h) deals with certain liabilities not incurred before economic performance. • Reg. Sec. 1.461-4(d)(1) states the principles for determining when economic performance occurs with respect to liabilities arising out of the performance of services, the transfer of property, or the use of property. • The Regulation referred to in the IRS letter ... Reg. Sec. 1.461-4(d)(2)(i) ... states that "if the liability of a taxpayer arises out of providing services or property to the taxpayer by another person, ***economic performance occurs as the services or property is provided.*** The only exception to this rule occurs in certain situations arising in connection with the sale or exchange of a trade or business by a taxpayer, ♦ For more on *The All Events & Economic Performance Tests ... How Soon Can the Tax Deduction Be Claimed?*, see page 9 of the September 2003 *LIFO Lookout.* • Reg. Sec. 1.461-4(d)(7) has nine examples illustrating these principles.
Note 8 ***Economic Performance*** ***Auto Dealer Advertising Example From Regulations***	• ***Example 5. Services or property provided to the taxpayer*** is below: ♦ "X Corporation, a calendar year, accrual method taxpayer, is an ***automobile dealer***. On January 15, 1990, X agrees to pay an additional $10 to Y, the manufacturer of the automobiles, for each automobile purchased by X from Y. Y agrees to provide advertising and promotional activities to X. ♦ "During 1990, X purchases from Y 1,000 new automobiles and pays to Y an additional $10,000 as provided in the agreement. Y, in turn, uses this $10,000 to provide advertising and promotional activities during 1992. ♦ "Under paragraph (d)(2) of this Section, economic performance with respect to X's liability for advertising and promotional services provided to X by Y occurs as the services are provided. Consequently, $10,000 is incurred by X for the 1992 taxable year." ♦ This example clearly shows that the automobile dealer (X) cannot deduct the $10,000 paid to the manufacturer (Y) for advertising in the year of payment (1990). Instead, the automobile dealer can only deduct this payment in the year 1992 when the advertising services are provided (i.e., technically, when the *economic performance* of the service actually occurs). • See also Letter Ruling 9243010, Issue #5, which deals with mandatory advertising fees listed on manufacturers' invoices. This evidences the fact that the IRS has been aware of/considering this issue since the early 1990s.
Note 8 ***Re: Sec. 263A***	• The Sec. 263A cost capitalization Regulation referred to in the IRS letter ... 1.263A-1(j)(2) ... relates to a "special rule" for "optional capitalization of period costs." ♦ "(i) In general - Taxpayers are not required to capitalize indirect costs that do not directly benefit or are not incurred by reason of the production of property or acquisition of property for resale (i.e., period costs). A taxpayer may, however, capitalize certain period costs if ..." ... The Regulation goes on to list certain qualifications. ♦ However, (ii) states ... "Thus, for example, marketing or ***advertising costs***, no portion of which are properly allocable to property produced or property acquired for resale do not qualify for elective capitalization under this paragraph (j)(2)."
Note 9	• This specifically states that the taxpayer is allowed to deduct the entire amount of the net negative Section 481(a) deduction in the year of change.
Note 10	• This specifically provides that the taxpayer is not required to reflect all of the underlying details in its books and records. Instead, the taxpayer is permitted to reflect the effect of this change in accounting method affecting the timing of the deduction(s) via year-end worksheets/schedules that support reconciling journal entries.
Note 11	• Different letters from the IRS are signed by different individuals from different branches of the National Office.

CAMs for Trade Discounts, Etc.

On this "typical" IRS letter, in a number of places, we have added notes in bold brackets (i.e., ***[Note 1]***, etc.,) where certain variations were found to appear. Some notes have been added to emphasize certain critical issues. The explanations for these notes appear on pages 9-11.

ACTUAL CONSENT MECHANICS

As a matter of routine, to complete the procedure, the taxpayer is required to sign and return one copy of the letter within 45 calendar days from the ***date*** of the IRS letter ... not from the date of receipt of the letter ... to the IRS (if the taxpayer still wants to make the change in method at the time when it receives the IRS' formal approval).

The (signed) copy of the letter that the taxpayer sends back to the IRS has the legend ***CONSENT AGREEMENT*** as a superscript (i.e., at the top of) the first page.

Also, the IRS letter adds the requirement that a copy of the executed agreement must be attached to the taxpayer's Federal income tax return for the year of change when it is filed with the IRS.

(Continued from page 5)

The IRS approval/consent letter includes a discussion of several circumstances where the IRS' consent will not be valid. However, these circumstances involve what are generally unusual or extraordinary situations.

CONCLUSION

Based on growing evidence, one might make the case that auto dealerships that still have not changed their accounting methods to eliminate trade discounts (floorplan assistance payments) are not only out of step with the Internal Revenue Code, but they are also out of step with prevailing Generally Accepted Accounting Principles.

Furthermore, one might make the case that CPAs who have not recommended (or insisted on) compliance by their dealer clients with the Code for at least trade discounts, should contemporaneously document the reasons for this non-compliance. That way, if ... or when ... the proper method of accounting is eventually brought to the dealer's attention ... usually by another CPA firm ... they can defend their position either to the IRS or in a malpractice suit.

Letter Ruling 9243010	***Advertising Fees Are Deductible as Ordinary & Necessary, Even Though They Are Mandatory In the Sense that the Dealer Must Pay Them To Acquire the Vehicles***
General	This Letter Ruling / Technical Advice Memorandum involved an automobile dealership and one issue addressed in it involved the proper treatment of mandatory "advertising fees."
Issue #5	Are mandatory "advertising fees" that are listed on manufacturers' invoices necessary charges incurred in acquiring inventory under Reg. Sec. 1.471-3 ... or are they *ordinary and necessary business expenses* deductible under Section 162 of the Internal Revenue Code?
Facts	Along with other costs, advertising costs were detailed on the manufacturers' invoices. These advertising costs were typically a flat fee per vehicle or a set percentage of the invoice price. X, an automobile dealer, must pay this advertising fee when acquiring vehicles from manufacturers. The fees collected by the manufacturers were paid to local advertising associations (one for each make of vehicle). To the extent the funds were not spent, dealers receive a refund or credit against the next year's advertising charges. X currently deducted the advertising costs pursuant to Section 162.
Revenue Ruling 80-141	***Revenue Ruling 80-141*** (1980-1 C.B. 111) addressed the issue of whether certain fees paid by the taxpayer-grocer to its supplier were necessary charges incurred in acquiring inventory within the meaning of Reg. Sec. 1.471-3(b), or deductible as ordinary and necessary business expenses under Section 162. For the taxpayer to purchase goods, the taxpayer had to pay a "sales-service" fee, which was based on the volume of purchases. The sales-service fee was mandatory, but the taxpayer was not required to avail itself of any of the services offered. Further, the taxpayer could also elect to receive additional services, for which it was charged on a "per-service-rendered" basis. The amount charged for these services depended upon the amount of services utilized by the taxpayer. In Rev. Rul. 80-141, the Service concluded that because the sales-service fee was directly incurred as a result of the acquisition of inventory, and the amount of the fee was exclusively dependent upon the volume of purchases rather than the amount of services provided, the sales-service fee was a necessary charge incurred in acquiring possession of the goods within the meaning of Reg. Sec. 1.471-3(b). In contrast, a fee based on services rendered, rather than the amount of goods purchased, was deductible under Section 162.

Letter Ruling 9243010

Advertising Fees Are Deductible as Ordinary & Necessary, Even Though They Are Mandatory In the Sense that the Dealer Must Pay Them To Acquire the Vehicles

Applicable Law (Discussions of Certain Sections Included in the LTR Are Omitted)

Reg. Sec. 1.471-3 provides that the term "cost" means: (a) in the case of merchandise on hand at the beginning of the taxable year, the inventory price of such goods; (b) 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. To this net invoice price should be added transportation or other necessary charges incurred in acquiring possession of the goods.

Section 162 provides that there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business.

Reg. Sec. 1.162-1(a) provides that business expenses deductible from gross income include the ordinary and necessary expenditures directly connected with or pertaining to the taxpayer's trade or business, except items that are used as the basis for a deduction or a credit under provisions of the Code other than Section 162.

Section 263A requires the capitalization of all direct and certain indirect costs incurred after December 31, 1986, that are allocable to personal property described in Section 1221(l) which is acquired by the taxpayer for resale. Costs incurred for advertising ordinarily are not required to be allocated to particular activities.

Section 461(h)(1) provides that in determining whether an amount has been incurred with respect to any item during any taxable year, ***the all events test shall not be treated as met any earlier than when economic performance with respect to such item occurs.***

Section 461(h)(2)(A) and *Reg. Sec. 1.461-4(d)(2)(i)* provide that in general, if the liability of a taxpayer arises out of the providing of services to the taxpayer by another person, e***conomic performance occurs as the services are provided.***

Discussion & Rationale

X, the automobile dealer, argues that the fees charged by the manufacturers are used for advertising, and thus, are deductible as ordinary and necessary business expenses.

The examining Agent, however, argues that because these fees are mandatory, they should be viewed as necessary charges incurred in acquiring inventory in accordance with Rev. Rul. 80-141.

The relevant inquiry in this case is whether the advertising fees are incurred by X for advertising services rendered or to acquire the vehicles. Although the advertising fees are listed on the manufacturers' invoices and are mandatory charges, the fees are given to local advertising associations for the sole purpose of advertising the manufacturer's vehicles. Moreover, to the extent funds were not spent, dealers such as X received a refund or credit against the next year's advertising charges. These facts indicate that the advertising fees were incurred by X for advertising services to be rendered. Even though the fees are mandatory in the sense that the fees must be paid to acquire the vehicle, the ultimate use of the fees is for advertising. Accordingly, the advertising fees are deductible as ordinary and necessary business expenses under Section 162.

The timing of the deduction, however, is governed by the economic performance rules under Section 461(h) and Reg. Sec. 1.461-4. Reg. Sec. 1.461-4(d)(2)(i) provides that, in general, if the liability of a taxpayer arises out of the providing of services to the taxpayer by another person, economic performance occurs as the services are provided. See Example 5 in Reg. Sec. 1.461-4(d)(7).**

Thus, X can deduct the advertising fees when the advertising services are provided.

Conclusion

- The advertising fees are deductible as ordinary and necessary business expenses under Section 162.
- The timing of such deductions is determined pursuant to the economic performance rules under Reg. Sec. 1.461-4.

** Note: For the text of Example 5, see [Note 8] on page 11 of this issue of the *LIFO Lookout*.

GAAP Reporting

PUBLICLY-HELD AUTOMOBILE DEALERSHIP GROUPS
Reporting for Changes in Accounting Methods In Accordance with Emerging Issue Task Force (EITF) Issue No. 02-16 For Trade Discounts and/or Certain Advertising Fees & Expenses With Respect to Calendar 2003 Annual Reports

AutoNation, Inc. Auditor... KPMG	• "As of January 2, 2003, we adopted EITF Issue No. 02-16, 'Accounting by a Customer (Including a Reseller) for Certain Consideration Received from a Vendor.' • "EITF 02-16, as it applies to us, addresses the recognition of certain manufacturer allowances and requires that manufacturer allowances be treated as a reduction of inventory cost unless specifically identified as reimbursement for services or costs incurred. • "The adoption of EITF 02-16 resulted in a cumulative effect of accounting change, net of $9.1 million of income tax, totaling $14.6 million to reflect the deferral of certain allowances, primarily floorplan assistance, into inventory cost. • "The impact of this accounting change for the year ended December 31, 2003 was an increase of $3.3 million in Cost of Sales. On a comparable basis, the impact of this accounting change for the years ended December 31, 2002 and 2001 would have been an increase of $4.7 million and a decrease of $11.6 million, respectively, in Cost of Sales. • "Additionally, the adoption of EITF 02-16 impacted the accounting for certain manufacturers' advertising allowances resulting in a reclassification that increased Selling, General and Administrative Expenses and, correspondingly, reduced Cost of Sales by $18.6 million for the year ended December 31, 2003 to now reflect these allowances as a reduction of Cost of Sales. • "On a comparable basis, the reclassification to increase Selling, General and Administrative Expenses and to reduce Cost of Sales for the years ended December 31, 2002 and 2001 would have been $19.5 million and $21.4 million, respectively." ♦ Reported on page 35 as part of discussion of ***New Accounting Pronouncements.***
Asbury Automotive Group, Inc. Auditor... Deloitte & Touche	• "...Additionally, we receive advertising and interest credit assistance from certain automobile manufacturers. These credits are accounted for as purchase discounts and are reflected as reductions to the inventory cost on the accompanying Consolidated Balance Sheets and as a reduction of cost of sales in the accompanying Consolidated Statements of Income when the related vehicle is sold. • "At December 31, 2003 and 2002, advertising and interest credits from automobile manufacturers reduced inventory cost by $4.6 million and $4.1 million, respectively, and reduced the cost of sales from continuing operations for the years ended December 31, 2003, 2002, and 2001, by $32.5 million, $30 million and $29.5 million, respectively." ♦ Reported on page 42 as part of Note 2, ***Summary of Significant Accounting Policies ... Inventories.***
Sonic Automotive, Inc. Auditor... Deloitte & Touche	• "...In January 2003, the Emerging Issues Task Force of the FASB reached a consensus on Issue No. 02-16 'Accounting by a Customer for Certain Consideration Received from a Vendor.' • "In accordance with Issue No. 02-16, which was effective January 1, 2003, payments received from manufacturers for floorplan assistance and certain types of advertising allowances should be recorded as a reduction of the cost of inventory and recognized as a reduction of the cost of sales when the inventory is sold. Previous practice was to recognize such payments as a reduction of cost of sales at the time of vehicle purchase. • "The cumulative effect of the adoption of Issue No. 02-16 resulted in a decrease to income of $5.6 million, net of applicable income taxes of $3.3 million, for 2003. • "Had the guidance from Issue No. 02-16 been retroactively applied, results of operations and net income per share for the years 2002 and 2001 would not have been materially different from the previously reported results." (Independent auditors are Deloitte & Touche, LLP.) ♦ Reported on page 13 in its discussion of ***Recent Accounting Pronouncements.***
Carmax, Inc. Auditor... KPMG	• "...Certain manufacturer incentives and rebates for new car inventory, including holdbacks, are recognized as a reduction to new car inventory when the company purchases the vehicles. Volume-based incentives are recognized as a reduction to new car inventory cost when achievement of volume thresholds are determined to be probable." ♦ Reported on page 33 of Annual Report for its fiscal year 2004, in its ***Summary of Significant Accounting Policies.***

GAAP Reporting	***PUBLICLY-HELD AUTOMOBILE DEALERSHIP GROUPS*** ***Reporting for Changes in Accounting Methods*** ***In Accordance with Emerging Issue Task Force (EITF) Issue No. 02-16*** ***For Trade Discounts and/or Certain Advertising Fees & Expenses*** ***With Respect to Calendar 2003 Annual Reports***
Group 1 Automotive, Inc. Auditor... Ernst & Young	• "...Additionally, we received interest assistance from some of our manufacturers. The assistance is accounted for as vehicle purchase price discount and is reflected as a deduction to the inventory cost on the balance sheet and as a reduction to cost of sales in the income statement as the vehicles are sold." ♦ Reported on page 37 as part of its discussion of ***Critical Accounting Policies***.
Lithia Motors, Inc. Auditor... KPMG	• "Manufacturers reimburse us for holdbacks, floorplan interest, and advertising credits, which are earned when each vehicle is purchased by us. The manufacturers reimburse us weekly, monthly, or quarterly depending on the manufacturer and the type of program. The manufactures determine the amount of the reimbursements based on many factors including the value and make of the vehicles purchased. • "Pursuant to EITF 02-16 'Accounting by a Customer (Including a Reseller) for Certain Consideration Received from a Vendor,' we recognize advertising credits, floorplan interest credits, holdbacks, cash incentives and other rebates received from manufacturers that are tied to specific vehicles as a reduction to cost of goods sold as the related vehicles are sold. When amounts are received prior to the sale of the vehicle, such amounts are netted against inventory until the vehicle is sold." ♦ Reported on page F-9 as part of Note 1, ***Summary of Significant Accounting Policies ... Incentives, Credits and Floor Plan Assistance***. • "In March 2003, the EITF issued EITF 02-16 'Accounting by a Customer (Including a Reseller) for Certain Consideration Received from a Vendor.' EITF 02-16 primarily applies to floorplan interest credits and advertising credits received by us from auto manufacturers and specifies the timing of and appropriate classification of such items in our statement of operations. • "We recognize floorplan interest credits and advertising credits that are tied to specific vehicles as a reduction to the carrying value of the specific inventory and ultimately as a reduction to cost of goods sold as related vehicles are sold and we recognize other advertising credits as a credit to advertising expense. The adoption of EITF 02-16 on January 1, 2003 resulted in the reclassification of certain expenses, but did not have any effect on our net income or financial position (see Note 14.)" ♦ Reported on page F-26 as part of Note 17, ***Recent Accounting Pronouncements***.
United Auto Group Auditors... Deloitte & Touche / KPMG Audit	• "In March 2003, the Financial Accounting Standards Board's ('FASB') Emerging Issues Task Force ('EITF') finalized Issue No. 02-16, 'Accounting by a Customer (Including a Reseller) for Cash Consideration Received from a Vendor' ('EITF 02-16'), which addresses the accounting treatment for vendor allowances. • "EITF 02-16 provides that cash consideration received from a vendor should be presumed to be a reduction of the prices of the vendor's product and should therefore be shown as a reduction in the purchase price of the merchandise. To the extent that the cash consideration represents a reimbursement of a specific, incremental and identifiable cost, then those vendor allowances should be used to offset such costs. "Historically, the Company recorded non-refundable floor plan credits and certain other non-refundable credits when received. As a result of EITF 02-16, these credits are now presumed to be reductions in the cost of purchased inventory and are deferred until the related vehicle is sold. "In accordance with EITF 02-16, the Company recorded a cumulative effect of accounting change as of January 1, 2003, the date of adoption, that decreased net income by $3.1 million, or $0.07 per diluted share." ♦ Reported on pages 6-7 in the ***Notes to Consolidated Condensed Financial Statements: Accounting Change*** section of *Quarterly Financial Data* for the 9-month period ended September 30, 2003 (available at www.UnitedAuto.com/InvestorRelations/Financials).

Source: 2003 Annual Reports and notes to consolidated financial statements issued by respective companies, except for Carmax which has a fiscal year ended February 28/29, or where otherwise indicated.

LIFO RESERVE RECAPTURE IN CERTAIN TRANSACTIONS WILL BE EXTENDED BY PROPOSED CHANGES TO SEC. 1363(d) REGULATIONS

The generally understood and relatively longstanding rule has been that when a regular C corporation using LIFO to value its inventories elects to be treated as an S corporation, it will have to recapture its LIFO reserve in accordance with the treatment prescribed in Revenue Procedure 94-61 (1994-2 C.B. 775). This mandates the continuation of the LIFO election by the S corporation and the creation of a special "collapsed layer" for all pre-S years. A review of these general requirements appears on page 23.

On August 13, 2004, the IRS proposed changes to the Regulations under Section 1363(d). These changes will extend the recapture of LIFO inventory reserves to more partnership-corporate restructuring situations in the near future. These proposed changes do not affect the general rules for more straightforward situations. Rather, they have been proposed to overcome the reversal the IRS suffered in *Coggin Automotive Corp. v. Comm.*, when the taxpayer appealed in June 2002 to the U.S. Court of Appeals for the 11th Circuit.

This article contains brief discussions of the case law and statutory background for the proposed changes to the Regulations and a summary of the proposed changes. The text of the proposed changes and two examples in slightly edited form appear on pages 20-22.

COGGIN AUTOMOTIVE CORPORATION

The IRS wins in the Tax Court recapturing $4.8 million LIFO reserves. The *Coggin* case involved a consolidated group of automobile dealership corporations that went through a rather complicated restructuring involving the creation of limited partnerships, after which the holding company changed its status from being taxed as a C corporation to being taxed as an S corporation in 1993.

In October 2000, the Tax Court (115 T.C. 349) upheld the IRS in its assertion that Coggin Automotive Corporation must pay tax on $4.8 million of new vehicle LIFO reserves that were on the books of its subsidiaries. This LIFO reserve recapture, the IRS had argued, was required by Section 1363(d).

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

However, the IRS's second–or alternative–challenge was based on its interpretation that Code Section 1363(d) should apply. The Tax Court agreed with the IRS and upheld the deficiency it had assessed against the parent corporation, based on the recapture of the LIFO reserves on the subsidiaries' books.

Appeals Court allows taxpayer to escape $4.8 million LIFO recapture. Coggin appealed the decision of the Tax Court, and it prevailed in avoiding the LIFO recapture. In June 2002, the U.S. Court of Appeals for the Eleventh Circuit reversed the Tax Court's decision (292 F.3d 1326, 89 AFTR2d 2002-2826 [CA-11]). The Appeals Court opinion is brief and to-the-point.

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

Finding no ambiguity in the language of the statute, the Appeals Court concluded that the Tax Court's analysis should not have gone beyond the plain language of the statute. After making the observation that "...perhaps the Tax Court is straining to extend its interpretation of the legislative histories ... in order to close what it perceives to be a loophole in the case of holding companies that own no inventory yet elect S Corporation status," the Appeals Court said that if this were an inequity, only Congress or the Secretary has the authority to ameliorate it.

The Appeals Court summarized it all in six short sentences: "Coggin was a holding company. It held stock in other C corporations. It was not engaged in

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the sale of automobiles. Under plain language of the statute, it had no LIFO inventory requiring recapture upon its election to become an S corporation. It is not necessary to resort to legislative history. Any potential windfall to holding companies must be cured by Congress, not the judiciary."

The Tax Court decision and the Appeals Court decision are discussed in detail in previous issues of the *LIFO Lookout*. In addition, before this case ever went to court, the IRS examining agent had sought Technical Advice from the IRS National Office, and this was formalized in TAM 9716003, and that was covered in an even earlier issue of the *LIFO Lookout*. (See below.)

STATUTORY BACKGROUND

Section 1374. Approximately 20 years ago, Section 1374 was modified as part of the repeal of the *General Utilities* doctrine which originated out of the *General Utilities & Operating Co. v. Helvering* case that was decided in 1935.

Specifically, Section 1374 imposes a corporate level tax on an S corporation's net recognized built-in gain if that gain is attributable to assets that it held on the date it converted from a C corporation to an S corporation. Gain is recognized by an S corporation to the extent that the income or gain is attributable to appreciation that occurred while the assets were held by a C corporation.

The Section 1374 tax is imposed only during the 10-year period beginning on the first day the corporation is an S corporation. In addition, Section 1374 imposes a corporate level tax on an S corporation's net recognized built-in gain attributable to assets that the S corporation acquires if the S corporation's adjusted tax bases for such assets are determined, in whole or in part, by reference to the bases of such assets (or any other property) in the hands of a C corporation. This tax is imposed only during the 10-year period beginning on the date that the S corporation acquires the assets.

In Announcement 86-128 (1986-51 I.R.B. 22), the IRS stated that, for purposes of Section 1374(d)(2)(A), the inventory method used by a taxpayer for tax purposes (FIFO, LIFO, etc.) shall be used in determining whether goods disposed of following a conversion from C corporation to S corporation status were held by the corporation at the time of conversion.

Concern over avoidance of LIFO recapture. After the issuance of this Announcement, Congress became concerned that taxpayers owning LIFO inventory might avoid the built-in gain rules of Section 1374. Congress believed that taxpayers owning LIFO inventory, who have enjoyed the deferral benefits of the LIFO method during their status as a C corporation, should not be treated more favorably than their FIFO counterparts.

Section 1363(d). Congress wanted to eliminate this potential disparity in treatment. Therefore, it enacted Section 1363(d) in 1987, in order to require a taxpayer owning LIFO inventory to recapture the benefits of using the LIFO method. Section 1363(d)(1) provides that a C corporation that owns LIFO inventory and that elects to be taxed as an S corporation must include in its gross income for its final tax year as a C corporation the LIFO recapture amount.

Under Section 1363(d)(3), the LIFO recapture amount is the excess of the inventory amount of the inventory using the First-In, First-Out (FIFO) method (the FIFO value) over the inventory amount of the inventory using the LIFO method (the LIFO value) at the close of the corporation's final tax year as a C

see **LIFO RECAPTURE POTENTIAL**, page 18

Selected Bibliography of Previous LIFO Lookout *Articles*

Tax Court Decision ... *Tax Court Upholds Big LIFO Reserve Recapture in 'Coggin Automotive Corporation' Dealership Restructuring* ... December 2000 *LIFO Lookout.*

Appeals Court Decision ... *'Coggin Automotive Corporation' Escapes LIFO Recapture Despite Changes from C to S Status* ... September 2002 *LIFO Lookout.*

Technical Advice Memo Issued During Audit ... *LTR 9716003 - Corporate Group Restructuring Creating S Corps & Limited Partnerships Triggers LIFO Recapture* ... June 1997 *LIFO Lookout.*

Revenue Procedure 94-61 ... *LIFO Recapture Tax & Mechanics in C to S Conversions - Special "Collapsed Layer" for Pre-S Years* ... September 1994 *LIFO Lookout* ... See also page 23.

(Continued from page 17)

corporation. Essentially, this is the amount of income the corporation has been able to defer by using the LIFO method rather than the FIFO method, and this difference is referred to as the *"LIFO Reserve"*.

Final Regulations under Section 1363(d) were published in October 1994 (TD 8567) to describe the recapture of LIFO benefits when a C corporation that ***directly*** owns LIFO inventory elects to become an S corporation or transfers LIFO inventory to an S corporation in a nonrecognition transaction. These final Regulations do not explicitly address the ***indirect*** ownership of inventory through a partnership.

RATIONALE FOR PROPOSED CHANGES

Coggin beat the recapture. We've discussed *Coggin* in some detail earlier in this article. As part of Coggin's restructuring, each subsidiary contributed its assets (including its LIFO inventory) to a different partnership. The subsidiaries were then merged into the holding company, which elected to be taxed as an S corporation. The Court of Appeals held that the holding company's S corporation election did not trigger LIFO recapture under Section 1363(d) because it was the partnerships in which the holding company held interests, and not the holding company itself, that used the LIFO method.

But there's still Section 337(d) to contend with. Section 337(d)(1) authorizes the Secretary to prescribe Regulations to prevent the circumvention of the purposes of the repeal of the *General Utilities* doctrine through the use of any provision of law or Regulations. The Treasury Department and the IRS believe that these proposed Regulations are necessary to implement *General Utilities* repeal.

The potential or possibility for the permanent avoidance of corporate level tax on the built-in gain reflected in the LIFO reserve is present regardless of whether the converting corporation owns inventory directly or indirectly through a partnership or tiered partnerships.

Accordingly, the Treasury Department and the IRS believe it is appropriate to require the recapture of a converting corporation's share of the LIFO reserves of partnerships in which it is a partner or in which it otherwise participates. Such an approach is consistent with the Regulations under Section 1374, which generally adopt a ***lookthrough approach*** to partnerships.

PROPOSED CHANGES TO REGS.

Here's what will happen under the proposed new rules in the case of S elections and transfers made on or after August 13, 2004 ...

1. A C corporation that holds an interest in a partnership owning LIFO inventory must include the lookthrough LIFO recapture amount in its gross income where the corporation either (1) elects to be an S corporation or (2) transfers its interest in the partnership to an S corporation in a nonrecognition transaction.

2. The ***lookthrough LIFO recapture amount*** is the amount of income that would be allocated to the corporation, taking into account Section 704(c) and Reg. Sec. 1.704-3, if the partnership sold all of its LIFO inventory for the FIFO value.

3. A corporate partner's lookthrough LIFO recapture amount must be determined, in general, as of the day before the effective date of the S corporation election or, if the recapture event is a transfer of a partnership interest to an S corporation, the date of the transfer (the recapture date).

4. If a partnership is not otherwise required to determine inventory values on the recapture date, the lookthrough LIFO recapture amount may be determined based on inventory values of the partnership's opening inventory for the year that includes the recapture date.

5. A corporation owning LIFO inventory through a partnership must increase its adjusted tax basis for its partnership interest by the lookthrough LIFO recapture amount.

6. The partnership through which the LIFO inventory is owned will be allowed to adjust the basis of partnership inventory (or lookthrough partnership interests held by that partnership) to account for LIFO recapture.

This adjustment to basis is to be patterned in manner and effect after the adjustment in Section 743(b). Thus, the basis adjustment constitutes an adjustment to the basis of the LIFO inventory (or lookthrough partnership interests held by that partnership) with respect to the corporate partner only. No adjustment is made to the partnership's common basis.

The IRS and the Treasury Department have requested comments on whether the partnership should be required, in some or all circumstances, to increase the basis of partnership assets by the lookthrough LIFO recapture amount attributable to those assets.

No de minimis exception. Under Reg. Sec. 1.1374-4(i)(1), an S corporation's distributive share of partnership items is not taken into account in determining the S corporation's share of net recognized built-in gain or loss if the S corporation's part-

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nership interest represents less than 10% of the partnership capital and profits and has a fair market value of less than $100,000.

This exception to the application of Section 1374 reduces the burden on the S corporation and the partnership of tracking built-in gain assets that are relatively small in amount. The burden of looking through a partnership interest under Section 1374 is greater than the burden of looking through a partnership interest under Section 1363(d). Under Section 1374, partnership assets must be tracked for a 10-year period. No such tracking problem exists under Section 1363 because recapture generally occurs on the date of the S election. Accordingly, the proposed Regulations do not contain an exception for partnership interests that are less than a specified percentage and/or smaller than a specified threshold.

CONCLUSION

The proposed changes to the Regulations do not affect the general C to S recapture rules that apply in most ordinary situations. Relatively few corporations engage in the type of transactions that will become subject to the reach of the new provisions. Basically, situations that will be covered by the new rules involve (1) the conversion from C corporation to S corporation status while holding an interest in a partnership that owns LIFO inventory or (2) the transfer of an interest in such a partnership by a C corporation to an S corporation in a nonrecognition transaction.

It will take some real inventiveness (i.e., read: clever advisors) or aggressiveness (i.e., read: foolhardiness) on the part of taxpayers to find a way to avoid LIFO reserve recapture in these more specialized and sophisticated restructuring situations.

Coordinating Partnership Provisions of Sections 704, 743(b) & 754 With the LIFO Inventory Reserve Recapture Provisions of Section 1363(d)

In connection with the proposed changes to the Section 1363(d) Regulations, provision is made for corporations incurring LIFO recapture to make corresponding basis adjustments as prescribed under Sections 704, 743(b) and 754. The recapture situations addressed in the proposed Regulations often involve extremely complicated fact situations, and these now will have to be layered into the extremely complicated partnership provisions found in Subchapter K of the Internal Revenue Code.

Section 704. In general, the purpose of Section 704(c) is to prevent the shifting of tax consequences among partners with respect to precontribution gain or loss. A partnership is required to allocate income, gain, loss and deduction with respect to property contributed by a partner to the partnership so as to take into account any variation between the adjusted tax basis of the property and its fair market value at the time of contribution. Reg. Sec. 1.704-3 provides a series of qualifications, operating rules and definitions. Special rules for transfers of partnership interests are included at Reg. Sec. 1.704-3(7) and for tiered partnerships at Reg. Sec. 1.704-3(9). Other limitations (such as anti-abuse rules) are also found in this Regulation.

Sections 743 & 754. Section 743(a) allows taxpayers to elect to make optional adjustments to the basis of partnership property only if an election under Section 754 has been made. Section 743(b) provides the specific rules for these adjustments which are permitted as a result of the transfer of an interest in a partnership by sale or exchange (or upon the death of a partner - a situation not relevant to this LIFO reserve recapture discussion).

Selected references. Final Regulations for these partnership basis adjustments were adopted December 14, 1999 by T.D. 8847. Discussions of these Final Regulations can be found in three articles: (1) *New Section 743/755 Regulations for Adjusting "Inside Basis," (Journal of Taxation)*, May 2000, pages 281-300; (2) *New Regulations Offer Guidance on Partnership Adjustment Allocations, (Practical Tax Strategies)*, July 2000; and (3) *New Partnership Basis Rules, (The Tax Adviser)*, August 2000.

The first article, by Terence F. Cuff, is the most comprehensive ... 20 pages of solid text and schedules ... and it is highly recommended. Mr. Cuff explains, in detail, the examples in Reg. Sec. 1.743-1(j) ... the Regulation cited in the proposed changes. This article also contains an excellent background discussion, including the difference between ***"inside" and "outside" basis disparities.*** "Outside" basis refers to a partner's basis in his partnership interest. "Inside" basis refers to the partnership's basis in its assets. The sale of a partnership interest (or the death of a partner) will affect "outside" basis, but it does not directly affect "inside" basis. However, the partnership is permitted under Section 743(b) to adjust its "inside" basis when such a sale or exchange occurs. Mr. Cuff warns that the rules found in the Final Regulations have been designed specifically to counter tax abuse, and the anti-abuse rules rarely are simple.

PROPOSED CHANGES TO EXPAND LIFO RECAPTURE SITUATIONS INVOLVING PARTNERSHIPS, ETC.

Text of Proposed Changes to Reg. Sec. 1.1363-2 ... Recapture of LIFO Benefits

Summary ***Reg. Sec. 1.1363-2***	***(b) LIFO inventory held indirectly through partnership*** ***(c) Definitions*** ***(1) Lookthrough partnership interest*** ***(2) Lookthrough LIFO recapture amount*** ***(3) Recapture date*** ***(d) Payment of tax*** ***(e) Basis adjustments*** ***(1) General rule*** ***(2) LIFO inventory owned through a partnership*** ***(3) Election*** ***(f) Examples*** ***(g) Effective dates***
(b) ... LIFO Inventory Held Indirectly Through Partnership	• A C corporation must include the lookthrough LIFO recapture amount ... in its gross income ... ♦ ... In its last taxable year as a C corp. if, on the last day of the corporation's last taxable year before its S corp. election becomes effective, the corporation held a lookthrough partnership interest ♦ ... In the year of transfer by the C corp. to an S corp. of a lookthrough partnership interest if the corporation transferred its lookthrough partnership interest to the S corp. in a nonrecognition transaction (within the meaning of Sec. 7701(a)(45)) in which the transferred interest constitutes transferred basis property (within the meaning of Sec. 7701(a)(43)).
(c)(1) ... "Lookthrough Partnership Interest"	• A partnership interest is a ***lookthrough partnership interest*** if the partnership owns (directly or indirectly through one or more partnerships) assets accounted for under the Last-In, First- Out (LIFO) method (LIFO inventory).
(c)(2) ... "Lookthrough LIFO Recapture Amount"	• A corporation's ***lookthrough LIFO recapture amount*** is the amount of income that would be allocated to the corporation, taking into account Section 704(c) and Reg. Sec. 1.704-3, if the partnership sold all of its LIFO inventory for the inventory's FIFO value. • For this purpose, the FIFO value of inventory is the inventory amount of the inventory assets under the First-In, First-Out method of accounting authorized by Section 471. • The ***lookthrough LIFO recapture amount*** generally shall be determined as of the end of the recapture date. • However, if the partnership is not otherwise required to determine the inventory amount of the inventory using the LIFO method (the LIFO value) on the recapture date, ♦ The partnership may determine the lookthrough LIFO recapture amount as though the FIFO and LIFO values of the inventory on the recapture date equaled the FIFO and LIFO values of the opening inventory for the partnership's taxable year that includes the recapture date. ♦ For this purpose, the opening inventory includes inventory contributed by a partner to the partnership on or before the recapture date and excludes inventory distributed by the partnership to a partner on or before the recapture date.
(c)(3) ... Recapture Date	• In the case of a transaction described in paragraph (b)(1), the recapture date is the day before the effective date of the S corp. election. • In the case of a transaction described in paragraph (b)(2), the recapture date is the date of the transfer of the partnership interest to the S corp. (but only the portion of that date that precedes the transfer).

PROPOSED CHANGES TO EXPAND LIFO RECAPTURE SITUATIONS INVOLVING PARTNERSHIPS, ETC.

Text of Proposed Changes to Reg. Sec. 1.1363-2 ... Recapture of LIFO Benefits

(d) ... Payment of tax	• Any increase in tax caused by including the LIFO recapture amount or the lookthrough LIFO recapture amount in the gross income of the C corp. is payable in four equal installments. • The C corp. must pay the first installment of this payment by the due date of its return, determined without regard to extensions, for the last taxable year it operated as a C corp. if paragraph (a)(1) or (b)(1) of this Section applies, or for the taxable year of the transfer if paragraph (a)(2) or (b)(2) of this Section applies. • The three succeeding installments must be paid ... ♦ For a transaction described in paragraph (a)(1) or (b)(1) of this Section, by the corporation that made the election under Section 1362(a) to be an S corp., on or before the due date for the corporation's returns (determined without regard to extensions) for the succeeding three taxable years; and ♦ For a transaction described in paragraph (a)(2) or (b)(2) of this Section, by the transferee S corp. on or before the due date for the transferee corporation's returns (determined without regard to extensions) for the succeeding three taxable years.
(e)(1) Basis Adjustments ... General Rule	• Appropriate adjustments to the basis of inventory are to be made to reflect any amount included in income under this Section.
(e)(2) ... LIFO Inventory Owned Through A Partnership	• ***Basis of corporation's partnership interest.*** Appropriate adjustments to the basis of the corporation's lookthrough partnership interest are to be made to reflect any amount included in income under paragraph (b) of this Section. • ***Basis of partnership assets.*** A partnership directly holding LIFO inventory that is taken into account under paragraph (b) may elect to adjust the basis of that LIFO inventory. ♦ In addition, a partnership that holds, through another partnership, LIFO inventory that is taken into account under paragraph (b) may elect to adjust the basis of that partnership interest. ♦ Any adjustment under this paragraph (e)(2) to the basis of inventory held by the partnership is equal to the amount of LIFO recapture attributable to the inventory. ♦ Likewise, any adjustment under this paragraph (e)(2) to the basis of a lookthrough partnership interest held by the partnership is equal to the amount of LIFO recapture attributable to the interest. ♦ A basis adjustment under this paragraph (e)(2) is treated in the same manner and has the same effect as an adjustment to the basis of partnership property under Section 743(b). See Reg. Sec. 1.743-1(j).
(e)(3) ... Election	• A partnership elects to adjust the basis of its inventory and any lookthrough partnership interest that it owns by attaching a statement to its original or amended income tax return for the first taxable year ending on or after the date of the S corp. election or transfer described in paragraph (b) of this Section. • This statement shall state that the partnership is electing under Reg. Sec. 1.1363-2(e)(3) ♦ The statement of election also must include the names, addresses, and taxpayer identification numbers of any corporate partner liable for tax under paragraph (d) of this Section and of the partnership, as well as the amount of the adjustment and the portion of the adjustment that is attributable to each pool of inventory or lookthrough partnership interest that is held by the partnership.
(f) ... Examples	• Example 1 ... See accompanying schedule. • Example 2 ... See accompanying schedule.
(g) ... Effective dates	• These provisions apply to S elections and transfers made on or after August 13, 2004.

PROPOSED CHANGES TO EXPAND LIFO RECAPTURE SITUATIONS INVOLVING PARTNERSHIPS, ETC.	
Example 1 ***Facts***	• G is a **C corporation** with a taxable year ending on June 30. • GH is a **partnership** with a calendar year taxable year. • G has a 20% interest in GH partnership. The remaining 80% interest is owned by an individual. • On April 25, 2005, G contributed LIFO inventory to GH, increasing G's interest in the partnership from 20% to 50%. GH (the partnership) holds no other LIFO inventory. • G elects to change from C corporation status to S corp. status, effective July 1, 2005. • The recapture date is June 30, 2005, and GH (the partnership) determines that the FIFO and LIFO values of the opening inventory for GH's 2005 taxable year, including the inventory contributed by G, are $200 and $120, respectively.
Example 1 ***Results***	• GH (the partnership) is not required to determine the FIFO and LIFO values of the inventory on the recapture date. ♦ Instead, GH may determine the lookthrough LIFO recapture amount as though the FIFO and LIFO values of the inventory on the recapture date equaled the FIFO and LIFO values of the opening inventory for the partnership's taxable year (2005) that includes the recapture date. ♦ For this purpose, the opening inventory includes the inventory contributed by G. ♦ The amount by which the FIFO value ($200) exceeds the LIFO value ($120) in GH's opening inventory is $80. ♦ Thus, if GH sold all of its LIFO inventory for $200, GH would recognize $80 of income. • ***G's lookthrough LIFO recapture amount is $80, the amount of income that would be allocated to G***, taking into account Section 704(c) and Reg. Sec. 1.704-3, if GH had sold all of its LIFO inventory for the FIFO value. • ***G must include $80 in income in its taxable year ending on June 30, 2005.*** • ***G must increase its basis in its interest in GH partnership by $80.*** • ***GH (the partnership) may elect to increase the basis of its LIFO inventory by $80*** (but, only with respect to G ... [i.e., the C corp. that previously contributed LIFO inventory to the partnership]) in accordance with Section 743(b) principles.
Example 2 ***Facts***	• J is a **C corporation** with a calendar year taxable year. • JK is a **partnership** with a calendar year taxable year. • J has a 30% interest in the partnership. • JK owns LIFO inventory that is not Section 704(c) property ... that LIFO inventory had its origin with the partnership, and it was not previously contributed to the partnership. • J elects to change from C corporation status to S corp. status effective January 1, 2005. • The recapture date is December 31, 2004, and JK (the partnership) determines that the FIFO and LIFO values of the inventory on December 31, 2004 are $240 and $140, respectively.
Example 2 ***Results***	• The amount by which the FIFO inventory value ($240) exceeds the LIFO value ($140) on the recapture date is $100. ♦ Thus, if JK (the partnership) sold all of its LIFO inventory for $240, it would recognize $100 of income. ♦ ***J's lookthrough LIFO recapture amount is $30.*** This is the amount of income that would be allocated to J (the corporate shareholder) if JK (the partnership) had sold all of its LIFO inventory for the FIFO value (30% of $100). • ***J must include $30 in income in its taxable year ending on December 31, 2004.*** • ***J must increase its basis in its interest in JK (the partnership) by $30.*** • ***JK (the partnership) may elect to increase the basis of its inventory by $30*** (but, this increase in basis is made only with respect to J [i.e., the corporate partner]) in accordance with Section 743(b) principles.
Source	• Changes proposed on August 13, 2004 to Reg. Sec. 1.1363-2(f), Examples 1 & 2.

RECAPTURE OF LIFO INVENTORY RESERVES WHEN A C CORPORATION CONVERTS TO S CORP. STATUS ... COMPUTATION OF SPECIAL "COLLAPSED LAYER" FOR PRE-S YEARS AND OTHER MATTERS ... REV. PROC. 94-61

Sec. 1363(d) C to S Recapture

Example. Taxpayer, a C corporation, elected the LIFO inventory method for valuing inventories in 1988. On December 31, 1991, the LIFO carrying value is $1,600 and the inventory is valued at $1,900 under the First-In, First-Out (FIFO) method using cost or market, whichever is lower. Taxpayer elected to be taxed as an S corporation effective January 1,1992. The LIFO recapture amount is $300 ($1,900 less $1,600), as shown below.

Special "collapsed layer" for pre-S years. The appropriate adjustments are made by collapsing the LIFO layers and adding the $300 LIFO recapture amount to the LIFO carrying value of the ending inventory as of the end of the 1991 taxable year. The LIFO valuation index is then changed/adjusted to reflect the adjusted relationship between the new LIFO carrying value (i.e., its FIFO cost on the date of the S election ... $1,900) and the total of all base year costs ... $1,500.

		Before			*After*		
		Base Year Cost	*Index*	*LIFO Carrying Value*	*Base Year Cost*	*Index*	*LIFO Carrying Value*
Jan. 1, 1988	Base year	$ 1,000	100%	$ 1,000		100%	
Dec. 31, 1988	Layer	200	110%	220		110%	
Dec. 31, 1989	(Decrement year)	-	115%	-		115%	
Dec. 31, 1990	Layer	100	120%	120		120%	
Dec. 31, 1991	Layer	200	130%	260		130%	
Dec. 31, 1991	***Special Collapsed Layer Resulting From Sec. 1363(d) Adjustment***	-	0%	-	1,500	126.67%	1,900
Totals		$ 1,500		$ 1,600	$ 1,500		$ 1,900

($1,900 = $1,600 LIFO value + $300 recapture amount)

Notes & Comments

#1. LIFO recapture amount. The LIFO recapture amount in this example is $300 ... $1,900 (FIFO cost) minus $1,600 (LIFO valuation).

#2. The base date, the base year and the base year total costs (of $1,500) do **not** change. The beginning inventory amount for the 1992 taxable year, which is the first year the taxpayer is taxed as an S corporation, is $1,900.

#3. Cumulative indexes. For a taxpayer using the link-chain method, the cumulative index is not recomputed. The cumulative index at December 31, 1991 is 130%, even though the adjusted index for the special collapsed layer resulting from the Section 1363(d) adjustment is 126.67% ($1,900 divided by $1,500). The cumulative index as of December 31, 1992 (the end of the first S year) will be the product of 130% multiplied by the current-year/annual inflation index or link computed for the year 1992.

#4. Computation of recapture tax. The total LIFO recapture tax is computed in 3 steps. ***Step 1***- Figure the tax on the C corporation's taxable income ***including*** the LIFO recapture amount. ***Step 2*** - Using a separate worksheet or computation, recompute the tax on the C corporation's taxable income ***excluding*** the LIFO recapture amount. Be sure to take in to account all limitations, credits, etc., in both steps. ***Step 3*** - Compare the tax computed in Step 2 with the tax computed in Step 1. The difference between the two is the ***LIFO recapture tax***. (See Form 1120 Instructions.)

#5. Payment of LIFO recapture tax in 4 equal installments. Generally, the additional income tax attributable to the inclusion in income of the LIFO recapture amount is payable in four equal installments. The first installment must be paid by the due date of the income tax return for the electing corporation's last taxable year as a C corporation. The other three equal installments of tax are due by the respective due dates of the S corporation's returns for the three succeeding taxable years. No interest is payable on these succeeding installments of tax if they are paid by the respective due dates.

#6. LIFO Inventory decrements in subsequent S corporation years. The index for the special collapsed layer (for the last C corporation year) is relevant only for the purpose of computing the LIFO carrying value of a decrement in the event there is a decrement experienced in a later S year which has to be carried back to the LIFO inventory as of, or prior to, the last C corp. year.

Thus, this adjusted index for the special collapsed layer would be used only if the end-of-year inventory. expressed in terms of base year cost, for a taxable year subsequent to the last C corp. taxable year (i.e., in an S year), is less than the base year cost of the inventory as of the last day of the last C year.

For example ... If, in 1992, the taxpayer's ending inventory as expressed in base dollar costs is $1,400 (i.e., resulting in a decrement of $100), the LIFO carrying value of the special collapsed layer resulting from the Section 1363(d) adjustment will decrease by $126.67 ($100 x 126.67%) to $1,373.33 ($1,400 x 1.2667, ignoring rounding).

IPIC LIFO RESOURCE GUIDE FOR CPAs
... NON-AUTO DEALER LIFO
by Lee Richardson, CPA

IPIC LIFO METHOD

CONTENTS

** Note: The Appendices not reproduced herein may be obtained directly from Lee Richardson.*

LIFO OPPORTUNITIES ABOUND

Opportunities abound for CPAs to help their clients with their LIFO inventory needs.

CPAs' responsibilities include financial reporting and tax compliance and optimization of accounting methods to provide maximum tax savings and efficient and error free computations.

Many accountants view the LIFO inventory method as a nuisance rather than an opportunity. LIFO is viewed as a nuisance because making the LIFO computations correctly can be time consuming and prone to error. Most CPAs lack the experience to assure the optimization of methods, accuracy of calculations and efficiency of making LIFO calculations.

Few CPAs, including Big 4 CPAs have enough clients using LIFO to develop expertise in this area. LIFO expertise is hard to achieve without on-the-job training because the IRS Regs. are written by tax lawyers and are difficult to understand and LIFO reference materials are generally poor. The only way to gain LIFO expertise is on-the-job training.

Virtually all LIFO situations provide opportunities for CPAs to provide valuable service to their clients because:

1. Optimum LIFO methods are seldom used and this presents opportunities for CPAs to increase their clients' tax savings and simplify their LIFO computational simplicity.

2. Compliance with IRS Regulations is seldom found yet full compliance is possible when IRS Regulations are understood by CPAs and LIFO methods are optimized. →

There are also many companies not on LIFO that should be. Determining whether a company would benefit from using LIFO and implementing LIFO calculations can be simple if you know how to go about this.

WHY LIFO METHODS ARE SELDOM OPTIMIZED AND COMPUTATION ERRORS ARE COMMON

Although the new IPIC method LIFO Regulations issued in 2002 simplified LIFO computations for many taxpayers, the LIFO Regs. are not simpler to understand. This is because: 1) the number of new rules and calculation methods increased in the new Regs. and 2) the Regs. are written by Washington IRS Accounting Methods lawyers for whom plain speaking seems to be a foreign language.

Aside from confusing IRS LIFO rules, one of the reasons LIFO errors are so common (we seldom review error free LIFO calculations) is that no one ever does enough LIFO calculations and IRS filings for enough different companies to develop expertise in this area sufficient to ensure full advantage is taken of the tax saving benefits of LIFO and to provide assurance that the calculations are correct. Even the "LIFO experts" at the large CPA firms are limited in hands-on experience because they concentrate mostly on accounting methods and compliance. The handful of written LIFO reference sources provides little help because they are written by college professors or accountants with little practical LIFO experience.

ABCS OF QUICK LIFO ANALYSIS

In most cases, it takes us very little time to determine whether a company is using the best LIFO methods or have made errors in past years' LIFO calculations. Shown below is an outline of steps we follow when analyzing companies' LIFO situations:

1. Review present methods from LIFO schedules, Forms 970 and 3115
2. Review prior year LIFO index computation schedule and LIFO layer history
3. Understand inventory products
4. Obtain FIFO inventory balances summary
5. Estimate current and prior year pro forma IPIC method LIFO indexes based on estimated breakdown of FIFO balances by PPI categories
6. Do analysis in stages to eliminate wasting time gathering more detailed inventory data than is necessary for each stage and don't proceed to next stage unless current stage results warrant proceeding to the next stage

HOW LIFO-PRO CAN HELP CPAS

The ways LIFO-PRO, Inc. helps CPA firms and their clients include:

1. We make all necessary LIFO calculations and provide complete documentation to you or your clients with one day turnaround
2. We will sell your firm or your clients a license to use our LIFO-PRO software if you or they would prefer to make the LIFO calculations
3. We prepare the necessary IRS Forms 970 and 3115 (a Form 3115 must be filed for all IPIC taxpayers for the mandatory changes required in the new Regs.)
4. We perform a full range of LIFO consulting work such as LIFO adoption analysis and IPIC method implementation
5. We provide LIFO training and our LIFO reference materials (we recently published IPIC method Guides for Planning & Implementation for several industries)

Whether a CPA firm wants to become more self sufficient in working with LIFO or wants to subcontract this work to us entirely, we can help a firm do either.

REASONS CPA FIRMS USE OUR LIFO SOFTWARE AND SERVICES:

1. To provide absolute assurance of correct LIFO calculations
2. To provide assurance that your clients are using the LIFO methods that produce maximum tax savings
3. To gain access to the LIFO expertise of the one non-auto dealer LIFO only practitioner in the U.S.
4. We provide firms a competitive advantage in this area without investment in substantial training time
5. We can enhance your firms profitability by providing high value services at a low cost

We are uniquely qualified to assist companies adopting the provisions of the new LIFO Regs. We, as the only company whose sole practice is non-auto dealer LIFO, provided substantial input to the IRS during the new LIFO Regs. drafting period and worked to ensure that some of the provisions of the preliminary Regs. that were harmful to taxpayers were changed in the final Regs.

Because we are a LIFO only practice, CPA firms can work with us without worrying about us competing with them.

see **IPIC LIFO RESOURCE GUIDE FOR CPAS**, page 29

5 Reasons LIFO May Be More Beneficial in 2004 Than in the Past

1. The IRS LIFO Regs. issued in 2002 increased from 80% to 100% the amount of PPI or CPI inflation taxpayers could use.
2. The new Regs. elimination of the stage of production margin change adjustment requirement substantially reduces the volatility of LIFO indexes.
3. The new Regs. provide for simpler calculations for most taxpayers.
4. Rev. Proc. 2002-9 makes most LIFO method changes automatic approval changes.
5. Inflation rates have increased for many goods in 2004.

Who Should Use the LIFO Method

1. Profitable company or expectations of future profitability
2. Consistent inflation
3. Significant inventories

Common LIFO Misconceptions

1. LIFO benefits will be minimal for companies with fast inventory turnover ...	• Inventory turnover rate is irrelevant; • only the amount of FIFO inventory value and inflation impact the amount of LIFO expense.
2. LIFO reserve increases require increasing FIFO inventory balances ...	• Unless FIFO values decrease significantly, the amount of inflation is a far more important determinant of LIFO expense than FIFO values and significant LIFO reserve ***increases*** are possible even with sizable FIFO inventory ***decreases***.
3. Low inflation rates will not produce significant LIFO benefits ...	• Consistent positive inflation can produce sizable LIFO benefits for companies with significant inventories. • Sizable LIFO benefits are also possible for companies with small inventories for which there is consistently high inflation.
4. Book and Tax LIFO methods need to be consistent ...	• This was true until the late 1970s but the IRS Regs. LIFO "conformity rule" was changed at that time to require only the conformity of the LIFO election scope (goods on LIFO). • The Regs. specifically permit different book and tax LIFO methods.
5. Valuation (Lower-of-Cost-or-Market) reserves provide as much, or more, benefit than LIFO ...	• If this seems to be true for a company, the reserving method would not likely pass muster with the IRS. • Even if a Lower-of-Cost-or-Market (LCM) reserve may exceed the first year LIFO reserve, the LIFO reserve will grow with continued inflation regardless of FIFO value increases and this is not true of LCM reserves. • LCM reserves must be taken into income when LIFO is adopted as a Section 481(a) adjustment, but this is spread over 3 years. • If the IPIC LIFO method is adopted, this provides taxpayers a "safe harbor" which prevents the IRS from challenging bad tax methods in pre-IPIC LIFO periods.

Source: *IPIC LIFO Resource Guide for CPAs ... Non-Auto Dealer LIFO* by Lee Richardson, CPA ... LIFO-PRO, Inc.

Opportunities for CPAs to Improve Clients' LIFO Situations	
1. Companies not using LIFO that should be	• There are many companies not on LIFO that should be because of lack of knowledge of expected tax savings and effort required to convert to LIFO.
2. Partial LIFO election where inflationary goods are excluded	• LIFO should be used for all goods for which there is inflation.
3. Using LIFO for goods with consistent deflation	• Partial LIFO terminations can solve this problem for some companies.
4. Using of the Double-Extension method rather than the Link-Chain method	• The use of this method (i.e., Double-Extension method) is rarely advisable and often produces LIFO inflation volatility and unexpected results. • See example comparing Double-Extension to Link-Chain method example (page 31).
5. Use of the Internal index rather than the IPIC method	• The IPIC method is a better choice for almost all companies. • See section describing the advantages of the IPIC method (page 28).
6. Use of accounting software inventory modules' LIFO pricing option ... Use of the Unit LIFO method instead of the dollar-value LIFO method	• Doing this almost always guarantees lower LIFO benefits for a company. This is because LIFO is applied on a item-by-item basis (Unit method is the IRS term for this) in this type of application. Using Unit LIFO almost always substantially decreases LIFO tax savings because LIFO layer erosions (causing reduction of previous years' LIFO benefits) occur for every item each year there are fewer units on hand compared to the prior year because there is essentially a LIFO pool for each item. • With the alternative Dollar-Value LIFO (which informed companies use), pools are established for broad types of goods (and usually a singe pool for manufacturers) so that increases and decreases in items on hand are netted together which results in fewer LIFO layer erosions.
7. Too many LIFO pools are used	• The fewer the pools, the better to maximize tax savings and simplify the LIFO computations.
8. Using pre-2002 IRS Regs. IPIC LIFO methodology	• This may not only be a compliance problem but could prevent maximum tax savings.
9. Using CPI indexes when PPI indexes produce higher inflation	• This is an increasingly popular idea which has helped some retailers maximize their tax savings.
10. Using discontinued PPI index categories	• The categories for which the Bureau of Labor Statistics compiles indexes change twice a year with 20% of the categories discontinued after December 2003, so the categories used must be reviewed annually.
11. IPIC pool index calculation errors	• These errors are very common for companies who use more than a few PPI or CPI categories. Just obtaining these indexes can be an adventure.
12. LIFO layer erosion calculation errors	• The longer a company is on LIFO, the more likely these errors will occur, usually as a result of incorrect layer erosion computations.
13. Using an incomplete "layers remaining only" LIFO layer history format	• Carryforward schedules that don't show the original FIFO balances, indexes and LIFO layer for years for which those layers have been subsequently eroded is a common problem.
14. Incorrect Sec. 263A costs capitalized	• Proper integration of this computation (i.e., the Section 263A cost capitalization computation) with the LIFO layer history is required and the more years a company is on LIFO, the less likely errors are avoided.
Source: *IPIC LIFO Resource Guide for CPAs ... Non-Auto Dealer LIFO* by Lee Richardson, CPA ... LIFO-PRO, Inc.	

Advantages of Using the IPIC LIFO Method	
#1 ***Higher inflation indexes possible***	• Many companies have found PPI or CPI inflation rates to be consistently higher than their internal index inflation. An example of this is large supermarket chains for whom the CPI v. internal index difference has consistently been almost 2% for the past 10 years.
#2 ***Less volatility of LIFO inflation***	• Many companies find PPI or CPI inflation rates to be less volatile than internal indexes. Two reasons for this are: ♦ PPI and CPI indexes reflect price changes for the entire U.S. and not a single company, and ♦ internal indexes are more reflective of raw materials prices and PPI or CPI indexes are more reflective of intermediate or finished goods prices and raw material prices are more volatile.
#3 ***Fewer pools possible***	• The IPIC Regs. provide for establishment of pools by PPI or CPI Major Groups. • Since this pooling method is optional and taxpayers can use other methods provided for in the Regs., taxpayer using the IPIC method are assured than the number of pools they use will be no greater than and may be less than alternative methods.
#4 ***Index calculation simpler than internal indexes***	• Use of a published index precludes the need to calculate an internal index unless companies switch for tax LIFO only. • Internal index calculations are usually a major undertaking and can be avoided if companies switch for book LIFO also. • The IPIC LIFO weighted average index calculations can also be complicated if done manually but this problem goes away with automated LIFO software.
#5 ***Easy way to switch from Double Extension***	• The IRS has been reluctant to permit changes from this method (i.e., from the Double-Extension method) to the Link-Chain method, especially for companies whose annual turnover of inventory items is not rapid. • Taxpayers can make this change as an automatic approval change which does not require IRS consent when electing the Link-Chain method at the same time as a change to the IPIC method. • Use of the Double-Extension method invariably produces more volatile LIFO indexes than Link-Chain indexes, so it is important for most taxpayers using the Double Extension method to switch to the Link-Chain method.
#6 ***Cutoff method accounting change***	• Prior year restatement of inventory balances is not required.
#7 ***IRS audit exposure reduced for past years***	• Companies switching to the IPIC method are provided a "Safe Harbor" by the IRS with respect to methods used in years prior to the change. IRS audit exposure may be eliminated in these areas: ♦ ***Statistical sampling*** ... Many companies use internal index sampling methods that are not acceptable to the IRS. For example, a company's sampling method may not give new items an equal chance for selection as the IRS requires. ♦ ***Pooling*** ... Many companies use pooling methods that are not authorized by the IRS. Taxpayers may elect the optional IPIC pooling rules thereby establishing an acceptable pooling method. ♦ ***Other*** ... Some manufacturers still use the components of cost method despite its prohibition by the IRS. Some manufacturers also incorrectly apply raw materials only indexes to total inventory dollars including labor and overhead dollars. Companies can eliminate exposure from use of these methods by adopting IPIC LIFO methods.
Source: *IPIC LIFO Resource Guide for CPAs ... Non-Auto Dealer LIFO* by Lee Richardson, CPA ... LIFO-PRO, Inc.	

(Continued from page 25)

IPIC LIFO SUCCESS STORIES

A medical equipment manufacturer was using internal index LIFO. They did not elect the IPIC method several years ago despite their Big 4 CPAs' recommendation because they believed the task of inventory sorting would be very time consuming. We visited their web site and saw that almost all of their inventory could be classified into a single PPI category. This allowed us to run proforma IPIC calculations without any input from them other than their LIFO history schedule. The proformas showed if they had used the IPIC Method they would have reduced their taxable income by an additional $1 million for the current year and an additional $5 million over the last ten years. They adopted the IPIC Method for tax purposes only.

A retail grocery chain used what we call Simplified Simplified LIFO for which a single index per pool is used and the pools are the standard grocery industry departments with a separate set of pools for each store. Some departments, amounting to about 15% of total inventory, were not on LIFO. We combined their pools into a single set of pools for each corporation and elected the IPIC pooling method. This resulted in using the minimum number of pools possible to maximize LIFO tax benefits (by minimizing LIFO layer erosions). We provided the client instructions to enable them to sort their FIFO inventory by the minimum number of CPI categories to meet IRS Regs. requirements. We expanded the LIFO election to include all goods, thereby increasing their LIFO tax savings.

A retail grocery chain used eleven pools corresponding to standard grocery business departments. We reduced the number of pools used and increase their tax savings by using the IPIC pooling method. The years were not labeled in the layer history except for the last two years. We referred to past years' CPI indexes (e.g., SAF Food at home was the single index used by the client for their Grocery pool) to identify the years corresponding to the layers history so that the old pools could be combined into six IPIC pools. We provided the client instructions to enable them to sort their FIFO inventory by the minimum number of CPI categories to meet IRS Regs. requirements. We also corrected numerous layer pricing errors in their layer history which were the result of calculating decrements incorrectly.

A convenience store chain using the IPIC method but used seven pools because they did not use the IPIC pooling method. We showed them they could reduce this to three pools and increase their tax savings by using the IPIC pooling method. The client used Retail LIFO and had recently experience a large decrease in their LIFO expense because of increased margins. We recommended that they use Cost LIFO to eliminate the effect of margin changes on their LIFO expense. The client used one CPI index per pool. We provided the client instructions to enable them to sort their FIFO inventory by the minimum number of CPI categories to meet IRS Regs. requirements. Not all goods were on LIFO. We expanded their LIFO election to include all goods thereby increasing their tax savings. We also corrected numerous errors in the client's layer history which were caused by calculating decrements incorrectly.

A discount store chain switched to the IPIC method using PPI indexes two years ago. Their Big 4 CPAs had instructed them to sort their prescription and over-the-counter drugs into just two PPI categories, *063 Drugs and pharmaceuticals* and *063807 Vitamins, nutrients, and hematic preparations.* This was clearly incorrect as the client did not have any inventory that would be included in 063 (such as medicinal chemicals or veterinary preparations) except items that should be classified in the eight categories included in *0638 Pharmaceutical preparations.* We performed pro forma calculations that showed the client would get a significantly larger LIFO expense for the most recent year if they sorted their drug inventories properly into the 0638 PPI categories.

A recreational vehicle dealer was not using LIFO. We first ran pro forma LIFO calculations using the IPIC Method for the most recent year, which showed that the client would have a significant reduction of taxable income. We then performed pro forma calculations for the last ten years which showed that the client's inventory had consistently experienced inflation without a single year of deflation.

A foodservice distributor was not using LIFO. Food businesses are excellent candidates to use LIFO because almost all food categories have inflation over time. Using the current year inventory breakdown by PPI category, we ran do pro forma IPIC Method calculations for the previous ten years. As expected, the pro formas showed an average annual inflation rate of about 2%. The client adopted LIFO and was able to significantly reduce their taxable income.

A retail grocery chain used what we call Simplified Simplified LIFO for which a single index per pool was used and the pools were the standard grocery industry departments with a separate set of pools for each store. We combined their pools into a single set of pools for each corporation and elected the IPIC

see **IPIC LIFO RESOURCE GUIDE FOR CPAS**, page 30

(Continued from page 30)

pooling method. This resulted in using the minimum number of pools possible to maximize LIFO tax benefits(by minimizing LIFO layer erosions). We provided the client instructions to enable them to sort their FIFO inventory by the minimum number CPI categories to meet IRS Regs. requirements.

A manufacturing company using Internal Indexes and Double Extension methods would have had a 10% decrease in their pool index despite having some inflation in their raw material costs. This would have wiped out their $3 million LIFO reserve. Using a rough estimate of their most recent year end FIFO balances broken down by PPI category, we ran proforma IPIC method(Link-Chain) LIFO calculations for the past 10 years and this showed that, not only would they have LIFO inflation for this year end resulting in increasing their LIFO reserve by over $1 million, but the LIFO inflation in past years would have been substantially higher using the IPIC and Link-Chain methods resulting in a LIFO reserve about $5 million higher than the actual reserve. This set of facts is quite common for companies using Internal Indexes and Double Extension LIFO methods.

A publicly traded manufacturing company using Internal Indexes and Double Extension methods had a sizable LIFO reserve but the amount of LIFO expense or income varied greatly from year to year. For example there was LIFO expense of $600,000 one year and $700,000 LIFO income the next despite relatively stable FIFO balances and raw material price inflation. We explained why we thought the use of Internal Indexes and Double Extension methods gave them a double whammy of volatility in indexes from year to year. We ran pro-forma calculations to show them that the big swings in LIFO expense from year to year would have been almost entirely avoided had they used the IPIC and Link-Chain methods in prior years.

A retail grocery client using IPIC and Link-Chain methods had a sizable LIFO reserve but the amount of LIFO expense or income varied greatly from year to year. For example there was LIFO expense of $1,200,000 one year and $900,000 LIFO income the next despite the fact that the average of CPI indexes used for supermarket chains has not been outside of the 1-3% annual inflation range for the past 15 years. Their volatility in LIFO indexes was caused by significant margin changes(about 2% which is significant for grocers) from one year to the next because they used the Retail LIFO method. We advised them to switch to the Cost LIFO method to avoid the margin change volatility because the new IRS IPIC Regs. issued in 2002 eliminated the requirement to adjust CPI inflation to reflect margin changes.

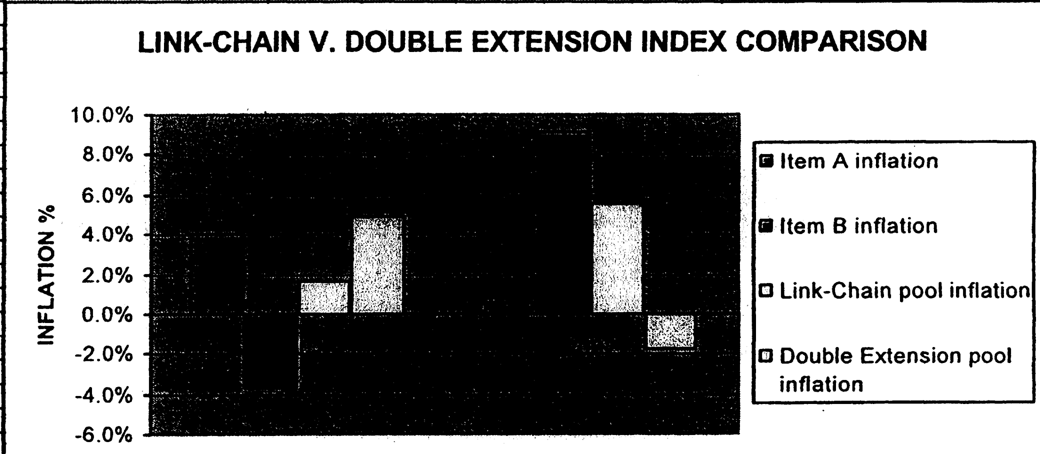
A home improvement products retailer used the IPIC method and CPI indexes. We advised them to switch to using PPI indexes because they were about 2% higher than CPI inflation and had been for several years. They did so and increase their tax savings considerably. They made this change for tax purposes only and now enjoy the best of both financial reporting and tax worlds, deflation for book LIFO and inflation for tax LIFO.

A company discovered they had overstated their Section 263A costs when they started using our LIFO-PRO software. They had improperly calculated the total Section 263A costs to be capitalized for some of the years for which they had LIFO layer erosions.

LIFO taxpayers must integrate their Section 263A costs calculation with their LIFO layer history. The longer a company is on LIFO, the more likely errors of this nature occur.

We told a company they ought to elect LIFO because they had significant inventories and there was consistent inflation for their goods. They were reluctant to adopt LIFO because they thought their inventory levels would decrease because of inventory reduction initiatives and believed this would prevent growth of their LIFO reserve. We ran pro forma calculations to show them that their LIFO reserve could grow significantly without increases in their FIFO inventory balances.

	A	B	C	D	E	F	G	H
1	**COMPARISON OF CURRENT YEAR LIFO INFLATION INDEXES**							
2	**BETWEEN DOUBLE EXTENSION & LINK CHAIN METHODS**							
3	**EXAMPLE 3**							
4								
5	Assumptions used:							
6	Inventory falls into 2 different PPI categories, 111303 & 101706							
7	Assume FIFO balances by PPI category shown on Rows 18 & 19(This is only thing that is different from other examples)							
8	Actual PPI indexes are shown on Rows 14 & 15							
9								
10								
11		PPI Code	12/31/1982	12/31/1999	12/31/2000	12/31/2001	12/31/2002	
12			Base year					
13	PPI indexes:							
14	Water systems	111303	100.5	131.2	132.5	137.8	138.5	
15	Steel pipe and tube	101706	95.7	104.4	106.0	102.1	111.4	
16								
17	Year end FIFO values:							
18	Water systems	111303			5,000	7,000	4,000	
19	Steel pipe and tube	101706			5,000	3,000	6,000	
20	Total				10,000	10,000	10,000	
21								
22	Calculation of Double Extension Cumulative Deflator Index:							
23	Water systems	111303			1.318	1.371	1.378	Row 14 2000 etc, index/1982 Col. C index
24	Steel pipe and tube	101706			1.108	1.067	1.164	Row 15 2000 etc, index/1982 Col. C index
25								
26	Calculation of Double Extension Inventory at Base:							
27	Water systems	111303			3,792.45	5,105.22	2,902.53	Row 18 FIFO/Row 23 cum. Deflator
28	Steel pipe and tube	101706			4,514.15	2,811.95	5,154.40	Row 19 FIFO/Row 24 cum. Deflator
29	Total				8,306.60	7,917.17	8,056.93	
30	Pool Cumulative Deflator Index-Double Extension				1.204	1.263	1.241	Row 20 FIFO total/Row 29 Inv. At Base Total
31	Pool Current Year Deflator Index-Double Extension					1.049	0.983	Current Year Row 30/Prior Year Row 30
32								
33	Current Year PPI Category Indexes:							
34	Water systems	111303			1.010	1.040	1.005	Current Year Row 14/Prior Year Row 14
35	Steel pipe and tube	101706			1.015	0.963	1.091	Current Year Row 15/Prior Year Row 15
36								
37	FIFO at Prior Year Prices(Harmonic Extension):							
38	Water systems	111303			4,950.94	6,730.77	3,979.78	Row 18/Row 34
39	Steel pipe and tube	101706			4,924.53	3,114.59	5,499.10	Row 19/Row 35
40	Total				9,875.47	9,845.36	9,478.89	
41								
42	Pool Current Year Deflator Index-Link Chain					1.016	1.055	Row 20/Row 40
43								
44	Difference in Current Year LIFO Indexes					0.033	(0.072)	Row 31 - Row 42
45	Percentage difference					3.3%	-7.2%	
46								



The purpose of this schedule is to show how the use of the Double Extension method can produce unexpected LIFO results.

For 2001, the Double Extension pool inflation is 4.9% which is higher than either of the two products' individual inflation rates of 4.0% and -3.7%. The Link-Chain pool inflation is 1.6%.

For 2002, the Double Extension pool inflation is -1.7% which is lower than either of the two products' individual inflation rates of .5% and 9.1%. The Link-Chain pool inflation is 5.5%.

The *De Filipps' LIFO Lookout* newsletter is a quarterly publication of LIFO News, Views and Ideas by Willard J. De Filipps, CPA, P.C., 317 West Prospect Avenue, Mt. Prospect, IL 60056. It is intended to provide accurate, general information on LIFO matters and it should not be construed as offering accounting or legal advice or accounting or legal opinion on any specific facts or circumstances. The contents are intended for general information purposes only. Readers should consult their certified public accountant, attorney and/or other competent advisors to discuss their own situations and specific LIFO questions. Mechanical or electronic reproduction or photocopying is prohibited without permission of the publisher. Annual subscription: $475 plus shipping and handling. Back issues available for $80 each. Not assignable without consent. Any quoted material must be attributed to *De Filipps LIFO Lookout* published by Willard J. De Filipps, CPA, P.C. Editorial comments and article suggestions are welcome and should be directed to Willard J. De Filipps at (847) 577-3977; FAX (847) 577-1073 or by email to cpawjd@aol.com. © Copyright 2004 Willard J. De Filipps.
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