



## 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. LIFO IS STILL ON THE HORIZON FOR THE FORESEEABLE FUTURE.** That is still my opinion and answer to the two questions that I am asked most frequently these days ... What about LIFO? ... How much longer will it be around?

The short answer: I still believe that LIFO will be with us for quite some time. I've exhausted your eyes with lengthy articles explaining the reasons for my belief. If you really want the details, please refer to "Status of LIFO ... What's New?" in the Mid-Year 2010 Edition of the *Lookout*. Not much has really changed since then.

**Timelines.** The 2011 Timeline on page 4 summarizes the LIFO guidance and developments that occurred during the year. I've also included LIFO Timelines for 2010, 2009 and 2008 to summarize and provide some context for LIFO developments we've been dealing with over the past few years.

Some of the Timeline developments are of more general applicability to all LIFO situations; others relate specifically to auto dealerships using LIFO.

**#2. SAMPLING & LIFO INVENTORIES ... NEW REVENUE PROCEDURE PROVIDES ONLY GENERAL GUIDANCE.** Recently, the IRS issued Revenue Procedure 2011-42 which is intended to "provide taxpayers with guidance regarding the use and evaluation of statistical samples and sampling estimates." The guidance set forth is only *general* in nature.

Regrettably, there is no specific discussion of the guidance in the Rev. Proc. as it relates to taxpayers using the LIFO inventory valuation method. It is interesting to note, however, that the IRS Field Directive on sampling, which preceded the Revenue Procedure by 2 years, did at least include a few references to LIFO inventory situations.

From the reluctance of the IRS to include these LIFO-related discussions in the Revenue Procedure, or to bring up other LIFO inventory-related sampling

## LOOKOUT LOOKS INTO

LIFO UPDATE .....	1
TIMELINES ...	
CALENDAR YEAR 2011 .....	4
CALENDAR YEARS 2010, 2009 & 2008 .....	5
IRS FAA SAYS IFRS STATEMENTS VIOLATED THE LIFO CONFORMITY REQUIREMENTS .....	8
DEALERSHIP YEAR-END REPORTS TO MANUFACTURERS	
• DON'T GET CARELESS WITH YEAR-END REPORTS ....	14
• CONFORMITY FLOWCHARTS	
• CALENDAR YEAR DEALERSHIPS .....	16
• FISCAL YEAR DEALERSHIPS .....	17
EARTHQUAKES + TSUNAMIS = LOWER YEAR-END INVENTORIES SECTION 473 RELIEF FOR RECAPTURED LIFO RESERVES? .....	18
MISSED FORM 970 FILINGS REQUIRE EXTENSIONS .....	22
COMBINING LIFO INVENTORIES IN SEC. 381(a) TAX-FREE TRANSFERS .....	24
SAMPLING & LIFO INVENTORIES ...	
NEW REV. PROC. PROVIDES ONLY GENERAL GUIDANCE .....	27
QUICK YEAR-END INFLATION ESTIMATES FOR AUTO DEALERS	
• YEAR-END PROJECTIONS FOR DEALERS BASED ON "ONE-OF-EACH" MIX ASSUMPTION .....	47
• SUMMARY OF INDEXES & CHARTS .....	48
• SAMPLE LETTER FOR YEAR-END PROJECTIONS .....	52
• <b>DETAIL BY MAKE</b> FOR YEAR-END ESTIMATES 2011-2012 NEW VEHICLE INFLATION SURVEY ASSUMING ENDING INVENTORY MIX OF ONE-OF-EACH ITEM CATEGORY .....	53

issues, it appears all that CPAs have to fall back on is what little has been said on this subject to date. And, that's not very much.

Given the lack of any specific guidance in Rev. Proc. 2011-42 on applying its general guidance to LIFO inventory situations, the major focus of this Edition of the *LIFO Lookout* and the objective of the article and materials (beginning on page 27) is to provide additional background for CPAs with more general practices who - for whatever reason - find it see **LIFO UPDATE**, page 2

necessary and/or appropriate to apply (statistical) sampling in connection with their clients' LIFO inventories.

### **#3. CONFORMITY: WATCH THOSE YEAR-END FINANCIAL STATEMENTS.**

To place this discussion into its broader LIFO context, keep in mind that compliance with the year-end financial statement conformity requirements is just one of four LIFO eligibility requirements. The other three requirements are that (1) LIFO must be properly elected by filing Form 970 with the tax return for the first year when LIFO will be used, (2) the inventory on LIFO must be valued at cost, and (3) adequate books and records must be maintained to support all aspects of the LIFO calculations.

Each of these requirements has numerous ramifications. But, the financial statement conformity requirements seem to be most troublesome. One of the reasons is because - in fact - there are many conformity requirements, rather than just one. And, violation of any one of these conformity requirement technicalities would allow the IRS to take the position that the taxpayer's LIFO election must be terminated, although asserting that harsh penalty is discretionary with the IRS.

You may recall that last year, Letter Ruling 201034004 provided ample evidence of the importance of complying with these strict disclosure requirements. In this Letter Ruling, the IRS reviewed and approved the disclosures that the parent corporation of a subsidiary using LIFO was planning to include in its consolidated financial statements.

For several years, the Year-End Edition of the *LIFO Lookout* has included a lengthy article reminding readers of the LIFO financial statement conformity issues. This year, I'm going to break tradition by not including that article in full. If you missed it, just request a copy by e-mail, and I'll be happy to send one to you.

Instead, in this Edition, I'm focusing only on two aspects of the conformity requirements. The first is evidenced in the discussion of Field Service Advice 20114202F described in more detail below.

The second is what may be a wake-up call to some practitioners and/or dealership controllers who might be tempted to downplay the importance of following through on the conformity requirements in the year-end reports that auto dealerships send to their manufacturers and other lending sources. (If nothing else, the FAA analysis discussed below should reemphasize how strictly the IRS interprets the Regulations.)

(Continued from page 1)

With respect to auto dealerships, you'll find a review of these requirements beginning on page 14. You'll also find two flowcharts - one for dealerships with December 31 yearends and one for dealerships with fiscal yearends. These charts may be helpful in tracking compliance. They are every bit as complicated and sophisticated in tracking the compliance requirements as is the discussion of FAA 20114702F.

One can't overdo reminders about year-end projections, estimates and the importance of placing proper LIFO disclosures in all year-end financial statements.

### **#4. DISCLOSURES IN IFRS FINANCIAL STATEMENTS VIOLATED THE LIFO CONFORMITY REQUIREMENTS.**

This year, in Field Service Advice 20114702F, an IRS LIFO Specialist concluded that a taxpayer committed multiple LIFO financial statement conformity violations when - without making adequate disclosures - it simply submitted statements prepared using the International Financial Reporting Standards (IFRS) to a lending bank in accordance with lending requirements under a letter of credit.

This FAA appears to be the first published IRS guidance involving how disclosures in financial statements using International Financial Reporting Standards (which prohibit the use of LIFO) must be presented as supplementary information or supplementary disclosures in order to comply with the very strict LIFO conformity requirements.

The \$64 Question was not answered by the IRS analyst. That question, of course, is whether the IRS should require the taxpayer to discontinue its LIFO election because it violated the conformity requirements. *[Good question...]*

This FAA, discussed in some detail beginning on page 8, is not easy reading. That's because the conformity requirements are not intended (by the IRS) to be easily circumvented.

### **#5. UNFILED LIFO ELECTIONS ... MISSED FORM 970 FILINGS REQUIRE EXTENSIONS.**

While I'm (or we're) on the subject of LIFO eligibility requirements, two Letter Rulings from the IRS during 2011 highlight the importance of filing a Form 970 to properly elect (or continue) to use the LIFO method.

If this filing requirement is overlooked, but subsequently discovered, the proper course of action is to promptly request an extension of time to file Form 970.

Getting an extension of time to file a Form 970 can be somewhat of an "ordeal" because the taxpayer is required to formally request a Letter Ruling from the

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## **LIFO Update**

IRS granting it permission to make the late filing. If granted, the extension of time by the IRS usually is for 30 days from the date of issuance of the extension letter. In most cases, the taxpayer is also required to pay a user fee for obtaining that permission.

If the taxpayer meets certain conditions, these extensions of time are permitted under Reg. Sec. 301.9100. For a discussion of two Letter Rulings issued mid-2011 involving taxpayers who found themselves in these circumstances, see page 22.

Note: For some of you who are also subscribers to the *Dealer Tax Watch*, this will look very similar to the discussion in the Year-End 2011 Edition regarding the need to obtain extensions - under the same Administrative Regulations - if a taxpayer making an automatic change in accounting method fails to timely file a duplicate copy of the signed Form 3115 with the IRS in Washington, D.C.

**#6. EARTHQUAKES, TSUNAMIS, RESULTING IN LOWER YEAR-END INVENTORIES ... Will Section 473 Relief Be Available for Dealership Recaptured LIFO Reserves?** At December 31, 2011, some automobile dealerships may have (significantly) lower ending inventories because certain auto manufacturers were severely affected by the natural disasters that occurred in Southeast Asia earlier in the year. The impact of these disasters on the manufacturers has, in turn, affected the inventory levels of many dealerships.

There has been considerable discussion about the possibility of dealerships obtaining some tax relief to compensate for the large amounts of LIFO reserve recapture income they will have to include in their 2011 tax returns as a result of having lower inventories.

The concern is so significant that NADA has even approached the Treasury and/or certain members of Congress in an effort to obtain relief under Code Section 473.

For a further discussion of Section 473 and the possibility of its application in these situations, see page 18.

**#7. RULES FOR COMBINING LIFO INVENTORIES IN CERTAIN TAX-FREE TRANSFER SITUATIONS ARE CLARIFIED IN FINAL SECTION 381 REGULATIONS.** On August 1, 2011, final Regulations were issued under Sections 381(c)(4) and (c)(5). The Regulations under (c)(5) specifically relate to the carryover of inventory accounting methods, including LIFO inventory methods, for certain corporate reorganizations and/or tax-free liquidations.

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Under the final Regulations, the determination of which inventory accounting method will carry over is to be made on the basis of considering ***only the inventories of the trades or businesses that are going to be integrated*** after the (tax-free) transaction/acquisition takes place.

Under the proposed Regulations, the determination would have been made by considering the overall fair market values of ***all of the*** transferor and the transferee's ***inventories***, regardless of whether trades or businesses were going to be combined after the acquisition.

The acquiring corporation generally will not be required to renew any election previously made by it or by another party to the transaction if the acquiring corporation will continue to use the method after the acquisition.

See pages 24-26 for more details relating to the new inventory method carryover rules.

**#8. YEAR-END PROJECTIONS FOR AUTO DEALERS BASED ON "ONE-OF-EACH" MIX ASSUMPTION.** To assist you in making year-end projections, each year we provide a listing for automobile dealership *new* vehicle LIFO inventories showing weighted average inflation (or deflation) information for each model.

The summaries for this year-end are on pages 48-51, and the detail lists for each make/model are on pages 53-59.

This includes the weighted One-of-Each-Item-Category inflation indexes for those dealerships that have already changed, or may be considering changing, to the single, combined LIFO pool (i.e., the "Vehicle-Pool") method for new vehicles.

**#9. DE FILIPPS UNIVERSITY AUDIO SEMINARS.** This year was especially busy because I began presenting a series of 3-hour audio seminars to supplement my publications and various speaking engagements.

Complete information about De Filippis University and each audio seminar is available on our web site ([www.defilipps.com](http://www.defilipps.com)). If you missed any of our 2011 seminars, On Demand Audio Recordings (which include all of the presentation materials for that seminar) can be purchased at [www.krm.com/wjd](http://www.krm.com/wjd) (on the "Recordings" tab).

To facilitate CPE credits for participants, we are registered as a sponsor of continuing education with the National Association of State Boards of Accountancy (NASBA).

Please call or e-mail me with any suggestions you might have for seminar topics. \*



<b>LIFO Lookout Timeline</b>	<b>CALENDAR YEAR 2011 ... THE YEAR IN REVIEW</b>
<i>Jan. 2011</i>	<ul style="list-style-type: none"> <li>• <b>Revenue Procedure 2011-14</b> revised and updated the procedures for taxpayers making designated <i>automatic</i> changes in (LIFO and other) accounting methods and filing Forms 3115. <ul style="list-style-type: none"> <li>♦ This Revenue Procedure included the Section 263A safe harbor elections for motor vehicle dealerships that can be made as automatic changes #150 and #151.</li> <li>♦ This Revenue Procedure supersedes Rev. Procs. 2008-52 and 2009-39.</li> <li>♦ Effective for the filing of Forms 3115 on or after January 10, 2011.</li> </ul> </li> </ul>
<i>March 2011</i>	<ul style="list-style-type: none"> <li>• In <b>TAM 201111004</b>, the IRS held that a taxpayer may defer the gain on an involuntary conversion of inventory if the business is located in a Federally-declared disaster area.</li> <li>• This guidance emphasizes to practitioners that the provisions of Code Section 1033(h)(2) should not be overlooked by dealerships located in disaster areas.</li> <li>• The broader application of this TAM is that Section 1033(h)(2) could allow a dealership (in a Federally-designated disaster area) to defer reporting gain if (or when) it reinvests insurance or salvage proceeds in other assets used in the business.</li> </ul>
<i>May 2011</i>	<ul style="list-style-type: none"> <li>• IRS released its <b>Audit Technique Guide (ATG) for Wineries</b>.</li> <li>• This <b>ATG</b> sets forth the criteria that wineries should use to define their wine items and to value their LIFO inventories.</li> <li>• Essentially, the <b>ATG</b> requires that the winery must define items of wine in a way that subdivides bulk wine and bottled wines into inventory items based on factors such as type of wine, source of grapes, process recipe or formula used, length of aging time, type of container, length of time wine has been stored after bottling, etc.</li> <li>• This <b>Audit Technique Guide</b> basically follows the IRS holdings in ILM 201043029 (July 2010).</li> </ul>
<i>May 2011</i>	<ul style="list-style-type: none"> <li>• In <b>FAA 20114702F</b>, the IRS concluded that the absence of proper disclosures related to the use of the LIFO method in financial statements prepared using IFRS (International Financial Reporting Standards) resulted in violations of several LIFO conformity requirements.</li> <li>• IFRS standards do not permit the use of LIFO for valuing inventories, and the financial statements did not comply with various exceptions that are available in the Regulations.</li> <li>• What this FAA does suggest is that the LIFO financial statement conformity requirements would not be violated if proper supplementary disclosures accompany financial statements issued under IFRS.</li> <li>• This appears to be the first published IRS guidance involving IFRS-prepared statements.</li> </ul>
<i>April - June 2011</i>	<ul style="list-style-type: none"> <li>• In <b>LTRs 201130001</b> and <b>201136006</b>, the IRS granted taxpayers extensions of time to file Form 970. <ul style="list-style-type: none"> <li>♦ In one instance, the taxpayer failed to file Form 970 after a Section 351(a) exchange.</li> <li>♦ In the other case, a parent corporation overlooked filing 14 LIFO elections forms for various subsidiaries over a long period of time.</li> </ul> </li> <li>• In both cases, the oversight by the taxpayer was called to its attention when a pair of "fresh eyes" reviewed their LIFO situations and caught the omissions.</li> </ul>
<i>June 2011</i>	<ul style="list-style-type: none"> <li>• President Obama's Administration included the repeal of LIFO as a tax break to be eliminated as part of the negotiations to reach a deal on the debt limit increase impasse.</li> <li>• Apparently, this is a follow-up to the President's proposal at the beginning of this year - as part of his "Greenbook" proposals - when he had included the repeal of LIFO after the year 2012 ... with a 10-year spread period for the recapture of the LIFO reserve into taxable income.</li> </ul>
<i>August 2011</i>	<ul style="list-style-type: none"> <li>• In <b>Rev. Proc. 2011-42</b>, the IRS provided general guidance regarding its requirements concerning the use and evaluation of statistical samples and sampling estimates.</li> <li>• There is no specific discussion in the Revenue Procedure that relates to LIFO inventory application situations.</li> <li>• Accordingly, the general principles and guidance in the Rev. Proc. will have to be adapted to LIFO situations on a case-by-case basis, depending on the facts and circumstances.</li> </ul>
<i>October 2011</i>	<ul style="list-style-type: none"> <li>• The Treasury published <b>Final Regulations under Section 381</b> relating to the carryover / combination of inventory methods, including LIFO inventory methods, in reorganizations or tax-free liquidations.</li> <li>• Under the Final Regulations, the determination of which inventory accounting method will carry over is to be made on the basis of considering <i>only the inventories of the trades or businesses that are going to be integrated</i> after the (tax-free) transaction/acquisition takes place.</li> </ul>



<b>LIFO Lookout Timeline</b>	<b>CALENDAR YEAR 2010 ... THE YEAR IN REVIEW</b>
<b>Feb. 2010</b>	<ul style="list-style-type: none"> <li>In <i>Letter Ruling 201005026</i>, the IRS granted an extension of time to file Form 970 to an automobile dealership because its <i>old</i> CPA firm did not recognize the tax consequences when the transfer of a minority interest in that entity occurred. It was the <i>new</i> CPA firm that brought the failure to file Form 970 to the attention of the taxpayer.</li> <li>This LTR emphasizes that a change in ownership in a disregarded entity may result in the creation of a new partnership, and 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.</li> </ul>
<b>Feb. 2010</b>	<ul style="list-style-type: none"> <li>In <i>Field Attorney Advice (FAA) 20100501F</i>, the IRS held that a Closing Agreement with a taxpayer did not prevent the IRS from challenging the same LIFO methodology for defining inventory "items" when those item definitions were used in later years.</li> </ul>
<b>Feb. 2010</b>	<ul style="list-style-type: none"> <li>On Feb. 1, 2010, President Obama released the proposed Federal Budget for Fiscal Year 2011.</li> <li>The Administration's proposal to eliminate LIFO would allow the use of LIFO through the end of 2011 and then terminate the use of LIFO effective for taxable years beginning on or after January 1, 2012. This repeal provision 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.</li> </ul>
<b>March 2010</b>	<ul style="list-style-type: none"> <li>In <i>Letter Ruling 201010026</i>, the IRS held that Section 1363(d) LIFO recapture did not apply when a sole proprietorship using the LIFO method transferred its assets to a newly formed corporation in a transaction under Section 351, and the new corporation elected to be an S corporation and to continue to use the LIFO method.</li> </ul>
<b>May 2010</b>	<ul style="list-style-type: none"> <li><i>Form 3115 - Application for Change in Accounting Method - and the Instructions for Form 3115</i> were released by the IRS.</li> <li>Both revisions of Form 3115 and the Instructions are dated December 2009.</li> <li>The revised Form 3115 must be used for all filings with the IRS after June 1, 2010.</li> </ul>
<b>July 2010</b>	<ul style="list-style-type: none"> <li>In <i>ILM 201043029</i>, the IRS accepted a winery's item definitions for its dollar-value, link chain, LIFO calculations in valuing its bulk and bottled wine inventory.</li> <li>The taxpayer maintained one natural business unit pool, and it did not consider goods that do not have similar characteristics as the same item. <ul style="list-style-type: none"> <li>The taxpayer subdivided its bulk wines and bottled wines into appropriate inventory items based on factors such as varietal, quality, length of time of aging, and other criteria noted.</li> <li>The taxpayer defined items of wine in a manner that allowed for an accurate measure of inflation.</li> <li>The IRS held that these determinations by the taxpayer properly defined items within its dollar-value LIFO pool for purposes of computing the LIFO price/inflation index for the pool.</li> </ul> </li> </ul>
<b>Aug. 2010</b>	<ul style="list-style-type: none"> <li>In IRS <i>Letter Ruling 201034004</i>, the IRS reviewed and approved the disclosures that the parent corporation of a subsidiary using the LIFO method was planning to include in its reviewed (i.e., unaudited) year-end consolidated financial statements that it would issue to its shareholders and creditors, including a foreign parent. <ul style="list-style-type: none"> <li>The Ruling addressed potential conformity requirement violations under Section 472(c), (e) and (g) for affiliated groups.</li> </ul> </li> <li>This Ruling illustrates the finer points of the analysis that must be made in attempting to comply with the financial statement conformity requirement, especially where several layers of subsidiaries are part of the fact pattern.</li> </ul>
<b>Nov. 2010</b>	<ul style="list-style-type: none"> <li>In <i>Rev. Proc. 2010-44</i>, the IRS allowed motor vehicle dealerships to use either or both of two safe harbor methods of accounting in order to elect or change their Section 263A accounting methods to... <ul style="list-style-type: none"> <li>Treat certain sales facilities as retail sales facilities for purposes of Sec. 263A, and/or</li> <li>Be treated as resellers without production activities for purposes of Sec. 263A.</li> </ul> </li> <li>Other Sec. 263A changes in accounting method to be considered w/r/t these Form 3115 filings... <ul style="list-style-type: none"> <li>Change to use the Simplified Resale Method under Reg. Sec. 1.263A-3(d) for all other inventories that may not be subject to the safe harbor elections above.</li> <li>Inclusion (or exclusion) of labor costs and internal profit capitalized in previous years with respect to Sec. 263A in the computation of the Section 481(a) adjustment.</li> <li>Clarification that in determining storage, handling and purchasing costs to be capitalized after making these changes, the "1/3 - 2/3 rule for allocating labor costs" and other 90%-10% <i>de minimis</i> rules will be used.</li> </ul> </li> <li>Dealerships may use the automatic consent procedures under Rev. Proc. 2008-52 for filing Forms 3115 to implement the changes to elect to use the safe harbor methods for calendar year 2010.</li> </ul>



<b>March 2008</b>	<ul style="list-style-type: none"> <li>• Tax Court's decision in <i>Huffman, et al.</i> was affirmed by the U.S. Court of Appeals for the 6<sup>th</sup> Circuit. This decision had allowed the IRS to change an automobile dealership's (accountant's) errors in LIFO calculations by making a Section 481(a) adjustment to the dealership's earliest open year.</li> <li>• The Tax Court, in its 2006 decision in <i>Huffman</i> (126 T.C. No. 17), reviewed the LIFO computations made over long periods of time by four automobile dealerships doing business in Kentucky. These computations were supposedly made using the link-chain, dollar-value LIFO method. <ul style="list-style-type: none"> <li>♦ The CPA had consistently omitted the critical step of properly valuing inventory increments in all of the LIFO computations that were made over periods ranging from 11 to 21 years.</li> <li>♦ The Tax Court permitted the IRS to adjust the first open year of each of the dealerships and to revalue the dealership's inventory because the adjustments constituted a change in the method of (LIFO) accounting. The IRS was permitted to make these adjustments by Section 481(a).</li> </ul> </li> <li>• There was no bar to the statute of limitations preventing these adjustments to the LIFO computations, even though there had been several prior IRS audits of the dealerships, including some where the IRS apparently had "looked at" (and accepted) these erroneous LIFO calculations.</li> </ul>
<b>March 2008</b>	<ul style="list-style-type: none"> <li>• In <i>Revenue Procedure 2008-23</i>, the IRS announced that it would permit automobile dealerships to use a single, combined pool for their new vehicle LIFO calculations. This simplified method of pooling, referred to as the Vehicle-Pool Method, was available for dealerships' calculations for 2007. <ul style="list-style-type: none"> <li>♦ Some dealerships made the change for 2007; many others made the change in a later year ... and some dealerships still have not made the change.</li> </ul> </li> <li>• To change to this method, dealerships using the Alternative LIFO Method (under Revenue Procedure 97-36, formerly 92-79) would have to combine their two separate pools for (1) all new automobiles (including demonstrators) and (2) all new light-duty trucks (including demonstrators) into a single pool as of the beginning of the year of change.</li> <li>• This change may also be made for used vehicle inventories that are on LIFO using two pools under the Alternative LIFO Method for Used Vehicles (under Revenue Procedure 2001-23).</li> <li>• The IRS also clarified how new and/or used crossover vehicles should be treated by dealerships if they do not elect to use the single, combined LIFO pool method.</li> </ul>
<b>May 2008</b>	<ul style="list-style-type: none"> <li>• In <i>Chief Counsel Office Memo (CCM) 200825044</i>, the IRS issued "guidance" on how dealerships implementing the change to the Vehicle-Pool Method (for either new or used vehicles on LIFO) under Rev. Proc. 2008-23 should combine their existing LIFO pools.</li> <li>• This CCM provided two examples showing how to establish the year of change (2008 in both examples) as the new base year for making the change to the single, combined pool method. These examples follow the format used for examples found in the LIFO Regulations. <ul style="list-style-type: none"> <li>♦ The first example showed the combination of the two new vehicle pools in a situation where both pools have the same base year. This example is pretty straight-forward.</li> <li>♦ The second example showed the combination of the two new vehicle pools in a situation where both pools did not start on LIFO in the same year. In other words, these LIFO pools do not have the same base year. This is a situation which is sometimes described as one involving "disappearing base dollars."</li> </ul> </li> <li>• Per the CCM, the sequence of steps for combining pools is to ... combine the two pools (first), then rebase the combined pool (second). <ul style="list-style-type: none"> <li>♦ The IRS computational approach was problematic for many dealerships.</li> <li>♦ The result obtained by following the approach in the Chief Counsel Memo examples shifted the amount of the LIFO reserve allocable to a specific year's LIFO layer to different years' LIFO layers.</li> <li>♦ In many dealership situations, if the sequence of steps set forth in the CCM is followed (i.e., combine the two pools first and then rebase the combined pool), the end result will produce a large shift of the contribution to the LIFO reserve for the years immediately before the year of change, as well as in all of the other years.</li> <li>♦ This result will be avoided if the sequence of operations is reversed (i.e., the two pools being combined are each rebased to 1.000 before they are combined).</li> <li>♦ In any given dealership, these shifts in the amounts contributed to the LIFO reserve by the underlying annual LIFO layers can go either way, based on the facts and circumstances which include different base years, rates of inflation and years' layers represented in the pools being combined.</li> </ul> </li> </ul>
<b>Summer 2008</b>	<ul style="list-style-type: none"> <li>• In <i>Letter Ruling 200812010</i>, the IRS granted a taxpayer an extension of time to file a <i>second</i> Form 970 in connection with the shuffling of assets and the restructuring of a corporate group which involved the use of disregarded entities (Single Member Limited Liability Companies) and subsequent elections and deemed transfers of assets. This extension of time to file Form 970 was granted under the relief provisions in Reg. Sec. 301.9100-1(c).</li> </ul>



<b>Aug. 2008</b>	<ul style="list-style-type: none"> <li>In <i>Revenue Procedure 2008-43</i>, the IRS reversed its long-standing opposition to the use of a rolling-average inventory valuation method. It will now permit the use of a rolling-average inventory method, subject to certain conditions.</li> <li>The IRS will generally consider a rolling-average method that is used to value inventories for financial accounting purposes as clearly reflecting income for Federal income tax purposes. <ul style="list-style-type: none"> <li>The key here is that that method is being used for financial statement purposes.</li> <li>If a taxpayer does not use a rolling-average method for financial accounting purposes, then the rolling-average method may not accurately determine costs or clearly reflect income.</li> </ul> </li> <li>If two other requirements are satisfied, taxpayers may obtain the IRS' automatic consent to change to a rolling average method.</li> </ul>
<b>Aug. 2009</b>	<ul style="list-style-type: none"> <li>In <i>ILM 200935024</i>, the IRS issued guidance on Section 481(a) adjustments and spread periods <i>for dealership recapture of LIFO reserves</i> when dealers who lost their franchises terminated their LIFO elections.</li> <li>In this ILM, the agent was questioning whether the usual 4-year spread period for the Section 481(a) adjustment resulting from the termination of the LIFO election should be accelerated because the dealership no longer had new vehicle inventory specific to the franchise that was terminated.</li> <li>Three fact situations were addressed in the ILM. <ul style="list-style-type: none"> <li>In the first two situations, the dealership involved was not using the Alternative LIFO Method for new vehicles. Instead, this dealership was using a separate LIFO pool for the new vehicles for each <i>franchise</i> ... the dealership had 5 different franchises, and it had 5 separate LIFO pools.</li> <li>The third situation seems to provide a "blueprint" that might be beneficial to certain dealerships that have lost their franchises. The IRS guidance in this third situation may help dealerships to stay on LIFO for some of their new vehicle inventories, while losing only the benefit of the LIFO reserve attributable to the lost franchise.</li> <li>This would involve the pool-split-and-partial-termination-of-LIFO-election strategy.</li> </ul> </li> </ul>
<b>Mid-Year 2009</b>	<ul style="list-style-type: none"> <li>In <i>LTR 200914015</i>, the IRS granted a taxpayer an extension of time to file Form 970 in connection with its continuation of the previous LIFO election when a partnership was terminated under Section 708.</li> <li>This LTR involved a consolidated group consisting of a parent corporation and two subsidiaries. <ul style="list-style-type: none"> <li>One of the subsidiaries was a partner in a two-partner partnership in which the other partner was an unrelated party.</li> <li>In a subsequent year, the partnership interest owned by the unrelated party was bought out by the other/second subsidiary.</li> </ul> </li> </ul>
<b>Fall 2009</b>	<ul style="list-style-type: none"> <li>In <i>ILM 200911008</i>, the IRS clarified the relationship between the two criteria in the IPIC Regulations that are used to determine the selection of the month for pricing dollar-value IPIC LIFO pools.</li> <li>The IRS held that the IPIC taxpayer <i>must use December, and not November</i>, for purposes of pricing its dollar-value LIFO pools because December was the month that is most consistent with (1) its method of determining current-year cost [under Reg. Sec. 1.472-8(e)(2)(ii)] and (2) its history of inventory production or purchases during the taxable year.</li> </ul>
<b>Nov. 2009</b>	<ul style="list-style-type: none"> <li>In <i>Internal Revenue Service Legal Memorandum (ILM) 200945034</i>, the IRS discussed the proper treatment of "member satisfaction merchandise allowances."</li> <li>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]."</li> <li>The major holding in this ILM was that the vendor allowances for defective merchandise were to be treated as reductions of inventory cost because they were, in essence, trade discounts.</li> <li>The impact of the holding in this ILM on auto dealerships using LIFO is unclear because almost all automobile dealerships selling new vehicles receive trade discounts in the form of floorplan assistance allowances and other adjustments from the manufacturers. Some dealers using LIFO have reduced their inventory costs by the amount of these trade discounts; others have not.</li> </ul>
<b>Nov. 2009</b>	<ul style="list-style-type: none"> <li><i>Field Directive on the Use of Estimates from Probability Samples</i> (LMSB Control No. LMSB-4-0809-032) was issued by the IRS Director of Field Specialists.</li> <li>This Field Directive provided issue direction to IRS audit personnel for evaluating samples and sampling estimate procedures used by taxpayers.</li> <li>In referring to situations where LIFO inventories are involved, the Directive states that <ul style="list-style-type: none"> <li>LIFO applications were more specialized than the general guidance in the Field Directive contemplated, and</li> <li>IRS agents should seek further assistance from other IRS Sampling Specialists if they encountered sampling in connection with the use of the LIFO method.</li> </ul> </li> </ul>





# IFRS FINANCIAL STATEMENTS VIOLATE THE LIFO CONFORMITY REQUIREMENTS

## BACKGROUND

In general discussions about the Last-In, First-Out (LIFO) financial statement conformity requirements, one often hears or reads that the conformity requirements mandate that any year-end financial statements **issued in the traditional report form** by the business to creditors, shareholders, partners or other users must reflect the year-end results on LIFO. But, this generalization is too broad and requires modification to be more technically correct. It should be said that the IRS only requires LIFO to be used in reporting results in the taxpayer's primary presentation of income (i.e., in the Income Statement).

Accordingly, it is more accurate to say that a taxpayer may use the LIFO inventory method only if it has used no other procedure than LIFO in preparing an Income Statement or a profit or loss statement for any year covered by the LIFO election. This requirement applies not only to the first taxable year on LIFO, but to all subsequent taxable years when the method is in use.

In the primary presentation of income (i.e., in the Income Statement), the results of operations being disclosed must only be the net-of-LIFO results. The primary Income Statement *cannot* show results before LIFO, followed by either an addition or subtraction for the net LIFO change, coming down to a final net income or loss after-LIFO figure.

This means that during a period of rising prices, a business using LIFO will usually be reporting lower operating results in order to comply with the conformity requirements. Very strict disclosure limitations existed with no room for deviation for many years.

Form 970 is the LIFO election form which is required to be included with the tax return for the first LIFO year. One of the significant traps for the unwary is that Form 970 asks only whether the year-end financial statements for the first year of the LIFO election have satisfied the conformity requirements.

On its face, Form 970 does not warn taxpayers that these conformity requirements also must be satisfied on the year-end financial statements for every subsequent year for as long as the LIFO method is being used.

Worse yet, the relatively limited Form 970 instructions give no hint of the many troublesome interpretations that can arise under the incredibly complicated Regulations.

The Treasury has attempted to justify the need for these financial statement conformity requirements by explaining that they are necessary to insure that the use of LIFO for tax purposes conforms as nearly as possible with the best accounting practice in the trade or business in order to provide a clear reflection of income.

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 liberalized in 1981.

Even after being liberalized, the Regulations were still complicated. This was evidenced throughout the late 1980s and early 1990s when auto dealerships and their CPAs floundered for nearly a decade before the IRS provided some clarification and relief... but not without first exacting a pound of flesh from dealers who inadvertently committed conformity violations in the financial reports/statements they provided to their manufacturers and other credit sources.

## "LIBERALIZED" REGULATIONS

The changes to the conformity Regulations in 1981 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 those disclosures were in supplementary financial information or statements and did not appear in the primary presentation of income (i.e., the Income Statement).

However, those supplementary non-LIFO financial statements must satisfy two tests: **First**, they must be issued as part of a report which includes the primary presentation of income on a LIFO basis. **Second**, each non-LIFO financial statement must contain on its face a warning or statement to the reader that the non-LIFO results are supplementary to the primary presentation of income which is on a LIFO basis. Accordingly, in year-end financial statements, a LIFO taxpayer's results on a non-LIFO basis can be fully disclosed as supplementary information if both of these requirements are met.

→





## Conformity

Alternatively, the Regulations permit disclosure of non-LIFO results in a footnote to the regular year-end financial statements, provided that the Statement of Income itself does not disclose this information parenthetically or otherwise on its face, and the notes are all presented together and accompany the Income Statement in a single report.

As a result of these "liberalizations" in the Regulations in 1981, these LIFO conformity requirements should not present any major reporting problems. However, as evidenced in numerous Letter Rulings issued by the IRS over the years, the Regulations must be studied carefully in order to avoid inadvertent violations.

### LTR 201034004

More recently, IRS guidance on financial statement conformity matters has been focused on questions relating to the application of these requirements to more complex fact patterns involving taxpayers using LIFO who are part of international, multi-layer ownership chains and groups. Not surprisingly, foreign entities are often at the top of these ownership chains.

IRS Letter Ruling 201034004 (August 2010) involved a newly-formed limited liability company (i.e., the taxpayer) which was treated as a U.S. corporation for U.S. Federal tax purposes, and it was the common parent of an affiliated group of corporations that was included in a consolidated Federal income tax return.

In this Letter Ruling, the IRS reviewed **and approved** the disclosures that the parent corporation of a subsidiary using the LIFO method was planning to include in its reviewed (i.e., unaudited) year-end consolidated financial statements that it would issue to its shareholders and creditors, including a foreign parent.

This Letter Ruling is discussed on pages 20-21 in the Year-End 2010 Edition of the *LIFO Lookout*.

### THE EMERGENCE OF IFRS

The emergence of the possibility that may U.S. taxpayers might be required to adopt International Financial Reporting Standards (IFRS) has resulted in a great deal of literature explaining that the use of LIFO, although permissible under Generally Accepted Accounting Principles, is incompatible with reporting standards under IFRS.

It is well-known and generally accepted that LIFO cannot be used in financial statements issued under IFRS. Accordingly, if financial statements were issued under IFRS, that would appear to prevent the use of LIFO but for the inclusion in the Regulations of the numerous exceptions to the conformity requirements.

(Continued)

### FAA 20114702F

In May 2011, in Field Service Advice 20114702F, the IRS concluded that a taxpayer committed multiple violations of the LIFO financial statement conformity requirements when it submitted year-end statements prepared using International Financial Reporting Standards (IFRS) to a bank.

This FAA appears to be the first published IRS guidance involving how disclosures in financial statements using International Financial Reporting Standards (which prohibit the use of LIFO) must be presented as supplementary information or in supplementary disclosures in order to comply with the very strict LIFO conformity requirements.

This FAA involves a somewhat complicated ownership structure of affiliated/consolidated group entities consisting of (1) the foreign parent [a foreign entity], (2) ABC - a member of the ABC consolidated group - who owns the sub, (3) the ABC consolidated group [which consists of ABC and other members] and (4) the Taxpayer, a subsidiary of ABC [and thus, a second-tier member of the ABC consolidated group].

The IRS held that the taxpayer failed to include or make the necessary, restrictive, and/or appropriate disclosures in its IFRS-prepared financial statements when it submitted these statements to a lending bank in accordance with lending requirements under a letter of credit.

In more terse language, the FAA concluded ... "The provision of financial statements prepared using IFRS to the lending bank violated the conformity requirements." See pages 10-13 for more specifics on this FAA.

But note what this FAA does suggest ... it suggests that the LIFO financial statement conformity requirements would not be violated if proper supplementary disclosures were to accompany the financial statements that were issued under International Financial Reporting Standards.

Interestingly, the question most likely to be on a reader's mind after reading the FAA was not answered by the IRS analyst. That question, of course, is whether the IRS would require the taxpayer to discontinue its LIFO election because it violated the conformity requirements.

The Commissioner does have the discretion to allow taxpayers to continue to use the LIFO method even though conformity violations might have occurred. However, one should not be too optimistic about obtaining a happy ending or relief if a conformity violation is discovered by the IRS ... especially if that discovery happens during an audit. \*



## *IFRS FINANCIAL STATEMENTS VIOLATE THE LIFO CONFORMITY REQUIREMENTS*

**Notes:** Four entities are involved in this FAA ... (1) the foreign parent [a foreign entity], (2) ABC, a member of the ABC consolidated group who owns the sub, (3) the ABC consolidated group [which consists of ABC and other members] and (4) the Taxpayer, a subsidiary of ABC [and thus, a second-tier member of the ABC consolidated group].

This FAA appears to be the first published IRS guidance involving the application of the LIFO conformity requirements to financial statements that are issued using the International Financial Reporting Standards (IFRS).

Three actual dates have been redacted from the text of the FAA. I have inserted assumed dates in the above statement of facts in order to make it a little easier to follow the fact pattern.

On *[January 1, 2008]*, the Taxpayer became a wholly-owned subsidiary of ABC and a member of the ABC Consolidated Group. The ABC Consolidated Group filed a consolidated federal tax return for Tax Year *[2008]*.

ABC is wholly-owned by Foreign Parent, a foreign entity. Foreign Parent reported its worldwide consolidated financial statements using the International Financial Reporting Standards (IFRS) for Tax Year *[2008]*.

Foreign Parent required the Taxpayer to adopt the IFRS standards to facilitate the process of preparing these worldwide consolidated financial statements. Therefore, the Taxpayer adopted IFRS for the first time for Tax Year *[2008]*. This marked the first year that the Taxpayer issued any IFRS based financial statements. Prior to the adoption of IFRS, the Taxpayer used U.S. Generally Accepted Accounting Principles (GAAP) as its accounting standard.

The Last-In, First-Out (LIFO) inventory method is not an allowable method under IFRS. The Taxpayer has used the LIFO inventory method for accounting for a portion of its inventory since *[2002]* for both tax and financial reporting purposes. The Taxpayer continued to use the LIFO inventory method for Tax Year *[2008]*.

The Taxpayer provided financial statements to its foreign parent based upon IFRS standards for Tax Year *[2008]*. These financial statements included a balance sheet and income statement based upon IFRS standards.

*The Taxpayer also provided the IFRS-only balance sheet and income statement to its lending bank.*

Along with the IFRS-only balance sheet and income statement, the Taxpayer provided its lending bank with tabulated versions of its balance sheet and income statement whereby each was presented on an IFRS and U.S. GAAP standard.

Specifically, the tabulated financial statements made adjustments (including LIFO adjustments) to the IFRS column to arrive at U.S. GAAP. The IFRS version of the profit/income of the Taxpayer was based on a method that did not include LIFO principles in inventorying goods.

*The Taxpayer did not make a distinction between primary or supplemental information within these financial statements related to the change from IFRS to U.S. GAAP reporting standards.* Also, the Taxpayer did not include explanatory footnotes regarding the change.

The Taxpayer provided these financial statements to the lending bank in accordance with lending requirements imposed by the bank related to a letter of credit.



## IFRS FINANCIAL STATEMENTS VIOLATE THE LIFO CONFORMITY REQUIREMENTS

The Taxpayer is subject to the LIFO conformity requirements because it elected to use the LIFO method of accounting for Federal income tax purposes.

With respect to the financial statements provided to its lending bank, the Taxpayer violated the LIFO conformity requirements if ...

- (1) It used an inventory method other than LIFO to ascertain its income, profit or loss in the financial statements,
- (2) The financial statements were "for credit purposes," *and*
- (3) The financial statements are not within any of the exceptions to the LIFO conformity requirements.

The Taxpayer provided the same IFRS-only balance sheet and income statement provided to the foreign parent to the lending bank. It also provided tabulated versions of these documents that adjusted the IFRS amounts to arrive at U.S. GAAP amounts.

Both the balance sheets and income statements involve the ascertainment of items of income, profit, or loss. The balance sheets do not fall within the exception under Reg. Sec. 1.472-2(e)(1)(ii), (4), which provides valuing inventory as an asset is not an ascertainment of income, profit, or loss, as the Taxpayer also used IFRS to ascertain retained earnings and net income on the balance sheets. The income statements by their nature involve the ascertainment of income, profit, or loss.

There is no question the IFRS-only versions used a method other than LIFO to ascertain income, profit, or loss, as IFRS is a non-LIFO method and was the only method used.

Arguably, the tabulated versions of the financial statements provided to the lending bank comply with the LIFO conformity requirements as they used U.S. GAAP to determine income, profit, and loss. However, they also used IFRS.

The LIFO conformity requirements do not merely require the use of a LIFO inventory method; *they require that no method other than LIFO be used.*

The financial statements were issued to the Taxpayer's lending bank in accordance with lending requirements related to a letter of credit. Thus, there was a debtor-creditor relationship between the Taxpayer and the lending bank and the financial statements were provided pursuant to this debtor-creditor relationship. The Taxpayer's continued receipt of credit was dependent upon the provision of such financial statements. Therefore, the financial statements were "for credit purposes."

It could be argued that the use of IFRS was for purposes of supplementing or explaining the Taxpayer's primary U.S. Generally Accepted Accounting Principles (GAAP) position and, thus, the tabulated financial statements meet the exception for supplemental or explanatory information. However, the provision of information using IFRS was not presented as either supplemental or explanatory.

With respect to the tabulated balance sheet, the disclosure of income, profit, and loss using IFRS was not made in the form of a footnote to the balance sheet or a parenthetical disclosure on the face of the balance sheet. Even if the disclosure qualified as a parenthetical, despite the lack of parentheses, or other punctuation or formatting to indicate the IFRS information is an aside, there is still the problem of the tabulated income statement. Reg. Sec. 1.472-2(e)(3)(i) clearly provides that "[i]nformation reported on the face of a taxpayer's financial income statement for a taxable year is not considered a supplement to or explanation of the taxpayer's primary presentation of the taxpayer's income, profit, or loss." The IFRS information was reported on the face of the income statement and not as part of a note to the income statement.

Moreover, even if the tabulated financial statements conformed to the requirements of Section 472(e) and the Regulations thereunder, the Taxpayer also provided the lending bank with the same balance sheet and income statement it provided to the Foreign Parent. These documents were prepared based solely on IFRS. These documents were not identified as supplemental, explanatory, or appendixes. For instance, the balance sheet was not clearly identified as a supplement to or explanation of the taxpayer's primary presentation. Similarly, the income statement was not marked as an appendix or otherwise clearly identified as a supplement to or explanation of the taxpayer's primary position.

Therefore, these documents do not meet the exception for supplemental or explanatory information, and no other exception applies. *Accordingly, the issuance of these financial statements to the lending bank violated the LIFO conformity requirements.*



<b>Conformity Requirements</b>	<p style="text-align: center;"><b>CODE &amp; REGULATIONS RE: NON-LIFO DISCLOSURES</b>  <b>AS SUPPLEMENTARY INFORMATION IN YEAR-END FINANCIAL STATEMENTS</b></p> <p style="text-align: right;">Page 1 of 2</p>
<p style="text-align: center;"><b>Code Section 472(c)</b></p>	<ul style="list-style-type: none"> <li>• A taxpayer that elects to use the LIFO inventory method for Federal income tax purposes must establish to the satisfaction of the Commissioner that it has used no method other than LIFO in inventorying goods specified in its LIFO election to ascertain income, profit, or loss <i>for the first taxable year</i> for which the method is to be used, for the purpose of a report or statement covering such taxable year to shareholders, partners, or other proprietors, or to beneficiaries, or for credit purposes.</li> </ul>
<p style="text-align: center;"><b>Code Section 472(g)</b></p>	<ul style="list-style-type: none"> <li>• All members of the same group of financially related corporations are treated as a single taxpayer for purposes of the LIFO conformity requirements of Sections 472(c) and (e)(2).</li> <li>• The term "group of financially related corporations" means any affiliated group as defined in Section 1504(a), determined by substituting "50%" for 80% each place it appears, and any other group of corporations that consolidate or combine for purposes of financial statements.</li> </ul>
<p style="text-align: center;"><b>Reg. Sec. 1.472-2(e)(1)</b></p>	<ul style="list-style-type: none"> <li>• The taxpayer must establish to the satisfaction of the Commissioner that the taxpayer, in ascertaining the income, profit, or loss for the taxable year for which the LIFO inventory method is first used, or for any subsequent taxable year, for credit purposes or for purposes of reports to shareholders, partners, or other proprietors, or to beneficiaries, has not used any inventory method other than the LIFO method or at variance with the requirement referred to in Reg. Sec. 1.472-2(c). [Requiring the use of average cost.]</li> <li>• The taxpayer's "use of an inventory method other than LIFO for purposes of ascertaining information reported <i>as a supplement to or explanation of the taxpayer's primary presentation of the taxpayer's income, profit, or loss</i> for a taxable year in credit statements or financial reports" is not considered at variance with the requirements of Reg. Sec. 1.472-2(e)(1).</li> <li>• The "use of an inventory method other than LIFO to ascertain the value of the taxpayer's inventory of goods on hand for purposes of <i>reporting the value of such inventories as assets</i>" is not considered at variance with the requirements of Reg. Sec. 1.472-2(e)(1).</li> <li>• The taxpayer's "use of an inventory method other than LIFO for purposes of ascertaining information reported in internal management reports" is not considered at variance with the requirements Reg. Sec. 1.472-2(e)(1).</li> </ul>
<p style="text-align: center;"><b>Reg. Sec. 1.472-2(e)(4)</b></p>	<ul style="list-style-type: none"> <li>• Under Reg. Sec. 1.472-2(e)(1)(ii), the use of an inventory method other than LIFO to ascertain the value of the taxpayer's inventories for purposes of <i>reporting the value of the inventories as assets is not considered the ascertainment of income, profit, or loss</i>, and therefore, is not considered at variance with the [conformity] requirement.</li> <li>• Therefore, a taxpayer may disclose the value of inventories on a <i>Balance Sheet</i> (i.e., a statement of asset values) using a method other than LIFO to identify the inventories, and such a disclosure will not be considered at variance with the [conformity] requirement.</li> <li>• However, <i>the disclosure of income, profit, or loss for a taxable year on a Balance Sheet</i> issued to creditors, shareholders, partners, other proprietors, or beneficiaries <i>is considered at variance with the [conformity] requirement if such income information is ascertained using an inventory method other than LIFO and such income information is for a taxable year for which the LIFO method is used for Federal income tax purposes.</i></li> <li>• Therefore, a <i>Balance Sheet</i> that discloses the net worth of a taxpayer, determined as if income had been ascertained using an inventory method other than LIFO, <i>may</i> be at variance with the [conformity] requirement <i>if</i> the disclosure of net worth is made in a manner that also discloses income, profit, or loss for a taxable year.</li> </ul>
<p style="text-align: center;"><b>Reg. Sec. 1.472-2(e)(4)</b></p>	<ul style="list-style-type: none"> <li>• <b>Footnote or parenthetical disclosures.</b> A disclosure of income, profit, or loss using an inventory method other than LIFO is not considered at variance with the [conformity] requirement if the disclosure is made in the form of either a footnote to the balance sheet or a parenthetical disclosure on the face of the balance sheet.</li> <li>• <b>In addition</b>, an income disclosure is not considered at variance with the [conformity] requirement if the disclosure is made on the face of a supplemental Balance Sheet labeled as a supplement to the taxpayer's primary presentation of financial position, <i>but only if</i>, consistent with the rules discussed below (i.e., Reg. Sec. 1.472-2(e)(3)), <i>such a disclosure is clearly identified as a supplement to or explanation of the taxpayer's primary presentation of financial income as reported on the face of the taxpayer's Income Statement.</i></li> </ul>



**Conformity  
Requirements**

**CODE & REGULATIONS RE: NON-LIFO DISCLOSURES  
AS SUPPLEMENTARY INFORMATION IN YEAR-END FINANCIAL STATEMENTS**

Page 2 of 2

**Reg. Sec.  
1.472-2(e)(3)**

**Specific Rules  
Related to the  
Exceptions  
to the  
Conformity  
Requirements  
for ...**

**Supplemental  
and/or  
Explanatory  
Information**

- **Face of the Income Statement (i).** Information reported *on the face* of a taxpayer's financial *Income Statement* for a taxable year is not considered a supplement to or explanation of the taxpayer's primary presentation of the taxpayer's income, profit, or loss for the taxable year in credit statements or financial reports.
  - ♦ For this purpose, the face of an income statement does not include *notes to the Income Statement* presented on the same page as the income statement, *but only if* all notes to the financial income statement are presented together.
- **Notes to the Income Statement (ii).** Information reported in notes to a taxpayer's financial *Income Statement* is considered a supplement to or explanation of the taxpayer's primary presentation of income, profit, or loss for the period covered by the *Income Statement* if (1) all notes to the financial *Income Statement* are presented together and (2) if they accompany the *Income Statement* in a single report.
- **Appendices & supplements to the Income Statement (iii).** Information reported in an appendix or supplement to a taxpayer's financial *Income Statement* is considered a supplement to or explanation of the taxpayer's primary presentation of income, profit, or loss for the period covered by the *Income Statement* but, *only if*
  - ♦ (1) The appendix or supplement accompanies the income statement in a single report *and*
  - ♦ (2) The information reported in the appendix or supplement is clearly identified as a supplement to or explanation of the taxpayer's primary presentation of income, profit, or loss as reported on the face of the taxpayer's *Income Statement* . . .
- Information is considered to be clearly identified as a supplement to or explanation of the taxpayer's primary presentation of income, profit, or loss as reported on the face of the taxpayer's *Income Statement* if the information either ...
  - (1) Is reported in an appendix or supplement that contains a general statement identifying all such supplemental or explanatory information,
  - (2) Is identified specifically as supplemental or explanatory by a statement immediately preceding or following the disclosure of the information,
  - (3) Is disclosed in the context of making a comparison to corresponding information disclosed both on the face of the taxpayer's *Income Statement* and in the supplement or appendix, *or*
  - (4) Is a disclosure of the effect on an item reported on the face of the taxpayer's *Income Statement* of having used the LIFO method.
- For example, a restatement of cost of goods sold based on an inventory method other than LIFO is considered to be clearly identified as supplemental or explanatory information if the supplement or appendix containing the restatement contains a general statement that all information based on such inventory method is reported in the appendix or supplement as a supplement to or explanation of the taxpayer's primary presentation of income, profit, or loss as reported on the face of the taxpayer's *Income Statement*.

**Internal  
Management  
Reports**

- Reg. Sec. 1.472-2(e)(5) is supposed to provide specific rules related to exceptions to the conformity requirements for internal management reports.
- No Regulations have been promulgated to date ... This Reg. Sec. has been reserved.



# DON'T GET CARELESS WITH DEALERSHIP YEAR-END REPORTS TO MANUFACTURERS

This year, the AICPA Annual National Auto Dealership Conference was held at the Loews Royal Pacific Resort, Orlando, FL on October 20-21. I was again asked to speak at the Conference, and this year my presentation was entitled "*Tax Update: LIFO Issues & Tax Treatment of Manufacturer Payments to Dealerships for Facility Improvements & Upgrades.*"

In the LIFO Update portion of my presentation at the Conference, I wanted to emphasize the importance to dealerships of carefully following through on all aspects of the financial statement conformity requirements relating to year-end statements sent to the manufacturers.

These requirements apply to the 12<sup>th</sup> month statement, and if issued, also to the 13<sup>th</sup> statement sent by the dealership to the manufacturer and/or to the credit/financing corporation.

Over the years, some dealership controllers and/or their CPAs may have become lax in complying with the requirement that, in *all* year-end statements to the manufacturer, the actual change in the LIFO reserve should be reflected as a reduction (or an increase) in net income.

This means that the change in the LIFO reserve ... or the adjustment of a year-end projected amount to the actual amount of the LIFO reserve change for the year ... should **not** be charged directly against retained earnings. Furthermore, and specifically, this adjustment (from the projected change amount to the actual change amount) should **not** be included as an adjustment in the monthly statement for January or for February of the following year.

**"At a Glance" Flowchart.** As a visual reminder to emphasize this, I included the **financial statement conformity flowcharts** that I developed many years ago.

These flowcharts were originally developed in 1995 (i.e., before the IRS issued Revenue Ruling 97-42). This was at the height of the controversy with the IRS over conformity violations in statements sent by dealers to the manufacturers and to the credit corporations.

In 1995, the IRS was issuing Private Letter Rulings which required the termination of auto dealers' LIFO elections because the dealerships failed to satisfy the financial statement conformity requirements in the year-end reports they were required to send to their manufacturers and to their credit corporations.

These Letter Rulings represented the culmination of years of controversy with the IRS over this issue. Although these Rulings were non-precedential, there was no doubt that the IRS was taking a hard line against any dealer who was not properly reflecting LIFO adjustments in its Factory statements.

Two years later, the IRS eased up a bit on its position and in Revenue Ruling 97-42, it finally allowed auto dealerships to reflect the change in the LIFO reserve for the year as an adjustment to **either** the *Cost of Goods Sold* account **or** to the *Other Income* or the *Other Deductions* accounts. An adjustment to any of these accounts flows directly to the net income line in the Income Statement.

If the dealership makes a projection of the change in the LIFO reserve for the year, and that change is reflected on the 12<sup>th</sup> statement, then - after the final computation of the change in the LIFO reserve is made for the year - the net amount to adjust from the projected amount of change to the actual amount of change for the year must be reported on the 13<sup>th</sup> statement **as a charge against (or as a credit to) income for that year.**

In other words, auto dealerships must reflect the projected change and the actual change in the LIFO reserve for the year as a charge against (or as a credit to) income **in the income statement for that year.**

**Interpreting the Flowcharts.** In the flowchart for calendar-year dealerships, there are three boxes (and in the flowchart for fiscal-year dealerships, there are four boxes) where references are made to reflecting the amount of a LIFO adjustment ... "In the *CGS* (*Cost of Goods Sold*) section of the Income Statement."

As a result of the IRS' more liberal allowances in Rev. Rul. 97-42, when interpreting these flowcharts now, all references in the flowcharts to the *CGS* account would be expanded to read ... "In the *CGS* section **or** in the *Other Income or Other Deductions* accounts." This is stated in the very small print in the rectangular box near the center of each flowchart.

These flowcharts, updated with notation to reflect Rev. Rul. 97-42, appear on pages 16 and 17.



**AUTO DEALER LIFO REPORTING VARIATIONS IN  
CERTAIN FACTORY-FORMATTED STATEMENTS  
ISSUED "FOR CREDIT PURPOSES"**

**REVENUE RULING 97-42**

	<b><u>SITUATION 1</u></b>		<b><u>SITUATION 2</u></b>		<b><u>SITUATION 3</u></b>	
	LIFO REFLECTED IN GROSS PROFIT (CGS) *		LIFO REFLECTED IN ADJ. TO NET INCOME **		LIFO NOT REFLECTED ANYWHERE ON THE INCOME STATEMENT	
	INCOME STATEMENT DECEMBER 1996		INCOME STATEMENT DECEMBER 1996		INCOME STATEMENT DECEMBER 1996	
	<u>MONTH</u>	<u>YEAR-TO-DATE</u>	<u>MONTH</u>	<u>YEAR-TO-DATE</u>	<u>MONTH</u>	<u>YEAR-TO-DATE</u>
Sales of Automobiles	\$ 300x	\$3,600x	\$ 300x	\$3,600x	\$ 300x	\$3,600x
Cost of Goods Sold	<u>( 255x)</u>	<u>(2,400x) *</u>	<u>( 195x)</u>	<u>(2,340x)</u>	<u>( 195x)</u>	<u>(2,340x)</u>
Gross Profit	\$ 45x	\$1,200x	\$ 105x	\$1,260x	\$105x	\$1,260x
Variable Expenses	( 12x)	( 144x)	( 12x)	( 144x)	( 12x)	( 144x)
Fixed Expenses	<u>( 18x)</u>	<u>( 216x)</u>	<u>( 18x)</u>	<u>( 216x)</u>	<u>( 18x)</u>	<u>( 216x)</u>
Operating Profit	\$ 15x	\$ 840x	\$ 75x	\$ 900x	\$ 75x	\$ 900x
Other Income & Expenses	<u>-0-</u>	<u>-0-</u>	<u>( 60x)</u>	<u>( 60x) **</u>	<u>-0-</u>	<u>-0-</u>
Net Income	<u>\$ 15x</u>	<u>\$ 840x</u>	<u>\$ 15x</u>	<u>\$ 840x</u>	<u>\$ 75x</u>	<u>\$ 900x</u>

**NOTES**

*In Situations 1 and 2, A and B did not violate the LIFO conformity requirement in their statements to Y (a financing subsidiary of the Factory/manufacturer) because they used the LIFO method in inventorying goods to ascertain their net income in the Month and Year-To-Date columns of the December income statement. **The results in Situations 1 and 2 would be the same if the \$60x LIFO adjustment reflected in the Month and Year-To-Date columns of the December 1996 income had been a reasonable estimate of the change in LIFO reserve for the year.***

Further, if A or B had employed a *fiscal taxable year*, the results in Situations 1 and 2 would be the same if A or B made *either (1)* an adjustment for the change in the LIFO reserve that occurred during the calendar year in the Month and Year-To-Date column of the December income statement or *(2)* an adjustment for the change in the LIFO reserve that occurred during the fiscal year in the Month and Year-To-Date columns of the income statements provided for the last month of the fiscal year.

*In Situation 3, C violated the LIFO conformity requirement in its statements to Y because C used a method other than LIFO (i.e., it used the specific identification inventory method) in inventorying goods to ascertain its net income in the Year-To-Date column of the December income statement. Further, C violated the LIFO conformity requirement because the January through November income statements can be combined with the December income statement to ascertain C's net income for the year using a single inventory method other than LIFO.*

C used the specific identification inventory method to calculate its Cost of Goods Sold, Gross Profit, and Net Income for the year and month without adjusting for a \$60x increase in C's LIFO reserve for 1996. **Thus, the December 1996 income statement does not reflect C's use of the LIFO inventory method.** The result in Situation 3 would be the same even if C's December 31, 1996 Balance Sheet had reflected a 1996 adjustment to C's LIFO reserve.

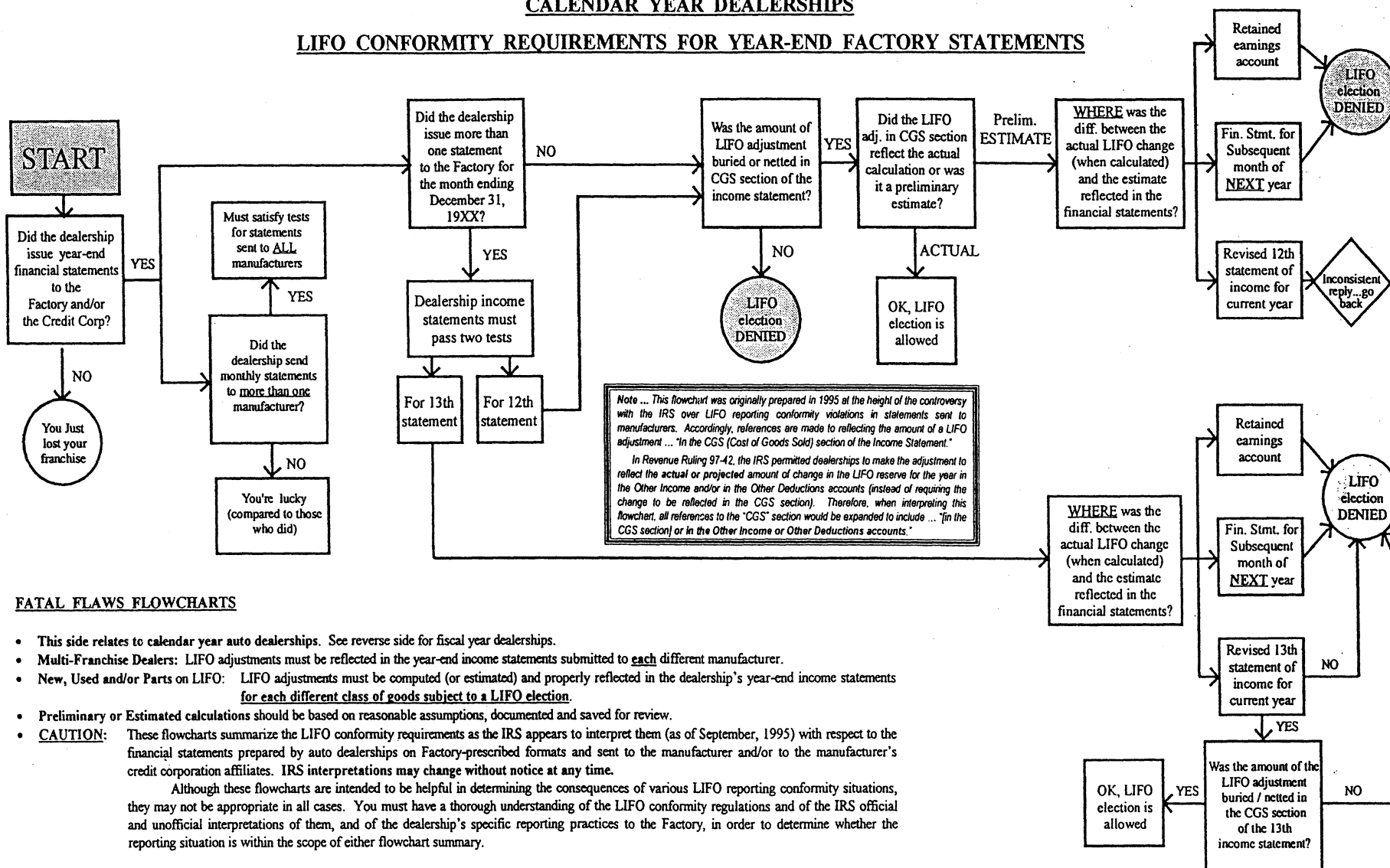
**WARNING:** These examples can only be read and interpreted in the context of the entire discussions in Revenue Ruling 97-42 and Revenue Procedure 97-44 which relates to franchised automobile dealers who have provided monthly financial (income) statements "FOR CREDIT PURPOSES" to the credit subsidiary of the franchisor/automobile manufacturer.





## CALENDAR YEAR DEALERSHIPS

## LIFO CONFORMITY REQUIREMENTS FOR YEAR-END FACTORY STATEMENTS



## FATAL FLAWS FLOWCHARTS

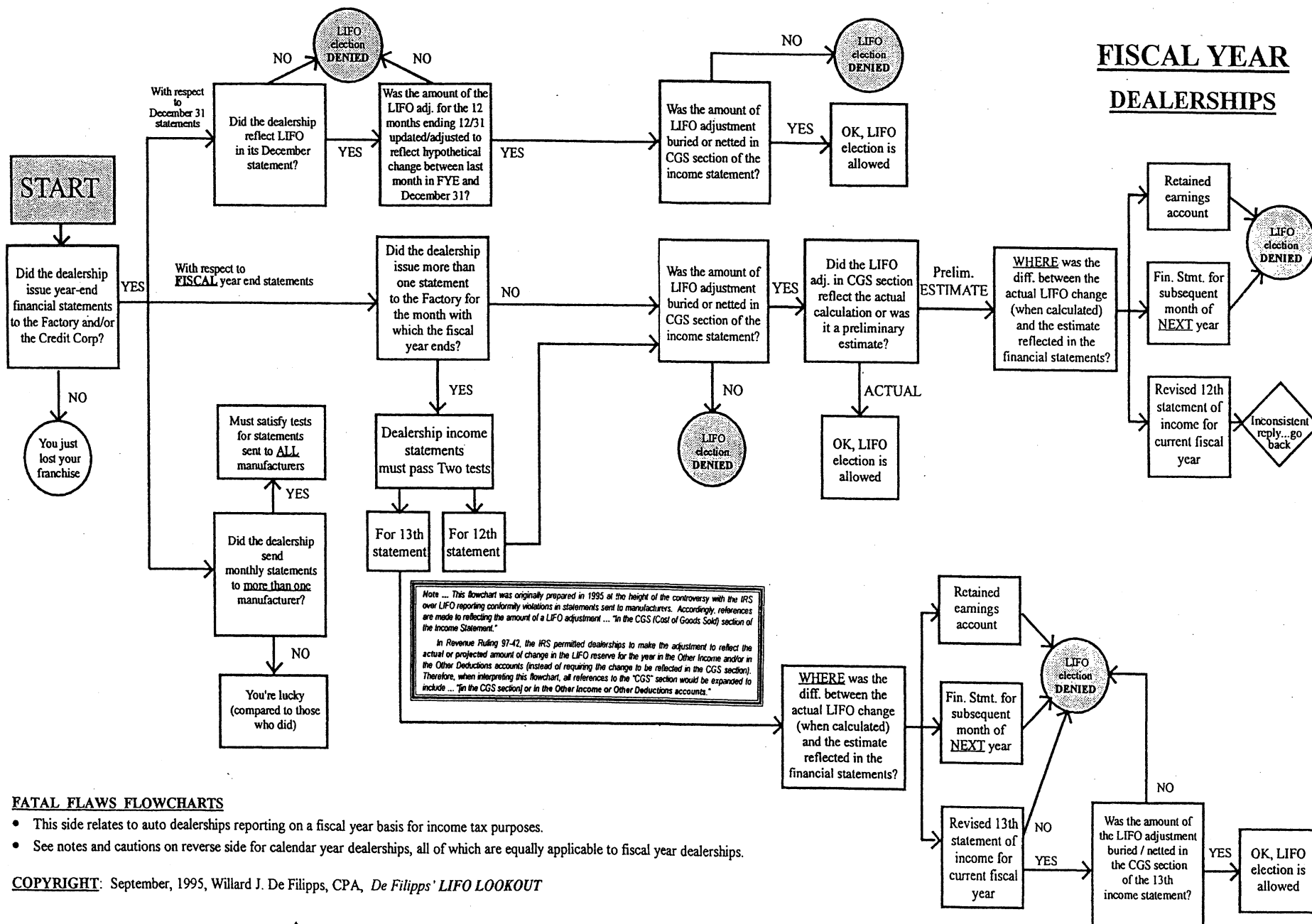
- This side relates to calendar year auto dealerships. See reverse side for fiscal year dealerships.
- **Multi-Franchise Dealers:** LIFO adjustments must be reflected in the year-end income statements submitted to each different manufacturer.
- **New, Used and/or Parts on LIFO:** LIFO adjustments must be computed (or estimated) and properly reflected in the dealership's year-end income statements for each different class of goods subject to a LIFO election.
- Preliminary or Estimated calculations should be based on reasonable assumptions, documented and saved for review.
- **CAUTION:** These flowcharts summarize the LIFO conformity requirements as the IRS appears to interpret them (as of September, 1995) with respect to the financial statements prepared by auto dealerships on Factory-prescribed formats and sent to the manufacturer and/or to the manufacturer's credit corporation affiliates. IRS interpretations may change without notice at any time.

Although these flowcharts are intended to be helpful in determining the consequences of various LIFO reporting conformity situations, they may not be appropriate in all cases. You must have a thorough understanding of the LIFO conformity regulations and of the IRS official and unofficial interpretations of them, and of the dealership's specific reporting practices to the Factory, in order to determine whether the reporting situation is within the scope of either flowchart summary.

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## FISCAL YEAR DEALERSHIPS



### FATAL FLAWS FLOWCHARTS

- This side relates to auto dealerships reporting on a fiscal year basis for income tax purposes.
- See notes and cautions on reverse side for calendar year dealerships, all of which are equally applicable to fiscal year dealerships.

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# EARTHQUAKES + TSUNAMIS = LOWER YEAR-END INVENTORIES

## ... SECTION 473 RELIEF

### FOR RECAPTURED LIFO RESERVES?

I mentioned in the Mid-Year 2011 Update #2 that some dealerships with fiscal year-ends might face considerable LIFO reserve recapture because of reduced new vehicle inventory levels. The primary reason for the reduced inventory levels would be the serious problems created by the inability of manufacturers to get parts from Japan and other Southeast Asian sources.

This shortage of inventory problem may be particularly acute for Honda, Toyota and Kia dealerships because production for these manufacturers was more severely affected by earthquakes and tsunamis in Japan in March 2011.

The same concern remains for many December 31 year-end inventories because what few vehicles might be available to dealerships seem to be snapped up by eager customers.

As a result of this LIFO reserve recapture dilemma, I've received several questions over the last few months concerning whether some dealerships might be able to obtain "relief" under the somewhat obscure provisions of Section 473 of the Internal Revenue Code.

It is my understanding that NADA and at least one other state dealership association have approached Treasury and/or certain members of Congress in an effort to obtain relief for dealers under Section 473.

Two important observations, before getting into some of the details.

**First**, "relief" - if it is available - is entirely elective. In other words, a taxpayer is not required to claim the benefits. This is significant because some dealerships might not want "relief" because they are more interested in reducing their overall LIFO reserves in order to make their balance sheets look better or to use up net operating losses.

**Second**, Code Section 473 is somewhat complicated. "Benefits" from electing its provisions can only be obtained by filing amended returns for the "liquidation year" after the LIFO reserve recapture (due to the lower ending inventory levels) has been included in taxable income for that year. In other words, when the inventory level is restored in a succeeding year, that restoration event will trigger a recomputation for the preceding year and the filing of an amended tax return.

#### SECTION 473 SPECIFICS

Here is a succinct description of Section 473 ... "In certain circumstances, reductions in inventory levels may be beyond the control of the taxpayer. Section 473 of the Code mitigates the adverse effects in certain specified cases by allowing a taxpayer to claim a refund of taxes paid on LIFO inventory profits resulting from the liquidation of LIFO inventories if the taxpayer purchases replacement inventory within a defined replacement period.

"The provision generally applies when a decrease in inventory is caused by reduced supply due to government regulation or supply interruptions due to the interruption of foreign trade."

This description comes from a *Paper Prepared by the Staff of the Joint Committee on Taxation for presentation before the Senate Committee on Finance* on May 12, 2011.

Section 473 became effective for taxable years ending after October 31, 1979. It was part of the *1980 Crude Oil Windfall Profit Tax Act*, and its primary focus related to qualified inventory interruptions as defined by the Department of Energy's regulations or actions with respect to energy supplies, embargos and international boycotts.

#### CAUSE & EFFECT PROBLEMS

The text of Code Section 473 is reproduced in its entirety as part of this article.

Whether or not Section 473 might apply to some current dealership situations seems to depend on whether the impact of earthquakes and tsunamis earlier this year would be considered to constitute or result in what the Code considers to be **"any ... other major foreign trade interruption."** Note: the use of the adjective **"major"** in the language of the Section raises the question of the matter of degree and may result in potential differences of opinion.

In the context that might be applicable to the circumstances here under discussion, Section 473 provides that "whenever the Secretary (of the Treasury), after consultation with the appropriate Federal officers, determines that ... any ... other major foreign trade interruption has made difficult or impossible the replacement (during the liquidation year) of **any** class of goods for **any** class of taxpayers, **and** that the application of this Section to that class of goods and taxpayers **is necessary to carry out the purposes**

→



## Section 473 Relief

**of this Section**, he shall publish a notice of such determination in the *Federal Register*, together with the period to be affected by such notice."

This wording seems to give the Treasury/IRS considerable latitude in determining which situations would qualify for Section 473 relief. Note that "consultation with appropriate Federal officers" is a prerequisite. Also note that a clear understanding of the "purposes of this Section" is required in order to determine whether relief should be provided.

### LEGISLATIVE INTENT

This could be troublesome because the *Senate Committee Report on P.L. 96-223* (i.e., the enabling legislation) states ... "In certain **narrowly defined circumstances**, the Senate Amendment allows taxpayers to claim a refund...."

The *Conference Agreement* follows the Senate Amendment but makes certain clarifying and technical amendments. The *Conference Agreement* seems to reflect the intention to narrow the application of the relief to be provided by Section 473 by substituting the terms "**qualified liquidation**" and "**qualified inventory interruption**" for the broader term "inventory liquidation" that had been used in the Senate Amendment.

The *Conference Agreement* further states that a qualified liquidation occurs ... "only if the taxpayer establishes to the **satisfaction of the Secretary** that the decrease is **directly and primarily attributable** to a qualified inventory interruption."

Query: What will it take to "satisfy" the Secretary on this point?

The *Conference Agreement* also provides that "where there is more than one reduction in a taxpayer's LIFO inventory and these reductions are due to different causes, the reduction in the closing inventory will be presumed to occur first as a result of qualified liquidations, if any, under this provision."

Finally, the *Conference Agreement* states, "It is expected that the Secretary will issue Regulations determining how this Section is to be applied in the case of a taxpayer using the 'dollar-value' LIFO method of inventory, consistent with the 'dollar-value' regulations under Section 472."

This last expectation raises at least three troublesome issues... (1) More than 30 years have elapsed and the expected Regulations have yet to materialize, (2) It would appear that before automobile dealerships using the dollar-value LIFO method could obtain relief under this Section, the Treasury would first have to issue Regulations in some form, and (3) Probably a very high percentage of the dealerships using the LIFO method employ the Vehicle-Pool

(Continued)

Method which allows all new vehicles, regardless of manufacturer, to be placed in the same LIFO pool.

With respect to the third issue expressed above (i.e., for auto dealerships using the Vehicle-Pool Method), it might be extremely difficult to identify how much of the LIFO cost of a dealer's reduced year-end inventory is attributable to an alleged qualified inventory interruption.

This is because under the Vehicle-Pool Method (which dealerships have been allowed to use since 2007), the dealership combines all new automobiles and all new light-duty trucks - **regardless of manufacturer** - into a single pool.

For example, consider the situation where the dealership has two linemakes or franchises, one of which has reduced inventory levels as a result of the natural disasters and the other which has not been so affected... How might the combination of influences be separated and quantified to identify and measure the impact of only those which are **directly and primarily attributable** to the earthquake/tsunami consequences?

If the Treasury/IRS were to formulate some ad hoc analysis by which such a determination would be based on decreases in the number of units in inventory, any approach using such a criteria (i.e., based on simply counting the number of units) would be inconsistent with the dollar-value LIFO concept that most dealerships use because it treats their LIFO pools as representing an aggregate investments of dollars.

### I'M PESSIMISTIC

I am not at all optimistic about the possibility of any relief for dealerships under Section 473 ... although I would like to be pleasantly surprised.

I don't think the Treasury/IRS is inclined to more broadly interpret what seems to be a narrowly-drawn relief provision in order to favor auto dealers. (After all, hasn't the industry been saved by Administrative fiat once already?) Besides, the Treasury moves very slowly when it has to draft Regulations.

As for Congress, given the highly partisan divisions and current stalemate situations, it seems even if some members wanted to provide relief for dealers, others would instinctively resist the idea. In other words, I don't think Congress can or is likely to act favorably toward auto dealers.

The likelihood of Federal officials doing anything constructive to help dealers in this regard is, in my opinion, extremely remote. And, if they do anything, it might be "too little, too late." I'm afraid dealers are just going to have to do the best they can with their own LIFO recapture minimization strategies. ✱



- (a) **General rule** ... If, for any liquidation year ...
- (1) There is a **qualified liquidation** of goods which the taxpayer inventories under the LIFO method, and
  - (2) The **taxpayer elects** to have the provisions of this Section apply with respect to such liquidation, then the gross income of the taxpayer for such taxable year shall be adjusted as provided in Subsection (b).
- (b) **Adjustment for replacements** ... If the liquidated goods are replaced (in whole or in part) during any replacement year and such replacement is reflected in the closing inventory for such year, then the gross income for the liquidation year shall be ...
- (1) Decreased by an amount equal to the excess of ...
    - (A) The aggregate replacement cost of the liquidated goods so replaced during such year, over
    - (B) The aggregate cost of such goods reflected in the opening inventory of the liquidation year, or
  - (2) Increased by an amount equal to the excess of ...
    - (A) The aggregate cost reflected in such opening inventory of the liquidated goods so replaced during such year, over
    - (B) Such aggregate replacement cost.
- (c) **Qualified liquidation defined** ... For purposes of this Section ...
- (1) In general ... The term "**qualified liquidation**" means ...
    - (A) A decrease in the closing inventory of the liquidation year from the opening inventory of such year, but only if
    - (B) The taxpayer establishes to the satisfaction of the Secretary that such decrease is directly and primarily attributable to a qualified inventory interruption.
  - (2) Qualified inventory interruption defined
    - (A) In general ... The term "**qualified inventory interruption**" means a Regulation, request, or interruption described in subparagraph (B) but only to the extent provided in the notice published pursuant to subparagraph (B).
    - (B) Determination by Secretary ... Whenever the Secretary, *after consultation with the appropriate Federal officers*, determines ...
      - (i) That ...
        - (I) Any Department of Energy Regulation or request with respect to energy supplies, or
        - (II) Any embargo, international boycott, or other major foreign trade interruption,  
Has made difficult or impossible the replacement during the liquidation year of any class of goods for any class of taxpayers, **and**
      - (ii) That the application of this Section to that class of goods and taxpayers is necessary to carry out the purposes of this Section,  
He shall publish a notice of such determinations in the Federal Register, together with the period to be affected by such notice.
- (d) **Other definitions and special rules** ... For purposes of this Section ...
- (1) Liquidation year ... The term "**liquidation year**" means the taxable year in which occurs the qualified liquidation to which this Section applies.
  - (2) Replacement year ... The term "**replacement year**" means any taxable year in the replacement period; **except that such term shall not include any taxable year after the taxable year in which replacement of the liquidated goods is completed.**



(d) **Other definitions and special rules ... (continued...)**(3) Replacement period ... The term "**replacement period**" means the *shorter of* ...

(A) The period of the 3 taxable years following the liquidation year, or

(B) The period specified by the Secretary in a notice published in the Federal Register with respect to that qualified inventory interruption.

Any period specified by the Secretary under subparagraph (B) may be modified by the Secretary in a subsequent notice published in the Federal Register.

(4) LIFO method ... The term "LIFO method" means the method of inventorying goods described in Section 472.

(5) Election

(A) In general ... **An election under Subsection (a)** shall be made subject to such conditions, and in such manner and form and at such time, as the Secretary may prescribe by Regulation.(B) **Irrevocable election** ... An election under this Section shall be irrevocable and shall be binding for the liquidation year and for all determinations for prior and subsequent taxable years insofar as such determinations are affected by the adjustments under this Section.(e) **Replacement; inventory basis** ... For purposes of this chapter ...(1) **Replacements** ...

If the closing inventory of the taxpayer for any replacement year reflects an increase over the opening inventory of such goods for such year, the goods reflecting such increase shall be considered, in the order of their acquisition, as having been acquired in replacement of the goods most recently liquidated (whether or not in a qualified liquidation) and not previously replaced.

(2) **Amount at which replacement goods taken into account** ...

In the case of any qualified liquidation, any goods considered under paragraph (1) as having been acquired in replacement of the goods liquidated in such liquidation shall be taken into purchases and included in the closing inventory of the taxpayer for the replacement year at the inventory cost basis of the goods replaced.

(f) **Special rules for application of adjustments** ...(1) **Period of limitations** ... If ...

(A) An adjustment is required under this Section for any taxable year by reason of the replacement of liquidated goods during any replacement year, and

(B) The assessment of a deficiency, or the allowance of a credit or refund of an overpayment of tax attributable to such adjustment, for any taxable year, is otherwise prevented by the operation of any law or rule of law (other than Section 7122, relating to compromises),

Then such deficiency may be assessed, or credit or refund allowed, within the period prescribed for assessing a deficiency or allowing a credit or refund for the replacement year if a notice for deficiency is mailed, or claim for refund is filed, within such period.

(2) **Interest** ... Solely for purposes of determining interest on any overpayment or underpayment attributable to an adjustment made under this Section, such overpayment or underpayment shall be treated as an overpayment or underpayment (as the case may be) for the replacement year.(g) **Coordination with Section 472** ...**The Secretary shall prescribe such Regulations as may be necessary to coordinate the provisions of this Section with the provisions of Section 472.**

(Note: No Regulations have ever been published.)

Section 473 became effective for taxable years ending after Oct. 31, 1979.

It was part of the 1980 Crude Oil Windfall Profit Tax Act ... P.L. 96-223.



## ***MISSED FORM 970 FILING DATES REQUIRE EXTENSIONS***

In order to be eligible to use the LIFO method, a taxpayer must properly elect LIFO by filing Form 970. This is the LIFO election form which is required to be included with the income tax return for the first LIFO year. In certain circumstances, the IRS requires the filing of Form 970 in order to notify the Service that a LIFO election is being continued.

In the Mid-Year 2010 *LIFO Lookout*, we discussed Letter Ruling 201005026, and in the Mid-Year 2009 *LIFO Lookout*, we discussed Letter Rulings 200812010 and 200914015. These Letter Rulings involved unusual fact patterns in which the taxpayers overlooked the need to file Forms 970, and subsequently, requested - and obtained - permission to make late filings in order to perfect their eligibility to use LIFO.

During 2011, two other unusual situations occurred which involved the same oversight and the subsequent need to obtain an extension of time from the IRS to file Form 970. These Rulings are worthy of mention because of their specific fact patterns.

In both situations, upon learning that Form 970 should have been filed, the taxpayers promptly requested an extension of time to file. Also in both cases, the IRS concluded that the taxpayers had acted reasonably and in good faith in making their requests, and extensions were granted under the Section 301.9100 Regulations. Each extension was for a period of 30 days from the date of the Ruling and the taxpayers were directed by the IRS to attach a copy of the Letter Ruling to its Form 970 when it was filed. (Presumably, the taxpayers would file an amended return, which would include the Form 970.)

### **LTR 201130010 ... Section 351(a) LIFO Inventory Transfers Require Form 970 Filings**

In Letter Ruling 201130010, a subsidiary corporation owned another entity, which was a disregarded entity for Federal tax purposes. The parent of the subsidiary had filed Form 970 on behalf of the subsidiary to adopt the LIFO method for the inventory that was held by the disregarded entity.

Subsequently, the subsidiary formed another entity (which was the taxpayer in this ruling) and the subsidiary transferred its interests in the disregarded entity to the taxpayer (i.e., to the other entity that the subsidiary had formed) in a transaction qualifying as a tax-free contribution of assets under Code Section 351.

The assets transferred in the Section 351 exchange included the entity's inventory that was on LIFO. The taxpayer continued to use the LIFO method ... however, the parent did not file the required Form 970. Note: the parent had represented to the IRS that there were no financial statement conformity violations.

The parent engaged "Old Firm" to prepare its consolidated Federal income tax return for the taxable year in which the Section 351 transaction occurred. Although "Old Firm" was informed of the transaction between the subsidiary and the taxpayer, "Old Firm" did not advise the parent that it was required to file Form 970 on behalf of the taxpayer.

Some time later, the parent was acquired by another corporation ("Acquiring Corporation") and "Acquiring Corporation" engaged a "New Firm" to prepare an accounting method change application. While it was preparing the Form 3115 (which was apparently required because of the nature of the acquisition), "New Firm" discovered that the Form 970 had not previously been filed on behalf of the taxpayer.

***Revenue Ruling 70-564 provides that a taxpayer must file a Form 970 if that taxpayer wants to use the LIFO inventory method to account for LIFO inventory which it receives in a transfer that qualifies under Section 351(a).***

### **LTR 201136006 ... 14 Different Form 970s Should Have Been Filed, But Weren't**

In Letter Ruling 201136006, the taxpayer was the parent corporation of an affiliated group of entities that filed consolidated Federal income tax returns on a calendar year basis. These consolidated returns included 14 different subsidiaries. These subsidiaries became members of the consolidated group in different years over a lengthy period of time, and each subsidiary used the LIFO inventory method for tax purposes since their respective first years.

During a review of accounting method issues for the subsidiaries by an accounting firm, it was discovered that the parent inadvertently failed to attach Forms 970 to its consolidated Federal income tax returns for all of the initial tax returns for all of the subsidiaries who were using LIFO. The parent represented to the IRS that, for all years, the LIFO financial statement conformity requirements had been satisfied by all subsidiaries.





Form 970 LIFO Election Late Filing Relief	<b>REQUESTING PERMISSION FROM THE IRS FOR AN EXTENSION OF TIME TO FILE AFTER THE REGULAR FILING DUE DATE HAS BEEN MISSED REASONABLE EXTENSIONS OF TIME FOR LATE FILINGS</b>
<b>IRS Can Permit Late Filing</b>	<ul style="list-style-type: none"> <li>• Under Reg. Sec. 301.9100-1(c), the Commissioner has the discretion to grant a reasonable extension of time to make a <b>regulatory election</b> ... provided that ... <ul style="list-style-type: none"> <li>♦ The taxpayer has acted reasonably and in good faith, and</li> <li>♦ Provided that granting relief will not prejudice the interests of the Government.</li> </ul> </li> <li>• A <b>regulatory election</b> is defined to include a request to adopt, change or retain an accounting method.</li> <li>• The rules governing automatic extensions for regulatory elections are in Section 301.9100-2.</li> <li>• If the provisions of Reg. Sec. 301.9100-2 do not apply, then Reg. Sec. 301.9100-3 may apply instead.</li> </ul>
<b>"Standards" for Relief</b>	<ul style="list-style-type: none"> <li>• These standards are set forth in Reg. Sec. 301.9100-3.</li> <li>• These standards apply to determine whether the Commissioner will grant an extension of time to make a <b>regulatory election</b>.</li> <li>• These standards also detail the information and representations that must be furnished by the taxpayer in order to enable the IRS to determine whether the taxpayer has satisfied these standards.</li> <li>• The standards also are applied to determine whether <ul style="list-style-type: none"> <li>♦ The taxpayer acted reasonably and in good faith and</li> <li>♦ Whether granting relief would prejudice the interests of the Government.</li> </ul> </li> </ul>
<b>"Good Faith"</b>	<ul style="list-style-type: none"> <li>• A taxpayer applying for relief for failure to make an election <b>before the failure is discovered by the Service</b> ordinarily will be deemed to have acted reasonably and in good faith.</li> <li>• Reg. Sec. 301.9100-3(b)(1)(i)</li> </ul>
<b>Three Indicators of "Bad Faith"</b>	<ul style="list-style-type: none"> <li>• A taxpayer will not be considered to have acted reasonably and in good faith ... if the taxpayer ... <ul style="list-style-type: none"> <li>♦ Seeks to alter a return position for which an accuracy-related penalty has been or could be imposed under Section 6662 at the time the taxpayer requests relief and the new position requires or permits a regulatory election for which relief is requested.</li> <li>♦ Was informed in all material respects of the required election and related tax consequences but chose not to file the election.</li> <li>♦ Uses hindsight in requesting relief.</li> </ul> </li> <li>• Reg. Sec. 301.9100-3(b)(3)</li> </ul>
<b>Interests of the Government Are Prejudiced</b>	<ul style="list-style-type: none"> <li>• The interests of the Government are prejudiced ... if granting relief to the taxpayer ... <ul style="list-style-type: none"> <li>♦ Would result in a taxpayer having a lower tax liability in the aggregate for all tax years affected by the regulatory election than the taxpayer would have had if the election had been timely made (taking into account the time value of money).</li> <li>♦ Would result in a tax liability that is lower, in the aggregate, for a group of taxpayers (as a result of extending the time for making the election) than the (collective) tax liability of the group would have been if the election had been timely made.</li> <li>♦ Reg. Sec. 301.9100-3(c)(1)(i)</li> </ul> </li> <li>• The interests of the Government are <b>ordinarily</b> prejudiced if the tax year in which the <b>regulatory election</b> should have been made ... or any tax years that would have been affected by the election had it been timely made ... are closed by the period of limitations on assessment under Section 6501(a) before the taxpayer's receipt of a Ruling granting relief under Reg. Sec. 301.9100-3. <ul style="list-style-type: none"> <li>♦ Reg. Sec. 301.9100-3(c)(1)(ii)</li> </ul> </li> </ul>



On August 1, 2011, the Treasury published the final Regulations under Section 381 relating to the methods of accounting, including the inventory methods, that are to be used by corporations that acquire the assets of other corporations in certain corporate reorganizations and tax-free liquidations. These Regulations clarify and simplify the rules regarding the accounting methods to be used following these reorganizations and liquidations.

There were two final Regulations issued. Reg. Sec. 1.381(c)(4) addresses the carryover of overall methods of accounting and certain accounting methods. Reg. Sec. 1.381(c)(5) addresses the carryover of inventory methods of accounting, including LIFO inventory methods.

These Regulations are effective on August 31, 2011. According to the IRS and the Treasury Department, these Regulations are expected to not have a significant economic impact on a substantial number of small entities because the corporate reorganizations and tax-free liquidations described in Section 381(a) generally involve large entities.

The keystone of the final Regulations for Sections 381(c)(4) and 381(c)(5) continues to be whether the acquiring corporation operates the trades or businesses of the parties to a Section 381(a) transaction as separate and distinct trades or businesses following the date of distribution or transfer.

The final Regulations provide that when the acquiring corporation operates the trades or businesses of the parties as separate and distinct trades or businesses after the date of distribution or transfer, the acquiring corporation will use a *carryover* method for each continuing trade or business ... unless the carryover method is impermissible and must be changed. [Reg. Sec. 1.381(c)(5)-1(a)(2)] A carryover method is an inventory method that each party to a Section 381(a) transaction uses for each separate and distinct trade or business immediately prior to the date of distribution or transfer.

In contrast, when the acquiring corporation does *not* operate the trades or businesses of the parties as separate and distinct trades or businesses after the date of distribution or transfer (in other words, if the trades or businesses are combined/integrated), then the acquiring corporation will use a *principal* method ... unless the principal method is impermissible and must be changed. [Reg. Sec. 1.381(c)(5)-1(a)(3)]

These rules do not apply when a carryover method or principal method, as applicable, is not a permissible method, or when the acquiring corporation chooses not to use a carryover method or principal method. In those cases, the general rules under Section 446(e) that govern methods of accounting apply.

The final Regulations modify the test for determining a *principal* method when the acquiring corporation does *not* operate the trades or businesses of the parties to the Section 381(a) transaction as separate and distinct trades or businesses after the date of distribution or transfer.

The determination of whether the distributor or transferor corporation is larger than the acquiring corporation is made by comparing certain attributes (that is, under Section 381(c)(5) the *fair market value* of the inventory) of only the trades or businesses that will be integrated after the date of distribution or transfer rather than comparing the attributes for the entire entity.

This provision reflects the belief of the IRS and the Treasury Department that the attributes of a trade or business that will continue to operate as a separate and distinct trade or business after the date of distribution or transfer should not influence the determination of a principal method that will be used by trades or businesses that will be integrated after the date of distribution or transfer.

The IRS and the Treasury Department also believe that applying the test at the trade or business level is consistent with Reg. Sec. 1.446-1(d) because methods of accounting are generally determined at the trade or business level.



The final Regulations also provide rules on how an acquiring corporation identifies a *principal* method when an acquiring corporation or a distributor or transferor corporation *operates more than one separate and distinct trade or business* on the date of distribution or transfer, *has more than one method of accounting* used in the trades or businesses, *and the acquiring corporation combines the trades or businesses* after the date of distribution or transfer. By providing these rules, the acquiring corporation will know whether or not it has to file Form 3115 in connection with method changes. This will eliminate, in many instances, the need for the acquiring corporation to request a Private Letter Ruling to find out whether or not it should have to file a Form 3115.

The final Regulations also ...

- (1) Expand the definition of "cut-off basis" to clarify that a taxpayer that makes a change within the Last-In, First-Out (LIFO) inventory method from one LIFO method or sub-method to another LIFO method or sub-method does not recompute the cost of its beginning inventories for the year of change under the new LIFO inventory method when it implements the change on a cut-off basis.
- (2) Provide that (when inventory not on LIFO is being combined with inventory on LIFO) the restoration to cost of any previous write-downs to market value (for the inventory previously not on LIFO) shall be taken into account by the acquiring corporation ratably in each of the three taxable years beginning with the taxable year that includes the date of the distribution or transfer. This is consistent with the amendments to Section 472(d).
- (3) Deny audit protection to an acquiring corporation when it uses a *principal* method after the date of distribution or transfer ... because changes to a principal method pursuant to these final Regulations are made on the acquiring corporation's income tax return with no disclosure on a Form 3115 - *Application for Change in Accounting Method* - that a change in method of accounting occurred.
- (4) Provide that, in *determining whether there are separate and distinct trades or businesses after the date of distribution or transfer*,
  - Whether an acquiring corporation will operate the trades or businesses of the parties to a Section 381(a) transaction as separate and distinct trades or businesses after the date of distribution or transfer *will be determined as of the date of distribution or transfer based upon the facts and circumstances*.
  - Intent to combine books and records of the trades or businesses may be demonstrated by contemporaneous records and documents or by other objective evidence that reflects the acquiring corporation's ultimate plan of operation, even though the actual combination of the books and records may extend beyond the end of the taxable year that includes the date of distribution or transfer.
- (5) Provide that, for purposes of combining pools, all base year inventories or layers of increment that occur in taxable years including the same December 31 shall be combined. A base year inventory or layer of increment occurring in any short taxable year of a distributor or transferor corporation shall be merged with and considered a layer of increment of its immediately preceding taxable year.

**Determination of principal method.** This is applicable when the acquiring corporation does *not* operate the trades or businesses of the parties as separate and distinct trades or businesses (i.e., when the trades or businesses are combined/integrated). [Reg. Sec. 1.381(c)(5)-1(c)(1)]

- For each integrated trade or business, the principal method for a particular type of goods is generally the inventory method used by the component trade or business of the acquiring corporation immediately prior to the date of distribution or transfer for that type of goods.



- If, however, on the date of distribution or transfer the component trade or business of the distributor or transferor corporation ***holds more inventory*** of a type of goods than the component trade or business of the acquiring corporation, the principal method for such goods is the inventory method used by the component trade or business of the distributor or transferor corporation immediately prior to that date.
- ***Determination of which party holds more inventory.*** For each integrated trade or business, the component trade or business of the distributor or transferor corporation holds more inventory ***if, for a particular type of goods, the aggregate of the fair market value of the goods held by each component trade or business of the distributor or transferor corporation exceeds the aggregate of the fair market value of the goods held by each component trade or business of the acquiring corporation*** immediately prior to the date of distribution or transfer.
- Alternatively, as a simplifying convention, the acquiring corporation may elect to apply the preceding sentence to the aggregate fair market value of the entire inventories, held by each component trade or business of the acquiring corporation and each component trade or business of the distributor or transferor corporation, that will be integrated after the date of distribution or transfer.
- If the component trade or business with the larger aggregate fair market value of the entire inventories does not have an inventory method for a particular type of goods immediately prior to the date of distribution or transfer, the principal method for that type of goods is the inventory method used by the component trade or business that does have an inventory method for that type of goods.
- The Regulation continues with numerous examples involving various fact patterns, one of which is below.

### **Example**

Since its incorporation in 1982, X Corporation elected to use the LIFO inventory method under Section 472 to identify its inventory of tennis balls.

Since its incorporation in 2002, T Corporation elected to use the FIFO inventory method to identify its inventory of tennis balls.

X Corporation acquires the assets of T Corporation in a transaction to which Section 381(a) applies.

Immediately prior to the date of distribution or transfer, the fair market value of X Corporation's inventory in its tennis balls (which uses the LIFO method) exceeds the fair market value of the tennis balls inventory held by T Corporation (which uses the FIFO method).

After the date of distribution or transfer, X Corporation will not operate its business as a trade or business that is separate and distinct from T Corporation's business. In other words, after the acquisition, the businesses of X and T will be integrated or combined.

Because on the date of distribution or transfer T Corporation (using FIFO) does not hold more inventory than X Corporation (which uses LIFO), the ***principal method for identifying inventory*** is the method used by X Corporation (LIFO) on the date of distribution or transfer.

After the date of distribution or transfer, X Corporation is not required to renew its election to identify inventory using the LIFO inventory method, and X Corporation is bound by the election.



# SAMPLING & LIFO INVENTORIES ...

## REV. PROC. 2011-42 PROVIDES ONLY GENERAL GUIDANCE ON SAMPLING PROCEDURES

### OVERVIEW

In many situations where business use the Last-In, First-Out (LIFO) inventory valuation method, especially where there may be thousands of SKUs, part numbers or items, taxpayers often rely upon general sampling procedures or on more specific statistical sampling procedures to minimize the amount of cost and effort required to compute inflation indexes for their LIFO inventory pools.

In August 2011, the IRS issued Revenue Procedure 2011-42 which is intended to "provide taxpayers with guidance regarding the use and evaluation of statistical samples and sampling estimates."

Regrettably, there is no specific discussion or application of the general guidance in the Revenue Procedure to taxpayers using the LIFO inventory valuation method.

Given this lack of any specific guidance, the objective of this article and supplementary materials is to provide additional background for CPAs with more general practices who - for whatever reason - find it necessary and/or appropriate to apply (statistical) sampling in connection with their clients' LIFO inventories.

### WHEN ELECTING LIFO, TAXPAYERS MUST ALSO ELECT TO USE SAMPLING APPROACHES

If taxpayers on their Forms 970 have elected to use either the (1) index or (2) link-chain, index LIFO

sub-method for valuing their LIFO inventories, they are permitted to make their inflation index determinations based up on a representative portion of their inventory. In other words, they do not have to reprice every item; instead they are permitted to reprice less than every item in the inventory.

On the other hand, if taxpayers on their Forms 970 have elected to use either the (1) double-extension or (2) link-chain LIFO sub-method for valuing their LIFO inventories, they **may not** make their inflation index determinations based upon an analysis of a representative portion of their inventory. In other words, these methods require that **every** item of inventory be repriced **and** that the date of reference for this repricing of the current cost of all items must be the first day of the first year of the LIFO election.

Accordingly, if a taxpayer on its Form 970 has not elected either the index or the link-chain, index method (but instead elected to use the double-extension or the link-chain method), then these other methods elected by the taxpayer, by their very nature, preclude the use of sampling because under these methods, **every** item in inventory must be repriced.

In IRS audit examination situations, it should be expected that the agent will look at the Form 970 to determine whether or not the index or the link-chain, index method has been properly elected. And, if either one has not been properly elected, then the agent may simply challenge the taxpayer's right to see **SAMPLING PROCEDURES**, page 28

### SAMPLING & LIFO INVENTORIES ... SUPPLEMENTARY MATERIALS

• <i>Revenue Procedure 2011-42 ... Text &amp; Comments</i>	
• Purpose, Background, Scope & General Application.....	[Sections 2, 3 & 4.01] ..... 32
• Evaluation of a Probability Sample ... Two-Step Method .....	[Sections 4.02(1) & (2)] ..... 33
• Variable Sampling Plans .....	[Section 4.02(3)] ..... 34
• Attribute Sampling Plans.....	[Section 5.02(4)] ..... 35
• Application Limitations.....	[Section 4.02(5)] ..... 36
• <i>Additional Comments</i> .....	37
• <i>Rev. Proc. 2011-42 Appendix A ... Sampling Plan Standards</i> .....	38
<i>Appendix B ... Sampling Documentation Standards</i> .....	38
<i>Appendix C ... Technical Formulas</i> .....	39-41
• <i>IRS 1995 Coordinated Issue Paper ... Computation of Dollar-Value LIFO Indexes</i> .....	42-43
• <i>Sampling Documentation Report Describing Statistical Sampling Procedures Used to     Determine the Inflation Index for a Parts Inventory Pool</i> .....	44-46



## Sampling Procedures

use sampling procedures without even getting into any discussion of whether or not the sampling methods used were appropriate.

### IF SAMPLING IS USED, HOW SHOULD THE INFLATION INDEX FOR THE POOL BE COMPUTED?

There are significant differences of opinion between the IRS and many LIFO practitioners over how inflation indexes for a pool must or should be computed when the taxpayer has properly elected to reprice less than every item in the pool (i.e., the taxpayer has elected to use a sampling approach).

The Regulations provide that an index may be computed by double-extending (i.e., repricing) **a representative portion of the inventory pool or by the use of other sound and consistent statistical methods**. The index used must be appropriate to the inventory pool to which it is to be applied. The appropriateness of the method of computing the index and the accuracy, reliability, and suitability of the use of such index must be demonstrated to the satisfaction of the district director in connection with the examination of the taxpayer's income tax returns.

It should be noted that "representativeness" is not a statistical concept.

It should also be noted that the wording of the Regulation uses the disjunctive "**or**." In other instances where the LIFO Regulations use the disjunctive "**or**," it has been held that "**or**" clearly implies an alternative to what precedes the word "**or**" - rather than qualifying what precedes the word "**or**."

For example, the LIFO Regulations provide that a retailer is allowed to determine the content of its pools on the basis of major lines, types, "**or**" classes of goods. The importance of the disjunctive "**or**" in interpreting the Regulations was litigated in *Fox Chevrolet, Inc. v. Comm.* In this case, the taxpayer wanted to pool by "classes," and the IRS wanted the taxpayer to pool by "lines" because the IRS equated each model line with a "major line" of goods." In its decision in favor of the taxpayer, the Tax Court said that the petitioner (Fox Chevrolet) "... is as much entitled to pool by classes as by lines."

As a result of the Tax Court's interpretation of the word "**or**" in *Fox Chevrolet*, some taxpayers have taken the position that their sampling procedures can satisfy the "representative" standard without necessarily being consistent with the use of "sound and consistent statistical methods."

Note: This would be a good issue for some LIFO taxpayer to litigate!

(Continued from page 27)

The position of the IRS appears to be that the phrase in the Regulations "other sound and consistent statistical methods" clearly implies that the "representative" sample would necessarily have to be a properly selected probability sample (i.e., a sample in which every item in the inventory has an equal chance of selection).

### IRS RELUCTANCE TO ISSUE FORMAL GUIDANCE

For more than half a century, the IRS has been reluctant to issue any formal guidance on how taxpayers using the LIFO inventory method can or should apply sampling procedures to the process of valuing their inventories on LIFO.

For decades, the IRS relied upon guidance provided in Revenue Procedure 64-4 for sampling procedures involving revolving credit accounts as its basic model in evaluating sampling approaches in other situations, including LIFO inventories.

There is information in several IRS training guides and in the *Internal Revenue Manual* that may be useful ... but it is not precedential. In addition, there are numerous Letter Rulings and Technical Advice Memoranda that have been published over the years. These include: LTR/TAM 8421010, 8437004, 8749005, 9210002, 9243010, 9251001 and 9332003. Taxpayers who find themselves at odds with the IRS over sampling may want to look at these Letter Rulings to see if they suggest any useful material or arguments.

### APPROACHES THAT THE IRS HAS SAID IT WILL NOT ACCEPT

The IRS has stated in a Coordinated Issue Paper (CIP) in 1995 that it will not accept taxpayers' use of certain short-cut methods in computing LIFO inflation indexes. The following short-cuts were specifically listed as being unacceptable...

- The double extension of only the large dollar items in the inventory, with the resulting index applied to the entire inventory.
- The exclusion of new items in the determination of an inflation index, with the resulting inflation index applied to the entire inventory dollars, including new items.
- The determination of an index for one segment of the inventory (for example, a warehouse) and the application of that index to all other segments of the inventory (i.e., other stores or other warehouse locations) where the inventory mix may be different.
- The use of samples that are not statistically valid which are applied to the entire inventory population.

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## Sampling Procedures

### 1995 COORDINATED ISSUE PAPER

In April of 1994, the IRS issued a proposed Coordinated Issue Paper (CIP) on the use of sampling in connection with LIFO inventories. This proposed CIP was finalized on June 26, 1995 in a Coordinated Issue for "All Industries." This 1995 CIP is entitled "*Dollar-Value LIFO: Segment of Inventory Excluded from the Computation of the LIFO Index.*"

In this 1995 CIP, the IRS held that a LIFO inflation index cannot be applied to a segment of inventory which was not represented when the index was computed **unless** the taxpayer can demonstrate that the index is representative of the price movements of such segment (and clearly reflects income).

The IRS has not said how a LIFO taxpayer might be able to demonstrate that its index is representative of the price movements and clearly reflects income. It seems the "unless" wording and what follows it was included just to make things tougher for LIFO taxpayers.

In addition to discussing the Regulations, the CIP relies heavily upon the Tax Court decision in *Basse v. Commissioner* (10 T.C. 328 (1948)). It also emphasized that the burden of proving the accuracy of LIFO indexes clearly falls upon the taxpayer - not on the IRS.

This CIP, including its discussion of the *Basse* case, is included as supplementary material.

#### IS THE RATIONALE IN THE 1995 CIP CORRECT?

Although LIFO practitioners might not disagree with the IRS' conclusion in the CIP, many practitioners disagree with the language used in the CIP to set up the rationale for its conclusion.

The 1995 Coordinated Issue Paper includes language upon which the IRS relies heavily, not only in reaching its conclusion in the CIP, but also in much of its subsequently published guidance.

"The use of the word "other" in the Regulations **implies** that the "representative portion" must be selected using sound and consistent statistical methods. Those methods require that every item in the population must have an equal non-zero chance of selection. If some portion of the population has no chance of selection, defensible statistical projections cannot be made to that portion."

Many practitioners disagree with these statements in the CIP, taking the position that they are incorrect. As contended in one comment letter submitted to the IRS after publication of the CIP ...

"This statement is incorrect in its requirement that all items have an 'equal non-zero chance of selection' to achieve statistical validity. It is clear that valid statistical methods require proper representation from

(Continued)

all segments of the population being sampled, to ensure that every item has a chance of selection.

"Yet, as is often applied in statistical sampling techniques, stratification of the items in the population can result in an increased, or even absolute, likelihood that a portion of the population will be selected. Stratification often enhances, not distorts, the overall index result. As a result, a requirement that all items have an equal non-zero chance of selection is not necessary for valid statistical sampling results and should not be required.

"In the absence of evidence that the representative portion index is not applicable to the LIFO pool, no statistical verification should be required of the taxpayer. To do otherwise would subject taxpayers to unnecessary and costly procedures that would provide little in the way of increased accuracy and would, in the case of many smaller taxpayers, limit their ability to use the LIFO method."

#### 2009 IRS FIELD DIRECTIVE

Over the years, there have been several attempts by representatives of the AICPA and the IRS to try to reach a mutually acceptable understanding of the terms and conditions that might be included in a Revenue Procedure specifically addressing the use of sampling in connection with LIFO inventories.

All of these efforts have come to an impasse for one reason or another. Accordingly, there currently exists no definition of an acceptable representative portion sampling standard for this purpose.

On November 3, 2009, the IRS Director of Field Specialists issued "*Field Directive on the Use of Estimates from Probability Samples*" (LMSB Control No. LMSB-4-0809-032). This superseded a previous Field Directive on this subject that was issued in March of 2002.

The 2009 Field Directive stated that examiners should perform a two-step inquiry in evaluating a taxpayer's probability sample. First, they should determine whether the taxpayer has appropriately used a probability sample to support or be the primary evidence of tax amounts. Second, they should determine whether the final answer represents a valid estimate.

The Field Directive also stated that **the appropriateness of using a probability sample is a facts and circumstances determination**. Some of the factors to be used in determining whether a probability sample is appropriate include the time required to analyze large volumes of data, the cost of analyzing data, and other books and records that may independently exist or have greater probative value.

see **SAMPLING PROCEDURES**, page 30





Probability samples generally should be considered appropriate if there is a compelling reason for their use and taxpayers cannot reasonably obtain more accurate information. However, probability samples generally should not be considered appropriate if evidence is readily available from another source that can be demonstrated to be a more accurate answer, or if the use of sampling does not conform to Generally Accepted Accounting Principles.

Once examiners determine that the use of a probability sample was appropriate, they should determine the validity of the final estimate by testing to see if all of the conditions described in detail in the Field Directive are met.

This 2009 Field Directive contains a few general comments regarding probability sampling and LIFO inventories. However, those references basically state that LIFO applications were more specialized than the general guidance in the Field Directive contemplated ... and that IRS agents should seek further assistance from other IRS Sampling Specialists if they encountered sampling in connection with the use of the LIFO method.

### **REV. PROC. 2011-42 ... GENERAL GUIDANCE ON SAMPLING PROCEDURES ... BUT NOTHING SPECIFIC ON LIFO INVENTORIES**

In August 2011, the IRS issued Revenue Procedure 2011-42 (2011-37 I.R.B. 318). Like its Field Directive predecessor, this Rev. Proc. is also intended to "provide taxpayers with guidance regarding the use and evaluation of statistical samples and sampling estimates." However, this Revenue Procedure may be cited as having precedential authority in negotiations with the IRS, so it carries a higher level of precedential value than the Field Directive.

The Revenue Procedure, which includes three *Appendices*, appears on the following pages. I have added some commentary of my own on a few items to try to provide a little more background.

Rev. Proc. 2011-42 almost exactly matches the 2009 Field Directive word-for-word ... except that the references to LIFO applications in the Field Directive do not appear in the Revenue Procedure. Therefore, it is disappointing that the Rev. Proc. includes no specific discussion of the application of the general "guidance" it sets forth to taxpayers using the LIFO inventory valuation method.

### **SO WHERE ARE WE NOW? ...**

#### **WHERE DO WE GO FROM HERE?**

Based on informal brief conversations I've had with some IRS representatives after the publication of the Rev. Proc., it appears that the IRS will not be

issuing any formal guidance in the near future specifically relating to LIFO sampling applications.

It is not unreasonable to expect that IRS Sampling Specialists will attempt to apply the general "principles" and/or "guidance" in Rev. Proc. 2011-42 to LIFO inventory situations on a facts-and-circumstances, case-by-case basis.

LIFO practitioners are still without specific guidance from the IRS on three major LIFO valuation computational problems ...

- The definition of what constitutes a "representative portion" (sample?) of the inventory pool, as that term is used in the Regulations.
- The determination of what constitutes an acceptable, specific precision requirement for the estimate of the LIFO inflation index derived from the sample.
- The determination of an acceptable methodology or sampling plan, with corresponding formulas by which inflation indexes could be calculated and estimates could be made of their precision.

A Revenue Procedure addressing these issues is sorely needed. Until then, in coping with these unaddressed issues, LIFO practitioners can only rely on (1) what little has been said on this subject to date, (2) very limited case law and (3) the general guidance in Revenue Procedure 2011-42.

### **SOME GENERALIZATIONS ABOUT CURRENT PRACTICES**

Without question, many LIFO taxpayers employ various procedures, statistical and/or non-statistical, as part of their LIFO inventory valuation processes. In most instances, the LIFO taxpayer's approach - if it is not audited by the IRS - is simply ... "if it ain't broke, don't fix it."

As a result, various methodologies using skip intervals, different random number selection techniques, procedures for dealing with "exceptions," etc., are carried forward (usually without question) year after year.

In many instances, taxpayers have based their approaches on the belief that a sample should consist of 70% of the cost of items in the inventory pool. In some cases, this approach has been modified to attempt to encompass 70% of the inventory dollars in the pool **and** 30% of the items. Obviously, expanding the rule of thumb to include 30% of the items often results in sample sizes that are extremely large, and certainly larger than sample sizes that otherwise might be acceptable if statistical sampling were applied to determine the size of the sample.

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## Sampling Procedures

Generally, in the past, if inflation index computations developed under these circumstances have been challenged by the IRS, and the IRS takes the position that the taxpayer's sampling plan does not provide an acceptable coefficient of variation or precision, the taxpayer usually is left with the following choices...

- Extend the sample to include more items until acceptable levels have been reached,
- Replace the LIFO point estimate with lower 95% confidence interval LIFO values,
- Agree to subtract a negotiated or "arbitrarily agreed upon" amount from the alleged inflation index in order to arrive at a lower inflation index for the pool that is acceptable to the IRS, or
- Discontinue the sampling approach entirely and instead arbitrarily use an inflation index derived from the appropriate CPI or PPI indexes.

There are situations where it is either practical or necessary to compute inflation indexes by means of sampling procedures. In some cases, it becomes desirable or more practical to expand the process to involve the use of statistically sound (sampling) procedures. This may appear to be a daunting task, especially when one reads Revenue Procedure 2011-42 or looks at the formulas in *Appendix C*.

However, with some specialized guidance and properly-planned and executed procedures, the work involved can be minimized and the benefit to the client maximized. In addition, once the sampling methodology is set, and a proforma of the required Sampling Documentation Report is complete, the amount of time spent in future years with respect to the sampling process should be minimal.

Sampling software packages which are appropriate for use in LIFO applications are difficult (nearly impossible?) to obtain, yet they are an integral part of computing and evaluating the indexes accurately and cost-effectively. In my experience, I have seen many CPA firms mistakenly trying to "fit" their LIFO-related sampling applications into existing audit sampling software packages in an attempt to "make do with what's available."

While one may sympathize with these "round-peg-in-square-hole" approaches, they are simply incorrect and most likely will not stand up in an audit situation under close scrutiny by an IRS Sampling Specialist.

In the past, I have found it necessary to develop and use a tailor-made software program for certain LIFO consulting engagements. Apparently, the ma-

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jor accounting firms also have their own sampling software packages for use with their own clients.

Finally, an important consideration involved in *all* LIFO applications is the requirement of maintaining "adequate books and records" used in support of the LIFO computations. The use of statistical sampling procedures to compute inflation indexes will also necessitate additional documentation retention requirements, related specifically to the sampling process itself.

## SAMPLING DOCUMENTATION REPORT

*Appendices A and B* to Rev. Proc. 2011-42 set forth Sampling Plan Standards and Sampling Documentation Standards. To give you an idea of what a Sampling Documentation Report might look like, I have included an abbreviated and modified version of a Sampling Documentation Report prepared many years ago in a situation where statistical sampling - i.e., a stratified random sample - was used to determine the inflation index for a parts inventory.

Although subject to a few disclaimers, this Report at least shows you what one might look like. It describes the key steps that were involved in the sampling process which the IRS accepted as satisfying its standards (as set forth by the examining agent at that time) on the acceptability of computing LIFO indexes by using statistical sampling methods.

## CONCLUSION

In the *Internal Revenue Manual*, the "IRS Agent's Checklist for Taxpayers Using the LIFO Method for Valuing Inventories" states that ... "If the taxpayer is using sampling techniques to calculate a current-year index, [the IRS examining agent should] verify that no segment of the inventory has been excluded from the sample population **and** that the index sample is based on valid statistical sampling principles."

In audits where taxpayers are using sampling methods in connection with LIFO inventory valuations, the examining agent will usually bring in an IRS specialist (i.e., a "Statistical Sampling Coordinator"). This IRS sampling expert is charged with the responsibility of providing assistance and guidance to examining agents in the field in an attempt to secure some level of consistency in the application of the IRS' positions on sampling to situations involving LIFO inventory valuations.

It is reasonable to expect that taxpayers using LIFO will have to negotiate their way to a settlement in order to resolve most, if not all, of these technical issues.



Sampling Rev. Proc.	<p style="text-align: center;"><b>REVENUE PROCEDURE 2011-42</b>  <b>STATISTICAL SAMPLING &amp; SAMPLING ESTIMATES GUIDANCE</b></p> <p style="text-align: right;">Page 1 of 6</p>
<p style="text-align: center;"><i>Summary of Rev. Proc.</i></p>	<ul style="list-style-type: none"> <li>• <b>Purpose</b> ... This Revenue Procedure 2011-42 (2011-37 I.R.B. 318) provides taxpayers with <b>guidance regarding the use and evaluation of statistical samples and sampling estimates</b>.</li> <li>• Taxpayers may use statistical sampling procedures to support items on their income tax returns. The IRS will use the criteria provided in the guidance in determining whether to accept a statistical sampling estimate as adequate substantiation for a return position.</li> <li>• Statistical samples that fail to meet the criteria will be rejected.</li> <li>• The use of statistical sampling is provided in several items of published guidance. <ul style="list-style-type: none"> <li>♦ Any published guidance in effect before the effective date of Rev. Proc. 2011-42 that allows statistical sampling is modified and amplified by the Revenue Procedure.</li> </ul> </li> <li>• Rev. Proc. 2011-42 is effective for tax years ending after August 18, 2011. <ul style="list-style-type: none"> <li>♦ The IRS will allow, but won't require, application of Rev. Proc. 2011-42 to the use of statistical sampling for a tax year ending before August 19, 2011, for which the applicable limitations period has not expired.</li> </ul> </li> </ul>
<p style="text-align: center;"><i>Contents</i></p>	<ul style="list-style-type: none"> <li>• <b>Sec. 1 ... Purpose</b> ... See <i>Summary</i> above</li> <li>• <b>Sec. 2 ... Background</b></li> <li>• <b>Sec. 3 ... Scope</b></li> <li>• <b>Sec. 4 ... Application</b></li> <li>• <b>Sec. 5 ... Effect on Other Documents</b> ... Text Omitted</li> <li>• <b>Sec. 6 ... Effective Date</b> ... Taxable years ending on or after August 19, 2011</li> <li>• <b>Sec. 7 ... Paperwork Reduction Act</b> ... Text Omitted</li> <li>• <b>Appendix A ... Sampling Plan Standards</b></li> <li>• <b>Appendix B ... Sampling Document Standards</b></li> <li>• <b>Appendix C ... Technical Formulas</b></li> </ul>
<p style="text-align: center;"><i>Background</i> <b>Section 2.</b></p>	<ul style="list-style-type: none"> <li>• The use of statistical sampling is provided in several items of published guidance. See, for example, <ul style="list-style-type: none"> <li>♦ <b>Rev. Proc. 2011-35</b> ... Provides safe harbor methodologies to determine basis in stock acquired in transfer basis transactions,</li> <li>♦ <b>Rev. Proc. 2004-29</b> ... Provides the statistical sampling methodology that a taxpayer may use in establishing the amount of substantiated meal and entertainment expenses that are excepted from the 50% deduction disallowance under section 274(n)(1),</li> <li>♦ <b>Rev. Proc. 2007-35</b> ... Addresses when statistical sampling may be used for purposes of Section 199 (income attributable to domestic production activities),</li> <li>♦ <b>Rev. Proc. 2002-55</b> ... Permits external auditors of qualified intermediaries to use statistical sampling, and</li> <li>♦ <b>Rev. Proc. 72-36</b> ... Sets forth statistical sampling guidelines for determining the redemption rate of trading stamps.</li> </ul> </li> <li>• If statistical sampling is determined to be appropriate under prior published guidance or under this Revenue Procedure, a taxpayer may use only the statistical sampling procedures set forth in this Revenue Procedure. <ul style="list-style-type: none"> <li>♦ Any published guidance in effect prior to the effective date of this Revenue Procedure that permits statistical sampling is modified and amplified by this Revenue Procedure.</li> </ul> </li> </ul>
<p style="text-align: center;"><i>Scope</i> <b>Section 3.</b></p>	<ul style="list-style-type: none"> <li>• When permitted by the Service, taxpayers may use statistical sampling procedures to support items on their income tax returns.</li> <li>• The Service will use the criteria set forth in Section 4 of this Rev. Proc. in determining whether to accept a statistical sampling estimate as adequate substantiation for a return position.</li> <li>• Statistical samples that fail to meet these criteria will be rejected.</li> </ul>
<p style="text-align: center;"><i>Application ... In General</i> <b>Section 4.01</b></p>	<ul style="list-style-type: none"> <li>• When permitted by the Service, a taxpayer may use statistical sampling in establishing, with respect to its income tax liability, items on its return by following the procedures provided in ... <ul style="list-style-type: none"> <li>♦ <b>Appendix A</b> (Sampling Plan Standards),</li> <li>♦ <b>Appendix B</b> (Sampling Documentation Standards) and</li> <li>♦ <b>Appendix C</b> (Technical Formulas).</li> </ul> </li> </ul>



***Evaluation  
of a  
Probability  
Sample...***

***Step 1  
Determine  
Appropriateness***

**Section 4.02(1)**

- The appropriateness of using a probability sample, to either support or be primary evidence of a tax amount, is a facts and circumstances determination.
- Factors to be used in determining whether a probability sample is appropriate include, but are not limited to, the following:
  - ♦ The time required to analyze large volumes of data;
  - ♦ The cost of analyzing data; and
  - ♦ The other books and records that may independently exist or have greater probative value.
- Probability samples generally will not be considered appropriate...
  - ♦ If evidence is readily available from another source that can be demonstrated to provide a more accurate answer, *or*
  - ♦ If the use of sampling does not conform to applicable financial accounting standards (e.g., Generally Accepted Accounting Principles (GAAP)).

***Evaluation  
of a  
Probability  
Sample...***

***Step 2  
Determine  
Validity  
of the  
Final  
Estimate***

**Section 4.02(2)**

- Taxpayers must determine whether the final estimate represents a valid estimate.
- In general, a final estimate will be considered valid (without regard to audit adjustment(s)) provided that all of the following three (3) conditions are met.
- **Documentation**
  - ♦ Taxpayers must maintain all of the proper documentation to support the statistical application, sample unit findings, and all aspects of the sample plan.
  - ♦ Proper supportive documentation generally includes all of the information contained in *Appendix A* and *Appendix B* of this Revenue Procedure.
- **Known chance of selection**
  - ♦ The estimate must be based on a probability (i.e., statistical) sample, in which each sampling unit in the population has a known (non-zero) chance of selection, using either a simple random sampling method or stratified random sampling method.
- **Taxpayer uses the least advantageous 95% one-sided confidence limit**
  - ♦ The estimate must be computed at the least advantageous 95% one-sided confidence limit.
  - ♦ The “least advantageous” confidence limit is either the upper or lower limit that results in the least benefit to the taxpayer.
  - ♦ If the relative precision for a sampling plan (as described in Section 4.03(4) of this Rev. Proc.) does not exceed 10%, the point estimate may be used in place of the least advantageous 95% one-sided confidence limit.
  - ♦ When the relative precision is less than 15% and greater than 10%, the estimate will be computed as an amount between the least advantageous 95% one-sided confidence limit and the point estimate determined as follows:
 
$$\text{Estimate} = \text{Point Estimate} - (\text{Relative Precision} - .10) / .05 * (\text{Point Estimate} - \text{Least Advantageous 95\% One-Sided Confidence Limit})$$
- ♦ Although many methods exist to estimate population values from the sample data, only the following estimators will be considered for acceptance:
  - (i) Variable estimators permitted include the Mean (also known as the direct projection method),
  - (ii) Difference (using “paired variables”),
  - (iii) (combined) Ratio (using a variable of interest and a “correlated” variable), and
  - (iv) (combined) Regression (using a variable of interest and a “correlated” variable).
- The first variable used for the difference, ratio and regression estimators must be the variable used in the mean estimator.
- The second variable used for the difference, ratio, and regression estimators must be a variable that can be paired with the first variable and should be related to the first variable.
- ♦ To be accepted by the Service as a method to estimate population values from the sample data, taxpayers who choose to use methods (iii) or (iv) described above must first demonstrate that the statistical bias inherent in those methods is negligible. See Section 4.03(3) of this Rev. Proc.
  - The formulas for these estimators are provided in *Appendix C* and assume sampling without replacement.
  - Attribute estimators permitted include (combined) proportion or total count.



**Variable  
Sampling  
Plans**

**Section 4.03**

- **Use estimate with smallest overall standard of error**
  - ♦ Of all the final estimates determined as qualifying, the estimate with the smallest overall standard of error, as an absolute value, will generally be used (i.e., the size of the estimate is irrelevant in the determination of the value to be reported).
  - ♦ Situations may exist when only a single estimator may be appropriate for the plan objective.  
[Note: See page 6 of 6 for deleted reference to LIFO inventories.]
  - ♦ In those specialized situations, the relevant estimator may be evaluated without consideration of other methods.
- **Calculation of confidence limits**
  - ♦ Confidence limits are calculated by adding and subtracting the precision of the estimate from the point estimate when precision is determined by multiplying the standard error by ...
    - The 95% one-sided confidence coefficient based on the Student's t-distribution with the appropriate degrees of freedom, or
    - 1.645 (i.e., the normal distribution), assuming the sample size is at least 100 in each non-100% stratum.
- **Demonstration of statistical bias**
  - ♦ For either the (combined) Ratio or Regression methods (as described in section 4.02(2)(c)), in order to demonstrate that little statistical bias exists, the following applies after excluding all strata tested on a 100% basis (i.e., the entire population of a stratum is selected for evaluation):
    - (i) The total sample size of all strata must be at least 100 units,
    - (ii) Each stratum for which a population estimate is made should contain at least 30 sample units,
    - (iii) The coefficient of variation of the paired variable must be 15% or less,
    - (iv) The coefficient of variation of the primary variable of interest, represented by either the corrected value or the difference between the reported and corrected values in common accounting situations, must be 15% or less, and
    - (v) For only the (combined) Ratio method, the reported values of the units must be of the same sign.
  - ♦ Definitional formulas for the paired variable (described in (iii) above), and the corrected value and the difference between the reported and corrected values (each described in (iv) above) are provided in *Appendix C* (Technical Formulas).
- **Calculating the relative precision for each estimator**
  - ♦ The relative precision for each estimator is commonly calculated by dividing the precision at the 95% one-sided confidence limit (sometimes referred to as sampling error) of the estimate by the estimator.
  - ♦ When an estimate may be calculated using either a corrected value or difference perspective, as in the case of Ratio and Regression methods, or solely a corrected value perspective as in the case of a Mean method, the test will be applied on the basis of a difference perspective.
  - ♦ In these cases the numerator of the calculation is the sampling error of the adjustment and the denominator the point estimate of the adjustment.
- **Specialized situations**
  - ♦ For specialized situations, the 10% test that applies to the particular sampling objective must be appropriate for the plan, and adjusted accordingly to reflect an acceptable level of precision.  
[Note: See page 6 of 6 for deleted reference to LIFO inventories.]
  - ♦ Additional modifications may be necessary for other unique types of sampling plans.
- **Exclusion of certain items for purposes of the 10% relative precision test**
  - ♦ For the purpose of the 10% relative precision test, any stratum, when the sampling units or the process of evaluating the sampling units are different from those in other strata, must be excluded in calculating the relative precision.

**Lookout  
Comment**

- See above for locations in the Rev. Proc. text where references to LIFO inventories that were included in the 2009 Field Directive have been deleted from the corresponding text in the Rev. Proc.



**Attribute  
Sampling  
Plans**

**Section 4.04**

- **Determining confidence limits**
  - ♦ When using simple random samples, the confidence limits are determined using the Hypergeometric, Poisson, or Binomial distribution.
  - ♦ If the proportion being estimated is between 30% and 70%, then the normal distribution approximation may be used in lieu of one of the above distributions.
  - ♦ For stratified random samples, when at least two strata are sampled (i.e., not 100% samples), the confidence limits must be determined using the normal distribution approximation.
  - ♦ If stratified random samples are not used, then confidence limits will be determined using the Hypergeometric, Poisson, or Binomial distribution.
- **Calculating the relative precision**
  - ♦ For the normal distribution approximation, the precision is calculated by multiplying the standard error by ...
    - The 95% one-sided confidence coefficient based on the Student's t-distribution with the appropriate degrees of freedom, or
    - 1.645 (i.e., the normal distribution), assuming the sample size is at least 100 in each non-100% stratum.
- **Point estimate [\*]**
  - ♦ One of the following two tests must be achieved for the use of the point estimate from an attribute sampling plan.
    - A relative precision of 10% or less must be achieved on the point estimate (i.e., the estimated proportion, p) and on its complement (i.e., 1 - p).
    - A simple random sample size of at least 300 must be used to determine the point estimate, when the sample size of 300 excludes dummy and null sampling units.

**Lookout  
Comment [\*]**

- The following discussion of the term "*point estimate*" appears in the IRS *Student Coursebook for Advanced Statistical Sampling*.
- "*The sample will give a point estimate in the form of an index. This index is an estimate of the inflation the taxpayer has experienced from the beginning of the year to the end of the year (assuming link chain). The sample, however, will also have precision. Unfortunately, the Regulations do not offer any guidelines for precision regarding the computation of the index. In many instances, the taxpayer ignores this precision and the point estimate is used as the index.*"
- "*Suppose a situation where the taxpayers sample gave an index of 1.0800 at point estimate. If the precision of that index was .0600, the sample has indicated that inflation is between 2% and 14% (1.0800 indicates 8% inflation). The previous discussions regarding taxpayer samples indicate a need for those estimates to be precise. LIFO index estimates are not different. If this error of the index is material, the taxpayer should be required to use the least advantageous position for this estimate. In this case, the link index should be 1.0200.*"

**Lookout  
Comment**

- **Variability...** The primary goal of sampling is to accurately estimate total population values from selected sample values. Consequently, the amount of variability (or difference in value) among the population items, sample items and resulting sample estimates is of great concern. If there is a wide range in value among items in the population, there will most likely be a similarly wide range among selected sample values. This spread is undesirable because it increases the variability and, therefore, the standard error (or sampling error) of the estimates from the sample. (The sampling error is the error associated with the estimate because it is based on a sample, and not on the entire population.) The sampling error must be minimal in order for the estimate to be acceptable.
- Two methods of reducing the variability of the sample estimates and increasing the precision of the results are to either (1) increase the sample size or (2) to stratify the population into homogeneous sub-populations (e.g., those items having similar dollar values). However, each method is not without its drawbacks. Increasing the sample size can add to the cost of the sample exercise because of the additional time required to handle more repricings (and to clear up any exceptions). On the other hand, it may be very difficult to appropriately stratify the entire parts inventory because the parts pad listings are usually printed out in part number order, and not in size (dollar value) order.



***Limitations***

**Section 4.05**

- The Service's allowance of a taxpayer's estimate does not correspondingly require acceptance by the Service of the taxpayer's use of an estimate for the determination of associated adjustments, allocation, or subdivision of the findings for other purposes.
  - This Revenue Procedure only addresses the statistical requirements that must be met for a probability sample to meet preliminary acceptance.
    - ♦ It is not intended to further require acceptance of individual sample unit determinations.
    - ♦ Valuation or attribute determinations remain subject to independent verification along with other non-statistical issues such as missing sampling items.
    - ♦ Likewise, the statistical procedures followed may be examined and adjusted if the procedures are found to be in error.
    - ♦ Any fatal error in statistical methodology that renders the probability sample invalid will preclude the use of any statistical estimate based on the sample and will only allow for consideration of the sample findings on an actual basis.
    - ♦ When a probability sample is determined to be not appropriate and is raised as an issue, the examining agent may pursue a more accurate determination or allow the findings of units examined on an actual basis.
    - ♦ The computational validity of the estimator should still be considered and addressed along with other alternative issues in un-agreed cases.
  - This Revenue Procedure does not preclude the Service from raising or pursuing any income, employment, or other tax issues identified in the review of a statistical sample.
  - It is recognized that existing industry practices and specific taxpayers may be using techniques that are not covered by this Revenue Procedure.
    - ♦ If a taxpayer employed a probability sample or method not covered by this Revenue Procedure, then the estimate may be referred to a Statistical Sampling Coordinator for resolution or issue development.
- [Note: See page 6 of 6 for deleted reference to LIFO inventories.]*
- This Revenue Procedure does not relieve taxpayers of their responsibility to maintain any documentation required by Section 6001, other Sections, or subsections that have specific documentation requirements for the entire population.
    - ♦ Issues regarding documentation or support may be raised as appropriate.
  - This Revenue Procedure does not supersede any specific rules for substantiation, such as those under Section 274(d).

***Lookout  
Comment***

- See above for location in the Rev. Proc. text where references to LIFO inventories that were included in the 2009 Field Directive have been deleted from the corresponding text in the Rev. Proc.

***Sections  
Omitted***

- *Sec. 5 ... Effect on Other Documents*
- *Sec. 7 ... Paperwork Reduction Act*





**REVENUE PROCEDURE 2011-42**  
**STATISTICAL SAMPLING & SAMPLING ESTIMATES GUIDANCE**

Page 6 of 6

*Three  
References to  
LIFO  
Applications...  
Deleted  
from  
Rev. Proc.  
2011-42,  
But Included  
in 2009  
Field Directive*

**#1 ... Section 4.03 - Variable Sampling Plans:****Use Estimate with Smallest Overall Standard Error ... (Page 3 of 6)**

- "Of all the final estimates determined as qualifying, the estimate with the smallest overall standard error, as an absolute value, will generally be used (i.e., the size of the estimate is irrelevant in the determination of the value to be reported). Some situations exist where only a single estimator may be appropriate for the plan objective, *such as when estimating a LIFO index, where only a ratio estimation method may be appropriate*. In those specialized situations, the relevant estimator may be evaluated without consideration of other methods."

**#2 ... Section 4.03 - Variable Sampling Plans: Specialized Situations ... (Page 3 of 6)**

- "For specialized situations, *such as when determining a LIFO index using probability sampling techniques*, the 10% test that applies to the particular sampling objective, must be appropriate for the plan, and adjusted accordingly to reflect an acceptable level of precision. *For a LIFO index the 10% test is determined by dividing the sampling error of the index by the point estimate of the index minus one, using the difference between the beginning and end of year sample unit values.*
- "Additional modifications may be necessary for other unique types of sampling plans."

**#3 ... Section 4.05 - Limitations ... (Page 5 of 6)**

- "This memorandum is not intended to supersede any formal Regulations, Rulings, or Procedures (e.g., Rev. Proc. 2007-35 and Rev. Proc. 2004-29) that address the specific application of statistical principles. It is recognized that existing industry practices and specific taxpayers may be using techniques that are not covered by this directive or other published documents. If a taxpayer has employed a probability sample or method not covered, the estimate will be referred to a Statistical Sampling Coordinator for resolution or issue development.
- "Similarly, *the application of probability sampling techniques to unique areas, like for LIFO inventory as covered earlier, may require modification of the guidelines to better fit the circumstances, and as a result should also be referred for consideration.*"

*Discussion  
Illustrating  
Computation  
of  
Adjustments  
under  
Section  
4.02(2)(c)*

- Section 4.02(2)(c) of Rev. Proc. 2011-42 provides...
  - **Taxpayer uses the least advantageous 95% one-sided confidence limit.** The estimate must be computed at the least advantageous 95% one-sided confidence limit. The "least advantageous" confidence limit is either the upper or lower limit that results in the least benefit to the taxpayer. If the relative precision for a sampling plan ... does not exceed 10%, the point estimate may be used in place of the least advantageous 95% one-sided confidence limit. When the relative precision is less than 15% and greater than 10%, the estimate will be computed as an amount between the least advantageous 95% one-sided confidence limit and the point estimate determined as follows:  

$$\text{Estimate} = \text{Point Estimate} - (\text{Relative Precision} - .10) / .05 * (\text{Point Estimate} - \text{Least Advantageous 95\% One-Sided Confidence Limit})$$
- The adjustments intended by this Section are discussed and described in the "Shop Talk" section of the *Journal of Taxation*, October 2011.
  - **Forgiveness of the sampling error "haircut" for those sampling situations where the relative precision of the estimate is 10% or better.** (According to the Procedure, "sampling error" is synonymous with "precision at the 95% one-sided confidence limit.")
    - For example, if the estimate of a benefit produced by the sample is \$1 million and the associated sampling error is \$100,000 (or less), the taxpayer may claim the full benefit of \$1 million without any reduction for sampling error. Without this provision, this taxpayer would have to reduce the potential benefit by the \$100,000 haircut, therefore realizing a net benefit of only \$900,000.
  - **"Phase-in" of the sampling error haircut when the relative precision is worse than 10%.** That is, if the sampling error in the above example exceeds \$100,000 but falls below \$150,000, the taxpayer will be allowed to "phase-in" the sampling error haircut over the range of 10% to 15%. Let's say the sampling error is \$120,000 or 12% of the \$1 million estimate; in that event, the taxpayer will be required to recognize only two-fifths of the sampling error because 12% is two-fifths of the range between 10% and 15%. The sampling error haircut would be calculated as 2/5 of \$120,000, or \$48,000, allowing the taxpayer to realize a net benefit of \$952,000.



Appendix A ... Sampling Plan Standards

*Taxpayers are required to have a written sampling plan prior to the execution of a sample.*

The plan must include the following items...

- (1) The objective of the plan including a description of what value is being estimated and for which tax year(s) the estimate is applicable,
- (2) Population definition and reconciliation of the population to the tax return,
- (3) Definition of the sampling frame,
- (4) Definition of the sampling unit,
- (5) Source of the random numbers, the starting point or seed, and the method used in selecting them,
- (6) Sample size, along with supporting factors in the determination,
- (7) Method used to associate random numbers to the frame,
- (8) Steps to be taken to insure that the serialization of the frame is carried out independent of the drawing of random numbers,
- (9) Steps to be taken in evaluating the sampling unit, and
- (10) The appraisal method(s) to be used in appraising the sample.

Appendix B ... Sampling Documentation Standards ... Sample Execution Documentation

*Taxpayers must retain adequate documentation* to support the statistical application, sample unit findings, and all aspects of the sample plan and execution.

The execution of the sample must be documented and include information for each of the following...

- (1) The seed or starting point of the random numbers,
- (2) The pairing of random numbers to the frame along with supporting information to retrace the process,
- (3) List of the sampling units selected and the results of the evaluation of each unit,
- (4) Supporting documentation which support the conclusion reached about each sample item. This would include such items as notes, invoices, purchase orders, project descriptions, etc.,
- (5) The calculation of the projected estimate(s) to the population, including the computation of the standard error of the estimate(s),
- (6) A statement as to any slips or blemishes\* in the execution of the sampling procedure and any pertinent decision rules, and
- (7) Computation of all associated adjustments.
  - An example of an associated adjustment would be the amount of depreciation allowable based on a probability determination of an amount capitalized.

*\*Comment: The term "slips or blemishes" is not defined ... It would seem to correspond with "unusual factors or complications."*



**REVENUE PROCEDURE 2011-42**

**STATISTICAL SAMPLING & SAMPLING ESTIMATES GUIDANCE**

**APPENDIX C - TECHNICAL FORMULAS ... DEFINITION OF SYMBOLS**

TERM	DEFINITION
n	Sample Size
N	Population Size
x	The value of the sampling unit that is being used as the primary variable of interest. In audit sampling, this would be the audited (or revised) value of the transaction.
y	The value of the sampling unit that is being used as the "paired" variable that is related to the variable of interest. In audit sampling, this would be the reported (or original) value of the transaction.
d	The value of the sampling unit that is the difference between "paired" variable (y) and the variable of interest (x). That is, $d = x - y$ . In audit sampling, this would be the difference (or the change) of each transaction's value.
X	The total value of the primary variable of interest. In audit sampling, this would be the estimated total audited value of the population. Typically, this value is not known for the entire population and is estimated based on the statistical sample selected.
Y	The total value of the variable that is paired with variable of interest. In audit sampling, this would be the total reported value of the population. Typically, this value is known for the entire population and may be estimated based on the statistical sample selected.
D	The total value of the difference between the "paired" variable and the variable of interest. In audit sampling, this would be the estimated total difference of the population. Typically, this value is not known for the entire population and is estimated based on the statistical sample selected.
$U_R$	The confidence coefficient which is based on either the Student's t-distribution or the normal distribution. For example, a 95% one-sided confidence coefficient based on the normal distribution is 1.645. This term is often referred to as the t-value and the z-value.





# APPENDIX C

## Technical Formulas

### UNSTRATIFIED (SIMPLE RANDOM SAMPLE) MEAN ESTIMATOR

### STRATIFIED MEAN ESTIMATOR

*Sample Mean of Audited Amounts*

$$\bar{x} = \frac{\sum x_j}{n}$$

*Estimate of Total Audited Amount*

$$\hat{X}_M = N \bar{x}$$

$$\hat{X}_{Ms} = \sum (N_i \bar{x}_i)$$

*Estimated Standard Deviation of the Audited Amount*

$$S_x = \sqrt{\frac{[\sum (x_j^2)] - n(\bar{x}^2)}{n-1}}$$

*Estimated Standard Error of the Total Audited Amount*

$$\hat{\sigma}(\hat{X}_M) = \frac{NS_x \sqrt{1 - n/N}}{\sqrt{n}}$$

$$\hat{\sigma}(\hat{X}_{Ms}) = \sqrt{\sum \left[ N_i (N_i - n_i) \frac{S_{x_i}^2}{n_i} \right]}$$

*Achieved Precision of the Total Audited Amount*

$$A'_M = \frac{NU_R S_x \sqrt{1 - n/N}}{\sqrt{n}}$$

$$A'_{Ms} = U_R \sqrt{\sum \left[ N_i (N_i - n_i) \frac{S_{x_i}^2}{n_i} \right]}$$

### UNSTRATIFIED (SIMPLE RANDOM SAMPLE) DIFFERENCE ESTIMATOR

### STRATIFIED DIFFERENCE ESTIMATOR

*Estimate of Total Difference*

$$\hat{D} = N \bar{d}$$

$$\hat{D}_s = \sum (N_i \bar{d}_i)$$

*Estimate of Total Audited Amount*

$$\hat{X}_D = Y + \hat{D}$$

$$\hat{X}_{Ds} = Y + \hat{D}_s$$

*Estimated Standard Deviation of the Difference Amount*

$$S_D = \sqrt{\frac{[\sum (d_j^2)] - n(\bar{d}^2)}{n-1}}$$

*Estimated Standard Error of the Difference Amount*

$$\hat{\sigma}(\hat{D}) = \frac{NS_D \sqrt{1 - n/N}}{\sqrt{n}}$$

$$\hat{\sigma}(\hat{D}_s) = \sqrt{\sum \left[ N_i (N_i - n_i) \frac{S_{d_i}^2}{n_i} \right]}$$

*Achieved Precision of the Difference Amount*

$$A'_D = \frac{NU_R S_D \sqrt{1 - n/N}}{\sqrt{n}}$$

$$A'_{Ds} = U_R \sqrt{\sum \left[ N_i (N_i - n_i) \frac{S_{d_i}^2}{n_i} \right]}$$

UNSTRATIFIED (SIMPLE RANDOM SAMPLE)  
RATIO ESTIMATORSTRATIFIED  
COMBINED RATIO ESTIMATOR*Estimated Ratio of Audited Amount to Recorded Amount*

$$R = \frac{\sum x_j}{\sum y_j} = 1 + \frac{\sum d_j}{\sum y_j} \quad \hat{R}_C = \frac{\sum (N_i \bar{x}_i)}{\sum (N_i \bar{y}_i)} = 1 + \frac{\sum (N_i \bar{d}_i)}{\sum (N_i \bar{y}_i)}$$

*Estimate of Total Audited Amount*

$$\hat{X}_R = Y\hat{R}$$

$$\hat{X}_{RC} = Y\hat{R}_C$$

*Estimated Standard Deviation of the Ratio*

$$S_R = \sqrt{\frac{\sum (x_j^2) + \hat{R}^2 \sum (y_j^2) - 2\hat{R} \sum (x_j y_j)}{n-1}}$$

*Estimated Standard Deviation of the Ratio in  $i^{\text{th}}$  Stratum*

$$S_{RC_i} = \sqrt{\frac{[(\sum x_{ij}^2 - (\sum x_{ij})^2 / n_i)] + [\hat{R}_C^2 (\sum y_{ij}^2 - (\sum y_{ij})^2 / n_i)] - [2\hat{R}_C (\sum x_{ij} y_{ij} - n_i \bar{x}_i \bar{y}_i)]}{n_i - 1}}$$

*Estimated Standard Error of the Ratio Amounts*

$$\hat{\sigma}(\hat{X}_R) = \frac{NS_R \sqrt{1 - n/N}}{\sqrt{n}} \quad \hat{\sigma}(\hat{X}_{RC}) = \sqrt{\sum \left[ N_i (N_i - n_i) \frac{S_{RC_i}^2}{n_i} \right]}$$

*Achieved Precision of the Ratio Amounts*

$$A'_R = \frac{NU_R S_R \sqrt{1 - n/N}}{\sqrt{n}} \quad A'_{RC} = U_R \sqrt{\sum \left[ N_i (N_i - n_i) \frac{S_{RC_i}^2}{n_i} \right]}$$

UNSTRATIFIED (SIMPLE RANDOM SAMPLE)  
REGRESSION ESTIMATORSTRATIFIED  
COMBINED REGRESSION ESTIMATOR*Estimated Regression Coefficient*

$$b = \frac{[\sum (x_j y_j)] - n \bar{x} \bar{y}}{[\sum (y_j^2)] - n \bar{y}^2} = 1 + \frac{[\sum (d_j y_j)] - n \bar{d} \bar{y}}{[\sum (y_j^2)] - n \bar{y}^2} \quad b_c = \frac{\sum N_i (N_i - n_i) S_{xyi} / n_i}{\sum N_i (N_i - n_i) S_{yi}^2 / n_i} = 1 + \frac{\sum N_i (N_i - n_i) S_{dyi} / n_i}{\sum N_i (N_i - n_i) S_{yi}^2 / n_i}$$

*Estimate of Total Audited Amount*

$$\hat{X}_G = N \bar{x} + b(Y - N \bar{y})$$

$$\hat{X}_{GC} = \sum (N_i \bar{x}_i) + b_c [Y - \sum (N_i \bar{y}_i)]$$

*Estimated Standard Deviation of the Regression Amounts*

$$S_G = \sqrt{\frac{1}{n-2} \left[ [\sum (x_j^2)] - n \bar{x}^2 - \frac{(\sum (x_j y_j) - n \bar{x} \bar{y})^2}{\sum (y_j^2) - n \bar{y}^2} \right]}$$

*Estimated Covariance between the Audited and Recorded Amounts in  $i^{\text{th}}$  Stratum*

$$S_{x_{ri}} = \frac{[\sum (x_{ij} y_{ij})] - n_i \bar{x}_i \bar{y}_i}{n_i - 1}$$

*Estimated Standard Deviation between the Audited and Recorded Amounts in  $i^{\text{th}}$  Stratum*

$$S_{GC_i} = \sqrt{S_{x_i}^2 - 2b_c S_{x_{ri}} + b_c^2 S_{y_i}^2}$$

*Estimated Standard Error of the Audited and Recorded Amounts*

$$\hat{\sigma}(\hat{X}_G) = \frac{NS_G \sqrt{1 - n/N}}{\sqrt{n}} \quad \hat{\sigma}(\hat{X}_{GC}) = \sqrt{\sum \left[ N_i (N_i - n_i) \frac{S_{GC_i}^2}{n_i} \right]}$$

*Achieved Precision of the Audited and Recorded Amounts*

$$A'_G = \frac{NU_R S_G \sqrt{1 - n/N}}{\sqrt{n}} \quad A'_{GC} = U_R \sqrt{\sum \left[ N_i (N_i - n_i) \frac{S_{GC_i}^2}{n_i} \right]}$$

**Dollar-Value LIFO**  
**Segment of Inventory Excluded from**  
**the Computation of the LIFO Index**  
**COORDINATED ISSUE PAPER (CIP) ... ALL INDUSTRIES**

**Statement of the Issue Addressed by the CIP**

Whether a LIFO index developed by double-extending one segment of the inventory can be applied to another segment of the inventory that was not double-extended.

**Facts ... Discussion of Background**

The Regulations allow a taxpayer to compute an index by double-extending a representative portion of the inventory in a pool or by the use of other sound and consistent statistical methods.

Many taxpayers attempt to shortcut the requirements of the Regulations. This is attempted by...

1. Double-extending only the large dollar items in the inventory and applying the derived index to the entire inventory,
2. Using samples that are not statistically valid and applying the derived index to the population,
3. Not including new items in the computation of their index and applying the index to the entire inventory including new items, and
4. Determining an index for one segment of the inventory (a warehouse for example) and applying that index to other segments of the inventory (its stores for example).

Because each of these methods involve the same fundamental question, they have been combined into one coordinated issue.

**Law**

*(The citation of various Regulations has been omitted from this summary)*

"... Thus, a taxpayer using the index or link-chain method may compute an index by double-extending [i.e., repricing] a representative portion of the inventory in a pool or by the use of other sound and consistent statistical methods. The index used must be appropriate to the inventory pool to which it is to be applied. The appropriateness of the method of computing the index and the accuracy, reliability, and suitability of the use of such index must be demonstrated to the satisfaction of the district director in connection with the examination of the taxpayer's income tax returns."

**[Comment:]** *At the time when this Coordinated Issue was published, the IRS had not recognized that there really are four methods for computing an inflation index. In addition to the double-extension method and the index and link-chain methods, the fourth method, more accurately described as the "link-chain, index method" was recognized by the IRS in subsequent guidance. As stated in the accompanying article, only two of the four methods (i.e., the index and the link-chain, index methods) permit a taxpayer to reprice less than all of the items in the inventory in determining an inflation index for the LIFO pool ... and one of these two methods must be specifically elected by the taxpayer on its Form 970 LIFO election filed with the IRS in the initial LIFO year.]*

*[Because the index method requires the repricing to compare current year prices with base year prices, the index method is almost always disadvantageous to LIFO taxpayers, and in the real world, most LIFO computations should elect to use the "link chain, index method."]*

*[Also note that the CIP refers to the mechanical process of repricing as "double-extending." It would far less confusing if the IRS had substituted the term "repricing" instead of using the term "double-extending" because the latter term ("double-extending") might suggest to some readers that the IRS is referring to the technical sub-election for valuing LIFO inventories which is described as the "double-extension method."]*

**Conclusion**

The LIFO index cannot be applied to a segment of inventory which was not represented when the index was computed ***unless the taxpayer can demonstrate that the index is representative of the price movements of such segment (and clearly reflects income).***



**Dollar-Value LIFO**  
**Segment of Inventory Excluded from**  
**the Computation of the LIFO Index**  
**COORDINATED ISSUE PAPER (CIP) ... ALL INDUSTRIES**

**Discussion of the Issue by the CIP**

The Regulations allow an index or link-chain taxpayer to develop an index by double-extending a "representative portion of the inventory in the pool or by the use of other sound and consistent statistical methods."

**[Comment:]** Note previous Comment indicates that the reference to "link-chain" in this sentence would be more technically accurate if it were to the "link-chain, index method."]

The use of the word "other" in the Regulations *implies* that the "representative portion" must be selected using sound and consistent statistical methods.

Those methods require that every item in the population must have an equal non-zero chance of selection. If some portion of the population has no chance of selection, defensible statistical projections cannot be made to that portion. **[Comment:]** See the accompanying article for a discussion of the reasons why many practitioners disagree with the statements in this paragraph.]

**CIP conclusion basically relies upon Tax Court's decision in *Basse v. Comm.*** In *Basse v. Commissioner* (10 T.C. 328 (1948)), the Tax Court did not allow a taxpayer to apply an index, computed without reference to a material segment of inventory, to the total inventory. Basse was a retailer using the LIFO method of valuing inventory.

Basse had a pool containing inventory at both a warehouse and a number of stores. The goods located at the warehouse were the same as the goods at the stores, but in a different ratio or mix. Basse double-extended 100 percent of the warehouse goods in order to determine an index of inflation for the year. None of the goods located at the stores were double-extended. Basse divided the end-of-year costs at the stores by the warehouse index in order to determine the beginning-of-year costs for the stores.

The Service challenged the application of Basse's warehouse index to goods located at the stores on the grounds that the flow of goods at the warehouse was different from the flow of goods at the stores, and the application of the warehouse index to the goods at the various stores would not clearly reflect income. The Court agreed with the Service on this point, holding that Basse could not use the warehouse index to compute the beginning-of-year costs of the stores' inventories.

Many taxpayers have situations similar to Basse in that they also do not double-extend a representative portion of the inventory when they compute the index for their pools.

The Tax Court based its decision in *Basse* on the fact that the evidence of record disclosed that the taxpayer failed to prove that the warehouse index applied to goods located at the stores. Taxpayers may claim that they "considered" all segments of inventory when they computed the pool index. The Regulations, however, require more than consideration. They require double-extension. The taxpayer must offer proof that the computed index is appropriate for the entire inventory. Failure to prove this will, as the Court ruled in *Basse*, prevent the application of the indexes to the inventory not double-extended.

**Burden of proving accuracy of LIFO indexes.** The taxpayer clearly has the burden of proving its LIFO index. Treasury Regulations, which are legislative Regulations, place the burden of proof directly upon the taxpayer: "The appropriateness of the method of computing the index and the accuracy, reliability, and suitability of the use of such index must be demonstrated to the satisfaction of the district director in connection with the examination of the taxpayer's income tax returns." Reg. Sec. 1.472-8(e)(1).

The Supreme Court, in *Comm. v. Houston*, 283 U.S. 223, 228 (1931), stated "The impossibility of proving a material fact upon which the right to relief depends, simply leaves the claimant upon whom the burden rests with an unenforceable claim, a misfortune to be borne by him, as it must be borne in other cases, as the result of a failure of proof."

If the taxpayer is unable to substantiate the accuracy, reliability and suitability of the LIFO index for a segment of its inventory, then the District Director has the authority to hold that the base-year cost of that inventory is equal to the current-year cost. The District Director could assume no inflation (or other assumptions that protect the Government's interest) for that segment of inventory until the taxpayer meets its burden of proof.



# SAMPLING DOCUMENTATION REPORT

## *Describing Statistical Sampling Procedures Used to Determine Inflation Index For XYZ Corp Parts Inventory Pool*

- *This Document is for discussion and/or illustration purposes only. It is an abbreviated and modified version of a Sampling Documentation Report prepared many years ago in a situation where statistical sampling was used to determine the inflation index for a parts inventory. This involved the design and execution of a stratified random sample.*
- *Report content. This Documentation Report outlines and describes the key steps that were involved in the sampling process that were accepted by the IRS in this case. It also reflects the IRS' positions (as set forth by the examining agent at that time) on the acceptability of LIFO indexes computed by using statistical sampling methods.*
- *Additional materials. In addition to the written narrative portion, a comprehensive Documentation Report package should include detailed information relating to the preliminary and final sample results (e.g., detailed index computations, statistical evaluation results), a copy of the random numbers generated, and all other supporting information.*
- *Disclaimers. (1) No attempt has been made to update or integrate this Report to reflect the IRS' positions and/or requirements as set forth in Revenue Procedure 2011-42, and (2) Although the procedures employed could have been more comprehensive or technically accurate, they were, at the time, "good enough to get by."*

### Sampling Documentation Report

#### Section #1

#### Sampling Plan

- The objective of the sample was to compute a statistically valid and reliable LIFO inflation index for XYZ Company's Parts Inventory pool by the use of "sound and consistent statistical methods." This was accomplished by designing and executing a **stratified random sample**.
- The population sampled included the total of all "AA Parts" and "BB Parts" which were in inventory at [year end].
  - ♦ An "item" was defined as the total quantity of each unique item (based on stock number) in the taxpayer's ending inventory.
- The [year end] Parts Inventory pool had an exact population size of 12,345 (i.e., there were 12,345 unique items in inventory at year-end).
- The **frame used for sampling purposes** was the inventory listing extended by stock class at [year end]. This report was 451 pages long, with no uniform number of items per page.
  - ♦ In addition to the items included in the sample (i.e., AA Parts and BB Parts), this listing included other items such as XX Parts and YY Parts; however, these other items were **not** included in the sample in any way (because they were not included in the LIFO election).
  - ♦ The sampling frame excluded all items having zero quantity on hand at the end of the year.
- XYZ Company manually counted and numbered the items in the population to be sampled (i.e., AA Parts and BB Parts) in order to determine the **exact** (versus estimated) population size.
  - ♦ Any items **not** to be sampled (e.g., XX Parts, YY Parts) were **not** included in the count.
  - ♦ In addition, blank lines and lines showing additional detail for items already counted (i.e., the second line of an item description) were not included in the population count.
  - ♦ Consequently, only valid sampling items were included in the population count.

#### Section #2

#### Stratification

- The Parts Inventory pool was stratified by dividing the pool into two segments...
  - ♦ A "high dollar stratum" which was sampled 100%, and
  - ♦ A stratum containing the remainder of the population, which was randomly sampled.
- The results of the samplings for the different strata were then combined into an overall estimate or inflation index (using a combined ratio estimator) for the entire population.
- The **purpose of stratification of the population** is twofold...
  - ♦ (1) To decrease the sampling error (i.e., "precision") without increasing the sampling size and
  - ♦ (2) To result in a more "representative" sample.
- If the population is divided into homogeneous groups, that is groups that have little variation in the characteristic being measured (i.e., the amount of inflation from beginning of the year to end of the year), then the variability of the overall estimate based on the stratified sample will be less than the overall sample based on a simple random sample of the population.
- The population was divided into 2 strata...
  - ♦ **Stratum 1.** This stratum consisted of all items in the population which had an extended dollar value of less than \$1,000.
    - The total number of items in this stratum was 12,301.
  - ♦ **Stratum 2.** This "high dollar" stratum consisted of all items with an extended dollar value of \$1,000 or greater.
    - There were 44 items in this stratum.

(continued...)





For Discussion Purposes	<p style="text-align: center;"><b>SAMPLING DOCUMENTATION REPORT</b>  <i>Describing Statistical Sampling Procedures Used to Determine Inflation Index For XYZ Corp Parts Inventory Pool</i></p> <p style="text-align: right;">Page 2 of 3</p>
<p style="text-align: center;"><b>Section #2</b>   <b>Stratification</b>  <i>(continued)</i></p>	<ul style="list-style-type: none"> <li>• In <i>Stratum 1</i>, items were sampled randomly, based on random numbers generated. <ul style="list-style-type: none"> <li>• In other words, <u>no</u> judgment was used in the selection of the individual sampling units in this stratum.</li> </ul> </li> <li>• All 44 items in the “high dollar” stratum (i.e., <i>Stratum 2</i>) were sampled and repriced, resulting in a 100% repricing in this strata.</li> <li>• The following are standard requirements for stratification of a population. <u>All</u> requirements were met: <ul style="list-style-type: none"> <li>• The population was divided into non-overlapping strata.</li> <li>• The combination of all strata included the entire population.</li> <li>• The samples selected from each strata were mutually exclusive of one another.</li> <li>• The total sample size of 150 items (excluding the 44 items in the high dollar sample) exceeded the minimum total sample size requirement of 100 items.</li> <li>• The strata sizes of 150 items and 44 items exceeded the minimum stratum size requirement of 25 items.</li> </ul> </li> <li>• The sample was a valid stratified random sample.</li> </ul>
<p style="text-align: center;"><b>Section #3</b>   <b>Source of Random Numbers</b></p>	<ul style="list-style-type: none"> <li>• One set of random numbers was generated for the Parts inventory pool in order to draw the random sample from <i>Stratum 1</i>.</li> <li>• The random starting point (seed number 49816) was chosen by the software.</li> <li>• A total of 150 random numbers within the range of 1 to 12,345 were generated for the preliminary sample.</li> </ul>
<p style="text-align: center;"><b>Section #4</b>   <b>Procedures Followed</b></p>	<ul style="list-style-type: none"> <li>• The random numbers generated were matched to the corresponding item number in the population. This was done by taking, in the order generated, each of the random numbers selected and locating the item from the ending inventory listing with the corresponding number (based on the earlier numbering which determined the exact population count). <i>These items comprised the sample.</i> <ul style="list-style-type: none"> <li>• None of the random numbers generated corresponded to an item already included in the high dollar stratum.</li> <li>• In addition, because an exact population count was taken, there were no “invalid” items included in the population.</li> <li>• Consequently, there were no instances of an invalid item being selected.</li> </ul> </li> <li>• A list of all 150 items (plus the 44 high dollar stratum items) selected for the preliminary sample was compiled.</li> <li>• XYZ Company then located beginning-of-the-year and end-of-the-year prices for each item in the sample. <ul style="list-style-type: none"> <li>• <i>Repricing of new items.</i> In any instance in which there was an item for which a beginning-of-the-year price was not available (i.e., a “new item”), the current cost of that item (i.e., end-of-the-year cost) was used as the beginning-of-the-year cost.</li> <li>• This resulted in an LIFO inflation index of 1.000 for those items.</li> </ul> </li> <li>• All items selected for the sample (150 items via random numbers + 44 “high dollar” items = 194 total items) were repriced at both beginning-of-the-year and end-of-the-year prices. <ul style="list-style-type: none"> <li>• <i>All selected items were treated consistently ... No items were omitted from the sample.</i></li> </ul> </li> <li>• Upon completion of the sample repricing, a detailed spreadsheet and data file was developed. <ul style="list-style-type: none"> <li>• This detailed spreadsheet and data file showed the following information <u>for each item</u>: (1) the random number, (2) corresponding item number, (3) item description, (4) quantity at end of year, (5) cost at the end of the year, (6) cost at the end of the preceding year (i.e., the beginning-of-the-year cost) and (7) extensions to weight the quantity of each item times its respective cost.</li> </ul> </li> <li>• The data files were then reformatted and modified for compatibility with the sample evaluation software being used.</li> <li>• All 150 items for which random numbers were generated were included in the sample and repriced.</li> <li>• The next step was to verify the files to ensure that... <ul style="list-style-type: none"> <li>• (1) The correct random numbers had been used,</li> <li>• (2) All data had been transferred from the spreadsheet to the evaluation software correctly, and</li> <li>• (3) The extended dollar amounts were calculated/weighted to correctly reflect inventory quantities.</li> </ul> </li> </ul>



**SAMPLING DOCUMENTATION REPORT**  
*Describing Statistical Sampling Procedures Used to Determine Inflation Index  
For XYZ Corp Parts Inventory Pool*

Page 3 of 3

**Section #5**

**Sample  
Evaluation**

- The sample estimate of the LIFO inflation index and corresponding precision for the preliminary sample were then calculated by using the software package, LIFO (licensed for the exclusive use of Willard J. De Filippis, CPA, P.C. by Mr. X [the software developer]).
  - ♦ Mr. X developed and tested this software, and he has developed software used by the IRS for its own sampling, as well as the programs used by the Defense Contract Audit Agency.
- The program uses a combined ratio estimate for a stratified sample.
- The precision was calculated using a 95% one-sided confidence level, as required by the *Internal Revenue Manual*.
- The *preliminary sample*, excluding the results of the 100% high dollar stratum, *results* were...
  - ♦ Inflation index .....1.0354
  - ♦ The precision of the index .....0.020
  - ♦ The coefficient of variation of the index .....0.012
- The results of the preliminary sample fell within the determined acceptable range for a preliminary sample; consequently, it was decided that no further sampling was necessary.
- The *final index*, precision and coefficient of variation were then calculated, based on all items sampled (i.e., the 44 items in the high dollar stratum and the 150 items in the remaining strata).
- The *final sample results* are as follows...
  - ♦ Sample size .....194
  - ♦ Dollars sampled .....\$93,589
  - ♦ % sampled of total dollars ..... 15%
  - ♦ Inflation index .....1.032417
  - ♦ Precision at one-sided 95% confidence level.....0.0168
  - ♦ Coefficient of variation.....0.010
- It should be understood that the IRS recognizes and requires the need for some control over the precision of a sampled LIFO index before allowing the use of the index point estimate.
  - ♦ Either a prescribed sample size, a set precision or a coefficient of variation limit has been required.
  - ♦ Failure to meet the particular standard set forth makes the sample results unacceptable to the IRS.
- *The current LIFO Regulations offer no guidelines as to the standards of accuracy which would be acceptable with regard to the precision of an estimated LIFO index.*
  - ♦ Despite this lack of guidance, there are a few official positions which deal with sampling which may offer a guide to be considered in LIFO index situations.
  - ♦ It is further understood that meeting the requirements of any of these official positions will be treated as adequate support for use of the index estimate made by the taxpayer.
- *The most commonly referenced and most relevant position is found in Revenue Procedure 64-4.*
  - ♦ Rev. Proc. 64-4 requires a sampling procedure and sample size such as to provide for a precision of about 3.5% at a 95%, one-sided confidence level.
  - ♦ If this requirement is met, the point estimate is allowed.
- XYZ Company's precision of the estimated LIFO index at a one-sided 95% confidence level is 1.68%.
  - ♦ This falls well within the requirements of Revenue Procedure 64-4.
- XYZ Company has carefully controlled the precision of the sample estimate and has met the burden of proof required in order for the point estimate to be considered an acceptable LIFO inflation index.

**Summary  
and  
Conclusion**

- No *unusual factors and/or complications* were encountered in the sampling process.
  - ♦ [If any had been encountered, they would be discussed as a separate Section #6 of this Report.]
- A valid, statistically sound random sample was used to generate a sample estimate of the LIFO inflation index for XYZ Company's Parts Inventory pool.
- This LIFO index is based on weighted quantities, and the corresponding precision and reliability calculations were computed using statistical sampling software specifically tailored to LIFO inventory applications.
- The resulting precision and reliability amounts were found to be well within IRS prescribed guidelines.
- Consequently, the sample result (i.e., the estimated LIFO index) was found to be a valid estimate of the true population LIFO inflation index.



# YEAR-END PROJECTIONS OF LIFO RESERVE CHANGES FOR AUTOMOBILE DEALERSHIPS BASED ON A "ONE-OF-EACH" MIX ASSUMPTION

Most auto dealers are under great pressure to release their year-end financial statements before their actual LIFO calculations can be completed. To assist in making year-end projections, each year we provide a listing for *new* vehicle LIFO inventories showing weighted average inflation (deflation) information for each model.

The summary table and charts are on pages 48-51. In general, based on our one-of-each new vehicle item category compilations for this year-end, we are expecting that inflation rates will be fairly flat in comparison with last year except for BMW, Chevrolet, GMC trucks, Infiniti, Lexus, Nissan and Toyota.

There is some subjective language built into the tests under the Alternative LIFO Method for determining whether or not a vehicle is a "new" item or a "continuing" item. Our one-of-each inflation indexes for each manufacturer reflect all of these factors as well as our interpretations.

Our "one-of-each item category" report compares everything in our *SUPERLIFO™* database as of December 29, 2011 ... with intro-2012 model prices, unless the 2012 intro price was subsequently updated, and that information is also in our database for the end of the year. December 1, 2010 is the reference date for the equivalent of the calendar year 2011 beginning of the year date; i.e., December 31, 2010/January 1, 2011.

The weighted averages are determined by taking all of the underlying item categories (for which information is currently available) and simplistically assuming that a dealer at year-end would have an inventory mix of one-of-each item category.

These simplified, one-of-each inflation indexes may be used in year-end projections as a substitute for some other arbitrary or assumed inflation rate (like 1%, 2% or 3%) or by some other guesswork.

**Warning & Limitations.** If you are going to use this information, please be aware of the following limitation. ... Our database is not entirely complete at this time because not all manufacturers have made their information available as we go to press.

Notwithstanding this limitation, some readers have found our one-of-each inflation indexes to be useful in estimating LIFO reserve changes or in comparing their results with ours. The detailed analyses for each make and model appear on pages 53-59.

## **Two Pools or Single Pool for New Vehicles?**

We've included information on pages 48-49 for those dealerships that have already changed, or may be considering changing, to the single, combined LIFO pool (i.e., the "Vehicle-Pool") method permitted by Revenue Procedure 2009-23.

**Reasonable Estimates.** If you're going to reflect an *estimate* of the LIFO change for the year in a year-end Income Statement, that *estimate* should be a *reasonable* estimate in order to satisfy the IRS guidance found in Revenue Ruling 97-42.

Unfortunately, no one really has any idea of what the IRS will accept as reasonable ... or reject as unreasonable. So be careful, and save your projection calculations in case the IRS ever wants to see them.

When the year-end LIFO computations are made using all of the actual year-end invoices, the results based on detailed item categories may be significantly different from the projections based on one-of-each weighted averages. Also, a dealer's beginning-of-the-year average cost for an item category may be considerably lower than the intro dealer cost used in compiling the intro-to-intro averages, and this could result in a slightly higher inflation index.

**The Best Way.** A more accurate way to project LIFO changes is to input all of the dealer's invoices on hand as of a date close to the end of the year. By doing this, a more accurate weighted model mix is factored into the year-end LIFO reserve change projection. In addition, this process also factors in the actual average beginning-of-the-year item category costs for all of the continuing models.

We will use the information on pages 48-59 in connection with many of our year-end LIFO reserve projection activities. In the December 2004 *LIFO Lookout*, we included an extensive look at how we do year-end projections including **Practice Guides** and sample formats showing ...

1. How you can come up with a LIFO projection for a new (i.e., first year) LIFO election without using special LIFO software.

2. Worksheet approach for determining a blended inflation rate to apply to an auto dealer's pool which contains multiple makes.

3. Schedule formats and correspondence that we use to summarize LIFO projection information for our clients.



MODEL/ITEM CATEGORY INFLATION SURVEY  
FOR QUICK, ONE-OF-EACH, LIFO ESTIMATES  
DEALER COST FOR THE YEAR ENDED 12/31/11

INFLATION ESTIMATE REPORT BY MAKE  
BASED ON INFORMATION AVAILABLE

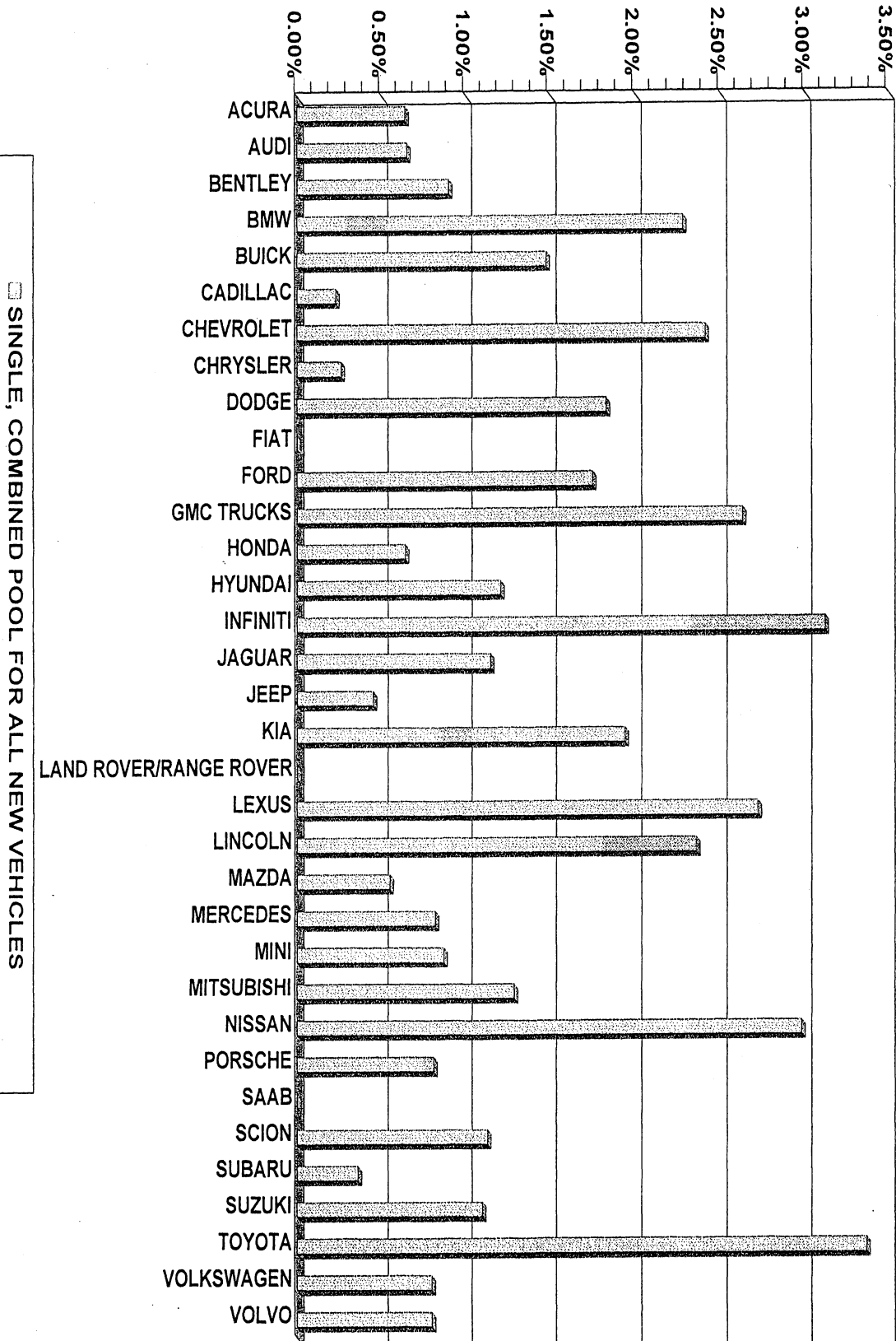
	POOL #1 NEW AUTOMOBILES	POOL #2 NEW L-D TRUCKS	ALL NEW VEHICLES COMBINED
ACURA	0.56%	0.73%	0.64%
AUDI	0.59%	1.31%	0.65%
BENTLEY	0.90%	0.00%	0.90%
BMW	1.97%	4.74%	2.28%
BUICK	1.27%	1.87%	1.48%
CADILLAC	1.78%	(0.68)%	0.23%
CHEVROLET	2.06%	2.48%	2.41%
CHRYSLER	0.20%	0.58%	0.26%
DODGE	0.99%	1.93%	1.83%
FIAT	0.00%	0.00%	0.00%
FORD	1.10%	1.83%	1.75%
GMC TRUCKS	0.00%	2.63%	2.63%
HONDA	0.51%	0.79%	0.64%
HYUNDAI	1.13%	1.37%	1.21%
INFINITI	2.76%	3.92%	3.12%
JAGUAR	1.15%	0.00%	1.15%
JEEP	0.00%	0.45%	0.45%
KIA	1.26%	2.35%	1.94%
LAND ROVER/RANGE ROVER	0.00%	0.00%	0.00%
LEXUS	2.79%	2.51%	2.72%
LINCOLN	2.80%	2.01%	2.36%
MAZDA	0.60%	0.45%	0.55%
MERCEDES	0.74%	1.09%	0.82%
MINI	0.87%	0.00%	0.87%
MITSUBISHI	1.32%	1.19%	1.29%
NISSAN	3.27%	2.89%	2.98%
PORSCHE	0.63%	3.27%	0.81%
SAAB	0.00%	0.00%	0.00%
SCION	1.13%	0.00%	1.13%
SUBARU	0.30%	0.46%	0.36%
SUZUKI	0.78%	1.68%	1.10%
TOYOTA	2.90%	3.46%	3.37%
VOLKSWAGEN	0.88%	0.00%	0.80%
VOLVO	0.72%	0.89%	0.80%

Source: De Filippis' SuperLIFO™

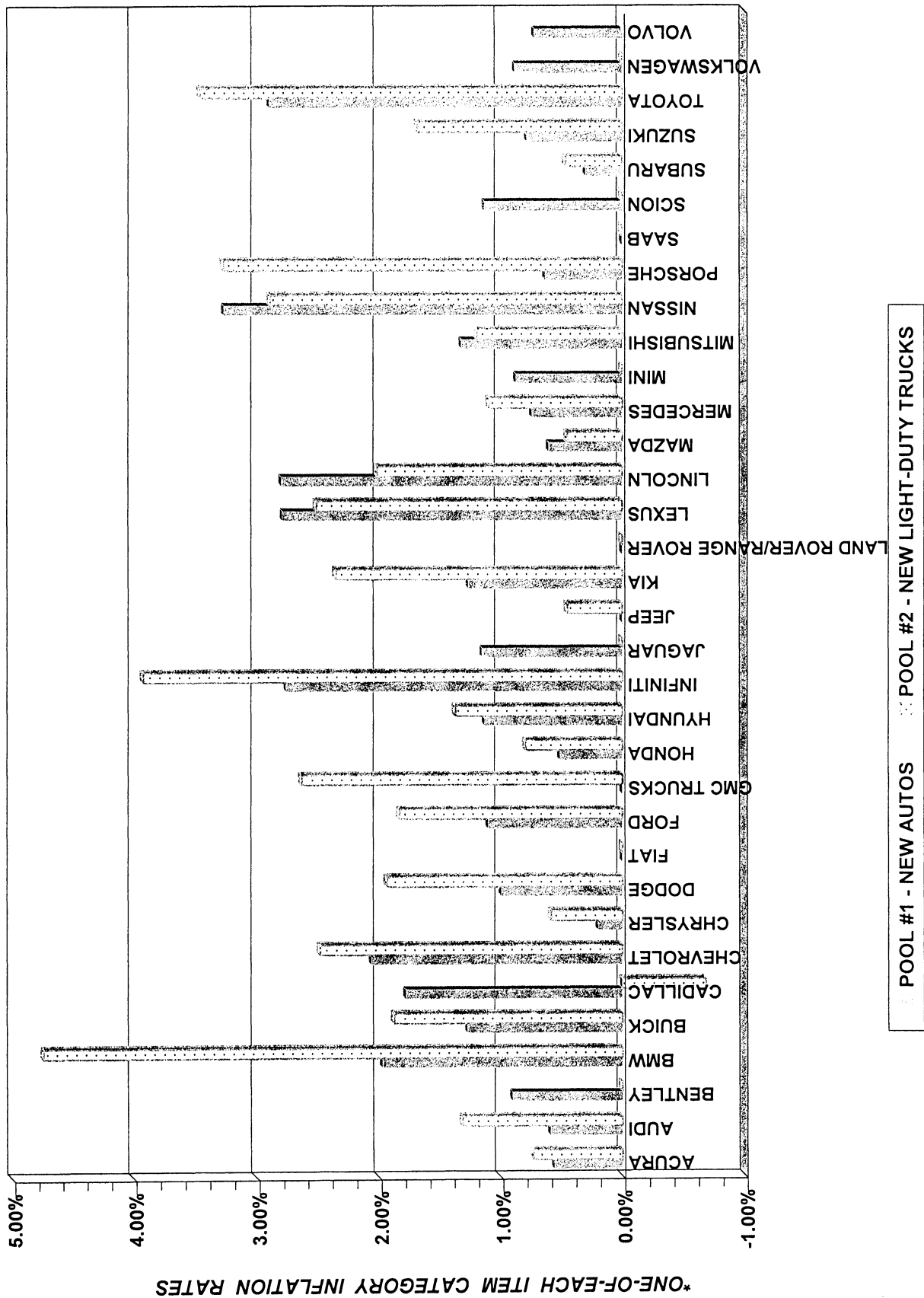




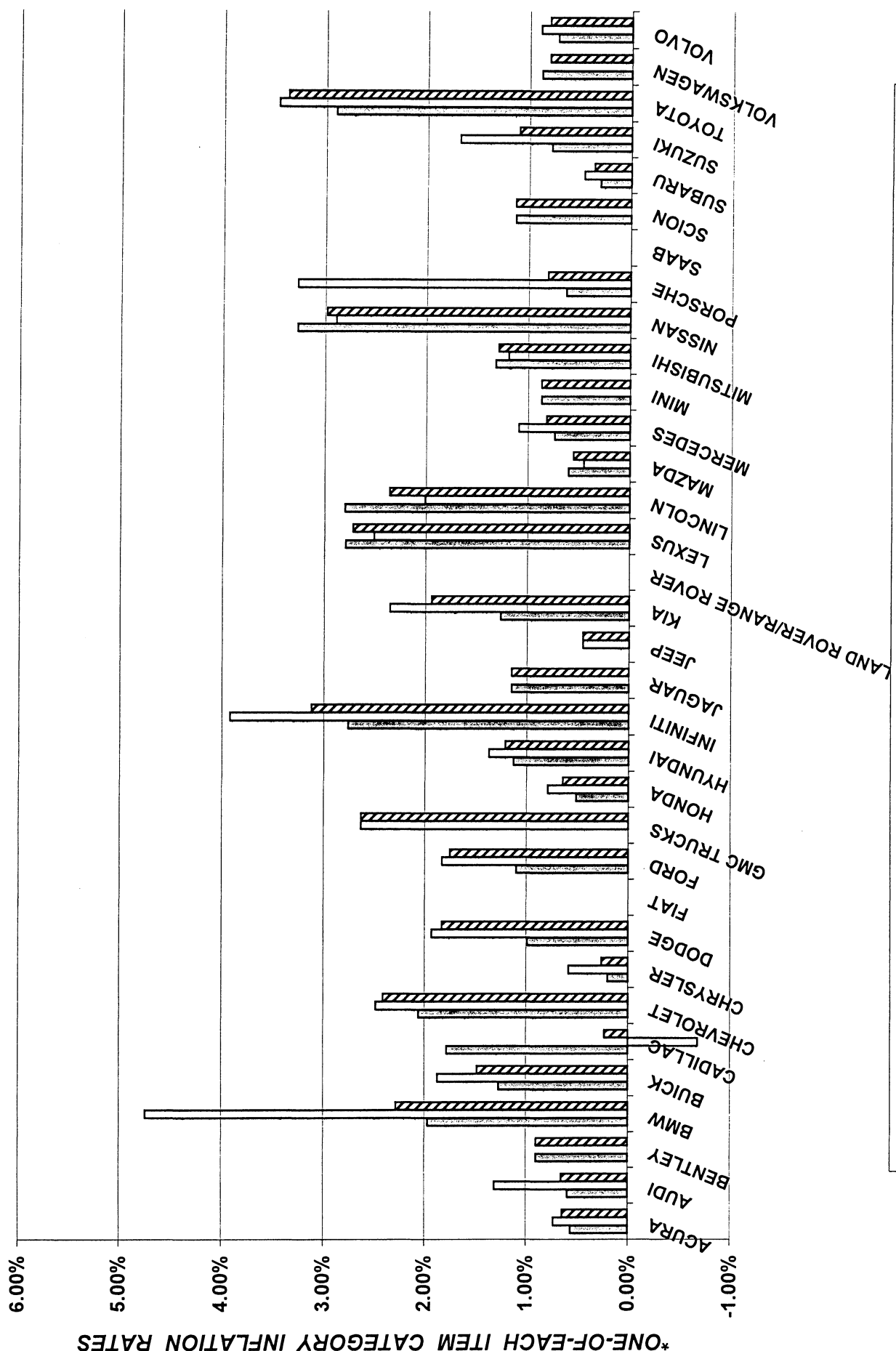
## \*ONE-OF-EACH ITEM CATEGORY INFLATION RATES



# WEIGHTED AVERAGE\* INFLATION FOR THE YEAR ENDED 12/31/11



# WEIGHTED AVERAGE\* INFLATION FOR THE YEAR ENDED 12/31/11



December \_\_, 2011

Mr./Ms. Dealer and/or CFO  
XYZ Dealership, Inc.

Dear \_\_\_\_\_:

This will summarize our discussion regarding the projected changes in your new vehicle LIFO reserves at year-end. These projections are based on certain assumptions and estimates. However, the principles underlying this analysis will not change given the estimated year-end inventory levels.

Currently, the dealership maintains separate pools for new autos and for new light-duty trucks. For purposes of our discussion, I used the anticipated inventory levels of roughly \$1,600,000 for new automobiles and \$1,700,000 for new light-duty trucks. As an estimate of inflation for the year, I used 2%. To the extent that the vehicles in ending inventory will reflect some inflation at year-end, that will work to increase the LIFO reserve for each pool.

**Pool #1.** In the LIFO pool for new automobiles, the year-end anticipated inventory level (\$1,600,000) will be greater than last year's inventory level. Accordingly, this pool will experience an increment for LIFO purposes, but this increment will not increase the amount of the LIFO reserve for 2011. The only increase in the LIFO reserve for this pool at year-end will be due to the inflation factor that is experienced by the mix of vehicles in the ending inventory.

**Pool #2.** In the new light-duty truck pool, the projected year-end inventory amount (\$1,700,000) is significantly less than the amount of last year's ending inventory. This will result in an overall decrement in this pool and (excluding the impact of inflation,) in a recapture or repayment of the LIFO reserve at year-end of *approximately \$xxx,xxx*. To simplify our discussion here, I'll omit the details of how the decrement is carried back against prior years resulting in the recapture of the LIFO reserve.

**Opportunity to use a single LIFO pool for all new vehicles.** We have previously discussed the opportunity that the dealership has to elect to use a single, combined pool for all new vehicles for its LIFO calculations. This was a change you decided not to make in previous years.

If this change to a single LIFO pool for all new vehicles were made for 2011, a portion of the overall decrement that will be experienced (in what would have been a separate pool) for new light-duty trucks would be offset against the increment that will be experienced (in what would have been a separate pool) for new automobiles.

The amount of net decrement (in the single LIFO pool that would combine new autos and trucks) would be approximately \$xxx,xxx less than if the separate LIFO pool for new light-duty trucks were maintained. This translates into the following conclusion. ***By electing to combine the new vehicle LIFO pools for 2011, the dealership would (1) limit the overall amount of LIFO recapture in that single pool to roughly \$yy,yyy and thereby (2) avoid a payback of the LIFO reserve of approximately \$zzz,zzz.***

This change in pooling is relatively easy to make and it does not require advance approval from the IRS. It can be made as part of filing the income tax return for the dealership after year-end.

**In summary.** The anticipated decrease in the year-end inventory levels is significant. This will result in the recapture of some of the LIFO reserves regardless of whether or not the LIFO pools are combined for 2011.

***However, a significant portion of this LIFO Reserve recapture (\$zzz,zzz out of \$xxx,xxx) can be avoided if the pools are combined.***

If your objective is to reduce your overall LIFO reserves, then you will not want to combine the LIFO pools (since keeping the LIFO pools separate will result in a greater LIFO payback under the separate pool approach). A second strategy for reducing your overall LIFO reserve - if that is your objective - would be to do as much as you possibly can to drop the level of inventory of new light-duty trucks at year-end. In other words, the fewer the number of light-duty truck units in ending inventory and the smaller the dollar amount of investment in that pool, the better.

On the other hand, if you want to preserve or retain the highest LIFO reserve possible, then the strategy to accomplish this goal would be to combine the two new vehicle LIFO pools for 2011.

Please call at your convenience so we can discuss this further.





PAGE: 1

DECEMBER 29, 2011

INFLATION ESTIMATE REPORT BY MAKE/MODEL/POOL  
DEALER COST FOR THE YEAR ENDED 12/31/11  
NEW ITEMS AT CURRENT COST - I.E., NO INFLATION

BODY STYLE	CONT. ITEMS	NEW ITEMS	TOTAL ITEMS	12/01/10 PRICE	NEW ITEMS	ENDING PRICE	DOLLAR CHANGE	PERCENT CHANGE
<b>ACURA</b>								
NEW AUTOS - POOL #1								
RL	3	0	3	139,253		140,599	1,346	0.97%
TL	5	2	7	184,310	80,395	266,082	1,377	0.52%
TSX	4	3	7	126,383	85,288	212,405	734	0.35%
TOTAL NEW AUTOS	12	5	17	449,946	165,683	619,086	3,457	0.56%
NEW LIGHT-DUTY TRUCKS - POOL #2								
MDX	5	0	5	223,034		224,620	1,586	0.71%
RDX	4	0	4	130,932		131,940	1,008	0.77%
ZDX	3	0	3	139,266		140,287	1,021	0.73%
TOTAL NEW L-D TRUCKS	12	0	12	493,232		496,847	3,615	0.73%
TOTAL ACURA	24	5	29	943,178	165,683	1,115,933	7,072	0.64%
<b>AUDI</b>								
NEW AUTOS - POOL #1								
A3	6	0	6	161,024		161,020	(4)	(0.00)%
A4	4	0	4	125,437		127,227	1,790	1.43%
A5	4	0	4	149,247		151,314	2,067	1.38%
A6	0	2	2		85,190	85,190	0	0.00%
A7	0	1	1		55,103	55,103	0	0.00%
A8	2	1	3	150,707	124,157	276,166	1,302	0.47%
R8	8	1	9	1,057,596	183,024	1,246,572	5,952	0.48%
S4	2	0	2	87,978		89,282	1,304	1.48%
S5	3	0	3	154,242		156,522	2,280	1.48%
TT	2	0	2	74,028		74,030	2	0.00%
TTS	2	0	2	90,210		90,210	0	0.00%
TOTAL NEW AUTOS	33	5	38	2,050,469	447,474	2,512,636	14,693	0.59%
NEW LIGHT-DUTY TRUCKS - POOL #2								
Q5	2	0	2	72,262		73,098	836	1.16%
Q7	3	0	3	144,616		146,615	1,999	1.38%
TOTAL NEW L-D TRUCKS	5	0	5	216,878		219,713	2,835	1.31%
TOTAL AUDI	38	5	43	2,267,347	447,474	2,732,349	17,528	0.65%
<b>BENTLEY</b>								
NEW AUTOS - POOL #1								
CONTINENTAL	3	2	5	605,151	437,379	1,051,923	9,393	0.90%

PAGE: 2

DECEMBER 29, 2011

INFLATION ESTIMATE REPORT BY MAKE/MODEL/POOL  
DEALER COST FOR THE YEAR ENDED 12/31/11  
NEW ITEMS AT CURRENT COST - I.E., NO INFLATION

BODY STYLE	CONT. ITEMS	NEW ITEMS	TOTAL ITEMS	12/01/10 PRICE	NEW ITEMS	ENDING PRICE	DOLLAR CHANGE	PERCENT CHANGE
<b>MULSANNE</b>								
	0	0	0				0	N/A%
TOTAL NEW AUTOS	3	2	5	605,151	437,379		9,393	0.90%
TOTAL BENTLEY	3	2	5	605,151	437,379	1,051,923	9,393	0.90%
<b>BMW</b>								
NEW AUTOS - POOL #1								
1 SERIES	4	0	4	129,400		136,740	9,340	7.22%
3 SERIES	14	0	14	549,660		568,095	18,435	3.35%
5 SERIES	9	1	10	471,180	45,080	531,755	15,495	3.00%
6 SERIES	0	6	6		467,080	467,080	0	0.00%
7 SERIES	9	2	11	877,135	164,220	1,047,875	6,520	0.63%
M3	2	0	2	115,415		118,175	2,760	2.39%
X6	3	0	3	196,790		201,665	4,875	2.48%
Z4	2	1	3	104,835	44,760	154,565	4,970	3.32%
TOTAL NEW AUTOS	43	10	53	2,444,415	721,140	3,227,950	62,395	1.97%
NEW LIGHT-DUTY TRUCKS - POOL #2								
X3	2	0	2	71,575		72,910	1,335	1.87%
X5	6	0	6	321,445		338,750	17,305	5.38%
TOTAL NEW L-D TRUCKS	8	0	8	393,020		411,660	18,640	4.74%
TOTAL BMW	51	10	61	2,837,435	721,140	3,639,610	81,035	2.28%
<b>BUICK</b>								
NEW AUTOS - POOL #1								
LA CROSSE	4	6	10	118,449	197,432	323,394	7,513	2.38%
REGAL	0	7	7		203,938	203,938	0	0.00%
VERANO	0	3	3		69,442	69,442	0	0.00%
TOTAL NEW AUTOS	4	16	20	118,449	470,812	596,774	7,513	1.27%
NEW LIGHT-DUTY TRUCKS - POOL #2								
ENCLAVE	6	2	8	226,936	73,188	305,738	5,614	1.87%
TOTAL NEW L-D TRUCKS	6	2	8	226,936	73,188	305,738	5,614	1.87%
TOTAL BUICK	10	18	28	345,385	544,000	902,512	13,127	1.48%



PAGE: 3

INFLATION ESTIMATE REPORT BY MAKE/MODEL/POOL  
DEALER COST FOR THE YEAR ENDED 12/31/11  
NEW ITEMS AT CURRENT COST - I.E., NO INFLATION

DECEMBER 29, 2011

BODY STYLE	CONT. ITEMS	NEW ITEMS	TOTAL ITEMS	12/01/10 PRICE	NEW ITEMS	ENDING PRICE	DOLLAR CHANGE	PERCENT CHANGE
<b>CADILLAC</b>								
NEW AUTOS - POOL #1								
CTS	26	0	26	1,114,168		1,133,948	19,780	1.78%
TOTAL NEW AUTOS	26	0	26	1,114,168		1,133,948	19,780	1.78%
NEW LIGHT-DUTY TRUCKS - POOL #2								
ESCALADE	23	0	23	1,598,929		1,580,598	(18,331)	(1.15)%
SRX	7	0	7	278,609		284,144	5,535	1.99%
TOTAL NEW L-D TRUCKS	30	0	30	1,877,538		1,864,742	(12,796)	(0.68)%
TOTAL CADILLAC	56	0	56	2,991,706		2,998,690	6,984	0.23%

**CHEVROLET**

NEW AUTOS - POOL #1								
CAMARO	9	0	9	266,030		275,280	9,250	3.48%
CORVETTE	6	0	6	366,787		372,750	5,963	1.63%
CRUZE	6	0	6	108,624		111,755	3,131	2.88%
IMPALA	6	0	6	148,546		154,818	6,272	4.22%
MALIBU	5	2	7	113,149	55,206	171,283	2,928	1.74%
SONIC	0	12	12		184,906	184,906	0	0.00%
VOLT	1	0	1	38,669		37,579	(1,090)	(2.82)%
TOTAL NEW AUTOS	33	14	47	1,041,805	240,112	1,308,371	26,454	2.06%
NEW LIGHT-DUTY TRUCKS - POOL #2								
AVALANCHE	6	0	6	234,420		238,931	4,511	1.92%
COLORADO	16	0	16	359,609		372,721	13,112	3.65%
COLORADO CHASSIS CAB	2	0	2	40,257		40,929	672	1.67%
EQUINOX	8	0	8	198,447		204,917	6,470	3.26%
EXPRESS CARGO VAN	14	0	14	425,772		429,335	3,563	0.84%
EXPRESS CUTAWAY VAN	6	0	6	183,020		185,726	2,706	1.48%
EXPRESS PASSENGER VAN	7	0	7	230,607		231,462	855	0.37%
SILVERADO 1500	35	0	35	1,057,216		1,089,215	31,999	3.03%
SILVERADO 2500HD	28	0	28	938,351		958,181	19,830	2.11%
SILVERADO 3500HD	38	0	38	1,316,537		1,359,866	43,329	3.29%
SILVERADO 3500HD CHASSIS CAB	12	0	12	370,780		377,415	6,635	1.79%
SUBURBAN	13	0	13	554,082		568,187	14,105	2.55%
TAHOE	9	0	9	390,314		399,715	9,401	2.41%
TRAVERSE	8	0	8	261,268		266,838	5,570	2.13%
TOTAL NEW L-D TRUCKS	202	0	202	6,560,680		6,723,438	162,758	2.48%
TOTAL CHEVROLET	235	14	249	7,602,485	240,112	8,031,809	189,212	2.41%

PAGE: 4

INFLATION ESTIMATE REPORT BY MAKE/MODEL/POOL  
DEALER COST FOR THE YEAR ENDED 12/31/11  
NEW ITEMS AT CURRENT COST - I.E., NO INFLATION

DECEMBER 29, 2011

BODY STYLE	CONT. ITEMS	NEW ITEMS	TOTAL ITEMS	12/01/10 PRICE	NEW ITEMS	ENDING PRICE	DOLLAR CHANGE	PERCENT CHANGE
<b>CHRYSLER</b>								
NEW AUTOS - POOL #1								
200	7	0	7	172,870		173,931	1,061	0.61%
300	0	10	10		352,338	352,338	0	0.00%
TOTAL NEW AUTOS	7	10	17	172,870	352,338	526,269	1,061	0.20%
NEW LIGHT-DUTY TRUCKS - POOL #2								
TOWN & COUNTRY	3	0	3	96,389		96,950	561	0.58%
TOTAL NEW L-D TRUCKS	3	0	3	96,389		96,950	561	0.58%
TOTAL CHRYSLER	10	10	20	269,259	352,338	623,219	1,622	0.26%

**DODGE**

NEW AUTOS - POOL #1								
AVENGER	2	2	4	39,425	47,760	87,160	(25)	(0.03)%
CALIBER	3	0	3	51,836		53,375	1,539	2.97%
CHALLENGER	3	0	3	92,820		95,505	2,685	2.89%
CHARGER	3	3	6	84,083	100,829	184,842	(70)	(0.04)%
TOTAL NEW AUTOS	11	5	16	268,164	148,589	420,882	4,129	0.99%
NEW LIGHT-DUTY TRUCKS - POOL #2								
DURANGO	8	0	8	271,700		271,740	40	0.01%
GRAND CARAVAN	4	0	4	105,535		104,000	(1,535)	(1.45)%
JOURNEY	7	0	7	182,807		184,396	1,589	0.87%
RAM CHASSIS CAB	0	0	0				0	N/A%
RAM PICKUP	69	12	81	2,363,240	568,142	2,998,702	67,320	2.30%
TOTAL NEW L-D TRUCKS	88	12	100	2,923,282	568,142	3,558,838	67,414	1.93%
TOTAL DODGE	99	17	116	3,191,446	716,731	3,979,720	71,543	1.83%
<b>FIAT</b>								
NEW AUTOS - POOL #1								
500	0	5	5		91,820	91,820	0	0.00%
TOTAL NEW AUTOS	0	5	5		91,820	91,820	0	0.00%
TOTAL FIAT	0	5	5		91,820	91,820	0	0.00%



PAGE: 5

INFLATION ESTIMATE REPORT BY MAKE/MODEL/POOL  
DEALER COST FOR THE YEAR ENDED 12/31/11  
NEW ITEMS AT CURRENT COST - I.E., NO INFLATION

DECEMBER 29, 2011

BODY STYLE	CONT. ITEMS	NEW ITEMS	TOTAL ITEMS	12/01/10 PRICE	NEW ITEMS	ENDING PRICE	DOLLAR CHANGE	PERCENT CHANGE
<b>FORD</b>								
NEW AUTOS - POOL #1								
CROWN VICTORIA	0	0	0				0	N/A%
FIESTA	5	1	6	73,454	13,634	88,516	1,428	1.64%
FOCUS	0	8	8		165,967	165,967	0	0.00%
FUSION	7	0	7	164,345		168,050	3,705	2.25%
MUSTANG	10	1	11	315,964	36,999	356,195	3,232	0.92%
TAURUS	6	0	6	170,598		172,618	2,020	1.18%
<b>TOTAL NEW AUTOS</b>	<b>28</b>	<b>10</b>	<b>38</b>	<b>724,361</b>	<b>216,600</b>	<b>951,346</b>	<b>10,385</b>	<b>1.10%</b>
NEW LIGHT-DUTY TRUCKS - POOL #2								
CUTAWAY	10	0	10	233,333		238,309	4,976	2.13%
E-SERIES	17	0	17	474,922		483,864	8,942	1.88%
EDGE	8	0	8	246,162		251,591	5,429	2.21%
ESCAPE	10	0	10	257,451		262,432	4,981	1.93%
EXPEDITION	8	0	8	320,276		323,804	3,528	1.10%
EXPEDITION EL	8	0	8	341,274		344,802	3,528	1.03%
EXPLORER	6	0	6	186,572		189,744	3,172	1.70%
F150 PICKUP	54	0	54	1,745,180		1,786,480	41,300	2.37%
F250 SUPER DUTY PICKUP	32	0	32	1,118,586		1,144,092	25,506	2.28%
F350 SUPER DUTY CHASSIS CAB	35	0	35	1,155,480		1,172,127	16,647	1.44%
F350 SUPER DUTY PICKUP	51	0	51	1,849,707		1,889,711	40,004	2.16%
F450 SUPER DUTY PICKUP	4	0	4	203,806		207,920	4,114	2.02%
FLEX	9	0	9	319,366		308,776	(10,590)	(3.32)%
TRANSIT CONNECT	8	0	8	165,818		171,567	5,749	3.47%
<b>TOTAL NEW L-D TRUCKS</b>	<b>260</b>	<b>0</b>	<b>260</b>	<b>8,617,933</b>		<b>8,775,219</b>	<b>157,286</b>	<b>1.83%</b>
<b>TOTAL FORD</b>	<b>288</b>	<b>10</b>	<b>298</b>	<b>9,342,294</b>	<b>216,600</b>	<b>9,726,565</b>	<b>167,671</b>	<b>1.75%</b>
<b>GMC TRUCKS</b>								
NEW LIGHT-DUTY TRUCKS - POOL #2								
ACADIA	10	0	10	364,422		370,748	6,326	1.74%
CANYON	11	3	14	234,218	80,276	332,535	18,041	5.74%
CANYON CHASSIS CAB	2	0	2	40,257		40,469	212	0.53%
SAVANA CARGO VAN	14	0	14	425,772		429,335	3,563	0.84%
SAVANA CUTAWAY VAN	6	0	6	183,020		185,726	2,706	1.48%
SAVANA PASSENGER VAN	7	0	7	230,606		231,462	856	0.37%
SIERRA 1500 SERIES PICKUP	37	0	37	1,150,173		1,185,828	35,655	3.10%
SIERRA 2500HD SERIES PICKUP	30	0	30	1,028,305		1,053,184	24,879	2.42%
SIERRA 3500HD CHASSIS CAB	12	0	12	373,059		379,693	6,634	1.78%
SIERRA 3500HD SERIES PICKUP	38	0	38	1,326,618		1,369,293	42,675	3.22%
TERRAIN	8	0	8	211,472		219,395	7,923	3.75%
YUKON	20	0	20	926,590		949,743	23,153	2.50%
<b>TOTAL NEW L-D TRUCKS</b>	<b>195</b>	<b>3</b>	<b>198</b>	<b>6,494,512</b>	<b>80,276</b>	<b>6,747,411</b>	<b>172,623</b>	<b>2.63%</b>
<b>TOTAL GMC TRUCKS</b>	<b>195</b>	<b>3</b>	<b>198</b>	<b>6,494,512</b>	<b>80,276</b>	<b>6,747,411</b>	<b>172,623</b>	<b>2.63%</b>

PAGE: 6

INFLATION ESTIMATE REPORT BY MAKE/MODEL/POOL  
DEALER COST FOR THE YEAR ENDED 12/31/11  
NEW ITEMS AT CURRENT COST - I.E., NO INFLATION

DECEMBER 29, 2011

BODY STYLE	CONT. ITEMS	NEW ITEMS	TOTAL ITEMS	12/01/10 PRICE	NEW ITEMS	ENDING PRICE	DOLLAR CHANGE	PERCENT CHANGE
<b>HONDA</b>								
NEW AUTOS - POOL #1								
ACCORD	21	0	21	506,823		510,622	3,799	0.75%
CIVIC	0	31	31		616,738	616,738	0	0.00%
CR-Z	6	0	6	119,827		121,773	1,946	1.62%
FIT	5	0	5	81,796		82,324	528	0.65%
INSIGHT	4	0	4	78,188		79,104	916	1.17%
<b>TOTAL NEW AUTOS</b>	<b>36</b>	<b>31</b>	<b>67</b>	<b>786,634</b>	<b>616,738</b>	<b>1,410,561</b>	<b>7,189</b>	<b>0.51%</b>
NEW LIGHT-DUTY TRUCKS - POOL #2								
ACCORD CROSSTOUR	5	0	5	152,050		153,451	1,401	0.92%
CR-V	0	10	10		249,748	249,748	0	0.00%
ODYSSEY	7	0	7	227,908		228,946	1,038	0.46%
PILOT	12	0	12	377,028		382,450	5,422	1.44%
RIDGELINE	4	1	5	119,412	27,180	147,858	1,266	0.86%
<b>TOTAL NEW L-D TRUCKS</b>	<b>28</b>	<b>11</b>	<b>39</b>	<b>876,398</b>	<b>276,928</b>	<b>1,162,453</b>	<b>9,127</b>	<b>0.79%</b>
<b>TOTAL HONDA</b>	<b>64</b>	<b>42</b>	<b>106</b>	<b>1,663,032</b>	<b>893,666</b>	<b>2,573,014</b>	<b>16,316</b>	<b>0.64%</b>
<b>HYUNDAI</b>								
NEW AUTOS - POOL #1								
ACCENT	0	6	6		88,125	88,125	0	0.00%
AZERA	0	0	0				0	N/A%
ELANTRA	9	0	9	156,108		158,031	1,923	1.23%
EQUUS	2	0	2	114,454		116,316	1,862	1.63%
GENESIS	11	2	13	303,113	85,168	390,805	2,524	0.65%
SONATA	8	1	9	180,047	24,383	210,015	5,585	2.73%
VELOSTER	0	6	6		103,758	103,758	0	0.00%
<b>TOTAL NEW AUTOS</b>	<b>30</b>	<b>15</b>	<b>45</b>	<b>753,722</b>	<b>301,434</b>	<b>1,067,050</b>	<b>11,894</b>	<b>1.13%</b>
NEW LIGHT-DUTY TRUCKS - POOL #2								
SANTA FE	9	0	9	227,909		229,865	1,956	0.86%
TUCSON	8	0	8	175,111		179,367	4,256	2.43%
VERACRUZ	4	0	4	120,224		121,166	942	0.78%
<b>TOTAL NEW L-D TRUCKS</b>	<b>21</b>	<b>0</b>	<b>21</b>	<b>523,244</b>		<b>530,398</b>	<b>7,154</b>	<b>1.37%</b>
<b>TOTAL HYUNDAI</b>	<b>51</b>	<b>15</b>	<b>66</b>	<b>1,276,966</b>	<b>301,434</b>	<b>1,597,448</b>	<b>19,048</b>	<b>1.21%</b>



PAGE: 7

INFLATION ESTIMATE REPORT BY MAKE/MODEL/POOL  
DEALER COST FOR THE YEAR ENDED 12/31/11  
NEW ITEMS AT CURRENT COST - I.E., NO INFLATION

DECEMBER 29, 2011

BODY STYLE	CONT. ITEMS	NEW ITEMS	TOTAL ITEMS	12/01/10 PRICE	NEW ITEMS	ENDING PRICE	DOLLAR CHANGE	PERCENT CHANGE
<b>INFINITI</b>								
NEW AUTOS - POOL #1								
G	0	0	0				0	N/A%
G25	3	0	3	90,291		94,154	3,863	4.28%
G37	13	0	13	488,378		502,906	14,528	2.97%
M	4	1	5	197,012	49,563	250,992	4,417	1.79%
TOTAL NEW AUTOS	20	1	21	775,681	49,563	848,052	22,808	2.76%
NEW LIGHT-DUTY TRUCKS - POOL #2								
EX35	4	0	4	132,854		138,779	5,925	4.46%
FX35	2	0	2	79,091		81,815	2,724	3.44%
FX50	1	0	1	52,050		54,924	2,874	5.52%
QX56	2	0	2	108,430		111,513	3,083	2.84%
TOTAL NEW L-D TRUCKS	9	0	9	372,425		387,031	14,606	3.92%
TOTAL INFINITI	29	1	30	1,148,106	49,563	1,235,063	37,414	3.12%
<b>JAGUAR</b>								
NEW AUTOS - POOL #1								
XF	0	0	0				0	N/A%
XJ	6	0	6	504,068		509,864	5,796	1.15%
XK	0	0	0				0	N/A%
TOTAL NEW AUTOS	6	0	6	504,068			5,796	1.15%
TOTAL JAGUAR	6	0	6	504,068		509,864	5,796	1.15%
<b>JEEP</b>								
NEW LIGHT-DUTY TRUCKS - POOL #2								
COMPASS	4	2	6	87,941	43,639	131,693	113	0.09%
GRAND CHEROKEE	6	1	7	206,778	51,968	256,528	(2,218)	(0.86)%
LIBERTY	4	2	6	99,766	53,594	153,728	368	0.24%
PATRIOT	4	2	6	78,252	41,088	121,351	2,011	1.69%
WRANGLER	7	0	7	186,467		189,987	3,520	1.89%
TOTAL NEW L-D TRUCKS	25	7	32	659,204	190,289	853,287	3,794	0.45%
TOTAL JEEP	25	7	32	659,204	190,289	853,287	3,794	0.45%

PAGE: 8

INFLATION ESTIMATE REPORT BY MAKE/MODEL/POOL  
DEALER COST FOR THE YEAR ENDED 12/31/11  
NEW ITEMS AT CURRENT COST - I.E., NO INFLATION

DECEMBER 29, 2011

BODY STYLE	CONT. ITEMS	NEW ITEMS	TOTAL ITEMS	12/01/10 PRICE	NEW ITEMS	ENDING PRICE	DOLLAR CHANGE	PERCENT CHANGE
<b>KIA</b>								
NEW AUTOS - POOL #1								
FORTE	10	0	10	170,140		171,730	1,590	0.93%
OPTIMA	5	0	5	106,410		109,050	2,640	2.48%
RIO	0	4	4		60,155	60,155	0	0.00%
TOTAL NEW AUTOS	15	4	19	276,550	60,155	340,935	4,230	1.26%
NEW LIGHT-DUTY TRUCKS - POOL #2								
SEDONA	2	0	2	51,145		51,145	0	0.00%
SORENTO	11	0	11	280,895		286,490	5,595	1.99%
SOUL	4	1	5	61,300	15,100	79,650	3,250	4.25%
SPORTAGE	7	0	7	153,290		157,655	4,365	2.85%
TOTAL NEW L-D TRUCKS	24	1	25	546,630	15,100	574,940	13,210	2.35%
TOTAL KIA	39	5	44	823,180	75,255	915,875	17,440	1.94%
<b>LAND ROVER/RANGE ROVER</b>								
NEW LIGHT-DUTY TRUCKS - POOL #2								
LAND ROVER LR2	0	0	0				0	N/A%
LAND ROVER LR4	0	0	0				0	N/A%
RANGE ROVER	0	0	0				0	N/A%
TOTAL NEW L-D TRUCKS	0	0	0				0	N/A%
TOTAL LAND ROVER/RANGE ROVER	0	0	0				0	0.00%
<b>LEXUS</b>								
NEW AUTOS - POOL #1								
CT	0	2	2		56,084	56,084	0	0.00%
ES	1	0	1	32,209		33,299	1,090	3.38%
GS	4	0	4	185,185		188,511	3,326	1.80%
HS	2	0	2	66,402		69,916	3,514	5.29%
IS	8	0	8	276,401		286,450	10,049	3.64%
IS F	1	0	1	53,108		55,170	2,062	3.88%
LS	5	0	5	344,619		352,860	8,241	2.39%
TOTAL NEW AUTOS	21	2	23	957,924	56,084	1,042,290	28,282	2.79%
NEW LIGHT-DUTY TRUCKS - POOL #2								
GX	2	0	2	97,438		99,042	1,604	1.65%
LX	1	0	1	69,201		69,913	712	1.03%
RX	4	0	4	150,131		155,768	5,637	3.75%
TOTAL NEW L-D TRUCKS	7	0	7	316,770		324,723	7,953	2.51%
TOTAL LEXUS	28	2	30	1,274,694	56,084	1,367,013	36,235	2.72%

INFLATION ESTIMATE REPORT BY MAKE/MODEL/POOL  
DEALER COST FOR THE YEAR ENDED 12/31/11  
NEW ITEMS AT CURRENT COST - I.E., NO INFLATION

DECEMBER 29, 2011

BODY STYLE	CONT. ITEMS	NEW ITEMS	TOTAL ITEMS	12/01/10 PRICE	NEW ITEMS	ENDING PRICE	DOLLAR CHANGE	PERCENT CHANGE
<b>LINCOLN</b>								
NEW AUTOS - POOL #1								
MKS	3	0	3	122,106		125,271	3,165	2.59%
MKZ	3	0	3	96,567		99,483	2,916	3.02%
TOWN CAR	2	0	2	91,389		93,982	2,593	2.84%
<b>TOTAL NEW AUTOS</b>	<b>8</b>	<b>0</b>	<b>8</b>	<b>310,062</b>		<b>318,736</b>	<b>8,674</b>	<b>2.80%</b>
NEW LIGHT-DUTY TRUCKS - POOL #2								
MKT	2	0	2	87,816		86,993	(823)	(0.94)%
MKX	2	0	2	73,887		75,882	1,995	2.70%
NAVIGATOR	4	0	4	219,714		226,214	6,500	2.96%
<b>TOTAL NEW L-D TRUCKS</b>	<b>8</b>	<b>0</b>	<b>8</b>	<b>381,417</b>		<b>389,089</b>	<b>7,672</b>	<b>2.01%</b>
<b>TOTAL LINCOLN</b>	<b>16</b>	<b>0</b>	<b>16</b>	<b>691,479</b>		<b>707,825</b>	<b>16,346</b>	<b>2.36%</b>
<b>MAZDA</b>								
NEW AUTOS - POOL #1								
MAZDA2	4	0	4	60,423		60,423	0	0.00%
MAZDA3	10	8	18	190,530	160,741	353,669	2,398	0.68%
MAZDA6	7	0	7	158,131		159,745	1,614	1.02%
MIATA MX-5	10	1	11	248,527	23,550	273,137	1,060	0.39%
<b>TOTAL NEW AUTOS</b>	<b>31</b>	<b>9</b>	<b>40</b>	<b>657,611</b>	<b>184,291</b>	<b>846,974</b>	<b>5,072</b>	<b>0.60%</b>
NEW LIGHT-DUTY TRUCKS - POOL #2								
CX-7	7	0	7	179,296		179,296	0	0.00%
CX-9	6	0	6	176,740		178,135	1,395	0.79%
MAZDA5	4	0	4	79,085		79,650	565	0.70%
<b>TOTAL NEW L-D TRUCKS</b>	<b>17</b>	<b>0</b>	<b>17</b>	<b>435,131</b>		<b>437,081</b>	<b>1,950</b>	<b>0.45%</b>
<b>TOTAL MAZDA</b>	<b>48</b>	<b>9</b>	<b>57</b>	<b>1,092,742</b>	<b>184,291</b>	<b>1,284,055</b>	<b>7,022</b>	<b>0.55%</b>
<b>MERCEDES</b>								
NEW AUTOS - POOL #1								
C CLASS	4	5	9	162,930	196,268	359,907	709	0.20%
CL CLASS	4	0	4	586,121		590,829	4,708	0.80%
CLS CLASS	0	3	3		223,200	223,200	0	0.00%
E CLASS	10	1	11	546,876	85,095	633,723	1,752	0.28%
S CLASS	6	1	7	730,826	86,072	824,074	7,176	0.88%
SL CLASS	2	0	2	225,735		227,003	1,268	0.56%
SLK CLASS	1	0	1	50,069		50,964	895	1.79%
SLS CLASS	1	0	1	170,190		176,328	6,138	3.61%
<b>TOTAL NEW AUTOS</b>	<b>28</b>	<b>10</b>	<b>38</b>	<b>2,472,747</b>	<b>590,635</b>	<b>3,086,028</b>	<b>22,646</b>	<b>0.74%</b>

INFLATION ESTIMATE REPORT BY MAKE/MODEL/POOL  
DEALER COST FOR THE YEAR ENDED 12/31/11  
NEW ITEMS AT CURRENT COST - I.E., NO INFLATION

DECEMBER 29, 2011

BODY STYLE	CONT. ITEMS	NEW ITEMS	TOTAL ITEMS	12/01/10 PRICE	NEW ITEMS	ENDING PRICE	DOLLAR CHANGE	PERCENT CHANGE
<b>NEW LIGHT-DUTY TRUCKS - POOL #2</b>								
G CLASS	1	0	1	98,348		99,603	1,255	1.28%
GL CLASS	3	0	3	193,837		194,779	942	0.49%
GLK CLASS	2	0	2	68,390		68,596	206	0.30%
M CLASS	0	2	2		92,517	92,517	0	0.00%
R CLASS	2	0	2	95,341		99,073	3,732	3.91%
SPRINTER	9	0	9	344,878		348,455	3,577	1.04%
<b>TOTAL NEW L-D TRUCKS</b>	<b>17</b>	<b>2</b>	<b>19</b>	<b>800,794</b>	<b>92,517</b>	<b>903,023</b>	<b>9,712</b>	<b>1.09%</b>
<b>TOTAL MERCEDES</b>	<b>45</b>	<b>12</b>	<b>57</b>	<b>3,273,541</b>	<b>683,152</b>	<b>3,989,051</b>	<b>32,358</b>	<b>0.82%</b>
<b>MINI</b>								
NEW AUTOS - POOL #1								
COOPER	12	0	12	279,579		282,003	2,424	0.87%
<b>TOTAL NEW AUTOS</b>	<b>12</b>	<b>0</b>	<b>12</b>	<b>279,579</b>		<b>282,003</b>	<b>2,424</b>	<b>0.87%</b>
<b>TOTAL MINI</b>	<b>12</b>	<b>0</b>	<b>12</b>	<b>279,579</b>		<b>282,003</b>	<b>2,424</b>	<b>0.87%</b>
<b>MITSUBISHI</b>								
NEW AUTOS - POOL #1								
ECLIPSE	6	2	8	145,893	50,762	199,038	2,383	1.21%
GALANT	2	0	2	43,673		44,248	575	1.32%
H-MEV	0	2	2		58,955	58,955	0	0.00%
LANCER	9	1	10	190,843	19,342	213,968	3,783	1.80%
<b>TOTAL NEW AUTOS</b>	<b>17</b>	<b>5</b>	<b>22</b>	<b>380,409</b>	<b>129,059</b>	<b>516,209</b>	<b>6,741</b>	<b>1.32%</b>
NEW LIGHT-DUTY TRUCKS - POOL #2								
OUTLANDER	5	0	5	117,878		119,077	1,199	1.02%
OUTLANDER SPORT	4	0	4	79,190		80,337	1,147	1.45%
<b>TOTAL NEW L-D TRUCKS</b>	<b>9</b>	<b>0</b>	<b>9</b>	<b>197,068</b>		<b>199,414</b>	<b>2,346</b>	<b>1.19%</b>
<b>TOTAL MITSUBISHI</b>	<b>26</b>	<b>5</b>	<b>31</b>	<b>577,477</b>	<b>129,059</b>	<b>715,623</b>	<b>9,087</b>	<b>1.29%</b>
<b>NISSAN</b>								
NEW AUTOS - POOL #1								
370Z	8	0	8	275,702		282,388	6,686	2.43%
ALTIMA	7	0	7	159,798		163,848	4,050	2.53%
GT-R	0	0	0				0	N/A%
LEAF	2	0	2	63,687		69,375	5,688	8.93%
MAXIMA	2	0	2	58,931		60,814	1,883	3.20%
SENTRA	7	0	7	118,035		121,578	3,543	3.00%
VERSA	3	4	7	43,354	51,990	98,721	3,377	3.54%
<b>TOTAL NEW AUTOS</b>	<b>29</b>	<b>4</b>	<b>33</b>	<b>719,507</b>	<b>51,990</b>	<b>796,724</b>	<b>25,227</b>	<b>3.27%</b>



PAGE: 11

INFLATION ESTIMATE REPORT BY MAKE/MODEL/POOL  
DEALER COST FOR THE YEAR ENDED 12/31/11  
NEW ITEMS AT CURRENT COST - I.E., NO INFLATION

DECEMBER 29, 2011

BODY STYLE	CONT. ITEMS	NEW ITEMS	TOTAL ITEMS	12/01/10 PRICE	NEW ITEMS	ENDING PRICE	DOLLAR CHANGE	PERCENT CHANGE
NEW LIGHT-DUTY TRUCKS - POOL #2								
ARMADA	6	0	6	248,389		255,007	6,618	2.66%
CUBE	5	0	5	80,476		84,496	4,020	5.00%
FRONTIER PICKUP	26	0	26	611,854		630,135	18,281	2.99%
JUKE	8	0	8	164,076		170,780	6,704	4.09%
MURANO	8	1	9	251,634	41,009	298,990	6,347	2.17%
NV	0	0	0				0	N/A%
PATHFINDER	9	0	9	292,171		300,053	7,882	2.70%
QUEST	0	4	4		124,098	124,098	0	0.00%
ROGUE	6	0	6	132,884		141,470	8,586	6.46%
TITAN	14	0	14	413,903		425,165	11,262	2.72%
XTERRA	7	0	7	178,920		182,584	3,664	2.05%
TOTAL NEW L-D TRUCKS	89	5	94	2,374,307	165,107	2,612,778	73,364	2.89%
TOTAL NISSAN	118	9	127	3,093,814	217,097	3,409,502	98,591	2.98%
PORSCHÉ								
NEW AUTOS - POOL #1								
911	14	13	27	1,396,440	1,590,121	3,006,121	19,560	0.65%
BOXSTER	3	1	4	149,580	58,500	209,610	1,530	0.74%
CAYMAN	2	2	4	101,250	120,060	222,300	990	0.45%
PANAMERA	5	2	7	424,890	241,020	669,600	3,690	0.55%
TOTAL NEW AUTOS	24	18	42	2,072,160	2,009,701	4,107,631	25,770	0.63%
NEW LIGHT-DUTY TRUCKS - POOL #2								
CAYENNE	5	0	5	295,740		305,400	9,660	3.27%
TOTAL NEW L-D TRUCKS	5	0	5	295,740		305,400	9,660	3.27%
TOTAL PORSCHÉ	29	18	47	2,367,900	2,009,701	4,413,031	35,430	0.81%
SAAB								
NEW AUTOS - POOL #1								
9-3	0	0	0				0	N/A%
9-5	0	0	0				0	N/A%
TOTAL NEW AUTOS	0	0	0				0	N/A%
NEW LIGHT-DUTY TRUCKS - POOL #2								
9-4X	0	0	0				0	N/A%
TOTAL NEW L-D TRUCKS	0	0	0				0	N/A%
TOTAL SAAB	0	0	0				0	0.00%

PAGE: 12

INFLATION ESTIMATE REPORT BY MAKE/MODEL/POOL  
DEALER COST FOR THE YEAR ENDED 12/31/11  
NEW ITEMS AT CURRENT COST - I.E., NO INFLATION

DECEMBER 29, 2011

BODY STYLE	CONT. ITEMS	NEW ITEMS	TOTAL ITEMS	12/01/10 PRICE	NEW ITEMS	ENDING PRICE	DOLLAR CHANGE	PERCENT CHANGE
SCION								
NEW AUTOS - POOL #1								
IQ	0	1	1		14,501	14,501	0	0.00%
TC	2	2	4	35,672	40,672	76,914	570	0.75%
XB	2	0	2	31,302		31,872	570	1.82%
XD	2	0	2	29,344		29,914	570	1.94%
TOTAL NEW AUTOS	6	3	9	96,318	55,173	153,201	1,710	1.13%
TOTAL SCION	6	3	9	96,318	55,173	153,201	1,710	1.13%
SUBARU								
NEW AUTOS - POOL #1								
IMPREZA	9	26	35	257,040	496,827	754,705	838	0.11%
LEGACY	12	0	12	272,306		274,513	2,207	0.81%
TOTAL NEW AUTOS	21	26	47	529,346	496,827	1,029,218	3,045	0.30%
NEW LIGHT-DUTY TRUCKS - POOL #2								
FORESTER	14	0	14	326,312		327,046	734	0.22%
OUTBACK	13	0	13	321,711		324,100	2,389	0.74%
TRIBECA	3	0	3	92,811		93,067	276	0.30%
TOTAL NEW L-D TRUCKS	30	0	30	740,834		744,233	3,399	0.46%
TOTAL SUBARU	51	26	77	1,270,180	496,827	1,773,451	6,444	0.36%
SUZUKI								
NEW AUTOS - POOL #1								
KIZASHI	11	4	15	246,569	98,780	347,937	2,588	0.75%
SX4	7	4	11	112,118	70,844	184,476	1,514	0.83%
TOTAL NEW AUTOS	18	8	26	358,687	169,624	532,413	4,102	0.78%
NEW LIGHT-DUTY TRUCKS - POOL #2								
EQUATOR	6	0	6	141,988		144,925	2,937	2.07%
GRAND VITARA	5	2	7	106,267	44,398	152,633	1,988	1.31%
TOTAL NEW L-D TRUCKS	11	2	13	248,255	44,398	297,558	4,905	1.68%
TOTAL SUZUKI	29	10	39	606,942	214,022	829,971	9,007	1.10%



PAGE: 13

INFLATION ESTIMATE REPORT BY MAKE/MODEL/POOL  
DEALER COST FOR THE YEAR ENDED 12/31/11  
NEW ITEMS AT CURRENT COST - I.E., NO INFLATION

DECEMBER 29, 2011

BODY STYLE	CONT. ITEMS	NEW ITEMS	TOTAL ITEMS	12/01/10 PRICE	NEW ITEMS	ENDING PRICE	DOLLAR CHANGE	PERCENT CHANGE
<b>TOYOTA</b>								
NEW AUTOS - POOL #1								
AVALON	2	0	2	60,631		62,668	2,037	3.36%
CAMRY	6	2	8	134,066	49,037	184,547	1,444	0.79%
COROLLA	5	0	5	76,045		82,133	6,088	8.01%
MATRIX	5	0	5	86,263		93,793	7,530	8.73%
PRIUS V	0	3	3		77,784	77,784	0	0.00%
YARIS	0	7	7		105,039	105,039	0	0.00%
<b>TOTAL NEW AUTOS</b>	<b>18</b>	<b>12</b>	<b>30</b>	<b>357,005</b>	<b>231,860</b>	<b>605,964</b>	<b>17,099</b>	<b>2.90%</b>
NEW LIGHT-DUTY TRUCKS - POOL #2								
4RUNNER	5	0	5	158,271		165,511	7,240	4.57%
FJ CRUISER	3	0	3	72,343		75,089	2,746	3.80%
HIGHLANDER	10	0	10	304,783		314,840	10,057	3.30%
LAND CRUISER	1	0	1	59,821		61,862	2,241	3.76%
RAV4	12	0	12	280,048		288,565	8,517	3.04%
SEQUOIA	11	0	11	487,439		507,747	20,308	4.17%
SIENNA	12	0	12	354,241		367,355	13,114	3.70%
TACOMA PICKUP	20	0	20	423,147		432,335	9,188	2.17%
TUNDRA	28	0	28	806,582		835,019	28,437	3.53%
VENZA	4	0	4	101,474		104,977	3,503	3.45%
<b>TOTAL NEW L-D TRUCKS</b>	<b>106</b>	<b>0</b>	<b>106</b>	<b>3,047,949</b>		<b>3,153,300</b>	<b>105,351</b>	<b>3.46%</b>
<b>TOTAL TOYOTA</b>	<b>124</b>	<b>12</b>	<b>136</b>	<b>3,404,954</b>	<b>231,860</b>	<b>3,759,264</b>	<b>122,450</b>	<b>3.37%</b>
<b>VOLKSWAGEN</b>								
NEW AUTOS - POOL #1								
BEETLE	0	28	28		649,888	649,888	0	0.00%
CC	16	0	16	494,762		499,614	4,852	0.98%
EOS	0	3	3		104,157	104,157	0	0.00%
GOLF	10	24	34	199,794	580,934	786,752	6,024	0.77%
GTI	32	0	32	832,592		848,402	15,810	1.90%
JETTA	30	12	42	586,436	285,677	896,346	14,233	1.61%
JETTA GLI	0	12	12		296,196	296,196	0	0.00%
PASSAT	0	23	23		586,922	586,922	0	0.00%
<b>TOTAL NEW AUTOS</b>	<b>88</b>	<b>102</b>	<b>190</b>	<b>2,123,584</b>	<b>2,503,774</b>	<b>4,668,277</b>	<b>40,919</b>	<b>0.88%</b>
NEW LIGHT-DUTY TRUCKS - POOL #2								
ROUTAN	0	0	0				0	N/A%
TIGUAN	0	14	14		400,989	400,989	0	0.00%
TOUAREG	0	2	2		88,910	88,910	0	0.00%
<b>TOTAL NEW L-D TRUCKS</b>	<b>0</b>	<b>16</b>	<b>16</b>		<b>489,899</b>	<b>489,899</b>	<b>0</b>	<b>0.00%</b>
<b>TOTAL VOLKSWAGEN</b>	<b>88</b>	<b>118</b>	<b>206</b>	<b>2,123,584</b>	<b>2,993,673</b>	<b>5,158,176</b>	<b>40,919</b>	<b>0.80%</b>

PAGE: 14

INFLATION ESTIMATE REPORT BY MAKE/MODEL/POOL  
DEALER COST FOR THE YEAR ENDED 12/31/11  
NEW ITEMS AT CURRENT COST - I.E., NO INFLATION

DECEMBER 29, 2011

BODY STYLE	CONT. ITEMS	NEW ITEMS	TOTAL ITEMS	12/01/10 PRICE	NEW ITEMS	ENDING PRICE	DOLLAR CHANGE	PERCENT CHANGE
<b>VOLVO</b>								
NEW AUTOS - POOL #1								
30 SERIES	2	4	6	48,457	110,544	159,800	799	0.50%
70 SERIES	4	7	11	135,313	267,148	404,999	2,538	0.63%
S80	2	1	3	64,555	40,373	105,938	1,010	0.96%
S80	2	4	6	72,991	159,048	234,154	2,115	0.91%
<b>TOTAL NEW AUTOS</b>	<b>10</b>	<b>16</b>	<b>26</b>	<b>321,316</b>	<b>577,113</b>	<b>904,891</b>	<b>6,462</b>	<b>0.72%</b>
NEW LIGHT-DUTY TRUCKS - POOL #2								
XC60	6	7	13	211,359	274,762	491,479	5,358	1.10%
XC90	4	4	8	150,766	157,732	310,200	1,702	0.55%
<b>TOTAL NEW L-D TRUCKS</b>	<b>10</b>	<b>11</b>	<b>21</b>	<b>362,125</b>	<b>432,494</b>	<b>801,679</b>	<b>7,060</b>	<b>0.89%</b>
<b>TOTAL VOLVO</b>	<b>20</b>	<b>27</b>	<b>47</b>	<b>683,441</b>	<b>1,009,607</b>	<b>1,706,570</b>	<b>13,522</b>	<b>0.80%</b>

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