

APPEALS  
INDUSTRY SPECIALIZATION PROGRAM  
SETTLEMENT GUIDELINES

INDUSTRY: All Industries

ISSUE: Dollar-Value LIFO  
Earliest Acquisition Method

ACTING COORDINATOR: Fred Gavin

TELEPHONE: (616) 235-1280

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APPROVED:

*for* Thomas C. Lillie  
DIRECTOR, APPEALS LMSB SPECIALTY  
PROGRAMS

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Andrew E. Blanche  
DIRECTOR, APPEALS LMSB OPERATING UNIT

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**SETTLEMENT GUIDELINES**  
**DOLLAR-VALUE LIFO EARLIEST ACQUISITION METHOD**  
**ISSUE**

Whether a taxpayer, electing the earliest acquisition method of determining the current year cost of items making up a dollar-value LIFO pool, can determine the index used to value an increment without double-extending the actual cost of the goods purchased or produced during the year in the order of acquisition.

**EXAMINATION DIVISION POSITION**

Taxpayers electing the earliest acquisition cost method of determining the current year cost of items making up a pool may not do the following: (1) use a prior year's cumulative index in determining current year cost (earliest acquisitions); or (2) use an inventory turn, shortcut approach unless the taxpayer can demonstrate to the satisfaction of the District Director that its method consistently results in the clear reflection of its income. Some factors that may support clear reflection are: (a) the inflation rate is substantially the same throughout the year; and (b) the items are purchased or produced at a substantially constant rate and mix throughout the year. The combined variances in (a) and (b) above generally support an assumption that the application of the shortcut method produces substantially the same results as if the taxpayer had double-extended each item at current-year and base-year cost (in the case of taxpayers using the double extension method) or current-year and prior-year cost (in the case of taxpayers using the link-chain method).

**BACKGROUND**

Taxpayers adopt LIFO on a Form 970 filed with their tax return. When adopting LIFO, subsidiary elections are also made on the Form 970 for the initial year; e.g., methods of pooling, computation methodologies to compute increases and decreases in quantity of LIFO inventory and valuing increments (increases) to inventory which is the subject matter of this guideline. The subsidiary elections, such as the method of valuing increments, and each of the methods elected constitute methods of accounting. Any change from the initially elected

method requires approval by the Commissioner by filing a Form 3115, Application for Change in Accounting Method, in accordance with Rev. Proc. 97-27, 1997-1 C.B. 680 or Rev. Proc. 99-49, 1999-2 C.B.725 (or any successor).

#### LEGAL DISCUSSION AND ANALYSIS

I.R.C. Sec. 472(a) provides that a taxpayer may elect to use a LIFO inventory method consistent with applicable regulations.

I.R.C. Sec. 472(b)(1) provides that, under the LIFO method, goods comprising ending inventory are treated as first being those included in the opening inventory of the taxable year (in the order of acquisition) to the extent thereof; and second, those acquired in the taxable year. I.R.C. Sec. 472(b)(2) provides that in inventorying goods under the LIFO method, the taxpayer shall inventory them at cost. Treas. Reg. Sec. 1.472-3(d) provides that the propriety of all computations incidental to the use of the LIFO method will be determined by the Commissioner in connection with the examination of the taxpayer's income tax returns.

Treas. Reg. Sec. 1.472-8 prescribes the operating rules for the use of the dollar-value LIFO method of pricing inventories. Treas. Reg. Sec. 1.472-8(e)(1) is the basic provision, which outlines three methods to price dollar-value LIFO inventories: (1) double-extension method; (2) index method; and (3) link-chain method. These three methods apply different techniques to accomplish the following two objectives: (1) determine the base-year costs of current-year inventories; and (2) compute an index to price increments of base-year costs occurring during the current year. The use of the phrase "index method" can be misunderstood because each of the three LIFO pricing methods, i.e., double-extension, index and link-chain, are methods that apply price indexes. Treas. Reg. Sec. 1.472-8(e)(1) also states, among other things, that the appropriateness of the index must be demonstrated to the satisfaction of the district director in connection with the examination of the taxpayer's income tax returns.

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

The index method is an allowable method where indexes are developed by double-extending a representative portion of the

inventory in a LIFO pool(s) or by using other sound and consistent statistical methods. In contrast to the double-extension method, the index method divides the sample index into total current-year costs to obtain total base-year costs in the current inventory. This projection technique is necessary because the index method does not double-extend the entire current-year inventory. This index is also used to value increments (increases) in inventory, which is the subject of this guideline.

The link-chain index method is a cumulative index which considers all annual indexes dating back to the year of the LIFO election and must be computed every year to keep the cumulative index current. Each year, a taxpayer computes a new cumulative index and uses that index to determine the base-year cost of the ending inventory in a pool and to value the increment for the year, if any.

The taxpayer's link-chain method may double-extend all items in ending inventory or use a sampling technique. The ending inventory must be priced at their beginning and end-of-year costs in order to obtain the annual index that is "linked" (multiplied) to the prior year cumulative index to arrive at the current year cumulative index. In actual practice, it will be found that the procedures used by most large taxpayers are to double-extend a representative portion of the inventory by some type of sampling technique, similar to what a taxpayer on the index method performs. The use of a sampling technique to compute the link-chain index is allowable, assuming it was properly elected, and the sampling methodology is statistically sound and consistently applied.

The regulations also include examples as to how LIFO inventories should be computed under the double-extension method. There are no examples or other regulations that relate specifically to the use of the index or link-chain methods, but it is commonly agreed that those methods are conceptually comparable to the double-extension method. See, e.g., All Industry Coordinated Issue Paper, Dollar-Value LIFO Segment of Inventory Excluded from the Computation of the LIFO Index (June 26, 1995). Except for the requirement to double-extend each item in ending inventory, the principles and operating rules in the double-extension regulations are conceptually applicable to taxpayers on the index or link-chain methods. The double-extension regulations are cited frequently to

justify various methods and approaches used in conjunction with the link-chain method. For example, Treas. Reg. Sec. 1.472-8(e)(2)(iv), which describes the rules for determining layer increments and decrements, has been applied to the link-chain method.

Treas. Reg. Sec. 1.472-(8)(e)(2)(ii) provides that a taxpayer is allowed to determine the current-year cost of items making up the inventory by reference to:

(a) the actual cost of the goods most recently purchased or produced during the year;

(b) the actual cost of the goods purchased or produced during the year in the order of acquisition (the so-called, "earliest acquisition" method);

© the average cost of the goods purchased or produced during the year; or

(d) any other proper method which clearly reflects income.

Treas. Reg. Sec. 1.472-8(e)(2)(iv) states in part:

"To determine whether there is an increment or liquidation in a pool for a particular taxable year, the end of the year inventory of the pool expressed in terms of base-year cost is compared with the beginning of the year inventory of the pool expressed in terms of base-year cost. When the end of the year inventory of the pool is in excess of the beginning of the year inventory of the pool, an increment occurs in the pool for that year. If there is an increment for the taxable year, the ratio of the total current-year cost of the pool to the total base-year cost of the pool must be computed. This ratio when multiplied by the amount of the increment measured in terms of base-year cost gives the LIFO value of such increment."

Taxpayer's sometimes use shortcut methods to value increments that are not permitted by the regulations. One common impermissible shortcut method is to use the prior year's cumulative index to value the current year increment. In other words, the ratio of the prior-year cost of the pool to the total base-year cost of the pool. This method would assume there is no inflation in the current year increment. Generally, such an assumption is unrealistic. Furthermore,

this method is in direct violation of Treas. Reg. Sec. 1.472-8(e)(2)(iv) which requires that increments be valued using the ratio of the total current-year cost of the pool to total base-year cost of the pool. Further, use of the prior year's index squarely addresses the primary position of this coordinated issue of not allowing such prior year's index as an acceptable "short-cut" methodology.

Some taxpayers will maintain their inventory records using the cost of last acquisition or year-end FIFO cost under a standard cost system. If they elect LIFO, however, taxpayers prefer to use the earliest acquisition method to determine their current-year cost without changing their record keeping system. Taxpayer's using dual indexes must establish the appropriateness, accuracy, reliability, and suitability of such indexes to the satisfaction of the district director.

When dual indexes are used by taxpayers on the link-chain method, they must compute a "primary" index. The primary index measures current year inflation by double-extending end of year quantities at most recent purchase or last acquisition (FIFO) costs in effect at the beginning of the year.

Taxpayer's then multiply this primary index by the prior year's cumulative index to arrive at a deflator index. The deflator index is used to compute inflation from the beginning of the taxable year for which LIFO was first adopted (the base year) to the current year. If the taxpayer's ending inventory stated at base-year costs is greater than the taxpayer's beginning inventory at base-year costs, an increment results.

The increment, at base year cost, is then converted to current LIFO cost by applying the increment valuation index. You should only see this type of dual index with a deflator index on a link-chain taxpayer. This secondary or increment valuation index is developed to value increments. This secondary index is computed by extending a representative portion of the current year ending inventory using earliest acquisition cost and then dividing this result by the base year cost of the same inventory. Taxpayers using the double extension method do not need the deflator index, although they still need a proper index to value any increments.

When computing the increment valuation or secondary index, many taxpayers fail to double-extend the end of year quantities and earliest acquisition costs as required in Treas. Reg. Sec. 1.472-8(e)(2). Instead, they rely on various shortcut methods to estimate earliest acquisition costs. It is

important to remember that the regulations require the taxpayer to use actual acquisition prices from the beginning of the year for the number of items acquired to develop the increment valuation index. Taxpayers with large complex inventories that use a standard cost system have difficulties in determining cost at the beginning of the year in order of acquisition so as to literally comply with the technical requirements of Treas. Reg. Sec. 1.472-8(2)(ii)(b). Generally, a perpetual standard cost system averages costs so that a taxpayer using a standard cost method will have the same book cost for all production of an item during the year. Therefore, taxpayer's argue certain "shortcuts" may be necessary to emulate the earliest acquisition method. These shortcut or non-regulatory methods utilized by taxpayers may subject the methodology to closer scrutiny under the clear reflection of income standard.

Tax accounting and inventory commentators discuss the fact that the dual index method can produce correct results, but warn that the earliest acquisition costs would not reflect the costs incurred by the taxpayer on any particular date, such as the first day or the last day of the first quarter of the taxpayer's year. Instead, such costs must be computed by determining the quantity of each particular type of item which is contained in the taxpayer's ending inventory and by comparing a sufficient number of the same items purchased or produced by the taxpayer during the year, commencing with the first day of the year and working forward until the number of units which are priced equals the quantity of such items in the taxpayer's ending inventory.

If properly applied, the use of a two index method or dual indexes may result in an inventory valuation method that is substantially the same as if the ending inventory was double-extended on an item-by-item basis in the order of acquisitions (proper regulatory method). In other words, the standard for clear reflection of income must be the use of a single overall index that one obtains through the regulatory method. Verification of the result must be satisfactorily demonstrated by the taxpayer to the district director in accordance with Treas. Reg. Sec. 1.472-8(e)(1).

The inventory turn method is another short-cut methodology that may cause a potential distortion because of its treatment relative to new items entering the inventory. One of the reasons taxpayers elect the link-chain method is because they

have a significant number of new items entering the inventory every year, but it causes difficulties in computing any increment under the earliest acquisition method or strict regulatory method. This short-cut inventory turn method assumes that items are purchased at a constant rate and mix throughout the year. Under this method, if the inventory turned twelve times a year, the operative portion of the index would be divided by twelve. For example, if the current index were 1.12, the operative portion would be .12 (1.12 minus 1).

This method would then assume the secondary index was 1.01 (.12 divided by 12 equals .01 and 1. plus .01 equals 1.01).

The possible distortion is based on the fact that the inventory turn method assumes a constant rate of inflation throughout the year. If inflation does not occur at a constant rate, the inventory turn method will not produce the same result, which the strict earliest acquisition regulatory method described in Treas. Reg. Sec. 1.472-8(e)(2)(ii)(b) produces. The materiality difference can only be measured if the taxpayer has the records or means to compute the increment by the regulatory method. Essentially, it's an argument on an argument because their book or standard cost system for non-tax purposes is what caused them to use the short-cut inventory turn method in the first place. Some taxpayers cannot meet this required burden and adjustments are conceivably necessary for clear reflection of income.

Whether there is a reasonable constant rate, including the first inventory turn, or whether the majority of new items would be purchased (or produced) after the first inventory turn must be reviewed. If new items make up a material portion of the overall inventory, and the new items are not considered in the computation of the increment valuation index, that index will be understated during periods of inflation thereby valuing the layer below the regulatory method and understating taxable income. New items must be included in the computation of the LIFO increment indexes for income to be clearly reflected. The distortion is not limited to understatement of the index, but inventory turn method could result in an overstatement of the index. The amount and severity of the distortion is dependent upon the actual rate of inflation throughout the year, and at times of the year, compared to an assumed constant rate. It would be unusual for the distortion to be zero. The taxpayers, in order to sustain their burden, must provide proofs or studies that their methodology emulates the regulatory method elected, otherwise adjustments may be

required by the district director's examiner for income to be clearly reflected.

Taxpayers may argue that if their short-cut method to determine the increment valuation is not an acceptable method under Treas. Reg. Sec. 1.472-(8)(e)(2)(ii)(b) then it is an acceptable method under Treas. Reg. Sec. 1.472-8(e)(2)(ii)(d) - any other proper method that clearly reflects income. In order to determine whether a method that is intended to emulate the earliest acquisition method is reasonable, the proposed method must be judged by comparing it to the earliest acquisition method. Therefore, if the taxpayer changed from the earliest acquisitions method to a short-cut method, the taxpayer has made an unauthorized change in its method of accounting. In that case, the Service may change the taxpayer back to the earliest acquisitions method and propose a section 481(a) adjustment.

There is no case law directly on point with the various short-cut methods described above. The taxpayer clearly has the burden of proving its LIFO index is an accurate reflection of its inflationary price increases. The LIFO regulations are legislative, which gives them the effect of law. These regulations place a strong burden of proof on the taxpayer. See Boecking v. Commissioner, TC Memo 1993-497 where the petitioner failed to meet its burden and their LIFO election was terminated and the accumulated LIFO reserve was required to be reported into income. The Supreme Court, in Commissioner 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." The Houston case was not a LIFO case, but a substantiation case. There are a myriad of substantiation cases that turn based on the facts and circumstances of the respective issues.

I.R.C. Sections 446 and 471 govern the treatment of inventories for tax purposes. These sections grant the Commissioner broad discretion in matters of inventory accounting and grant latitude to adjust a taxpayer's method of accounting for inventory so as to clearly reflect income. Thor Power Tool Co. v. Commissioner, 439 U.S. 522 (1979). The Commissioner's determination with respect to the clear reflection of income is given more than the usual presumption

of correctness, and the taxpayer bears a heavy burden of overcoming a determination that a method of accounting does not clearly reflect income.

Once the Commissioner determines that a taxpayer's method of accounting does not clearly reflect income, the Commissioner may select for the taxpayer a method, which clearly reflects income. The taxpayer has the burden of showing that the method selected by the Commissioner is incorrect, and such burden is extremely difficult to carry. Photo-Sonics, Inc. v. Commissioner, 357 F.2d 656 (9<sup>th</sup> Cir. 1966). The Commissioner's determination as to the proper method of accounting for inventory must be upheld unless shown to be arbitrary. Lucas v. Kansas City Structural Steel Company, 281 U.S. 264 (1930); E.W. Richardson v. Commissioner, T.C. Memo. 1996-368 (involving LIFO).

Treas. Reg. Sec. 1.446-1(e)(2)(ii)(a) provides, in part, that "a change in the method of accounting includes a change in the overall plan of accounting for gross income or deductions or a change in the treatment of any material item used in such overall plan." A "material item" is any item, which involves the proper time for the inclusion of the item in income or the taking of a deduction. The regulation further states, "changes in method of accounting include a change...involving the method or basis used in the valuation of inventories." See I.R.C. Sec. 471 and Sec. 472 and the regulations there under.

I.R.C. Sec. 481(a) provides that, if a taxpayer's method of accounting is changed, the taxpayer is required to make an adjustment (sometimes called a "catch-up adjustment") to prevent amounts from being duplicated or omitted by reason of change.

The Tax Court stated in Hamilton Industries, Inc. v. Commissioner, 97 T.C. 120 (1991) that a change in the method of valuing closing inventory constitutes a change in the method of accounting to which section 481 applies. In addition, the court held that if adjustments affect the timing of the inclusion of income deferred by the taxpayer, those adjustments constitute a change in the method of accounting. See also Kohler Co. and Subsidiaries v. U.S., 34 Fed. Cl. 379 (1995), aff'd, 124 F.3d 1451 (Fed. Cir. 1997). Likewise, changes that affect increment pricing methods affect the timing and valuation of inventory and, therefore, also constitute a change in method of accounting.

## SETTLEMENT GUIDELINES

### 1. Prior Year's Cumulative Index In Determining Current Year Cost For The Earliest Acquisition Method:

Taxpayers using such methodology are not in compliance with the regulatory authorities cited herein and there should be little reason for its continued use or for some intermediate percentage settlement. It is an unallowable method. Such methods are not approved when taxpayers request a change in method of accounting with the National Office and should not be authorized at the field level (Exam or Appeals).

It is important to consider the facts and circumstances of each case. One approach to resolution is to give the taxpayer an opportunity to properly reconstruct its increment valuation as technically required in the order of acquisition under Treas. Reg. Sec. 1.472-8(e)(2)(ii)(b). This is the regulatory method the taxpayer elected and the standard to start with to determine clear reflection of income.

Computing the increment valuation under Treas. Reg. Sec. 1.472-8(e)(2)(ii)(a) is another approach to resolution. This is a regulatory method that uses the actual cost of goods most recently purchased or produced during the year, commonly called the "most recent purchases method". It does not follow the reverse flow of goods LIFO theory as well as the earliest acquisition method. A specific matters closing agreement under I.R.C. Sec. 7121 should be used if the resolution results in a permanent accounting method change to this acceptable regulatory method.

Another approach may be to compute the increment valuation using the average cost method provided by Treas. Reg. Sec. 1.472-8(e)(2)(ii)©. The average cost method is another permissible method that is consistent with manufacturers' standard cost or burden rate method.

If the taxpayer does not have the records in the order of acquisition to properly compute its elected method and further does not have records to reconstruct under the alternative most recent purchases regulatory method, the viability of continuing the LIFO method must be analyzed thoroughly. Rev. Proc. 79-23, 1979-1, C.B. 564, is the Service's official position on Termination or revocation of a taxpayer's LIFO method. Consultation with the Appeals Inventory specialist is essential and required.

## **2. Use of Dual Indexes or Inventory Turn Methods:**

In terms of potentially litigating cases with this LIFO earliest acquisition method issue, it is difficult to establish a firm cut-off percentage to delineate good cases from bad. If the taxpayer can reconstruct the items acquired in the first part of the year according to the regulations, an informed decision can be made of this reconstructed data to the taxpayer's return position.

The acceptability of these and other similar approaches depends on whether the short-cut method produces results that approximate the methods prescribed in the regulations. This is a facts and circumstances intensive issue that requires careful review and study. Contact your Inventory Issue Specialists for assistance, review and concurrence.

Again, it is difficult to give a pro-forma percentage or formula because of the many mitigating factors. Intermediate settlements based on a percentage difference below the most recent purchases method (least advantageous to the taxpayer) may be a good starting point, since it is a regulatory method.

This approach should only be used for intermediate settlements based on the hazards of litigation for the years under the jurisdiction of Appeals. It would not be an acceptable permanent accounting method to place the taxpayer on since it is a nonregulatory method.

Not all fact situations can be covered in a guideline such as this. Different factual situations or variations may arise that cause the guideline to be inappropriate for your case. IRM 8.7.1.6.1.2 explains the approval procedures for appeals officers and team chiefs. Delegation Order 247 requires examination case managers to obtain the approval from both Exam and Appeals specialists.