



# Internal Revenue Service

DEPARTMENT OF THE TREASURY

## LB&I Concept Unit

<b>Unit Name</b>	Adopting LIFO	
<b>Primary UIL Code</b>	00472.01-00	Election

<b>Library Level</b>	<b>Title</b>
<b>Knowledge Base</b>	Corporate/Business Issues & Credits
<b>Shelf</b>	Inventory and IRC 263A
<b>Book</b>	Inventory LIFO
<b>Chapter</b>	Election of LIFO Method

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# General Overview

## Adopting LIFO

Treas. Reg. 1.472-2 provides the general requirements for the adoption and use of the Last-in First-out (LIFO) method.

The following are the basic requirements for adopting and using the LIFO method that will be discussed in this concept unit:

- A taxpayer must file an application to use the LIFO method and specify the inventory to which the election applies.
- A taxpayer must value beginning inventory at cost in accordance with the regulations.
- A taxpayer must restore any inventory write-downs.
- A taxpayer must use the LIFO method for book purposes and for any income statements to shareholders in the year it adopts the LIFO method and all subsequent years it uses the LIFO method.
- Once adopted, a taxpayer must use the LIFO method unless the IRS Commissioner consents to termination.
- A taxpayer must maintain adequate records to enable verification of its inventory computation and compliance with the regulations.

# Detailed Explanation of the Concept

## Adopting LIFO

Analysis	Resources
<p><u>How to Elect LIFO</u></p> <p>A taxpayer must complete Form 970, <i>Application to Use the LIFO Inventory Method</i>, and attach it to the tax return in which it first elects LIFO.</p> <p><u>Value Beginning Inventory at Cost</u></p> <p>A taxpayer must value its beginning inventory at cost in the first taxable year that it uses the LIFO method. See IRC 472(d). In the first taxable year (the year of change), a taxpayer must treat the items in beginning inventory as if it acquired them all at the same time and the taxpayer must re-determine their value using the average cost method. See IRC 472(b)(3). To determine the average cost, a taxpayer sums the cost it paid for each item in ending inventory and divides the summation by the number of items in ending inventory.</p> <p>A taxpayer adopting the LIFO method cannot use the lower of cost or market method to value its inventory. See IRC 472(b)(2). A taxpayer that had been using the lower of cost or market method before it adopted LIFO must adjust its inventory balances to cost.</p> <p>The IRS may terminate a taxpayer's LIFO election if the taxpayer does not value its inventory at cost for the year preceding the LIFO election. Termination is not automatic due to the Service's discretionary authority in IRC 472(e)(2).</p>	<ul style="list-style-type: none"><li>▪ IRC 472(b)(2)</li><li>▪ IRC 472(b)(3)</li><li>▪ IRC 472(d)</li><li>▪ IRC 472(e)(2)</li><li>▪ Rev. Proc. 79-23</li><li>▪ Form 970 - <i>Application to use the LIFO Inventory Method</i></li></ul>

# Detailed Explanation of the Concept (cont'd)

Adopting LIFO	
Analysis	Resources
<p><u>Value Beginning Inventory at Cost (cont'd)</u></p> <p>When terminating a taxpayer's LIFO election, the inventory is restored to cost by changing the beginning inventory in the year of change (see discussion below). See Rev. Proc. 79-23.</p> <p>A change from the First-in, First-out (FIFO), or any other inventory method, is a change in accounting method. A taxpayer is required to recompute the inventory account balances for inventory using the LIFO cost. A taxpayer includes in income the increase in inventory value, resulting from the restoration of write-downs, ratably in each of the three taxable years beginning with the first taxable year the taxpayer uses the LIFO method. See IRC 472(d).</p> <p><u>Restore Inventory Write-downs</u></p> <p>A taxpayer adopting the LIFO method must restore all inventory write-downs in ending inventory that the taxpayer claimed in previous years into taxable income. This restoration is required for all write-downs, including write-downs from cost to market value, write-downs for subnormal goods and excess inventory, and percentage write-downs (financial accounting inventory write-downs based on the company's historical experience). See Rev. Proc. 76-28 and Issue Snapshot - <i>Overview of Inventory Write-Downs</i>.</p>	<ul style="list-style-type: none"><li>▪ IRC 472(d)</li><li>▪ Rev. Proc. 76-28</li><li>▪ Rev. Proc. 79-23</li><li>▪ Issue Snapshot - <i>Overview of Inventory Write-Downs</i></li></ul>

# Detailed Explanation of the Concept (cont'd)

Adopting LIFO	
Analysis	Resources
<p><u>LIFO Conformity Requirements</u></p> <p>A taxpayer must use the LIFO method for book purposes and for any income statements to shareholders in the year the taxpayer adopts the LIFO method and any subsequent year. Financial statement conformity requirements when using the LIFO inventory method are covered in Treas. Reg. 1.472-2(e). The regulation also explains the exceptions to the requirements.</p> <p>LIFO conformity requirements:</p> <ul style="list-style-type: none"><li>▪ If a taxpayer uses the LIFO method for tax, they must use the LIFO method for book.</li><li>▪ The LIFO method a taxpayer uses for book and tax can be different.</li><li>▪ Adoption of International Financial Reporting Standards (IFRS) will cause a LIFO termination (IFRS does not allow the LIFO inventory method).</li><li>▪ A foreign parent of a consolidated group need not use the LIFO method of inventory valuation in the consolidated financial statements of a consolidated group that engages in substantial foreign operations, even though one or more of its subsidiaries use the LIFO method of valuing inventories for federal tax purposes. See Rev. Rul. 78-246. A 30% test is used to establish whether the foreign operations are substantial. Also see Practice Unit - <i>LIFO Conformity for U.S. Corporations with Foreign Subsidiaries Using LIFO</i>.</li><li>▪ A taxpayer must use the LIFO method for all reporting: credit purposes, reports to shareholders, partners, proprietors, and beneficiaries.</li></ul>	<ul style="list-style-type: none"><li>▪ Treas. Reg. 1.472-2(e)</li><li>▪ Rev. Rul. 78-246</li><li>▪ Issue Snapshot – <i>LIFO Conformity and Exceptions</i></li><li>▪ Practice Unit - <i>LIFO Conformity for U.S. Corporations with Foreign Subsidiaries Using LIFO</i></li></ul>

# Detailed Explanation of the Concept (cont'd)

Adopting LIFO	
Analysis	Resources
<p><u>LIFO Conformity Requirements (cont'd)</u></p> <p>A taxpayer does not have to use the LIFO method in the following items when reporting for financial statement purposes:</p> <ul style="list-style-type: none"> <li>▪ Supplemental and explanatory information</li> <li>▪ Certain balance sheet disclosures</li> <li>▪ Internal management reports</li> <li>▪ Interim reports</li> <li>▪ Lower of LIFO cost or market</li> </ul> <p><u>Continue to Use the LIFO method</u></p> <p>A taxpayer must continue to use the LIFO method after adoption unless:</p> <ul style="list-style-type: none"> <li>▪ The Commissioner approves a change to a different method; or</li> <li>▪ The Commissioner terminates the taxpayer's LIFO method due to the taxpayer calculating income for the taxable year using an inventory method other than LIFO               <ul style="list-style-type: none"> <li>- for credit purposes, or</li> <li>- for reports to shareholders, partners, other proprietors, or to beneficiaries.</li> </ul> </li> </ul>	<ul style="list-style-type: none"> <li>▪ IRC 472</li> <li>▪ IRC 472(e)(2)</li> <li>▪ Issue Snapshot - <i>LIFO Conformity and Exceptions</i></li> </ul>

# Detailed Explanation of the Concept (cont'd)

Adopting LIFO	
Analysis	Resources
<p><u>Maintain Adequate Records</u></p> <p>A taxpayer must maintain supplemental and detailed inventory records to enable verification of the taxpayer's inventory computations and determine its compliance with the requirements of IRC 472 and Treas. Regs. 1.472-1 through 1.472-8. The taxpayer must maintain detailed records of the current and base costs of the items in inventory and the detail of all index determinations.</p> <p>Termination of a taxpayer's LIFO election may be warranted if the taxpayer does not maintain adequate books and records for its LIFO inventory and all computations incident thereto in accordance with Rev. Proc 79-23. However, termination in these situations is not automatic due to the Commissioner's discretionary authority in IRC 472(e)(2) and the underlying regulations.</p> <p>Since the LIFO inventory value contains historic layers, a taxpayer must maintain the current cost detail listing for every year in which the taxpayer uses the LIFO method. See Treas. Reg. 1.472-8(e).</p> <p>The listing includes the SKU (i.e., stock-keeping unit number), item description, quantity, and current cost of each item in inventory. See Treas. Reg. 1.472-8(e). The annual current cost detail listing allows for verification of new items that enter into the inventory, the current cost of the new items, and the LIFO computation at any time during the duration of the LIFO election.</p>	<ul style="list-style-type: none"><li>▪ IRC 472</li><li>▪ Treas. Regs. 1.472-1 through 1.472-8</li><li>▪ Treas. Reg. 1.472-8(e)</li><li>▪ Rev. Proc 79-23</li></ul>



# Detailed Explanation of the Concept (cont'd)

Adopting LIFO	
Analysis	Resources
<p><u>Changes in Accounting Methods</u></p> <p>A change from a LIFO Method to a non-LIFO method for valuing inventory is a change in accounting method. See IRC 472(e).</p> <p>If the Service terminates a taxpayer's LIFO election due to conformity issues, then the taxpayer must follow the rules outlined in Treas. Reg. 1.472-6. A taxpayer must value the inventory:</p> <ul style="list-style-type: none"> <li>▪ In conformity with the method the taxpayer used under IRC 471 for inventories not included in its LIFO computations, or</li> <li>▪ If all the inventory was valued under LIFO, then the inventory method the taxpayer used prior to its adoption of the LIFO method, or</li> <li>▪ If there were no prior inventories and no inventories valued by a method other than LIFO, then the taxpayer may select a method that the Commissioner approves as a clear reflection of income, or</li> <li>▪ Any method change made on Form 3115 that the Commissioner approves.</li> </ul> <p>If the Service terminates a taxpayer's LIFO election, the taxpayer will not be entitled to any special relief provisions and the termination adjustment would be made under IRC 481.</p>	<ul style="list-style-type: none"> <li>▪ IRC 471</li> <li>▪ IRC 472(e)</li> <li>▪ Treas. Reg. 1.472-6</li> <li>▪ Form 3115 - <i>Application for Change in Accounting</i></li> </ul>

# Detailed Explanation of the Concept (cont'd)

Adopting LIFO							
Analysis	Resources						
<p><u>Changes in Accounting Methods (cont'd)</u></p> <p>This would result in a change of accounting method for the earliest year under examination with a corresponding IRC 481(a) adjustment equal to the taxpayer's LIFO tax reserve as of the first day of the year of change. In addition, there would be a current year adjustment for the difference between LIFO and FIFO costs.</p> <p>The LIFO reserve is the difference between the ending inventory valued using LIFO and ending inventory valued at current year cost.</p> <p>Example:</p> <table><tr><td>LIFO Cost</td><td>800,000</td></tr><tr><td>Current Year Cost</td><td><u>1,000,000</u></td></tr><tr><td>LIFO Reserve</td><td>200,000</td></tr></table> <p>The Service reaffirms that, absent unusual circumstances, a taxpayer may not readopt the LIFO method for at least five taxable years after terminating the election in accordance with Rev. Proc. 2011-14.</p>	LIFO Cost	800,000	Current Year Cost	<u>1,000,000</u>	LIFO Reserve	200,000	<ul style="list-style-type: none"><li>▪ IRC 481(a)</li><li>▪ Rev. Proc. 2011-14</li></ul>
LIFO Cost	800,000						
Current Year Cost	<u>1,000,000</u>						
LIFO Reserve	200,000						

# Detailed Explanation of the Concept (cont'd)

Adopting LIFO	
Analysis	Resources
<p><u>Changes in Accounting Methods (cont'd)</u></p> <p>When the Service determines a taxpayer's book inventory method is not a LIFO inventory method, the taxpayer is using an impermissible method of accounting for income tax reporting. The Service may change the taxpayer's inventory method of accounting to a permissible non-LIFO inventory method for income tax reporting.</p> <p>You can find additional information on Service-imposed method change issues in the Servicewide Virtual Library (VL). Go to the Examination floor, then to the Corporate/Business Issues &amp; Credits Knowledge Base (KB) and select the Change in Methods book on the Methods of Accounting and Timing shelf.</p>	<ul style="list-style-type: none"><li>▪ Corporate/Business Issues &amp; Credits KB, Change in Methods Book, Ch. 1 - <i>Basic Method of Accounting Concepts</i></li><li>▪ Corporate/Business Issues &amp; Credits KB, Change in Methods Book, Ch. 5 - <i>IRC 446(b): Service-Imposed Method Change Issues</i></li><li>▪ Corporate/Business Issues &amp; Credits KB, Change in Methods Book, Ch. 6 - <i>IRC 481(a) Adjustments</i></li></ul>

# Index of Referenced Resources

<b>Adopting LIFO</b>
IRC 471
IRC 472
IRC 472(b)(2)
IRC 472(b)(3)
IRC 472(d)
IRC 472(e)
IRC 472(e)(2)
IRC 481
IRC 481(a)
IRC 481(b)
Treas. Reg. 1.472-1 through 8
Treas. Reg. 1.472-2(e)
Treas. Reg. 1.472-8(e)
Rev. Rul. 78-246

# Index of Referenced Resources (cont'd)

## Adopting LIFO

Rev. Proc. 76-28

Rev. Proc. 79-23

Rev. Proc. 2011-14

Form 970 - Application to Use the LIFO Inventory Method

Form 3115 - Application for Change in Accounting Method

Issue Snapshot - LIFO Conformity and Exceptions

Issue Snapshot - Overview of Inventory Write Downs

Corporate/Business Issues & Credits KB, Change in Methods Book, Ch. 1 – Basic Method of Accounting Concepts

Corporate/Business Issues & Credits KB, Change in Methods Book, Ch. 5 – IRC 446(b): Service-Imposed Method Change Issues

Corporate/Business Issues & Credits KB, Change in Methods Book, Ch. 6 - IRC 481(a) Adjustments

# Training and Additional Resources

Adopting LIFO	
Type of Resource	Description(s)
Other Training Materials	<ul style="list-style-type: none"><li>▪ Overview of Basic LIFO PPT - 2012-10</li></ul>

# Glossary of Terms and Acronyms

Term/Acronym	Definition
FIFO	First in-First out
IFRS	International Financial Reporting Standards
IRC	Internal Revenue Code
KB	Knowledge Base
LIFO	Last in-First out
Rev. Proc.	Revenue Procedure
Rev. Rul.	Revenue Ruling
Service	Internal Revenue Service
Treas. Reg.	Treasury Regulation
VL	Virtual Library

# Index of Related Practice Units

Associated UIL(s)	Related Practice Unit
00472.05-00	<i>LIFO Conformity for U.S. Corporations with Foreign Subsidiaries Using LIFO</i>