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December 16, 2020

Hon. Charles P. Rettig
Commissioner
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

Hon. David Kautter
Assistant Secretary (Tax Policy)
Department of the Treasury
1500 Pennsylvania Ave., NW, Room 3120
Washington, DC 20220

Hon. Michael J. Desmond
Chief Counsel
Internal Revenue Service
1111 Constitution Ave., NW, Room 5408
Washington, DC 20224

Re: Request for Limited Tax Relief for Businesses Using Dollar-Value LIFO Methods to Value Inventories And Suggested Framework for Implementing Relief

Gentlemen:

Virtually every taxpayer doing business in the United States has suffered significant losses and interruptions due to the outbreak of the Coronavirus Disease (Covid-19) in March this year. For many, the devastating impact has steadily increased throughout the year, and it has become a disaster of nearly Biblical proportions. This was recognized when, in March, the President issued *Proclamation 9994* declaring that the Coronavirus disease (Covid-19) outbreak in the United States constitutes a National Emergency.[1]

On top of that, throughout the year, taxpayers in many areas have also suffered losses and significant business interruptions resulting from devastating hurricanes, floods and forest fires – further compounding their inability to carry on normal business operations and maintain ordinary and necessary desired inventory levels.

Many taxpayers identify the flow of goods through their inventories using the Last-In, First-Out (LIFO) assumption, and because of the complexity of their businesses, they have elected to compute the overall valuation of their inventories using Dollar-Value (LIFO) methods which the Regulations under Section 472 permit.[2]

(continued)

Due to the events above, when these taxpayers apply Dollar-Value LIFO methods to value their lower inventory levels at year-end, many will experience unforeseen adverse results because they will realize "paper profits" on which income taxes are payable. At the same time, these taxpayers have experienced reduced sales and profits while fixed overhead costs remained disproportionately high … a truly severe situation, created by economic conditions far beyond anyone's ability to control or successfully mitigate.

Accordingly, I am writing to request that Treasury and the IRS provide temporary relief for these taxpayers, with that relief to be effective for years ending on or after February 28, 2020. In support of this request, I am submitting a set of recommendations which could be adopted … or modified … to provide a framework for that relief. The accompanying case study – consisting of five sets of scenarios – shows the details for a model to achieve that relief. The application of these results and recommendations would be consistent with the underlying principles inherent in the Dollar-Value method LIFO Regulations.[3]

Contents

Recommendations

1. Amend Section 473 – *Qualified Liquidation of LIFO Inventories* – by adding a new Subsection. This Subsection would free taxpayers from the burdens of having to prove themselves entitled to relief. This will considerably lessen otherwise substantial administrative oversight burdens for the Treasury and the Internal Revenue Service.

2. ***Alternative Dollar-Value LIFO Method.*** Allow taxpayers to (elect to) use a substitute or surrogate historical cost level in determining the LIFO valuations of their inventories at the end of 2020. This historical cost level will continue to be reflected in each year in the succeeding 3-year (recovery) period … 2021, 2022 and 2023.

   This substitute inventory level would be determined by reference to the 3-year average historical cost level as of the end of the pre-liquidation year (i.e., determined as of Dec. 31, 2019 or other corresponding fiscal years ending in 2019).

3. ***Defer adjustment of the LIFO reserve for the pre-liquidation year until the end of the suspension period.*** Treat the 4-year period which includes the liquidation year (i.e., calendar year 2020) and the 3 years thereafter (i.e., 2021, 2022 and 2023) as a 4-year "suspension period." At the end of each year during the suspension period (2020-2024), taxpayers would compute their year-end inventory LIFO valuations based upon the historical average amount as a substitute for the actual cost amount in their 2020 LIFO valuation calculations.

   The net changes in the LIFO reserves that are computed at the end of 2020, 2021 and 2022 would be held "in suspense" (via Schedule M adjustments) and not given effect until the end of the fourth year (i.e., Dec. 31, 2023). At the end of the last year in the suspension period (i.e., Dec. 31, 2023), the taxpayer would make a single, lump-sum adjustment to increase or decrease the LIFO valuation of the inventory at the end of the pre-liquidation year (i.e., the balance as of Dec. 31, 2019) to the amount computed as the LIFO valuation of the taxpayer's inventory as of Dec. 31, 2023.

4. Require taxpayers who elect relief to include in their tax returns evidence confirming (1) their compliance with the requirements of Section 472 to use the LIFO method and (2) the overall reasonableness of their LIFO computations as of Dec. 31, 2019.

5. If taxpayers have included Forms 3115 to terminate their LIFO elections as part of their tax returns filed before relief becomes available, they should be allowed to revoke their elections to terminate LIFO so that they can take advantage of the relief procedures if they so desire.

In General

For more than 50 years, I have worked with clients using all types of LIFO methodologies.[4] Based on my experience, I believe that my recommendations and suggestions regarding a framework for their implementation could be of some assistance in your consideration of how to provide efficient, timely and effective relief for taxpayers who use Dollar-Value LIFO methods for valuing inventories.

My recommendations are applicable to all taxpayers using Dollar-Value methods, regardless of whether these methods are using sub-elections for double-extension, link-chain or IPIC (Inventory Price Index Computation) procedures. Double-extension and link-chain methods involve the taxpayer making determinations of inflation in their inventory based on internal evaluations (i.e., pricing) of the goods in ending inventory. IPIC methods permit taxpayers to use inflation indexes computed "externally" by reference to Producer Price Indexes or Consumer Price Indexes. IPIC LIFO valuation results can readily be converted to apply the recommendations herein.

Where Dollar-Value methods are used, each taxpayer's specific "facts and circumstances" and its unique LIFO layer history determine the correlation between (i) the amount of a taxpayer's decrease in ending inventory and (ii) the amount of additional tax to be paid as a result of the reduction in the LIFO reserve at the end of the year.

Although the LIFO layer history for each taxpayer reflects a "personalized" fact pattern, it is true for all Dollar-Value LIFO taxpayers that the amount of an increase or decrease in their LIFO reserves at year-end is determined by three factors:

1. The rate of inflation (determined either internally or externally) reflected in the cost of the goods in ending inventory,

2. The inventory levels at the beginning of the year and at the end of the year. These inventory levels must be expressed in both actual dollars and in base dollars (i.e., the base dollar equivalent amounts that represent the purchasing power of the dollar on the first day of the first year of the LIFO election), and

3. The build-up or accumulation of annual LIFO layers of increment (i.e., the LIFO layer history). In some cases, these annual layers may reflect reductions from their original amounts because a decrement incurred in a later year may have been carried back to reduce that previous year's amount.[5]

In anticipating a substantial decline in inventory, if panic sets in over the presumed consequences because the ending inventory is expected to be 25%, 30%, even 50% lower at year-end, that panic may be unfounded. The reason panic may be unfounded is that the percentage of repayment of the LIFO reserve is usually not proportionate to the percentage decrease in the ending inventory compared to the inventory at the beginning of the year. Where Dollar-Value methods are employed, a common result is that the LIFO reserve will actually increase at the end of the year, even though the ending inventory has substantially decreased.[6]

Given any specific combination of inflation rates and inventory levels over a period of years and the proper application of arithmetic to these facts, the amount of the LIFO reserve has to be an exact, precise dollar amount. This is true even if the assumptions made in determining the inflation indexes used in the calculations are somewhat subjective. The mathematics that drive proper Dollar-Value LIFO computations are not subjective. 1 + 1 will always equal 2, and 2 x 2 will always equal 4. If the LIFO reserve is not the exact amount that the mathematical proof requires, then an error has been made in computing the LIFO reserve … and that error should always be corrected.

Recommendation #1 – Exposition

> ***Amend Section 473 – Qualified Liquidation of LIFO Inventories – by adding a new Subsection. This Subsection would free taxpayers from the burdens of having to prove themselves entitled to relief. This will considerably lessen otherwise substantial administrative oversight burdens for the Treasury and the Internal Revenue Service.***

- In its present form, the requirements of Section 473 are ambiguous, at best, and insufficient to provide timely relief to help businesses cope with the effect of significant inventory reductions on their tax obligations for 2020.

- The *Presidential Proclamation on Declaring a National Emergency Concerning the Novel Coronavirus Disease (COVID-19) Outbreak* should make it unnecessary for taxpayers using the LIFO method to be required to justify their need for relief at this time. Requirements of this nature presently in Section 473 seem unnecessary in light of the significant disruption on our economy everywhere.

- I am aware that the Internal Revenue Service recently received a letter from the National Automobile Dealers Association (NADA) dated Nov. 20, 2020 requesting expedited relief for certain franchised automobile and truck dealers.[7]

  - Substantially all of NADA's proposal (7 pages) is devoted to making the case that substantial inventory interruptions have been experienced by its members and that the sources and blame for these disruptions can be traced all over the world and are not the fault of the dealers. Clearly, the causes and results of these interruptions are significant enough to fall within the general tolerance for relief in the language of Section 473.

- Although NADA's proposal builds a strong case for the need for inventory liquidation relief by describing the devastating impact that Covid-19 has had on dealerships, I believe that NADA's proposal would not be in that industry's best interest because it straight-jackets its membership and automobile manufacturers into a labyrinth of Department of Energy procedures. NADA's proposal also invites countless other associations to barrage the Treasury/IRS with similar requests for relief for their specific industry and/or memberships.

- Is it not obvious that all businesses have been significantly affected to a similar degree and that evidence to make this case doesn't really need to be presented? Surely, Treasury and the IRS can relate to this, even though neither Agency has to receive, handle, store, display, attempt to sell – or deliver – merchandise … all activities dependent on employees being able to be present at work on a daily, regular basis.

- Under these circumstances, I believe there should not be any requirement that determinations be made by the Department of Energy or any other Agency of the government as a prerequisite for establishing eligibility for relief.

- The applicability of this new Subsection (Subsection (h)? … (**h**) stands for help!) would be specifically limited to qualified inventory liquidations occurring at the end of calendar year 2020 or any corresponding fiscal years ending on or after March 1, 2020.

  - If the impact of Covid-19 continues through 2021 substantially affecting year-end inventory levels, comparable/additional relief should be available.

- Section 473 was enacted in 1979, some 40 years ago, generally becoming effective after 1979. Regulations under Section 473 have not been issued since then in Proposed, Temporary or Final form.

  - My reading of the *Senate Report* and the *Conference Report* suggests that, when enacted, this provision was to be narrowly applied to a specific situation (Oil Crisis, embargo, etc.). If so, it seems that it was more likely to be applied in the context of taxpayers using the specific goods or unit method for valuing their LIFO inventory. The way the Specific Goods/Unit method operates is far different from the way the Dollar-Value method operates.

  - The Law and the *Committee Reports* specifically recognized this limitation. Both call for the Secretary to provide guidance in coordinating with the provisions of Section 472. In particular, the Conference Agreement states, "It is expected that the Secretary will issue Regulations regarding how this Section is to be applied in the case of a taxpayer using the 'dollar-value' method of LIFO inventory, consistent with the 'dollar-value' Regulations under Section 472."[8]

- Without Regulation guidance, taxpayers are likely to encounter serious difficulties in attempting to understand what kind of relief is available from the existing language of Section 473. Taxpayers seem to be "on their own" in trying to figure out just exactly what to do.

- More problematic, in my opinion, is that the *"gross income for the liquidation year"* can be affected by changes in the inventory level at the end of any one of possibly three succeeding years which make up the *replacement period*.

- Therefore, it would be more desirable from an administrative standpoint to avoid requiring taxpayers to make adjustments to their LIFO reserves at the end of the liquidation year (i.e., as of Dec. 31, 2020). Instead, it would be better to place the net effect of any relief adjustments in an appropriate subsequent year. See *Recommendation #3*.

Recommendation #2 – Exposition

> ***Alternative Dollar-Value LIFO Method*. Allow taxpayers to (elect to) use a substitute or surrogate historical cost level in determining the LIFO valuations of their inventory at the end of 2020. This historical cost level will continue to be reflected in each year in the succeeding 3-year (recovery) period … 2021, 2022 and 2023. This substitute inventory level would be determined by reference to the 3-year average historical cost level as of the end of the pre-liquidation year (i.e., determined as of Dec. 31, 2019 or other corresponding fiscal years ending in 2019).**

- Again, referencing NADA's proposal for relief mentioned above, its request seems to be insufficient to deal with the LIFO inventories of its automobile and truck dealership members. During the last 50 years of my career, I have worked closely with automobile and truck dealerships and LIFO applications for their industries. The majority of automobile dealers use the Dollar-Value LIFO method, and more particularly, the Alternative LIFO Method for New Vehicles.[9] Accordingly, "LIFO relief" for these dealers should be specifically tailored to the Dollar-Value method applications, rather than to specific goods or unit method LIFO applications.

  - NADA's proposal seems to be insufficient to an even greater extent because it does not go far enough to address the broader population of taxpayers (who are not NADA members) who use Dollar-Value LIFO method for valuing their inventories and who similarly require relief.

- For businesses using Dollar-Value LIFO methods, the real consequence that needs to be addressed is not the presence of factors causing the reduction in an ending inventory. The real result for which relief should be sought is the postponement – for a reasonable amount of time – of the payment of a significant amount of tax that would otherwise be attributable to the decrease in the LIFO reserve which follows from a decrease in the inventory level at the end of the year.

- I propose that taxpayers be allowed to use an Alternative Dollar-Value LIFO method … And that its use be specifically limited to situations involving Covid-19 and other 2020 business disruptions.

- In that respect, they should be permitted to use a "substitute" or "surrogate" cost (instead of their actual cost) as their inventory level in the computation of the LIFO valuation of their inventory as of Dec. 31 2020. In other words, this substitute (higher dollar) amount would be used instead of their actual (lower) ending inventory amount in the LIFO calculations for 2020.

  - In computing the LIFO valuation of ending inventory for 2020, this substitute cost would be the average of the ending inventory cost amounts at the end of each of the 3 taxable years preceding the liquidation year. In other words, the 3-year historical average would reflect cost amounts as of Dec. 31, 2017, 2018 and 2019.

  - Taxpayers should be required to apply this approach to all classes of goods and/or pools currently subject to their LIFO elections.

  - This would also apply to taxpayers with corresponding fiscal years ending in 2020.

- There is adequate precedent found in other Code Sections and/or Regulations for allowing taxpayers to use a substitute amount based upon actual prior year experience. This precedent has been allowed in order to simplify matters and relieve computational burdens based on more detailed analyses of multiple years' historical information. Typically, the historical reference period has been 3 years.

  - Most recently, the *CARES Act*[10] amended Section 163(j) to allow taxpayers to ***substitute (i.e., to elect to use)*** their Adjusted Taxable Income (ATI) amounts for the last year beginning in 2019 for their actual ATI amounts in 2020 in determining their interest expense deduction limitations for any year beginning in 2020.

  - In re-valuing LIFO inventories, the Regulations under Section 263A allow taxpayers to apply a revaluation factor based upon the average of their experience in the 3 years immediately preceding the year-of-change. This substitution approach is allowed when a Section 481(a) adjustment is required in connection with a change in accounting method which affects the LIFO valuations of the opening inventory in the year of change. This "short-cut" method is permitted regardless of how many years a taxpayer has been on LIFO. Reg. Sec. 1.263A-7(c)(2)(v).

  - Effective for years after 2017, small business taxpayers are eligible to use the cash method of accounting. The cash method is available for taxpayers that had average annual gross receipts for the three preceding tax years of $25 million or less.

- In some cases, a "lookback" period of 3 years might not be considered to be representative for purposes of determining the "average cost" substitute historical level. In these circumstances, there are several ways this 3-year historical reference period could be adjusted or limited to accommodate different fact patterns or scenarios.

  - For example, in a taxpayer's previous 5-year history, the inventory levels at the end of one or two of these years may have been unusually higher or lower than the other years. In this case, the highest and the lowest inventory levels could be disregarded, and the ending inventory levels of the other three years in the overall 5-year range could be used to compute the 3-year substitute historical cost average.

- The application of this recommendation should be as simple, straightforward and administratively less burdensome as possible. Therefore …

  - The computations of the LIFO valuation of the inventory in subsequent years would continue to reflect the result of using the substitute inventory cost of Dec. 31, 2020 for all purposes.

  - All historical LIFO layers as of Dec. 31, 2019 (i.e., as of the end of the pre-liquidation year) would retain their identities and respective LIFO valuations. These Dec. 31, 2019 layers would only change if they are affected by a net adjustment as of Dec. 31, 2023 which reduces that Dec. 31, 2019 (pre-liquidation year) LIFO reserve.

  - There would be no adjustment or revaluation of the LIFO layers as of Dec. 31, 2019 because the relief provided should not be regarded as a change in accounting method that requires a Section 481(a) adjustment.

- Rebasing the indexes to 1.000 as of the beginning-of-the-year (i.e., as of Dec. 31, 2019/Jan. 1, 2020) as a result of using the substitute cost in the LIFO computations for 2020 could easily be made a requirement. If required, this rebasing to 1.000 would not change the LIFO valuation of each historical layer or the contribution made by each historical layer to the LIFO reserve. In some situations where changes in LIFO methods are involved, the Section 472 Regulations require the rebasing of indexes to 1.000 as of the beginning of a year-of-change.

Recommendation #3 – Exposition

> ***Defer adjustment of the LIFO reserve for the pre-liquidation year until the end of the suspension period. Treat the 4-year period which includes the liquidation year (i.e., calendar year 2020) and the 3 years thereafter (i.e., 2021, 2022 and 2023) as a 4-year "suspension period." At the end of each year during the suspension period (2020-2024), taxpayers would compute their year-end inventory LIFO valuations based upon the historical average amount as a substitute for the actual cost amount in their 2020 LIFO valuation calculations.***
>
> ***The net changes in the LIFO reserves computed at the end of 2020, 2021 and 2022 would be held "in suspense" (via Schedule M adjustments) and not given effect until the end of the fourth year (i.e., Dec. 31, 2023). At the end of the last year in the suspension period (i.e., Dec. 31, 2023), the taxpayer would make a single, lump-sum adjustment to increase or decrease the LIFO valuation of the inventory at the end of the pre-liquidation year (i.e., the balance as of Dec. 31, 2019) to the amount computed as the LIFO valuation of the taxpayer's inventory as of Dec. 31, 2023.***

- As indicated previously, holding the year of liquidation (i.e., 2020) open and subjecting it to adjustments that would be determined in subsequent years unduly complicates matters. This could create additional complications because of the recent expansion of the net operating loss carryback rules opening up 5 previous years to tentative claims for refund (Forms 1139 or 1045) or amended returns.

- It is probable to expect that in many cases, Dollar-Value LIFO inventory levels are likely to be restored to some extent, if not, fully within a few years after 2020. However, the amounts by which inventory levels may be restored in future years and how quickly that may happen is far from reasonably estimable.

- Under this recommendation, the impact of the lower inventory level in the liquidation year (i.e., as of Dec. 31, 2020) would be determined year-by-year during the 4-year period (2020 through 2023) and held "in suspense" for the 3-year period following the year of liquidation.

  - For 2020 LIFO computation purposes, the taxpayer would substitute the 3-year historical average cost for the actual ending inventory amount. The taxpayer would continue to carry forward the results of the 2020 computation in valuing its ending inventories for the years 2021 through 2023 for purposes of determining increments or decrements.

  - As of Dec. 31, 2023, taxpayers would adjust the Dec. 31, 2019 LIFO reserve to reflect the overall net difference.

- This recommendation would apply to all taxpayers using Dollar-Value LIFO methods. These methods include the double-extension method, the link-chain method and the IPIC (Inventory Price Index Computation) method. These methods all are based upon the same underlying computational principles.

- The effect of this approach would not be to fully forgive the difference in taxable income due to the LIFO decrement in the liquidation year. Instead, this approach would carry the potential impact of that difference forward … And subject the net impact over four years to be accounted for at the end of 2023 based on the inventory level at the end of 2023.

  - In other words, LIFO taxpayers would receive relief by (i) the use of the higher substituted cost as the inventory amount at Dec. 31, 2020 in the LIFO computations for the years in the suspension period, and (ii) the postponement until 2023 of the net adjustment for the difference in the LIFO reserves.

  - The amount of the net adjustment for this difference could be included in income in 2023, either in full or to some lesser extent … for example subject to a "hair-cut" of 10%, 15% or some other amount.

  - This lump-sum net adjustment should not be required to be made as of the end of the year when the taxpayer has restored its inventory level to the same (or a greater) amount of the pre-liquidation year (i.e., Dec. 31, 2019) inventory level. The net adjustment should be held in abeyance until Dec. 31, 2023. This differs in result from the definition of a "replacement year" currently in Section 473(d) which provides that the replacement period ends as soon as "the replacement of the LIFO goods is completed."

- The benefit of this approach is its simplicity and ease of administrative burdens once the rigors of the Dollar-Value method calculation have been made. There are no further adjustments to the inventory in subsequent years as a result of this benefit.

- The effect of this approach is best illustrated by the summary included in Sets 1(e) and 2(e) of the case study scenarios. In this case, the ending inventory has increased gradually over 2021, 2022 and 2023 to the pre-liquidation level.

  The LIFO reserve balance at the end of the pre-recovery period (as of Dec. 31, 2019) would be frozen (i.e., remain unchanged) during the recovery period. In other words, any adjustments to the LIFO reserve balances during the recovery period would be "suspended." Only the net adjustment amount would be recorded to either increase or decrease the LIFO reserve to the appropriate amount as of Dec. 31, 2023.

  LIFO Reserve at Dec. 31, 2019/Jan. 1, 2020 in the amount of $9,204,088 is increased by $156,035 to $9,360,123 as of Dec. 31, 2023.

  This net adjustment of $156,035 over the period of 4 years (2020 - 2023) reflects an increase due to inflation in the amount of $1,607,245, and this is offset by a reduction in (or payback of) the LIFO Reserve due to shifting of the decrement of $1,451,210 in 2021. ***The relief the taxpayer has received is that it has avoided having to take the net decrease in the LIFO reserve as Dec. 31, 2020 (i.e., $1,605,558) into income in its 2020 income tax return.***

> *This has allowed the taxpayer to receive the benefit of 4 years' worth of inflation ($1,607,245), and it reflects the impact of the decrement as calculated using the substitute inventory level ($1,451,210), which nets to an increase of $156,035.*
>
> *Compared to using the actual cost method for 2020, using the historical average (substitute) method in the calculations over the period has resulted in a $240,206 increase in the LIFO reserve due to the inflation and a further increase in the LIFO reserve of $448,126 because that amount reflects less LIFO reserve payback because of the shifting of the decrement from 2020 to 2021 in slightly different amounts.*

- The obvious effect is that the impact of the decrement in 2020 has been shifted to 2021 (or possibly also to 2022 and 2023 in other situations). The consequence of that shift is offset by inflation reflected in the inventory through the end of the entire suspension period.

<u>Recommendation #4 – Exposition</u>

> ***Require taxpayers who elect relief to include in their tax returns evidence confirming (1) their compliance with the requirements of Section 472 to use the LIFO method and (2) the overall reasonableness of their LIFO computations as of Dec. 31, 2019.***

- Over the years, I have represented taxpayers at both the IRS Agent and Appeals levels and in conferences in the National Tax Office where the taxpayer's LIFO computations were far from accurate and needed to be, at a minimum, mathematically corrected. As a result, I believe that taxpayers availing themselves of relief at this time should come to the IRS with "clean hands."

- Accordingly, I believe a taxpayer electing to use the recommended "Dollar-Value method relief " – in whatever its final form may take – should be required to include with the tax return for the liquidation year, at a minimum, certain certifying information, including …

    - A statement that the taxpayer has complied in all years of its LIFO election with the financial statement conformity requirements set forth in the Regulations.

    - A statement that the taxpayer has previously filed Form 970 to elect to use the LIFO method.

    - A statement or schedule showing for each year of the LIFO election the cost of the ending inventory subject to the LIFO election (for each pool) and the inflation rate that was applied to that inventory each year. This requirement would enable the IRS to review the reasonableness of the computation of the LIFO reserves and the contribution to the LIFO reserve at the end of each year made by each historical layer.

    - A statement that the taxpayer has maintained books and records to support its LIFO valuations for all preceding years.

    - A statement of election to use this new method.

- Revenue Procedure 79-23 provides that, as a condition to the adoption and use of the LIFO method, taxpayers are required to maintain adequate books and records as well as comply with several other conditions.[11] Therefore, taxpayers in compliance with the Dollar-Value LIFO Regulations should not have any problems with providing this information … and this information would save the Internal

Revenue Service considerable time and effort that it might otherwise have to expend in reviewing the accuracy of the taxpayer's LIFO computations to date.

Recommendation #5 – Exposition

> ***If taxpayers have included Forms 3115 to terminate their LIFO elections as part of their tax returns filed before relief becomes available, they should be allowed to revoke their elections to terminate LIFO so that they can take advantage of the relief procedures if they so desire.***

- Taxpayers faced with the impact of large inventory reductions in their LIFO reserves may have decided to terminate their LIFO elections for 2020 (i.e., as of Jan. 1, 2020). Terminating their LIFO elections would allow them to avoid having to take 100% of the impact of the decrement at the end of 2020 in their income tax returns for 2020.
  - Instead, by terminating their LIFO elections for 2020, they would be allowed to take the amount of their LIFO reserves as of Dec. 31, 2019 into income as a Section 481(a) adjustment ratably over a period of 4 years … (25% in 2020 … 25% in 2021 … 25% in 2022 … 25% in 2023). For some, this might have been a preferable alternative.
- Absent any expectation of relief, these taxpayers may have believed it would be more beneficial to terminate their LIFO election than to remain on LIFO and absorb the entire impact of a substantial inventory reduction in their LIFO calculations in their 2020 tax return.
- Taxpayers having fiscal years already ended in 2020 may have already included Forms 3115 to terminate their LIFO elections in their income tax returns. Calendar year taxpayers may be filing their 2020 income tax returns before a decision is reached to provide relief in one form or another. Generally, an election to terminate a LIFO election cannot be revoked.
- If the decision is made to provide relief for Dollar-Value LIFO taxpayers, it would seem fair to those who previously filed returns in which they terminated their LIFO elections to be given the opportunity to revoke those elections. When filing their returns, they would have had no reasonable expectation that there might be a better alternative.
- Also, in this regard, the requirement for compliance with the financial statement conformity requirements for 2020 should be waived since these taxpayers would have thought they no longer had LIFO elections, and therefore, did not have to satisfy these requirements.

Case Study – Facts & Comments

Facts …

  - The taxpayer has been on LIFO for 35 years. Since making its election in 1985, it has made numerous changes in LIFO accounting methods, and its historical LIFO layers have been rebased to 1.000 several times during the period.

- At the end of 2020, the taxpayer's inventory dropped to $23,800,000 (post-liquidation amount) from $38,256,910 (pre-liquidation amount) the year before.

- The same inflation rate of 1.25% per year is assumed for all years 2020-2023.

- 3-year historical average of ending inventories at cost (Dec. 31, 2017 - 2019) is $44,890,402.

December 31, 2017	42,328,190
December 31, 2018	54,086,107
December 31, 2019	38,256,910
3-Year Total	134,671,207
	÷ 3
3-Year Average	44,890,402

- Use of the substitute cost level in lieu of the actual cost amount as of Dec. 31, 2020 increases the 2020 ending inventory by $21,090,402 or 88.6% ($44,890,402 - $23,800,00).

  - This increase in actual dollars of $21,090,402 converts to an increase in base dollars of $15,679,378 ($33,373,170 - $17,693,792). ($21,090,402 ÷ 1.345105 = $15,679,372).

  - As a result, instead of using the actual cost at Dec. 31, 2020 and having a decrement of $11,103,317 (expressed in base dollars), there is an increment of $4,576,061 (using the substitute 3-year average cost). The sum of these two amounts is $15,682,378 (the amount of increase expressed in base dollars – per above).

  - By using the substitute cost level, there is no decrement computed for 2020. This avoids the reduction in the LIFO reserve of $1,899,399 otherwise due to carrying back the decrement (if the actual cost level were used).

  - If the taxpayer does not obtain relief, it will have to pick up $1,605,558 … the decrease in its LIFO reserve as of Dec. 31, 2020 … in income in its 2020 income tax return.

- To show the consistency of all of the case study results with Dollar-Value LIFO principles, the changes in the LIFO reserves for all years are supported (i) by proofs/reconciliations of the contributions to the LIFO reserve by each layer and (ii) by analyzing the two factors that determine the net change in the LIFO reserve for the year. For taxpayers using the Dollar-Value method and valuing increments by using the cumulative index at the end of each respective year (i.e., a dual-index approach is not used in valuing increments), these factors are (i) the effective rate of inflation for the year and (ii) the increase or decrease in the ending inventory (at cost), expressed in base dollars.

- ***Actual Dollars vs. Base Dollars.*** As mentioned previously, when working with LIFO computations, all calculations involving "actual dollars" are reduced to their expression in terms of base dollars (i.e., the equivalent purchasing power of the dollar as of the first day of the year when the LIFO election was made).

  - To simplify the discussion and presentation of the various year-end inventory levels at the end of 2021, 2022 and 2023, these amounts are expressed in actual dollars.

- If it were desired to have exactly the same amount of purchasing power reflected in the ending inventory computations, the inventory levels would be slightly larger in order to take into account the effect or impact of inflation. More goods could be purchased for \$38,256,910 at Dec. 31, 2019 – the pre-liquidation level – than could be purchased for that same amount of dollars (\$38,256,910) at Dec. 31, 2023.

  - This *purchasing power equivalency* is exactly what Dollar-Value LIFO method computations are all about.

  - Accordingly, to reflect the exact purchasing power equivalence at Dec. 31, 2023, the \$38,256,910 amount would have to be increased to reflect the cumulative effect of inflation during the period from the end of 2019 to the end of 2023. For example, if the inflation rates for 2020, 2021, 2022 and 2023 were 1.10%, 1.65%, 1.40% and 1.33%, respectively, the equivalent purchasing power at the end of 2023 would require an actual inventory cost of \$40,396,555[12] … an additional \$2,139,645.

- The computations and discussions relating to 5 scenarios in the case study are related to the same terms and definitions in Section 473(d) for "qualified liquidation," "liquidation year," "replacement year," and "replacement period."[13] In connection with using the historical 3-year average substitute, the year immediately preceding the liquidation year is referred to as the "pre-liquidation year."

<u>Case Study – Summary of Results for 5 Sets of Assumed Changes in Year-End Inventory Levels</u>

- Sets 1(a) & 2(a) … For 2021 - 2023, the year-end inventory levels remain at the same level as the actual Dec. 31, 2020 level (\$23,800,000). Throughout the entire 3-year recovery period, the taxpayer's inventory level has not been built back up to the Dec. 31, 2019 pre-liquidation level of \$38,256,910.

  - As of Dec. 31, 2023, the net adjustment is a ***decrease*** of \$867,410 to the Dec. 31, 2019 LIFO reserve.

- Sets 1(b) & 2(b) … At the end of 2021, the ending inventory has returned to the Dec. 31, 2019 (pre-liquidation) actual level (\$38,256,910). The inventory remains at that level at the end of 2022 and 2023.

  - As of Dec. 31, 2023, the net adjustment is an ***increase*** of \$1,643,531 to the Dec. 31, 2019 LIFO reserve.

- Sets 1(c) & 2(c) … For 2021 ending inventory remains at 2020 actual liquidation level (\$23,800,000) and the inventory increases to the pre-liquidation level (\$38,256,910) in 2022 and the inventory stays at that level in 2023. In other words, it takes 2 years (2021 and 2022) for the inventory level to return to the pre-liquidation level. Accordingly, by the end of the second year of the recovery period (Dec. 31, 2022), the taxpayer's inventory level has returned to the pre-liquidation level.

  - As of Dec. 31, 2023, the net adjustment is a ***decrease*** of \$583,544 to the Dec. 31, 2019 LIFO reserve.

- Sets 1(d) & 2(d) … For 2021 and 2022 the ending inventories remain at the 2020 actual liquidation level (\$23,800,000), and the inventory increases to the pre-liquidation level (\$38,256,910) in 2023. In other words, it takes the entire 3-year recovery period for the inventory level to return to the pre-liquidation level. Accordingly, by the end of the third year (Dec. 31, 2023), the taxpayer's inventory level has returned to the pre-liquidation level of \$38,256,910.

    - As of Dec. 31, 2023, the net adjustment is a ***decrease*** of $811,360 to the Dec. 31, 2019 LIFO reserve.

- Sets 1(e) & 2(e) … For 2021, 2022 and 2023 ending inventories increase each year by one-third of liquidation amount. (Liquidation amount is $14,456,910 [$38,256,910 - $23,800,000 ... Increase is $4,818,970 during each year].) By the end of the third year of the recovery period (Dec. 31, 2023), the taxpayer's inventory level has returned to the Dec. 31, 2019 pre-liquidation level ($38,256,910).

    - As of Dec. 31, 2023, the net adjustment is an ***increase*** of $156,035 to the Dec. 31, 2019 LIFO reserve.

- See the charts immediately following this page.

<u>Conclusion</u>

Schedules are attached showing all the computations and supplementary discussions. These explain the results which essentially reflect a trade-off in which the taxpayer waits 4 years, to the end of 2023, before realizing the net effect of any advantages of using its LIFO election. In the process, the taxpayer has avoided the disadvantage of having to realize a significant increase in income in 2020 due to the unforeseen and uncontrollable drop in inventory level. In addition, the taxpayer has been able to continue the use of the LIFO method, rather than having to terminate it.

In a sense, my recommendations mirror my experience over many years in situations where it was desirable to propose a compromise with the IRS to try to reach a mutually acceptable resolution of an issue where neither party was likely to be completely satisfied with the end result. It seems that a good compromise is one where both parties feel like they have left something on the table, but they can't go back to try to get it.

Given the complexities of the computations involved and the uncertainty we all have over what may happen in the next few years, perhaps this suggested framework for relief – or some modification of it – will be of benefit to taxpayers using Dollar-Value LIFO methods, and to the Treasury, and to the Internal Revenue Service.

Respectfully,

Willard J De Filipps

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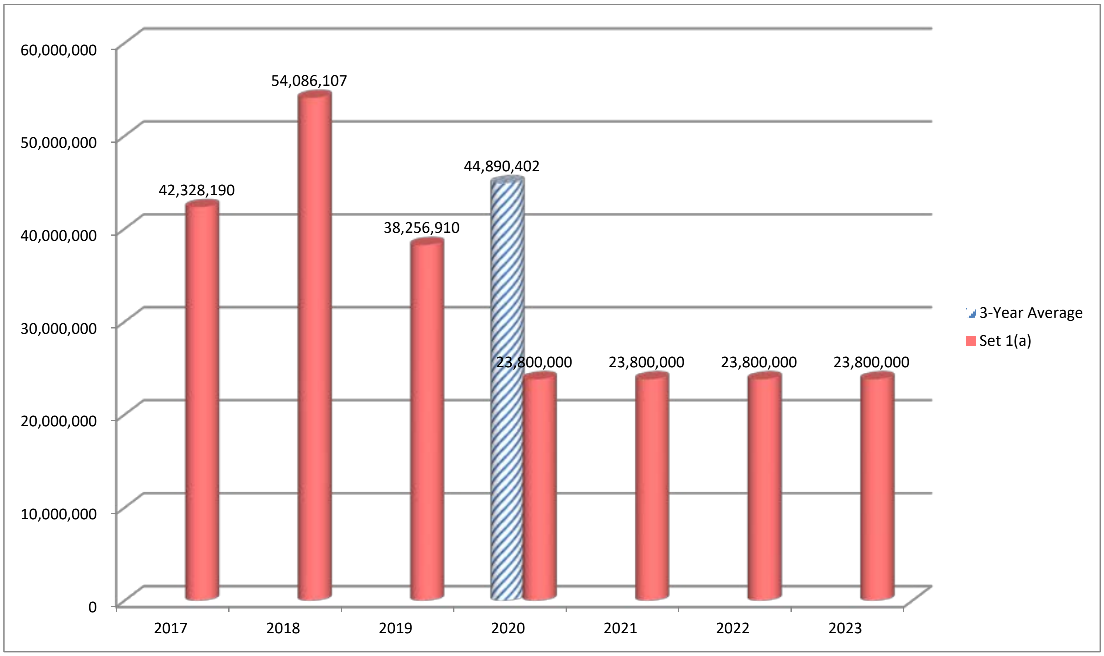
<u>Footnotes</u> … Follow immediately after the Charts

Facts & Summary of Results for Case Study Sets 1(a) & 2(a)

For 2021 through 2023, Taxpayer's Year-End Inventory Levels Are Not Built Back Up to the Dec. 31, 2019 Pre-Liquidation Level

Actual (Historical) Cost Dec. 31, 2017 - 2020 **Projected 3-Year Recovery Period**



	2017	**2018**	**2019**	**2020**	**2021**	**2022**	**2023**
3-Year Average				44,890,402			
Set 1(a)	42,328,190	54,086,107	38,256,910	23,800,000	23,800,000	23,800,000	23,800,000

Sets 1(a) & 2(a) … For 2021 - 2023, the year-end inventory levels remain at the same level as the actual Dec. 31, 2020 level ($23,800,000). Throughout the entire 3-year recovery period, the taxpayer's inventory level has not been built back up to the Dec. 31, 2019 pre-liquidation level of $38,256,910. The 3-year average ending inventory level is $44,890,402. This amount is substituted for/used in the LIFO calculations instead of the actual lower cost.

Summary of Results for Case Study Sets 1(a) & 2(a)

1. Impact of the decrement in the amount of $1,899,399 in 2020 (if actual cost is used) is increased during the period from 2021 through 2023 by $143,333 in 2023 for a total decrement impact of $2,042,732. If the historical substitute cost method is used, the 2020 decrement is shifted to 2021 and becomes $2,125,353; in addition small amounts of decrement carryback are reflected in 2022 ($49,336) and 2023 ($52,377) for a total decrement impact under this substitute cost method of $2,227,066. The net amount of the difference in the decrement carryback impact is $184,334. This is in contrast to the impact of the decrement that would have been felt in 2020 ($1,899,399) if the actual cost method had been used that year.
2. Throughout the entire 3-year recovery period, the taxpayer's inventory level has not been built back up to the Dec. 31, 2019 pre-liquidation level of $38,256,910. The entire impact of inventory liquidation (decrement) incurred in 2020 is shifted to 2021.
3. Using the substitute cost method, there is additional inflation of $184,385 in 2020 because of the higher amount of base dollars avoided the decrement in base dollars computed for that year ($11,103,317 x 0.016606 or [1.345105 - 1.328498]).
4. Instead of having a decrease in the LIFO reserve of $1,605,572 in 2020, using the substitute cost method results in a small increase in the LIFO reserve for 2020 of $478,212. However, under this method in 2021, there is a net decrease in the LIFO reserve of $1,831,563.
5. At the end of 2021, there is the possibility that the ending inventory levels in the remaining 2 years of the recovery period may be increased to the pre-liquidation level. Because of this possibility, any adjustment to reflect the involuntary liquidation of inventory at Dec. 31, 2020 should be postponed until the end of the 3-year recovery period.
6. The computations of the LIFO valuations and the LIFO reserves for 2021 and 2022 and 2023 under both methods (actual cost and substitute cost) are identical … when made with the "knowledge" that the inventory liquidation amount was never restored.
7. Accordingly, it may be desirable to postpone the taxpayer's adjustment for relief until the end of 2023 (i.e., until the end of the 3-year recovery period). This approach may be more desirable for equitable purposes or more logically consistent with adjustments that would be made under the other case study scenarios.
8. If the adjustment for relief (in this case) is postponed until Dec. 31, 2023, when it is known for a fact that the inventory levels were never restored, the amount of the postponed adjustment is $867,410.
9. If the adjustment for relief (in this case) is postponed until Dec. 31, 2023, then the amount of the LIFO reserve at Dec. 31, 2019/Jan. 1, 2020 ($9,204,088) would be decreased by $867,410 to $8,336,678 as of Dec. 31, 2023.
10. The overall effect of postponing the adjustment is to allow the taxpayer to reduce the amount of the impact of the decrement incurred in 2020 by the amount of inflation reflected in the inventory over the 4-year period (2020 through 2023). At that time, the taxpayer would reflect a single, lump-sum adjustment to increase income (i.e., by reducing the LIFO reserve) by $867,410. The relief to the taxpayer comes in the form of allowing it to postpone the impact of its decrease in inventory in 2020 for 3 years.
11. As of Dec. 31, 2023, the LIFO layer histories are identical regardless of whether they are computed under the substitute cost calculation method or the actual cost method. They reflect base dollars of $17,046,523 valued at $15,463,322, and the LIFO reserve at that date under either method is $8,336,678 ($23,800,000 - $15,463,322).
12. For 2024 and subsequent years' LIFO calculations, the taxpayer would continue to use this LIFO layer history as calculated under the 3-year average substitute cost method.

Facts & Summary of Results for Case Study Sets 1(b) & 2(b)

At Dec. 31, 2021, the End of the First Year After the Involuntary Liquidation , the Taxpayer's Inventory Level Has Returned to the Pre-Liquidation Level

Actual (Historical) Cost Dec. 31, 2017 - 2020 **Projected 3-Year Recovery Period**

	2017	2018	2019	2020	2021	2022	2023
3-Year Average				44,890,402			
Set 1(b)	42,328,190	54,086,107	38,256,910	23,800,000	38,256,910	38,256,910	38,256,910

Sets 1(b) & 2(b) … At the end of 2021, the ending inventory has returned to the Dec. 31, 2019 (pre-liquidation) actual level ($38,256,910). The inventory remains at that level at the end of 2022 and 2023. In other words, by the end of the first year of the recovery period (i.e., as of Dec. 31, 2021), the taxpayer's inventory level has returned to the Dec. 31, 2019 pre-liquidation level.

Summary of Results for Case Study Sets 1(b) & 2(b)

1. Impact of the decrement in the amount of $1,899,336 in 2020 (if actual cost is used) is increased by $5,832 in 2023 for a total decrement impact of $1,905,231. If the historical substitute cost method is used, small amounts of decrement carryback are reflected in 2021 ($104,088), 2022 ($70,666) and 2023 ($76,850) for a total decrement impact under this method of $251,604. The net amount of the difference in the decrement carryback impact is $1,653,627. This is in contrast to the impact of the decrement that would have been felt in 2020 ($1,899,399) if the actual cost method had been used that year.

2. Technically, the recovery period is 1 year ending Dec. 31, 2021. If the LIFO reserve balances under the different methods were adjusted as of that date (Dec. 31, 2021), the LIFO reserve adjustment would be an increase of $846,432 (from $9,204,088 at Dec. 31, 2019 to $10,050,520 at Dec. 31, 2021). The net increase in the LIFO reserve for the 2-year period as of Dec. 31, 2021 would reflect two years' inflation in the amount of $950,520 ($478,212 for 2020 and $472,308 for 2021). This adjustment would also reflect a reduction of $104,088 for the payback in the LIFO reserve based upon the decrement of $5,282,712. ($846,432 = $950,520 - $104,088). This would bring the LIFO reserve at Dec. 31, 2021 up to $10,050,520.

   The effect of the relief is that (1) the taxpayer is treated as if the liquidation in 2020 had not occurred, (2) the taxpayer continues to use the higher historical average cost substitute method for its LIFO calculations going forward, (3) the taxpayer is allowed to reflect the net benefit of inflation in its LIFO adjustments for 2022 and 2023 ($401,641 + $395,458 = $797,099), and (4) the taxpayer is allowed to deduct $846,432 in its 2021 income tax return.

3. *Alternatively*, it may be desirable to postpone the taxpayer's adjustment for relief until the end of 2023 (i.e., until the end of the 3-year recovery period, even though, technically, the recovery period was shortened to the end of 2021 because at that time, the inventory was restored to the pre-liquidation level). This approach may be more desirable for equitable purposes or more logically consistent with adjustments that would be made under the other case study scenarios.

   If the adjustment is postponed until Dec. 31, 2023, the amount of the postponed adjustment is $1,643,531. This has not been spread over the interim period which would happen if $846,432 of this amount were accelerated into a deduction in 2021 and $401,641 was accelerated as a deduction in 2022.

4. If the alternative (#3 above) of postponing the adjustment for relief until 2023 is followed, then the amount of the LIFO reserve at Dec. 31, 2019/Jan. 1, 2020 ($9,204,088) would be increased by $1,643,531 to $10,847,619 as of Dec. 31, 2023.

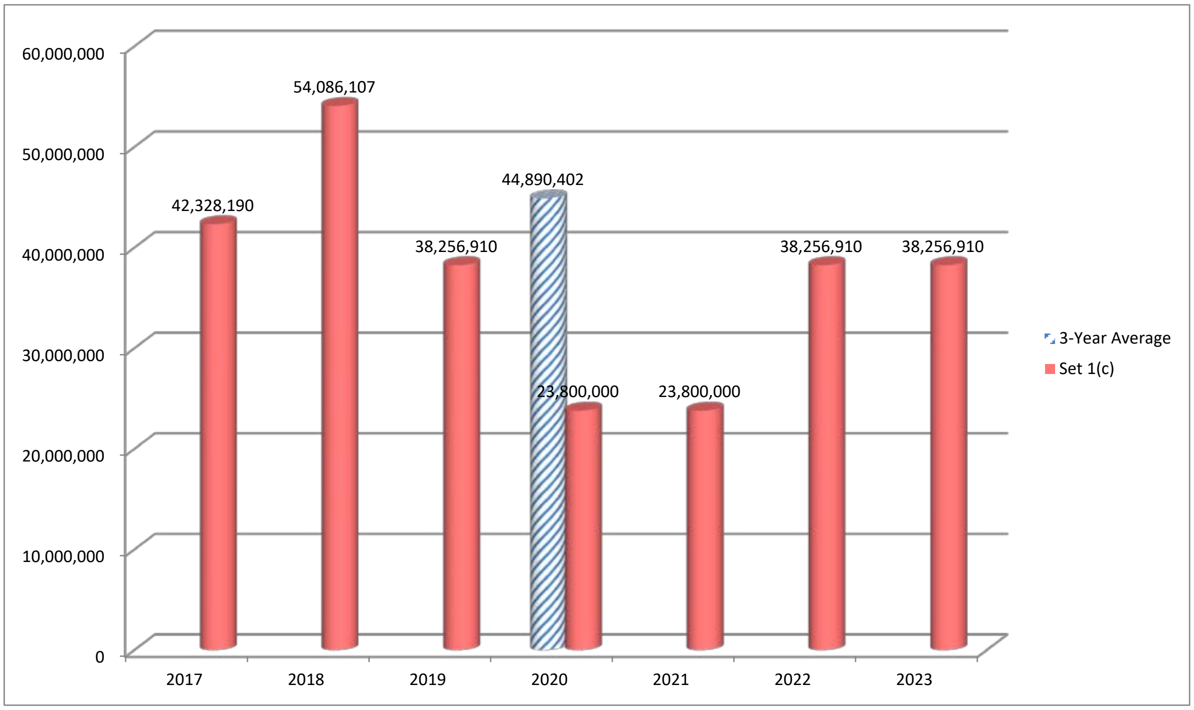
5. The overall effect of postponing the adjustment is to make the taxpayer wait until 2023 to get the benefit of a single, lump-sum deduction that, on a year-by-year basis would average to $410,000 per year.

6. In 2024, the LIFO layer history through Dec. 31, 2023 as computed under the substitute cost calculation method reflects base dollars of $27,401,148 valued at $27,409,292. For 2024 and subsequent years' LIFO calculations, the taxpayer would continue to use this LIFO layer history as calculated under the 3-year average substitute cost method.

Facts & Summary of Results for Case Study Sets 1(c) & 2(c)

The Taxpayer's Inventory Remains Low for 1 More Year; Then It Returns to the Pre-Liquidation Level at the End of the Second Year

Actual (Historical) Cost Dec. 31, 2017 - 2020 | **Projected 3-Year Recovery Period**



	2017	2018	2019	2020	2021	2022	2023
3-Year Average				44,890,402			
Set 1(c)	42,328,190	54,086,107	38,256,910	23,800,000	23,800,000	38,256,910	38,256,910

Sets 1(c) & 2(c) … For 2021 ending inventory remains at 2020 actual liquidation level ($23,800,000) & the inventory increases to the pre-liquidation level ($38,256,910) in 2022 and the inventory stays at that level in 2023. In other words, it takes 2 years (2021 & 2022) for the inventory level to return to the pre-liquidation level. Accordingly, by the end of the second year of the recovery period (Dec. 31, 2022), the taxpayer's inventory level has returned to the pre-liquidation level and the recovery period ends at that time.

Summary of Results for Case Study Sets 1(c) & 2(c)

1. The impact of the decrement in the amount of $1,899,336 in 2020 (if actual cost is used) is increased by $41,620 in 2021 for a total decrement impact of $1,941,019. If the historical substitute cost method is used, the decrement is shifted in 2021 and becomes $2,125,390. The net amount of the difference in the decrement carryback impact is $184,371. This is in contrast to the impact of the decrement that would have been felt in 2020 ($1,899,399) if the actual cost method had been used that year.

2. Technically, the recovery period is 2 years ending Dec. 31, 2022. If the LIFO reserve balances under the different methods were adjusted as of that date (Dec. 31, 2022), the LIFO reserve adjustment would be a decrease of $1,055,851 (from $9,204,088 at Dec. 31, 2019 to $8,148,237 at Dec. 31, 2022). The net decrease in the LIFO reserve for the 3-year period as of Dec. 31, 2022 would reflect three years' inflation in the amount of $1,069,539 ($478,212 for 2020, $293,827 for 2021 and $297,499 for 2022). This adjustment would be offset by a reduction of $2,125,390 for the payback in the LIFO reserve due to the decrement. This net adjustment of $1,055,851 would bring the LIFO reserve at Dec. 31, 2022 down to $8,148,236.

   The effect of the "relief" penalizes the taxpayer for having built up its inventory at the end of the second year because the taxpayer is not allowed to get the benefit of inflation experienced during the third year (2023) if the adjustment were made at the end of the 3-year recovery period.

3. *Alternatively*, it may be desirable to postpone the taxpayer's adjustment for relief until the end of 2023 (i.e., until the end of the 3-year recovery period, even though, technically, the recovery period was shortened to the end of 2022 because at that time, the inventory was restored to the pre-liquidation level). This approach may be more desirable for equitable purposes or more logically consistent with adjustments that would be made under the other case study scenarios.

4. If the alternative (#3 above) of postponing the adjustment for relief until 2023 is followed, then the amount of the LIFO reserve at Dec. 31, 2019/Jan. 1, 2020 ($9,204,088) would be decreased by $583,544 to $8,620,544 as of Dec. 31, 2023.

5. At the end of 2023, the taxpayer does realize a payback (or reduction) of a portion of its LIFO reserve because its inventory level has not grown beyond the pre-liquidation level. However, adjustment at that time (i.e., a reduction of $583,544) has (1) delayed until 2023 the impact that would have been felt a few years sooner and (2) reduced the amount of the adjustment because it includes the impact of inflation reflected in that inventory throughout the years.

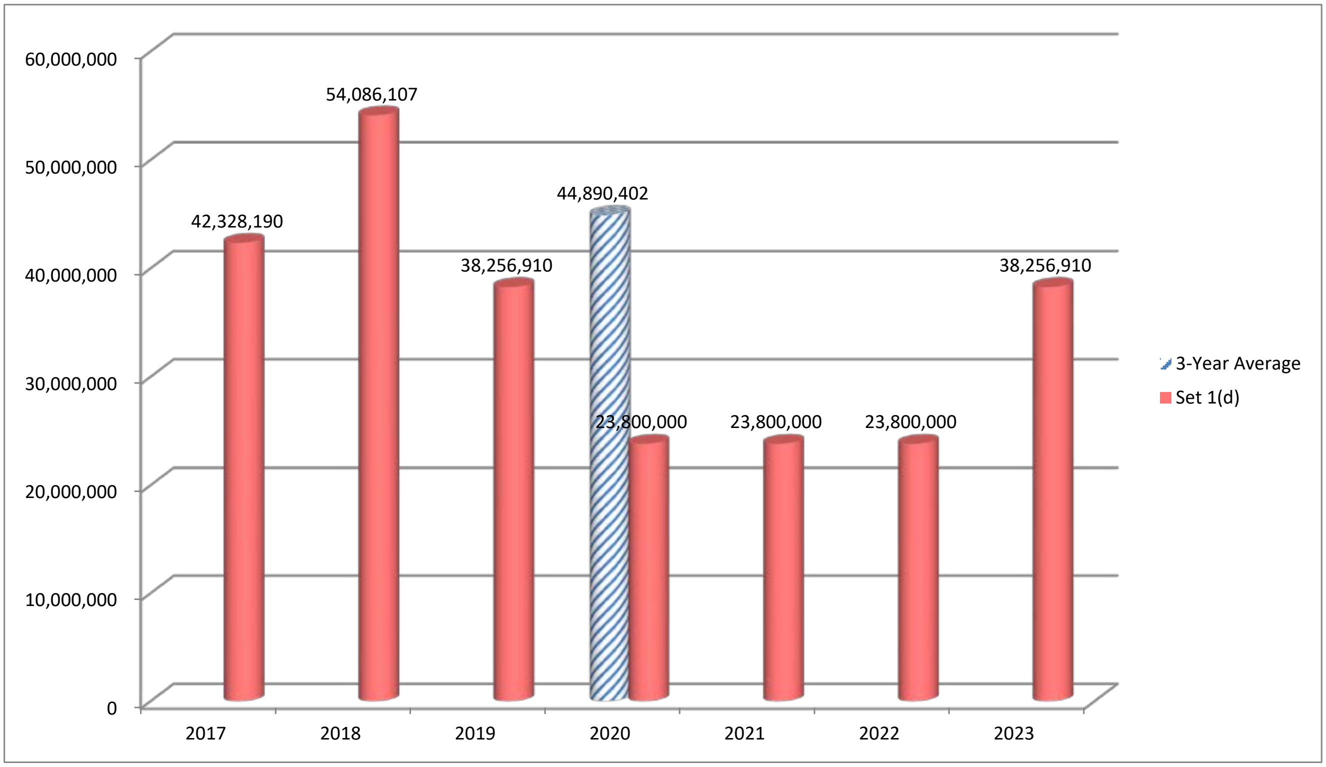
6. As of Dec. 31, 2023, the LIFO layer histories are identical regardless of whether they are computed under the substitute cost calculation method or the actual cost method. They reflect base dollars of $27,401,148 valued at $29,636,366, and the LIFO reserve at that date under either method is $8,620,544 ($38,256,910 - $29,636,366).

7. For 2024 and subsequent years' LIFO calculations, the taxpayer would continue to use this LIFO layer history as calculated under the 3-year average substitute cost method.

Facts & Summary of Results for Case Study Sets 1(d) & 2(d)

The Taxpayer's Inventory Remains Low for 2 More Years; Then It Returns to the Pre-Liquidation Level at the End of the Third Year

Actual (Historical) Cost Dec. 31, 2017 - 2020 | **Projected 3-Year Recovery Period**



	2017	**2018**	**2019**	**2020**	**2021**	**2022**	**2023**
3-Year Average				44,890,402			
Set 1(d)	42,328,190	54,086,107	38,256,910	23,800,000	23,800,000	23,800,000	38,256,910

Sets 1(d) & 2(d) … For 2021 & 2022 the ending inventories remain at the 2020 actual liquidation level ($23,800,000), and the inventory increases to the pre-liquidation level ($38,256,910) in 2023. In other words, it takes the entire 3-year recovery period for the inventory level to return to the pre-liquidation level. Accordingly, by the end of the third year of the recovery period (Dec. 31, 2023), the taxpayer's inventory level has returned to the pre-liquidation level of $38,256,910.

Summary of Results for Case Study Sets 1(d) & 2(d)

1. Impact of the decrement in the amount of $1,899,336 in 2020 (if actual cost is used) is spread over the years 2021 in the amount $2,125,390 and $49,336 in 2022. Total decrement impact is $2,174,726.
2. Recovery period is 3 years (2021, 2022, and 2023), ending Dec. 31, 2023.
3. LIFO Reserve at Dec. 31, 2019/Jan. 1, 2020 in the amount of $9,204,088 is decreased by $811,360 to $8,392,728 as of Dec. 31, 2023.
4. This net adjustment of the decrease of $811,360 over the period of 4 years (2020 - 2023) reflects an increase due to inflation in the amount of $1,363,368, and this is offset by a reduction in (or payback of) the LIFO Reserve due to shifting of the decrement of $2,174,726 in 2021 and 2022 ($2 rounding).
5. Using the substitute cost calculation method, the increase in the LIFO reserve due to inflation for 2020 is greater by $184,385 ($478,212 - $293,827). This method resulted in avoiding the decrement of $11,103,317 computed if the actual cost at Dec. 31, 2020 had been used. The effective rate of inflation for 2020 (0.016606 = 1.345105 – 1.328498) multiplied by the $11,103,307 decrement that does not exist when the substitute cost method is used ($28,797,109 - $17,693,792) results in the $184,385 difference. This difference is eliminated from the adjustment by the greater amount of decrement carried back in the 2021 calculations.
6. In 2024, (the first year after the end of the recovery period) the LIFO layer history through Dec. 31, 2023 as computed under the substitute cost calculation method reflects base dollars of $27,401,148 valued at $29,864,181. These are the same amounts as those in the LIFO layer history if the substitute cost calculation method had not been used (i.e., as if the actual cost method had been used).
7. In 2024 (the first year after the end of the recovery period), the taxpayer could continue to use the LIFO layer history under the substitute cost calculation method. Or the taxpayer could use the LIFO layer history as calculated under the actual cost method (i.e., the original method) because the LIFO layer histories as of Dec. 31, 2023 are identical under both methods.

Facts & Summary of Results for Case Study Sets 1(e) & 2(e)

The Taxpayer's Inventory Level Has Returned to the Pre-Liquidation Level at the End of the Third Year (of the Recovery Period)

Actual (Historical) Cost Dec. 31, 2017 - 2020 ***Projected 3-Year Recovery Period***

	2017	2018	2019	2020	2021	2022	2023
3-Year Average				44,890,402			
Set 1(e)	42,328,190	54,086,107	38,256,910	23,800,000	28,618,970	33,437,940	38,256,910

Sets 1(e) & 2(e) … For 2021, 2022 & 2023 ending inventories increase each year by one-third of liquidation amount. (Liquidation amount is $14,456,910 [$38,256,910 - $23,800,000 ... Increase is $4,818,970 during each year].) Accordingly, by the end of the third year of the recovery period (Dec. 31, 2023), the taxpayer's inventory level has returned to the Dec. 31, 2019 pre-liquidation level ($38,256,910). At the end of each year, inventory amounts are $28,618,970 (2021), $33,437,940 (2022) and $38,256,910 (2023).

Summary of Results for Case Study Sets 1(e) & 2(e)

1. Impact of the decrement in the amount of $1,899,336 in 2020 (if actual cost is used) is shifted to be a decrement in 2021 in the amount of $1,451,210.
2. Recovery period is 3 years (2021, 2022, and 2023), ending Dec. 31, 2023.
3. The LIFO reserve balance at the end of the pre-recovery period (as of Dec. 31, 2019) would be frozen (i.e., remain unchanged) during the recovery period. In other words, any adjustments to the LIFO reserve balances during the recovery period would be "suspended." Only the net adjustment amount would be recorded to either increase or decrease the LIFO reserve to the appropriate amount as of Dec. 31, 2023.
4. LIFO Reserve at Dec. 31, 2019/Jan. 1, 2020 in the amount of $9,204,088 is increased by $156,035 to $9,360,123 as of Dec. 31, 2023.
5. This net adjustment of $156,035 over the period of 4 years (2020 - 2023) reflects an increase due to inflation in the amount of $1,607,245, and this is offset by a reduction in (or payback of) the LIFO Reserve due to shifting of the decrement of $1,451,210 in 2021. The relief the taxpayer has received is that it has avoided having to take the net decrease in the LIFO reserve as Dec. 31, 2020 (i.e., $1,605,558) into income in its 2020 income tax return.
6. This has allowed the taxpayer to receive the benefit of 4 years' worth of inflation ($1,607,245), and it reflects the impact of the decrement as calculated using the substitute inventory level ($1,451,210), which nets to an increase of $156,035.
7. Compared to using the actual cost method for 2020, using the historical average (substitute) method in the calculations over the period has resulted in a $240,206 increase in the LIFO reserve due to the inflation and a further increase in the LIFO reserve of $448,126 because that amount reflects less LIFO reserve payback because of the shifting of the decrement from 2020 to 2021 in slightly different amounts.
8. In 2024, (the first year after the end of the recovery period) the LIFO layer history through Dec. 31, 2023 as computed under the substitute cost calculation method reflects base dollars of $27,401,137 valued at $28,896,797 and a LIFO reserve of $9,360,123.
9. In 2024 (the first year after the end of the recovery period), the taxpayer will continue to use the LIFO layer history under the substitute cost calculation method.

Footnotes

1. *Presidential Proclamation on Declaring a National Emergency Concerning the Novel Coronavirus Disease (COVID-19) Outbreak* … issued March 13, 2020. (https://www.whitehouse.gov/presidential-actions/proclamation-declaring-national-emergency-concerning-novel-coronavirus-disease-covid-19-outbreak/). Proclamation 9994, *Federal Register*, Vol. 85, No. 53, March 18, 2020, pg. 15337.

2. Regulation Section 1.472-8 … *Dollar-Value Method for Pricing LIFO Inventories*

3. In essence, the three fundamental principles inherent in Dollar-Value LIFO Regulations are …

   (1) A LIFO reserve cannot be increased in a year when additional inventory in is purchased. One cannot expect to increase a LIFO reserve simply by purchasing additional inventory. The increase in the LIFO reserve due to the inflation factor for each year is computed by multiplying (*i*) the difference between the cumulative inflation index at the end of the current year and the cumulative inflation index at the beginning of the year (Line E in the computation schedule) by the (*ii*) lower of the beginning inventory or the ending inventory expressed in base dollars.

   (2) At year-end when there has been a liquidation of LIFO inventory (expressed in base dollars), the effect of that liquidation is carried back by removing in reverse chronological order the inventory increments built up in prior years.

   (3) Once an increment (i.e., a LIFO layer) from a prior year has been removed, that layer cannot be restored in a subsequent year by the purchase of additional inventory.

4. For more information on Willard J. De Filipps, CPA, please visit https://defilipps.com/about/. From March 1991 through December 2012, Mr. De Filipps wrote and published *De Filipps' LIFO Lookout*, a periodic update providing a comprehensive look at how current IRS rulings, audit developments and court decisions affect LIFO elections, computations and practices.

   Also, from June 1994 through December 2012, Mr. De Filipps wrote and published *De Filipps' Dealer Tax Watch*, a periodic update discussing current IRS tax rulings, audit developments and court decisions that affect auto dealers and dealerships.

   Complete Indexes of all articles in both publications are available at https://defilipps.com/.

5. "Visualizing Multi-Year LIFO Applications & Reconciliations," *LIFO … Love It or Leave It: Projecting the Impact of Covid-19 on Year-End Inventories & Planning for What Your Clients Can Do About It* (seminar materials), De Filipps, Willard J., November 24, 2020, pgs. 45-46.

6. "Understanding Why LIFO Reserves Go Up Even Though Inventory Levels Go Down," *LIFO … Love It or Leave It: Projecting the Impact of Covid-19 on Year-End Inventories & Planning for What Your Clients Can Do About It* (seminar materials), De Filipps, Willard J., November 24, 2020, pg. 47.

7. Letter dated Nov. 20, 2020 from the National Automobile Dealers Association (NADA) addressed to Messrs. David Kautter and Michael J. Desmond requesting expedited relief for certain franchised automobile and truck dealers.

8. *Public Law 96-223 Crude Oil Windfall Profit Tax Act of 1980* … Text of Law & Committee Reports, Department of Treasury Internal Revenue Service, *Internal Revenue Cumulative Bulletin 1980-3*. [*Report of the Committee on Ways and Means*, U.S. House of Representatives on H.R. 3919, related to the Crude Oil Windfall Profit Tax Act of 1979.]

Footnotes

9. "How LIFO Works," De Filipps, Willard J., published Feb. 1975 in *Cars & Trucks* (Vol. 47, No. 2), by the National Automobile Dealers Association

   Almost 20 years after my first article, the IRS published Revenue Procedure 92-79 which sets forth the Alternative LIFO Method for New Vehicles. Fifteen years after that, the IRS published Revenue Procedure 2008-23 which permits the LIFO pools for new automobiles and new light-duty trucks to be combined into a single LIFO pool. Revenue Procedure 92-79 was superseded by Revenue Procedure 97-36 which simply eliminated the transitional rules which were necessary in 1992 to permit auto dealers using various Dollar-Value LIFO methodologies to make an automatic change in accounting method to apply the Alternative LIFO Method.

   The similarity of the methods and procedures advocated in my article in 1975 and these Revenue Procedures is not coincidental. See "Proposal to the Internal Revenue Service for Simplified Alternative LIFO Method," submitted by W.J. De Filipps - July 14, 1992. Reprinted in the September 1992 issue of *De Filipps' LIFO Lookout*, Vol. 2 No. 3, pgs. 16-19.

   I submitted this proposal to the IRS after (i) vigorously representing (and successfully defending) auto dealerships using the Dollar-Value LIFO method described in my 1975 article at all IRS audit levels, and (ii) participating in a meeting in the National Office on July 7, 1992 which addressed various ways of resolving disagreements over computational methods and issues that had emerged during the two decades from 1974 to 1992.

10. *Coronavirus Aid, Relief and Economic Security (CARES) Act*, P.L. 116-136.

    See also *LIFO … Love It or Leave It: Projecting the Impact of Covid-19 on Year-End Inventories & Planning for What Your Clients Can Do About It* (seminar materials), De Filipps, Willard J., November 24, 2020 … especially "Year-End Planning and Tax Return Reminder Checklist," pg. 61.

11. Revenue Procedure 79-23 … *The LIFO Users Bill of Rights* … 1979-1 C.B. 564, 1979

12. $40,396,555 ÷ 1.402799 = $28,797,109 (the base dollars in inventory at Dec. 31, 2019) … 1.402799 = [1.328498 x 1.01100 x 1.01650 x 1.01400 x 1.01330]

13. Section 473(d) terms and definitions include…

    "The term 'qualified liquidation' means (A) decrease in the closing inventory of the liquidation year from the opening inventory of such liquidation year, but only if (B) … [The remainder of this sub-paragraph requires determination by the Secretary, after consultation with appropriate Federal officers … and the essence of my proposal to amend Section 473 by adding a new section (h) reflects the expectation that the impact of the Coronavirus is so evident that no further justification or involvement in this regard is necessary].

    "The term 'liquidation year' means the taxable year in which occurs the qualified liquidation to which this Section applies."

    "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 the replacement of the LIFO goods is completed."

    "The term 'replacement period' means the shorter of (A) period of the three taxable years following the liquidation year or (B) period specified by the Secretary …"

    In connection with using the historical 3-year average substitute, the year immediately preceding the liquidation year is referred to as the "pre-liquidation year."

Attachments & Schedules

Attachments

Proclamation Declaring National Emergency Due to Coronavirus Disease Outbreak

Visualizing Multi-Year LIFO Applications & Reconciliations

Understanding Why LIFO Reserves Go Up Even Though Inventory Levels Go Down

"How LIFO Works," De Filipps, Willard J., published Feb. 1975 in *Cars & Trucks* (Vol. 47, No. 2), by the National Automobile Dealers Association (page 1 only)

Schedules Comparing 2020 LIFO Calculations Using Both Methods

LIFO Calculations for the Years 2018 - 2020 … Using Dec. 31, 2020 Actual Inventory Cost

LIFO Calculations for the Years 2018 - 2020 … Using Dec. 31, 2020 Substitute (3-Yr. Avg.) Inventory Cost

LIFO Calculations for the Years 2018 - 2020 … Comparing Results Under Both Methods

Summary of LIFO Reserve Balances & Analyses of Net Changes in LIFO Reserves - Both Methods

Composition & Contribution Made by Each Layer to the LIFO Reserve at Dec. 31, 2020 - Both Methods

Composition & Contribution Made by Each Layer to the LIFO Reserve at Dec. 31, 2018 & 2019

Case Study Sets 1(a) & 2(a)

Summary of Results Based on Assumed Changes in Year-End Inventory Levels
Analysis of Differences in LIFO Reserve Changes During the Recovery Period

Set 1(a) … Actual

3-Year Projection of LIFO Inventories – Based on Actual Inventory Amount for 2020
Summary of LIFO Reserve Balances & Analyses of Net Change in LIFO Reserve
Composition & Contribution Made by Each Layer to the LIFO Reserve (2020 & 2023)

Set 2(a) … Substitute

3-Year Projection of LIFO Inventories – Based on Substitute Inventory Amount for 2020
Summary of LIFO Reserve Balances & Analyses of Net Change in LIFO Reserve
Composition & Contribution Made by Each Layer to the LIFO Reserve (2020 & 2023)

Schedules in the same format described above for Case Study Sets 1(a) and 2(a) are included for each of the Case Study Sets 1(b) & 2(b) … 1(c) & 2(c) … 1(d) & 2(d) … 1(e) & 2(e). Individual detail listings for these Case Study Sets have not been repeated.

REQUEST FOR LIMITED TAX RELIEF FOR BUSINESSES USING DOLLAR-VALUE LIFO METHODS TO VALUE INVENTORIES & SUGGESTED FRAMEWORK FOR IMPLEMENTING RELIEF

Proposal Submitted to:

Hon. Charles P. Rettig	Hon. David Kautter	Hon. Michael J. Desmond
Commissioner	Assistant Secretary (Tax Policy)	Chief Counsel
Internal Revenue Service	Department of the Treasury	Internal Revenue Service

Submitted by

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December 16, 2020

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