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A Periodic Update of LIFO - News, Views and Ideas

LIFO LOOKOUT

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LIFO UPDATE

If you had called me personally to ask "What's happening lately with LIFO that I need to know about?"... Here's what I'd say:

#1. WELCOME TO OUR 20th YEAR OF PUBLISHING THE *LIFO LOOKOUT*. I can hardly believe we've reached a 20-year milestone with this publication. Some of you have been subscribers ever since our first issue way back in March of 1991 ... Many of you have joined us along the way. Thank you for your many, many years of friendship, support and calls suggesting topics to be explored in these pages.

As I've said previously, when I first started this publication, I was seriously concerned that there might not be enough LIFO-related "stuff" to sustain a specialized publication like this. As you can tell, that concern wasn't really warranted.

#2. STATUS OF LIFO ... WHAT'S BEEN SAID LATELY ABOUT LIFO? I do expect that LIFO will be around for closely-held businesses for many years to come ... despite much of the brouhaha over the last few years about its demise, repeal or evaporation if or when global accounting "principles" are adopted here in the U.S.

I am now feeling more confident that LIFO for our closely-held businesses will survive all efforts to make it extinct - whether these efforts might come from Congress by legislation to repeal LIFO, or indirectly from the much-discussed and anticipated adoption of International Financial Reporting Standards by U.S. companies.

I want to give you an update on some recent articles and my shift in thinking from a more tentative "I-wonder-if-LIFO-will-be-around-much-longer" frame of mind. See *"Status of LIFO ... What's New?"* beginning on page 9.

Also, please let me know whether you think I'm being overly optimistic about the ability of LIFO to withstand pressures for its demise, and I'd be interested in *your* thoughts on this.

#3. HOW BIG ARE AUTO DEALERS' LIFO RESERVES? Almost all of the articles that have been written about the repeal of LIFO have been written by academics, economists or Beltway bureaucrats. Many of these articles rely heavily on statistics taken from information in the financial statements of publicly-held companies reporting to the SEC. In addition, many statistics relate to years (i.e., 2006, etc.) which are somewhat remote.

Other than in brief, broad generalizations, it seems few have dared to speculate about the impact of the potential repeal of LIFO on closely-held businesses.

I thought it might be useful to try to shed some light on the impact of the repeal of LIFO on some automobile dealerships in the real-world. To that end,

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LOOKOUT LOOKS INTO

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I've done a survey of approximately 100 dealers for whom we provide LIFO computations.

There are many reasons why any one of the individual auto dealers within the survey/sample group is (quite) different from the others ... Obviously, not all of the dealerships are of the same size, and the mix of franchises handled by any one dealer could be quite unlike the others. Therefore, the rates of inflation experienced over the years by these dealerships will vary.

Also, not all of the dealerships in the survey/sample elected LIFO in the same year, so some have been on LIFO much longer than others.

Furthermore, some dealerships in prior years changed from C to S status and recaptured their LIFO reserves (under Section 1363(d)) and then started all over again to build their LIFO reserves in their S years. Some of the dealerships made the change a few years ago; others changed many years ago.

Another example of the lack of uniformity within the survey/sample is that some dealers recently changed to the single, combined (Vehicle-Pool) method in order to boost their LIFO reserves. Other dealers, given exactly the same opportunity to enhance their LIFO reserves, declined to do so because - for one reason or another - they wanted to minimize rather than maximize their reserves at this point in time. In other words, some dealerships have changed ... and some have not.

In September 2009, NADA estimated that over 75% of automobile dealerships (excluding, of course, publicly-held dealership groups) currently use LIFO for their New Vehicle inventory. Undoubtedly, some dealers terminated their LIFO elections for 2009, so I would arbitrarily guess that has now been reduced from 75% to somewhere in the range of 60-70%. (That is based on my own LIFO experience with dealers for 2009.)

Admittedly, the 100 dealerships in the survey/sample are a diverse bunch. However, in my opinion, those differences are what make the overall, or collective, results representative of many other dealers on LIFO. I also believe that the results of our survey/sample are typical of what other CPA firms would expect to find if they took the time to conduct similar surveys.

If our results are representative, then you could extrapolate the results to all of the 60-70% of the dealerships in the country who are still using LIFO to great advantage. You're free to draw whatever conclusions you wish from the dealership facts in our survey.

#4. OUR EXPERIENCES WITH LIFO OVER THE <u>PAST FEW MONTHS</u>. Item #1 on page 6 of my *Bulletin Board* contains some information about the rates of inflation experienced by our dealerships in their LIFO calculations for 2009. These rates were surprisingly high, given the overall less-than-stellar events of the year.

On page 23 of the Year-End 2009 *LIFO Lookout*, I included a step-by-step listing of planning considerations for year-end LIFO inventories. Here's what happened in my experience with our auto dealership LIFO clients, almost all of whom faced significant decreases in their LIFO inventories at the end of 2009 compared to 2008. We'll take it in reverse order...

First ... Step 6 ... none of our clients changed to the IPIC method in order to try to expand the dollars in their LIFO pools.

Second ... Step 5 ... none of our clients elected LIFO for used vehicles in order to offset some of the payback in their new vehicle LIFO pools ... basically because used vehicles continued to reflect deflation for 2009.

Third ... Step 4 ... only a surprisingly small number of our clients terminated their LIFO election.

Fourth ... Step 3 ... the vast majority of our clients requested projections [discussed in Step 1] of the changes in their year-end LIFO inventories to assist them (and us) in making their decisions.

Fifth ... Step 2 ... a significant number of our clients who had not changed to the single, combined (Vehicle-Pool) method for either 2007 or 2008, decided to make the change for 2009 in order to minimize the impact of a decrement in their LIFO inventories. But, quite a few dealers still opted not to make the change, even though it would have increased their LIFO reserves.

All in all, the months of December 2009 and the first quarter of 2010 were extremely busy months for us.

#5. IRS UPDATES FORM 3115 & INSTRUCTIONS FOR ACCOUNTING METHOD CHANGES ... <u>NEW REVISIONS & NEW CONCERNS</u>. Form 3115 is the form that taxpayers must file when they are changing most LIFO accounting methods. The IRS recently updated this Form and the Instructions to incorporate various developments. The new Form 3115 and Instructions are dated December 2009 and supersede the last revision of Form 3115 (December 2003) and the last revision of the Instructions (June 2006).

It is nice to now have a more current revision of Form 3115, and at first glance, there doesn't appear →

to be much difference between the "old" Form 3115 and Instructions and the "new" revisions. However, there are several new requirements and/or conditions that have been slipped into Form 3115 in various places.

The Instructions have been updated to include all of the Automatic Changes that do not require advance permission from the IRS. The total is 149, but that includes 6 "automatics" that are now obsolete. The Automatic Change list will continue to grow over time. Many of these automatic changes involve changes ***within*** the LIFO method.

My analysis of the changes assumes that you are basically familiar with many aspects of Form 3115 and the underlying changes in methods being discussed. Accordingly, my comments are selective in nature, and they focus on areas that require new emphasis in light of more recent developments.

Currently, the biggest problem relating to many changes in accounting methods arises in connection with automobile dealerships and the amounts they are capitalizing as additional inventory costs under Section 263A. (A discussion of these technicalities is beyond the scope of this article. However, these technicalities have all been addressed more thoroughly in many articles in our sister publication, the *Dealer Tax Watch.*)

In September 2009, auto dealerships were encouraged by the Director of the LMSB (in its issuance of a moratorium on pursuing Section 263A matters until January 1, 2011) to consider filing Forms 3115 to change to the Section 263A methodology espoused in TAM 200736026. Dealerships and their CPAs are not living in the real world if they are not in a quandary over whether they should file Forms 3115 in connection with their Section 263A methods of accounting. And, this applies to one and all, regardless of whether or not the dealership is using LIFO. This affects everybody!

But, let's put the focus more sharply on businesses using LIFO, and again, especially on automobile dealerships. If they are contemplating the termination of their LIFO elections (or if they have recently terminated their LIFO elections), there are several unanswered questions ... and no real guidance from the IRS ... which significantly muddy the waters around a decision to terminate a LIFO election.

Could these businesses be in for more than just the recapture of their LIFO reserves?

I've tried my best to incorporate these concerns into the article that begins on page 22 and in the revised proforma materials for Forms 3115 for terminating a LIFO election which begin on page 36.

The Mid-Year 2009 *LIFO Lookout* included a sample proforma Form 3115 filing package for terminating a LIFO election. That proforma was included in order to reflect changes introduced by Revenue Procedure 2008-52 which allowed more LIFO terminations by automobile dealers to be made as automatic changes because of the relaxation of the position of the IRS concerning the use of what were "permitted methods of accounting" after the change. (It also preceded the announcement by the IRS of its temporary "moratorium" on initiating Section 263A cost capitalization audit issues.)

Because of the continuing strong interest in terminating LIFO elections and the more recent emphasis by the IRS on the alleged improper application of Section 263A by many auto dealers, the sample proforma Form 3115 materials have been updated (and expanded) to some extent for use in connection with the December 2009 revision of Form 3115.

Keep in mind that a taxpayer filing Form 3115 has a duty to reveal all material factors pertinent to its request for an accounting method change. It is not the responsibility of the IRS National Office to try to pry all of the pertinent information out of the taxpayer who wants to make the change. This applies regardless of whether the taxpayer is filing a Form 3115 that requests advance permission from the Commissioner to change the method, or whether the Form 3115 simply supports an "automatic" change in method, to which the Commissioner is deemed to consent.

One other note of caution: The IRS disclaims responsibility for the accuracy or reliability of its own forms and instructions. Letter Ruling 200328001 states that "Generally, forms and instructions do not bind the Service and are not intended to replace the law or change its meaning. The sources of authoritative law in the tax field are the statutes and regulations and not the informal publications and tax forms that are published by the Service.... ***Therefore, taxpayers who rely solely on IRS forms and instructions are at risk.***" Not very comforting, is it?

As I've said before, my intention in providing sample proformas is to help you avoid having to "reinvent the wheel" by giving you a head-start in dealing with these situations. However, this proforma will have to be modified to fit your exact situation. So, please be sure to read the Form, Instructions and our proforma supplementary responses carefully. Be sure to tailor your responses on the Forms 3115 that you are preparing to the specific facts and circumstances of the situation and the type of business you are dealing with.

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#6. THE BEST SUGGESTION I CAN MAKE ... OBTAIN A SIGNED ENGAGEMENT LETTER WHEN PREPARING FORM 3115 FILINGS. In my opinion, you should consider obtaining a written engagement letter from the client before embarking on most, if not all, change in accounting method request filings.

Once initiated, the Form 3115 filing process may involve considerably more time and expense than originally anticipated. This likelihood increases if the IRS should require additional information to be submitted or computations to be provided, or if it raises unexpected or novel reasons for considering an adverse ruling in response to your request.

It may be desirable to have a written, signed understanding up-front with your client (i.e., an engagement letter before you proceed) that reflects these possibilities.

This letter might (or should) include an estimate of how much time and fees might be involved in (1) accumulating information for the ruling request, (2) actually drafting it, (3) reviewing it with the client after it is prepared, but before it is sent to the IRS, (4) discussing it with the IRS, either by phone or in a conference in the National Office if that should become necessary and (5) implementing the change if permission to make the change is granted or deemed to be granted, in the case of automatic changes.

Another practical problem created by the length of time some accounting request changes take is that the taxpayer may change CPA accounting firms before the National Office completes its review and acts on the Form 3115.

If the client has (recently) changed CPA firms, there may be significant problems between the predecessor CPA firm and the successor CPA firm ... especially if additional information needs to be gathered before the Form 3115 can be filed or if additional information is requested by the IRS after the original Form 3115 has been submitted. Note the problems illustrated by *Bulletin Board* item #3 which discusses Letter Ruling 201005026 on page 7 of this Edition.

In summary, all of this suggests the importance having a signed, written engagement letter describing the responsibility for the accumulation of information, the computation of the transitional adjustments, if any, and the representation services to be rendered before the IRS in connection with the Form 3115 accounting method change request.

#7. RECENT IRS GUIDANCE ON TRADE DISCOUNTS HAS A BEARING ON LIFO INVENTORIES. In Internal Revenue Service Legal Memorandum (ILM 200945034), the IRS recently discussed the proper treatment of "member satisfaction merchandise allowances."

The relevant issue was ... should these allowances be treated as trade discounts. The answer to this question was, "Yes," they should be. The IRS concluded that these were "akin to [a] trade discount[s]."

In addition, if the allowances were properly treated as trade discounts, the next questions were whether the allowances should reduce (1) the cost of all merchandise purchased from the vendor, or (2) only the cost of merchandise subsequently determined to be defective. The answers here were, "Yes," to the former, and "No," to the latter.

Some of the taxpayer's inventory was valued using LIFO and some inventory was valued using FIFO. Since one of the "eligibility" requirements for the election to use the LIFO method is that the inventory on LIFO must be valued at cost, this ILM resurrects - but does not consider - a potentially troublesome issue ... What are the consequences if the inventory on LIFO has not been reduced by the vendor allowances which were held to be trade discounts?

After discussing the details of this ILM, we have mentioned some of the possible ramifications with respect to the use of LIFO by the taxpayer.

This touches still another nerve ending ... because all auto dealers, whether they are using LIFO or not, receive trade discounts from the manufacturers in connection with floorplan assistance payments and/or certain advertising fees.

#8. CLOSING AGREEMENT DID NOT PREVENT THE IRS FROM CHALLENGING LIFO METHOD IN LATER YEARS. In Field Attorney Advice (FAA) 20100501F, released in February 2010, the IRS held that a Closing Agreement that had been executed in a prior tax year did not bar or prevent the IRS from changing that taxpayer's method of defining inventory "items" for LIFO purposes in a later year.

This FAA basically held that the language of the Closing Agreement did not reflect an agreement between the parties (i.e., the taxpayer and the Internal Revenue Service) in settling a prior year audit as to the appropriateness of the taxpayer's LIFO item definitions or the permissibility of such item definitions in future years.

Even though the FAA is heavily redacted, and therefore many of the specifics cannot be deter- →

mined, it is worth examining for the more general insights one should be aware of when dealing with the IRS in closing audits ... and in signing a Closing Agreement with the IRS ... that involve LIFO matters.

Since the really important content in that Closing Agreement has been redacted, on pages 56-57, I've included a copy of a recent Closing Agreement (with just enough redactions to still make it useful) to give you a better sense of what a Closing Agreement involving LIFO matters might or should look like.

#9. HOW BIG ARE AUTO DEALERS' TRADE DISCOUNTS? I've also done a survey/sample of the impact of eliminating dealership trade discounts for floorplan assistance payments and certain advertising costs. Like the LIFO reserve survey/sample, this trade discount information is taken from dealers for whom we provide LIFO computations. It may help to put my comments in perspective and quantify, to some extent, the importance of dealers properly treating trade discounts for LIFO purposes.

In short, is a 2% overstatement of the cost of the ending inventory on LIFO - if trade discounts are not eliminated - large enough to get excited about? Or, could this "technicality," no matter how small, rise to the level of jeopardizing a LIFO election?

#10. *De Filipps' LIFO BULLETIN BOARD*. Beginning on page 6, the *Bulletin Board* items are ... (1) Inflation indexes for 2009 reflected in our dealerships' LIFO calculations, (2) "More Sour Grapes for Wineries' LIFO Methods under IRS Audit," (3) "Loss of Status as a Disregarded Entity Creates Trap for Making LIFO Election," and (4) "LIFO Recapture Does Not Apply to a Sole Proprietorship When It Incorporates & Elects S Status."

I've already commented on #3 in connection with the advisability of obtaining a written engagement letter when getting involved with Form 3115 filings ... especially where it was the former CPA firm that dropped the ball.

#11. COMPARISON OF IRS & *SuperLIFO™* "UNOFFICIAL" NEW ITEM DETERMINATIONS. We have always compared our *SuperLIFO™* new item determinations with those published by the Office of the IRS Motor Vehicle Technical Advisor.

The last comparison, involving manufacturer model years 2008-2009, appeared in the Mid-Year 2009 Edition of the *LIFO Lookout*. In this Edition, we have summarized our current comparison for manufacturer model years 2009-2010 new items with respect to Dec. 31, 2009 year-end inventories for auto dealers. This is based on the new items lists the IRS released in April of this year.

Our comparison schedules are set up so that you can see all of the vehicles which were treated as new items by the IRS, even if you don't care about how the IRS list compares with ours.

We have continued to use the two separate classifications for automobiles and light-duty trucks. Many dealerships don't care about this distinction any more because they have changed to the single, combined (Vehicle-Pool) method for all new vehicles.

However, a significant number of dealers (at least many of those we are doing LIFO calculations for) have not changed to the Vehicle-Pool Method, for one reason or another. Therefore, this classification distinction is still relevant for them.

Many CPAs and/or dealers are using service bureaus for their LIFO calculations. To this extent, they are relying on the new item determinations made by their service bureaus. Other CPA firms and dealerships still do their own new vehicle LIFO calculations on spreadsheets of their own creation, so they must be making these new item determinations each year for themselves.

A glance at the IRS lists (and ours) makes it clear that item category determinations are required to be detailed down to the most precise level of differentiation. Calculations cannot be based on rough averages of models or other generalized groupings that might be forthcoming from other shortcuts, such as downloading less than all of the required information.

Our overview and related statistics begins on page 58. The full Lists are available upon request.

#12. UPDATED, IMPROVED INDEX OF *LOOKOUT* ARTICLES THROUGH DEC. 31, 2009. We have completely revised and expanded our *Index* of all articles appearing in the *LIFO Lookout* from our first issue, March 1991, through December 2009.

The updated *Index of Articles* on our web site (www.defilipps.com) is now electronically **searchable** to make it more user-friendly for your reference purposes. In other words, you can search the *Index* by keyword(s). You can also save the 46-page *Index* on your computer for handy reference and printing.

This *Index of Articles* is divided into nineteen sections, each of which is further sub-divided by key topic or subject. It also includes (1) a separate list of what I consider the best of our *Practice Guides* over the years, and (2) *Finding Lists* for all tax cases, Revenue Rulings and Procedures, Letter Rulings (including TAMs), and other precedential and/or non-precedential IRS guidance.

The nineteen sections of our *Index of Articles* are listed on page 64.

DE FILIPPS' LIFO BULLETIN BOARD

1. Inflation Indexes for 2009 under the Alternative LIFO Method for New Vehicles

For Dec. 31, 2009 inventories, most of the automobile dealerships for whom we did LIFO computations experienced a slight upward pressure on their LIFO reserves for new vehicles due to the amount of inflation that was reflected in the dealer invoice costs. In general, here are the overall results for our dealerships.

	Inflation Range
• Chrysler (Dodge) Trucks ... GMC	4½-5½%
• General Motors ... Chevrolet	3½ -4%
• Chrysler ... Ford ... Lincoln-Mercury	2½-3½%
• Lexus ... Toyota	1½-2½%
• Nissan ... Honda ... Mitsubishi ... BMW ... Volvo	1-1½%

Unfortunately, many dealers' LIFO reserves at year-end went down because their inventory levels were somewhat lower than at the end of 2008, and this resulted in a greater downward pressure (on their reserves) due to the recapture of a portion of their LIFO reserve attributable to increments in pre-2009 years.

2. More Sour Grapes for Some Wineries Using LIFO

Background. We have previously reported on several developments related to the very active audit procedures that the IRS has been applying to wineries (vintners) in recent years.

- *"Winery's LIFO Calculations Leave a Bitter Taste in the IRS' Mouth ... FAA 20064301F," LIFO Lookout*, March 2007, pg. 10.
- *"Winemaker's LIFO Calculations: FSA 1999-999 Provides Insight into IRS Thinking," LIFO Lookout*, June 1999, pg. 18.

These articles highlighted the more narrow item definition preferred by the IRS to the more broad item definitions such as "case goods" or "bulk wines" used by the taxpayers.

Recent development. It has come to our attention that the IRS is now tightening the noose, so to speak, on many wineries in northern California who are using the dollar-value LIFO method. Apparently, the IRS is pushing for wineries to accept one of three options in order to settle these LIFO disputes ...

(1) Use the inflation indexes under the IPIC method developed by the Bureau of Labor Statistics.

(2) Recompute their LIFO inventories using the narrower item definitions preferred by the IRS for all years on LIFO ***and then change*** to use the IRS preferred item definitions in future years.

(3) Pay an administratively agreed-upon amount which would be 27% of the LIFO reserve with 20% for the last open year and 7% for the current year, ***and then change*** to use the IPIC method or change their definition of items in the future years.

One CPA has been quoted as saying that for some of their clients, although the 27% adjustment amount is significant, it probably wouldn't be worthwhile to dispute it in the Tax Court.

Another CPA has suggested that its clients might look to using a 3-year weighted average basis construct for the more narrow definition of items preferred by the IRS and argue this approach at Appeals.

In mid-June, we were advised that some of the cases are currently being settled using the 27% adjustment proposed by the IRS, which includes a change in method of accounting for the taxpayer's item definition.

It is possible that the IRS may issue some form of guidance (such as an ILM or a Chief Counsel Memo) on this in the near future.

3. LOSS OF STATUS AS A DISREGARDED ENTITY CREATES TRAP FOR MAKING LIFO ELECTION

Background. There are many LIFO planning opportunities ... and traps ... in connection with disregarded entities ... especially where Q-subs, or multi-member LLCs and/or single-member LLCs (SMLLCs) are involved.

Recent development. In Letter Ruling 201005026, the IRS granted an extension of time to file Form 970 to an automobile dealership because its ***old*** CPA firm did not recognize the tax consequences when the transfer of a minority interest in that entity occurred. It was the ***new*** CPA firm that brought the oversight to the taxpayer's attention.

Summary of facts.

- For many years, the taxpayer had operated an automobile dealership.
- Several years ago, S Corporation filed Form 970 to elect LIFO on behalf of the taxpayer's inventories because the taxpayer was properly treated as a disregarded entity for Federal income tax purposes. *[It appears that the taxpayer/disregarded entity was a Q-sub.]*
- On a given date, an X% interest in the taxpayer was transferred to a minority owner.
- Because of this transfer of ownership, for Federal income tax purposes, the taxpayer became a partnership and lost its status as a disregarded entity.
- Thus, the taxpayer became obligated to file an annual From 1065, *U.S. Return of Partnership Income*, and to file Form 970 for the taxable year if it wanted to elect to use the LIFO inventory method.
- The dealership's ***old*** CPA firm failed to file Form 970 with the taxpayer's Form 1065 for its first taxable year.
- The ***old*** CPA firm also failed to compute the taxpayer's opening inventories using the average cost method (as required by Revenue Ruling 70-564).
- The ***old*** CPA firm did not actually compute the LIFO inventories of S Corporation. All LIFO-related computations were performed by an ***outside firm***, which was unaware of the transfer of ownership and of the fact that a new partnership (i.e., the taxpayer) had become the owner of those inventories.
- In a subsequent year, the dealership's ***new*** CPA firm discovered that the taxpayer had not filed Form 970 and brought that fact to the taxpayer's attention.
- In the same year that the omission of Form 970 was discovered, the taxpayer attempted to comply with Rev. Rul. 70-564 on a catch-up basis, and it changed its LIFO inventory method without obtaining the Commissioner's consent.
- The taxpayer agreed that if the IRS granted it permission to elect LIFO now, it would "file amended Forms 1065 ... to comply with Rev. Rul. 70-564," for its initial partnership year ("Year A"), the next year ("Year B") and the year in which the omission was discovered and the LIFO method was changed without permission ("Year C").

Holding. The IRS granted an extension of time to file Form 970 for the initial partnership year. The Ruling held that granting the dealership an extension (of time to file Form 970) would not prejudice the interests of the Government, ***provided that the dealership filed the amended returns for the three years described above.***

Observations. What is instructive in this case is not that the IRS granted the extension of time to file Form 970 many years after the Form 970 should have been filed. In fact, over the years, many articles have appeared in the *LIFO Lookout* that have discussed the filing procedures and requirements under Reg. Sec. 301.9100.

The lesson to be reinforced by Letter Ruling 201005026 is that a change in ownership in a disregarded entity may bring with it (i.e., it may result in) the creation of a new partnership. Assuming the new partnership wants to value its inventory using LIFO, it must make a new election to do so, effective for the first year of its status as a partnership.

[Sometimes the change is in the opposite direction: i.e., there is a change from a two-member LLC to a SMLLC. If a two-member LLC changes to a single-member LLC because one member buys out the other member (and becomes the 100% owner), that change in ownership results in a termination of the partnership status (of the two-member LLC) under Section 708. This is a taxable event, and there is a recapture of the LIFO reserve at that time. Accordingly, this taxable event results in a step-up in basis for the inventory.

If the new SMLLC wants to elect the LIFO method for its inventory, it must file Form 970 to make that election. In that case, it would reflect its stepped-up cost basis for the inventory as part of the base inventory for the initial taxable year to which the new LIFO election applies. (The old LIFO layers, valuations and LIFO reserve do not carry over from the old two-member LLC to the new SMLLC.)]

4. LIFO RECAPTURE DOES NOT APPLY TO A FORMER SOLE PROPRIETORSHIP

Background. When a regular C corporation changes to S status, it is required to recapture its LIFO reserve as of the end of its final year as a C corporation. Section 1363(d) provides that there is essentially a step-up on basis for the inventory on LIFO as a result of the full recapture of the LIFO reserve.

But, what happens when a sole proprietorship using the LIFO method transfers its assets to a newly formed corporation in a transaction under Section 351, and the new corporation elects to be an S corporation and to continue to use the LIFO method?

Recent development. In Letter Ruling 201010026, the IRS held that Section 1363(d) did not apply in the fact pattern presented in the question above.

The taxpayer was a manufacturer of a product which it distributed in several states and international destinations. The taxpayer manufactured its product from raw materials, some of which were produced by the taxpayer, and others which were purchased from other unrelated parties.

The proprietorship used an accrual method for inventory production costs and the cash method for all other activities of the business. In addition, the proprietorship used the LIFO inventory method and was in compliance with the Uniform Capitalization Rules of Section 263A.

The National Office said that Section 1363(d) "mandates the taxation of the LIFO recapture amount if an S corporation was a C corporation for the last taxable year before the first taxable year for which an S corporation election was effective." Reading the words of Section 1363(d) literally, the National Office concluded that it does not apply to the facts presented by the taxpayers. The proprietorship had never been a C corporation, and the corporation to be formed would be electing to be an S corporation for the first year of its existence.

The National Office explained that its ... "literal reading of Section 1363(d) in this case does not thwart Congressional intent.

"Congress enacted a related provision, Section 1374, to tax an S corporation on the built-in gains attributable to the period when it was a C corporation. Section 1374 applies, however, only to built-in gains recognized during the first 10 years of the corporation's existence as an S corporation ("10-year recognition period"). Because of the mechanics of the LIFO inventory method, the built-in gains from LIFO inventories will not be fully recognized until the taxpayer experiences a decrement in every inventory layer that existed on the date the C corporation elected to be an S corporation. It is possible, even likely, that the S corporation will not experience a decrement in any of these inventory layers during the 10-year recognition period and, thus, will escape taxation under Section 1374 altogether. This result gives an S corporation using the LIFO inventory method a tax-based competitive advantage over an S corporation using the FIFO inventory method. To counter this result, Congress enacted Section 1363(d), which prevents an S corporation from avoiding the taxation of *any* built-in gains attributable to LIFO inventories held when it was a C corporation."

The National Office also said that it did not believe that Congress intended Section 1363(d) to apply when avoidance of the built-in gain rules of Section 1374 is not possible, and thus, cannot be one of the goals of the corporation's election to be an S corporation. The National Office said that the existence of built-in gain subject to Section 1374 was not possible in the situation under consideration for the same reasons that Section 1363(d) literally did not apply to the facts of this case.

Accordingly, Letter Ruling 201010026 held that Section 1363(d) does not apply when three conditions are met...

(1) A sole proprietorship using the LIFO inventory method transfers its assets to a newly formed corporation in a transaction that meets the requirements of Section 351,

(2) That corporation timely files an election to use the LIFO inventory method for the first year of its existence, ***and***

(3) That corporation timely elects to be an S corporation for the first year of its existence.

STATUS OF LIFO ... WHAT'S NEW?

A year ago, I speculated on the fate of LIFO in the materials *"What's Going to Happen to LIFO?"* on pages 6-9 in the Mid-Year 2009 Edition of the *LIFO Lookout.*

Then, at year-end, I indicated my optimism that the LIFO method would still be around at least through the end of next year (2011), although it might be repealed starting in 2012. After that, what might happen would be still pure speculation.

As I said both times, many events or developments might occur that could radically alter LIFO's life expectancy ... either prematurely shortening it or granting it a new lease on life.

On February 1, 2010, President Obama released the proposed Federal Budget for Fiscal Year 2011. The 2011 budget proposal contains many of the same revenue proposals that had been included in the previous year's budget, but have never been enacted by Congress.

The projected budget deficit for 2011 is staggering. To address the huge projected revenue shortfall, part of the current year budget proposal includes (1) the expectation that, most, if not all, of the "Bush tax cuts" will be allowed to expire, and (2) a proposal to repeal the use of LIFO by ***all*** taxpayers.

At the same time as the Administration released its Budget Proposal, the Treasury issued its own document, *General Explanations of the Administration's Fiscal Year 2011 Revenue Proposals.* The Treasury explanation is referred to as the "green book."

The Administration's current proposal to eliminate LIFO is the same as last year's proposal. It would allow the use of LIFO through the end of next year (i.e., 2011) and then terminate the use of LIFO effective for taxable years beginning on or after January 1, 2012. The current repeal provision, however, would permit the repayment of the tax on the recaptured LIFO reserves over a period of 10 years. LIFO reserves would be repaid pro-rata, 10% per year. The previous repeal provision would have required the repayment over only 8 years.

Some businesses either have small LIFO reserves or inventory that is subject to physical or functional obsolescence, spoilage or other damaging conditions that would reduce value. For these businesses, the inability to use the LIFO method might not be very traumatic because they might instead elect to value their inventories under the lower-of-cost-or-market (LCM) method.

Unfortunately, for these businesses, both the previous LIFO repeal proposal and the current LIFO repeal proposal also contain a provision that would repeal the us of the LCM method. Consequently, the repeal of the use of both the LIFO method and the LCM method would hit these businesses particularly hard. For other businesses, such as automobile dealerships, however, the repeal of the LCM method would not have a significant impact on the valuation of their new vehicle inventories. But, it obviously would be a blow in connection with auto dealers inventories of used vehicles.

How much revenue would the Government gain from the repeal of LIFO? In reality, no one really knows. But that doesn't stop speculation or prevent rough estimates from being thrown around all over the place. The revenue that would be raised by the repeal of LIFO was projected to be $61 billion when the repeal proposal was raised last year. This year, the revenue projected to be raised in the current proposal is slightly lower, coming in at $59 billion. The general reason for this decrease may be due to a significant extent to the reduction of inventory levels over the last few years caused by the depressed conditions in our economy.

The *LIFO Coalition* (website *www.savelifo.org*) is an organization of more than a 100 trade associations committed to lobbying Congress to oppose the repeal of LIFO. In a recent e-mail to its members, the *LIFO Coalition* stated that after Congress has considered which provisions of the "Bush tax cuts" will be extended, Congress will be forced to discuss the LIFO repeal proposal in order to finance the budget shortfall. LIFO repeal is simply all about money.

But wait! What about all the discussions about LIFO being put out of its misery or "repealed" when the SEC/FASB requires reporting U.S. companies to adopt the global International Financial Reporting Standards?

In the June 2006 issue of the *LIFO Lookout* on page 3 and also on page 4 (in my letter to the Senate Finance Committee), I referred to the testimony before Congress of Prof. George Plesko that gained much attention at the time and was critical of the use of LIFO for many reasons. As will be discussed below, it appears that any discussion about repealing LIFO because of its alleged imperfections and/or potential for management misuse seems to be more important in college classrooms, than in the real world.

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"CONVERGENCE:" GAAP ... iGAAP ... UNIGAAP?

For some time now, the accounting profession and its protective associations in the U.S. have been thumping their collective chests about the importance and desirability of the U.S. joining the "global network" that is bent on initiating the adoption of one "high-quality" set of standards for reporting in financial statements.

Some critics of the profession suspect that all of this attention focused on improving reporting in the future is intended to deflect attention and criticism that really should be directed to the appalling failure of the profession in the past to adhere to rather clear reporting standards. Just consider the number of financial statements that are revised every year as a result of management mistakes, errors in judgment and lack of backbone or competence in their independent auditors. That number is appalling.

Anyway, now we have GAAP (Generally Accepted Accounting Principles) and we have its overseas counterpart, iGAAP (International Generally Accepted Accounting Principles) ... pronounced "eye-gap." Little GAAP and big GAAP? Bad GAAP and good GAAP. GAAP for publicly-held companies and a different GAAP for everyone else (i.e., partnerships, S Corporations and closely-held companies).

EVERYWHERE YOU LOOK, THERE'S A GA(A)P

Many of the articles in accounting journals today discuss or assume the need to adopt iGAAP and the activity of the Securities and Exchange Commission (SEC) as it evaluates what should be done about this and what the "time table" should be for moving in this direction.

The discussion of the adoption of iGAAP by U.S. companies ***in the future*** in order to produce financial statements that are more "reliable" interacts - in a most interesting way - with the discussion of the repeal of LIFO ***almost immediately*** in order to raise more tax revenue to counteract budget deficits that are seemingly unsustainable.

This interaction comes about because LIFO is not within the pantheon of iGAAP. It is verboten ... bad stuff. Its use is not acceptable in the presence of more pure accounting and reporting practices. Besides, many foreign countries do not recognize it as acceptable for one reason or another for financial statements reporting on the operations of their own businesses.

Discussions of how LIFO works in contrast with FIFO, in inflationary and/or deflationary times or how managements might use or misuse LIFO to paint a different picture to their shareholders ... these are all topics that are beyond the scope and intention of this article. Besides, they have been addressed many times in the *LIFO Lookout* over the past 20 years. And, there's no shortage of good articles on all of this elsewhere.

The important interaction ("linkage" is the buzzword) between the adoption of iGAAP and the current discussions over the impact of repealing LIFO from a tax revenue raising standpoint arises because if a business adopts iGAAP - which does not permit the use of LIFO - that business will forfeit the use of LIFO for U.S. income tax purposes.

Included in the Internal Revenue Code is a provision that, generally speaking, requires a business to use LIFO for financial statement purposes in order for it to be eligible to use LIFO for U.S. income tax purposes. (For a comprehensive discussion of the tax ramifications of the conformity requirement, see "*Special LIFO Challenges: Conformity Reporting Requirements and Projections for Year-End Planning.*" This article appears in the 2009 Year-End Edition of the *LIFO Lookout,* pages 5-19.)

RECENT ARTICLES

Many recent articles have discussed the interaction or linkage between the use of LIFO for tax purposes and the adoption of iGAAP for financial statement purposes. These articles include: (1) *"Must LIFO Go to Make Way for IFRS?"* by Michael Hoffman and Karen McKenzie in the March 2009 issue of the *Tax Adviser*, and (2) *"LIFO and IRS: How Closely Linked?"* by George White in the July 13, 2009 issue of *Tax Notes.*

In discussing the politics of LIFO repeal, the article by Hoffman and McKenzie (wisely) concludes that "taking the steps needed to allow LIFO to continue in the United States without impeding the international convergence of GAAP is more an exercise in politics than standard setting."

The authors, both university professors, add "the qualitative characteristic of neutrality puts the *[financial statement reporting]* standard-setting process ***above*** such mundane and practical economic considerations" (emphasis added). The "mundane and practical economic considerations," of course, are such things as cost-benefit analysis, and "collateral costs, such as the income tax cost associated with the effective repeal of LIFO for U.S. income tax purposes." In other words, they're referring to the additional taxes that are payable when the LIFO reserves are recaptured by repeal.

"Mundane" ... Oh well, after all, it's only (someone else's) money!

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THE DEMISE OF LIFO ... HOW SOON MIGHT THIS HAPPEN?

The authors also state that "even if the likelihood of LIFO repeal through Congressional action is remote, repeal through Congressional inaction is still a possibility ... (because) if internationally converged GAAP (i.e., iGAAP) does not permit the use of LIFO the result will be the same as LIFO repeal."

That statement seems to be an oversimplification in several respects.

First, the adoption of iGAAP will initially only apply to publicly-held companies reporting to the SEC. In other words, partnerships, S corporations and other privately-owned/closely-held businesses will not be subject to the requirements of iGAAP.

Second, it is possible that changes might be made to extend the iGAAP principles to the above entities ***if*** they issue audited (as differentiated from reviewed or compiled) financial statements. However, all other businesses that do not issue audited financial statements would still remain beyond the scope of the iGAAP requirement that prevents the use of LIFO.

Third, if a change were proposed by the AICPA/SEC/FASB to require ***all*** U.S. businesses that issue audited financial statements to discontinue using LIFO in their financial statements, then that change probably would not become effective immediately. It would have to be implemented over time, subject to reasonable phase-in or other transitional rules.

Transitional rules are always needed when major changes are being implemented. If past timetables for implementing transitional reporting changes are any indicator of what to expect in this regard, the profession has been notoriously slow in its deliberations, which often are akin to filibusters. Consequently, one might reasonably expect a further delay of several more years before this change would be fully implemented.

Fourth, there has been much discussion of the possibility of a strong movement (by the *LIFO Coalition* or others) to attempt to get Congress to change the law to permit the use of LIFO in financial statements and the use of LIFO for tax purposes. This could be done by modifying or eliminating the conformity requirement, either completely or just enough to retain the use of LIFO for tax purposes. In short, a lobbying effort to change Code Section 472 - the law - might prevail.

There also has been much discussion of the possibility of attempting to persuade the Treasury, by reinterpreting its own Regulations, to reach the same result.

The conformity requirement has a long history, during which the Internal Revenue Service has strictly policed its general prohibition against two sets of reporting (one for books and one for tax). However, the prohibitions in the conformity Regulations were significantly weakened in 1981 when Reg. Sec. 1.472-2(c) was substantially liberalized.

These liberalizations modified the requirements, the end result of which was to permit a variety of disclosures that would allow the user/reader of financial statements reporting on the LIFO basis to "convert" the LIFO results to FIFO in order to closely approximate what the operating statement and balance sheet would look like if the LIFO method had not been used. This was accomplished by providing that supplementary and/or explanatory information on a non-LIFO basis could be associated with the financial statements, so long as, essentially, those disclosures were in ***supplementary*** financial information or statements and did not appear in the ***primary*** presentation of income (i.e., the Income Statement).

With so many teeth already removed from the jawbone of the conformity requirement, what real harm might there be in removing what few teeth are left? ... And, getting it a new set of dentures?

At this point, a passage from the article by George White should wrap it up ... "Despite its diminished potency, the (conformity) statutory requirement still poses a formidable challenge for LIFO taxpayers contemplating the possible adoption of IFRS (i.e., iGAAP)."

We seem to be faced with a timing dilemma. If, as suggested, Congress were to simply wait for the adoption of iGAAP to effectively or indirectly result in the repeal of the use of LIFO ... This might not happen for a long time.

In February 2010, the SEC decided to carry out a work plan and identify issues to be furthered explored before the SEC makes a decision in 2011 as to whether or not to incorporate the international financial reporting standards (i.e. iGAAP) into the U.S. financial reporting system by 2015 or 2016. That's quite a long way from now.

Does anyone really believe that if Congress (desperately) needs to raise revenues and it decides to do so in part by repealing the use of LIFO ... that Congress can wait 5 more years? Fat chance!

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IS THE REPEAL OF LIFO WORTH THE EFFORT?

Two other recent articles address this interesting question ... Is the repeal of LIFO worth the effort? One article looks at this question from the taxpayers' point of view; the other article looks at the question from the Government's point of view of trying to reduce the deficit by raising tax revenues.

In *"Will LIFO Repeal Revenue Be Worth the Corporate Resistance?"* (*Tax Notes*, April 19, 2010, page 253), Thomas Jaworski describes in some detail the impact LIFO repeal would have on different types of businesses. In particular, he discusses the impact on whiskey distillers and the efforts by one member of the House Ways and Means Committee, John Yarmouth from Kentucky, to oppose the repeal of LIFO because of its significant impact on many of his corporate constituents.

In discussing "IFRS and the Fate of LIFO," Mr. Jaworski reports that "[t]he Financial Accounting Standards Board has officially informed the SEC that it does not wish to undermine the global convergence by granting the United States a variant for LIFO."

To the extent that two sets of GAAP ... or "dual-GAAP" ... were permitted, closely-held companies would follow a self-contained standard of about 230 pages tailored for the needs and capabilities of smaller, private businesses. This "GAAP-lite" is based on GAAP except (1) many of the principles in full GAAP for recognizing and measuring assets, liabilities, income and expenses have been simplified, (2) topics not relevant to closely-held businesses have been omitted and (3) the number of required reporting disclosures has been significantly reduced. In addition, to reduce the reporting burden, revisions to these standards would not occur more frequently than once every three years.

Interestingly, several of the other countries in the European Union apparently do permit "variants" from iGAAP for some of their own corporate citizens. Why should the U.S. and U.S. businesses be held to a more rigid standard of complete uniformity?

In the other article, *"Does Repealing LIFO Really Matter?"* (*Tax Notes,* May 24, 2010, page 901), authors Janet Mosebach and Michael Mosebach concluded, "No matter which way it is measured, the repeal of LIFO will not have a 'noticeable effect' on either the annual federal budget or the overall federal deficit when using the President's 5% of federal budget measure."

In the introduction to their article, they state that "[t]he repeal of LIFO for tax purposes may seem like a moot point because of the proposed convergence of U.S. Generally Accepted Accounting Principles with the international financial reporting standards." From this, Professors Mosebach conclude that "[t]his means firms would have to switch from LIFO to a non-LIFO method for federal income tax purposes if U.S. GAAP and IFRS converge."

For reasons already discussed, the authors' assumptions regarding the "mootness" or inevitability of the repeal of LIFO by the hand of convergence, rather than by the hand of Congress, are open to question.

In any event, the Mosebach article focuses on broader implications, with the stated objective of investigating "whether the benefits of LIFO repeal are economically significant." As a result, the article employs two sets of data and compares them in order to reach a conclusion.

The first data set is a sample reporting the LIFO reserves and other financial information for all firms identified in *Standard & Poor's Compustat* that had a LIFO reserve for the year 2006. This sample included 317 firms, all publicly-held companies, representing the largest firms in the economy. The year 2006 was chosen as the year of reference because it is the last "normal" year before the start of the current, major economic downturn.

In this table of descriptive statistics (all expressed in ***millions*** of dollars), the authors summarized data reported by these publicly-traded firms. This table shows computations of Mean, Minimum and Sums, and percentiles ranging from 10% on up of (1) total inventory, (2) total assets, (3) net income, (4) reported LIFO reserves, (5) cash flow from operations, (6) ratio of inventory to total assets, (7) projected tax on recapture of LIFO reserves, assuming a 35% effective Federal rate and ignoring any state income tax impact, (8) ratio of the tax on LIFO recapture to cash flow and (9) ratio of the tax on LIFO recapture to enterprise net income.

Very impressive, indeed!

The authors draw some interesting conclusions from this impressive data, especially because (1) the data is based on complete financial statement information of the firms included in the survey and (2) the presentation of the data is arrayed in percentiles. For example, "The average firm will need more than 9% of its operating cash flow to pay the additional tax resulting from the switch from LIFO."

Another way of looking at the impact of the repeal of LIFO involves the ratio of recapture tax to net income from operations. This is expressed as "T/NI," and it represents a firm's ability to pay the LIFO recapture tax out of its operating net income. In this

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context, "The average T/NI is 64%, meaning it will take 64% of operating net income to pay the additional tax resulting from the repeal of LIFO.

An examination of the percentiles reveals that at the 50th percentile, the tax on recaptured LIFO reserves begins to consume double-digit portions of operating net income. At the 80th percentile, firms are using almost one-third of their net income, and, at the highest level, a firm is paying tax 79 times greater than operating income."

Finally, the authors state that "[w]hether you consider operating cash flow or operating net income, the additional tax as a result of the switch from LIFO is economically significant." In other words, the impact of the repeal of LIFO on the firms in the survey is economically significant.

The authors' state that their intention and purpose in writing the article were to examine "whether eliminating LIFO will truly have a noticeable effect on the federal budget and more importantly on the federal deficit."

Accordingly, the other data set (to which the overall results drawn from the sample of 317 publicly-held companies is compared) involves detailed information concerning U.S. Government debt as a percentage of estimated GDP (Gross Domestic Product). In this data, summaries of the U.S. Government Budget receipts, outlays and surpluses (or deficits) ... are expressed in ***billions*** of dollars. Note that the other data set was expressed in ***millions*** of dollars.

In order to divine what might be the appropriate measure of "noticeable effect," the authors used President Obama's remarks at a February 18 town hall meeting in Henderson, Nevada. At this meeting, in referring to all the general discussions about Federal deficits and debt levels, President Obama said, "You could eliminate every earmark, you could eliminate foreign aid, you could eliminate all that stuff - it would amount to ***5%*** of the budget." Based on this statement by the President, the authors used 5% of the Federal budget as the measure of "noticeable effect."

On this basis, the authors concluded that "no matter which way it is measured, the repeal of LIFO will not have a 'noticeable effect' on either the annual federal budget or the overall federal deficit when using the President's 5% of federal budget measure." Accordingly, "One is left to speculate as to why this provision [i.e., LIFO repeal] was included in the fiscal 2011 budget, especially since it was previously included in the fiscal 2010 budget when it was estimated to generate (slightly more) revenue." And finally, "It appears that Congress did not have the political will to repeal LIFO before and, in such a year of political unrest, may be unlikely to do so now."

Regarding the speculation over why the repeal of LIFO is included in the proposed 2011 fiscal budget, perhaps the reasons for including it might be that (1) the Administration didn't know that repeal would not pass the "noticeable effect" test, (2) Congress needs to raise revenue - and have a "poster child" for doing it - as soon as possible and/or (3) Congress doesn't want to wait for iGAAP convergence to do the hatchet job on only a portion of the universe of U.S. taxpayers using LIFO.

THE TIMING DILEMMA

In summary, then, as in the case of considering the repeal of LIFO by Congress vis-à-vis, the natural attrition of LIFO with the onset of iGAAP convergence, we seem to be faced with a timing dilemma.

The authors Mosebach suggest that LIFO could, should or might be left alone until such time as the revenue from recapturing all LIFO reserves reached the point of "noticeable effect" on the annual Federal budget or the overall Federal deficit. If that should be the case, then that time will never come ... and LIFO should be around forever, or at least it should outlive Methuselah.

On the other hand, if Congress really needs to raise revenue ... and it is able to overcome whatever opposition is mounted against LIFO repeal ... LIFO could be gone in the wink of an eye.

Several observations come to mind in analyzing the Mosebach article. These are not necessarily criticisms, nor limitations that might affect their overall conclusions. Rather, these observations are intended to try to sharpen the focus a little bit more on this difficult-to-quantify issue.

First, in their sample, the amounts reported as "total inventory" are not necessarily the amounts of inventory that the companies are valuing by using the LIFO method. This is because *Compustat* provides only a total inventory amount. In most firms, some of their inventory is valued using LIFO and other inventory is valued using non-LIFO methods.

One source referenced in the article, which has access to 2006 confidential tax return data, "finds that of all LIFO firms with inventory larger than $1 million, 74% of their inventory is valued using LIFO." This suggests that approximately 25% or more of the inventory was not being valued using the LIFO method.

As a result, one of the tabulations which the sample could not determine was the ratio of the LIFO reserves to the non-LIFO cost of the inventory valued

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at LIFO. This could have been approximated by reducing the total amount of inventory reported (reflecting LIFO and non-LIFO methods) by 25% and dividing the remainder by the LIFO reserve.

The authors point out that this difference in inventory methods will not affect their analysis of the impact of LIFO repeal because all projections of the additional tax expense (if LIFO were repealed) are done using the amounts of the LIFO reserves, and these amounts are not affected by the mix of inventory methods used.

DIFFERENT SETS OF LIFO CALCS ... ONE FOR "BOOKS" & ONE FOR "TAX"

There is perhaps a more serious consideration, even though it would not change the authors' overall conclusions about "noticeable effect." The Mosebachs are relying on the amounts of the LIFO reserves that are reported by these entities in their financial statements to the SEC. What is unknown - and cannot be known - is the amount of the LIFO reserves these entities are actually reporting on their Federal income tax returns. These amounts may be far, far greater.

One fact recognized by many LIFO practitioners is that it is possible to significantly understate the amount of the LIFO reserves in the financial statements that an entity reports to the Securities and Exchange Commission. This can be done legally and in accordance with GAAP (Generally Accepted Accounting Principles) and without running afoul of the financial statement conformity requirements in the Internal Revenue Code that the IRS so jealously guards.

The obvious motivation a business has for reporting two different sets of LIFO computations (one with greater LIFO reserves for tax purposes and the other with smaller LIFO reserves for book/financial statement purposes) to two different regulatory agencies (the IRS and the SEC, respectively) is to overstate the amount of income reported in the audited financial statements that are required for public consumption.

As a result of using two different sets of LIFO calculations, the entity obtains the benefits of reporting larger LIFO reserves, lower taxable income and paying less income tax while it simultaneously reports smaller LIFO reserves and greater income (albeit at the "cost" of paying more income tax to the IRS) for financial statement purposes.

Stated another way, the use of different LIFO methodologies by companies could create a ***significant*** cumulative and/or overall difference between (1) the greater income (lower LIFO reserves) reported by these entities in their financial statements to the SEC and (2) the lower income (higher LIFO reserves) reported by these businesses in their tax returns to the IRS. To the extent that these differences may be significant, the conclusions reached by the authors may be incorrect, or at least somewhat understated.

How do some businesses get around the LIFO conformity limitations? In fact, this can be done easily, thanks to loopholes conveniently provided in the Regulations. One only has to know that the loopholes exist and be willing to do the work it takes to achieve the desired objective by maneuvering around them.

The Regulations allow taxpayers to legitimately avoid the intent of the conformity requirement by allowing them to use LIFO methods and sub-elections in their financial statements that are different from those LIFO sub-elections and methods that are used in their income tax return computations.

That's right: Different LIFO methods may be used for book and for tax purposes ... Different strokes for different folks.

It is not necessary for the year-end financial statements to use the same exact LIFO sub-elections that are used in the tax return LIFO calculations. The Regulations simply require that both sets of financial statements (i.e., those included in the financial reports and those inherent in the income tax returns) must report using LIFO methods.

This allows some companies to use more pools ... in some cases, dozens of pools; and in others, even hundreds of pools ... for financial reporting purposes than for income tax purposes. Others use link-chain or link-chain, index (dollar-value) methods to lower LIFO income for tax purposes, while they use double-extension (dollar-value) LIFO methods for financial reports. Still others reconstruct long distant base prices for new items in their tax return LIFO calculations while they price new items at current cost in their financial statements. These companies enjoy the best of both worlds without violating the fine print of the "conformity" requirements.

And, there is usually no disclosure of the effect of these different LIFO methods for book and tax purposes in the notes to the financial statements. There is only the disclosure of the difference between the FIFO and the LIFO valuations of the inventory, without any further elaboration.

As mentioned previously, the data on the LIFO reserves of the 317 publicly-held entities came from SEC filings for the year 2006, "because it is the last 'normal' year before the start of the current, major

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economic downturn." For some, the year 2006 might be ancient history.

It seems reasonable to generalize that one of the consequences of the economic downturn through which we are all still laboring is that entities using LIFO have experienced reduced inventories in successive years-end. This may be the result of implementing cost management initiatives or because of other unavoidable pressures on their businesses.

If one is willing to accept that generalization, the reasonable inference from it would be that since 2006, for these entities, the LIFO reserves for both financial statement and for tax purposes would also be lower to some extent as a result of having portions of their higher LIFO reserves in previous years recaptured as the inventory levels decreased at the end of the intervening years.

In considering the data presented by the authors for 2006, the actual LIFO reserves and the LIFO recapture tax potential would seem to be much greater than amounts that are based on LIFO reserves reported in financial statements filed with the SEC.

In speculating on LIFO reserve data that might be presented for more recent years (2009, in particular) it would appear that any data based on financial statements filed with the SEC would similarly tend to understate the amount of potential LIFO reserves that would be recaptured if the LIFO method were repealed.

This is not to suggest the futility of collecting and analyzing LIFO reserve data. Rather, it is intended to emphasize that the impact of dual LIFO methodologies for financial statement purposes and for tax purposes may be a reality that ought to be taken into account in some fashion, even though it cannot be computed quantitatively.

HOW BIG ARE AUTO DEALERS' LIFO RESERVES? ... OUR SURVEY OF DEALERS' LIFO RESERVES

Since the articles referred to in this LIFO status update reflect generalizations based upon LIFO information provided by publicly-held companies, it might be useful to attempt to grasp the potential impact of the repeal on LIFO on closely-held businesses.

I have attempted to do this in some small measure by surveying the impact of LIFO repeal on some of the automobile dealerships for whom we have done LIFO calculations for many years.

Accordingly, accompany this article are a discussion and supporting exhibits of our survey of dealerships' LIFO reserves for years ending December 31, 2008 and 2009.

Conclusions

How Big Are Auto Dealers' LIFO Reserves? ... Our Firm's Survey of LIFO Reserve Balances

(1) On a collective, weighted-average basis, LIFO reserves for new vehicle inventories averaged 18-20% of ending inventory cost as of Dec. 31, 2009. The table shows 18.12% - including the largest dealership, and 19.31% - excluding the largest dealership.

(2) On a collective, weighted-average basis, LIFO reserves for new vehicle inventories averaged 13-15% of ending inventory cost as of Dec. 31, 2008. The table shows 13.63% - including the largest dealership, and 14.66% - excluding the largest dealership.

(3) This increase in the LIFO reserves expressed as a percent of ending inventory cost at the end of 2009 is what one would expect because inventory levels were lower at Dec. 31, 2009 than they were one year earlier, and this resulted in considerable LIFO recapture of some dealerships' LIFO reserves at the end of 2009.

(4) Collectively, inventory levels as of Dec. 31, 2009 were lower than inventory levels one year earlier by almost by 30%. The table shows 28.98% - including the largest dealership, and 28.33% - excluding it.

(5) However, the overall effective rate of net decline in LIFO reserve balances was only 5½% (5.53% or 5.56%) ... even though the overall effective rate of net decline in inventory levels was almost 5 times greater, i.e., almost 30% (28.98% or 28.33).

(6) When the data for the single largest dealership was eliminated from the survey computations, that did not significantly alter any of these results.

How Big Are Auto Dealers' LIFO Reserves? ... Our Firm's Survey of LIFO Reserve Balances

Much has been written and speculated about the potential impact of the repeal of LIFO and how significantly businesses using LIFO would be impacted. Most articles have been written based on generalizations from reviewing the Annual Report information filed by publicly held companies with the SEC.

What about the impact of the repeal of LIFO on privately held companies ... the so-called backbone of our economy? How might the efforts of the *LIFO Coalition* be enhanced if information on the impact of LIFO repeal on small, closely-held businesses could be brought to the attention of Congress by various lobbyists?

To this end and in some small measure, I thought it might be useful to do a survey of my own, looking at the LIFO reserves for 105 automobile dealerships for whom we have done LIFO computations and have actual information.

Statistical sampling procedures were not employed in the selection of the dealerships included in this survey. These dealerships were included because comparative data is available for 2008 and for 2009. They are located all over the country. Collectively, these dealerships sell (not in any proportion) all manufacturers' makes and models.

Since we are not the accountants for these dealerships - we only do the LIFO calculations for them - we cannot provide the wealth of information relating the absolute amounts of the LIFO reserves to other financial statement information for the dealerships such as the relationships of the LIFO reserves at year-end to the their net income, total assets, cash flow or selected operating ratios.

Accordingly, the data collected in our survey only includes the dealerships' ending inventory at cost as of Dec. 31, 2008 and 2009, and the LIFO reserve balances as of those dates. From this, we have computed the increases/decreases (absolute and percentage), comparing year-end 2008 and 2009 inventory levels and LIFO reserves. Of one thing I am almost absolutely certain ... these dealerships used our LIFO computations in filing their 2008 and 2009 income tax returns.

Similarities of the Dealerships

None of these dealerships are publicly held companies.

Our survey is based on the LIFO computations we have done for their new vehicle inventories in accordance with the Alternative LIFO Method for New Vehicles. In other words, the LIFO computations for these dealerships are all consistent in the respect that they have all been done in accordance with the requirements set forth in Revenue Procedure 97-36.

Differences Among the Dealerships

Some of the dealerships have recently elected to use the Vehicle-Pool Method (under Rev. Proc. 2008-23) which permits them to combine what were previously two, separate LIFO pools - one for new automobiles and the other for new light-duty trucks - into a single, combined pool for all new vehicles.

Other dealerships have elected not to make this change for one reason or another. Frankly, some dealers did not want to further increase their LIFO reserves by making this pooling change. Other dealers did not make the change because they had net operating loss carryovers that would absorb the income effect of the recapture of a portion of their LIFO reserves.

As of Dec. 31, 2009, slightly more than one-half of the dealerships (59 out of 105 or 56% of the total) had changed to the single, combined Vehicle-Pool Method. Of these 59 dealerships, 36 had made the change for 2008, and 23 made the change for 2009. The other dealerships (46 out of 105 or 44%) had not elected to change to the Vehicle-Pool Method (i.e., these dealerships maintained two separate LIFO pools ... Pool #1 for new automobiles and Pool #2 for new light-duty trucks). As explained elsewhere, this difference in pooling method is not relevant to this survey.

How Big Are Auto Dealers' LIFO Reserves? ... Our Firm's Survey of LIFO Reserve Balances

For those 46 dealerships that had not elected to change to the Vehicle-Pool Method, the LIFO inventory cost amounts for both pools were added together, and the LIFO reserve amounts for both pools were added together. This apparent difference in the pooling method for the dealerships in this survey does not impact the computation of the ratio of the LIFO reserve to the inventory cost at the end of the year. However, this difference does affect the underlying LIFO layer history structure and rate of LIFO recapture potential for each layer. The LIFO layer structure and the layer-by-layer recapture potential are not relevant factors in this survey.

Inconsistency of dealerships in eliminating trade discounts, etc. from inventory cost. There is also a slight inconsistency in the information presented for the dealerships because some of them have reduced their ending inventory amounts to eliminate trade discounts, floorplan assistance payments and certain (local or regional) advertising payments. Other dealerships have not reduced their ending inventory amounts by these costs. The ending inventory amounts for these dealerships has not been adjusted to reflect an estimate (2% or other) to make the inventory amounts and the percentage calculations comparable.

Most Important Difference Among the Dealerships

The single most important difference involving all the dealerships is that they have elected LIFO at different points in time. Technically speaking, they have different base years, and their LIFO elections have not all been in effect for the same number of years. Some have been on LIFO since the early '70s ... some have elected LIFO in the '80s ... some in the '90s, etc.

Furthermore, some dealerships that elected LIFO many years ago when they were operating for tax purposes as C corporations changed to operate as S corporations - either in 1986 or shortly thereafter. Other dealerships that elected LIFO when they were C corporations did not make the change to S status shortly after 1986, but held off for many years until some change in their size, scope, or method of operation made it more practical for tax purposes to elect S status in order to achieve other, more significant potential tax benefits even though that change was made at the cost of recapturing their entire LIFO reserves as of the end of their last C corporations year.

Most of these dealerships continued on LIFO with their first S corporation year. Therefore, their LIFO reserves as of December 31, 2008 and 2009 reflect a much, later start on LIFO. What is important in this context, however, is that the use of the LIFO method for these "johnny-come-lately" to the S election dealerships provided enormous benefits in previous years and without these LIFO elections, even though they had to repay their LIFO reserves previously it is unlikely that these dealerships would not have been able to grow to their present size and status.

What Can I Say About the Results?

Our survey yields 6 ***Conclusions***, and these are set forth on the previous page.

The dissimilarities, including the difference in periods of time that these dealerships have been on LIFO, coupled with the diversity of manufacturers new vehicles sold by the dealerships, could be argued to support the conclusion that this sample is representative of a far larger number of dealerships. The greater diversity of the individual dealerships is what strengthens its representativeness of a larger number of dealerships.

After analyzing these dealerships and their data included in our survey, I am reasonably confident in making one claim: Despite the disparity of the dealerships (and their respective LIFO histories) reflected in our survey, if any other CPA firm were to draw a comparable composite of 50, 100, 250 or more of their dealerships on LIFO ... the overall results would not be significantly different from the results of our survey.

On the following pages, ***Exhibit 1*** presents the dealership listing ranked by size of December 31, 2009 ending inventory levels. ***Exhibit 2*** presents the same data for the dealerships ranked by size of percentage decrease in ending inventory levels from 2008 to 2009.

There are totals at the bottom of each Exhibit. One set of totals reflects all of the dealerships; the other set of totals excludes the single largest dealership since it is significantly larger than all of the rest.

Exhibit 1

Comparison of Automobile Dealership New Vehicle Inventory Levels
Based on a Sample of 105 Dealerships
Ranked by Size of December 31, 2009 Ending Inventory Levels

	Dec. 31, 2009 — Single, Combined Pool - All New Vehicles				Dec. 31, 2008 — Single, Combined Pool - All New Vehicles				Ending Inventory Decrease (Increase) from the 2008 to 2009 Level		LIFO Reserve Decrease (Increase) from 12/31/08 to 12/31/09	
#	Ending Inventory at Cost	LIFO Reserve		LIFO Reserve as a % of Ending Inventory at Cost	Ending Inventory at Cost	LIFO Reserve		LIFO Reserve as a % of Ending Inventory at Cost	Amount	%	Amount	%
46	43,624,941	2,424,638	*	5.56%	67,338,997	2,540,116	*	3.77%	23,714,056	35.22%	115,478	4.55%
34	20,018,749	4,547,992	*	22.72%	26,558,800	4,934,140	*	18.58%	6,540,051	24.62%	386,148	7.83%
82	19,832,156	2,476,884	*	12.49%	5,761,857	2,324,220	*	40.34%	(14,070,299)	-244.20%	(152,664)	-6.57%
10	16,830,086	2,357,557	*	14.01%	18,589,045	2,272,573	†	12.23%	1,758,959	9.46%	(84,984)	-3.74%
98	15,492,052	1,369,006	*	8.84%	21,379,740	1,264,680	†	5.92%	5,887,688	27.54%	(104,326)	-8.25%
49	14,857,949	1,429,233	*	9.62%	22,132,739	1,297,788	*	5.86%	7,274,790	32.87%	(131,445)	-10.13%
88	14,398,969	3,774,858	*	26.22%	5,366,379	3,625,302	*	67.56%	(9,032,590)	-168.32%	(149,556)	-4.13%
18	12,411,785	2,393,889	*	19.29%	14,396,129	2,161,630	*	15.02%	1,984,344	13.78%	(232,259)	-10.74%
67	10,557,251	3,517,706	*	33.32%	19,466,053	3,884,508	*	19.96%	8,908,802	45.77%	366,802	9.44%
103	10,448,997	385,378	†	3.69%	8,931,779	357,064	†	4.00%	(1,517,218)	-16.99%	(28,314)	-7.93%
11	9,780,357	368,451	*	3.77%	11,395,246	248,047	†	2.18%	1,614,889	14.17%	(120,404)	-48.54%
56	9,601,992	248,118	*	2.58%	14,784,102	141,607	*	0.96%	5,182,110	35.05%	(106,511)	-75.22%
101	9,347,754	2,225,543	*	23.81%	17,438,539	2,070,628	*	11.87%	8,090,785	46.40%	(154,915)	-7.48%
70	9,314,324	1,217,941	*	13.08%	14,836,727	1,174,971	†	7.92%	5,522,403	37.22%	(42,970)	-3.66%
89	9,263,007	880,719	*	9.51%	15,741,658	849,128	†	5.39%	6,478,651	41.16%	(31,591)	-3.72%
52	8,399,154	2,382,221	*	28.36%	12,004,988	2,558,642	†	21.31%	3,605,834	30.04%	176,421	6.90%
84	8,255,841	391,311	*	4.74%	8,524,059	392,441	†	4.60%	268,218	3.15%	1,130	0.29%
35	8,139,036	1,312,764	*	16.13%	12,538,181	1,254,159	†	10.00%	4,399,145	35.09%	(58,605)	-4.67%
59	6,942,457	361,509	†	5.21%	7,496,475	235,193	†	3.14%	554,018	7.39%	(126,316)	-53.71%
54	6,611,664	1,270,126	†	19.21%	9,824,256	1,048,587	†	10.67%	3,212,592	32.70%	(221,539)	-21.13%
100	6,329,266	1,371,880	*	21.68%	8,344,735	1,439,471	*	17.25%	2,015,469	24.15%	67,591	4.70%
71	6,196,245	514,134	*	8.30%	5,763,131	399,384	*	6.93%	(433,114)	-7.52%	(114,750)	-28.73%
2	6,116,665	3,063,230	*	50.08%	12,394,509	3,231,323	*	26.07%	6,277,844	50.65%	168,093	5.20%
15	6,097,629	939,819	*	15.41%	10,414,193	846,785	†	8.13%	4,316,564	41.45%	(93,034)	-10.99%
55	6,045,786	721,355	*	11.93%	6,408,579	645,766	*	10.08%	362,793	5.66%	(75,589)	-11.71%
27	5,904,856	1,621,540	*	27.46%	13,033,828	2,022,807	†	15.52%	7,128,972	54.70%	401,267	19.84%
28	5,824,499	2,559,114	*	43.94%	17,640,803	3,037,984	*	17.22%	11,816,304	66.98%	478,870	15.76%
75	5,759,469	989,490	†	17.18%	5,685,394	815,893	†	14.35%	(74,075)	-1.30%	(173,597)	-21.28%
62	5,703,891	682,501	†	11.97%	5,511,399	559,988	†	10.16%	(192,492)	-3.49%	(122,513)	-21.88%
40	5,662,262	2,422,733	†	42.79%	12,288,218	2,398,089	†	19.52%	6,625,956	53.92%	(24,644)	-1.03%
29	5,101,903	1,082,137	*	21.21%	10,869,908	1,526,963	†	14.05%	5,768,005	53.06%	444,826	29.13%
3	4,989,073	799,147	†	16.02%	8,291,183	775,027	†	9.35%	3,302,110	39.83%	(24,120)	-3.11%
8	4,665,505	589,346	*	12.63%	3,406,508	403,117	*	11.83%	(1,258,997)	-36.96%	(186,229)	-46.20%
22	4,542,014	963,630	†	21.22%	3,275,219	827,600	†	25.27%	(1,266,795)	-38.68%	(136,030)	-16.44%
41	4,428,286	383,696	†	8.66%	7,670,583	260,259	†	3.39%	3,242,297	42.27%	(123,437)	-47.43%
104	4,300,270	241,314	†	5.61%	6,313,887	187,844	†	2.98%	2,013,617	31.89%	(53,470)	-28.47%
4	4,252,441	2,047,741	†	48.15%	6,527,547	2,312,980	†	35.43%	2,275,106	34.85%	265,239	11.47%
32	4,182,902	1,864,716	*	44.58%	5,265,406	1,833,003	*	34.81%	1,082,504	20.56%	(31,713)	-1.73%
86	4,106,535	608,132	†	14.81%	6,200,220	579,048	†	9.34%	2,093,685	33.77%	(29,084)	-5.02%
17	4,020,193	842,926	*	20.97%	3,709,253	722,627	*	19.48%	(310,940)	-8.38%	(120,299)	-16.65%
23	3,957,768	713,930	*	18.04%	5,206,045	396,273	†	7.61%	1,248,277	23.98%	(317,657)	-80.16%
21	3,882,248	510,663	*	13.15%	4,488,052	410,413	*	9.14%	605,804	13.50%	(100,250)	-24.43%
105	3,826,348	307,788	†	8.04%	6,763,631	324,961	†	4.80%	2,937,283	43.43%	17,173	5.28%
78	3,735,055	2,321,240	†	62.15%	3,957,457	2,282,186	†	57.67%	222,402	5.62%	(39,054)	-1.71%
87	3,645,284	294,155	†	8.07%	3,513,415	294,044	†	8.37%	(131,869)	-3.75%	(111)	-0.04%
53	3,503,764	1,671,703	†	47.71%	3,874,109	1,660,008	†	42.85%	370,345	9.56%	(11,695)	-0.70%
63	3,423,840	98,043	†	2.86%	1,976,227	85,703	†	4.34%	(1,447,613)	-73.25%	(12,340)	-14.40%
16	3,376,999	1,092,581	*	32.35%	6,372,364	1,331,029	*	20.89%	2,995,365	47.01%	238,448	17.91%
6	3,263,340	292,294	†	8.96%	7,294,521	406,472	†	5.57%	4,031,181	55.26%	114,178	28.09%
19	3,230,522	705,611	*	21.84%	5,671,226	971,300	*	17.13%	2,440,704	43.04%	265,689	27.35%
72	3,046,147	531,665	†	17.45%	2,267,602	523,232	†	23.07%	(778,545)	-34.33%	(8,433)	-1.61%
13	3,011,263	629,061	*	20.89%	2,575,693	572,761	†	22.24%	(435,570)	-16.91%	(56,300)	-9.83%
102	2,933,232	326,184	*	11.12%	4,438,870	427,410	*	9.63%	1,505,638	33.92%	101,226	23.68%
38	2,926,299	602,063	*	20.57%	3,197,333	535,837	*	16.76%	271,034	8.48%	(66,226)	-12.36%
33	2,906,428	1,174,939	*	40.43%	4,805,242	1,196,382	*	24.90%	1,898,814	39.52%	21,443	1.79%
1	2,841,031	1,170,462	*	41.20%	4,457,247	1,203,833	†	27.01%	1,616,216	36.26%	33,371	2.77%
97	2,817,638	357,043	†	12.67%	6,392,181	397,862	†	6.22%	3,574,543	55.92%	40,819	10.26%
9	2,666,278	1,514,721	†	56.81%	3,210,901	1,479,689	†	46.08%	544,623	16.96%	(35,032)	-2.37%
65	2,662,536	92,595	†	3.48%	5,702,068	105,711	†	1.85%	3,039,532	53.31%	13,116	12.41%
85	2,609,296	217,748	†	8.35%	2,008,393	189,189	†	9.42%	(600,903)	-29.92%	(28,559)	-15.10%
66	2,525,029	362,397	*	14.35%	4,417,147	334,131	†	7.56%	1,892,118	42.84%	(28,266)	-8.46%
30	2,517,591	216,575	*	8.60%	3,660,601	208,468	*	5.69%	1,143,010	31.22%	(8,107)	-3.89%
96	2,498,063	434,044	†	17.38%	6,788,401	481,756	†	7.10%	4,290,338	63.20%	47,712	9.90%
68	2,481,722	209,942	*	8.46%	3,137,841	130,306	†	4.15%	656,119	20.91%	(79,636)	-61.11%
50	2,344,496	209,898	*	8.95%	7,486,306	260,989	*	3.49%	5,141,810	68.68%	51,091	19.58%
Subtotals Forward to Page 2 of 2 ...	444,990,428	75,701,770			607,183,125	75,671,327			162,192,697		(30,443)	

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A Periodic Update of LIFO - News, Views and Ideas

Exhibit 1

Comparison of Automobile Dealership New Vehicle Inventory Levels
Based on a Sample of 105 Dealerships
Ranked by Size of December 31, 2009 Ending Inventory Levels

Page 2 of 2

#	Dec. 31, 2009 — Single, Combined Pool - All New Vehicles: Ending Inventory at Cost	Dec. 31, 2009: LIFO Reserve	Dec. 31, 2009: LIFO Reserve as a % of Ending Inventory at Cost	Dec. 31, 2008 — Single, Combined Pool - All New Vehicles: Ending Inventory at Cost	Dec. 31, 2008: LIFO Reserve	Dec. 31, 2008: LIFO Reserve as a % of Ending Inventory at Cost	Ending Inventory Decrease (Increase) from the 2008 to 2009 Level: Amount	Ending Inventory Decrease (Increase): %	LIFO Reserve Decrease (Increase) from 12/31/08 to 12/31/09: Amount	LIFO Reserve Decrease (Increase): %
Subtotals Carried From Page 1 of 2 ...	444,990,428	75,701,770		607,183,125	75,671,327		162,192,697		(30,443)	
24	2,318,225	111,382 †	4.80%	2,882,637	79,674 †	2.76%	564,412	19.58%	(31,708)	-39.80%
94	2,142,115	658,069 *	30.72%	2,218,863	609,322 *	27.46%	76,748	3.46%	(48,747)	-8.00%
76	2,120,424	427,515 †	20.16%	1,579,347	368,309 †	23.32%	(541,077)	-34.26%	(59,206)	-16.08%
42	2,114,278	942,795 †	44.59%	3,833,534	1,293,136 †	33.73%	1,719,256	44.85%	350,341	27.09%
93	2,064,768	1,092,545 †	52.91%	2,694,945	1,244,724 †	46.19%	630,177	23.38%	152,179	12.23%
83	2,060,488	1,350,740 *	65.55%	4,445,434	2,500,896 *	56.26%	2,384,946	53.65%	1,150,156	45.99%
20	2,039,269	500,521 *	24.54%	1,970,313	447,625 *	22.72%	(68,956)	-3.50%	(52,896)	-11.82%
58	2,001,120	165,488 †	8.27%	5,347,675	221,767 †	4.15%	3,346,555	62.58%	56,279	25.38%
90	1,924,832	172,382 *	8.96%	6,653,252	186,459 †	2.80%	4,728,420	71.07%	14,077	7.55%
64	1,902,713	1,049,256 *	55.15%	2,079,708	1,020,967 †	49.09%	176,995	8.51%	(28,289)	-2.77%
12	1,899,944	168,980 *	8.89%	3,483,649	187,543 †	5.38%	1,583,705	45.46%	18,563	9.90%
39	1,895,465	596,021 †	31.44%	5,404,438	930,367 †	17.21%	3,508,973	64.93%	334,346	35.94%
61	1,841,817	226,396 †	12.29%	1,582,182	202,649 †	12.81%	(259,635)	-16.41%	(23,747)	-11.72%
5	1,801,482	23,683 †	1.31%	1,719,911	30,271 †	1.76%	(81,571)	-4.74%	6,588	21.76%
92	1,748,770	122,272 †	6.99%	1,841,521	105,691 †	5.74%	92,751	5.04%	(16,581)	-15.69%
57	1,672,567	31,715 †	1.90%	1,257,506	35,863 †	2.85%	(415,061)	-33.01%	4,148	11.57%
7	1,645,403	192,932 †	11.73%	1,976,284	178,928 †	9.05%	330,881	16.74%	(14,004)	-7.83%
81	1,599,901	1,159,174 *	72.45%	2,242,034	1,593,341 *	71.07%	642,133	28.64%	434,167	27.25%
99	1,597,591	218,444 *	13.67%	2,524,019	205,451 *	8.14%	926,428	36.70%	(12,993)	-6.32%
74	1,567,920	468,334 †	29.87%	3,162,365	755,103 †	23.88%	1,594,445	50.42%	286,769	37.98%
36	1,398,274	32,385 *	2.32%	2,611,260	18,483 *	0.71%	1,212,986	46.45%	(13,902)	-75.22%
95	1,381,698	76,310 †	5.52%	3,259,358	87,985 †	2.70%	1,877,660	57.61%	11,675	13.27%
26	1,371,179	773,885 †	56.44%	2,352,795	1,191,367 †	50.64%	981,616	41.72%	417,482	35.04%
37	1,336,819	333,368 †	24.94%	2,036,186	341,418 †	16.77%	699,367	34.35%	8,050	2.36%
25	1,314,380	701,481 *	53.37%	3,294,021	908,775 †	27.59%	1,979,641	60.10%	207,294	22.81%
73	1,311,088	365,532 †	27.88%	2,174,014	448,067 †	20.61%	862,926	39.69%	82,535	18.42%
51	1,284,768	18,712 *	1.46%	3,236,462	38,851 *	1.20%	1,951,694	60.30%	20,139	51.84%
77	1,239,591	517,647 †	41.76%	1,942,228	656,434 †	33.80%	702,637	36.18%	138,787	21.14%
79	1,206,753	115,790 †	9.60%	1,335,982	118,124 †	8.84%	129,229	9.67%	2,334	1.98%
91	1,158,259	40,208 †	3.47%	1,393,554	44,424 †	3.19%	235,295	16.88%	4,216	9.49%
47	1,156,309	635,025 *	54.92%	1,622,796	773,793 *	47.68%	466,487	28.75%	138,768	17.93%
45	1,120,306	716,680 *	63.97%	3,921,133	1,304,503 †	33.27%	2,800,827	71.43%	587,823	45.06%
80	1,062,715	445,543 *	41.92%	2,450,711	717,578 †	29.28%	1,387,996	56.64%	272,035	37.91%
60	993,981	268,670 †	27.03%	866,373	264,216 †	30.50%	(127,608)	-14.73%	(4,454)	-1.69%
14	987,452	181,838 *	18.41%	2,454,310	184,469 †	7.52%	1,466,858	59.77%	2,631	1.43%
31	883,972	387,484 †	43.83%	3,479,552	874,181 †	25.12%	2,595,580	74.60%	486,697	55.67%
43	867,212	393,698 *	45.40%	2,011,317	871,448 *	43.33%	1,144,105	56.88%	477,750	54.82%
48	845,671	54,544 *	6.45%	1,701,332	52,101 *	3.06%	855,661	50.29%	(2,443)	-4.69%
44	482,412	9,357 *	1.94%	1,296,228	5,113 *	0.39%	813,816	62.78%	(4,244)	-83.00%
69	475,397	45,866 †	9.65%	1,330,645	83,101 †	6.25%	855,248	64.27%	37,235	44.81%

Totals for All 105 Dealerships

Dec. 31, 2009 Ending Inventory	Dec. 31, 2009 LIFO Reserve	%	Dec. 31, 2008 Ending Inventory	Dec. 31, 2008 LIFO Reserve	%	Inventory Decrease Amount	%	LIFO Reserve Decrease Amount	%
504,827,756	91,494,437	18.12%	710,852,999	96,853,844	13.63%	206,025,243	28.98%	5,359,407	5.53%

Totals Excluding Largest Dealership (#46)

Dec. 31, 2009 Ending Inventory	Dec. 31, 2009 LIFO Reserve	%	Dec. 31, 2008 Ending Inventory	Dec. 31, 2008 LIFO Reserve	%	Inventory Decrease Amount	%	LIFO Reserve Decrease Amount	%
461,202,815	89,069,799	19.31%	643,514,002	94,313,728	14.66%	182,311,187	28.33%	5,243,929	5.56%

Notes:

1. See the accompanying discussion for specifics regarding the compilation of this information.
2. As of Dec. 31, 2009, slightly more than one-half of the dealerships had changed to the single, combined (Vehicle-Pool) method.
3. Dealerships that had changed to the single pool method are indicated by the * following their LIFO Reserve amount.
4. For those dealerships that had not changed to the single pool method, the sum of their two separate pools (one for new automobiles and one for new light-duty trucks) is indicated by the † following their LIFO Reserve amount.

Exhibit 2

Comparison of Automobile Dealership New Vehicle Inventory Levels
Based on a Sample of 105 Dealerships
Ranked by Size of Percentage Decrease in Ending Inventory Levels from 2008 to 2009

	Dec. 31, 2009 — *Single, Combined Pool - All New Vehicles*				*Dec. 31, 2008* — *Single, Combined Pool - All New Vehicles*				*Ending Inventory Decrease (Increase) from the 2008 to 2009 Level*		*LIFO Reserve Decrease (Increase) from 12/31/08 to 12/31/09*	
#	Ending Inventory at Cost	LIFO Reserve		LIFO Reserve as a % of Ending Inventory at Cost	Ending Inventory at Cost	LIFO Reserve		LIFO Reserve as a % of Ending Inventory at Cost	Amount	Percentage Decrease (Increase)	Amount	%
31	883,972	387,484	†	43.83%	3,479,552	874,181	†	25.12%	2,595,580	74.60%	486,697	55.67%
45	1,120,306	716,680	*	63.97%	3,921,133	1,304,503	†	33.27%	2,800,827	71.43%	587,823	45.06%
90	1,924,832	172,382	*	8.96%	6,653,252	186,459	†	2.80%	4,728,420	71.07%	14,077	7.55%
50	2,344,496	209,898	*	8.95%	7,486,306	260,989	*	3.49%	5,141,810	68.68%	51,091	19.58%
28	5,824,499	2,559,114	*	43.94%	17,640,803	3,037,984	*	17.22%	11,816,304	66.98%	478,870	15.76%
39	1,895,465	596,021	†	31.44%	5,404,438	930,367	†	17.21%	3,508,973	64.93%	334,346	35.94%
69	475,397	45,866	†	9.65%	1,330,645	83,101	†	6.25%	855,248	64.27%	37,235	44.81%
96	2,498,063	434,044	†	17.38%	6,788,401	481,756	†	7.10%	4,290,338	63.20%	47,712	9.90%
44	482,412	9,357	*	1.94%	1,296,228	5,113	*	0.39%	813,816	62.78%	(4,244)	-83.00%
58	2,001,120	165,488	†	8.27%	5,347,675	221,767	†	4.15%	3,346,555	62.58%	56,279	25.38%
51	1,284,768	18,712	*	1.46%	3,236,462	38,851	*	1.20%	1,951,694	60.30%	20,139	51.84%
25	1,314,380	701,481	*	53.37%	3,294,021	908,775	†	27.59%	1,979,641	60.10%	207,294	22.81%
14	987,452	181,838	*	18.41%	2,454,310	184,469	†	7.52%	1,466,858	59.77%	2,631	1.43%
95	1,381,698	76,310	†	5.52%	3,259,358	87,985	†	2.70%	1,877,660	57.61%	11,675	13.27%
43	867,212	393,698	*	45.40%	2,011,317	871,448	*	43.33%	1,144,105	56.88%	477,750	54.82%
80	1,062,715	445,543	*	41.92%	2,450,711	717,578	†	29.28%	1,387,996	56.64%	272,035	37.91%
97	2,817,638	357,043	†	12.67%	6,392,181	397,862	†	6.22%	3,574,543	55.92%	40,819	10.26%
6	3,263,340	292,294	†	8.96%	7,294,521	406,472	†	5.57%	4,031,181	55.26%	114,178	28.09%
27	5,904,856	1,621,540	*	27.46%	13,033,828	2,022,807	†	15.52%	7,128,972	54.70%	401,267	19.84%
40	5,662,262	2,422,733	†	42.79%	12,288,218	2,398,089	†	19.52%	6,625,956	53.92%	(24,644)	-1.03%
83	2,060,488	1,350,740	*	65.55%	4,445,434	2,500,896	*	56.26%	2,384,946	53.65%	1,150,156	45.99%
65	2,662,536	92,595	†	3.48%	5,702,068	105,711	†	1.85%	3,039,532	53.31%	13,116	12.41%
29	5,101,903	1,082,137	*	21.21%	10,869,908	1,526,963	†	14.05%	5,768,005	53.06%	444,826	29.13%
2	6,116,665	3,063,230	*	50.08%	12,394,509	3,231,323	*	26.07%	6,277,844	50.65%	168,093	5.20%
74	1,567,920	468,334	†	29.87%	3,162,365	755,103	†	23.88%	1,594,445	50.42%	286,769	37.98%
48	845,671	54,544	*	6.45%	1,701,332	52,101	*	3.06%	855,661	50.29%	(2,443)	-4.69%
16	3,376,999	1,092,581	*	32.35%	6,372,364	1,331,029	*	20.89%	2,995,365	47.01%	238,448	17.91%
36	1,398,274	32,385	*	2.32%	2,611,260	18,483	*	0.71%	1,212,986	46.45%	(13,902)	-75.22%
101	9,347,754	2,225,543	*	23.81%	17,438,539	2,070,628	*	11.87%	8,090,785	46.40%	(154,915)	-7.48%
67	10,557,251	3,517,706	*	33.32%	19,466,053	3,884,508	*	19.96%	8,908,802	45.77%	366,802	9.44%
12	1,899,944	168,980	*	8.89%	3,483,649	187,543	†	5.38%	1,583,705	45.46%	18,563	9.90%
42	2,114,278	942,795	†	44.59%	3,833,534	1,293,136	†	33.73%	1,719,256	44.85%	350,341	27.09%
105	3,826,348	307,788	†	8.04%	6,763,631	324,961	†	4.80%	2,937,283	43.43%	17,173	5.28%
19	3,230,522	705,611	*	21.84%	5,671,226	971,300	*	17.13%	2,440,704	43.04%	265,689	27.35%
66	2,525,029	362,397	*	14.35%	4,417,147	334,131	†	7.56%	1,892,118	42.84%	(28,266)	-8.46%
41	4,428,286	383,696	†	8.66%	7,670,583	260,259	†	3.39%	3,242,297	42.27%	(123,437)	-47.43%
26	1,371,179	773,885	†	56.44%	2,352,795	1,191,367	†	50.64%	981,616	41.72%	417,482	35.04%
15	6,097,629	939,819	*	15.41%	10,414,193	846,785	†	8.13%	4,316,564	41.45%	(93,034)	-10.99%
89	9,263,007	880,719	*	9.51%	15,741,658	849,128	†	5.39%	6,478,651	41.16%	(31,591)	-3.72%
3	4,989,073	799,147	†	16.02%	8,291,183	775,027	†	9.35%	3,302,110	39.83%	(24,120)	-3.11%
73	1,311,088	365,532	†	27.88%	2,174,014	448,067	†	20.61%	862,926	39.69%	82,535	18.42%
33	2,906,428	1,174,939	*	40.43%	4,805,242	1,196,382	*	24.90%	1,898,814	39.52%	21,443	1.79%
70	9,314,324	1,217,941	*	13.08%	14,836,727	1,174,971	†	7.92%	5,522,403	37.22%	(42,970)	-3.66%
99	1,597,591	218,444	*	13.67%	2,524,019	205,451	*	8.14%	926,428	36.70%	(12,993)	-6.32%
1	2,841,031	1,170,462	*	41.20%	4,457,247	1,203,833	†	27.01%	1,616,216	36.26%	33,371	2.77%
77	1,239,591	517,647	†	41.76%	1,942,228	656,434	†	33.80%	702,637	36.18%	138,787	21.14%
46	43,624,941	2,424,638	*	5.56%	67,338,997	2,540,116	*	3.77%	23,714,056	35.22%	115,478	4.55%
35	8,139,036	1,312,764	*	16.13%	12,538,181	1,254,159	†	10.00%	4,399,145	35.09%	(58,605)	-4.67%
56	9,601,992	248,118	*	2.58%	14,784,102	141,607	*	0.96%	5,182,110	35.05%	(106,511)	-75.22%
4	4,252,441	2,047,741	†	48.15%	6,527,547	2,312,980	†	35.43%	2,275,106	34.85%	265,239	11.47%
37	1,336,819	333,368	†	24.94%	2,036,186	341,418	†	16.77%	699,367	34.35%	8,050	2.36%
102	2,933,232	326,184	*	11.12%	4,438,870	427,410	*	9.63%	1,505,638	33.92%	101,226	23.68%
86	4,106,535	608,132	†	14.81%	6,200,220	579,048	†	9.34%	2,093,685	33.77%	(29,084)	-5.02%
49	14,857,949	1,429,233	*	9.62%	22,132,739	1,297,788	*	5.86%	7,274,790	32.87%	(131,445)	-10.13%
54	6,611,664	1,270,126	†	19.21%	9,824,256	1,048,587	†	10.67%	3,212,592	32.70%	(221,539)	-21.13%
104	4,300,270	241,314	†	5.61%	6,313,887	187,844	†	2.98%	2,013,617	31.89%	(53,470)	-28.47%
30	2,517,591	216,575	*	8.60%	3,660,601	208,468	*	5.69%	1,143,010	31.22%	(8,107)	-3.89%
52	8,399,154	2,382,221	*	28.36%	12,004,988	2,558,642	†	21.31%	3,605,834	30.04%	176,421	6.90%
47	1,156,309	635,025	*	54.92%	1,622,796	773,793	*	47.68%	466,487	28.75%	138,768	17.93%
81	1,599,901	1,159,174	*	72.45%	2,242,034	1,593,341	*	71.07%	642,133	28.64%	434,167	27.25%
98	15,492,052	1,369,006	*	8.84%	21,379,740	1,264,680	†	5.92%	5,887,688	27.54%	(104,326)	-8.25%
34	20,018,749	4,547,992	*	22.72%	26,558,800	4,934,140	*	18.58%	6,540,051	24.62%	386,148	7.83%
100	6,329,266	1,371,880	*	21.68%	8,344,735	1,439,471	*	17.25%	2,015,469	24.15%	67,591	4.70%
23	3,957,768	713,930	*	18.04%	5,206,045	396,273	†	7.61%	1,248,277	23.98%	(317,657)	-80.16%
93	2,064,768	1,092,545	†	52.91%	2,694,945	1,244,724	†	46.19%	630,177	23.38%	152,179	12.23%
Subtotals Forward to Page 2 of 2 ...	307,288,129	59,447,089			534,455,937	67,360,565			227,167,808		7,913,476	

Exhibit 2

Comparison of Automobile Dealership New Vehicle Inventory Levels
Based on a Sample of 105 Dealerships
Ranked by Size of Percentage Decrease in Ending Inventory Levels from 2008 to 2009

#	Dec. 31, 2009 — Single, Combined Pool - All New Vehicles: Ending Inventory at Cost	LIFO Reserve		LIFO Reserve as a % of Ending Inventory at Cost	Dec. 31, 2008 — Single, Combined Pool - All New Vehicles: Ending Inventory at Cost	LIFO Reserve		LIFO Reserve as a % of Ending Inventory at Cost	Ending Inventory Decrease (Increase) from the 2008 to 2009 Level: Amount	Percentage Decrease (Increase)	LIFO Reserve Decrease (Increase) from 12/31/08 to 12/31/09: Amount	%
Subtotals Carried From Page 1 of 2 ...	307,288,129	59,447,089			534,455,937	67,360,565			227,167,808		7,913,476	
68	2,481,722	209,942	*	8.46%	3,137,841	130,306	†	4.15%	656,119	20.91%	(79,636)	-61.11%
32	4,182,902	1,864,716	*	44.58%	5,265,406	1,833,003	*	34.81%	1,082,504	20.56%	(31,713)	-1.73%
24	2,318,225	111,382	†	4.80%	2,882,637	79,674	†	2.76%	564,412	19.58%	(31,708)	-39.80%
9	2,666,278	1,514,721	†	56.81%	3,210,901	1,479,689	†	46.08%	544,623	16.96%	(35,032)	-2.37%
91	1,158,259	40,208	†	3.47%	1,393,554	44,424	†	3.19%	235,295	16.88%	4,216	9.49%
7	1,645,403	192,932	†	11.73%	1,976,284	178,928	†	9.05%	330,881	16.74%	(14,004)	-7.83%
11	9,780,357	368,451	*	3.77%	11,395,246	248,047	†	2.18%	1,614,889	14.17%	(120,404)	-48.54%
18	12,411,785	2,393,889	*	19.29%	14,396,129	2,161,630	*	15.02%	1,984,344	13.78%	(232,259)	-10.74%
21	3,882,248	510,663	*	13.15%	4,488,052	410,413	*	9.14%	605,804	13.50%	(100,250)	-24.43%
79	1,206,753	115,790	†	9.60%	1,335,982	118,124	†	8.84%	129,229	9.67%	2,334	1.98%
53	3,503,764	1,671,703	†	47.71%	3,874,109	1,660,008	†	42.85%	370,345	9.56%	(11,695)	-0.70%
10	16,830,086	2,357,557	*	14.01%	18,589,045	2,272,573	†	12.23%	1,758,959	9.46%	(84,984)	-3.74%
64	1,902,713	1,049,256	*	55.15%	2,079,708	1,020,967	†	49.09%	176,995	8.51%	(28,289)	-2.77%
38	2,926,299	602,063	*	20.57%	3,197,333	535,837	*	16.76%	271,034	8.48%	(66,226)	-12.36%
59	6,942,457	361,509	†	5.21%	7,496,475	235,193	†	3.14%	554,018	7.39%	(126,316)	-53.71%
55	6,045,786	721,355	*	11.93%	6,408,579	645,766	*	10.08%	362,793	5.66%	(75,589)	-11.71%
78	3,735,055	2,321,240	†	62.15%	3,957,457	2,282,186	†	57.67%	222,402	5.62%	(39,054)	-1.71%
92	1,748,770	122,272	†	6.99%	1,841,521	105,691	†	5.74%	92,751	5.04%	(16,581)	-15.69%
94	2,142,115	658,069	*	30.72%	2,218,863	609,322	*	27.46%	76,748	3.46%	(48,747)	-8.00%
84	8,255,841	391,311	*	4.74%	8,524,059	392,441	†	4.60%	268,218	3.15%	1,130	0.29%
75	5,759,469	989,490	†	17.18%	5,685,394	815,893	†	14.35%	(74,075)	-1.30%	(173,597)	-21.28%
62	5,703,891	682,501	†	11.97%	5,511,399	559,988	†	10.16%	(192,492)	-3.49%	(122,513)	-21.88%
20	2,039,269	500,521	*	24.54%	1,970,313	447,625	*	22.72%	(68,956)	-3.50%	(52,896)	-11.82%
87	3,645,284	294,155	†	8.07%	3,513,415	294,044	†	8.37%	(131,869)	-3.75%	(111)	-0.04%
5	1,801,482	23,683	†	1.31%	1,719,911	30,271	†	1.76%	(81,571)	-4.74%	6,588	21.76%
71	6,196,245	514,134	*	8.30%	5,763,131	399,384	*	6.93%	(433,114)	-7.52%	(114,750)	-28.73%
17	4,020,193	842,926	*	20.97%	3,709,253	722,627	*	19.48%	(310,940)	-8.38%	(120,299)	-16.65%
60	993,981	268,670	†	27.03%	866,373	264,216	†	30.50%	(127,608)	-14.73%	(4,454)	-1.69%
61	1,841,817	226,396	†	12.29%	1,582,182	202,649	†	12.81%	(259,635)	-16.41%	(23,747)	-11.72%
13	3,011,263	629,061	*	20.89%	2,575,693	572,761	†	22.24%	(435,570)	-16.91%	(56,300)	-9.83%
103	10,448,997	385,378	†	3.69%	8,931,779	357,064	†	4.00%	(1,517,218)	-16.99%	(28,314)	-7.93%
85	2,609,296	217,748	†	8.35%	2,008,393	189,189	†	9.42%	(600,903)	-29.92%	(28,559)	-15.10%
57	1,672,567	31,715	†	1.90%	1,257,506	35,863	†	2.85%	(415,061)	-33.01%	4,148	11.57%
76	2,120,424	427,515	†	20.16%	1,579,347	368,309	†	23.32%	(541,077)	-34.26%	(59,206)	-16.08%
72	3,046,147	531,665	†	17.45%	2,267,602	523,232	†	23.07%	(778,545)	-34.33%	(8,433)	-1.61%
8	4,665,505	589,346	*	12.63%	3,406,508	403,117	*	11.83%	(1,258,997)	-36.96%	(186,229)	-46.20%
22	4,542,014	963,630	†	21.22%	3,275,219	827,600	†	25.27%	(1,266,795)	-38.68%	(136,030)	-16.44%
63	3,423,840	98,043	†	2.86%	1,976,227	85,703	†	4.34%	(1,447,613)	-73.25%	(12,340)	-14.40%
88	14,398,969	3,774,858	*	26.22%	5,366,379	3,625,302	*	67.56%	(9,032,590)	-168.32%	(149,556)	-4.13%
82	19,832,156	2,476,884	*	12.49%	5,761,857	2,324,220	*	40.34%	(14,070,299)	-244.20%	(152,664)	-6.57%
Totals for All 105 Dealerships	504,827,756	91,494,437		18.12%	710,852,999	96,853,844		13.63%	206,025,243	28.98%	5,359,407	5.53%
Totals Excluding Largest Dealership (#46)	461,202,815	89,069,799		19.31%	643,514,002	94,313,728		14.66%	182,311,187	28.33%	5,243,929	5.56%

Notes:

1. See the accompanying discussion for specifics regarding the compilation of this information.
2. As of Dec. 31, 2009, slightly more than one-half of the dealerships had changed to the single, combined (Vehicle-Pool) method.
3. Dealerships that had changed to the single pool method are indicated by the * following their LIFO Reserve amount.
4. For those dealerships that had not changed to the single pool method, the sum of their two separate pools (one for new automobiles and one for new light-duty trucks) is indicated by the † following their LIFO Reserve amount.

FORM 3115 FILINGS: NEW REVISIONS & NEW CONCERNS

One of the most important forms a practitioner has to deal with when a client is going to change an accounting method is Form 3115. This form is required to be filed for many, but not necessarily for ***all***, changes in accounting methods (CAMs), whether they relate to different LIFO methods or to any other accounting procedures.

The IRS does not revise Form 3115 annually. Rather, every so often a revision is introduced, and until recently, the last revision of Form 3115 was in December of 2003. The last revision of the Instructions for Form 3115 was in May of 2006.

The recent issuance of several Revenue Procedures - especially Rev. Proc. 2008-52 - and the lengthening of the list of accounting method changes that can be made without advance approval from the IRS account for some of the difficulties that CPAs have experienced in the recent past in completing Forms 3115.

In May, the IRS released revisions of both Form 3115, *Application for Change in Accounting Method*, and the Instructions for Form 3115. Both revisions of Form 3115 and the Instructions are dated December 2009. Accordingly, for some, these revisions are a welcome development.

The December 2009 revision of Form 3115 must be used for all filings with the IRS after June 1, 2010. In certain circumstances, taxpayers were allowed to use the previous version of Form 3115 for method changes that were filed with the IRS before June 1.

As a general rule, if a taxpayer wants to change an accounting method, it must secure permission from the Internal Revenue Service before making the change. However, there are two exceptions.

First, there are some changes in accounting method that do not require permission from the IRS because these changes are required to be made by a different filing procedure (such as filing Form 970 to elect or expand the use LIFO) or because these changes are permitted by Regulation (such as when corporations merge and the accounting methods of two entities are required to be combined according to precise rules found in the Regulations under Section 382).

The second exception requires an awareness that if the IRS had to approve every change in accounting method before the change was made, it would be totally swamped. Therefore, as a practical matter, over the years, the IRS has found it necessary to permit some changes to be made automatically - that is without requiring the taxpayer to obtain permission before making a change.

The list of changes that can be made automatically has lengthened significantly over time, perhaps as the IRS has found itself more and more understaffed in the National Office. It was not uncommon for taxpayers to have to wait years before the IRS would respond and permit certain changes. Accordingly, in the name of efficiency, the list of automatic changes continues to grow.

Over the years, the *LIFO Lookout* has contained many articles describing the procedures ... and the perils ... one should be aware of when making changes in methods ***within*** the LIFO election or when making changes to terminate their LIFO elections. Technically, when a LIFO election is being terminated, that is considered to be a change ***from*** the LIFO method. Changes ***within*** the LIFO method are reported on Page 5 (Schedule C) of Form 3115. In contrast, changes ***from*** the LIFO method are reported on Page 6 (Schedule D, Part II). This is a distinction that sometimes slips by a less experienced practitioner.

see **FORM 3115 FILINGS...**, page 26

Form 3115 Changing Methods

PROCEDURES FOR REQUESTING PERMISSION TO CHANGE LIFO METHODS & SUBMETHODS OF ACCOUNTING ANALYSIS OF FORM 3115 & INSTRUCTIONS (DEC. 2009 REVISION)

At A Glance	***APPLICATION FOR CHANGE IN ACCOUNTING METHOD*** ***FORM 3115 & INSTRUCTIONS ... CHANGES & REVISIONS - REV. DEC. 2009***
Background	• In almost all situations, Form 3115 must be filed to request a change in an accounting method, a submethod or the accounting treatment or definition of any "item." All are considered to be CAMs. ◆ For situations where Form 3115 is (or might not be) required to be filed, see *Practice Guide.* ◆ There are two procedures a taxpayer may use to request a change in accounting method. ▪ ***Automatic change*** requests ... wherein advance permission or consent from the IRS to make the change in method is not required. (Rev. Proc. 2008-52) ▪ ***Advance consent*** requests ... this involves all changes in method other than those specifically treated as automatic change requests. (Rev. Proc. 97-27) • Current revision of Form 3115 is dated Dec. 2009 ... Previous revision was Dec. 2003 • Current revision of Instructions is dated Dec. 2009 ... Previous revision was May 2006
Form 3115 ... 8 Pages	
Page 1	• Taxpayer Identification, CAM Identification & Signature Blocks • Part I ... Information for Automatic Change Request (Ques. 1-2) • Part II ... Information for All Requests (Ques. 3, 4a & b)
Page 2	• Part II ... Information for All Requests ... Cont. (Ques. 4c-11)
Page 3	• Part II ... Information for All Requests ... Cont. (Ques. 12-17) • Part III ... Information for Advance Consent Request (Ques. 18-23) • Part IV ... Section 481(a) Adjustment (Ques. 24-25)
Page 4	• Part IV ... Section 481(a) Adjustment ... Cont. (Ques. 26-27) • ***Schedule A ... Change in Overall Method of Accounting*** ◆ ***Part I ... Change in Overall Method*** (Ques. 1-3) ◆ ***Part II ... Change to the Cash Method for Advance Consent Request*** (Ques. 1-2) • ***Schedule B ... Change to the Deferral Method for Advance Payments*** (Ques. 1-2d)
Page 5	• ***Schedule C ... Changes within the LIFO Inventory Method*** ◆ Part I ... General LIFO Information (Ques. 1-6) ◆ Part II ... Change in Pooling Inventories (Ques. 1-4)
Page 6	• ***Schedule D ... Change in the Treatment of Long-Term Contracts under Section 460, Inventories or Other Section 263A Assets*** ◆ Part I ... Change in Reporting Income from Long-Term Contracts (Ques. 1-5) ◆ Part II ... Change in Valuing Inventories including Cost Allocation Changes (Ques. 1-5c)
Page 7	• ***Schedule D*** ... Cont. ◆ Part III ... Method of Cost Allocation ▪ Section A ... Allocation & Capitalization Methods (Ques. 1-3) ▪ Section B ... Direct and Indirect Costs Required to Be Allocated (Lines 1-28)
Page 8	• ***Schedule D*** ... Cont. ◆ Part III ... Method of Cost Allocation ...Cont. ▪ Section C ... Other Costs Not Required to be Allocated (Lines 1-11) • ***Schedule E ... Change in Depreciation or Amortization*** (Ques. 1-7g)
Instructions for Completing Form 3115 ... 17 Pages	
Instructions ... Page Layout	• General & specific instructions (Pages 1-4) • Part I ... Information for automatic change request (Page 4) • Part II ... Information for all requests (Pages 4-6) • Part III ... Information for advance consent requests; discussion of scope limitations (Page 6) • Part IV ... Section 481(a) adjustment (Page 7) • ***Schedule A*** ... Change in overall method (Pages 7-8) • ***Schedule B*** ... Change to the deferral method for advance payments (Page 8) • ***Schedule C*** ... Changes within the LIFO inventory method (Page 8) • ***Schedule D*** ... Change in the treatment of long-term contracts, inventories or other Sec. 263A assets (Page 8-9) • ***Schedule E*** ... Change in depreciation or amortization (Page 9) • List of 149 ***Automatic*** Accounting Method Changes (Pages 9-17). This includes 6 previously automatic CAMs which are now obsolete.

FORM 3115 ... APPLICATION FOR CHANGE IN ACCOUNTING METHOD ... PAGES 1 - 4

Form **3115**
(Rev. December 2009)
Department of the Treasury
Internal Revenue Service

Application for Change in Accounting Method

OMB No. 1545-0152

Name of filer (name of parent corporation if a consolidated group) (see instructions)	Identification number (see instructions)
	Principal business activity code number (see instructions)
Number, street, and room or suite no. If a P.O. box, see the instructions.	Tax year of change begins (MM/DD/YYYY)
	Tax year of change ends (MM/DD/YYYY)
City or town, state, and ZIP code	Name of contact person (see instructions)
Name of applicant(s) (if different than filer) and identification number(s) (see instructions)	Contact person's telephone number

If the applicant is a member of a consolidated group, check this box . . . . ▶ ☐

If Form 2848, Power of Attorney and Declaration of Representative, is attached (see instructions for when Form 2848 is required), check this box . . . . ▶ ☐

Check the box to indicate the type of applicant.

☐ Individual
☐ Corporation
☐ Controlled foreign corporation (Sec. 957)
☐ 10/50 corporation (Sec. 904(d)(2)(E))
☐ Qualified personal service corporation (Sec. 448(d)(2))
☐ Exempt organization. Enter Code section ▶
☐ Cooperative (Sec. 1381)
☐ Partnership
☐ S corporation
☐ Insurance co. (Sec. 816(a))
☐ Insurance co. (Sec. 831)
☐ Other (specify) ▶

Check the appropriate box to indicate the type of accounting method change being requested. (see instructions)

☐ Depreciation or Amortization
☐ Financial Products and/or Financial Activities of Financial Institutions
☐ Other (specify) ▶

Caution. *To be eligible for approval of the requested change in method of accounting, the taxpayer must provide all information that is relevant to the taxpayer or to the taxpayer's requested change in method of accounting. This includes all information requested on this Form 3115 (including its instructions), as well as any other information that is not specifically requested.*

The taxpayer must attach all applicable supplemental statements requested throughout this form.

Part I — Information For Automatic Change Request (Yes / No)

1 Enter the applicable designated automatic accounting method change number for the requested automatic change. Enter only one designated automatic accounting method change number, except as provided for in guidance published by the IRS. If the requested change has no designated automatic accounting method change number, check "Other," and provide both a description of the change and citation of the IRS guidance providing the automatic change. See instructions.

▶ (a) Change No. ________ (b) Other ☐ Description ▶ ________

2 Do any of the scope limitations described in section 4.02 of Rev. Proc. 2008-52 cause automatic consent to be unavailable for the applicant's requested change? If "Yes," attach an explanation. . . . .

Note. *Complete Part II below and then Part IV, and also Schedules A through E of this form (if applicable).*

Part II — Information For All Requests (Yes / No)

3 Did or will the applicant cease to engage in the trade or business to which the requested change relates, or terminate its existence, in the tax year of change (see instructions)? . . . .
If "Yes," the applicant is not eligible to make the change under automatic change request procedures.

4a Does the applicant (or any present or former consolidated group in which the applicant was a member during the applicable tax year(s)) have any Federal income tax return(s) under examination (see instructions)? . . . . .
If "No," go to line 5.

b Is the method of accounting the applicant is requesting to change an issue (with respect to either the applicant or any present or former consolidated group in which the applicant was a member during the applicable tax year(s)) either (i) under consideration or (ii) placed in suspense (see instructions)? . . . .

Signature (see instructions)

Under penalties of perjury, I declare that I have examined this application, including accompanying schedules and statements, and to the best of my knowledge and belief, the application contains all the relevant facts relating to the application, and it is true, correct, and complete. Declaration of preparer (other than applicant) is based on all information of which preparer has any knowledge.

Filer	Preparer (other than filer/applicant)
Signature and date	Signature of individual preparing the application and date
Name and title (print or type)	Name of individual preparing the application (print or type)
	Name of firm preparing the application

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Part II — Information For All Requests (continued) (Yes / No)

4c Is the method of accounting the applicant is requesting to change an issue pending (with respect to either the applicant or any present or former consolidated group in which the applicant was a member during the applicable tax year(s)) for any tax year under examination (see instructions)? . . . .

d Is the request to change the method of accounting being filed under the procedures requiring that the operating division director consent to the filing of the request (see instructions)? . . . .
If "Yes," attach the consent statement from the director.

e Is the request to change the method of accounting being filed under the 90-day or 120-day window period? . .
If "Yes," check the box for the applicable window period and attach the required statement (see instructions).
☐ 90 day ☐ 120 day: Date examination ended ▶ ________

f If you answered "Yes" to line 4a, enter the name and telephone number of the examining agent and the tax year(s) under examination.
Name ▶ ________ Telephone number ▶ ________ Tax year(s) ▶ ________

g Has a copy of this Form 3115 been provided to the examining agent identified on line 4f? . . . . .

5a Does the applicant (or any present or former consolidated group in which the applicant was a member during the applicable tax year(s)) have any Federal income tax return(s) before Appeals and/or a Federal court? . . . .
If "Yes," enter the name of the (check the box) ☐ Appeals officer and/or ☐ counsel for the government, telephone number, and the tax year(s) before Appeals and/or a Federal court.
Name ▶ ________ Telephone number ▶ ________ Tax year(s) ▶ ________

b Has a copy of this Form 3115 been provided to the Appeals officer and/or counsel for the government identified on line 5a? . . . .

c Is the method of accounting the applicant is requesting to change an issue under consideration by Appeals and/or a Federal court (for either the applicant or any present or former consolidated group in which the applicant was a member for the tax year(s) the applicant was a member) (see instructions)? . . . .
If "Yes," attach an explanation.

6 If the applicant answered "Yes" to line 4a and/or 5a with respect to any present or former consolidated group, attach a statement that provides each parent corporation's (a) name, (b) identification number, (c) address, and (d) tax year(s) during which the applicant was a member that is under examination, before an Appeals office, and/or before a Federal court.

7 If, for federal income tax purposes, the applicant is either an entity (including a limited liability company) treated as a partnership or an S corporation, is it requesting a change from a method of accounting that is an issue under consideration in an examination, before Appeals, or before a Federal court, with respect to a Federal income tax return of a partner, member, or shareholder of that entity? . . . .
If "Yes," the applicant is not eligible to make the change.

8a Does the applicable revenue procedure (advance consent or automatic consent) state that the applicant does not receive audit protection for the requested change (see instructions)? . . . .

b If "Yes," attach an explanation.

9a Has the applicant, its predecessor, or a related party requested or made (under either an automatic change procedure or a procedure requiring advance consent) a change in method of accounting within the past 5 years (including the year of the requested change)? . . . .

b If "Yes," for each trade or business, attach a description of each requested change in method of accounting (including the tax year of change) and state whether the applicant received consent.

c If any application was withdrawn, not perfected, or denied, or if a Consent Agreement granting a change was not signed and returned to the IRS, or the change was not made or not made in the requested year of change, attach an explanation.

10a Does the applicant, its predecessor, or a related party currently have pending any request (including any concurrently filed request) for a private letter ruling, change in method of accounting, or technical advice? . . . .

b If "Yes," for each request attach a statement providing the name(s) of the taxpayer, identification number(s), the type of request (private letter ruling, change in method of accounting, or technical advice), and the specific issue(s) in the request(s).

11 Is the applicant requesting to change its overall method of accounting? . . . .
If "Yes," check the appropriate boxes below to indicate the applicant's present and proposed methods of accounting. Also, complete Schedule A on page 4 of this form.

Present method: ☐ Cash ☐ Accrual ☐ Hybrid (attach description)
Proposed method: ☐ Cash ☐ Accrual ☐ Hybrid (attach description)

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Part II — Information For All Requests (continued) (Yes / No)

12 If the applicant is either (i) not changing its overall method of accounting, or (ii) is changing its overall method of accounting and also changing to a special method of accounting for one or more items, attach a detailed and complete description for each of the following:
a The item(s) being changed.
b The applicant's present method for the item(s) being changed.
c The applicant's proposed method for the item(s) being changed.
d The applicant's present overall method of accounting (cash, accrual, or hybrid).

13 Attach a detailed and complete description of the applicant's trade(s) or business(es), and the principal business activity code for each. If the applicant has more than one trade or business as defined in Regulations section 1.446-1(d), describe: whether each trade or business is accounted for separately; the goods and services provided by each trade or business and any other types of activities engaged in that generate gross income; the overall method of accounting for each trade or business; and which trade or business is requesting to change its accounting method as part of this application or a separate application.

14 Will the proposed method of accounting be used for the applicant's books and records and financial statements? For insurance companies, see the instructions . . . .
If "No," attach an explanation.

15a Has the applicant engaged, or will it engage, in a transaction to which section 381(a) applies (e.g., a reorganization, merger, or liquidation) during the proposed tax year of change determined without regard to any potential closing of the year under section 381(b)(1)? . . . .

b If "Yes," for the items of income and expense that are the subject of this application, attach a statement identifying the methods of accounting used by the parties to the section 381(a) transaction immediately before the date of distribution or transfer and the method(s) that would be required by section 381(c)(4) or (c)(5) absent consent to the change(s) requested in this application.

16 Does the applicant request a conference with the IRS National Office if the IRS proposes an adverse response?

17 If the applicant is changing to either the overall cash method, an overall accrual method, or is changing its method of accounting for any property subject to section 263A, any long-term contract subject to section 460, or inventories subject to section 474, enter the applicant's gross receipts for the 3 tax years preceding the tax year of change.

1st preceding year ended: mo. yr.	2nd preceding year ended: mo. yr.	3rd preceding year ended: mo. yr.
$	$	$

Part III — Information For Advance Consent Request (Yes / No)

18 Is the applicant's requested change described in any revenue procedure, revenue ruling, notice, regulation, or other published guidance as an automatic change request? . . . .
If "Yes," attach an explanation describing why the applicant is submitting its request under advance consent request procedures.

19 Attach a full explanation of the legal basis supporting the proposed method for the item being changed. Include a detailed and complete description of the facts that explains how the law specifically applies to the applicant's situation and that demonstrates that the applicant is authorized to use the proposed method. Include all authority (statutes, regulations, published rulings, court cases, etc.) supporting the proposed method. Also, include either a discussion of the contrary authorities or a statement that no contrary authority exists.

20 Attach a copy of all documents related to the proposed change (see instructions).

21 Attach a statement of the applicant's reasons for the proposed change.

22 If the applicant is a member of a consolidated group for the year of change, do all other members of the consolidated group use the proposed method of accounting for the item being changed? . . . .
If "No," attach an explanation.

23a Enter the amount of user fee attached to this application (see instructions). ▶ $ ________

b If the applicant qualifies for a reduced user fee, attach the required information or certification (see instructions).

Part IV — Section 481(a) Adjustment (Yes / No)

24 Does the applicable revenue procedure, revenue ruling, notice, regulation, or other published guidance require the applicant to implement the requested change in method of accounting on a cut-off basis rather than a section 481(a) adjustment? . . .
If "Yes," do not complete lines 25, 26, and 27 below.

25 Enter the section 481(a) adjustment. Indicate whether the adjustment is an increase (+) or a decrease (-) in income. ▶ $ ________ Attach a summary of the computation and an explanation of the methodology used to determine the section 481(a) adjustment. If it is based on more than one component, show the computation for each component. If more than one applicant is applying for the method change on the same application, attach a list of the name, identification number, principal business activity code (see instructions), and the amount of the section 481(a) adjustment attributable to each applicant.

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Part IV — Section 481(a) Adjustment (continued) (Yes / No)

26 If the section 481(a) adjustment is an increase to income of less than $25,000, does the applicant elect to take the entire amount of the adjustment into account in the year of change? . . . .

27 Is any part of the section 481(a) adjustment attributable to transactions between members of an affiliated group, a consolidated group, a controlled group, or other related parties? . . . .
If "Yes," attach an explanation.

Schedule A—Change in Overall Method of Accounting (If Schedule A applies, Part I below must be completed.)

Part I — Change in Overall Method (see instructions)

1 Enter the following amounts as of the close of the tax year preceding the year of change. If none, state "None." Also, attach a statement providing a breakdown of the amounts entered on lines 1a through 1g.

		Amount
a	Income accrued but not received (such as accounts receivable)	$
b	Income received or reported before it was earned (such as advanced payments). Attach a description of the income and the legal basis for the proposed method	
c	Expenses accrued but not paid (such as accounts payable)	
d	Prepaid expenses previously deducted	
e	Supplies on hand previously deducted and/or not previously reported	
f	Inventory on hand previously deducted and/or not previously reported. Complete Schedule D, Part II .	
g	Other amounts (specify). Attach a description of the item and the legal basis for its inclusion in the calculation of the section 481(a) adjustment. ▶	
h	Net section 481(a) adjustment (Combine lines 1a–1g.) Indicate whether the adjustment is an increase (+) or decrease (-) in income. Also enter the net amount of this section 481(a) adjustment amount on Part IV, line 25.	$

2 Is the applicant also requesting the recurring item exception under section 461(h)(3)? . . . . ☐ Yes ☐ No

3 Attach copies of the profit and loss statement (Schedule F (Form 1040) for farmers) and the balance sheet, if applicable, as of the close of the tax year preceding the year of change. Also attach a statement specifying the accounting method used when preparing the balance sheet. If books of account are not kept, attach a copy of the business schedules submitted with the Federal income tax return or other return (e.g., tax-exempt organization returns) for that period. If the amounts in Part I, lines 1a through 1g, do not agree with those shown on both the profit and loss statement and the balance sheet, attach a statement explaining the differences.

Part II — Change to the Cash Method For Advance Consent Request (see instructions)

Applicants requesting a change to the cash method must attach the following information:

1 A description of inventory items (items whose production, purchase, or sale is an income-producing factor) and materials and supplies used in carrying out the business.

2 An explanation as to whether the applicant is required to use the accrual method under any section of the Code or regulations.

Schedule B—Change to the Deferral Method for Advance Payments (see instructions)

1 If the applicant is requesting to change to the Deferral Method for advance payments described in section 5.02 of Rev. Proc. 2004-34, 2004-1 C.B. 991, attach the following information:
a A statement explaining how the advance payments meet the definition in section 4.01 of Rev. Proc. 2004-34.
b If the applicant is filing under the automatic change procedures of Rev. Proc. 2008-52, the information required by section 8.02(3)(a)-(c) of Rev. Proc. 2004-34.
c If the applicant is filing under the advance consent provisions of Rev. Proc. 97-27, the information required by section 8.03(2)(a)-(f) of Rev. Proc. 2004-34.

2 If the applicant is requesting to change to the deferral method for advance payments described in Regulations section 1.451-5(b)(1)(ii), attach the following.
a A statement explaining how the advance payments meet the definition in Regulations section 1.451-5(a)(1).
b A statement explaining what portions of the advance payments, if any, are attributable to services, whether such services are integral to the provisions of goods or items, and whether any portions of the advance payments that are attributable to non-integral services are less than five percent of the total contract prices. See Regulations sections 1.451-5(a)(2)(i) and (3).
c A statement explaining that the advance payments will be included in income no later than when included in gross receipts for purposes of the applicant's financial reports. See Regulations section 1.451-5(b)(1)(ii).
d A statement explaining whether the inventoriable goods exception of Regulations section 1.451-5(c) applies and if so, when substantial advance payments will be received under the contracts, and how the exception will limit the deferral of income.

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Schedule C—Changes Within the LIFO Inventory Method (see instructions)

Part I General LIFO Information

Complete this section if the requested change involves changes within the LIFO inventory method. Also, attach a copy of all Forms 970, Application To Use LIFO Inventory Method, filed to adopt or expand the use of the LIFO method.

1 Attach a description of the applicant's present and proposed LIFO methods and submethods for each of the following items:

a Valuing inventory (e.g., unit method or dollar-value method).

b Pooling (e.g., by line or type or class of goods, natural business unit, multiple pools, raw material content, simplified dollar-value method, inventory price index computation (IPIC) pools, vehicle-pool method, etc.).

c Pricing dollar-value pools (e.g., double-extension, index, link-chain, link-chain index, IPIC method, etc.).

d Determining the current-year cost of goods in the ending inventory (i.e., most recent acquisitions, earliest acquisitions during the current year, average cost of current-year acquisitions, or other permitted method).

2 If any present method or submethod used by the applicant is not the same as indicated on Form(s) 970 filed to adopt or expand the use of the method, attach an explanation.

3 If the proposed change is not requested for all the LIFO inventory, attach a statement specifying the inventory to which the change is and is not applicable.

4 If the proposed change is not requested for all of the LIFO pools, attach a statement specifying the LIFO pool(s) to which the change is applicable.

5 Attach a statement addressing whether the applicant values any of its LIFO inventory on a method other than cost. For example, if the applicant values some of its LIFO inventory at retail and the remainder at cost, identify which inventory items are valued under each method.

6 If changing to the IPIC method, attach a completed Form 970.

Part II Change in Pooling Inventories

1 If the applicant is proposing to change its pooling method or the number of pools, attach a description of the contents of, and state the base year for, each dollar-value pool the applicant presently uses and proposes to use.

2 If the applicant is proposing to use natural business unit (NBU) pools or requesting to change the number of NBU pools, attach the following information (to the extent not already provided) in sufficient detail to show that each proposed NBU was determined under Regulations section 1.472-8(b)(1) and (2):

a A description of the types of products produced by the applicant. If possible, attach a brochure.

b A description of the types of processes and raw materials used to produce the products in each proposed pool.

c If all of the products to be included in the proposed NBU pool(s) are not produced at one facility, state the reasons for the separate facilities, the location of each facility, and a description of the products each facility produces.

d A description of the natural business divisions adopted by the taxpayer. State whether separate cost centers are maintained and if separate profit and loss statements are prepared.

e A statement addressing whether the applicant has inventories of items purchased and held for resale that are not further processed by the applicant, including whether such items, if any, will be included in any proposed NBU pool.

f A statement addressing whether all items including raw materials, goods-in-process, and finished goods entering into the entire inventory investment for each proposed NBU pool are presently valued under the LIFO method. Describe any items that are not presently valued under the LIFO method that are to be included in each proposed pool.

g A statement addressing whether, within the proposed NBU pool(s), there are items both sold to unrelated parties and transferred to a different unit of the applicant to be used as a component part of another product prior to final processing.

3 If the applicant is engaged in manufacturing and is proposing to use the multiple pooling method or raw material content pools, attach information to show that each proposed pool will consist of a group of items that are substantially similar. See Regulations section 1.472-8(b)(3).

4 If the applicant is engaged in the wholesaling or retailing of goods and is requesting to change the number of pools used, attach information to show that each of the proposed pools is based on customary business classifications of the applicant's trade or business. See Regulations section 1.472-8(c).

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Schedule D—Change in the Treatment of Long-Term Contracts Under Section 460, Inventories, or Other Section 263A Assets (see instructions)

Part I Change in Reporting Income From Long-Term Contracts (Also complete Part III on pages 7 and 8.)

1 To the extent not already provided, attach a description of the applicant's present and proposed methods for reporting income and expenses from long-term contracts. Also, attach a representative actual contract (without any deletion) for the requested change. If the applicant is a construction contractor, attach a detailed description of its construction activities.

2a Are the applicant's contracts long-term contracts as defined in section 460(f)(1) (see instructions)? . . ☐ Yes ☐ No

b If "Yes," do all the contracts qualify for the exception under section 460(e) (see instructions)? . . . . ☐ Yes ☐ No

If line 2b is "No," attach an explanation.

c If line 2b is "Yes," is the applicant requesting to use the percentage-of-completion method using cost-to-cost under Regulations section 1.460-4(b)? . . . ☐ Yes ☐ No

d If line 2c is "No," is the applicant requesting to use the exempt-contract percentage-of-completion method under Regulations section 1.460-4(c)(2)? . . . ☐ Yes ☐ No

If line 2d is "Yes," attach an explanation of what cost comparison the applicant will use to determine a contract's completion factor.

If line 2d is "No," attach an explanation of what method the applicant is using and the authority for its use.

3a Does the applicant have long-term manufacturing contracts as defined in section 460(f)(2)? . . . . . ☐ Yes ☐ No

b If "Yes," attach an explanation of the applicant's present and proposed method(s) of accounting for long-term manufacturing contracts.

c Attach a description of the applicant's manufacturing activities, including any required installation of manufactured goods.

4 To determine a contract's completion factor using the percentage-of-completion method:

a Will the applicant use the cost-to-cost method in Regulations section 1.460-4(b)? . . . . ☐ Yes ☐ No

b If line 4a is "No," is the applicant electing the simplified cost-to-cost method (see section 460(b)(3) and Regulations section 1.460-5(c))? . . . ☐ Yes ☐ No

5 Attach a statement indicating whether any of the applicant's contracts are either cost-plus long-term contracts or Federal long-term contracts.

Part II Change in Valuing Inventories Including Cost Allocation Changes (Also complete Part III on pages 7 and 8.)

1 Attach a description of the inventory goods being changed.

2 Attach a description of the inventory goods (if any) NOT being changed.

3a Is the applicant subject to section 263A? If "No," go to line 4a . . . . ☐ Yes ☐ No

b Is the applicant's present inventory valuation method in compliance with section 263A (see instructions)? If "No," attach a detailed explanation . . . . . . ☐ Yes ☐ No

4a Check the appropriate boxes below.

	Inventory Being Changed		Inventory Not Being Changed
	Present method	Proposed method	Present method
Identification methods:			
Specific identification . . .			
FIFO . . .			
LIFO . . .			
Other (attach explanation) . . .			
Valuation methods:			
Cost . . .			
Cost or market, whichever is lower . . .			
Retail cost . . .			
Retail, lower of cost or market . . .			
Other (attach explanation) . . .			
b Enter the value at the end of the tax year preceding the year of change			

5 If the applicant is changing from the LIFO inventory method to a non-LIFO method, attach the following information (see instructions).

a Copies of Form(s) 970 filed to adopt or expand the use of the method.

b Only for applicants requesting advance consent. A statement describing whether the applicant is changing to the method required by Regulations section 1.472-6(a) or (b), or whether the applicant is proposing a different method.

c Only for applicants requesting an automatic change. The statement required by section 22.01(5) of the Appendix of Rev. Proc. 2008-52 (or its successor).

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Part III Method of Cost Allocation (Complete this part if the requested change involves either property subject to section 263A or long-term contracts as described in section 460 (see instructions)).

Section A—Allocation and Capitalization Methods

Attach a description (including sample computations) of the present and proposed method(s) the applicant uses to capitalize direct and indirect costs properly allocable to real or tangible personal property produced and property acquired for resale, or to allocate and, where appropriate, capitalize direct and indirect costs properly allocable to long-term contracts. Include a description of the method(s) used for allocating indirect costs to intermediate cost objectives such as departments or activities prior to the allocation of such costs to long-term contracts, real or tangible personal property produced, and property acquired for resale. The description must include the following:

1 The method of allocating direct and indirect costs (i.e., specific identification, burden rate, standard cost, or other reasonable allocation method).

2 The method of allocating mixed service costs (i.e., direct reallocation, step-allocation, simplified service cost using the labor-based allocation ratio, simplified service cost using the production cost allocation ratio, or other reasonable allocation method).

3 The method of capitalizing additional section 263A costs (i.e., simplified production with or without the historic absorption ratio election, simplified resale with or without the historic absorption ratio election including permissible variations, the U.S. ratio, or other reasonable allocation method).

Section B—Direct and Indirect Costs Required To Be Allocated

Check the appropriate boxes showing the costs that are or will be fully included, to the extent required, in the cost of real or tangible personal property produced or property acquired for resale under section 263A or allocated to long-term contracts under section 460. Mark "N/A" in a box if those costs are not incurred by the applicant. If a box is not checked, it is assumed that those costs are not fully included to the extent required. Attach an explanation for boxes that are not checked.

		Present method	Proposed method
1	Direct material . . .		
2	Direct labor . . .		
3	Indirect labor . . .		
4	Officers' compensation (not including selling activities) . . .		
5	Pension and other related costs . . .		
6	Employee benefits . . .		
7	Indirect materials and supplies . . .		
8	Purchasing costs . . .		
9	Handling, processing, assembly, and repackaging costs . . .		
10	Offsite storage and warehousing costs . . .		
11	Depreciation, amortization, and cost recovery allowance for equipment and facilities placed in service and not temporarily idle . . .		
12	Depletion . . .		
13	Rent . . .		
14	Taxes other than state, local, and foreign income taxes . . .		
15	Insurance . . .		
16	Utilities . . .		
17	Maintenance and repairs that relate to a production, resale, or long-term contract activity		
18	Engineering and design costs (not including section 174 research and experimental expenses) . . .		
19	Rework labor, scrap, and spoilage . . .		
20	Tools and equipment . . .		
21	Quality control and inspection . . .		
22	Bidding expenses incurred in the solicitation of contracts awarded to the applicant . .		
23	Licensing and franchise costs . . .		
24	Capitalizable service costs (including mixed service costs) . . .		
25	Administrative costs (not including any costs of selling or any return on capital) . . .		
26	Research and experimental expenses attributable to long-term contracts . . .		
27	Interest . . .		
28	Other costs (Attach a list of these costs.) . . .		

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Part III Method of Cost Allocation (see instructions) (continued)

Section C—Other Costs Not Required To Be Allocated (Complete Section C only if the applicant is requesting to change its method for these costs.)

		Present method	Proposed method
1	Marketing, selling, advertising, and distribution expenses . . .		
2	Research and experimental expenses not included in Section B, line 26 . . .		
3	Bidding expenses not included in Section B, line 22 . . .		
4	General and administrative costs not included in Section B . . .		
5	Income taxes . . .		
6	Cost of strikes . . .		
7	Warranty and product liability costs . . .		
8	Section 179 costs . . .		
9	On-site storage . . .		
10	Depreciation, amortization, and cost recovery allowance not included in Section B, line 11 . . .		
11	Other costs (Attach a list of these costs.) . . .		

Schedule E—Change in Depreciation or Amortization (see instructions)

Applicants requesting approval to change their method of accounting for depreciation or amortization complete this section. Applicants *must* provide this information for each item or class of property for which a change is requested.

Note. *See the List of Automatic Accounting Method Changes in the instructions for information regarding automatic changes under sections 56, 167, 168, 197, 1400I, 1400L, or former section 168. Do not file Form 3115 with respect to certain late elections and election revocations (see instructions).*

1 Is depreciation for the property determined under Regulations section 1.167(a)-11 (CLADR)? . . . . ☐ Yes ☐ No

If "Yes," the only changes permitted are under Regulations section 1.167(a)-11(c)(1)(iii).

2 Is any of the depreciation or amortization required to be capitalized under any Code section (e.g., section 263A)? . . . ☐ Yes ☐ No

If "Yes," enter the applicable section ▶ ______

3 Has a depreciation, amortization, or expense election been made for the property (e.g., the election under sections 168(f)(1), 179, or 179C)? . . . ☐ Yes ☐ No

If "Yes," state the election made ▶ ______

4a To the extent not already provided, attach a statement describing the property being changed. Include in the description the type of property, the year the property was placed in service, and the property's use in the applicant's trade or business or income-producing activity.

b If the property is residential rental property, did the applicant live in the property before renting it? . . ☐ Yes ☐ No

c Is the property public utility property? . . . ☐ Yes ☐ No

5 To the extent not already provided in the applicant's description of its present method, attach a statement explaining how the property is treated under the applicant's present method (e.g., depreciable property, inventory property, supplies under Regulations section 1.162-3; nondepreciable section 263(a) property, property deductible as a current expense, etc.).

6 If the property is not currently treated as depreciable or amortizable property, attach a statement of the facts supporting the proposed change to depreciate or amortize the property.

7 If the property is currently treated and/or will be treated as depreciable or amortizable property, provide the following information for both the present (if applicable) and proposed methods:

a The Code section under which the property is or will be depreciated or amortized (e.g., section 168(g)).

b The applicable asset class from Rev. Proc. 87-56, 1987-2 C.B. 674, for each asset depreciated under section 168 (MACRS) or under section 1400L; the applicable asset class from Rev. Proc. 83-35, 1983-1 C.B. 745, for each asset depreciated under former section 168 (ACRS); an explanation why no asset class is identified for each asset for which an asset class has not been identified by the applicant.

c The facts to support the asset class for the proposed method.

d The depreciation or amortization method of the property, including the applicable Code section (e.g., 200% declining balance method under section 168(b)(1)).

e The useful life, recovery period, or amortization period of the property.

f The applicable convention of the property.

g A statement of whether or not the additional first-year special depreciation allowance (for example, as provided by section 168(k), 168(l), 168(m), 168(n), 1400L(b), or 1400N(d)) was or will be claimed for the property. If not, also provide an explanation as to why no special depreciation allowance was or will be claimed.

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There are other serious implications involving the proper completion of Form 3115 for all taxpayers who have inventories, regardless of whether or not they are using the LIFO method ... and especially if they are changing from it. These implications have surfaced since the last revisions of Form 3115 and the Instructions, and they affect all automobile dealerships in a most significant way.

More recently, there has been a very significant, stepped-up initiative by the IRS to enforce (what it believes to be the) proper application of the Section 263A inventory cost capitalization rules to automobile dealers. As a general class or group of taxpayers, the IRS considers dealerships to be significantly derelict or out-of-compliance with applying the general rules for capitalizing certain costs to their inventories of new and used vehicles and parts and accessories.

The concern of the IRS over the improper capitalization of Section 263A costs by dealerships is so great that in September 2009, in a Memorandum to the LMSB (Large and Medium Sized Business) Industry Directors and other IRS personnel, the Industry Director (Heavy Manufacturing and Transportation) issued a Directive suspending the examination of auto dealership Section 263A issues effective September 15, 2009 and continuing through December 31, 2010.

In this Memorandum, the IRS said the moratorium was placed in effect in order to encourage dealerships to comply with Section 263A and to allow them the opportunity "to voluntarily change their methods of accounting to comply with the legal reasoning allowed in TAM 200736026."

Our sister publication, the *Dealer Tax Watch,* has closely followed these developments over the years. What is most significant at this time is that if a dealership is going to "voluntarily" change its cost capitalization methods and submethods - and many practitioners question the wisdom of doing so at this time - that dealership will have to cope with the revised Form 3115 and all its implications.

In general, the December 2009 revisions of Form 3115 and the Instructions are relatively straightforward. Form 3115 remains an eight (8) page document. The revised Instructions include an up-to-date list of 149 changes in accounting method which can be made without advance approval from the IRS. The Instructions, including the list of automatic changes, comprise 17 pages of fine print.

Although at first glance, there doesn't appear to be much difference between the schedules in the "old" Form and Instructions and the "new" revisions, there are several new requirements and/or conditions that have been slipped into Form 3115 in various places.

The most obvious change in Form 3115 that is noticeable when one is simply flipping through the pages appears on Page 4. Here, at the bottom of the page, the Dec. 2009 revision includes a special section addressed to taxpayers changing to the Deferral Method for Advance Payments described in Revenue Procedure 2004-34. (Note: this has nothing to do with LIFO.)

Also, in several instances, the revised Form 3115 and the Instructions present an interesting change in voice from the passive (in the old revisions) to the active in the new revisions.

My discussion of the revisions to Form 3115 in this article reflect the assumption that you are basically familiar with many aspects of the Form and the underlying changes in methods being discussed. Accordingly, my discussions and comments are somewhat selective.

The Mid-Year 2009 *LIFO Lookout* included a sample proforma Form 3115 filing package for terminating a LIFO election. This was included to reflect changes introduced by Revenue Procedure 2008-52. Because of the continuing significant interest in terminating LIFO elections and the more recent emphasis by the IRS on Section 263A matters, this sample proforma Form 3115 has been updated (and expanded) for use in connection with the December 2009 revision of Form 3115.

IS THE CAM AN "AUTOMATIC" CHANGE?

Before concluding that a change in accounting method can be made automatically or that the change requires advance consent, one must consider three sources. Stated differently: the following sources are to be consulted before reaching the conclusion that a change in accounting method can be made as an automatic change:

1. The controlling document that governs the type of change ... either Rev. Proc. 2008-52 which is the controlling guidance for ***automatic*** changes in method ... or Rev. Proc. 97-27, the controlling guidance for changes that require ***advance consent*** from the IRS.

2. The Appendix to Rev. Proc. 2008-52 to determine if, for the change being considered, there is a more specific section that waives the general prohibition found in the controlling document. This is particularly important in order to determine whether the scope limitations in Section 4 of Rev. Proc. 2008-52 are waived by the specific language found in the

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section of the Appendix where the automatic change is more fully discussed.

3. All Revenue Procedures and/or any other guidance issued by the IRS that amplifies or modifies these controlling documents. In this regard, it should be noted that Revenue Procedure 2008-52 (for automatic changes) has been modified by Revenue Procedure 2009-39 and that Revenue Procedure 97-27 (for advance consent changes) has been modified by Revenue Procedures 2002-19, 2002-54, 2007-67 and 2009-39.

SCOPE LIMITATIONS ... Page 1, Item 2

If the change in accounting method can be made under the automatic filing procedures, then Part I on Page 1, must be completed. There should be no entry in the section on Page 1, immediately above Part 1, caption "Check the appropriate box to indicate the type of accounting method change being requested."

All that needs to be entered on Part 1, Item 1 is the number that the IRS has designated as the automatic change number for the change that is being requested or made. This number can be found in the list of automatic changes included in the Instructions.

Item 2, in Part I asks for confirmation as to whether any of the scope limitations in Revenue Procedure 2008-52 apply to prevent the change in method from being made under the automatic provisions. If any limitation applies, the check-mark or "X" in the "Yes" box acts as a red flag; but that is not necessarily a problem because there may be a provision in the terms and conditions in the Appendix to Revenue Procedure 2008-52 describing the change that specifically provides for the waiver of the scope limitation.

For example, Section 22.01(2) of the Appendix to Rev. Proc. 2008-52 provides that in LIFO election termination situations, the five-year look-back scope limitation will not apply. Similarly, Section 23.01(3) provides that the scope limitations will not apply in connection with automatic changes in methods involving mark-to-market accounting by securities dealers.

It should also be noted that Sections 4.02(6) and 4.02(7) which describe the five-year look back requirement also contain several qualifications that may permit the change to be made as an automatic change.

Accordingly, if despite the more general expression of the scope limitations, the change is permitted to be made as an automatic change, an explanation describing and/or citing the appropriate source of the waiver must be attached to Form 3115.

AUDIT PROTECTION (OR LACK THEREOF) FOR CAMs ... Page 2, Item 8

In general, one of the advantages of initiating a change in accounting method by filing Form 3115 is that the taxpayer, by volunteering to make the change (i.e., not being forced to make the change under the duress of an actual IRS audit examination) receives "audit protection." Basically this means that the IRS will not try to go back and adjust in prior years for the use of a different, or improper, method. Audit protection is a good thing.

However, the IRS does not automatically grant audit protection in all cases, even if the change in method is one that is permitted to be made under the automatic filing procedures.

Item 8 on Page 2 highlights this and requires that an explanation be attached if the question is answered in the affirmative. A check-mark or "X" in the "No" box indicates that audit protection applies.

Once again, in order to correctly respond to Item 8, it is necessary not only to review the appropriate controlling Revenue Procedures, but also to review the applicable sections of the Appendices and any guidance that the IRS might have issued after those Revenue Procedures were issued.

One example should suffice ... Section 4.04(7)(b) of Rev. Proc. 2008-52 provides that ... "a taxpayer that changes a LIFO inventory submethod within five years of adopting or changing to the LIFO inventory method does not receive audit protection under Section 7 of this Revenue Procedure." Translation example: ***If*** an auto dealership changed to the Vehicle-Pool Method in order to combine its LIFO pools for new automobiles and for new light-duty trucks, and ***if*** this change were made (as an automatic change) within 5 years of adopting or changing the LIFO method, ***then*** the IRS could go back and audit the dealership's LIFO computations for years prior to the change because this is a change for which audit protection is not available.

Some practitioners erroneously believe that the use of the "cut-off method" to implement a change in method (which avoids the need for a Section 481(a) computation/adjustment) also grants audit protection for prior years to the taxpayer requesting/making the change. Practitioners should be careful not to assume that just because the IRS allows the change in method to be made using the "cut-off method," the use of that computational method confers any element of "audit protection." These two concepts are entirely separate and distinct from each other.

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5-YEAR "LOOK-BACK" PERIOD ... Page 2, Item 9

The purpose of Question 9 is to extract from the taxpayer any and all information related to any activities within the past five years that involved actual, potential or defective changes in accounting methods.

The five-year look-back period relates to the year of change plus the four years preceding the year of change. If a change in method effective for 2010 is requested, the look-back analysis involves the years 2006, -07, -08, -09 and 2010. Note that this reach for information includes: (1) not only the taxpayer, but any predecessor entity and any related party and (2) all changes that may have been made regardless of whether or not they were automatic or required advance approval from the IRS.

Also, this reach for information should not be confused with the five-year look-back period which is the focus for one of the scope limitations discussed above.

If there has been a CAM during the look-back period. Part (b) of Question 9 requires only a description of the change in method that was made. There is no specific requirement to attach a copy of the Form 3115 (or the subsequent consent documentation) that was filed with the IRS in connection with the prior change.

Part (c) of Question 9 probes even deeper. There are three other situation in which the IRS wants information regarding "defective" applications. In other words, information must be submitted related to potential changes in accounting methods that arose in any of the following situations: (1) the taxpayer filed the Form 3115 and subsequently withdrew it before the change was perfected, (2) a change was previously requested, but the request was denied by the IRS, or (3) a change was previously requested, permitted by the IRS, but the taxpayer did not follow through and make the change.

IRS FOLLOW-UPS ON WITHDRAWN CAM REQUESTS

The IRS will internally follow up on withdrawn requests and/or requests where IRS declines to issue (favorable) ruling. Interestingly, the IRS National Office (routinely) advises the local IRS offices in situations where the taxpayers have requested advance permission to change an accounting method and then either withdrawn the request or failed to follow through on it.

In connection with requests for permission to change accounting methods that require advance approval from the IRS, Section 2.01 of Rev. Proc. 2010-1 defines a Letter Ruling as a written determination issued to a taxpayer by an (IRS) Associate office in response to the taxpayer's written inquiry, filed prior to the filing of its income returns, about its status for tax purposes or the tax effects of its acts or transactions. One type of Letter Ruling is an Associate office's response to a request for a change in a taxpayer's method of accounting.

Section 7.07(2)(a) of Rev. Proc. 2010-1 states, "If a taxpayer withdraws a Letter Ruling request or if the Associate office declines to issue a Letter Ruling, the Associate office generally will notify, by memorandum, the appropriate Service official in the operating division that has examination jurisdiction of the taxpayer's tax return.

"For taxpayers under the jurisdiction of the Division Counsel/Associate Chief Counsel (Large and Mid-Size Business), the Associate office will also send a copy of the memorandum to the Director of Pre-Filing Technical Guidance. In doing so, the Associate office may give the Service official its views on the issues in the request for consideration in any later examination of the return."

This provision involving follow-up by the IRS generally does not apply if (1) the taxpayer withdraws the Letter Ruling request and submits a written statement that the transaction has been, or is being, abandoned ***and*** (2) if the Associate office has not already formed an adverse opinion. Note that the taxpayer is required to provide an affirmative declaration in this regard in order to pre-empt the "notification" by the Associate office.

The memorandum to the Service official that is referred to above may constitute Chief Counsel Advice and may be subject to disclosure to the public under Section 6110 and the *Freedom of Information Act*. This will only happen if the memorandum provides (1) more than the fact that the request was withdrawn and that the Associate office was tentatively adverse, or (2) more than the fact that the Associate office declines to issue a Letter Ruling.

Possible contest over refund of user fee paid by the taxpayer. Ordinarily, the user fee paid by the taxpayer will not be returned for a Letter Ruling request that is withdrawn. If the Associate office declines to issue a Letter Ruling on all of the issues in the request, the user fee will be returned. However, if the IRS issues a Letter Ruling on some, but not all, of the issues, the user fee will not be returned.

In IRS Legal Memorandum (ILM) 200003024, the taxpayer withdrew the request for a change in accounting method because of "the long delay in processing the Form 3115." The ILM states that at the

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time the taxpayer withdrew its request for change "we had not formed a tentative position on taxpayer's proposed change ... However, ... we had advised taxpayer's authorized representative by letter that we had concerns about whether these corrections are a change in method of accounting under Section 446(e) ..."

In contrast to the situation above which involved a withdrawal by the taxpayer of its request, in ILM 199952010, the taxpayer's request for permission to change was denied. Both ILMs were addressed to the respective *District Director: Attention Chief, Examination Division* where the taxpayers filed their returns. You can draw your own conclusions about what the District Director might have done with this information.

Needless to say, these "notification" provisions could prompt a visit to the taxpayer by a representative of the local IRS office.

CHANGING A "SPECIAL" METHOD OF ACCOUNTING - NEW ENTRY ... Page 3, Item 12

The revised Form 3115 adds something new in Question 12 on Page 3 where it requests information in connection with a change to "a ***special*** method of accounting for one or more items."

Examples of a special method of accounting include (1) the installment method under Section 453, (2) the mark-to-market method under Section 475, (3) the percentage of completion method for long-term contracts and (4) the referral method for advance payments.

IMPORTANCE OF THE TERM "SEPARATE TRADES OR BUSINESSES" ... Page 3, Item 13 and Page 1, Item 3

In some instances, all of the activities of a taxpayer comprise a single trade or business activity. In other instances, the activities of a taxpayer may consist of more than one separate trade or business.

The Regulations under Section 446 state the following in describing what will be considered as a separate trade or business.

"(1) Where a taxpayer has two or more separate and distinct trades or businesses, a different method of accounting may be used for each trade or business, provided the method used for each trade or business clearly reflects the income of that particular trade or business. ... The method first used in accounting for business income and deductions in connection with each trade or business, as evidenced in the taxpayer's income tax return in which such income or deductions are first reported, must be consistently followed thereafter.

"(2) No trade or business will be considered separate and distinct ... unless a complete and separable set of books and records is kept for such trade or business.

"(3) If, by reason of maintaining different methods of accounting, there is a creation or shifting of profits or losses between the trades or businesses of the taxpayer (for example, through inventory adjustments, sales, purchases or expenses) so that income of the taxpayer is not clearly reflected, the trades or business of the taxpayer will not be considered to be separate and distinct."

The new revisions (to Form 3115 and the Instructions) continue to use this term with no further clarifications.

One area where the "separate trade or business" distinction is important results from the proliferation of the use by many closely-held businesses of limited liability companies and other disregarded entities or S corporation tiered structures. There are many planning opportunities in connection with disregarded entities ... especially single-member LLCs ... in deciding whether or not to elect LIFO for the inventory of a member of a (dealership) group that was a multi-member LLC when that dealership becomes a single-member LLC.

One IRS Technical Advice Memorandum that dealt with LIFO pooling questions in connection with an auto dealer's new vehicle inventory involved the question of whether the separate departments in an automobile dealership could be considered separate trades or businesses, or whether all of these activities should be considered an integrated, single activity for LIFO pooling purposes.

In TAM 199911044, the IRS held that a dealership with multiple franchises and several locations all in the same city could use one pool for all new cars (and a separate pool for all new light-duty trucks) because all of the dealership's activities through its multiple franchises and locations constituted a single trade or business. The TAM discussed three factors ... (1) separate geographical locations, (2) one complete set of books and records and (3) separate sales force for new vehicle sales and service mechanics.

More recently, the significance of the term "separate trades or businesses" was discussed in the article in the Year-End 2009 Edition of the *LIFO Lookout* entitled *"Dealers Low on New Vehicle Inventory at Year-End May Face Stiff LIFO Reserve Recapture ... Planning May Lessen the Blow."*

This concept is particularly relevant and important in analyzing the potential for avoiding the accel-

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eration of the Section 481(a) adjustment for the recapture of the LIFO reserve when a LIFO election is terminated. This is discussed in more detail in the situations described in ILM 200935024 (dated August 17, 2009). A complete analysis of this ILM appears on pages 33-35 of the Year-End 2009 Edition of the *LIFO Lookout*.

Another situation emphasizing the distinction and the importance that can be attached to a separate trade or business came into play recently when one of the individual members of a limited liability company bought out the other member. The "twist" here was that the LLC, an automobile dealership that was not using LIFO, was one of two entities owned by a parent entity and the other automobile dealership entity was using LIFO. So, we had one dealership on LIFO and one dealership not on LIFO. Dealer X (1) owned the parent entity, (2) owned 100% of the dealership LLC that was using LIFO and (3) was the majority, but less-than-100%, ownership member of the LLC dealership that was not using LIFO.

The buy-out/change in ownership in the LLC that was not using LIFO caused that LLC (which was previously taxed as a partnership) to become a single-member LLC. This, in turn, terminated the partnership and caused the LLC (as a single-member LLC) to become a disregarded entity.

This raised three basic questions. ***First,*** is the new SMLLC disregarded entity automatically on LIFO? ***Second,*** is it required to elect LIFO, and if so, how should it proceed? ***Third,*** alternatively, can the new SMLLC choose not to elect LIFO for its inventory?

In discussing this with the dealer, the real question was: Did the dealer want to elect LIFO? Since the disregarded entity constituted a separate trade or business (from the other dealership entity), it was not required to elect LIFO. On the other hand, if the dealer wanted to, he could elect LIFO for this trade or business so as to obtain further LIFO-deferral benefits. It would be necessary to file a Form 970 (not a Form 3115) in order to establish the LIFO election for the single member LLC.

Our experience over many years is that some dealers, after being on LIFO for many years, do not necessarily want their LIFO reserves to become any larger. Especially in the last few years, some dealers have chosen not to use certain LIFO planning opportunities to increase their LIFO reserves; they have been quite content to pass up the opportunity. In the situation above, what the dealer chose to do is not important to this discussion. What is important is that the dealer clearly had an opportunity to chose one course of action (to elect LIFO) or another (to not elect LIFO) because of the separateness of the two dealerships (trades or businesses).

Clearly, it is important for practitioners to see the planning opportunities that lie just below the surface of the fact patterns.

For many closely-held businesses, the choice of entity expands well beyond the use of limited liability companies. In the area of S-corporations, the increasing use of Qualified S-Corporation Subsidiaries (Q-Subs) as part of an overall "S" Structure also highlights a number of situations where either combining or separating the activities of different QSSS members provides LIFO planning opportunities.

For example, if there are five different dealerships in five different locations in five different Q-Subs, do you want to include all new vehicles in one large LIFO pool? Or, do you want five separate LIFO pools, one for each dealership, for their respective new vehicle inventories? Is there a choice in this matter? What does the dealer who owns the controlling interest want to do? Are the activities conducted by each dealership Q-Sub considered to be "separate trades or businesses?"

For a more complete discussion, see "LIFO Pitfalls & Problems for S-Corporation Q-Sub Groups," in the December 2001 *LIFO Lookout*, pages 6-10.

Finally, for purposes of this discussion at least, another aspect of the "separate trades or businesses" concept has become increasingly more important as the IRS has stepped up its interest in how automobile dealerships are capitalizing inventory costs under Section 263A, particularly in terms of the IRS emphasis on production activities in contrast to reselling activities.

Can the argument be made, and sustained, that the separate departments in an automobile dealership ... (1) new vehicle sales, (2) used vehicle sales, (3) service department and (4) parts department ... should be considered separate trades or businesses, or are all of these activities considered an integrated, single activity for purposes of Section 263A?

This could be of importance in the resolution of Section 263A issues in the current controversy with the IRS, particularly in terms of the IRS' emphasis on trying to identify certain activities of the business (dealership) as production activities which are to be distinguished from its other, more distinct, activities as a reseller. These distinctions could be even more important because some of a dealership's inventories may be valued using LIFO for new vehicles, while other inventories are valued using lower-of-cost-or-

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market (used vehicles) and/or replacement cost (parts and accessories).

Accordingly, practitioners should pay considerable attention to what activities of a business (i.e., a dealership or any other type of business) may or may not constitute a separate trade or business.

GROSS RECEIPTS INFO IS NOW REQUIRED FOR ALL LIFO CAMs ... Page 3, Item 17

The previous revision of Form 3115 did not require the reporting of gross receipts information for 3 years in connection with LIFO method changes unless there also was a change in method of accounting under Section 263A. However, the current revision of Form 3115 now requires the reporting of gross receipts for the last three years in connection with any LIFO change.

This results from the subtle change in wording in Question 17 which now requires that ... "if the applicant is ... changing its method of accounting for any property subject to Section 263A ... enter the applicant's gross receipts for the 3 tax years preceding the year of change." In the previous Form 3115, the wording only referred to changes in method of accounting being made under Section 263A or 471. (LIFO changes, of course, involve Section 472.)

This is not a big deal, but it is a difference between the old Form 3115 and the new one.

CITATIONS OF AUTHORITY ... Page 3, Item 19

For changes requiring advance consent from the IRS, Item 19 requires a thorough dissertation of all matters related to the proposed change in method. After describing all of the information that an applicant is required to provide, the Form states ... "Also, include either a discussion of the contrary authorities ***or a statement that no contrary authority exists.***"

The requirement for a statement, if applicable, "that no contrary authority exists" has been added in the 2009 revision.

Query: How much research must one do before such a statement can be made with any degree of confidence or assurance? ... How extensive does your research have to be? ... Does this mean *"substantial authority"* based only on the sources listed in Reg. Sec. 1.6662-4(d)(3)(iii) as that term is defined?

Do you have to cite guidance issued by the IRS that has no precedential value, such as Private Letter Rulings and Technical Advice Memoranda (which are considered substantial authority in the list cited above)? ... There seems to be some conflict here.

How seriously does one have to take this requirement in order to sign the jurat that the Form 3115 preparer is required to sign?

This simple or mere "add-on" to Form 3115 deserves further clarification.

SECTION 481(a) ADJUSTMENT DETAIL ... Page 3, Item 25

Part IV relates to the adjustment required under Section 481(a). There is no material change in questions 24-27.

However, the point for emphasis here is the requirement in Question 25 that if the Section 481(a) adjustment is based on more than one component, the computation for each component should be shown.

This requirement takes on significantly greater emphasis as a result of the heightened interest by the IRS in auto dealership cost capitalization procedures. Accordingly, whenever Form 3115 is being filed in connection with the termination of a LIFO election, both components of the Section 481(a) adjustment should be shown ... (1) the amount of LIFO reserve being recaptured and (2) the amount of Section 263A adjustment attributable to the termination of the LIFO election.

This second element or component of the Section 481(a) adjustment would be the change/increase related to the additional amounts that would be capitalized applying Section 263A to the beginning inventory for the year of change when it is not valued at LIFO ... i.e., when it is valued at FIFO or Specific Identification Cost.

At the present time, the uncertainty over the proper computation of the component of the Section 481(a) adjustment attributable to any potential change in accounting method under Section 263A creates quite a dilemma for taxpayers (especially automobile dealers) who are terminating their LIFO elections.

In terminating their LIFO elections, some dealerships report as the amount of the Section 481(a) adjustment only the amount of the LIFO reserve being recaptured. Other dealerships will recompute their previously capitalized Section 263A costs and include this amount as a component of the Section 481(a) adjustment.

Still others make no reference at all to the impact of Section 263A on the computation of the Section 481(a) adjustment. If this (i.e., the Section 263A-related) component of the Sec. 481(a) adjustment is a zero amount, then perhaps that (position) should be stated, rather than not mentioned or identified at all ... because, it is, after all, a zero amount.

see **FORM 3115 FILINGS...**, page 32

(Continued from page 31)

TERMINATION OF LIFO ELECTIONS ... Page 6, Sch. D, Part II

The "mechanics" of the termination process are fairly straightforward.

If a taxpayer is terminating its LIFO election, it is required to complete Schedule D, Part II (and not Schedule C, Part I). The taxpayer is also required to attach copies of Forms 970 that were filed to adopt or expand the use of the LIFO method. Literally interpreted, this requirement does not obligate the taxpayer to attach copies of Forms 3115 that may have previously been filed in order to make changes ***within*** the LIFO method.

Taxpayers terminating a LIFO election are also required to complete Schedule D, Part III. This may required considerably more time, thought and effort than everything else in connection with the termination of the LIFO election, per se.

The aspect for ***immediate and significant*** concern in connection with LIFO terminations, especially for automobile dealerships, lies in Question 3(b) of Part II which brings Section 263A into the picture. This question asks: "Is the applicant's present inventory valuation method in compliance with Section 263A? If 'No,' attach a detailed explanation."

A discussion of the recent activities of the IRS in connection with its concerted effort to enforce a change in procedures followed by virtually all automobile dealerships in capitalizing costs under Section 263A is beyond the scope of this discussion. We have already referred to the crucial interplay with Section 263A in the discussions above regarding (1) the concept of separate trades or businesses and (2) the two components of the Section 481(a) adjustment.

What is critical here is that the position of the IRS, as set forth in the Instructions and in the Regulations is that ***"if an applicant is subject to, but not in compliance with, Section 263A, generally on the same Form 3115, the applicant must first comply with Section 263A before changing an inventory valuation method."***

Just what does this mean?

Could the IRS deny a taxpayer's request to terminate its LIFO election (even if it is made under the automatic filing procedure) if the taxpayer is not in compliance with Section 263A (as the IRS interprets proper compliance through its issuance of TAM 200736026)? In other words, could the IRS make a taxpayer remain on LIFO because it has not changed its method of accounting under Section 263A to comply with TAM 200736026? Possibly worse yet ... might the IRS take the position that there is some implied agreement by a dealership that wants to terminate (or has already terminated) its LIFO election that it also agrees (or agreed) to change to the "TAM Method"?

Although these questions are phrased in terms of automobile dealerships, they are equally applicable to other businesses using LIFO if those businesses are not in compliance with Section 263A (as the IRS might interpret the application of that Section to their businesses).

COST ALLOCATION METHODS & SEC. 263A CHANGES ... Pages 7 & 8, Sch. D, Part III

As discussed above, the more recent heightened emphasis by the IRS concerning proper capitalization of costs under Section 263A could or may pose problems for automobile dealerships, and other taxpayers, who want to terminate their LIFO elections, but not make any other changes in their methods for capitalizing costs to inventory under Section 263A.

As indicated in our proformas for LIFO terminations, our practice in the past has been to affirmatively state in the Form 3115 filing and attachment that "no changes are contemplated in connection with (the taxpayer's) Section 263A method of accounting" and to make no entries on Pages 7 or 8. Until such time as further guidance is forthcoming from the IRS to clarify its position, this disclosure approach may be questioned by the IRS. However, to date, the IRS has not rejected Forms 3115 filed in this manner nor has it requested further information. Beyond that, we can say no more.

OBTAIN A SIGNED ENGAGEMENT LETTER WHEN PREPARING FORM 3115 FILINGS

In my opinion, you should consider obtaining a written engagement letter from the client before embarking on most, if not all, change in accounting method request filings.

Once initiated, the Form 3115 filing process may involve considerably more time and expense than originally anticipated. This likelihood increases if the IRS should require additional information to be submitted or computations to be provided, or if it raises unexpected or novel reasons for considering an adverse ruling in response to your request.

It may be desirable to have a written, signed understanding up-front with your client (i.e., an engagement letter before you proceed) that reflects these possibilities.

This letter might (or should) include an estimate of how much time and fees might be involved in (1) accumulating information for the ruling request, (2) →

actually drafting it, (3) reviewing it with the client after it is prepared, but before it is sent to the IRS, (4) discussing it with the IRS, either by phone or in a conference in the National Office if that should become necessary and (5) implementing the change if permission to make the change is granted or deemed to be granted, in the case of automatic changes.

Another practical problem created by the length of time some accounting request changes take is that the taxpayer may change CPA accounting firms before the National Office completes its review and acts on the Form 3115.

If the client has (recently) changed CPA firms, there may be significant problems between the predecessor CPA firm and the successor CPA firm ... especially if additional information needs to be gathered before the Form 3115 can be filed or if additional information is requested by the IRS after the original Form 3115 has been submitted. Note that this type of problem is illustrated in recent Letter Ruling 201005026.

In summary, all of this suggests the importance having a signed, written engagement letter describing the responsibility for the accumulation of information, the computation of the transitional adjustments, if any, and the representation services to be rendered before the IRS in connection with the Form 3115 accounting method change request.

CONCLUSIONS

Form 3115 is a very important Form, and tax advisors must be aware of its intricacies.

Currently, the biggest problem relating to many changes in accounting methods arises in connection with automobile dealerships and the amounts they are capitalizing as additional inventory costs under Section 263A.

Given that, in September 2009, auto dealerships were encouraged by the Director of the LMSB (in its issuance of a moratorium on pursuing Section 263A matters until January 1, 2011) to consider filing Forms 3115 to change to the Section 263A methodology espoused in TAM 200736026, it's logical that all automobile dealerships are ... or should be ... in a quandary over whether they should file Forms 3115 in connection with their Section 263A methods of accounting.

Putting the focus more sharply on businesses using LIFO (and especially on automobile dealerships)... if these businesses are contemplating the termination of their LIFO elections (or if they have recently terminated their LIFO elections), there are several unanswered questions ... and no real guidance from the IRS ... which significantly muddy the waters around a decision to terminate a LIFO election.

Could these businesses be in for far more than just the recapture of their LIFO reserves?

Schedule C Page 5 Form 3115	**CHANGES (IN METHOD) WITHIN THE LIFO METHOD** **AUTOMATIC CHANGES VS. ADVANCE CONSENT CHANGES** Page 1 of 2
General	• For any taxpayer who has already made a LIFO election and who wishes to request a change in methods, submethods or the treatment of items ***WITHIN*** that existing LIFO election, such requests are to be reported in Schedule C, Parts I and/or II on Page 5 of Form 3115. ◆ The questions in Parts I and II require elaboration on narrative attachments to Form 3115. • ***Part I*** requires considerable information describing the LIFO methods currently being used (i.e., being changed) and the new method(s) to which the taxpayer is changing. • ***Part II*** relates to changes in LIFO pooling methods and should be completed only if applicable. • The Instructions state that ***Schedule D, Part II*** (relating to changes in the valuation of inventories) ***is not applicable*** if the applicant is currently using the LIFO method or submethod and is changing to another LIFO inventory method or submethod. • The instructions for Line 6 state that taxpayers changing to the IPIC Method must use the IPIC Method for ***all LIFO inventories***. ◆ This includes taxpayers requesting automatic changes ***to*** the IPIC Method (Automatic Change No. 61) and/or changes ***within*** the IPIC Method (Automatic Change No. 62).
Automatic CAM Procedures ***... Changes Within the LIFO Method Usually Are Automatic Changes***	• Unless otherwise provided in published guidance, a taxpayer ***must*** file under the automatic change request procedures if (1) the change in method of accounting is included in those procedures for the requested year of change and (2) the taxpayer is within the scope of those procedures for the requested year of change. • The ***original*** Form 3115 is included as an attachment to the Federal income tax return filed for the year of requested change. In other words, the ***original*** Form 3115 is filed ***after*** the end of the year of change as ***part of the income tax return for the year of change***. ◆ A copy of the Form 3115 is required to be filed with the IRS National Office in Washington, D.C. • No user fee is required. • A Form 3115 filed under these procedures ***may be*** reviewed by the IRS. ◆ The taxpayer may be notified if information in addition to that requested on Form 3115 is required or if the application request is denied. • An application that is timely filed and complies with the automatic change request procedure is granted consent to change the method, subject only to review by the IRS National Office and/or by the IRS Operating Division Director.
Automatic CAM Request Scope Limitations	• An applicant is not eligible to use the automatic change request procedures of Rev. Proc. 2008-52 (either in the Appendix or included by reference in other published guidance) if any of the following six (6) scope limitations (Section 4.02 of Rev. Proc. 2008-52) apply at the time the copy of the Form 3115 would be filed with the IRS National Office ... 1. The applicant is under examination, except as provided in Sec. 4.01(1) of Rev. Proc. 2008-52. 2. The applicant is (or was formerly) a member of a consolidated group that is under examination for a tax year(s) the applicant was a member of the group. 3. The applicant is an entity treated as a partnership or S corporation and the accounting method to be changed is an issue under consideration in an examination with respect to a partner, member or shareholder of the applicant. 4. The applicant engages in a transaction to which Section 381(a) applies within the proposed tax year of change. 5. The applicant is in the final tax year of its trade or business. 6. The applicant made or applied to make a change in method of accounting for the same item (or for its overall method) within the last 5 tax years, including the year of change. • These limitations will not apply if the applicable Section of the Appendix of Rev. Proc. 2008-52 or other published guidance states that the particular scope limitation does not apply to the applicant's requested change. ◆ The above limitations are stated in general terms. In fact, there are several instances where the Section of the Rev. Proc. stating the scope limitations also includes exceptions to the application of some of those limitations.

CHANGES (IN METHOD) WITHIN THE LIFO METHOD
AUTOMATIC CHANGES VS. ADVANCE CONSENT CHANGES

Automatic CAMs Within a LIFO Election

IRC Code Section	Designated Automatic CAM #	Change in Method Relates to ...
471	53	Qualifying volume-related trade discounts (for automobile dealers ... floorplan assistance payments, etc.)
	54	Impermissible methods of inventory valuation
472	57	Determining current-year cost
	58	Alternative LIFO Inventory Method (for *New* Vehicles)
	59	*Used* Vehicle Alternative LIFO Method
	60	Determining the cost of used vehicles purchased or taken as trade-ins
	61	Change to IPIC inventory method
	62	Changes within IPIC inventory method
471 & 472	63	Replacement cost method for auto dealers' parts inventory
	96	Replacement cost method for heavy equipment dealers' parts inventory
472	112	Changes to the Vehicle-Pool Method
471 & 472	114	Rolling-average method of accounting for inventories
471	139	For new vehicle retail dealerships, elimination of certain invoice advertising association costs from inventory
472	140	Changes within the Used Vehicle Alternative LIFO Method
	141	Changes to dollar-value pools of manufacturers (pool split & partial termination)

Notes re: Automatic LIFO CAMs

- The above listing of automatic CAMs is from the Form 3115 Instructions (rev. Dec. 2009).
- The IRS will continue to designate additional changes in accounting method as eligible to be made by the "automatic" change procedures in subsequent Revenue Procedures, other guidance and announcements.
- Automatic Change No. 56 ... Change ***from*** the LIFO inventory method (i.e., the termination of a LIFO election) is excluded from the above list of automatic CAMs because the termination of a LIFO election is a change in valuation of the inventory ... It is not a change ***within*** the LIFO election.
  - The termination of a LIFO election may be made as an automatic change if it satisfies the requirements for an automatic change (i.e., if the scope limitations are not applicable).
  - However, the request to terminate a LIFO election is reported in Schedule D, Part II of Form 3115 (Page 6), and it also entails involvement with Part III of Schedule D.
- When a LIFO election is being made for the first time, or when an existing LIFO election is being extended to an additional class of inventory goods, Form 970 (rather than Form 3115) is required to be filed to make those elections.
- Automatic Change Nos. 53 and 139 relate to the elimination of certain costs from inventory costs, and they are often made in connection with inventories that are valued using the LIFO method.
- Automatic Change No. 141, added by Revenue Procedure 2009-39, relates to splitting pools in connection with the partial termination of a LIFO election.
  - This change may be made as an automatic change only by manufacturers.
  - Accordingly, if an automobile dealership wanted to make a comparable change in pooling, it would have to file Form 3115 under the advance consent change procedures.

Advance Consent Request Procedure
(To be used if a change in (LIFO) accounting method cannot be made as an automatic change)

Advance Consent Request Procedure

- If the taxpayer is not within the scope of the ***automatic change*** request procedures, the taxpayer may be able to file a request to make the above changes within its LIFO method under the ***advance consent*** request procedure. (Rev. Proc. 97-27)
- Page 6 of the Instructions has information for advance consent requests and advance consent request scope limitations.
- Part III (Ques. 18-23b), Page 3 of Form 3115 must be completed.
- The Form 3115 must be filed ***before*** the end of the year of the requested change in method.
- A user fee is required to be paid. The amount of the user fee is currently $4,200.

Automatic Termination

TERMINATION OF LIFO ELECTION FOR NEW VEHICLE INVENTORY BY AN AUTOMOBILE DEALERSHIP

This section (pages 36-44) contains discussion and proforma Form 3115 materials for filing by an automobile dealership that is terminating its LIFO election for new vehicles under the automatic change in accounting method procedures of Rev. Proc. 2008-52.

This proforma reflects a previous election by the dealership to use the Alternative LIFO Method in Rev. Proc. 97-36.

REMINDERS ...

- Copies of Forms 970 filed and any subsequent Forms 3115 should be attached.
- Include Form 2848 *Power of Attorney*.
- Request a *Conference of Right* on Page 3 (Item 16).
- ***File the Original Form 3115 as Part of the Federal Income Tax Return for the Year-of-Change***
  - The original Form 3115 must be attached to the dealership's timely filed (including extensions) original Federal Income Tax Return for the year of change.
  - An officer of the corporation should sign and date the Form 3115 and also print his/her name below his/her signature on the left-hand side.
  - Form 3115 should also be signed by the preparer at the bottom of Page 1.

Termination of LIFO Elections *Under Automatic Change in Accounting Method Procedures of Rev. Proc. 2008-52*	

In General	• The termination of a LIFO election is a change ***"from"*** the LIFO inventory method.
	• Revenue Procedure 2008-52 significantly relaxed the technical interpretations that the IRS National Office was previously making which would have required many taxpayers (including, specifically, automobile dealerships) to first obtain permission from the IRS before terminating their LIFO elections.
	• Rules are found in Section 22.01 of the Appendix to Rev. Proc. 2008-52.
	• Designated automatic accounting method change number ... **56.**
	  ◆ Form 3115 is filed after the end of the year of change; no user fee is required.
	• A LIFO termination cannot be made under the automatic change in method procedures if the taxpayer does not meet specific requirements. (For a discussion of these requirements, see page 24 in the article on Rev. Proc. 2008-52 included in the *Year-End 2008 LIFO Lookout.*)
	  ◆ If a taxpayer cannot use the automatic change provisions of Rev. proc. 2008-52, it must file its Form 3115 to terminate its LIFO election before the end of the year of change and follow all of the requirements of Revenue Procedure 97-27 for advance permission.

Permitted Methods	• A taxpayer may change to one or more non-LIFO inventory methods for the LIFO inventories that are the subject of this accounting method change, but only if the selected non-LIFO method is a permitted method for the inventory goods to which it will be applied.
	  ◆ For example, a heavy equipment dealer may change to the specific identification method for new heavy equipment inventories and to the replacement cost method for heavy equipment parts inventories.
	• ***Definition of a "permitted" method.*** An inventory method (identification or valuation, or both) is a permitted method if it meets two requirements.
	  ◆ ***First,*** the method is specifically permitted by the Code, the Regulations, a decision by the United States Supreme Court, a Revenue Ruling, a Revenue Procedure, or other guidance published in the Internal Revenue Bulletin for the inventory goods, ***and***
	  ◆ ***Second,*** the taxpayer is neither prohibited from using that method nor required to use a different inventory method for those inventory goods.
	• In general, these requirements should be easily satisfied by the typical automobile dealership.
	• ***Interplay with Section 263A.*** Whether an inventory method is a permitted method is determined without regard to the types and amounts of costs capitalized under the taxpayer's method of computing inventory cost under Section 263A which governs the types and amounts of costs required to be included in inventory cost.

Recapture of LIFO Reserve	• Upon termination of the LIFO election, the LIFO reserve must be repaid by including the amount of the LIFO reserve in income 25% per year over a 4-year period beginning with the year of termination. The cut-off method may not be used. • This is the Section 481(a) adjustment. See Form 3115, Pages 3-4, Part IV, Questions 24-27.
Audit Protection	• Generally, audit protection applies if the taxpayer is not under IRS audit at the time of filing Form 3115. • All applicants must indicate whether or not audit protection for their change applies, regardless of whether the filing of Form 3115 is under the advance consent request procedures (R.P. 97-27) or the automatic change procedures (R.P. 2008-52). • The Revenue Procedures indicate circumstances under which audit protection may not be applicable.

Other Information to Provide	• Page 6, Schedule D, Part II should be completed.
	  ◆ Items 1 and 2 require the attachment of descriptions of
	    ▪ The inventory goods which are being changed from LIFO to another method, and
	    ▪ The inventory goods which are ***not*** being changed (i.e., all other inventory goods).
	• Section 263A information is required.
	  ◆ If the applicant is subject to, but not in compliance with, Section 263A, generally on the same Form 3115 the applicant must first comply with Section 263A ***before*** changing an inventory valuation method.

Instructions for Completing Form 3115

For Termination of the LIFO Election for New Vehicle Inventories

Under Section 22.01 of the Appendix to Rev. Proc. 2008-52 (Automatic Change Procedure)

This change is Automatic Change No. 56 on the ***List of Automatic Accounting Method Changes*** (included on page 12 in the 17 pages of Instructions to Form 3115). The current revision of Form 3115, *Application for Change in Accounting Method*, is dated Dec. 2009 and consists of 8 pages.

Page 1 ... ***Part I, Line 1(a)*** ... Identify as change #56 on Line (a). Do not make any other entries on Line 1(b). It is not necessary to include any information in the top right-hand section where *appropriate box* is asked to be checked.

Applicant/Filer/Taxpayer and Form 3115 Preparer must sign and date at bottom of Page 1.

Page 2 ... Enter all information, answer all questions.

Page 3 ... ***Part II, Lines 13-17*** ... Enter all information, answer all questions.

Part III ... Part III (Questions 18-23) is not required to be completed for automatic change requests.

Part IV, Line 24 ... Answer should be, "No." The cut-off method is not applicable where LIFO elections are being terminated ... the taxpayer must repay the amount of LIFO reserve attributable to the inventory going off of LIFO when it terminates its LIFO election for those goods.

Part IV, Line 25 ... Generally, the Sec. 481(a) adjustment is the amount of the LIFO reserve as of the end of the last year on LIFO for the goods going off of LIFO.

- The Instructions state ... "If the Section 481(a) adjustment is based on ***more than one component*** of the accounting method being changed, include a summary of the computation for each component.
  - "The summary of the computation and explanation of the Sec. 481(a) adjustment does not need to be extensive, but should be sufficient to demonstrate that the Sec. 481(a) adjustment is being computed correctly."
- Further discussion may be warranted in the case of the termination of New Vehicle LIFO elections and/or Used Vehicle LIFO elections ***and*** depending on how you are handling matters related to the application of the Section 263A inventory cost capitalization rules to the dealerships' inventories.

Page 4 ... ***Schedules A & B*** ... These Schedules should be left blank and/or marked, "Not applicable."

Page 5 ... ***Schedule C*** ... This Schedule should be left blank and/or marked, "Not applicable."

Page 6 ... ***Schedule D, Part I*** ... This Schedule should be left blank and/or marked, "Not applicable."

Schedule D, Part II ... This Part should be completed for LIFO terminations...

Schedule D, Part II, Line 4 ...

- *For inventory being changed (i.e., **New Vehicles**), "Present Method"*: Check the box for "LIFO" (which is the identification method), **and also** check the box for "cost" (which is the valuation method).
- *For inventory being changed (i.e., **New Vehicles**), "Proposed Method"*: Check the box for "specific identification" (which is the identification method), **and also** check the box for "cost or market, whichever is lower" (which is the valuation method).
- *For one of the inventories not being changed (i.e., **Used Vehicles**), "Present Method"*: Check the box for "specific identification" and write in "Used Vehicles" (which is the identification method), **and also** check the box for "cost or market, whichever is lower" and write in "Used Vehicles" (which is the valuation method).
- *For the other inventory not being changed (i.e., **Parts & Accessories Inventories**), "Present Method"*: Check the box for "Identification Methods - Other" and write in "Parts - Replacement Cost" and/or reference Rev. Proc. 2002-17, **and also** check the box for "Valuation Methods - Other" and write in "Parts - Replacement Cost" and/or reference Rev. Proc. 2002-17.

Pages 7 & 8...Schedule D, Part III, Sections A, B & C ... Whether or how you complete Part III (Sections A, B & C) will depend on how you are handling matters related to the application of the Section 263A inventory cost capitalization rules to the dealership's inventories. (Some dealerships have simply left these Sections blank or written, "Not applicable.")

Page 8 ... ***Schedule E*** ... This Schedule should be left blank and/or marked, "Not applicable."

"Narrative Statements & Other Information" ... Consists of 2 or 3 pages to be attached to Form 3115, following page 8.

Sch. D ... Part II | ***INFORMATION RE: PART II ... CHANGE IN VALUING INVENTORIES (Pg. 6)***

- Lines 1 & 2 ... See Proforma Narrative Statement for complete descriptions.
- Lines 3a & 3b ... Question 3a in Part II on Page 6 of Form 3115 usually will be answered ... "Yes."
  - The answer to Question 3b may be problematic (especially in view of the current IRS "moratorium").
  - ***The potential implications of this statement/requirement for automobile dealerships terminating their LIFO elections are unclear.***
  - The Instructions for Line 3 state: "If the applicant is subject to, but not in compliance with, Section 263A, generally on the same Form 3115 the applicant must first comply with Section 263A ***before*** changing an inventory valuation method."
    - This statement should not be interpreted as having little significance. It does not contradict the statement in Rev. Proc. 2008-52 in connection with "permitted methods" that "whether an inventory method is a permitted method is determined without regard to the types and amounts of costs capitalized under the taxpayer's method of computing inventory cost" under Section 263A which governs the types and amounts of costs required to be included in inventory cost. [Section 22.01(1)(b)(iii)]
- Line 4a ... *Inventory Identification Methods & Valuation Methods* ... See below & opposite page.
- Line 4b ... The amounts entered in the columns as the values at the end of the year preceding the year of change under the present method and the proposed method should agree or reconcile with the amount of the net Section 481(a) adjustment.
- Line 5c: *Statement Required by Section 22.01(5)* of the Appendix of Rev. Proc. 2008-52 ...
  - *"After the termination of Taxpayer's LIFO election for new vehicles, the new method of **identifying** new vehicle inventory goods is the specific identification method. After the termination of Taxpayer's LIFO election for new vehicles, the new method for **valuing** new vehicle inventory goods is cost or market, whichever is lower."*
  - This is included as part of Proforma Narrative Statement, and it is evident the proper completion of 4(a) below.

Part II **Change in Valuing Inventories Including Cost Allocation Changes** (Also complete Part III on pages 7 and 8.)

1 Attach a description of the inventory goods being changed.

2 Attach a description of the inventory goods (if any) NOT being changed.

3a Is the applicant subject to section 263A? If "No," go to line 4a . . . . ☐ Yes ☐ No

b Is the applicant's present inventory valuation method in compliance with section 263A (see instructions)? If "No," attach a detailed explanation . . . . ☐ Yes ☐ No

4a Check the appropriate boxes below.	Inventory Being Changed NEW VEHICLES		Inventory Not Being Changed
	Present method	Proposed method	Present method
Identification methods:			
Specific identification		✓	✓ USED + PARTS
FIFO			
LIFO	✓		
Other (attach explanation)			
Valuation methods:			
Cost	✓		
Cost or market, whichever is lower		✓	✓ USED
Retail cost			
Retail, lower of cost or market R.P. 2002-17			
Other (attach explanation) PARTS / REPLACEMENT COST			✓ PARTS
b Enter the value at the end of the tax year preceding the year of change			

5 If the applicant is changing from the LIFO inventory method to a non-LIFO method, attach the following information (see instructions).

a Copies of Form(s) 970 filed to adopt or expand the use of the method.

b **Only for applicants requesting advance consent.** A statement describing whether the applicant is changing to the method required by Regulations section 1.472-6(a) or (b), or whether the applicant is proposing a different method.

c **Only for applicants requesting an automatic change.** The statement required by section 22.01(5) of the Appendix of Rev. Proc. 2008-52 (or its successor).

Form **3115** (Rev. 12-2009)

Sch. D ... Part III	INFORMATION RE: PART III ... METHOD OF COST ALLOCATION (Pgs. 7-8)

- The caption at the top of Schedule D, Part II on Page 6 states ... "Also complete Part III on Pages 7 and 8."
- The Instructions on page 8-9 for the completion of Schedule D, Part III merely refer to the Regulations without further discussion.
- Whether or how you complete Form 3115, Pages 7-8, Schedule D, Part III (Sections A, B & C) will depend on how you are handling matters related to the application of the Sec. 263A inventory cost capitalization rules to the dealership's inventories.
- As discussed in the accompanying article, the more recent heightened emphasis by the IRS concerning proper capitalization of costs under Section 263A and its moratorium (ending Jan. 1, 2011) on raising Sec. 263A issues in audits could, or may, pose problems for automobile dealerships ... as well as other taxpayers ... who want to terminate their LIFO elections but who do not necessarily want to make any changes in their methods for capitalizing costs under Sec. 263A.
- At this time, given the uncertainties and the lack of specific, precedential guidance from the IRS on these matters, we have not attempted to suggest specific responses to Part III of Schedule D. In this regard, note particularly ...
  - "Handling, processing, assembly and repackaging costs" ... Section B *(Costs Required to Be Allocated)* ... Line 9.
  - "Offsite storage and warehousing costs" Section B *(Costs Required to Be Allocated)* ... Line 10.
  - "On-Site storage" Section C *(Costs Not Required to Be Allocated)* ... Line 9.

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Part III Method of Cost Allocation (Complete this part if the requested change involves either property subject to section 263A or long-term contracts as described in section 460 (see instructions)).

Section A—Allocation and Capitalization Methods

Attach a description (including sample computations) of the present and proposed method(s) the applicant uses to capitalize direct and indirect costs properly allocable to real or tangible personal property produced and property acquired for resale, or to allocate and, where appropriate, capitalize direct and indirect costs properly allocable to long-term contracts. Include a description of the method(s) used for allocating indirect costs to intermediate cost objectives such as departments or activities prior to the allocation of such costs to long-term contracts, real or tangible personal property produced, and property acquired for resale. The description must include the following:

1 The method of allocating direct and indirect costs (i.e., specific identification, burden rate, standard cost, or other reasonable allocation method).

2 The method of allocating mixed service costs (i.e., direct reallocation, step-allocation, simplified service cost using the labor-based allocation ratio, simplified service cost using the production cost allocation ratio, or other reasonable allocation method).

3 The method of capitalizing additional section 263A costs (i.e., simplified production with or without the historic absorption ratio election, simplified resale with or without the historic absorption ratio election including permissible variations, the U.S. ratio, or other reasonable allocation method).

Section B—Direct and Indirect Costs Required To Be Allocated

Check the appropriate boxes showing the costs that are or will be fully included, to the extent required, in the cost of real or tangible personal property produced or property acquired for resale under section 263A or allocated to long-term contracts under section 460. Mark "N/A" in a box if those costs are not incurred by the applicant. If a box is not checked, it is assumed that those costs are not fully included to the extent required. Attach an explanation for boxes that are not checked.

		Present method	Proposed method
1	Direct material		
2	Direct labor		
3	Indirect labor		
4	Officers' compensation (not including selling activities)		
5	Pension and other related costs		
6	Employee benefits		
7	Indirect materials and supplies		
8	Purchasing costs		
9	Handling, processing, assembly, and repackaging costs		
10	Offsite storage and warehousing costs		
11	Depreciation, amortization, and cost recovery allowance for equipment and facilities placed in service and not temporarily idle		
12	Depletion		
13	Rent		
14	Taxes other than state, local, and foreign income taxes		
15	Insurance		
16	Utilities		
17	Maintenance and repairs that relate to a production, resale, or long-term contract activity		
18	Engineering and design costs (not including section 174 research and experimental expenses)		
19	Rework labor, scrap, and spoilage		
20	Tools and equipment		
21	Quality control and inspection		
22	Bidding expenses incurred in the solicitation of contracts awarded to the applicant		
23	Licensing and franchise costs		
24	Capitalizable service costs (including mixed service costs)		
25	Administrative costs (not including any costs of selling or any return on capital)		
26	Research and experimental expenses attributable to long-term contracts		
27	Interest		
28	Other costs (Attach a list of these costs.)		

Form 3115 (Rev. 12-2009) Page 8

Part III Method of Cost Allocation (see instructions) (continued)

Section C—Other Costs Not Required To Be Allocated (Complete Section C only if the applicant is requesting to change its method for these costs.)

		Present method	Proposed method
1	Marketing, selling, advertising, and distribution expenses		
2	Research and experimental expenses not included in Section B, line 26		
3	Bidding expenses not included in Section B, line 22		
4	General and administrative costs not included in Section B		
5	Income taxes		
6	Cost of strikes		
7	Warranty and product liability costs		
8	Section 179 costs		
9	On-site storage		
10	Depreciation, amortization, and cost recovery allowance not included in Section B, line 11		
11	Other costs (Attach a list of these costs.)		

Spread Periods	*SECTION 481(a) ADJUSTMENTS*
Sec. 481(a) Adjustment Period ... General Rules	• For a net positive Sec. 481(a) adjustment, the spread period is 4 years. • For a net negative Sec. 481(a) adjustment, the spread period is 1 year. • ***De minimis rule.*** If the net positive Sec. 481(a) adjustment for the change in method is less than $25,000, a taxpayer may elect to use a one-year Sec. 481(a) adjustment period, in lieu of the 4-year spread period. ♦ The taxpayer must complete the appropriate line on Form 3115 to elect this treatment. • ***Short period as a separate taxable year.*** If the year of change or any other taxable year during the Sec. 481(a) adjustment period is a short taxable year, the Sec. 481(a) adjustment must be included in income as if that short taxable year were a full 12-month taxable year.
Certain Events *"Will"* Shorten the Spread Period **Section 5 of Rev. Proc. 2008-52**	• The spread period will be shortened if the taxpayer ceases to engage in the trade or business or if it terminates its existence. ♦ If a taxpayer ceases to engage in a trade or business or terminates its existence, it must take the remaining balance of any Sec. 481(a) adjustment relating to the trade or business into account in computing taxable income in the taxable year of the cessation or termination. • In general, a taxpayer is treated as ceasing to engage in a trade or business if the operations of the trade or business cease or substantially all the assets of the trade or business are transferred to another taxpayer. ♦ The "substantially all" requirement is met if ... "there is a transfer of assets representing at least 90% of the fair market value of the net assets ***and*** at least 70% of the fair market value of the gross assets held by the corporation immediately prior to the transfer. ♦ This is the definition of "substantially all" that is provided in Section 3.01 of Rev. Proc. 77-37. • Examples of the cessation of a trade or business include ♦ the incorporation of the trade or business, ♦ the purchase of the trade or business by another taxpayer in a transaction to which Sec. 1060 applies, ♦ the transfer or termination of the trade or business pursuant to a taxable liquidation, or ♦ the contribution of the assets of the trade or business to a partnership.

*LETTER OF TRANSMITTAL FOR FORM 3115 **

Internal Revenue Service
Attn: CC:ITA - Automatic Rulings Branch
P. O. Box 7604
Ben Franklin Station
Washington, DC 20044

Date__________, 2011

Re: XYZ Dealership, Inc.

EI No. ______________________________

Form 3115: ***Termination of LIFO Accounting Method for New Vehicle Inventories Using Automatic Change Procedures under Rev. Proc. 2008-52 For The Calendar Year Ending December 31, 2010***

Dear Sir or Madam:

Enclosed is a copy of the Form 3115 for the taxpayer identified above reflecting that taxpayer's request for permission to terminate its use of the Last-In, First-Out (LIFO) method for its new automobile and new light-duty truck inventories.

This change is to be effective for the calendar year ending December 31, 2010.

The original Form 3115 will be attached to Taxpayer's timely filed (including extensions) original Federal income tax return for 2010, the year of change. This copy of Form 3115 is also being filed at this time with the IRS National Office in Washington, D.C.

As of the dates of these filings, Taxpayer is ***not*** under audit examination, and Taxpayer does not have any Federal income tax return(s) under consideration by any IRS Appeals Officer or by any Federal Court.

No user fee is required in connection with this filing since it is being made under the published automatic change procedures set forth in Rev. Proc. 2008-52.

Respectfully submitted, etc.

** This letter should be prepared on dealership letterhead. The letter, with a copy of the Form 3115 and any attachments, should be mailed to the IRS National Office at the time when the dealership files its income tax return for the year of change.*

Form 3115: Application for Change in Accounting Method

w/r/t Taxable Year Ending December 31, 2010

Form 3115: Narrative Statements & Other Information

This request is for Change No. 56 ... *Termination of Taxpayer's LIFO Election for New Vehicle Inventories.*

This change is being made under Section 22.01 of the Appendix to Revenue Procedure 2008-52 effective for the calendar year beginning Jan. 1, 2010 and ending Dec. 31, 2010. This is an automatic accounting method change, and applicants filing Form 3115 under a designated automatic change procedure are not required to pay a user fee.

The original of Form 3115 is attached to Taxpayer's timely filed (including extension of time) income tax return for the year of change. A duplicate copy of this Form 3115 has been sent to the IRS National Office in Washington, D.C.

Taxpayer is not under IRS audit examination at the time of filing this Form 3115.

Taxpayer reports on the basis of a calendar year-end and it employs the accrual method of accounting for maintaining its books and records and for filing its Federal and State income tax returns. Taxpayer's business code for principal business activity is 441110. Taxpayer is a franchised automobile dealer engaged in the purchase and retail sale of new automobiles and light-duty trucks. Taxpayer also buys and sells used vehicles, and it provides parts, repair and maintenance services on the vehicles it sells, as well as on vehicles customers have purchased from other dealers.

Method for Valuing Used Vehicle Inventories. Some used vehicles are acquired by purchase (at auctions or from other dealers) and some used vehicles are acquired by trade from retail customers. Used vehicles are identified by specific identification, and they are valued at the lower of cost or market, with market considered to be lower of wholesale, "as is" value, less estimated reconditioning cost, or estimated current wholesale market value.

Method for Valuing Parts & Accessories Inventories. Pursuant to accepted industry-wide practice, cost of parts and accessories inventories is determined at year-end by reference to manufacturer current price lists in effect at year-end. As a result, the ending parts and accessories inventory is valued at replacement costs instead of at actual cost. In a period of rising prices, this practice results in an overall valuation for parts and accessories inventories that closely approximates, but usually is slightly in excess of, cost. This method for valuing parts inventories is permitted by Revenue Procedure 2002-17 which allows automobile dealers to approximate the actual cost of parts and accessories inventory items by reference to end-of-the-year prices taken from manufacturers' price lists.

Method for Valuing Miscellaneous Other Inventories. Gas, oil, grease, work in process, body shop supplies, sublet and other inventories are valued at cost.

Methods for New Vehicle Inventories (Statements Required by Sec. 22.01(5) of the Appendix to Rev. Proc. 2008-52)

(a) After the termination of Taxpayer's LIFO election for new vehicles, the new method of ***identifying*** new vehicle inventory goods is the specific identification method.

(b) After the termination of Taxpayer's LIFO election for new vehicles, the new method for ***valuing*** new vehicle inventory goods is cost or market, whichever is lower.

Section 263A Inventory Cost Capitalization Matters

Taxpayer is subject to the Section 263A Inventory Cost Capitalization Rules and uses a *Simplified Resale Method* as its method of accounting for inventories to reflect the Section 263A Uniform Cost Capitalization Rules. No changes are contemplated in connection with its Section 263A method of accounting.

Form 3115: Application for Change in Accounting Method

w/r/t Taxable Year Ending December 31, 2010

Form 3115: Narrative Statements & Other Information

Part IV, Page 3 - Computation of Net Positive Section 481(a) Adjustment

LIFO Inventories at Beginning of Year of Change (i.e., at the End of the Year Preceding the Year of Change)	*Pool #1 New Automobiles*	*Pool #2 New Light-Duty Trucks*	*Total All LIFO Inventories*
* Inventory at Cost (Dec. 31, 2009 / Jan. 1, 2010)	1,500,000	4,000,000	5,500,000
** LIFO Valuation of Above Inventory	(900,000)	(3,200,000)	(4,100,000)
Section 481(a) Adjustment (LIFO Reserve)	600,000	800,000	1,400,000

* Beginning inventory for the year of change under the proposed method.
** Beginning inventory for the year of change under the present (LIFO) method.

The Section 481(a) component relating to the amount of change in the inventory costs capitalized under Section 263A as a result of terminating the LIFO election...

- ☐ has not been computed.
- ☐ is estimated to be not more than $__________ amount.
- ☐ is $__________ . (* See *Alternative Presentation Format* for Sec. 481(a) Adjustment on Page 3 of 3.)
- ☐ has not been determined pending further clarification of the methodology under Sec. 263A to be applied to the inventory.

__Notes:__ *(1) The Instructions state, "If the Section 481(a) adjustment is based on more than one component of the accounting method being changed, include a summary of the computation of each component. The summary of the computation and explanation of the Section 481(a) adjustment does not need to be extensive but should be sufficient to demonstrate that the Section 481(a) adjustment is being computed correctly."*

(2) ***Re: Section 263A Inventory Cost Capitalization Adjustment.*** *In situations where the changes in the amounts of inventory costs capitalized under Section 263A as of the beginning of the year of change are also a component of the overall Section 481(a) adjustment, that component of the Section 481(a) adjustment should be separately identified.*

(3) ***Re: Termination of Used Vehicle LIFO Election.*** *If a LIFO election for used vehicle inventory is being terminated, in addition to the Section 263A cost capitalization adjustment as a component of the Section 481(a) adjustment (referred to above), it will also be necessary to consider (as a potential component of the overall Section 481(a) adjustment) adjustments made to value the inventory of used vehicles as of the beginning of the year of change using the lower-of-cost-or-market valuation method.*

Forms 970 Original LIFO Election

- ☐ A copy of the original Form 970 LIFO election for New vehicle inventories is attached.
- ☐ A copy of the original Form 970 LIFO election for New vehicle inventories is not attached.

I certify that to the best of my knowledge and belief ***XYZ Dealership, Inc.*** properly elected the LIFO inventory method by filing Form 970 with its income tax return for the taxable year ended Dec. 31, _____, and otherwise complied with the provisions of Section 472(d) and Reg. Sec. 1.472-3.

/S/ ____

Alternative Presentation Format for Computation of Section 481(a) Adjustment

	Pool #1 New Automobiles	Pool #2 New Light-Duty Trucks	Total All LIFO Inventories
Beginning Inventory for Year of Change Under ***Proposed*** Method	1,500,000	4,000,000	5,500,000
Beginning Inventory for Year of Change Under ***Present*** Method	(900,000)	(3,200,000)	(4,100,000)
Difference (Positive Section 481(a) Adjustment - Increase in Computing Taxable Income) Due to Recapture of LIFO Reserve as of the Beginning of the Year of Change	600,000	800,000	1,400,000
Section 263A Costs Capitalized in Beginning Inventory for Year of Change Under ***Proposed*** Method			85,000
Section 263A Costs Capitalized in Beginning Inventory for Year of Change Under ***Present*** Method			(60,000)
Difference (Positive Section 481(a) Adjustment - Increase in Computing Taxable Income) Due to the Additional Amount of Section 263A Costs Capitalized under the Simplified Resale Method with Respect to the Inventory as of the Beginning of the Year of Change			25,000 *
Total - Net Positive Section 481(a) Adjustment			1,425,000

Termination of LIFO Election ... Proper Identification of Change Requested on Page 1

Rev. Proc. 97-27 ... Advance Permission Required	Automatic Method Change Provisions Apply
• Complete the top, right-hand section of Page 1 of Form 3115 entitled "Check the appropriate box to indicate type of change being requested." • Check the ***"Other"*** box. • Describe the change as ***"Termination of LIFO method for valuing inventory."*** Alternatively, ... ***"Change from LIFO method to specific identification cost."*** • Do not complete Part I, Lines 1(a) or (b) for this change if advance consent from the IRS is required.	• Complete only Part I, Line 1(a) of Page 1 by identifying this change as ***Change No. 56.*** • Do not check the "Other" box or provide any further description of change.

REDUCTION OF INVENTORY COSTS FOR VENDOR ALLOWANCES FOR DEFECTIVE MERCHANDISE

The IRS recently issued some interesting guidance relating to the treatment of a special type of trade discount. This guidance could have a potentially significant impact on businesses using LIFO, including automobile dealerships using LIFO who receive another specialized type of trade discount (i.e., floorplan assistance payments) in connection with their new vehicle inventories.

In ILM 200945034, released in November 2009, the IRS held that vendor allowances that are in the nature of trade discounts must reduce inventory costs. This guidance was from the National Tax Office of the IRS to the Special Counsel of the Large & Mid-Size Business Division of the IRS.

ISSUES & HOLDINGS

This ILM involved three issues.

The ***first*** issue was whether the returned/defective merchandise vendor allowances in question should be treated as part of total sales or as a discount that reduces the cost of inventory under Reg. Sec. 1.471-3(b).

The National Office held that these allowances were not part of the total sales, but instead should be treated as discounts that reduce the cost of inventory.

The ***second*** issue related to the treatment of these allowances by the purchaser of the goods if the allowances for returned/defective merchandise were treated as discounts that reduce the cost of inventory. In other words, should the allowances reduce the cost of ***all*** of the merchandise that was purchased from the vendor? Or, alternatively, should the allowances reduce ***only*** the cost of merchandise in the lot purchased that was subsequently determined to be defective?

On this issue involving the allocation of the allowances to inventory costs, the National Office held that the returned/defective merchandise allowances should reduce the cost of ***all*** merchandise purchased from the vendor, rather than applied to reduce ***only*** the cost of the merchandise that was found to be defective.

The ***third*** issue involved the potential application of Section 263A to the defective merchandise included in the inventory. In this regard, the issue was whether the defective merchandise would qualify as *subnormal goods* under Reg. Sec. 1.471-2(c), or whether the cost of defective merchandise should be treated as rework labor, scrap or spoilage capitalizable to the non-defective merchandise. If the defective merchandise did not qualify as *subnormal goods*, then the allowances made by the vendor to allow for the defective merchandise would be capitalizable to the inventory as an indirect cost (of acquiring that inventory) in accordance with the Section 263A cost capitalization Regulations.

On this issue, the IRS concluded that the defective merchandise qualified as *subnormal goods.*

FACTS

The taxpayer involved in this situation was engaged in the business of selling merchandise. The merchandise it sold was acquired from a number of vendors that were unrelated to the taxpayer. As might be expected, some of the merchandise it purchased for resale was occasionally determined to be defective.

For inventory at some of its locations, the taxpayer used the retail inventory method. For inventory at other locations, it used the invoice cost method. Some of its inventory, including the merchandise for which the returned/defective merchandise allowances were received, was valued under the Last-In, First-Out, (LIFO) method, while other merchandise was valued under the First-In, First-Out (FIFO) method. The taxpayer used the Simplified Resale Method to capitalize additional Section 263A costs.

DEFECTIVE MERCHANDISE

Merchandise may be found to be defective in three different ways. The taxpayer may discover that an item is defective (1) when it is unloaded from the delivery truck at the taxpayer's distribution centers, (2) when the item is unpacked from its shipping container in either the distribution center or in the store, or (3) when the item is returned to the taxpayer by a customer who purchased the item.

Once the taxpayer determines that an item is defective, the defective item is either (1) discarded, (2) sold at reduced prices, or (3) returned to the vendor.

Different vendors have different practices or policies relating to defective goods. Many vendors permit or require the taxpayer to return defective merchandise for a refund.

Other vendors have adopted a policy under which the taxpayer receives "returned/defective merchandise vendor allowances" at the time when it purchases the merchandise. This allowance is stated as a fixed percentage of total purchases, and is intended to cover the estimated costs of defective merchandise sold to the taxpayer. In connection with this

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policy, the taxpayer is generally not required to actually return the defective merchandise or otherwise notify the vendor of the amount of merchandise determined to be defective.

The vendor practice in question in the ILM involved a "member satisfaction merchandise allowance" under which no claim was required to be filed with the vendor with respect to any goods that were found to be defective.

The agreement with the vendor provided that ... "Supplier is providing a Member Satisfaction Merchandise Allowance ... The percentage provided must be adequate to cover all returned merchandise, including but not limited to defective/returned merchandise, or additional claims will be filed by Company, in its sole discretion at our fiscal year end.

"Returned merchandise must be disposed of by the [store] . . . [t]hrough salvage, liquidation or recycling operations, with no obligation to account for the proceeds of such disposal. "

The general practice anticipated was that, from time-to-time, the taxpayer and/or the vendor would conduct a study to determine if the returned/defective merchandise allowances were representative of the actual rate allowed for defective goods. If the allowance rate was determined to be not representative (i.e., if a change in the rate allowed for defective goods were found to be necessary), the vendor allowances on future purchases would be adjusted.

Under some circumstances, the vendor might agree to retroactively adjust the amount of the vendor allowance, but a retroactive adjustment of the allowance was generally not anticipated. The agreement with the vendor in question did not require repayment or retroactive reduction of the vendor allowance if the rate of allowance for defective goods turned out to be less than the rate that had been estimated in setting the allowance.

ISSUE 1 ... ARE THE ALLOWANCES "TRADE DISCOUNTS?"

The controlling Regulation is Reg. Sec. 1.471-3(b) which provides that cost means, in the case of merchandise purchased since the beginning of the taxable year, the invoice price less trade or other discounts, except strictly cash discounts approximating a fair interest rate.

Cash discounts represent a reduction in the invoice or purchase price and are attributable to payment by the purchaser within a prescribed time period; the cash discount is only available if the purchaser makes payment within such time period. At the option of the taxpayer, cash discounts may be deducted or not, provided a consistent course is followed. The treatment of cash discounts is a method of accounting.

Trade discounts are to be distinguished from cash discounts. Trade discounts represent adjustments to the purchase price granted by a vendor. These discounts may vary depending upon volume or quantity purchases, or other factors established by the vendor. ***If a discount is always allowed irrespective of time of payment, it is considered to be a trade discount regardless of the purported conditions which must be met in order for the discount to apply.***

In a 1956 decision, (*Pittsburgh Milk Co. v. Comm.*), the Tax Court addressed whether allowances made by a milk producer to certain purchasers of its milk were adjustments to the sales price of the milk, or ordinary and necessary business expenses under Section 162. The Milk Company computed the adjustments by applying a specific percentage to list prices fixed by the Milk Control Commission. This resulted in a net cost to the customer which was below the list price, in violation of state law. The Court opined that when determining gain from the sale of property, the amount realized must be based on the actual price or consideration for which the property was sold, and not on some greater price for which it possibly should have been, but was not, sold.

The Tax Court found that the allowances were part of the sales transaction, and the Court concluded that gross income must be computed with respect to the agreed prices (net of rebate) at which the milk was sold. The Court noted that ***the allowances were ". . . not contingent upon any subsequent performance or consideration from the purchaser."*** Accordingly, the Tax Court held that the purpose and the intent of the allowance was to reach an agreed upon net selling price, and the allowance was properly viewed as an adjustment to the sales price.

Applying this reasoning to the facts in the ILM, the National Tax Office said that returned/defective merchandise vendor allowances are provided in lieu of actual merchandise returns. Although the accounting entries may differ from taxpayer-to-taxpayer, proper accounting for returned merchandise generally has the same effect as if the merchandise were sold for its cost. Thus, the issue arises as to whether returned/defective merchandise vendor allowances should be treated as part of total sales, because treating the returned/defective merchandise allowances as part of total sale in the year of acquisition would produce the same results as the proper accounting for actual merchandise returns if the defective merchandise

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had been discovered and discarded in the same taxable year of acquisition and the actual defective rate equaled the estimated defective rate.

The National Office held that the allowances should be properly accounted for as reductions to the invoice cost of merchandise under Reg. Sec. 1.471-3(b), despite the facts that (1) the returned/defective merchandise vendor allowances are provided in lieu of actual merchandise returns and (2) the allowances are characterized as compensation for defective goods.

The returned/defective merchandise allowances at issue were fixed allowances that were granted regardless of the amount (if any) of defective items in the purchased merchandise. Also, the allowances were not dependent upon proof of actual defects or upon return or disposition of defective merchandise. In negotiating the allowance, the vendor and the taxpayer were considered to have reached an agreed upon net selling price for all of the merchandise.

Thus, the allowances were held not to be part of total sales under Reg. Sec. 1.61-3(a). Instead, they should be treated as discounts that reduce the cost of inventory pursuant to Reg. Sec. 1.471-3(b). ***Accordingly, the allowances are akin to a trade discount.***

ISSUE 2 ... TRADE DISCOUNTS REDUCE INVENTORY COST

The second issue in the ILM related to the proper treatment of the allowances for defective goods, if they were held to be trade discounts. With respect to this treatment, the National Office stated that "because the existence and amount of actual defective items is unknown at the time of the sale and generally irrelevant to the net selling price, the returned/defective merchandise vendor allowance is properly treated as a ***reduction to the cost of all merchandise*** purchased from the vendor, rather than as a reduction only to the cost of items subsequently determined to be defective.

"The allowances are not dependent on Taxpayer's discovery of defective items in the purchased merchandise, and Taxpayer is not required to return the allowances if the actual amount of defective inventory is less than expected. The allowances therefore are not tied to specific items of defective inventory, but rather relate to all items of purchased merchandise. Accordingly, the discount reduces the cost of all of the merchandise purchased from the vendor."

ISSUE 3 ... SEC. 263A COST CAPITALIZATION

The third issue in this ILM related to whether or not Section 263A might apply to the defective merchandise. Section 263A would be applicable only if these goods did not qualify as subnormal goods. As it turned out, the National Office concluded that the defective merchandise did qualify for writedowns as subnormal goods (under Reg. Sec. 1.471-2(c)). Therefore, as a reseller, the taxpayer was not required to capitalize the acquisition cost of this defective merchandise as an indirect cost of non-defective merchandise under Reg. Sec. 1.263A-1(e)(3)(ii)(Q).

The analysis of the IRS' reasoning in connection with the cost capitalization aspects of this issue is quite detailed and interesting. However, it has no bearing on the "trade discount" treatment aspects of this article.

WHAT IS THE IMPACT OF THIS ILM ON BUSINESSES USING LIFO?

The taxpayer in this ILM had elected the LIFO inventory method for a portion of its inventory. In this regard, the National Tax Office stated (only in a footnote) that to the extent the LIFO method was used for a particular class of goods, any subnormal goods within that class may not be valued at less than their original cost. (Rev. Rul. 76-282). Beyond that, it said no more.

The major holding in ILM 200945034 was that the vendor allowances for defective merchandise were to be treated as reductions of inventory cost because they were, in essence, trade discounts. Interestingly, the National Office made no further mention of the potential ramifications of its holding with respect to whether the taxpayer would or should be required to change its method of accounting for these allowances (i.e., for trade discounts) because if they were not being treated as reductions of inventory cost, the taxpayer was using an improper method of accounting.

The ILM states that defective merchandise vendor allowances received by a seller of merchandise ***should be*** treated as discounts that reduce inventory costs. Do the words ***"should be"*** equate to the words ***"must be?"***

If they do, then (clearly?) the failure to reduce inventory costs by trade discounts would constitute an improper method of accounting. As such, a taxpayer using an improper method of accounting is obligated to continue to use that improper method until it receives permission to change the accounting method.

Fortunately, the IRS has designated a change from an improper method of accounting for trade discounts as a change that can be made by filing Form 3115 under the automatic consent provisions and procedures in Revenue Procedure 2008-52. This is automatic change ***Number 53*** for qualifying vol-

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ume-related trade discounts described in Section 21.04 of the Appendix to Rev. Proc. 2008-52.

Perhaps a potentially more significant ramification of this ILM with respect to the inventory valued on LIFO relates to whether the failure of the taxpayer to reduce its inventory costs by the amount of the trade discounts would (could, should or might) be considered to be a violation of the requirement that all inventory on LIFO be valued ***at cost***.

Code Section 472 and Revenue Procedure 79-23 clearly provide that inventory on LIFO must be valued at cost. Failure to value inventory on LIFO at cost is a violation of one of the requirements that must be satisfied in order to be eligible to use LIFO. This is also clear from the questions on Form 970.

Usually, the IRS seems to be more concerned about a taxpayer who is/may be (1) using the lower-of-cost-or-market writedown method for goods on LIFO or (2) taking a writedown for some portion of the goods on LIFO that might be defective or damaged goods.

Nevertheless, the failure to reduce the overall amount of inventory on LIFO by trade discounts might present a problem if an examining agent were to take the position that such a failure rendered the taxpayer's LIFO election invalid.

Might the IRS adopt such a restrictive interpretation? For those who believe that the Service might not take such a position, they should recall to memory the litigation in *Mountain State Ford Truck Sales.* In this case, the IRS successfully challenged the industry-wide practice of valuing parts and accessories at replacement cost ... a clear violation of the "cost" eligibility requirement by a taxpayer using LIFO. It was not until several years later, after a significant groundswell of opposition to the Tax Court's decision (because there was no way that actual cost could ever be computed for parts inventories), that the IRS finally relented by issuing Revenue Procedure 2002-17.

WHAT IS THE IMPACT OF THIS ILM ON AUTO DEALERSHIPS USING LIFO?

It is indisputable that ***all*** automobile dealerships selling new vehicles receive trade discounts in the form of floorplan assistance allowances and other adjustments from the manufacturers.

The IRS recognizes the floorplan assistance payments as trade discounts which may be eliminated from inventory costs and deducted currently, rather than capitalized as part of the inventory cost. Although the internal accounting procedures for some dealers expense these amounts as part of their initial entry to record the cost of the inventory, many dealerships do not do this.

Many dealers in recent years have filed Forms 3115 to change their method of accounting for treating these payments. Originally, these change requests required advance approval from the IRS, the payment of the user fee and the patience to wait for a fairly long time until the IRS responded. And, when the IRS responded, it granted these requests. After years of reviewing virtually identical Form 3115 applications for the same type of requested change in method, the IRS made life easier for everyone by designating this type of change as one which could be made under the automatic filing procedures (most recently set forth in Rev. Proc. 2008-52). Accordingly, such a change can be made as automatic change ***Number 53.***

Auto dealerships may also make a similar automatic change in accounting method for the treatment of certain invoice advertising association costs under Section 21.13 of the Appendix to Rev. Proc. 2008-52. This is automatic change ***Number 139***, and it is applicable only to advertising "in the dealership's market area" (i.e., this change includes only costs for local and regional advertising campaigns that promote the dealer's brand of vehicles in the dealership's specific market area ... it excludes costs for advertising on a national level).

Since 2002, over a dozen articles have appeared in the *LIFO Lookout* about these trade discounts and the clear advantage to a dealer who eliminates the cost of trade discounts from its LIFO inventory costs. As a result of articles in the *LIFO Lookout* and other publications that called attention to the benefits of making these changes, many Forms 3115 have been filed with the IRS.

Some dealerships which do not use LIFO have made the change; some dealerships which use LIFO have made the change; but, more significantly, notwithstanding these advantages, many dealerships using LIFO still do not reduce their LIFO inventory costs by these trade discounts. Are these dealerships who have not made the change risking their LIFO elections by failing to do so?

This is a question that has been raised and discussed many times in the *LIFO Lookout.* [For example, see (1) *"Dealer Caught between Conflicting Opinions about the Need to Change Accounting Methods for Trade Discounts"* in the March 2005 *LIFO Lookout*, on page 4; (2) *"CPAs Are Risking Their Dealers' LIFO Elections ... And They May Not Even Be Aware of It,"* in the March 2005 issue of the *LIFO Lookout*, on page 1; and (3) *"Follow-up on ... CPAs Are Risking Their Dealers' LIFO Elections ..."* in the December 2005 issue of the *LIFO Lookout*, on page 4.]

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In numerous presentations to dealership CPAs attending the AICPA National Dealership Conferences, Ms. Terri Harris (the IRS Motor Vehicle Technical Advisor) has indicated that she has raised this question informally with the National Office and that she has been told informally that a dealer's LIFO election would not be jeopardy if the LIFO inventory costs were not reduced by trade discounts. I've commented many times, in the *LIFO Lookout* and elsewhere, that I had found this answer "somewhat illogical and inconsistent."

Here's what appeared on this matter in the December 2006 issue of the *LIFO Lookout* (Update #7 on page 2).

"During the Question & Answer portion of Ms. Harris' presentation at the 2006 AICPA National Auto Dealership Conference in Phoenix, she was again asked...

"Is an automobile dealership that is using the LIFO method to value its new vehicle inventories risking the termination of its LIFO election (because of a violation of the cost requirement) if that dealership is not eliminating trade discounts and floorplan assistance payments from its year-end inventory costs?

"Ms. Harris's answer this year was exactly the same as it was last year [at the AICPA Conference in Baltimore]. She said that "someone" in the National Office "informally" told her that ... *The taxpayer would **not** be considered as being in violation of the LIFO eligibility cost requirement.*

"Ms. Harris did not identify the individual who gave her this answer, nor did she provide any rationale for this position. No one in the IRS National Office has "gone on record" or taken responsibility for this answer.

"We are unable to understand the IRS' rationale on this. Where is there precedent for ignoring the plain language of Reg. Sec. 1.471-3(b), the plain language of Revenue Ruling 84-481 and the plain language of Revenue Ruling 79-23?

"***Our advice.*** Until the IRS provides an "official" answer, we caution any taxpayer on LIFO against relying on this informal, undocumented answer."

But now, as a result of the holding in ILM 200945034 which simply reconfirms the proper treatment of trade discounts (but does not address the LIFO implication question), I continue question the correctness of the IRS' unofficial position on this matter. It would seem that the more the IRS relies upon the clear language of Reg. Sec. 1.471-3(b) in its holdings involving trade discounts, which it does again in ILM 200945034, the more important compliance with this Regulation should become for LIFO users.

Perhaps it is time for something more definite than an "unofficial answer" to this question ... preferably an answer that has precedential value attached to it.

HOW BIG ARE AUTO DEALER'S TRADE DISCOUNTS ... OUR SURVEY OF DEALERS' TRADE DISCOUNTS

For many years, I have been using the rule of thumb that one could safely estimate the amount of inventory cost reduction when floorplan assistance payment trade discounts were eliminated would be approximately 2 to 2½ percent of inventory costs. In my opinion, that still seems to be about right.

I recently did a survey of the amount of trade discounts (i.e., floorplan assistance payments and certain advertising fees) that were eliminated from the inventory costs as of Dec. 31, 2008 and 2009 by 50 dealerships that had made this change.

The results of this survey (following this article) will simply give you an idea of some of our dealers' figures. There are several qualifications that should be understood in reviewing these results, and they are clearly spelled out on page 50.

The average cost computation shows that for all of the dealers, the average percent of inventory reduction was 2.7% for 2008 and 1.8% for 2009.

The decrease from 2008 to 2009 in the amounts for trade discounts for floorplan assistance payments was significantly greater (1.7% for 2008 down to 1.0% for 2009) than was the decrease between years for advertising fees (1.0% for 2008 down to 0.8% for 2009).

The decrease at the end of 2009 in floorplan assistance payments as percent of inventory is not surprising given the enormous discontinuities that dealerships experienced when GM and Chrysler went into bankruptcy early in the year and that was followed later by the overall significant sell-out of inventory as a result of the mid-year, "Cash-for-Clunkers" Program and the scarcity of inventory later in the year as its aftermath.

Although it is not apparent from the two years' data in the table on page 51, the ± 2% "average" has remained relatively constant in years prior to 2008, as well.

Notwithstanding whatever flaws might underlie the data compiled in our survey, the results are what they are.

HOW BIG ARE AUTO DEALERS' TRADE DISCOUNTS? ... OUR FIRM'S SURVEY OF TRADE DISCOUNTS

I thought it might be useful to do a survey of my own, looking at the amounts of trade discounts (including certain advertising fees) for about 50 automobile dealerships for whom we have actual information.

Statistical sampling procedures were not employed in the selection of the dealerships included in this survey. These dealerships were included in the survey because comparative data is available for 2008 and for 2009. They are located all over the country. Collectively, these dealerships sell (not in any proportion) all manufacturers' makes and models.

All of the determinations of the amount of discount were made either by (1) dealership personnel, (2) the dealership's CPA firm or (3) by an outside organization that made the determination by accessing manufacturer information. In cases where the determination was not made by an outside organization, it's always possible that there might have been some fudging or shortcuts.

For certain brands, there are no advertising fees because there is no underlying advertising association activity.

The dealerships are listed in the schedule on the facing page based on the combined total of trade discounts and advertising fees removed from inventory cost for year-end 2009 expressed as a percentage of the unadjusted inventory cost. The results are presented in descending order and a collective average cost computation appears at the bottom.

Certain manufacturers (Chrysler and Nissan, in particular) account for a significant number of the dealerships that are listed at the "lower end" of the rankings in our survey. On the other hand, Ford, General Motors and Toyota dealerships are predominantly at the "higher end" of the list.

Conclusions

(1) The average cost computation shows that for all of the dealers, the average percent of inventory reduction was 2.7% for 2008 and 1.8% for 2009.

(2) The decrease from 2008 to 2009 in the amounts for trade discounts for floor plan assistance payments was significantly greater (1.7% for 2008 down to 1.0% for 2009) than was the decrease between years for advertising fees (1.0% for 2008 down to 0.8% for 2009).

(3) The decrease at the end of 2009 in floor plan assistance payments as percent of inventory is not surprising given the significant discontinuities that dealerships experienced when GM and Chrysler went into bankruptcy early in the year, followed by the significant sell-off of inventory later in the year as a result of the "Cash-for-Clunkers Program" and the resulting scarcity of inventory in its aftermath.

(4) Although it is not apparent from the two years' data in the table, the ± 2% "average" has remained relatively constant in years prior to 2008, as well.

Trade Discounts (Floorplan Assistance Payments) & (Certain) Invoiced Advertising Association Fees Eliminated from New Vehicle Year-End Inventory Cost in Accordance with Reg. Sec. 1.471-3(b) Based on a Sample of 50 Automobile Dealerships For the Years Ended December 31, 2008 & 2009

2008 — Single, Combined Pool - All New Vehicles

Dealership	# of Units	Ending Inventory at Cost	Trade Discounts	Certain Ad Fees	Total Trade Discounts & Ad Fees	% of Total Cost: TD	% of Total Cost: Ad Fees	% of Total Cost: % Total
1	67	2,380,605	98,253	14,750	113,003	4.1%	0.6%	4.7%
2	96	2,667,694	46,948	45,053	92,002	1.8%	1.7%	3.4%
3	818	23,124,989	668,383	323,868	992,250	2.9%	1.4%	4.3%
4	79	1,777,417	17,811	39,695	57,506	1.0%	2.2%	3.2%
5	90	2,149,672	39,461	30,504	69,965	1.8%	1.4%	3.3%
6	126	3,258,129	36,442	59,322	95,764	1.1%	1.8%	2.9%
7	108	3,328,248	91,786	-	91,786	2.8%	0.0%	2.8%
8	34	884,385	18,011	-	18,011	2.0%	0.0%	2.0%
9	1,070	27,344,413	387,322	398,291	785,612	1.4%	1.5%	2.9%
10	62	1,307,567	16,564	14,357	30,921	1.3%	1.1%	2.4%
11	292	6,968,893	180,492	-	180,492	2.6%	0.0%	2.6%
12	345	8,511,279	79,897	140,200	220,097	0.9%	1.6%	2.6%
13	0	-	-	-	-	0.0%	0.0%	0.0%
14	96	2,667,694	46,948	45,053	92,002	1.8%	1.7%	3.4%
15	643	16,147,925	150,202	256,065	406,267	0.9%	1.6%	2.5%
16	51	1,801,219	88,237	11,650	99,887	4.9%	0.6%	5.5%
17	318	7,822,651	270,080	66,265	336,345	3.5%	0.8%	4.3%
18	232	6,469,430	56,510	99,033	155,543	0.9%	1.5%	2.4%
19	461	12,335,782	134,002	196,792	330,794	1.1%	1.6%	2.7%
20	34	884,385	18,011	-	18,011	2.0%	0.0%	2.0%
21	89	2,340,690	64,948	-	64,948	2.8%	0.0%	2.8%
22	191	4,580,787	101,653	21,887	123,540	2.2%	0.5%	2.7%
23	66	2,045,582	41,165	28,133	69,297	2.0%	1.4%	3.4%
24	271	6,925,877	59,267	102,979	162,246	0.9%	1.5%	2.3%
25	259	6,543,811	54,997	96,633	151,630	0.8%	1.5%	2.3%
26	61	1,280,659	10,909	12,244	23,153	0.9%	1.0%	1.8%
27	0	-	-	-	-	0.0%	0.0%	0.0%
28	590	14,036,800	127,405	222,545	349,950	0.9%	1.6%	2.5%
29	89	2,340,690	64,948	-	64,948	2.8%	0.0%	2.8%
30	192	5,455,330	89,542	18,114	107,655	1.6%	0.3%	2.0%
31	4,532	130,921,586	1,385,050	1,548,495	2,933,545	1.1%	1.2%	2.2%
32	54	1,473,148	46,968	-	46,968	3.2%	0.0%	3.2%
33	69	2,014,982	72,755	-	72,755	3.6%	0.0%	3.6%
34	519	7,399,904	105,383	-	105,383	1.4%	0.0%	1.4%
35	58	2,077,724	29,182	-	29,182	1.4%	0.0%	1.4%
36	198	5,867,076	84,402	97,280	181,682	1.4%	1.7%	3.1%
37	2,629	70,217,158	2,507,788	370,373	2,878,161	3.6%	0.5%	4.1%
38	103	5,821,331		58,200	58,200	0.0%	1.0%	1.0%
39	164	4,525,582	37,530	-	37,530	0.8%	0.0%	0.8%
40	78	2,242,549	68,535	-	68,535	3.1%	0.0%	3.1%
41	235	6,753,902	102,850	123,505	226,355	1.5%	1.8%	3.4%
42	211	5,751,690	53,265	27,200	80,465	0.9%	0.5%	1.4%
43	148	3,766,692	34,040	23,400	57,440	0.9%	0.6%	1.5%
44	341	7,564,832	68,357	-	68,357	0.9%	0.0%	0.9%
45	607	14,645,730	176,826	72,775	249,601	1.2%	0.5%	1.7%
46	254	6,438,164	43,400	22,400	65,800	0.7%	0.3%	1.0%
47	261	6,481,642	62,157	42,520	104,677	1.0%	0.7%	1.6%
48	75	1,986,918	16,605	-	16,605	0.8%	0.0%	0.8%
49	181	8,987,374	-	55,595	55,595	0.0%	0.6%	0.6%
50	139	4,107,342	83,440	66,446	149,886	2.0%	1.6%	3.6%
Total - All Inventories		476,427,931						
Total - All Trade Discounts			8,038,726					
Total - All Advertising Fees				4,751,621				
Total - T/D & Ad Fees					12,790,348			
Averages - 48 Dealerships		9,925,582	167,473	98,992	266,466	1.7%	1.0%	2.7%
Averages - 50 Dealerships								

2009 — Single, Combined Pool - All New Vehicles

Dealership	# of Units	Ending Inventory at Cost	Trade Discounts	Certain Ad Fees	Total Trade Discounts & Ad Fees	% of Total Cost: TD	% of Total Cost: Ad Fees	% of Total Cost: % Total
1	83	3,253,295	188,898	18,250	207,148	5.8%	0.6%	6.4%
2	99	3,129,027	60,233	57,531	117,764	1.9%	1.8%	3.8%
3	541	15,504,965	314,199	218,861	533,060	2.0%	1.4%	3.4%
4	87	1,911,108	19,954	44,672	64,626	1.0%	2.3%	3.4%
5	72	1,963,200	32,462	28,025	60,487	1.7%	1.4%	3.1%
6	59	1,616,569	25,442	23,207	48,649	1.6%	1.4%	3.0%
7	58	1,381,260	12,000	28,496	40,496	0.9%	2.1%	2.9%
8	31	1,023,366	11,875	17,511	29,386	1.2%	1.7%	2.9%
9	802	20,598,244	290,621	288,874	579,495	1.4%	1.4%	2.8%
10	22	488,914	5,902	7,615	13,517	1.2%	1.6%	2.8%
11	112	2,567,451	24,995	44,393	69,388	1.0%	1.7%	2.7%
12	234	5,127,060	49,677	88,310	137,987	1.0%	1.7%	2.7%
13	352	8,361,757	80,767	141,954	222,721	1.0%	1.7%	2.7%
14	268	6,263,033	57,088	108,316	165,404	0.9%	1.7%	2.6%
15	391	9,510,172	90,186	156,979	247,165	0.9%	1.7%	2.6%
16	25	890,311	18,581	4,500	23,081	2.1%	0.5%	2.6%
17	110	2,447,999	39,947	19,970	59,917	1.6%	0.8%	2.4%
18	112	4,407,321	38,901	68,149	107,050	0.9%	1.5%	2.4%
19	314	8,604,903	62,205	143,544	205,749	0.7%	1.7%	2.4%
20	123	3,586,449	36,849	45,837	82,686	1.0%	1.3%	2.3%
21	63	1,518,033	12,818	22,152	34,970	0.8%	1.5%	2.3%
22	118	2,903,590	36,103	26,457	62,560	1.2%	0.9%	2.2%
23	46	1,681,433	20,335	15,694	36,029	1.2%	0.9%	2.1%
24	172	3,908,234	26,039	55,847	81,886	0.7%	1.4%	2.1%
25	129	2,877,077	21,247	38,192	59,439	0.7%	1.3%	2.1%
26	86	1,707,420	16,432	18,421	34,853	1.0%	1.1%	2.0%
27	61	1,425,931	11,102	16,555	27,657	0.8%	1.2%	1.9%
28	80	1,961,742	14,560	22,350	36,910	0.7%	1.1%	1.9%
29	41	1,183,912	9,655	10,279	19,934	0.8%	0.9%	1.7%
30	63	2,035,333	25,818	8,396	34,214	1.3%	0.4%	1.7%
31	2,514	73,340,202	685,426	544,135	1,229,561	0.9%	0.7%	1.7%
32	36	1,105,138	18,040	-	18,040	1.6%	0.0%	1.6%
33	43	1,257,826	15,610	2,625	18,235	1.2%	0.2%	1.4%
34	151	3,309,983	46,643	-	46,643	1.4%	0.0%	1.4%
35	58	1,223,996	17,243	-	17,243	1.4%	0.0%	1.4%
36	190	5,825,399	65,930	-	65,930	1.1%	0.0%	1.1%
37	1,745	45,477,562	278,987	175,245	454,232	0.6%	0.4%	1.0%
38	126	6,258,045	-	61,800	61,800	0.0%	1.0%	1.0%
39	122	3,920,923	38,675	-	38,675	1.0%	0.0%	1.0%
40	44	1,323,527	11,215	1,225	12,440	0.8%	0.1%	0.9%
41	139	4,291,820	38,335	1,045	39,380	0.9%	0.0%	0.9%
42	110	3,259,512	28,990	-	28,990	0.9%	0.0%	0.9%
43	166	4,055,123	34,930	-	34,930	0.9%	0.0%	0.9%
44	296	7,001,425	58,968	-	58,968	0.8%	0.0%	0.8%
45	524	12,513,628	101,843	-	101,843	0.8%	0.0%	0.8%
46	122	3,402,324	25,325	-	25,325	0.7%	0.0%	0.7%
47	96	2,196,399	14,905	-	14,905	0.7%	0.0%	0.7%
48	67	2,053,069	13,800	-	13,800	0.7%	0.0%	0.7%
49	203	10,513,619	-	64,623	64,623	0.0%	0.6%	0.6%
50	135	3,748,745	4,226	9,464	13,690	0.1%	0.3%	0.4%
Total - All Inventories		319,917,375						
Total - All Trade Discounts			3,153,982					
Total - All Advertising Fees				2,649,499				
Total - T/D & Ad Fees					5,803,481			
Averages - 48 Dealerships								
Averages - 50 Dealerships		6,398,347	63,080	52,990	116,070	1.0%	0.8%	1.8%

CLOSING AGREEMENT WITH THE IRS DID NOT PREVENT THE IRS FROM CHALLENGING LIFO METHOD IN LATER YEARS

In a recently released Field Attorney Advice (FAA), the IRS held that a Closing Agreement signed by the taxpayer in a prior tax year did not bar or prevent the IRS from challenging and changing the taxpayer's LIFO definition of an item ... and hence, its LIFO calculations ... in a later year.

The Closing Agreement had been signed by the taxpayer and the IRS in order to settle prior years' audits with some degree of finality.

This Advice basically held that the language of the Closing Agreement did not reflect an agreement between the parties (i.e., the taxpayer and the IRS) as to the appropriateness of the taxpayer's item definitions used in calculating the value of its dollar-value LIFO pools or the permissibility of such item definitions in future years.

This Field Attorney Advice 20100501F, released in February 2010, was issued by an Associate Area Counsel for the Large & Mid-Size Business Division, and it is heavily redacted. Therefore, many of the specifics cannot be determined or accurately reconstructed. Nevertheless, this FAA is worth analyzing for the more general insights that one should be aware of when signing a Closing Agreement with the IRS in connection with LIFO matters.

FACTS ... IN GENERAL

Apparently, the IRS had audited and then disputed the taxpayer's LIFO calculations for seven periods or years, and the Service had determined that the LIFO value of the inventory as of the end of the seventh year was not correctly computed. After initially disputing the IRS' recalculations of its LIFO inventories, the taxpayer finally agreed to accept the IRS' LIFO computations, and signed a Closing Agreement with the IRS.

The Agreement was signed in the third year after the end of the year for which the values had been recomputed for the goods in one of the taxpayer's LIFO pools.

The Closing Agreement was signed on behalf of the IRS by three different representatives: (1) an examination manager, (2) an Internal Revenue Agent and (3) the IRS Case Manager, with the following proviso ... "I have examined the specific matters involved and recommend the approval of the proposed agreement."

Unfortunately, in the document released, the IRS has redacted the key language in both the introductory section of the Agreement and in the body of the Agreement. Thus, one could only guess at what this language might have been.

THE FACTS GET MORE COMPLICATED

Briefly summarizing the sequence of years ... Year #1 was the year-end for which the LIFO value of the pool was determined to be $xxx ... Year #3 was the (subsequent) year in which the Closing Agreement was executed/signed ... Year #2, the intervening year, was the year in which several transactions occurred involving the inventories of the taxpayer.

In Year #2, after the taxpayer changed its name, (1) another company (Company B) merged into the taxpayer and (2) the assets of one of the divisions of yet another company (Company C) were transferred to the taxpayer in a tax-free exchange/transfer under Internal Revenue Code Section 351.

There's even more: At the time the FAA was written, the inventories in question were owned by a different entity (Company D), and this company was a single-member limited liability company owned solely by the taxpayer.

Note that the transfer of assets by Company C under Section 351 was not a reorganization under Section 368 to which the provisions for the carryover of methods of accounting would apply. Instead, the LIFO layers and base dates of the transferor's LIFO inventories carry over to an existing transferee also using the LIFO method in transaction that falls under Section 351.

With respect to the merger transaction involving Company B, Section 381(c)(5) provides that an acquiring corporation must compute inventories on the same basis used by the distributor or transferor corporation unless different methods were used by the acquiring corporation and the distributor or transferor corporation. If different methods were used and the businesses are to be integrated, then the principal method must be used. (Reg. Sec. 1.381(c)(5)-1(c)(1)).

A more detailed discussion of the rules for the carryover of accounting methods under Section 381 is beyond the scope of this article. However, for a comprehensive discussion see, *"Maneuvering Through the Proposed Rules for Post-Transaction*

→

Accounting Methods, by Rohrs & Walberg, in *The Tax Adviser*, September 2009, pg. 630.

In summary, in the FAA, the merger and Section 351 transfers resulted in a combination of the LIFO pools of these entities, and in general, the methods subsequently employed represent the predominant accounting methods for purposes of Section 381.

DISPUTED LANGUAGE IN CLOSING AGREEMENT

The IRS audit cycle of this taxpayer began in Year #2. During Year #2, the IRS took the position that the taxpayer, in determining the value of its LIFO pool, applied item definitions that were too broad. Accordingly, the IRS wanted to challenge the broad definition(s) that the taxpayer was using ... most likely in order to enforce the use of comparatively more narrow item definitions by the taxpayer.

The position of the taxpayer was that one of the paragraphs in the Closing Agreement that was signed in Year #3 (i.e., the year after the start of the year of the audit cycle challenging the item definitions) should bar or prevent the IRS from challenging or changing the way the taxpayer defined inventory items for LIFO purposes.

Unfortunately, the key language/wording of the paragraph in question has been redacted from the FAA.

"ITEM" DEFINITIONS FOR LIFO PURPOSES

As background for interpreting the item definition issue, a brief overview may be helpful.

Under the dollar-value LIFO method, goods in inventory are grouped into one or more pools. Each pool contains one or more classes of goods referred to as "items." Changes in inventory are calculated based on changes in the dollar value(s) of the pool(s). Whether there is an increment or a decrement in inventory during the year is determined by comparing the aggregate base-year cost of the items in a pool at the beginning of the year to the aggregate base-year cost of the items in the pool at the end of the year. The "base-year cost" is the cost of an item as of the base date, which is defined as the first day of the first year for which LIFO is adopted.

Unfortunately, neither the Code nor the applicable Regulations define the term "item."

However, the Tax Court in *Amity Leather Products Co.* opined that a narrower definition of the term "item" will provide a more accurate measure of inflation. In its opinion in *Amity Leather Products*, the Tax Court acknowledged that the definition of the term "item" must be administratively feasible and not unduly burdensome. A narrower definition of the term "item" will more *clearly reflect income* because that narrower definition will prevent factors other than inflation from entering into the inventory computations.

The following example, taken directly from *Amity Leather Products Co.*, illustrates this point. "If a taxpayer's inventory experiences mix changes that result in the substitution of less expensive goods for more expensive goods, the treatment of those goods as a single item increases taxable income. This occurs because any inflation in the cost of an item is offset by the reduction in cost resulting from the shift to less expensive goods.

"Conversely, if changes in mix of the inventory result in the substitution of more expensive goods for less expensive goods, the treatment of those goods as a single item decreases taxable income because the increase in inventory costs is eliminated from the LIFO costs of the goods as if such cost increase represented inflation."

From this, it follows that the valuation of an inventory under the LIFO method is critically affected by the pools and by the item definitions used by a taxpayer, as well as by the costs of the items in a pool.

Applying this background to the question under review in the FAA, the IRS said that the statement (that is redacted) in the Closing Agreement was meant to lock-in ***only*** the taxpayer's pre-Year #2 LIFO calculations and the data affecting such calculations. The (redacted) statement was not meant to establish the suitability or acceptability of item definitions used by the taxpayer going forward into future years.

The position of the IRS and the FAA was that nothing in the Agreement references the taxpayer's item definitions in the context of the appropriateness of such definitions or otherwise indicates that this was an issue the Closing Agreement was meant to resolve.

Consequently, the language of the Agreement did not bar the IRS from challenging the taxpayer's item definitions beginning in Year #2.

CLOSING AGREEMENTS ... IN GENERAL

In general, Section 7121 authorizes the IRS to enter into Closing Agreements "with any person relating to the liability of such person ... in respect of any internal revenue tax for any taxable period." If a Closing Agreement is properly executed, then it is final and conclusive unless fraud, malfeasance or misrepresentation of a material fact is involved.

Section 7121(b) provides that the taxpayer's case shall not be reopened as to the matters agreed upon. It also provides that the Agreement shall not be

see **CLOSING AGREEMENT WITH THE IRS...**, page 54

(Continued from page 53)

modified by any officer, employee or agent of the United States. Finally, it provides that the Agreement, or any determination made in accordance therewith, shall not be annulled, modified, set aside or disregarded.

The Regulations provide that Closing Agreements may be made with respect to taxable periods ending subsequent to the date of the Agreement. In such cases, "the agreement may relate to one or more separate items affecting the tax liability of the taxpayer." (Reg. Sec. 301.7121-1(b)(3)). Therefore, the Closing Agreement in question would be binding if it were properly executed, and if binding, it would bar the IRS from changing the taxpayer's item definitions for LIFO purposes if the parties had so agreed in the Closing Agreement.

INTERPRETING THE CLOSING AGREEMENT

Closing Agreements are created by statute and "are authorized, and limited by, the language of the statute." When not otherwise limited by the statute, courts apply principles of contract law when analyzing Closing Agreements.

Under common law, the intention of the parties to a contract controls its interpretation. If the terms of a contract are clear and unambiguous, courts do not consider extrinsic evidence in interpreting the contract; extrinsic evidence is only allowed if the contract is ambiguous.

Also, under contract law, (1) an interpretation that gives reasonable meaning to all parts of the contract is preferable to one that leaves portions of the contract meaningless and (2) provisions in a contract are interpreted in light of the entire Agreement.

Introductory clauses in a Closing Agreement are important for interpreting the Agreement. However, they do not bind the parties for purposes of resolving an issue concerning a matter other than the matter agreement upon. This was the Tax Court's holding in *Zaentz v. Comm.*

The FAA states that the Closing Agreement addressed the appropriate LIFO values for Company A's Pool A as of various year-ends ending with the end of Year #1, as of which the LIFO value was determined to be $xxx. However, the Agreement did not address the appropriateness of the taxpayer's item definitions, nor did the Agreement purport to lock in the taxpayer's item definitions for perpetuity.

Citing a portion of the Agreement that was redacted, the FAA states that the language of the Agreement was clear that it did not apply to anything that entered inventory after the end of Year #1.

The FAA states that the position of the taxpayer was not supportable because it interpreted the wording in question out of context. The wording in question in the Agreement was made in conjunction with another (redacted) stipulation and as part of an agreement to finalize the calculation of Company A's pre-Year #2 LIFO inventory.

The FAA adds that when examined within the framework of the entire Agreement, it was apparent that the redacted language was there in the Agreement in order to prevent the IRS from subsequently changing the inventory calculation of the LIFO valuation to be ($xxx + $yyy [i.e., some amount greater than $xxx]) as of the end of Year #1 by challenging the criteria upon which the calculation was based.

That language also was there in order to prevent the IRS from circumventing its Agreement not to change the taxpayer's pre-Year #2 inventory calculations. This was what left the item definition issue in Year #2 (i.e., post-Year #1) open to dispute.

One further point. The taxpayer's interpretation of the Agreement that would bar the IRS from challenging its item definition(s) in a subsequent year was contrary to the intent of the parties as evidenced in the Agreement. The Agreement stated that neither party had intended to admit the correctness of the other's position. Therefore, an interpretation of the Agreement that would have compelled the IRS to accept the taxpayer's LIFO methodology (to the extent it was in place as of the end of Year #1) would have been contrary to the acknowledgement that both parties had refused to admit the correctness of the other's position.

SECTION 481(a) ADJUSTMENTS

Section 481(a) provides that, in computing the taxpayer's income for the taxable year in which the change in method of accounting occurs, "there shall be taken into account those adjustments which are determined to be necessary solely by reason of the change in order to prevent amounts from being duplicated or omitted." Section 481 taxes in the year of change all income omitted in prior years under the old accounting system, regardless of whether the statute of limitations has expired for those years.

The Closing Agreement in the FAA contained language that limited the IRS's ability to make a Section 481(a) adjustment. That language was there because a Section 481(a) adjustment attributable to a change in item definitions would have, in part, required a change to the inventory calculation for pre-Year #2 tax years. Such an adjustment would have been in violation of the Closing Agreement.

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However, that Section 481(a) language did not prohibit the IRS from changing the taxpayer's item definitions for years subsequent to Year #1.

If the IRS were to successfully challenge the taxpayer's definition of items in Year #2, that would have resulted in the need for a Section 481(a) adjustment because a change in item definitions is a change in method of accounting under Section 446. However, in that case, the Section 481(a) adjustment would have been limited to tax years after Year #1.

APPLICATION OF THE CLOSING AGREEMENT TO VARIOUS INVENTORY TRANSFERS

The FAA also discussed the application of the Closing Agreement to the inventory that was obtained from Company B and Company C as a result of the merger and the transfer of the assets under Section 351, respectively.

The position of the IRS was that these inventories were subject to examination by the IRS even though they were owned by the predecessor companies prior to the end of Year #1. Although these inventories were combined with the taxpayer's inventory (including the taxpayer's pre-Year #2 inventory), they did not enter the taxpayer's inventory until after the end of Year #1.

The Closing Agreement provided that the IRS may examine goods that enter inventory after Year #1. Therefore, these inventories in question were subject to examination by the IRS even though apparently those inventories acquired from Company B or Company C were not included on an Attachment to the Closing Agreement.

The FAA reasoned that a conclusion to the contrary would allow application of the Closing Agreement to companies who were not parties to the Agreement.

In reaching this conclusion, the FAA cited several cases in support of three general rules. A person who is not a party to a contract "is in no position to invoke its protection." Rights are not granted to a third party unless the contract reflects the express or implied intent of the parties to benefit the third party. Closing Agreements are only binding with respect to the parties thereto.

Although, Closing Agreements may be binding on transferees, Company B and Company C were not parties to the Agreement. Furthermore, the Agreement did not reflect an intent, express or implied, to include inventory acquired in subsequent mergers, acquisitions, or other corporate transactions within the confines of the Closing Agreement.

In fact, the Closing Agreement reflected the opposite intention because it provided that the IRS may examine anything entering into inventory after the end of Year #1.

While Closing Agreements may have applied to transferees, Company B and Company C were not transferees. To the extent they were transferors, the same rule did not apply. Binding a transferee precludes a taxpayer from avoiding the application of a Closing Agreement by transferring assets. To have applied this rule conversely would not have achieved the same result; rather it would have allowed the application of a Closing Agreement to taxpayers and items to which it was never meant to apply.

SAMPLE CLOSING AGREEMENT

The really important language has been redacted from the Closing Agreement in FAA 20100501F. The attachment to this article may give you a better sense of what a Closing Agreement involving LIFO matters might or should look like.

Note that this sample Closing Agreement does not contain any language related to a Section 481(a) adjustment. This is because the IRS agreed that it would make no adjustments to the years under audit in return for the taxpayer's Agreement that it would change to the LIFO methodology that the IRS wanted it to adopt.

Form **906-c**
(Rev. August 1994)

Department of the Treasury --- Internal Revenue Service

Closing Agreement on Final Determination Covering Specific Matters

Under Section 7121 of the Internal Revenue Code

XYZ Corporation Tax ID #12-3456789

(Taxpayer's name, address, and identifying number)

Company Address

and the Commissioner of Internal Revenue ("Commissioner") (hereinafter collectively referred to as "the Parties") make the following closing agreement:

Whereas, Taxpayer's method of inventory valuation is the dollar value Last-In, First-Out, ("LIFO") method under I.R.C. Section 472;

Whereas, in connection with the Commissioner's examination of Taxpayer's tax years ended __________ [Year #1] and __________ [Year #2], the Commissioner disputed various aspects of Taxpayer's LIFO computations, including ____________________ [state specifically the previous method, submethods, etc., not allowed by the IRS], and, as a consequence of Taxpayer's disagreement with the Commissioner's position, the Commissioner has proposed Taxpayer be on an acceptable method of ____________________ [state specifically the new method, submethods, etc., to be employed], causing a proposed disallowance of Taxpayer's cost of goods sold deduction in the amount of $xxx ______ for the tax year ended __________ [Year #1] and a proposed disallowance of Taxpayer's cost of goods sold deduction of $yyy ______ for the tax year ended __________ [Year #2].

Whereas, Taxpayer followed its same LIFO method for the succeeding tax years up to and including the tax year ended __________ [Year #5];

Whereas, the Commissioner's Appeals Division will "no change" the tax years under Appeals jurisdiction which are the tax years ended __________ [Year #1] and __________ [Year #2];

Whereas, the Parties desire to resolve the dispute with finality by changing Taxpayer's LIFO method prospectively to a proper [____________________________] method under Treas. Reg. Sec. 1.472-8(e)(2)(ii)(b);

NOW IT IS HEREBY DETERMINED AND AGREED FOR FEDERAL INCOME TAX PURPOSES THAT:

1. Commencing with the tax year ended __________ [Year #5] and in tax years subsequent, Taxpayer's dollar-value method of LIFO inventory valuation elected under Treas. Reg. Sec. 1.472-8 will employ ____________________ [state specifically the new method, submethods, etc., that Taxpayer agrees to employ].

2. Commencing with the tax year ended __________ [Year #5] and in tax years subsequent to the tax year ended __________ [Year #5], Taxpayer will determine ____________________ [state specifically the new method, submethods, etc., that Taxpayer agrees to employ] ... without ____________________ [state specifically the method, submethods, etc., Taxpayer had previously used and is agreeing not to use in the future] under Treas. Reg. Sec. 1.472-8(e)(2)(ii)(b).

3. Accordingly, the accounting method changes in paragraphs one and two, above, shall be effectuated pursuant to a cut-off transition method and without an I.R.C. Section 481(a) adjustment. As a result, the tax year ended __________ [Year #4], shall be treated as a new base year for purposes of the LIFO calculations for the tax year ended __________ [Year #5], and thereafter. Taxpayer shall not be required to change its use of ____________________ [state specifically the previous method, submethods, etc., not allowed by the IRS] for any taxable year prior to the tax year ended __________ [Year #5].

Sample LIFO Closing Agreement
No Section 481(a) Adjustment ... Cut-Off Method

Closing Agreement with XYZ Corporation, EI #12-3456789

4. Taxpayer will file its Federal income tax return for the tax year ended __________ [Year #5] within the timeframe allowed by statute, to include any extension for filing at its option. Taxpayer will also file a copy of the Federal income tax return with ____________________ [IRS Employee Name], LMSB Manager of the __________________ [city, state] Internal Revenue Service Office concurrently with the one sent to the Internal Revenue Service Campus. The copy of the Federal income tax return filed with LMSB will have summary schedules in support of Taxpayer's new dollar-value method for LIFO inventory valuation that employs ____________________ [state specifically the new method, submethods, etc., to be employed].

5. The Commissioner is permitted to examine and propose adjustments to Taxpayer's use of the LIFO method for the tax year ended __________ [Year #5] and tax years subsequent to the tax year ended __________ [Year #5] to determine whether the amounts reported for each such tax year properly reflect income and are in accordance with the requirements of Treas. Reg. Sec. 1.472-8 and IRC Section 263A.

6. For the tax years subsequent to the tax year ended __________ [Year #5], Taxpayer has the right to file Form 3115, *Application For Change in Method of Accounting*, under Rev. Proc. 97-27, Rev. Proc. 2002-9 or any other such official published guidance by the Commissioner relevant to Taxpayer's use of the LIFO method and ____________________ [describe the new method, submethods, etc., to which Taxpayer may request permission from the IRS to change in the future], of which the approval of such request is under jurisdiction of the Office of Chief Counsel.

This Agreement is final and conclusive except:

(1) The matter it relates to may be reopened in the event of fraud, malfeasance, or misrepresentation of material fact;

(2) It is subject to the Internal Revenue Code sections that expressly provide that effect be given to their provisions (including any stated exception for Code Section 7122) notwithstanding any other law or rule of law; and

(3) If it relates to a tax period ending after the date of this agreement, it is subject to any law, enacted after the agreement date that applies to that tax period.

By signing, the above parties certify that they have read and agreed to the terms of this document

Your signature ______________________________ Date Signed ______________

Spouse's signature (if a joint return was filed) ______________________________ Date Signed ______________

Taxpayer's representative

______________________________ Date Signed ______________

Taxpayer (other than individual) XYZ Corporation ______________ EI # 12-3456789

By ______________________________ Date Signed ______________

Title Mr./Mrs. RST, President of XYZ Corporation

Commissioner of Internal Revenue

By ______________________________ Date Signed ______________

Title Mr./Mrs. MNO, Appeals Team Manager

Notes

- This sample Closing Agreement does not contain any language related to a Section 481(a) adjustment, other than referring (in Agreement #3) to the fact that there is none. There was no Section 481(a) adjustment in this case because the IRS agreed that it would make no adjustments to the years under audit in return for Taxpayer's Agreement that it would change to the LIFO methodology that the IRS wanted it to adopt.
- In Agreement #6, it is stated explicitly that in future years, Taxpayer has the right to file Form 3115 requesting permission to use a different method.

COMPARISON OF *SuperLIFO™* & IRS NEW ITEM DETERMINATIONS FOR NEW VEHICLES IN YEAR-END 2009 INVENTORIES

We are pleased to present our ***SuperLIFO™*** 2010 New Items Lists in a Report comparing our determinations of new items with those previously made available by the office of the IRS Motor Vehicle Technical Advisor in Grand Rapids, Michigan.

The IRS lists were distributed as an attachment to an e-mail dated April 1, 2010. In the attachment, the IRS Motor Vehicle Technical Advisor stated the following ... ***"This list is similar to the guidance I provide to examiners who audit automobile dealers' tax returns and is the result of research by my staff of the best information available to us. Since the list is not an 'Official List,' it does not reflect 'Service Position' and examiners are not required to follow it."***

The IRS has used the following sources to compile its New Items Lists... *Edmunds.com, Cars.com, NADAguides.com, Black Book New Car Cost Guide* (October 2009 Edition, November/December 2009 Edition and January/February 2010 Edition) *Automotive News*, and when available, product brochures, manufacturers' price lists and vehicle order guides.

HOW TO INTERPRET OUR *SuperLIFO™* - IRS COMPARATIVE REPORT

Our Comparative New Item Report covers 18 pages ... New automobiles on pages 1-10 and new light-duty trucks (including sport utility vehicles, minivans and off-roads) on pages 11-18.

Our Comparative New Item Report shows complete make, model, body style, model code and item category information.

The left-hand side of each Report page shows our *SuperLIFO™* New Items List.

The right-hand side of the Report (including the "Yes" column) shows the IRS' Motor Vehicle Industry Specialist's new item listing.

To make it easier to identify the differences in our respective new items listings, where a *new* item on our List also appears on the IRS' list, that detailed item category has not been listed again on the right-hand side.

The "Yes/No" columns should be read as follows: If an "X" appears in the "Yes" column, that item category has been determined by the IRS to be a *new* item category. Thus, every item category listed on the left-hand side of the page with a corresponding "X" in the "Yes" column indicates an item category where we are in agreement with the IRS.

Where there are blank spaces on the left-hand side of the page, but item category entries on the corresponding right-hand side of the page, you can clearly see those item categories (with model numbers) which the IRS concluded were new items, but which we concluded were not.

If an "X" appears in the "No" column, that item category is listed on the left-hand (i.e., *SuperLIFO™*) side, and that "X" indicates an item category that we treated as *new*, but which the IRS did not.

The IRS also used a calendar year cut-off, rather than a model year cut-off, in compiling its list. This eliminated many items that otherwise might have been differences resulting from overlapping time periods. But in some instances, varying introduction dates created differences in our respective determinations.

In summary: Everything listed on the left-hand (our) side with an "X" in the "Yes" column is an item category where we agree with the IRS that it is a *new* item. Everything with an "X" in the "Yes" column is on the IRS' new item list. Everything listed on the right-hand (IRS) side of the page is an item category that the IRS considers to be *new*... and we do not. Finally, everything with an "X" in the "No" column is something that we conclude should be a *new* item category, but the IRS does not.

With respect to the December 31, 2009 year-end vehicles, we identified a total of 563 new item categories (310 automobiles and 253 light-duty trucks) whereas the IRS identified a total of 496 (273 automobiles and 223 light-duty trucks). We both reached the same conclusion with respect to 314 new item categories. Note: it is pure coincidence that the number of new item categories that we both agreed upon happened to be 314 ... the same number as in our last comparison.

We have continued to use the two separate classifications for automobiles and light-duty trucks. Many dealerships don't care about this distinction any more because they have changed to the single, combined (Vehicle-Pool) method for all new vehicles. However, a significant number of dealers (at least many of those we are doing LIFO calculations for) have not changed to the Vehicle-Pool Method, for one

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reason or another. Therefore, this classification distinction for LIFO pooling purposes is still relevant for them.

The IRS has also continued to use these separate classifications; however, the IRS' new items lists for automobiles and for light-duty trucks both state the same qualification: ***"Caution: This list is not intended for pooling purposes."***

We identified 249 item categories as *new,* but the IRS determined them to be *continuing.* The IRS identified 182 items as *new*, but we concluded that they should be treated as *continuing* items.

A table summarizing the details of these differences in treatment appears on page ___.

Regional pricing differences have been eliminated because Chrysler dropped its "Regional Pricing" policy.

In some instances, we understand why we disagree with the IRS; in other situations, we're not quite sure why we don't agree - other than possibly because of conflicting information or timing differences in our respective resources.

In prior years' comparative lists, because of the format limitations involved in this side-by-side presentation, some of the new item vs. continuing item differences described as "due to timing" are not purely due to timing differences. Because we (i.e., *SuperLIFO™*) received the information sooner or more directly, some item categories were treated as new on an earlier compilation of new items ... and the IRS was simply catching up with treating them as new items on its "later" compilation.

In this year's comparative lists, information available to us for determining vehicle status was always (dated) earlier than the information the IRS was using for its determinations. This is clearly evident in the note at the bottom of page ___.

There are other instances involving models/vehicles that did not exist in the prior year where (1) we received information that the IRS did not, (2) we determined the item to be a new item, (3) the IRS did not even list that item (because the IRS did not have any information on it) and (4) that item appears in the "No" column and is "x'd" in the "No" column. The reason that these are not considered as timing differences between our respective lists is that the IRS had no information to evaluate. Therefore, that item will not result in a timing difference until, at some later date, the IRS receives information on the vehicle and then makes its determination as to its status.

DEFINITION OF A "NEW" ITEM

A *new* item category is defined as an item category not considered to be in existence in the prior taxable year.

Under Section 4.02(5) of Rev. Proc. 97-36, a new item category results from any one of the following:

- Any new or reassigned manufacturer's model code that was caused by a change in an existing vehicle,
- A manufacturer's model code created or reassigned because the classified vehicle did not previously exist, or
- If there is no change in a manufacturer's model code, but there has been a change to the platform (i.e., the piece of metal at the bottom of the chassis that determines the length and width of the vehicle and the structural set-up of the vehicle) that results in a change in track width or wheel base, whether or not the same model name was previously used by the manufacturer, a new item category is created.

NEW ITEM: WHAT DIFFERENCE DOES IT MAKE?

New item categories are required to be included at a 1.000 factor in the annual computation of the index of inflation or deflation. This is accomplished by using the same dollar amount for the end-of-the-year base cost as for the beginning-of-the-year base cost.

Since any number divided by itself equals 1.000, this new item treatment will contribute no inflation (or deflation) *for that item* to the annual index.

However, if there is overall inflation for the year, the inclusion of the same dollar amount for that new item in both the numerator and the denominator of the fraction will *reduce* the overall weighted index result (i.e., it will depress the index computed).

The opposite result will occur in a year where there is overall deflation. New item treatment (at 1.000) will raise or *increase* the overall weighted index result if there would otherwise be overall deflation for the year.

DETAIL LISTINGS

We have included the first page of the New Automobiles Report (Page 1 of 18) on page 62 and the first page of the New Light-Duty Truck Report (Page 11 of 18) on page 63. If you would like a copy of the entire 18-page Report, please write or e-mail us with your request.

SUPERLIFO™ 2010 NEW ITEMS VS. IRS LISTS

COMPARISON OF "UNOFFICIAL" NEW ITEM CATEGORY LISTS
SUPERLIFO™ AND IRS MOTOR VEHICLE TECHNICAL ADVISOR PROGRAM

NEW AUTOMOBILES AND LIGHT-DUTY TRUCKS
INVOLVING MANUFACTURER MODEL YEARS 2009 & 2010

SUPERLIFO™ - NEW ITEMS LIST FOR CALENDAR YEAR 2009 DEALERS & IRS MOTOR VEHICLE TECHNICAL ADVISOR PROGRAM (DECEMBER, 2009 CALENDAR YEAR)

LEGEND / COMMENT CODE

E =	DIFFERENCE IN ENGINE / MOST DETAILED DESCRIPTION
OPTION =	OPTION PACKAGES / MOST DETAILED DESCRIPTION
REGION =	DIFFERENT PRODUCT REQUIREMENTS OR OPTION PACKAGES WHICH VARY DEPENDING ON REGIONAL CONSIDERATIONS
TIMING =	TIMING DIFFERENCE: IRS RECEIVED INFO EARLIER OR LATER
DIFSC =	DIFFERENT INFORMATION SOURCES AVAILABLE TO IRS AND / OR TO *SUPERLIFO™*

NUMBER OF NEW ITEMS

	SUPERLIFO™ CATEGORY	IRS CATEGORY
AUTOMOBILES	310	273
LIGHT-DUTY TRUCKS	253	223
TOTAL NEW ITEM CATEGORIES	563	496

COMPARISON OF "UNOFFICIAL" NEW ITEM CATEGORY LISTS

SUPERLIFO™ AND IRS / MOTOR VEHICLE TECHNICAL ADVISOR PROGRAM
NEW AUTOMOBILES AND LIGHT-DUTY TRUCKS
FOR CALENDAR YEAR DEALERS - DECEMBER 31, 2009

	LEFT-HAND COLUMN *SUPERLIFO* SAID NEW (A)	IRS SAID NEW (B)	*SUPERLIFO* & IRS BOTH AGREE (A - C)	 (B - D)	*SUPERLIFO* SAID NEW, IRS SAID CONTINUING (C)	RIGHT-HAND COLUMN IRS SAID NEW, *SUPERLIFO* SAID CONTINUING (D)
AUTOS						
Page 1	10	35	7	7	3	28
Page 2	7	45	5	5	2	40
Page 3	42	9	8	8	34	1
Page 4	39	23	18	18	21	5
Page 5	41	31	28	28	13	3
Page 6	36	18	14	14	22	4
Page 7	41	36	31	31	10	5
Page 8	23	25	9	9	14	16
Page 9	37	29	24	24	13	5
Page 10	34	22	15	15	19	7
TOTAL AUTOS	310	273	159	159	151	114
TRUCKS						
Page 11	20	21	5	5	15	16
Page 12	38	16	13	13	25	3
Page 13	34	44	34	34	0	10
Page 14	34	31	22	22	12	9
Page 15	39	26	23	23	16	3
Page 16	33	35	26	26	7	9
Page 17	25	26	9	9	16	17
Page 18	30	24	23	23	7	1
TOTAL TRUCKS	253	223	155	155	98	68
TOTAL AUTOS & TRUCKS	563	496	314	314	249	182

Out of the differences in Columns C & D, 15 cars and 18 truck differences were not "interpretive" differences. Rather, these 33 differences were solely due to timing in the sense that S/L and the IRS obtained the vehicle data in different time periods and therefore the vehicles did (or did not) appear on one list, but not on the other. In other words, these 33 "timing" differences would not exist if the comparison of lists were made over a 2 year period.

TIMING DIFFERENCES

IRS RECEIVED INFO EARLIER OR LATER				SUPERLIFO RECEIVED INFO EARLIER OR LATER			
CARS - EARLIER	0	TRUCKS - EARLIER	0	CARS - EARLIER	15	TRUCKS - EARLIER	18
CARS - LATER	15	TRUCKS - LATER	18	CARS - LATER	0	TRUCKS - LATER	0

COMPARISON OF "UNOFFICIAL" NEW ITEM CATEGORY LISTS
SUPERLIFO™ AND IRS MOTOR VEHICLE TECHNICAL ADVISOR PROGRAM

NEW AUTOMOBILES AND LIGHT-DUTY TRUCKS
FOR CALENDAR YEAR DEALERS - DECEMBER 31, 2009

		SUPERLIFO™ - NEW ITEMS LIST FOR CALENDAR YEAR 2009 DEALERS		IRS MOTOR VEHICLE INDUSTRY (DECEMBER, 2009 CALENDAR YEAR)				PAGE 1 OF 18
MAKE	MODEL	BODY STYLE	MODEL CODE	YES	NO	BODY STYLE	COMMENT CODE	COMMENTS
		NEW AUTOMOBILES				NEW AUTOMOBILES		
ACURA	TL	4-DR AWD SEDAN V6 3.7 6-SP W/TECH/HP	UA9E5 TECHHP		X		OPTION	
		4-DR SEDAN V6 3.5 6-SP W/TECH	UA9E5		X		OPTION	
		4-DR SEDAN V6 3.5 AUTO W/TECH/18"WHEELS	UA8F5 TECH18W		X		OPTION	
	TSX	4-DR SEDAN V6 3.5 AUTO	CU4F4	X				
		4-DR SEDAN V6 3.5 AUTO W/TECH	CU4F6 TECH	X				
AUDI	A3	4-DR WAGON 2.0 TDI PREM STRONIC AUTO	8PA5PX	X				
			8PA59C	X		4-DR HATCHBACK 2.0T PREMIUM 6-SP	OPTION	09 MODEL
			8PA59X	X		4-DR HATCHBACK 2.0T PREMIUM AUTO	OPTION	09 MODEL
			8PA59L	X		4-DR HATCHBACK 2.0T PREMIUM AUTO QUATTRO	TIMING	09 MODEL WJD INTRO 5/16/08
			8PA5PX	X		4-DR HATCHBACK 2.0T PREMIUM PLUS TDI	OPTION	
	A4		8EC5E9	X		4-DR SEDAN 2.0T S-LINE 6-SP QUATTRO	OPTION	
			8K2569	X		4-DR SEDAN 2.0T PREMIUM 6-SP QUATTRO	TIMING	09 MODEL WJD INTRO 4/14/08
			8K256H	X		4-DR SEDAN 2.0T PREMIUM FRONT TRAK	TIMING	09 MODEL WJD INTRO 4/14/08
			8K556L	X		4-DR WAGON 2.0T PREMIUM AVANT TIP QUATTRO	TIMING	09 MODEL WJD INTRO 4/14/08
			8K256H	X		4-DR SEDAN 2.0T PREMIUM PLUS FRONT TRAK	OPTION	09 MODEL
			8K2569	X		4-DR SEDAN 2.0T PREMIUM PLUS 6-SP QUATTRO	OPTION	09 MODEL
			8K256L	X		4-DR SEDAN 2.0T PREMIUM PLUS TIP QUATTRO	OPTION	09 MODEL
			8K556L	X		4-DR WAGON 2.0T PREMIUM PLUS AVANT TIP QUATTRO	OPTION	09 MODEL
			8K2569	X		4-DR SEDAN 2.0T PRESTIGE 6-SP QUATTRO	OPTION	09 MODEL
			8K256L	X		4-DR SEDAN 2.0T PRESTIGE TIP QUATTRO	OPTION	09 MODEL
			8K556L	X		4-DR WAGON 2.0T PRESTIGE AVANT TIP QUATTRO	OPTION	09 MODEL
			8K25FL	X		4-DR SEDAN 3.2 PREMIUM PLUS TIP QUATTRO	TIMING	09 MODEL WJD INTRO 4/14/08
			8K25FL	X		4-DR SEDAN 3.2 PRESTIGE TIP QUATTRO	OPTION	09 MODEL
	A5	2-DR AWD CPE 4CYL 2.0T PREM QUATTRO 6-SP	8T3569	X				
		2-DR CABR 4CYL 2.0T PREM FT MULTITRONIC CVT	8F756H	X				
		2-DR CABRIOLET 4CYL 2.0T PREM QUATTRO TIP	8F756L	X				
		2-DR COUPE 4CYL 2.0T PREM QUATTRO AUTO	8T356L	X				
			8F756H	X		2-DR CABRIOLET 2.0T PREMIUM PLUS CVT FRONT TRAK	OPTION	
			8F756L	X		2-DR CABRIOLET 2.0T PREMIUM PLUS CVT FRONT TRAK	OPTION	
			8T3569	X		2-DR COUPE 2.0T PRESTIGE 6-SP	OPTION	
			8T356L	X		2-DR COUPE 2.0T PRESTIGE TIP QUATTRO	OPTION	
			8F756H	X		2-DR CABRIOLET 2.0T PRESTIGE CVT FRONT TRAK	OPTION	
			8F756L	X		2-DR CABRIOLET 2.0T PRESTIGE TIP QUATTRO	OPTION	
			8F756H	X		2-DR CABRIOLET 2.0T PRESTIGE S-LINE CVT FRONT TRAK	OPTION	
			8F756L	X		2-DR CABRIOLET 2.0T PRESTIGE S-LINE TIP QUATTRO	OPTION	
			8T35FL	X		2-DR COUPE 3.2 PREMIUM PLUS TIP QUATTRO	OPTION	
			8T35FL	X		2-DR COUPE 3.2 PRESTIGE TIP QUATTRO	OPTION	
			8T35FL	X		2-DR COUPE 3.2 PRESTIGE S-LINE TIP QUATTRO	OPTION	

MAKE	MODEL	SUPERLIFO™ - NEW ITEMS LIST FOR CALENDAR YEAR 2009 DEALERS BODY STYLE	MODEL CODE	IRS MOTOR VEHICLE INDUSTRY (DECEMBER, 2009 CALENDAR YEAR) YES	NO	BODY STYLE	COMMENT CODE	PAGE 11 OF 18 COMMENTS
		LIGHT-DUTY TRUCKS				LIGHT-DUTY TRUCKS		
ACURA	MDX	4-DR AWD SUV V6 3.7 AUTO W/TECH	YD2H6		X		DIFSC	
		4-DR SUV V6 3.7 AUTO	YD2H2		X		DIFSC	
		4-DR SUV V6 3.7 AUTO W/TECH/ADVANCE/DVD	YD2H7		X		DIFSC	
		4-DR SUV V6 3.7 AUTO W/TECH/DVD	YD2H4		X		DIFSC	
	RDX			X		4-DR AWD UTILITY SH	DIFSC	
				X		4-DR AWD UTILITY SH W/TECH PKG	DIFSC	
		4-DR FWD SUV 4CYL 2.3T AUTO	TB2H2	X				
		4-DR FWD SUV 4CYL 2.3T AUTO W/TECH	TB2H5	X				
	ZDX	4-DR AWD SUV V6 3.7 AUTO	YB1H2		X		DIFSC	10 MODEL WJD INTRO 12/1/09
		4-DR AWD SUV V6 3.7 AUTO W/ADVANCE	YB1H6		X		DIFSC	10 MODEL WJD INTRO 12/1/09
		4-DR AWD SUV V6 3.7 AUTO W/TECH	YB1H4		X		DIFSC	10 MODEL WJD INTRO 12/1/09
AUDI	Q5		8RB5EL	X		4-DR UTILITY PREMIUM	TIMING	09 MODEL WJD INTRO 10/1/08
			8RB5EL	X		4-DR UTILITY PREMIUM PLUS	OPTION	09 MODEL
			8RB5EL	X		4-DR UTILITY PREMIUM PLUS S-LINE	OPTION	09 MODEL
			8RB5EL	X		4-DR UTILITY PRESTIGE	OPTION	09 MODEL
			8RB5EL	X		4-DR UTILITY PRESTIGE S-LINE	OPTION	09 MODEL
	Q7		4LB5RL	X		4-DR UTILITY TDI 3.0 PREMIUM	DIFSC	
			4LB5RL	X		4-DR UTILITY TDI 3.0 PREMIUM PLUS	OPTION	
			4LB5RL	X		4-DR UTILITY TDI 3.0 PREMIUM PLUS S-LINE	OPTION	
			4LB5RL	X		4-DR UTILITY TDI 3.0 PRESTIGE	OPTION	
			4LB5RL	X		4-DR UTILITY TDI 3.0 PRESTIGE S-LINE	OPTION	
			4LB5DL	X		4-DR UTILITY 3.6 PREMIUM PLUS	OPTION	
			4LB5DL	X		4-DR UTILITY 3.6 PRESTIGE	OPTION	
			4LB5DL	X		4-DR UTILITY 3.6 PRESTIGE S-LINE	OPTION	
BMW	X5		63	X		4-DR SPORT ACTIVITY VEHICLE XDRIVE35D	TIMING	09 MODEL WJD INTRO 9/1/08
		M 4-DR SPORT ACTIVITY V8 4.4 TT	66	X			DIFSC	
	Z4	30I 2-DR ROADSTER 6CYL 3.0 6-SP	28		X		DIFSC	09 MODEL WJD INTRO 3/1/09
		35I 2-DR ROADSTER 6CYL TT 3.0 AUTO	29		X		DIFSC	09 MODEL WJD INTRO 3/1/09
BUICK	ENCLAVE	4-DR AWD UTILITY V6 3.6 2XL	4V14526 2XL		X		OPTION	
		4-DR FWD UTILITY V6 3.6 2XL	4R14526 2XL		X		OPTION	
CADILLAC	ESCALADE	4-DR 2WD ESV LUXURY V8 6.2 1SB	6C10906 LUX		X		OPTION	
		4-DR 2WD ESV PREMIUM V8 6.2 1SC	6C10906 PREM		X		OPTION	
		4-DR 2WD SUV LUXURY V8 6.2 1SB	6C10706 LUX		X		OPTION	
		4-DR 2WD SUV PLAT HYBRID V8 6.0	6C10706 PLATHY	X				09 MODEL
		4-DR 2WD SUV PREMIUM V8 6.2 1SC	6C10706 PREM		X		OPTION	
		4-DR 4WD SUV PLAT HYBRID V8 6.0	6K10706 PLATHY	X				09 MODEL

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A Periodic Update of LIFO - News, Views and Ideas
LIFO LOOKOUT

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