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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. NOT MUCH NEW EXCEPT MAYBE THE TOTAL REPEAL OF THE LIFO METHOD. Dol

have your attention? That's right. In June, the Senate Finance Committee held a hearing on the possible repeal ... they called it *"viability"* ... of the use of the LIFO Inventory Method ... **by all taxpayers**.

This started out a few months earlier in a fit of agitation and frustration over (obscene, some said,) windfall profits being reported by large U.S. oil companies. These companies were using LIFO to value their oil inventories in their U.S. tax returns. The backlash took the form of a measure introduced in Congress to prevent these U.S. oil companies from using the LIFO method. That proposal was quickly withdrawn.

However, what's come after that is even more startling ... consideration now by Congress of the possible repeal of the use of LIFO by **all** taxpayers. The Senate Finance Committee hearing on June 13 featured testimony by an accounting professor, George A. Plesko, who strongly implied that the LIFO method no longer served any useful purpose.

Repeal would involve significant revenue raising prospects ... billions and billions of dollars in LIFO reserve recaptures. And, then there's the IRS' delight over the removal of a Code Section that has been a thorn in its side ever since it was first enacted some 70 years ago ...

But, wait ... there's a "LIFO Coalition" on the horizon. There's lots of rhetoric to come, pleas to be made and hopefully heard. And, that includes my letter to Chairman Grassley (on pages 4-6) in which I've even suggested a possible compromise or alternative to the repeal of LIFO in the form of a surtax on the use of LIFO.

So, don't jump to any conclusions about this yet. The only thing for sure right now is that you'll be hearing a lot more about this proposal in the future. For a little more background on this, see page 3.

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#2. THE IRS ADJUSTS DECADES OF LIFO "ERRORS" IN LINK-CHAIN CALCULATIONS ... HUFFMAN et al. v. COMM. A recent case just

out of the Tax Court stands for the proposition that it's never too late for the IRS to correct botched LIFO calculations.

Let's qualify that statement ... "It's never too late ... **unless** the taxpayer has preemptively prevented the IRS from making adjustments by voluntarily filing for a change in its accounting method before coming under audit by the IRS. Huffman had the chance to do that as early as 1992, but it didn't.

Huffman involves a group of four auto dealerships that had elected LIFO, indicating that their calculations were going to be made under the link-chain, dollar-value method. For decades, the dealership's CPA incorrectly computed the LIFO valuations. He omitted the critical step of valuing annual increments (expressed in base dollars) at current cost. His error

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or mistake was based on his incorrect interpretation of a 1981 case, *Richardson Investments*.

Where was the IRS all this time? Six different IRS Agents audited the dealerships six different times over the years. They requested and were given copies of all calculations, but (until the last audit) they never made any changes to the dealerships' LIFO calculations. One agent even complimented the accountant on how good the LIFO calculations were. (For some reason, the statement about the "blind leading the blind" comes to mind here.)

A matter of intent? The dealerships and the IRS went 'round and 'round over whether the intent of the CPA should have any bearing on the IRS' ability to adjust the calculations. After all, the CPA **thought/believed** that he was doing the link-chain LIFO calculations correctly. He firmly and steadfastly believed that. He had no intention of doing them incorrectly.

As a matter of fact, when the Alternative LIFO Method for New Vehicles first became available in 1992, the CPA didn't think it was necessary to change to this safe-harbor computation because he believed that he was already doing the calculations properly... and prior IRS audits had made no changes to his methodology.

Interestingly, had he compared the computational steps outlined in (then) Revenue Procedure 92-79 (now Revenue Procedure 97-36), he would have found that his computations were not what the IRS would accept.

Should considerations of the CPA's intent or belief be given any weight in preventing the IRS from making adjustments under Section 481(a) to increase the significantly understated LIFO valuations? The IRS didn't think so. It said these considerations were irrelevant. In fact, the IRS even filed a motion, which the Court denied, trying to prevent the CPA from testifying at the trial.

Huffman argued that the changes proposed by the IRS were "corrections of an error" ... a *mathematical error*, at that ... and not changes in its accounting method.

In the simple life ... Even LIFO is simple. In presenting its arguments that the CPA could not possibly have made an "error," the IRS made it very clear that it thought that there is nothing complicated about LIFO. The IRS said... "LIFO has been a difficult area for Revenue Agents in the past, but is not complex and is a very, very simple computation. ... The math involved with LIFO calculations is as simple as it gets because there is only one math set of steps to do." But, even the Tax Court got confused. Now, if LIFO's so simple, how do you explain the fact that the Tax Court couldn't even do it right? Even the IRS, or at least IRS Agents and Specialists who understand LIFO, should be quick to disagree with the example that the Tax Court made up to describe how the linkchain method works! Even the Tax Court failed to value the link-chain increment correctly!

If the Court's error in this example is not corrected, countless practitioners in the future looking to the Court's example in *Huffman* for guidance on how to do their link-chain LIFO calculations could become casualties of misinformation like Huffman and its CPA. And, the IRS may have another Pyrrhic victory on its hands.

Correction of an error. If the audit adjustments proposed by the IRS were "corrections of an error," then the only adjustments the IRS could make would be to the dealerships' open years under Section 446(b). The IRS' adjustments to these years were not contested by the taxpayer.

On the other hand, if the changes proposed by the IRS were characterized as "changes in accounting method," then further adjustments under Section 481(a) to the opening inventories in the earliest open years would be permitted. These adjustments would correct for the cumulative effect of LIFO errors over stretches of 11, and as long as 21, years by the dealerships.

How "long" is "short"? In its final analysis, the Tax Court said that it might have felt differently if the dealerships' incorrect link-chain computations had not been carried out over such long periods of time. In wrestling with the question of how to distinguish a "short-lived" deviation (from an accounting method) from a "long-lived" deviation, the Tax Court said, "We need not today determine how long is short."

Instead, based on Huffman's long-standing misapplications, the Court concluded that since no member of the Huffman group had deviated from the linkchain method for less than 10 years, these deviations were too **long** to be considered **short**.

Accordingly, the Tax Court upheld all of the IRS' adjustments to Huffman's LIFO calculations.

There are several other interesting aspects to this case. In particular, the IRS' legal arguments to distinguish the *election* of a LIFO accounting method by a taxpayer from the *adoption* of that accounting method by the taxpayer (see page 11) were persuasive to the Court and are full of warning for all of us.

Our coverage of this case begins on page 7. 🗶

At a Glance	<u>SFC HEARING ON JUNE 13, 2006 re: VIABILITY/POSSIBLE REPEAL OF</u> THE LIFO METHOD & SELECTED COMMENTS IN RESPONSE
	THE BIT O METHOD & SEEECTED COMMENTS IN MESTONSE
Background	 A proposal to repeal the LIFO method on a limited basis was included in proposed legislation Gas Price Relief and Rebate Act of 2006. This proposal was withdrawn by Senator Frist, after strong opposition by business, so Congress might have more time to study viability of LIFO method. The Staff of the Joint Committee on Taxation submitted a memo dated June 12, 2006 re: Present Law & Background Related to LIFO Method in response to U.S. Senate Committee on Finance (SFC) request for background information in advance of SFC hearing on corporate tax issues. This memo provides a general description and comparison of various inventory accounting methods and discusses the present law governing inventory accounting for tax purposes. The SFC (Senator Chuck Grassley of Iowa, Chairman) held a hearing on June 13, 2006. "A Tune-Up on Corporate Tax Issues What's Going on Under the Hood." Witnesses included IRS Commissioner Mark Everson and Dr. George A. Plesko, University of Connecticut School of Business.
	• "Firms have a greater opportunity to manage the earnings they report to their shareholders. If a firm wants to
Professor Plesko's Testimony (Excerpts)	 report higher earnings, it can choose to sell from existing (lower cost) inventory rather than acquire or produce new inventory." "The use of LIFO has raised concerns that firms may have an incentive to hold more inventory than is optimal because of the tax costs of reducing their inventory levels. Firms may have incentive to purchase unneeded inventory to avoid recognizing the additional taxable income that would result from selling inventories valued at less than the current market price." "If the financial reporting benefits of LIFO were perceived as significant then we would expect to see more wide-spread use of LIFO by U.S. firms than revealed in Figures 1 and 2 and Table 1." "Since many companies that use LIFO for external reporting purposes do not use it for internal decision making (such as pricing or compensation), allowing LIFO for tax purposes in the absence of LIFO-conformity would appear to generate no benefit other than the deferral of income taxes by LIFO firms." "Given that few firms might use LIFO in the absence of the tax benefit, the economic benefits of LIFO need to be very large to justify its presence in the tax code. The additional conformity requirement only increases the distortions that LIFO may cause."
	• Comments from a letter submitted by the Tax Executives Institute (TEI) to the SFC dated June 9, 2006, after
TEI Letter to SFC	 withdrawal of initial proposed legislation and prior to SFC hearing on June 13, include "The Institute believes that repealing the LIFO method would adversely affect many business taxpayers by increasing their tax bills, potentially leading to a significant loss of U.Sbased jobs." "TEI fails to see what tax policy goal would be served by repealing the LIFO method of accounting. For nearly 70 years, the LIFO method has provided for the proper matching of revenues and expenses in the computation of the cost of goods sold and taxable profits, especially in periods of rising prices." "Because of the Internal Revenue Code's consistency (i.e., conformity reporting) requirement, the use of the LIFO method for tax purposes promotes transparency in reported book and tax gross profits."
De Filinns'	• On June 16, 2006, W.J. De Filipps, CPA (Mt. Prospect, Illinois) submitted his comments in response to
Letter to SFC	Professor Plesko's comments. These comments propose a surtax on the use of LIFO.
LIFO Coalition Memo to SFC	 See pages 4-0 for the full text of De Filipps' letter. On June 28, 2006, the LIFO Coalition submitted its comments in the form of a cover letter and memorandum prepared by Leslie J. Schneider in response to Professor Plesko's comments. The memo takes the position that Prof. Plesko's testimony Significantly understates (1) the use of LIFO by the U.S. business community and (2) the very substantial adverse affect of repeal on the U.S. economy, with such inaccuracies based in part on inclusion of irrelevant data and failure to recognize accounting protocols that create differences between statements of book and tax LIFO reserves. Fails to recognize the efficacy of the LIFO method in measuring financial condition and in calculating tax liability for a wide variety of industries that experience perennial increases in cost of inventory and production. Greatly exaggerates the potential for manipulation of taxable income under the LIFO method, and fails to recognize rulings of the IRS and case law endorsed by the U.S. Supreme Court that specifically addresses any such potential abuses. Begs the tax policy question of LIFO accounting as an appropriate means of measuring economic income for both book and tax purposes in his (Plesko's) assertion that businesses would not use LIFO for financial accounting purposes but for the tax savings and conformity requirement. Members of LIFO Coalition include National Association of Manufacturers, National Association of Wholesaler-Distributors, American Institute of Certified Public Accountants (AICPA), American International Automobile Dealers Association (NADA).

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June 16, 2006

Senate Committee on Finance Attn: Editorial and Document Section Rm. SD-203 Dirksen Senate Office Building Washington, D.C. 20510-6200

> Re: Current Consideration of the Use of the Last-In, First-Out (LIFO) Inventory Method

> > Senate Committee on Finance Hearing "A Tune-up on Corporate Tax Issues: What's Going on under the Hood?" Tuesday, June 13, 2006

Dear Chairman Grassley:

In response to the invitation to submit comments for consideration and inclusion in the record with respect to the hearing held on June 13, 2006 concerning the use of the LIFO (Last-In, First-Out) inventory method, I respectfully submit the following.

My primary concern in submitting these comments is to raise my voice in defense of the many closely-held businesses that are currently using the LIFO method. I believe that the Senate Finance Committee should not overlook the vital role that LIFO has played in sustaining these businesses over the years. Although some may argue that consistency with international accounting standards is an important consideration, the economic well-being of a broad base of U.S. taxpayers - to the extent that it can be enhanced by the use of the LIFO method - should, in my opinion, be given greater attention and precedence over other considerations.

Don't Overlook Reliance on the LIFO Method by Closely-Held Businesses

In the real world, thousands of non-publicly-held businesses (i.e., closely-held businesses) are using the LIFO method, with all of its limitations and complexities. Consideration of "the LIFO issue" solely on the basis of financial statement reporting merits and/or a desire to reduce "complexity in the tax code" could severely penalize the many businesses who depend, in part, upon the continued use of the LIFO method to survive in a competitive, inflation-threatened economy.

At the June 13th hearing, Professor George A. Plesko mentioned the so-called incentives to use LIFO to manage earnings reported by publicly-held companies. This is far less a real factor in the decisions of the closely-held businesses using LIFO that I have been involved with for over 40 years. Rather than trying to "manage earnings," these businesses rely upon LIFO to provide additional cash (resulting from paying lower taxes on lower reported profits) so they can use the money not paid in taxes to purchase new inventory (which costs more as a result of inflation) to replace the goods that were sold.

Often, these businesses have used the "tax savings from LIFO" to finance the cost of constructing new and/or enlarged facilities, to meet payroll needs and to address other pressing working capital needs. And, most of these closely-held or non-publicly-held businesses, operating in their own best interests, provide jobs and growth here in the United States, rather than abroad.

Professor Plesko states that, in theory, firms using LIFO may have a greater opportunity to manage the earnings that they report to their shareholders. However, it has been my consistent experience over the years that the vast majority of decision-makers that I have worked with would rather sell a product/inventory immediately (notwithstanding its LIFO valuation) than hold on to it for "tax purposes" and thereby lose the opportunity to make the sale.

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Senate Committee on Finance Re: The Use of the Last-In, First-Out (LIFO) Inventory Method

According to Prof. Plesko, again in theory, "firms may have an incentive to purchase unneeded inventory to avoid recognizing the additional taxable income." However, the more practical business considerations of the costs of financing and insuring the *additional* or *unneeded* inventory, not to mention the risk of loss by other means, far outweigh any other advantage that may theoretically exist. Also, effective measures exist by which the IRS can police such alleged tax-avoidance practices if they are suspected in the course of an audit examination.

More Useful Information Is Readily Available

I would urge the Committee to significantly question and to not rely entirely upon some of the inferences that otherwise might be drawn from Professor Plesko's comments about the use of LIFO by publicly-held companies. I believe that decisions about the continued viability of LIFO as part of the Internal Revenue Code should not be based on limited information drawn from the Fortune 1,000 (Prof. Plesko's Table 1).

The decline of the use of LIFO by "the 600 largest firms as reviewed by *Accounting Trends*" (Prof. Plesko's Figure 1) may be explained by many factors other than discontent over its impact on financial reporting. Perhaps there is a strong correlation between the inferred decline in the use of the LIFO method and the desire of publicly-held companies to manage and increase their reported earnings by discontinuing the use of a LIFO election.

In his comments, Professor Plesko refers to the findings reported in "Treasury I" that 95% of taxpayers use the FIFO (First-In, First-Out) cost-flow assumption/method. If I am not mistaken, "Treasury I" is now over 20 years old, and the years to which it referred in reporting on the use of LIFO further pre-date that 1984 report. This data is too far out of date to suggest anything meaningful.

A much more useful statistic is readily available and would shed a far more informative light on the reliance on LIFO by nonpublicly-held businesses.

Every business income tax return requires the completion of a few questions regarding inventory methods. On the second page, Question 9(d) in Schedule A of the current corporate income tax Form 1120 asks, simply, if the taxpayer used the LIFO inventory method in its calculation of taxable income for the year. Check the box, "Yes" or "No." If the answer is "Yes," then the taxpayer is required to report either (1) the percentage or (2) the dollar amounts of inventory computed by the use of the LIFO method. Comparable income tax returns for partnerships, electing S corporations and other businesses contain similar questions.

Is it not possible for Commissioner Everson to direct the IRS to collect this information for the Joint Committee? This *current* information on the use of LIFO by closely-held (i.e., non-publicly-held) businesses should be considered by the Committee in evaluating the potential impact of whatever action it may consider regarding the continuation of the use of the LIFO method. Given the remarkable strides that the IRS has reported in processing tax return information lately, the effort to collect this information about the use of LIFO in income tax returns should be minimal.

At the very least, I believe that the IRS should conduct a survey of the responses to these LIFO questions on the U.S. Income tax returns filed by all of the publicly-held companies. Either or both of these suggested surveys would provide the Committee with far more useful information than inferences from outdated *Accounting Trends* and/or Fortune 1,000 compilations.

An Alternative Proposal ... A LIFO User Surtax

It appears that the Committee may be considering only the two extreme alternatives of either (1) allowing LIFO to continue as is or (2) terminating or phasing out the use of LIFO entirely. I submit for your Committee's consideration a third alternative... Namely, *a surtax or surcharge on the use of LIFO*.

Some twenty years ago, I submitted similar views in proposing a LIFO user surtax to the drafters of the Tax Reform Act of 1986. Reflecting on this surtax proposal today, in June, 2006, and under the current circumstances, I have even more reason to believe that this proposal has merit as a possible solution to avoid either extreme. A copy of this proposal is attached as Exhibit I.

There are many possibilities for adapting both the degree of impact and the calculation effect of any surtax on the use of the LIFO method. These variations should enable the Committee to fashion an approach that would permit at least closely-held businesses to continue to retain the benefits afforded by the use of the LIFO method.

While implementing the proposed surtax or surcharge on the use of LIFO may slightly increase the "complexity" of just one section of the Internal Revenue Code, a surtax, in my opinion, provides a better resolution of the matter than would adoption of either of the two extreme alternatives.

(Continued)

A Quarterly Update of LIFO - News, Views and Ideas

Senate Committee on Finance Re: The Use of the Last-In, First-Out (LIFO) Inventory Method

Furthermore, if a surtax or surcharge on the use of LIFO were implemented, taxpayers continuing to use the LIFO method would simply have to regard the additional computations and cost as (modest) offsets against the overall benefits that the use of the LIFO method provides. No taxpayer is required to elect LIFO ... Therefore, any taxpayer that might consider the added burden or cost of the "surtax" on the use of LIFO to be excessive or unjust could simply elect to discontinue using the method.

LIFO Financial Statement Conformity Requirements

One of the aspects of the LIFO financial statement conformity requirements that Prof. Plesko did not address was the fact that taxpayers who use the LIFO method are permitted to report greater earnings for financial statement purposes than for income tax purposes by using different LIFO methods. In many cases, this is a common practice which achieves the desired results.

Many years ago, an AICPA Task Force studied what might be generally accepted and/or alternative practices for disclosing the use of LIFO in financial statements. The conclusions of this Task Force provide minimal guidance and permit many publicly-held companies to provide little useful information in their so-called LIFO-related disclosures.

I have enclosed, as Exhibit II, a discussion of the special challenges presented by the LIFO conformity requirements as they relate to the use of the LIFO method by closely-held businesses. This article may be useful in helping to understand the more practical impact of these requirements on the vast majority of companies that are outside of the publicly-held domain.

Finally, attached (Exhibit III) is an article that, despite being written long ago, demonstrates two significant points that are relevant to today's discussions of the use of LIFO.

First, not much has changed over the years in connection with the basic requirements and principles by which taxpayers must abide if they want to use the LIFO method for valuing their inventories for income tax purposes. (The article was written long before the IRS promulgated in 1992 a safe-harbor calculation approach for automobile dealers' new vehicle inventories on LIFO.)

Second, and more importantly, by its specific industry application, this article identifies just one of the many broad U.S. industries which the Committee might otherwise overlook if its consideration of this issue is not broadened to include the significant, beneficial impact that the use of LIFO has for non-publicly-held (i.e., closely-held) businesses.

In Conclusion

I believe that the Committee's consideration of the continued use of LIFO should not be limited, as it appeared to be in the June 13, 2006 hearing, to information on the use of the LIFO method by publicly-held corporations, or by the acceptance (or disfavor) of LIFO among the academic and international communities.

I would urge the Committee to give careful consideration to the articulate writings of some of the advocates of the use of the LIFO method in its emerging years (and particularly, with regard to the development and ultimate acceptability of the dollar-value LIFO method by the Tax Court). These discussions of sound accounting theory should not be ignored at this time in an effort to arrive at a simple, one-size-fits-all solution.

Also, I believe that a surtax on the use of LIFO should be considered as an alternative to its complete elimination or its retention in the Internal Revenue Code without change.

Since beginning practice as a CPA over 40 years ago, I have seen LIFO used as an important business and income tax strategy by countless closely-held businesses. I cannot help but protest as much as possible the one-sided and oversimplified attention that is focused on the use of the LIFO method when it is considered only in the context of publicly-held and/or international companies.

In addition to teaching seminars on the use of LIFO all over the country and consulting with closely-held businesses and CPA firms, I have written extensively on LIFO issues in my publication, the *LIFO Lookout*. For a comprehensive, topical index listing all articles from 1991 to Dec. 2005, see www.defilipps.com (follow the "Publication" and "Index of Articles" links).

Thank you for the opportunity to present my views and proposal for a LIFO user surtax. I would be pleased to expand on these comments and suggestions if you would like further information.

Sincerely,

Willard J. De Filipps, CPA

WJD/kml

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In Dow A. and Sandra E. Huffman, et al. v. Commissioner (126 T.C. No. 17), filed May 16, 2006, the Tax Court reviewed the LIFO computations made over long periods of time by a group of four automobile dealerships doing business in Kentucky. These computations were supposedly made using the linkchain, dollar-value LIFO method. In auditing the dealerships, the IRS refused to accept their calculations because the CPA had consistently omitted the critical step of properly valuing inventory increments in all of the computations for periods ranging from 11 to 21 years.

Four married sets of taxpayers owned stock in this group of four different dealerships ... Nissan, Volkswagen, Dodge and Chrysler. Each entity had elected to be treated as an S corporation under Section 1361. In discussing this case, the singular term "taxpayer" or "Huffman" may be used for simplicity or convenience. However, it should be understood that the S corporation shareholders are the individuals whose tax returns were ultimately impacted by the IRS adjustments.

THE ACCOUNTANT'S (INCORRECT) METHOD

The CPA/accountant responsible for the LIFO calculations for the Huffman dealerships was consistent, without exception, in applying his method of making the link-chain computations each year, for each member, beginning with the year that the member initially elected the link-chain method and continuing thereafter.

Huffman's CPA explained that he thought he was doing the LIFO calculations properly. He based his understanding of how the link-chain method "works" on two sentences found in a 1981 Tax Court case, *Richardson Investments, Inc.* This case involved the question of whether automobile dealerships should use one pool (no) or two pools (yes) for their new vehicle LIFO inventory calculations. See page 12 for further discussion of his incorrect reliance on *Richardson* and other related factors.

What the accountant did. Pursuant to his method, Huffman's accountant first determined the items in each dollar-value pool at the end of each year. He then determined the current-year cost of each pool and divided that current-year cost by a cumulative index to determine the base-year cost of the pool. He compared the base-year cost so determined to the base-year cost of the pool as of the beginning of the year. When the end-of-the-year base-year cost exceeded the beginning-of-the-year base-year cost, the accountant determined that there had been an increment to the pool, but he did not multiply the increment by the cumulative index (he failed to "index" the increment) to determine a LIFO value for the increment.

At the time of trial, the taxpayer and the IRS stipulated or agreed that the step that the CPA had omitted was essential in order to arrive at the correct

see HUFFMAN ET AL. - LINK-CHAIN CALCS, page 8

Huffman, et al.

IT'S NEVER TOO LATE FOR THE IRS TO CORRECT BOTCHED LIFO CALCULATIONS

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Huffman et al. - Link-Chain Calculations

valuation of the ending inventory under the link-chain, dollar-value LIFO method.

The CPA explained that he assumed the LIFO value of the increment to be the difference between the end-of-the-year and beginning-of-the-year base-cost of the pool. That assumption led him to (errone-ously) conclude that the year-end LIFO value of each pool was its value determined at base-year costs.

Under the CPA's (improper) method, for years in which he determined that there had been an increment to an inventory pool, his failure to index the increment generally resulted in his understating the year-end LIFO value of the pool. This, in turn, produced three consequences... *First*, an unwarranted increase in his computation of the cost of the goods sold from the pool. *Second*, an understatement of the gross income attributable to those sales. *Third*, an overstatement of the LIFO reserve attributable to the pool.

For years in which the calculations showed that an inventory pool had been liquidated in whole or in part, the accountant got lucky. His past failures to have indexed any increments remaining in the pool at the beginning of the year resulted in his computing too low a cost of goods sold from the pool, which, in turn,

(Continued from page 7)

resulted in an overstatement of the gross income attributable to those sales.

In other words, the accountant's error did not result in the permanent omission of any amount of gross income by the taxpayers. The accountant's error produced only timing differences.

In general, the failure to index an increment included in one year's ending inventory distorted the computation of income for both the first and the second years. As stated above, the distortion of income was only a *matter of timing*, however, since the understatement of income in the first year was rectified by the overstatement of income in the second year.

IRS ADJUSTMENTS

... ONE AGREED & ONE DISPUTED

After reviewing Huffman's LIFO computations, the IRS proposed two sets of adjustments.

First adjustment under Sec. 446(b)... To all of the open years of each dealership ... "For the earliest and each succeeding year of a member open to adjustment, the IRS increased or, in two cases, decreased the taxable income of the member to reflect its recalculation of the member's beginning and ending inventories for the year." \rightarrow

DECADES OF ERROR = \$2.7 MILLION ADJUSTMENT EFFECT OF CUMULATIVE UNDERSTATEMENT OF LIFO INVENTORIES

IRS Adjustments											
		To Open	Ye	ears See	c. 4	46(b)*	To I	Earliest Open	Year	Sec. 481(a)**	
Member		1997		1998		1999		1997		1998	 Total
Nissan	\$	-	\$	17,251	\$	41,273	\$	-	\$	794,993	\$ 853,517
Volkswagen		49,056		35,484		575,137		273,115		-	932,792
Dodge		-		(37,752)		256,315		-		348,762	567,325
Chrysler		-		76,402		(88,687)		-		337,423	 325,138
Totals	\$	49,056	\$	91,385	\$	784,038	\$	273,115	\$	1,481,178	\$ 2,678,772
Totals					\$	924,479			\$	1,754,293	\$ 2,678,772

* These IRS adjustments were not contested by the taxpayer.

** These IRS adjustments were contested by the taxpayer, but the Tax Court upheld the IRS.

Note: The Tax Court states ... "The parties vigorously dispute whether the Section 481 adjustments (cumulatively, \$1,709,293) are permissible, and it is that question that is the primary issue before us."

Query: The table in the case does not show totals. The totals shown above, which agree with the IRS' schedules show a cumulative total of \$1,754,293. Why did the Tax Court say that the total cumulative adjustment was \$45,000 less? Was there a transposition error somewhere? Someone, somewhere didn't double-check this.

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Huffman et al. - Link-Chain Calculations

Huffman did not dispute the propriety of this adjustment or the IRS' recalculations of the amounts of the beginning and ending inventories of each member of the Huffman group.

Second adjustment under Sec. 481(a) ... To the earliest open year of each dealership ... This adjustment increased the taxable income of each member for its earliest open year to reflect the cumulative adjustments to income revealed by the IRS' recalculations for all prior years that the LIFO elections had been in effect. This "catch-up" adjustment for all members was slightly in excess of \$1.7 million.

Huffman took the position that the IRS should not be allowed to make these Section 481(a) adjustments.

Change in accounting method. The IRS argued that in making these Section 481(a) adjustments, it was implementing a change in method of accounting. In effect, the IRS said it was changing Huffman's link-chain LIFO method of accounting *from* (1) a method which gave no recognition in the valuation of an increment to the element or component of cumulative inflation *to* (2) a method which gave full and proper recognition to that element of cumulative inflation in the valuation of the increment.

The element or component of inflation that had been omitted from the valuation of the ending inventory by the failure to index the increment was the inflation (from the first year of the LIFO election through the end of the current year) that should have been embedded in each annual LIFO (net) increment as part of the determination of its current cost.

Correction of an error. Huffman's position was that the adjustments proposed by the IRS under Sec. 481(a) were merely the result of the IRS correction of a mathematical error made by the accountant.

Huffman argued that the correction of a mathematical error is explicitly excluded from being considered a change in accounting method by Reg. Sec. 1.446-1(e)(2)(ii)(b). It would follow from Huffman's position, if its interpretation were upheld, that there was no change in any member's method of accounting, and therefore, the Section 481(a) adjustments proposed by the IRS would not be warranted.

Huffman did concede, however, that if Section 481 adjustments were warranted, the IRS had correctly computed the amounts of those adjustments.

THE TAX COURT'S DISCUSSION OF LIFO INVENTORIES

A substantial portion of the Tax Court's discussion of background information on LIFO inventories is based on the Stephen F. Gertzman treatise, *Federal Tax Accounting.* The Court said...

(Continued)

"There is more than one method for computing the value of a LIFO inventory. ... Nevertheless, all LIFO computational methods involve essentially three determinations:

determination must be made as to hether there has been a quantitative
g the period in question, and
nere must be a determination of the anner in which increments to (i.e., in- eases in the quantity of) each pool are to a valued."

The *Huffman* case was concerned mainly with the last of those determinations.

A reading of this case labors heavily under the weight of the Court's presentation of examples of how LIFO works in the dollar-value context, and how the dollar-value method may allow a taxpayer to liquidate its investment in a LIFO pool without incurring a tax on past inflation.

Tax Court's discussion of the link-chain LIFO method. In setting forth its understanding of how the link-chain method works, the Tax Court included an illustration of how the computation is (supposed) to adjust the increment for changing unit costs or values over a 3-year period. This is based on the requirements found in Reg. Sec. 1.472-8(a). For the first year, the Court uses the same facts (and gets the same results) as are found in the example of the doubleextension (dollar-value) method in the Regulation.

Following that, the Court includes a second example (of its own making) which is intended to show the continuity of the link-chain methodology in the second year. The Court observes that "the computational procedures for the link-chain method are described by the Commissioner in Revenue Procedure 97-36 at Sections 2.04(1)(c) and (d) (1997-2 C.B. 450, 451).

Even the Tax Court became confused. Ironically, even the Court became confused and incorrectly stated (in its own Example 2) that the result of its computation of the LIFO reserve at the end of the second year was \$10,121. In fact, the LIFO reserve at the end of the second year under the facts given must be \$9,673. The Tax Court generously included more inflation than it should have in the cost of goods sold and in the taxpayer's LIFO reserve.

The Court added a third year to its link-chain example to illustrate how a decrement or liquidation of inventory in the pool would be reflected in the LIFO

see HUFFMAN ET AL. - LINK-CHAIN CALCS, page 10 Photocopying or Reprinting Without Permission Is Prohibited

Huffman et al. - Link-Chain Calculations

computations at the end of the third year. The amounts used in the example are such that the decrement experienced in the third year was large enough to entirely offset the increment which was incorrectly valued in the second year. Accordingly, the LIFO reserve at the end of the third year which the Court computed as \$7,740 was the correct result. However, what had happened as a result of the incorrect calculation in the second year was that the error in the second year was washed into the net result for the third year. (Was this the Court's indirect way of illustrating the "timing difference" aspects?)

In a footnote, the statement/observation is made that ... "The LIFO reserve measures the potential gain built into the inventory pool." Unfortunately, the impact of this statement and the easy verification of the correct amount was overlooked by the Tax Court in trying to explain its own LIFO calculations. See *Even* the Tax Court Became Confused on pages 22-27.

THE TAX COURT'S LEGAL ANALYSIS

Regulations. The Tax Court's legal analysis begins with an examination of the controlling Regulation (Reg. Sec. 1.446-1(e)(2)), which gives content to the term "method of accounting." The Court summarized its discussion of the Regulation by indicating that it appears to settle the matter in dispute in favor of the IRS.

Case law. However, because various courts have not been uniform in their evaluation of consistency and timing matters, the Tax Court next turned its attention to the cases cited by both the IRS and by Huffman in advancing their arguments.

In discussing the case law, the Tax Court pointed out an important distinction involving cases decided before and after 1970. This distinction is created by the fact that in 1970, Reg. Sec. 1.446-1(e)(2) and (3) were revised to add some clarifying language. Accordingly, although Huffman had cited many pre-1970 cases in support of its arguments, the Tax Court felt it necessary to analyze only those cases that were decided after 1970.

In this regard, *Primo Pants Co. v. Comm.* turned out to be the case which impressed the Court (as well as the IRS) and which it found most supportive of the Section 481(a) adjustments proposed by the IRS. Four other post-1970 cases cited by the taxpayer on which the Court specifically commented were (1) *Korn Industries, Inc. v. U.S.*, (2) *Evans v. Comm.*, (3) *Gimbel Brothers, Inc. v. U.S.*, and (4) *Standard Oil Co. v. Comm.* In each of these cases, the Court found that the facts in Huffman were distinguishable.

See pages 14-19 for more of the Tax Court's analysis.

TAX COURT UPHOLDS THE IRS

In the end, the Tax Court held that the IRS was correct. For the first open year of each of the dealerships, the IRS' revaluation of the dealership's inventory constituted a change in the method of accounting. Therefore, the IRS' adjustments under Section 481(a) were permissible. Accordingly, each individual who owned shares of stock in any members of the Huffman group was required to take into account his or her share of the Section 481 adjustments.

SOME THOUGHTS TO PONDER

For A Few Lessons and Other Observations from Huffman, see pages 20-21. Also, a few thoughts on considering the position of the CPA, whose computations unfortunately resulted in the IRS adjustments, appear on page 28 in the discussion How Critical Should One Be in Evaluating LIFO Competence?

LIFO'S GOLDEN RULE ... THE PROOFS NEVER FAIL

LIFO's golden rule... The quintessence of LIFO can be simply stated ... LIFO gives the taxpayer a deduction for its estimate of the impact of inflation in ending inventory. Nothing more, nothing less. The Tax Court has consistently rejected taxpayers' LIFO calculations where it has been shown that the LIFO reserve (or the LIFO computations) reflected any factors **other than inflation**.

In teaching LIFO basics and computations to CPAs for over 30 years, I have always stressed the importance of reconciling the LIFO reserve at the end of the year in terms of the amounts contributed to the reserve by each year's layer of inventory increment. This permits one to confirm the correctness of the computation of the LIFO reserve at the end of **any** year by applying a (proof) method that is independent of retracing all of the steps sequentially followed in arriving at the amount of the LIFO reserve.

Had these reconciliations been attempted by the accountant in *Huffman*, they might have led him to question the results he computed.

For a little more background on the technicalities of the *Huffman* case, we have included a discussion of the dollar-value LIFO method alternatives on page 29. A step-by-step discussion of the link-chain procedures is on page 30. A worksheet format for the link-chain calculation follows on page 31, and on page 32, we have shown the reconciliations or proofs of the increases in the LIFO reserve calculations illustrated under the link-chain method.

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Critical Distinction	"ELECTION" vs. "ADOPTION" OF A LIFO METHOD
Background	 The boxes checked on the Form 970 evidence the intention to elect LIFO and the LIFO methodology intended to be used by the taxpayer. Each box checked on Form 970, standing alone, evidences a method of accounting. <i>Query:</i> What happens when the computations actually made in valuing the inventory at LIFO reflect the use of a method(s) different from the election indicated by the Taxpayer on the Form 970? What controls? What the taxpayer said it was going to do? (i.e., the election on Form 970) or What the taxpayer actually did? (i.e., the method actually <i>adopted</i> by the taxpayer) In the <i>Huffman</i> case, the LIFO method that the taxpayer <i>elected</i> on Form 970 was arguably not the method that the taxpayer <i>adopted</i>.
Huffman LIFO Elections Further Technical Inconsistencies	 The parties stipulated that each member of the Huffman group filed an election to use the link-chain, dollar-value LIFO inventory method. These elections were effective for the members as of the close of their taxable years ending: Nissan, June 30, 1979; Volkswagen, Dec. 31, 1979; Dodge and Chrysler, Dec. 31, 1989. The documentation is inconsistent with the described elections with respect to two out of the four dealerships. Two corporations elected to adopt "an index method as provided in [Reg. Sec. 1.472-8(e)(1), which] will be developed by double extending a representative portion of inventory at beginning of year cost and current cost." The Tax Court observed that such an index method is distinct from the link-chain method purportedly adopted hy the dealerships. The Court did not alchorate any further on the nature of the distinction
IRS Position	 The arguments presented in the IRS reply brief emphasize the distinction the IRS makes between "electing" a LIFO method and "adopting" a LIFO method. "The Huffman Group never adopted the link-chain, dollar-value LIFO method. It is undisputed that from the time each member of the Huffman Group elected to use the link-chain, dollar-value LIFO method through the 1999 tax year, the Huffman Group's CPA consistently omitted a computational step required for using that method. "The Huffman Group had only elected, not adopted, the link-chain, dollar-value LIFO method. "There is a big difference between electing to use an accounting method and actually adopting an accounting method." Black's Law Dictionary defines adopt as "to accept, consent to and put into effective operation." "Unlike the cases petitioners cite to support their position that the CPA's mistake was a mere mathematical error, the Huffman Group never actually adopted the link-chain, dollar-value LIFO method, but instead consistently used an erroneous accounting method that utilizes some, but not all, of the steps required to use the link-chain, dollar-value LIFO method."
How the Tax Court Dealt with the Inconsistency Between LIFO Method Elected & LIFO Method Actually Used	 "Petitioners equate the elections by the members of the Huffman Group to use the link-chain method with the elections made by [other taxpayers] so that deviation and subsequent adherence do not amount to changes in any accounting method." Gimbel Bros., Inc. v. United States, 210 Ct. Cl. 17, 535 F.2d 14 (1976) Standard Oil Co. v. Commissioner, 77 T.C. 349 (1981) "[The IRS] distinguishes those cases by arguing that, though the members duly elected the link-chain method. "We [the Tax Court] agree with respondent that the facts of Gimbel Bros., Inc. and Standard Oil Co. are distinguishable from those now before us. "The parties have stipulated that, for each member, for the election and following years (i.e., for 10 or 20 years), the accountant omitted a computational step required by the (pertinent) regulations "We agree with respondent that the members may, individually, have elected the link-chain method, but no member adopted it until respondent made his corrections. "That alone distinguishes the facts before us from those in Gimbel Bros., Inc. and Standard Oil, Co., where the errors were committed in the context of a broader compliance with the taxpayer's proper method of accounting. "Moreover, although stipulated by the parties, it is questionable whether all four of the members actually elected to use the link-chain method to value their respective inventories"
Our Comments	 By distinguishing the facts in the two post-1970 cases relied on by the taxpayer from Huffman's own fact pattern, the Court did not have to pursue any further the technical distinctions between "electing a LIFO method" and "adopting a LIFO method." It seems incorrect to say that Huffman did not elect the link-chain method. Huffman did not elect <i>the</i> link-chain method as the IRS prescribes its computations. It might have been argued that Huffman elected a "hybrid-" or "quasi-" link-chain method which reflected an erroneous valuation of annual increments clearly, a method of LIFO accounting that it always consistently followed, albeit an incorrect method, at that. See <i>Dollar-Value LIFO Method The Technicalities</i>, on page 29, for brief technical discussions.

INCORRECT RELIANCE ON RICHARDSON ... THE ROOT OF THE PROBLEM

Page 1 of 2

INSIGHTS INTO THE ACCOUNTANT'S MISTAKEN RELIANCE ON THE RICHARDSON CASE

Some insight may be gained in this area from the reply brief filed by the IRS dated Jan. 18, 2005 in the *Huffman* case. In its brief, the IRS requested "additional findings of fact." Some of this appears in the Tax Court's decision.

- Huffman's CPA learned about the link-chain, dollar-value LIFO method from a friend and another person who worked for the accounting firm of Peat Marwick Mitchell. (Apparently, this firm had made the LIFO election for the first member of the Huffman group to go on LIFO.)
- The CPA's contacts at that accounting firm referred him to the case of *Richardson Investments, Inc. v. Comm.* (76 T.C. 736 (1981))
- The CPA read and relied on two sentences in this case as the basis for his calculations for the Huffman group's LIFO inventories. The CPA said that he did not rely on any legal authorities other than *Richardson*.
- The CPA thought that the end result of the link-chain, dollar-value LIFO method calculations was described by the two sentences emphasized below from the *Richardson* case ...
 - "In the link-chain method, generally, a representative portion of the closing inventory in a year is valued at both current cost and by the unit cost used in valuing the closing inventory in the preceding year. The ratio of current year cost to cost used in prior year reflects the increase in prices for the year. In the year of conversion, the cost will be identical and the resulting index will be 1.00. In subsequent years, assuming rising prices, the ratio of current year cost to prior year cost will be a figure greater than 1.00. The object of the link-chain method is to relate statistically current price increases to all prior years. This is accomplished by attaining a so-called "cumulative index" for all years after the year of conversion. To obtain a cumulative index, the current index for the first year after conversion is multiplied by the current index of the year of conversion. Thereafter, the cumulative index is obtained by multiplying the current index by the prior year's cumulative index. MATHEMATICALLY, THE CLOSING INVENTORY VALUED AT CURRENT PRICES, WHEN DIVIDED BY THE CUMULATIVE INDEX, WILL YIELD THE VALUE OF CLOSING INVENTORY AT BASE YEAR COST THE LIFO VALUE OF THE CLOSING INVENTORY. BECAUSE BOTH OPENING AND CLOSING INVENTORIES WILL BE VALUED AT CURRENT PRICES."
- Immediately following this paragraph (which included the two sentences on which the CPA relied), the Tax Court described the eleven steps *Richardson* actually took in computing the link-chain, dollar-value LIFO ending inventory amounts.
- The CPA did not do the step in *Richardson* that requires that any increment be multiplied by the cumulative index.
- Throughout, the CPA believed that he had properly and correctly computed the LIFO valuations for the Huffman group.
- "Prior to being contacted by respondent's (i.e., IRS') counsel the week before the trial, the CPA had never heard of Fox Chevrolet, Inc. v. Comm. (76 T.C. 708 (1981))."
- Both Fox Chevrolet and Richardson Investments were issued on the same day (May 11, 1981) by the Tax Court.
- In fact, the Tax Court decision in *Richardson* specifically refers to *Fox Chevrolet*.
 - In a case released today, Fox Chevrolet, Inc. v. Commissioner, 76 T.C. 708 (1981), this Court held that a franchised Chevrolet dealer of new cars and trucks must place new cars and new trucks in separate pools. The Court in Fox found that the cars and trucks are two separate classes of goods. The Court took note of the fact that there were more than mere cosmetic differences between the two products and that licensing requirements for trucks, both with respect to the vehicle and the operator, can differ. That case is controlling, and, of course, its rationale is equally applicable in the instant case.
- The step (for valuing an increment at current cost) that the CPA omitted is described in both Fox Chevrolet and Richardson Investments. This step is also described in the LIFO Regulations.
- The CPA did not read the LIFO Regulations.
- The LIFO Regulations do not refer to the link-chain, dollar-value LIFO method, but instead describe the required steps as the "double extension method" and include an example of the double extension method at Reg. Sec. 1.472-8(e)(2)(v).
- "LIFO ... is not complex and is a very, very simple computation."
- "LIFO has been a difficult area for Revenue Agents in the past, but is not complex and is a very, very simple computation."
- According to the IRS, the CPA's mistake was not a mathematical error because, after all, LIFO is not really that complicated.
- These statements are the opinion of the IRS Inventory Specialist (not the examining agent) who testified at the trial.

INCORRECT RELIANCE ON RICHARDSON ... THE ROOT OF THE PROBLEM

Page 2 of 2

SOME OBSERVATIONS

- The two key sentences in Richardson on which the CPA mistakenly relied were presented above in full context.
 - The first part of the first sentence (up to the dash) is correct ... "Mathematically, the closing inventory valued at current prices, when divided by the cumulative index, will yield the value of closing inventory at base year cost. ..." That statement is correct.
 - The last part of the first sentence (after the dash) is incorrect ... "... the LIFO value of the closing inventory."
 - What is mathematically derived (as expressed by the words in the first part of the sentence) is actually the value of the closing inventory expressed in base dollars *before* the increment for the year, if any, is multiplied by the appropriate cumulative index in order to value the increment at its *current cost*.
 - This is the amount which must be determined as part of step (5) in order to continue on to the computation of an increment (or decrement) in step (6).
- Both the Fox case and the Richardson case involved the issue of whether an auto dealer could utilize a single pool for new cars and for new trucks. The Tax Court held in both cases that the auto dealers had to utilize one pool for new cars and a separate pool for new (light-duty) trucks.
- In describing the LIFO computation steps that *Richardson* used, there was one complication that one might say was "lurking beneath the surface." *That complication was that Richardson was apparently using an earliest acquisition or dual-index approach for valuing any increments computed under its LIFO methodology.*
 - The last six steps of Richardson's computation are described in the Richardson case as follows...
 - (5) To determine the index to reduce current inventory to base year costs, a current to base year index is computed. The current year's ending inventory is valued at actual cost and at beginning inventory cost. The current to base year index is obtained by dividing ending inventory at actual cost by ending inventory at beginning inventory cost. Ending inventory valued at base year costs is the ending inventory at actual cost divided by the index. In years after the year of conversion, the current to base year index is obtained by multiplying the current index times the prior year's cumulative index.
 - (6) Computation of increment (or decrement). The increment or decrement with reference to base year costs is the difference between the ending inventory valued at base year costs and the previous year's ending inventory at base year costs.
 - (7) The current year's inventory is then valued at earliest purchase cost (adjusted for cost increases between the first and the last purchases).
 - (8) The increment of inventory is then valued at earliest purchase value.
 - (9) Ending inventory at LIFO value. The previous year's inventory at base year costs is added to the increment at earliest purchase value.
 - (10) Total LIFO reserve. The total LIFO reserve is the ending inventory at actual cost less the ending inventory at LIFO value.
 - Note that step (7) says that the current year ending inventory "is then valued at earliest purchase cost" and step (8) says that the inventory increment "is then valued at earliest purchase value."
 - Is it possible that Huffman's CPA was confused by (or did not understand) the procedures that Richardson followed?
 Bishardson elected LIEO in 1974 and its first way LIEO calculation was at issue. Possibly because it used
 - Richardson elected LIFO in 1974 and its first year LIFO calculation was at issue. Possibly because it used an earliest acquisition approach for valuing its increment, its computations may have produced a 1.000 inflation index for its earliest acquisitions in that year. If so, then multiplying the increment for that year (and only that year) by 1.000 would have been consistent with its election (even though the IRS might not necessarily have agreed with that procedure).

RELIANCE ON OTHER FACTORS ... PRIOR IRS AUDITS ADDRESSED, BUT DID NOT CHANGE, LIFO CALCS

- Huffman's CPA testified that he definitely had relied on at least one other factor ... the IRS had audited the dealerships' LIFO calculations in several prior audits and had made no changes to them.
- Six different IRS Agents audited the dealerships six different times over the years. They requested and were provided copies of all calculations, but (until the last audit) they never made any changes to the Huffman's LIFO calculations.
 - One agent even complimented the taxpayer on how good the LIFO calculations were.
- The position of the IRS in the *Huffman* case was that it is not bound by the actions of its examining agents in prior years' audits. "... The fact that Respondent (the IRS) 'had the opportunity to, but did not, change an improper method of accounting in an earlier year does not mean that he is estopped from making the change in later year." [Citations omitted]

	CHANGE IN ACCOUNTING METHOD vs. CORRECTION OF AN ERROR?
Huffman, et al.	WHAT THE TAX COURT SAID
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Introduction	 A notable feature of Section 481 is that the adjustments called for by the Section may be made notwithstanding the fact that the period of limitations on assessment and collection of tax may have closed on the years (closed years) in which the events giving rise to the need for an adjustment occurred. While Section 481 may not necessarily conflict with the statute of limitations found in Section 6501, it does place a premium on distinguishing between the correction of errors (which is limited to open years) and a change in a method of accounting (which implicates Section 481). A determination that the accountant's error was a <i>mathematical error</i> would work in Huffman's favor. That is because, whether the adjustments accepted by Huffman result from the correction of mathematical errors or from accounting method changes, the adjustments result in a decrease in each member's LIFO reserves as of the beginning of the member's first year in issue, without any concomitant recognition of gain. If the adjustments result from the <i>correction of mathematical errors</i>, then the unrealized gains eliminated by the decreases in LIFO reserves result from changes in the members' methods of accounting, then the IRS' Section 481 adjustments will capture the unrealized gain eliminated by the decreases. It is necessary to examine both the pertinent Treasury Regulation and case law in order to distinguish between error correction and an accounting method change.
Reg. Sec. 1.446-1(e)(2) In General	 Reg. Sec. 1.446-1(a) gives content to the term "method of accounting." Reg. Sec. 1.446-1(a) (2) gives guidance as to what constitutes a change in a method of accounting. Reg. Sec. 1.446-1(a)(2)(ii)(a) provides that a change involving the method or basis used in the valuation of inventories is a change in method of accounting. This is suggestive that the IRS' adjustments, correcting the accountant's consistent failure to value properly the members' closing inventories, constitute changes in the members' methods of accounting. Other provisions in Reg. Sec. 1.446-1(e)(2)(ii) give consistency and timing considerations an important, if not determinative, role to play in determining whether an adjustment constitutes a change in method of accounting. The accountant erred in applying the link-chain method. He did so consistently for each member, beginning in the year the member elected the link-chain method and ending only when the IRS found the error. The accountant's error resulted in income being under-reported for some (most) years and over-reported for other years. If not corrected, the (accountant's) error would not result in the permanent omission of income by the taxpayers. The accountant's error was an error in allocating the cost of goods available for sale during a year between (1) the items sol during the year and (2) the items on hand at the end of the year. Generally, under a system of inventory accounting, the value assigned to the items on hand at the end of one year establishes the value of the items on hand at the beginning of the next year. Consequently, the accountant's error was an error in timing. Because it was an error in the proper time for reporting an item of income (gain from sales), the accountant's error was an error in temptor. On that ground alone, IRS' change to the taxpayer's method would appear to be a change in a method of accounting, as that expression is used in Reg. Sec. 1.446-1(e)(2)(ii)(a).
Reg. Sec.	 However, a change in method of accounting does not include correction of mathematical or posting errors. (Reg. Sec. 1.446-1(e)(2)(ii)(b))
1.440-1(<i>e</i>)(2)	 Huffman argued that, in correcting the accountant's error, the IRS did no more than correct a mathematical or posting error.
Correction	• The Tax Court (in <i>Wayne Bolt & Nut Co., v. Comm.</i>) has interpreted the term "posting error" to be an
of	error in "the act of transferring an original entry to a ledger."
Errors	 Accordingly, the Tax Court concluded that Huffman's accountant made no "posting error."

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	CHANGE IN ACCOUNTING METHOD vs. CORRECTION OF AN ERROR?
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"Mathematical Error" Is an Error in Arithmetic	 Page 2 of 6 The term "mathematical error" is not, as stated, defined in the Regulations. Also, the term "mathematical error" has not been defined by the Tax Court or any other court for purposes of Reg. Sec. 1.446-1(e)(2)(ii)(b). The term "mathematical error" does, however, appear in the Internal Revenue Code, principally in Section 6213(b). This Section allows the unrestricted assessment and collection of tax arising out of mathematical or clerical errors. For purposes of Section 6213, the term "mathematical or clerical error" is defined by Section 6213(g)(2). As pertinent to Huffman, the definition of a "mathematical error" is "an error in addition, subtraction, multiplication, or division." Moreover, before Congress provided the specific definition of the term "mathematical or clerical error" found in Section 6213(g). Courts generally had limited the scope of the term "mathematical error" for purposes of Section 6213(b) and its predecessors to errors in arithmetic. The Tax Court said it had no reason to believe that the drafters of Reg. Sec. 1.446-1(e)(2)(ii)(b), intended the term "mathematical error" to have any meaning beyond its common meaning. Huffman failed to demonstrate to the Tax Court that the term "mathematical error" has a common meaning different from the common meaning found by the District Court in Repetti v. Jamison (i.e., an error in arithmetic). That definition of "mathematical error" comports with the scope of the term "posting error," with which the term "mathematical error" is associated in the Regulations. Accordingly, the Tax Court concluded that the term imathematical error decises he did not make an error in arithmetic. "He (i.e., the accountant) neither divided when he should have multiplication, or division). The court said that Huffman's accountant did not make a mathematical error because he did not make an error in arithmetic. "He (i.e., the accountant nered in tha
	adjustments not involving the proper time for inclusion of an item of income or the taking of a deduction.
The Case Law Must Be Considered	 The Tax Court said that although Reg. Sec. 1.446-1(e)(2)(ii) appears to be dispositive in the IRS' favor, the Court could not reach a decision in this case based solely on the Regulation. The reason why the Court had to go further in its inquiry/analysis was because "courts addressing the issue of whether a change in method of accounting has occurred have not uniformly given consistency and timing considerations the weight given (to) those considerations by the Regulations."
Case Law, with 1970 as a Benchmark because of Changes in the Regulations in 1970	 The Tax Court said that it is necessary to distinguish between cases decided before and after 1970 in considering the case law dealing with what constitutes a change in method of accounting. Before 1970, courts were mostly left to their own devices to resolve whether an accounting adjustment rose to the level of a change in method of accounting. In 1970, the Treasury revised Reg. Sec. 1.446-1(e)(2) and (3). These 1970 revisions included The addition of the language found in paragraph (e)(2)(ii)(a) to the effect that, although a pattern of consistent treatment is not necessary to establish a method of accounting for an item, "in most instances a method of accounting is not established for an item without such consistent treatment." The redefinition of the term "material item" (also found in paragraph (e)(2)(ii)(a)) to provide the qualification that "A material item is any item which involves the proper time for the inclusion of the item in income or the taking of a deduction." Before the 1970 revision, the term "material item" was unqualified. The addition of rules of exclusion (found in paragraph (e)(2)(ii)(b)) to provide that a change in method of accounting includes neither (i.e., does not include) the correction of mathematical or posting errors, nor the adjustment of any item of income or the taking of a deduction of the item of income or the taking of a deduction of the item of income or the taking of a deduction of the item of income or the taking of a deduction.

A Quarterly Update of LIFO - News, Views and Ideas

	CHANGE IN ACCOUNTING METHOD vs. CORRECTION OF AN ERROR?
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The Taxpayer's Position	 The Tax Court described Huffman's argument is as follows "It has long been held that where a taxpayer properly elects a particular accounting method, the making by the taxpayer of an error in the use of that accounting method." The Court observed that Huffman's argument rested on the premise that a taxpayer does not change its method of accounting by deviating from it. The Court added, "If the premise is sound, then the taxpayer does not change its method of accounting by correcting that deviation, since before, during, and after the deviation, the taxpayer used the same method of accounting." The Court observed that Huffman could find some support for its premise in cases holding that a taxpayer does not change its method of accounting when it does no more than conform to a prior accounting election or some specific requirement of the law. However, many of the cases that Huffman relied on in support of its position were decided before the 1970 revisions to Reg. Sec. 1.446-1(e) which emphasized consistency and timing considerations. <i>Thompson-King-Tate, Inc. v. United States, 296</i> F.2d 290 (6th Cir. 1961) <i>N.C. Granite Corp. v. Commissioner, 43</i> T.C. 149 (1964) <i>Underhill v. Commissioner, 45</i> T.C. 489 (1966) The Court said that the precedential value of these three cases was uncertain because they were decided before 1970, and they did not address the consistency and timing considerations that were emphasized by the changes in 1970 to Reg. Sec. 1.446-1(e)(2)(ii).
Primo Pants Co. 1982	 In Prime Parts Court said that it has generally agreed with Reg. Sec. 1.440-1(6)(2)(1) that consistency in multicly of timing defines a method of accounting. In Prime Pants Co., the Tax Court had concluded "Because we are here dealing with inventory, where one year's closing inventory becomes the next year's opening inventory, we are satisfied that the present case involves only postponement of income and therefore involves a timing question." Case Capsule Prime Pants Co. In Prime Pants Co. v. Commissioner (78 T.C. 705 (1982)), the taxpayer arbitrarily valued its finished goods inventory at 50% of selling price and its materials and work in process inventories at 50% of cost. The taxpayer contended that the Commissioner's adjustments to those values, eliminating the unwarranted discounts (and making certain other changes), were not a "change in the treatment of any material item." In making that assertion, the taxpayer argued that its discounting practices had nothing to do with proper time for reporting income. The Tax Court reached the opposite conclusion, based on its inquiry whether the taxpayer's discounting practices caused its lifetime income to be underreported or merely shifted the time at which some of that income was reported. In the Huffman case, the Tax Court said that it has applied a similar analysis in other cases to conclude that a change from a flawed method of accounting. In this regard, the Court cited Superior Coach, Inc. v. Commissioner (80 T.C. at 910) and Wayne Bolt & Nut Co. v. Commissioner (93 T.C. at 511). Huffman's accountant's error had precisely the same effect as did the taxpayer's discounting practices in Primo Pants Co i.e., the error served merely to alter the distribution of a lifetime income among taxable periods. Accordingly, the Tax Court said that Primo Pants Co. would seem to govern it here, requiring it to conclude that the IRS' adjustments to the Huffman Group members'

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	CHANGE IN ACCOUNTING METHOD vs. CORRECTION OF AN ERROR?
Hu <u>f</u> fman, et al.	WHAT THE TAX COURT SAID
	 Page 4 of 6 Huffman relied heavily on Korn Industries, Inc. v. U.S. to support its position that the IRS was merely correcting mathematical errors, and therefore, there were no accounting method changes. In one of its briefs, Huffman stated that in Korn Industries, the Court "ultimately concluded, based on facts closely analogous to those presented here (i.e., by Huffman), that there had been no change in a method of accounting on the basis that Taxpayer made inadvertent, mathematical errors." Huffman also noted in this brief the observation made by Gertzman with respect to Korn Industries that "the Court was obviously impressed with the taxpayer's history of reporting, the element of inadvertence, and the taxpayer's overall intent and practice."
Korn Industries, Inc. 1976 (This case is relied on heavily by Huffman in support of its position.)	consecutive years, the taxpayer, a furniture manufacturer, deviated from its long-established method of valuing inventories. For those 4 years, the taxpayer improperly omitted certain costs from the value of its finished goods inventory, which caused a correspondingly improper addition to the cost of goods sold and, thus, an understatement of gross income. On its tax return for the fifth year, the taxpayer showed a correct beginning inventory, which included costs that had been omitted from the previous year's ending inventory. The taxpayer viewed its action as the correction of an error and not as a change in its method of accounting. Therefore, the taxpayer accepted the Commissioner's adjustments to its beginning and ending inventories for the 2 preceding years (for which the period of limitations on assessment and collection had not run), but it objected to the Commissioner's Section 481 adjustment, which the Commissioner made to account for the disparity between the taxpayer's opening inventory for the second preceding year and its ending inventory for the third preceding year (which could not be adjusted since the period of limitations had run). If the taxpayer were correct, that its method of accounting had not changed, it would enjoy, in effect, a double deduction, to the extent of the costs improperly omitted from inventory in the first 2 years. The Court of Claims conceded that the taxpayer had not properly accounted for the omitted costs. Nevertheless, the Court agreed with the taxpayer that, in revaluing its finished goods inventory for the first open year, the Commissioner had not changed its method of accounting. The Court reasoned that the taxpayer's omissions were "inadvertent," and, thus, analogous to mathematical or posting errors, the correction of which would not have amounted to a change in method of accounting.
	 In discussing Korn Industries, Inc., the Tax Court in Huffman observed that "Taxpayers on other occasions have brought Korn Industries, Inc. to our attention In Superior Coach of Fla., Inc. v. Commissioner (80 T.C. at 912), we noted that some commentators had pointed out that the good-faith exception seemingly created by Korn Industries, Inc. appears to be without statutory authorization Indeed, assuming that consistently made accounting errors are generally inadvertent (i.e., made in good faith), an inadvertence-based exception to the general rule (that the consistent treatment of an item amounts to a method of accounting) would seem to swallow that general rule." The Tax Court in Huffman said "We need not resolve that conundrum today, because, as in the past, the facts before us are distinguishable from those in Korn Industries, Inc. v. U.S." The Tax Court said that Huffman's facts are distinguishable from those in Korn Industries, Inc (Unlike in Korn Industries, Inc.), the Huffman "accountart's error in failing properly to apply the link chain method was neither An interruption in a history of proper application of that method, Nor was it restricted to only a portion of the costs to be taken into account in valuing inventories."

	CHANGE IN ACCOUNTING METHOD vs. CORRECTION OF AN ERROR?
Huffman, et al.	WHAT THE TAX COURT SAID
	 Page 5 of 6 Huffman also relied on Evans v. Commissioner to support its position that the IRS was merely correcting mathematical errors, and therefore, there were no accounting method changes.
Evans 1988	 Case Capsule Evans In Evans v. Commissioner (T.C. Memo 1988-228), the question was whether individual taxpayers on the cash method of accounting had established a different method of accounting for employment-related bonuses by, for 3 years, reporting such bonuses in the year in which the bonuses were authorized rather than in the year in which they were received. The taxpayers argued that, for those 3 years, they had merely misapplied the cash method and, therefore, no change in accounting method was involved when, in the fourth and fifth years, they changed their practice of reporting bonuses, from the year authorized to the year received, and reported the fourth year's bonuses in year five. The Tax Court agreed, concluding that the taxpayers never intended to adopt an accrual method of accounting for bonuses and their change in practice merely corrected inadvertent errors analogous to posting errors. The Tax Court, in part, supported its reasoning by citing Korn Industries, Inc. v. U.S. In disclaiming any precedential value that the Evans case might have in connection with Huffman, the Tax
	 Court observed Evans v. Comm. is a Memorandum Opinion of the Court, and memorandum opinions are not binding. The conclusion the Tax Court had expressed in Evans (i.e., that the taxpayer merely misapplied the cash method), appears to contradict an example in the Regulations interpreting Section 481. Reg. Sec. 1.4461(e)(3)(iii), Example 2 involves a taxpayer who consistently reports its income and expenses on an accrual method of accounting except for real estate taxes, which it reports on the cash method of accounting. The example concludes that a change in the treatment of real estate taxes from the cash method of accounting to an accrual method of accounting is a change in method of accounting practice. It is doubtful that intent plays a significant role in determining whether a taxpayer has adopted a method of accounting "If the change affects the amount of taxable income for 2 or more taxable years without altering the taxpayer's lifetime taxable income, then it is strictly a matter of timing and constitutes a change in method of accounting."
Gimbel Brothers 1976 & Standard Oil 1981	 Huffman cited two additional cases for the proposition that a taxpayer does not change its method of accounting when it corrects a deviation from a previously elected method of accounting. Gimbel Bros., Inc. v. United States, 210 Ct. Cl. 17, 535 F.2d 14 (1976) Standard Oil Co. v. Commissioner, 77 T.C. 349 (1981) Huffman wanted to equate the elections by the members of the Huffman Group to use the link-chain method with the elections made by the taxpayers in these two cases. If this similarity held up, then deviation (from an accounting method. The IRS argued that Gimbel Brothers, Inc. and Standard Oil, Co. could be distinguished from Huffman. According to the IRS, although the Huffman Group members duly elected the link-chain method, the Huffman Group never adopted the link-chain method because the method was never properly applied. The Tax Court agreed with the IRS that the facts of Gimbel Bros., Inc. and Standard Oil Co. are distinguishable from Huffman. The parties stipulated that, for each Huffman Group member, for the election and following years (i.e., for 10 or 20 years), the accountant omitted a computational step required by the regulations governing the dollar-value method, but no member adopted it until the IRS made its corrections to the LIFO calculations. "That alone distinguishes the facts before us from those in Gimbel Bros., Inc. and Standard Oil, Co., where the errors were committed in the context of a broader compliance with the taxpayer's proper method of accounting. "Moreover, although stipulated by the parties, it is questionable whether all four of the members' actually elected in the Form 970 disclosures and attachments.

	CHANGE IN ACCOUNTING METHOD vs. CORRECTION OF AN ERROR?
Huffman, et al.	WHAT THE TAX COURT SAID
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The Tax Court's Further Discussion	 There is an evident incongruity between Reg. Sec. 1.446-1(e)(2)(ii) which gives consistency and timing considerations an important, if not determinative, role to play in determining whether the treatment of an item constitutes a method of accounting, and The proposition, advanced by Huffman and evidenced by a body of case law (including cases of this Court), that a taxpayer does not change its method of accounting when it does no more than conform to a prior accounting election or some specific requirement of the law. The notion that a taxpayer does not change its method of accounting when it merely conforms to a prescribed (but ignored) method of accounting is contradicted by at least one example in the Regulations Reg. Sec. 1.446-1(e)(2)(ii)(c), Example (1) Moreover, the notion (above) is also inconsistent with the more recent view of the courts that a taxpayer needs the Commissioner's consent to change from an erroneous to a correct method of accounting. See Wayne Bolt & Nut Co. v. Commissioner (93 T.C. at 511) "A change in method of accounting occurs even when there is a change from an incorrect to a correct method of accounting." There are also three examples in Reg. Sec. 1.446-1(e)(2)(iii)(c) holding that an impermissible method of accounting is a method of accounting a change from which requires the consent of the Commissioner Examples (6), (7), and (8). The Tax Court in Huffman said "We question whether there is vitality to the notion that a taxpayer conforming to a required but theretofore ignored method of accounting does not change its method of accounting does not change its method of accounting is a method of accounting a change from the is of accounting does not change its method of accounting is a method of accounting a change from whether there is vitality to the notion that a taxpayer conforming to a required but theretofore ignored method of accounting does not change its method of accounting to a requi
	 accounting by so conforming." The Tax Court in <i>Huffman</i> provided the following example "Consider a taxpayer that elects a method of accounting and, for some time, adheres to the method (thereby adopting it). "The taxpayer then, for some time, deviates from the method before, again, adhering to it. "The notion that the taxpayer did not change its method of accounting when it either, first, deviated from the method or, thereafter, adhered to the method is a notion that is narrower than the previously described notion, and it is one we have supported. (See, e.g., <i>Evans v. Comm.</i>, T.C. Memo. 1988 at 228.)" "We have not (i.e., the Tax Court has not), however, been consistent in holding that a taxpayer does not change its method of accounting when it does no more than adhere to a method adopted pursuant to a prior accounting election. See, <i>Sunoco, Inc. & Subs. v. Comm.</i>(T.C. Memo 2004-29), <i>Handy Andy T.V. & Appliances, Inc. v. Comm.</i> (T.C. Memo 1983-713), and <i>First Natl. Bank of Gainesville v. Comm.</i> (88 T.C. 1069 (1987)).
Question:	• The Tax Court said that its inconsistency in holding that a taxpayer does not change its method of
How "Long" Does It Take before "Short" Becomes "Long?"	 accounting when it does no more than conform to a prior accounting election is not necessarily inconsistent with Reg. Sec. 1.446-1(e)(2)(ii)(a). That is because, generally, pursuant to that Regulation, consistency is important It is the consistent treatment of an item involving a question of timing that establishes such treatment as a method of accounting. Therefore, a short-lived deviation from an already established method of accounting need not necessarily be viewed as establishing a new method of accounting. If not so viewed (i.e., if a short-lived deviation does not necessarily establish a new method), then neither the deviation from, nor the subsequent adherence to, the method of accounting would be a change in method of accounting.
Answer: More Than 10 Years Is Not "Short"	 The \$64 question, of course, is "What is short-lived?" The IRS' position is that consistency is established (for purposes of Reg. Sec. 1.446-1(e)(2)(ii)(a)) by the same treatment of a material item in two or more consecutively filed returns. (See Rev. Proc. 2002-18, 2002-1 C.B. 678.) The Tax Court has said something similar in Johnson v. Comm., (108 T.C. 448 at 494). In Huffman, the Tax Court said "We need not today determine how long is short Here, even if we were to assume that the members elected the link-chain method and adopted it, no [Huffman Group] member deviated from the link-chain method for less than 10 years. That is not a short-lived deviation." In other words, a deviation for longer than 10 years is not a "short-lived" deviation."
The Tax Court's Conclusions	 The accountant consistently erred in applying the link-chain method. His error was an error in timing. The accountant's error was not either a mathematical or a posting error. While, in some circumstances, a taxpayer deviating from its previously established method of accounting may again adhere to its established method before the deviation has time to harden into a method of its own, <i>the accountant's consistent error for no less than 10 years rules out that possibility</i>. The accountant's method was, therefore, a material item in each Huffman Group member's overall plan of accounting. The IRS' change to the accountant's method (a material item) was, thus, a change in method of accounting and it was proper to require the adjustments under Section 481(a).

A FEW LESSONS & OTHER OBSERVATIONS FROM HUFFMAN

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First, how does the Alternative LIFO Method for New Vehicles (Rev. Proc. 92-79 and 97-36) fit into the overall Huffman picture?

Although the Tax Court definitely refers to the existence of the Alternative LIFO Method for automobile dealers, its references are only to the effect that the IRS has addressed LIFO computations for auto dealers and provided a procedural ruling.

Huffman's CPA was clearly aware of the Alternative LIFO Method when it was first promulgated (in 1992) because it had come just after the conclusion of one of the many IRS audits of the Huffman group dealerships. The CPA said he clearly recalled the examining agent complimenting him on his LIFO workpapers and procedures, and these comments reinforced his belief that there was no need to file a Form 3115 and change to the Alternative LIFO Method. After all, he thought he was doing everything just as it should be done.

Many articles over the years in the *LIFO Lookout* have discussed the Alternative LIFO Method. When it first became available in 1992, as well as in subsequent articles, we stated, in no uncertain terms, that we felt that one of the most compelling reasons for changing to that Method was that voluntarily changing to it would afford protection for those dealerships whose LIFO calculations might be subject to challenge by the IRS. These situations included LIFO calculations for auto dealers that were using a dual-index approach (i.e., an earliest acquisitions approach) for valuing the dealer's annual LIFO increments, dealerships where a single pool for all new vehicles was used (rather than two pools - one for new cars and another for new trucks), or where a multitude of other averaging techniques or improper computational approaches were being employed.

I am aware that a number of our readers jumped at the chance to change their dealers' LIFO methods back in 1992 because the a voluntary change to the Alternative LIFO Method afforded dealerships "audit protection," and thus, locked in the components of the LIFO reserves that were attributable to "factors other than inflation."

In this context, in general terms, one could describe the method used by Huffman as the "base dollar" approach for valuing all increments ... i.e., every annual increment was multiplied by 1.000, which mathematically produced a result equal to the base dollar amount of the increment. No surprise here, nor no mathematical error ... Just an indefensible method! A comparison of this approach with the step-by-step list of procedures included in the Revenue Procedures for the Alternative LIFO Method would easily have shown that the Huffman computations were not consistent with the requirements of the safe-harbor calculation method.

Second, the IRS (unsuccessfully) made a big issue over whether the CPA should be allowed to testify at the trial.

The taxpayers argued that the CPA's intent and belief that he was doing the computations properly should be taken into consideration. They argued that, in at least one case, *Korn Industries*, the Court had concluded on arguably analogous facts that there had been no change in accounting method on the basis that the taxpayer made inadvertent, unintentional mathematical errors.

The IRS took the position that there is no subjective element in the Code involved in determining whether a Section 481(a) adjustment is needed. The IRS said that whether or not the CPA had any intent to do the LIFO calculations incorrectly was irrelevant and of no concern. It cited *Buyers Home Warranty Co. v. Comm.* (T.C. Memo 1998-98) ... "There is nothing in the statute or Regulations concerning what to do if the taxpayer thought, incorrectly, that the method used clearly reflected income. The IRS is concerned with collecting the correct amount of revenue. Nowhere in the applicable provisions of the Code does the taxpayer get credit if it thought it correctly calculated income. If the taxpayer acts in good faith, but is incorrect, it owes the deficiency." [Emphasis added.]

The IRS went so far as to file a *motion in limine* to try to prevent Huffman's CPA from testifying at the trial. It said the accountant's testimony in this regard would be a waste of the Court's time. Tax Court felt otherwise and denied the IRS' motion, and the CPA did testify.

Third, because the IRS dragged its feet during the administrative aspects of its audit, the IRS was not permitted to charge interest for a portion of the period.

The IRS proposed deficiency was issued to the taxpayers on August 24, 2001, and the taxpayers timely filed a protest on September 1, 2001. However, the IRS failed to schedule an Appeals Conference until October 9, 2002 - more than one year later. Then, more than one year after the last Appeals Conference, the IRS mailed a Notice of Deficiency on December 19, 2003.

The taxpayer and the IRS, in their joint stipulation of facts, agreed that the IRS did not provide a Notice to Huffman specifically stating the liability and a basis for the liability before the close of the 18-month period beginning on the later of (1) the date the applicable return was filed or (2) the due date of the return (without regard for extensions). Therefore, interest was to be suspended for the applicable periods in accordance with Section 6404(g) of the Code.

A FEW LESSONS & OTHER OBSERVATIONS FROM HUFFMAN

Page 2 of 2

Fourth, there is a significant difference between (1) electing a LIFO method and (2) adopting that LIFO method.

The Tax Court indicated that it agreed with the IRS on this point. We have discussed this fully on page 11. We have seen far too many cases over the years where the Form 970 completed by the CPA was (significantly) inconsistent or at odds with the methodology actually employed in the doing of the LIFO computations.

The IRS' legal arguments to distinguish the "election" of an accounting method by a taxpayer from the "adoption" of that accounting method by the taxpayer were persuasive to the Court and are full of warning for all of us.

Fifth, in our simplistic view, the taxpayer clearly had adopted a method of accounting for its LIFO inventories.

It seems incorrect for the IRS to argue that Huffman did not elect the link-chain method. Huffman did not elect *the* link-chain method as the IRS would require it to be computed. It might have been argued that Huffman elected a "hybrid-" or "quasi-" link-chain (dollar-value) method which (in its own right) is a method of accounting even though it reflects an erroneous valuation of annual increments ... clearly, a method of LIFO accounting that it always consistently followed, albeit an incorrect method, at that.

Viewed in this simplistic context, there is no question that the IRS/Commissioner was changing Huffman from an incorrect LIFO inventory method to a correct LIFO inventory method. Such changes require Section 481(a) adjustments.

Had the IRS framed its objections to Huffman's method as an objection to the method it used for valuing the increments, rather than arguing that the taxpayer had not adopted *the link-chain* method, then changing Huffman's incorrect method to a proper method would have eliminated the need for legal argument over whether what was involved was the correction of an error.

More importantly, framing the issues in this way would have eliminated the need for the Tax Court to become involved with the conundrum "how long is short?" The Tax Court was able to back away from this in the *Huffman* case because of the length of the LIFO elections involved. As the Court said, *"We need not today determine how long is short."*

Maybe not "today," but sooner or later some court will have to wrestle with this issue. It seems like only a matter of time before other taxpayers present the Tax Court with tougher calls if, for example, only a "few years" are involved instead of, as in *Huffman*, 10 or 20 years.

Sixth, it is surprising that the Tax Court did not emphasize the failure of the LIFO calculations to "clearly reflect income."

In many LIFO inventory cases decided by the Tax Court, the Court has placed significant emphasis on the requirement that the results must "clearly reflect income," as this is a requirement of Section 472. The IRS briefs raise this directly.

"The Code requires that the change to and the use of LIFO methods must be in accordance with Treasury Regulations to ensure that the use of the LIFO method *clearly reflects income* [I.R.C. Section 472(a)]. Taxpayers may elect to use the dollar-value LIFO method ... 'provided that such method is used consistently and clearly reflects the income of the taxpayer [Reg. Sec. 1.472-8(a)].""

After further development, the IRS brief states ... "The Huffman Group's combined taxable income was understated for sixteen (16) of the twenty-one (21) years from 1979 through 1999. [Therefore,] ... the impermissible accounting method *did not clearly reflect* petitioners' incomes."

Surprisingly, the Tax Court opinion does not seem to pick up on this argument by the IRS ... Other than obviously supporting it in reaching the conclusion that the Section 481(a) adjustments to the earliest open years were proper. Instead, the Court freighted a good portion of the case with a recitation of LIFO mechanics examples ... and, in the process, even got itself confused.

Our discussion in *Even the Tax Court Became Confused (Actually, the Tax Court Did It Wrong!)* shows that the incorrect computation of a LIFO reserve can easily be discovered by applying a simple mathematical (dare one say "accounting?") technique. By this, I mean proving the composition of the LIFO reserve, and thereby showing that under the method employed by the CPA (or by the Tax Court, in the case of its own *Example 2*), the computed LIFO reserve either does or does not contain the correct and exact amount of inflation. If the LIFO reserve is not the exact amount that the mathematical proof requires, then the LIFO reserve includes factors other than inflation (i.e., errors), and it should be adjusted to reflect the proper amount (of inflation).

I have employed these proofs in my LIFO calculations for over 40 years. Many other CPAs have employed them also. These proofs are infallible, and they have *never* failed. The math *is* simple and unerring ... it's the assumptions that can be wrong.

Finally, how critical should one professional be in evaluating competence in handling LIFO matters?

Frankly, there are too many subjective considerations involved with this question to even attempt an answer. But, that doesn't mean that the question isn't worth considering. To that end, you'll find a few thoughts on this subject on page 28.

Link-Chain LIFO Cales	<u>EVEN THE TAX COURT BECAME CONFUSED</u> Page 1 of 6					
Background	 The Background portion of the Huffman case includes detailed discussions of the Tax Court's understanding of LIFO calculations based upon citations to LIFO treatises by Steven Gertzman and by Leslie Schneider. In observing that the Huffman LIFO calculations involved the link-chain, dollar-value LIFO method, the Court sought to present several Examples illustrating the application of that method. The Court described the application of the link-chain method over three consecutive years using three examples one Example for each year. Unfortunately, the Tax Court, itself, misunderstood how the link-chain method really works, and its computation of the LIFO valuation of the inventory and the related LIFO reserve at the end of the second year (all in Example 2) is absolutely incorrect. It does not reflect what the dollar-value Regulations prescribe as the proper methodology. Ironically, because of the assumptions given in Example 3 for the third year, the LIFO reserve at the end of that third year is correct because there was a decrement in the third year. The Court's obvious errors in its Example 2 in no way negate the correctness of the conclusion the Court reached that the IRS adjustments under Section 481(a) to the beginning inventory of the earliest open years for the dealerships in order to correct the cumulative effect of the taxpayer's errors. Before relying upon the Tax Court's computations in Example 2, you should understand that the effect of the Tax Court's computations in Example 2 produces the same incorrect consequences that the Court said it could not accept in Huffman's LIFO valuation of the cost of the pool, An understatement of the gross income attributable to those sales, and An understatement of the LIFO value of the enviro of the pool. In support of the above, we have reprinted the entire portion of Example 2, with our related analysis. 					
Tax Court's Preamble to Example 2	"The following example, <i>Example (2)</i> , continues the facts of <i>Example (1)</i> . It is based on the assumption that, as of the beginning of Year 1, in addition to electing to compute its inventory by use of the dollar-value LIFO method, T elected to use the link-chain method to compute the base-year and current-year cost of its inventory pools. " <i>Example (2)</i> illustrates the computation of T's ending inventory for Pool No. 1 for Year 2. An increment in Year 2 closing inventory is determined to exist at base-year costs, and a LIFO value is assigned to that increment, using yearly increments in cost, as shown." [Emphasis added]					
Our Comments	The facts in the Court's <i>Example 1</i> are identical to the facts in Example 1 found in Reg. Sec. $1.472-8(e)(2)(v)$. Because that Regulation illustrates the <i>double-extension LIFO Method</i> , the Court could not use the second Example that is included in the Regulations. Therefore, the Court substituted its own facts to illustrate the second and third years calculations under the <i>link-chain LIFO Method</i> .					
Tax Court's Calculation of Current Cost Second Year	 Example (2): During Year 2, T completely disposes of Item A and purchases Item D, which is properly includible in Pool No. 1. T constructs a prior year unit cost for Item D. Dec. 31, Yr. 2, Inventory <					

Link-Chain LIFO Cales	<u>EVEN</u>	THE TAX COU	URT BECAME CO	<u>PNFUSED</u> Page	2 of 6
Tax Court's Calculation of Cumulative Index Second Year	 Cumulative index: Base-year cost of Dec. 31, Yr 1st year percentage link 2nd year percentage link (33, <u>Product</u>: chain percentage, De to Jan. 1, Yr. 1, base date (Base-year cost (\$ 33,500/1 	. 2, inventory: 500/26,250 = 127.62% cc. 31, Yr. 2, relative 121.25% x 127.62%) 54.74%)	121.25% 127.62% 154.74% \$ 21,649		
Our Comments	 Inflation in the inventory po \$24,250 / \$20,000 = 1.2125. The "base-year cost" of \$21,6 the second year expressed in beginning of the first LIFO year interval of 2 years. 	ol for the first year, 49 referred to above i base dollars with ear and moving forwa	referred to as "1st yes is technically the base da base dollars being meas rd or through to the end	ar percentage link," is compute ate cost of the inventory at the e ured by starting with 1.000 as c of the second LIFO year ov	ed as nd of of the er an
Tax Court's Calculation of Inventory LIFO Value Second Year	• The LIFO value of the inventor Jan. 1, Yr. 1, Base cost Dec. 31, Yr. 1, Increment Dec. 31, Yr. 2 Increment Totals	Dec. 31, Yr. 2, Inventory at Base - Year Cost 14,000 6,000 1,649 21,649	ecember 31, Year 2, is \$ Ratio (as a %) of Current-Year Cost to Base-Year Cost 100.00% 121.25% 127.62%	223,379, computed as follows: Dec. 31, Yr. 2, Inventory at LIFO Value 14,000 7,275 2,104 23,379	
Our Comments	 The LIFO value of the pool a The Court erred in its valuatio The Court incorrectly valu inflation experienced or rein in use. The increment for Year 2 s This factor or cumulative the inventory pool attrimethod was in use. 	t the end of Year 2, a n of the increment for led the increment for flected in the invento should have been value we index of 1.5474 rep butable to all years (s computed by the Tax Year 2 (\$1,649 express Yr. 2 at 1.2762 Th ry attributable to the sec ued using the cumulative presents the cumulative i.e., both the first year	Court, is absolutely incorrect. ed in base dollars). is factor / index represents only cond year that the LIFO method re index, or 1.5474 inflation experienced or reflect and the second year) that the L	y the was ed in LIFO
The Correct Computation	• The correct computation of the Jan. 1, Yr. 1, Base cost Dec. 31, Yr. 1, Increment Dec. 31, Yr. 2 Increment Totals	ne inventory at LIFO Dec. 31, Yr. 2, Inventory at Base-Year Cost 14,000 6,000 1,649 21,649	value at the end of the s Ratio (as a %) of Current-Year Cost to Base-Year Cost 100.00% 121.25% 154.74%	second year is \$23,827. Dec. 31, Yr. 2, Inventory at LIFO Value 14,000 7,275 2,552 23,827	

Link-Chain LIFO Cales	EVEN	THE TAX C	OURT BECAME	CONFUS	SED Page 3 of 6		
Tax Court's Calculation	• According to the Tax Court's <i>Example 2</i> , the LIFO reserve for Pool No. 1 as of December 31, Yr. 2, is \$10,121, computed as follows:						
of the LIFO Reserve Second Year	Dec. 31, Yr. 2, inventory at c Less: LIFO value of ending Equals: LIFO reserve	urrent-year cost inventory	\$ 33,50 3,37 10,12	0 9 1			
	 The correct amount of the LIFO reserve at the end of Year 2 is \$9,673 \$448 less than the Tax Court's. The Tax Court's error in computing the LIFO reserve at the end of Year 2 automatically follows from its incorrect computation of the LIFO value of the inventory. The computations are shown below. 						
Our Comments			As Incorrectly Computed by the Tax Court	As Correc Compute in Accords with th Regulatio	r 2 ctly ed ance e Difference		
	Dec. 31, Yr. 2, inventory a Less: LIFO value of endin <i>Equals: LIFO Reserv</i>	t current-year cost g inventory ve	33,500 23,379 10,121	33, 	500 - 827 (448) 673 448		
	 Mathematically speaking, it is absolutely and exactly be (ass The above statement holds double-extension, index, o Composition of LIFO resession in the sum Inflation attributable to election has been in eff Inflation attributable to year (Year 2). The inflation attributable to index at the end of the sum 	is very easy to pro- suming one accepts s true regardless of r link-chain. erve at end of Year n of the following tw the base inventory ect (i.e., throughout the increment for th lation experienced i econd year (1.5474)	ve what the LIFO rese the underlying comput whether the dollar-value 2. In the example abor wo components (expressed in base dol : Years 1 and 2), <i>plus</i> e first year (Year 1) but n Year 2 is measured by and the cumulative ind	ten 2 should be at the erections of the ue LIFO me ve, the LIFO llars) for the t only inflation by the difference lex at the beg	and of any given year should inflation indexes). thod used by the taxpayer is reserve at the end of Year 2 full 2-year period the LIFO on experienced in the <i>second</i> ence between the cumulative inning of that year (1.2125).		
Proof that the Tax Court Calculation Is Incorrect	Jan. 1, Yr. 1, Base cost Dec. 31, Yr. 1, Increment	Dec. 31, Yr. 2, Inventory at Base - Year Cost 14,000 6,000	Proof Factor for Amount Contr to LIFO Reser <u>by Each Year's Inc</u> (1.5474 - 1.0000) = (1.5474 - 1.2125) =	r ibuted rve crement 0.5474 0.3349	Dec. 31, Yr. 2, Composition of LIFO Reserve (Factor x Base Yr. Cost) 7,664 2,009		
	Dec. 31, Yr. 2 Increment Totals	1,649 21,649	(1.5474 - 1.5474) =	- =	9,673		
	 Note that under the methodolo no amount to the LIFO reserve IRS evidenced in its many chal Any amount (other than \$9,673) The Tax Court, and other cou other than inflation. Therefore not attributable to inflation. The amount of the difference second year (1.5474 - 1.276) increment for the second year 	gy above, any increase at the end of the c llenges to the use of alleged to be the LIF urts, have consister re, any amount eith in the computed LI 2 = 0.2712), which increment. [\$1,649	rment in the LIFO pool urrent year. This result a so-called "dual-index FO reserve at the end of Y htly held that the LIFO her in excess of, or less FO reserves of \$448 is h the Tax Court incor $9 \times 0.2712 = $448].$	in the curren t is the consist "approach f (ear 2 reflects) reserve sho s than, \$9,76 s equal to the rectly failed	t year contributes nothing or stent with the position of the or valuing increments. "factors other than inflation." build not include any factors 3 reflects something that is a inflation attributable to the 1 to exclude in valuing the		

Link-Chain LIFO Cales		<u>EVEN</u>	THE TA	<u>X COURT</u>	BECAME	<u>CONFUSED</u>	Page 4 of 6
Third Year Example Background The Court's Error Self-Corrected	 The Tax Court (<i>Example 3</i>). the end of the y The Court's Y third year's cal In other wood However, th The facts in the Deflation, n A decrement in increment in A decrease in of the second 	continued its in its Example year. ear 3 example culation. rds, the LIFO r is happened on court's Year ot inflation. it in the pool i Year 2 (and i its second year n the LIFO rei d year (\$9,673	illustration of 3, the Tax C illustrates the eserve at the only because the 3 example ref that was an is , thereby, off ar calculations serve of \$1,92) instead of th	the mechanics ourt correctly at its error in end of the third e "facts" were flect amount large setting the error s). 33, based on us e incorrect am	s of the link-ch computed the the second yea d year is correc fortuitous and enough to be ror that the Ta sing the correc ount of \$10,12	ain LIFO method inventory valuatio ar's calculation ha tly stated as \$7,74 created a large de carried back and ax Court made in t amount of the L 1 computed by the	by adding a third year n and LIFO reserve at as self-corrected in the 0. correment. completely offset the the valuation of that IFO reserve at the end e Tax Court.
Tax Court's Calculation of Current Cost Third Year	 Example (3) co At base-yea liquidation c That liquida layer of inve Items B C D Totals	ntinues the fac r costs, Year f inventory ha tion is reflected ntory. Dec. 3 at <i>i</i> Quantity 1,500 600 2,500	ts of Example 3 closing in s occurred du d by the elimi e1, Yr. 3, Inve Prior -Year Co Unit Cost \$ 6.00 3.00 8.00	(2). iventory is lease ring Year 3. nation of the Year ntory <u>Amount</u> 9,000 1,800 20,000 30,800	ss than Year Year 2 layer of Dec. 31, Yr at Curren Unit Cost \$ 6.00 4.00 7.00	2 closing invento inventory and a re- c. 3, Inventory at-Year Cost Amount 9,000 2,400 17,500 28,900	ory, indicating that a eduction in the Year 1
Tax Court's Calculation of Cumulative Index Third Year	 Cumulative inde Base-year cost of 1st year percent 2nd year percent 3rd year percent Product: Chain relative to Jai (121.25% x 1 Base-year co 	ex: of Dec. 31, Yr. age link tage link age link (28,90 percentage, Do n. 1, Yr. 1, bas 27.62% x 93.8 st (\$ 28,900/14	3, inventory: 00/30,800 = 9 ec. 31, Yr. 3, e date 33%) 15.19%)	3.83%)	121. 127. 93. 145. \$ 19,905	25% 62% 83% 19%	
Tax Court's Calculation of Inventory LIFO Value Third Year	• The LIFO value Jan. 1, Yr. 1, Dec. 31, Yr. 1	of the invento Base cost Increment Totals	ry in Pool No Dec. 31, Yr. Inventory : Base-Year C 14, 5, 19,	. 1 at Decembe Rati 3, Cu at <u>Cost Bas</u> 000 905 905	er 31, Year 3, i o (as a %) of rrent-Year Cost to e-Year Cost 100.00% 121.25%	s \$21,161, comput Dec. 31, Yr Inventory LIFO Valu 1	ted as follows: . 3, at 4,000 7,160 1,160

Link-Chain LIFO Calcs	<u>EVEN THE</u>	TAX COURT	BECAME CONFUSED	Page 5 of 6				
Tax Court's	• The LIFO reserve for Pool No. 1 as of December 31, Yr. 3, is \$9,739, computed as follows:							
calculation of the LIFO Reserve	Dec. 31, Yr. 3, inventory at current-y Less: LIFO value of ending inventor	/ear cost ry	\$ 28,900 1,161					
Third Year	Equals: LIFO reserve		7,740	j ·				
Our Comments	 How can one be sure, or "prove" the incidentally, that any other amount sites incidentally, that any other amount sites is composition of LIFO reserve at endisors of the following three component. Inflation attributable to the base election has been in effect (1.4519) Inflation attributable to the increasing in the pool for only the second and. This attributable inflation is methind year (1.4519) and the current 1.2394, plus Inflation attributable to the increasing of the third year. This would be measured by the (1.4519) and the current pool for the third year. This would be measured by the second and the third year. This would be measured by the second and the current pool for the third year. The above statements, translated into 	the LIFO reserve hown for the LIFO is d of Year 3. The Lints inventory (expresse), plus ment for the first y rear, i.e., \$6,000 - 9 d third years reasured by the diff mulative index at the ment for the second he difference betwe dex at the beginning enced in the year, ar ed on the facts give essed in base dollar crement for the second the amount of inflat ero. numbers, appear be	we at the end of Year 3 should be reserve would be incorrect? IFO reserve at the end of Year 3 s ed in base dollars) for the full 3- year (but only to the extent that 5 = \$5,905), but considering only reference between the cumulative in e beginning of the second year (1. year, but considering only inflation een the cumulative index at the of g of that year (1.5474), and this would this factor would be negative. en for Year 3 result in showing a s ($\$21,649 - \$19,905$). This decre- ond year in full. (The second year able to the increment for Year 2 let tion attributable to this Year 2 con-	only \$7,740? And, should reflect only the year period the LIFO increment remains in inflation experienced dex at the end of the 2125). This factor is on experienced in the end of the third year ould get a little tricky decrement in for the ement is carried back r increment was only eff in the inventory at nponent at the end of				
		× 11	Droof Fostor	Dec. 31, Yr. 3,				
		Dec. 31, Yr. 3, Inventory at Base - Year Cost	for Amount Contributed to LIFO Reserve by Each Year's Increment	LIFO Reserve (Factor x Base Yr. Cost)				
	Jan. 1, Yr. 1, Base cost Dec. 31, Yr. 1, Increment (net) Dec. 31, Yr. 2 Increment	14,000 5,905	(1.4519 - 1.0000) = 0.4519 (1.4519 - 1.2125) = 0.2394	6,327 1,414 -				
	Totals	19,905		7,740				
er and a set of the states and								

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Link-Chain LIFO Cales	EVEN THE TAX COUR	T BECAME	CONFUSED	Page 6 of 6			
Proof of the Correctness	 The analyses above show that it is relatively easy to prove or demonstrate the composition of a LIFO reserve at the end of the year in terms of the amount of the LIFO reserve attributable to (or contributed by) each year's net increment or layer. The information needed to do this is simply The amount of each year's net layer or net increment, expressed in base dollars, and The cumulative inflation factors as of the end of each year that the LIFO election has been in effect. One can independently verify the correctness or accuracy of any computed change in the LIFO reserve for a given year using the same mathematical approach. This is shown below for all three years 						
of the			Year 2				
LIFO		Year 1	(Correct Amt.)	Year 3			
Reserve	LIFO Reserve at End of Year	2.975	9.673	7 740			
Computed	LIFO Reserve at Beginning of Year	_,,,,,,,,,,,,,,,,,,,,,,,,,,,,,,,,,,,,,,	2,975	9.673			
for the	Net Change in LIFO Reserve for the Year	2,975 *	6,698 *	(1,933) *			
Year				and the second			
	Proof of Annual Change in LIFO Reserve						
A Second	Cumulative Inflation Index at End of Year	1.2125	1.5474	1.4519			
Independent	Cumulative Inflation Index at Beginning of Year	1.0000	1.2125	1.5474			
Proof	Net Change in Cumulative Index for the Year	0.2125	0.3349	(0.0955)			
	Base Dollars in Inventory	14,000	20,000	19,905			
	Net Change in LIFO Reserve for the Year	2,975 *	6,698 *	(1,901)			
	Effect of Payback Due to Decrement (\$95 x 0.33	49)		(32)			
				(1,933) *			
In Conclusion	 If one plugs the numbers into these proof forma computations of the LIFO inventory are incorrect. For example, if the incorrect result computed by t (i.e., \$10,121) were substituted above, the proof wo Year 2, something was "wrong" with the amount of Based on the foregoing, by using these simple mathem easily shown that the Huffman Group's LIFO inven After all, wasn't it the IRS who stressed the point in its 1 + 1 will always equal 2, and 2 x 2 will always equa mathematical proof requires, then the LIFO reserve should be adjusted to reflect the proper amount (of infl Based on the foregoing, it would seem to be advisat <i>Example 2</i> in the <i>Huffman</i> case in order to avoid the proper amount for guidance in the future and find themse 	ts and the proof the Tax Court for uld obviously fai the LIFO reserve natical approaches tory computation brief that LIFO i il 4. If the LIFO includes factors of ation). ble for the Tax (possibility that ac clves doing their c	of "fails," it's because the LIFO reserve at I. That would indicate that was computed. s, it would seem that the s reflected factors of s "a very, very simple reserve is not the exa other than inflation (if Court to correct its car countants and others calculations incorrectly	the end of Year 2 e, that at the end of he IRS could have her than inflation. computation"? ct amount that the i.e., errors), and it omputations in its might refer to this 7.			

What Do You Think?

HOW CRITICAL SHOULD ONE PROFESSIONAL BE WITH ANOTHER IN EVALUATING COMPETENCE IN HANDLING LIFO MATTERS?

Let me start with the statement that over the years, and even as recently as within the last 6 months, I have seen other CPAs use exactly the same kind of (incorrect) LIFO methodology as was used by Huffman. Also, I have been told that the dealership using the incorrect method had been audited in previous years by the IRS with no changes. Of course, in these instances, by voluntarily changing the dealership over to the Alternative LIFO Method, we took immediate and hopefully corrective and preventive measures in working with the CPA firm who came upon the misuse of the LIFO method by the predecessor accounting firm.

Let me follow this up by stating that many of us might have a very sympathetic feeling - something akin to "there, but for the grace of God, go I." In working with LIFO over the years, we have all had to opportunity to learn from our own errors (which, hopefully, we caught at an early and relatively harmless stage). We've also had the opportunity to learn vicariously by observing the errors or mistakes of others, as often evidenced in tax litigation like *Huffman*.

Finally, a third observation can be made in this context. Many CPAs using incorrect LIFO methods have been audited by the IRS over the years, and the IRS Agents have made no changes to LIFO computations that were subsequently found to be in need of correction. In the *Huffman* case, the taxpayer tried to justify its LIFO computations by what it deemed to be the implicit acceptance of its calculations by the IRS over the course of several audits. As discussed elsewhere, with ample support, those arguments stand no chance of being accepted by the courts.

Accordingly, in the evaluation of a situation where the IRS challenges the LIFO computations made by a CPA, there are usually several factors that might warrant empathy and sympathy for the practitioner, at least to some extent.

On the other hand, one of the reasons that LIFO has such a bad reputation is that it has been improperly handled by some practitioners who were clearly "in over their heads" and should have had the sense to not get involved with it, or at least to seek competent technical assistance. Many taxpayers have had very bad experiences with LIFO because their calculations either were not properly done in the first instance or were not competently defended on audit.

In considering the plight of the practitioner in *Huffman*, the following factors should be considered. Note, however, that not all of the following ended up as facts jointly stipulated by the taxpayer and the IRS. However, these were incorporated into various briefs and reply briefs filed by either Huffman or the IRS.

- The CPA's familiarity with LIFO apparently came about by his discussing LIFO with a friend who worked for Peat Marwick Mitchell, formerly one of the original Big Eight accounting firms.
- In the course of these discussions, a Tax Court Case decided in 1981 Richardson Investments was mentioned, and the CPA looked up this case.
- The CPA said that he relied *completely* on just two sentences contained in the description of the way the auto dealership in that case was computing its new vehicle LIFO inventories under the link-chain, dollar-value LIFO method. (See page 12.) The CPA testified that he completely relied on these two sentences as summing up everything he needed to know in a nutshell.
- The IRS' reply brief states the following...
 - The CPA did not read the LIFO Regulations.
 - The CPA was not aware of the Fox Chevrolet decision. The Fox Chevrolet case was decided by the Tax Court on exactly the same day as the Richardson Investments case.
- The entire text of the *Richardson Investments* case (as well as the *Fox Chevrolet* case) reveals all of the steps taken by those dealerships in the valuation of their LIFO inventories. The difference between *Richardson Investments* and *Fox Chevrolet* is that in *Richardson*, the dealership used the link-chain (dollar-value) method, and in *Fox Chevrolet*, the dealership used the double-extension (dollar-value) method.

Apparently, Huffman's CPA had not consulted with anyone else outside of his own firm (other than initially with Peat Marwick Mitchell).

Had the CPA consulted the NADA LIFO Workbook, an Implementation & Procedure Manual for Car & Truck Dealers first published in 1981 - he would have been able to read discussions of how the link-chain method could/should be applied to an automobile dealers' new vehicles and parts inventories.

On the other hand, in the course of half a dozen audits of the LIFO calculations that Huffman's CPA had performed, he was complimented by at least one IRS Agent on the quality of his work, and no adjustments to his LIFO calculations were proposed in any of the exams until the last audit. So, as the saying goes, "if it ain't broke, don't fix it."

What does all of this add up to? ... What do you think?

DOLLAR-VALUE LIFO METHOD ... THE TECHNICALITIES

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

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

(1) double-extension method, (2) index method, and (3) link-chain method.

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

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

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

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

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

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

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

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

Reg. Sec. 1.472-(8)(e)(2)(ii) provides that a taxpayer is allowed to determine the current-year cost of items making up the inventory by reference to one of three prescribed alternatives or any other proper method which clearly reflects income. (* See note below.)

If there is an increment for the taxable year, the ratio of the total current-year cost of the pool to the total base-year cost of the pool must be computed. This ratio when multiplied by the amount of the increment measured in terms of base-year cost gives the LIFO value of such increment.

* Further discussion of the different (sub)elections that at taxpayer may make for determining current cost (i.e., for valuing an increment) has been omitted, because this was not an issue in *Huffman, et al.* Huffman and the IRS stipulated that the cumulative inflation index at the end of the year was the factor by which to multiply the current-year increment expressed in base dollars.

The above is taken from the IRS Appeals Industry Specialization Program Settlement Guidelines, Dollar-Value LIFO Earliest Acquisition Method ... Applicable to All Industries (Effective Date: February 8, 2002).

LINK-CHAIN LIFO CALCULATIONS ... STEP-BY-STEP ... IN WORDS

STEP-BY-STEP COMPUTATIONS... ALTERNATIVE LIFO METHOD FOR AUTO DEALERS

Under the new, simplified Alternative LIFO methodology, the inflation index is computed by reference to the *invoices for every vehicle in ending inventory*-no sampling, no shortcuts in this regard. *Copies of these invoices should be saved <u>indefinitely</u>*. The procedural steps in the computation are listed below:

STEP #1: Obtain the actual invoice for each vehicle in the ending inventory.

STEP #2: For each pool, group all of the invoices from Step 1 by item category (i.e., using the manufacturer's base model code numbers broken down as finely as possible [see "item" definition under special rules and definitions]).

<u>STEP #3</u>: For each item category, add together the dealer's base vehicle costs of all vehicles within each item category, from Step 2.

STEP #4: Within each pool, compute an average base vehicle costfor each item category by dividing the result from Step 3 for each item category by the number of vehicles in the item category. This average base vehicle cost for each item will be used in Step 6 of the succeeding year's computations.

STEP #5: For each pool, compute the total currentyear base vehicle cost of the pool by adding together the separate item category totals from Step 3.

STEP #6: For each pool, compute the total base vehicle cost of the ending inventory at prior-year's base vehicle cost:

First, multiply the number of vehicles in the current year's ending inventory for each item category by the average base vehicle cost of the same item category from Step 4 of the preceding year's inventory calculation.

If the same item was not in the prior year's ending inventory, special rules apply. If an item was **not** in existence in the prior year, then it must be repriced at 1.000 (since it is a "new" item) by using the current-year base vehicle cost of the new item category as (if it were) the prior-year base vehicle cost of that item category.

If an item in the ending inventory was in existence in the prior year, but was not stocked by the dealer at the end of that prior year, then repricing reference may be made to the manufacturer's price list that provides dealer purchase prices using the list in effect as of the beginning of the last month of the prior taxable year.

Finally, add together the total prior-year base vehicle cost of all of the item categories.

STEP #7: For each pool, compute the current-year (annual) index by dividing the amount from Step 5 by the amount from Step 6.

STEP #8: For each pool, compute the cumulative index by multiplying the current-year index from Step 7 by the cumulative index at the end of the preceding year (from Step 8 of the preceding year's computation).

STEP #9: For each pool, compute the total currentyear total-vehicle cost by adding together the total invoice cost, including installed options, accessories, and other inventoriable cost(s), of all of the vehicles in inventory at the end of the current year.

STEP #10: For each pool, compute the total cost of the current-year's ending inventory at base-year cost by dividing the total current-year total-vehicle cost of all of the vehicles in ending inventory, from Step 9, by the cumulative index from Step 8.

STEP #11: For each pool, determine if there is an increment for the current year by comparing the total cost of the pool's current-year ending inventory at base-year cost, from Step 10, with the total cost of the pool's preceding year's ending inventory at base-year cost, using the amount from Step 10 of the preceding year's calculation. If the amount from Step 10 of the current year's calculation is greater, there is an increment.

STEP #12: For each pool, value the current year's increment at current-year cost by multiplying the increment amount from Step 11 by the cumulative index from Step 8.

STEP #13: If there is no increment for a pool, but, rather, a liquidation (also referred to as a decrement), reduce the LIFO layers in reverse chronological order until the liquidation is fully absorbed.

STEP #14: For each pool, add together the current year's increment, if any, at current-year cost and the prior years' increments at each prior year's current-year cost to compute the total LIFO value for the pool.

NOTE: The result in step 14 is the total LIFO value for the pool. The LIFO reserve for the pool is determined be subtracting the result in Step 14 (the ending inventory at LIFO) from the result in Step 9 (the ending inventory at actual cost).

See the worksheet for the computational format on page 13.

*

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- Valuation of an increment. Step 12 accomplishes the LIFO valuation of the current year's increment (as expressed in base dollar amounts) by multiplying the increment (as determined in Step 11) by the cumulative index at the end of the year for the pool (as determined by Step 8). See following page for worksheet format.
- The accountant in Huffman "omitted" Step 12. Alternatively, it might be said that the accountant valued the increment by using a factor of 1.000 which represents the base date cost (rather than by using the correct factor as computed by Step 8 which represents the cumulative inflation for the pool from the first day of the first LIFO year through the end of the current year).

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A Quarterly Update of LIFO - News, Views and Ideas

De Filipps' LIFO LOOKOUT Vol. 16, No. 2

LINK-CHAIN LIFO CALCULATIONS ... STEP-BY-STEP ... IN FIGURES

· · · · · · · · · · · · · · · · · · ·	OLD I LINK-CHA	OLD METHOD NEW LINK-CHAIN, INDEX ALTERNATIVE		D METHOD NEW HAIN, INDEX ALTERNATIVE	
	19XX	19YY	LIFO METHOD REV. PROC. 92-79 *		
A. BEGINNING OF YEAR INVENTORY AT BASE DATE COST	\$558,078	\$764,616	STEP 10 OF PRIOR YEAR		
B. END OF YEAR INVENTORY AT END OF YEAR (CURRENT) PRICES	\$820,662	\$1,288,009	(LINE F OF PRIOR YEAR) STEP 1 & STEP 9		
C. END OF YEAR INVENTORY AT BEGINNING OF YEAR (BASE) PRICES	NOT FULLY	NOT FULLY	STEP 6		
D. CURRENT YEAR PRICE INDEX: END OF YEAR INVENTORY PRICED AT END OF YEAR PRICES (DIVIDED BY) STEPS 3	& 5				
END OF YEAR INVENTORY PRICED STEPS 3 AT BEGINNING OF YEAR PRICES	,4&6	1.0485	STEP 7		
E. CUMULATIVE LINK-CHAIN INDEX: CURRENT YEAR PRICE INDEX (LINE D) MULTIPLIED BY (X) PRIOR YEAR'S CUMULATIVE INDEX (LINE E OF PRIOR YEAR)	1.0733	1.1254	STEP 8		
F. END OF YEAR INVENTORY AT BASE DATE COST (LINE B DIVIDED BY LINE E)	\$764,616	\$1,144,490	STEP 10 (9 DIVIDED BY 8)		
G. CURRENT YEAR INVENTORY INCREASE (DECREASE) - Expressed in base dollars			STEP 11		
 END OF YEAR INVENTORY AT BASE DATE COST (LINE F) BEGINNING OF YEAR INVENTORY AT BASE DATE COST 	\$764,616	\$1,144,490	STEP 10 OF CURRENT YEAR		
(LINE A)	558,078	764,616	STEP 10 OF PRIOR YEAR		
3. CURRENT YEAR INCREASE (DECREASE)	\$206,538	\$379,874	STEP 11		
4. LIFO VALUATION OF CURRENT YEAR INCREMENT AMOUNT CARRIED TO LIFO SCHEDULE (BELOW)	x 1.0733	x 1.1254	STEP 8		
LINE G(3) X LINE E	\$221,673	\$427,510	STEP 12 (STEP 11 x STEP 8)		
H. ANALYSIS OF YEAR END INVENTORY LIFO "LAYERS" BASE INVENTORY	\$330,103	\$330,103	FROM PRIOR YEAR		
CALENDAR TEAR 1990 INCREMENT	227,975	227,975	FROM PRIOR YEAR		
CALENDAR YEAR 19YY INCREMENT	-	427,510	STEP 12		
ENDING INVENTORY AT LIFO VALUATION, PER ABOVE LESS: ENDING INVENTORY AT END OF YEAR PRICES (LINE B)	\$779,751 820,662	\$1,207,261 1,288,009	STEP 14 STEP 9		
LIFO RESERVE AT RESPECTIVE YEARS! END	¢/0 011	#90 7/P	ALLEO RECERVE - FOX		
LIFO RESERVE AT END OF PRIVIOUS YEAR	(28,127)	300,748 (40,911)	LIFO RESERVE - BOY		
INCREASE (DECREASE) IN LIFO RESERVE AT CURRENT YEAR END	\$12,784	\$39,837	NET CHANGE IN LIFO RESERVE		

* NOTE: THIS ILLUSTRATES ONLY THE COMPUTATIONAL METHODOLOGY OF SECTION 4.03 OF REV. RPOC. 92-79. IT DOES NOT REFLECT REBASING OF BEGINNING INVENTORY OF YEAR OF CHANGE TO 1.000 REQUIRED BY SECTION 9.02(8). NEW LIGHT-DUTY TRUCKS MUST BE PLACED IN A SEPARATE POOL #2.

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Worksheet format for the link-chain LIFO method, computed in accordance with the Alternative LIFO Method for New Vehicles.

- Valuation of increments. Under this methodology, in any year, there is no increase in the LIFO reserve for that year attributable to the current-year increment. This is because when the current-year increment, as expressed in base dollars, is multiplied by the cumulative index at the end of that year, all of the current-year's inflation attributable to the current year's increment is/has been eliminated.
- Mathematical proofs of the LIFO reserves at the end of 19XX (Year 1) and 19YY (Year 2) are shown on page 32.

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PROOF OF INCREASE IN LIFO RESERVES ... LINK-CHAIN CALCULATIONS ON PAGE 31

	19XX	19YY
(A) Current Year Index at End of Year	1.07330	1.12540
(B) Divided by Index for Current Year	1.02180	1.04850
(C) Equals: Current Index at Beginning of Year	1.05040	1.07330
 (D) Current Year Decrease in Cumulative Index 19XX: (A - C) or (1.07330 - 1.05040) 19YY: (A - C) or (1.12540 - 1.07330) 	0.02290	0.05210
(E) Current Increase in LIFO Reserve Should Be the Beginning-of-the-Y at Base Dollars Multiplied by the Current Year Increase In Cumulat	ear Inventory ive Index (D)	
19XX: \$558,078 x 0.02290 = 19YY: \$764,616 x 0.05210 =	12,779	39,836
(F) Increase per Schedule	12,784	39,837
Difference (Due to Rounding at Different Decimal Places)	5	1

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