



Internal Revenue Service

DEPARTMENT OF THE TREASURY

LB&I Concept Unit

Unit Name	LIFO Records	
Primary UIL Code	472.08-00	Dollar Value Method

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

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General Overview

LIFO Records

A taxpayer's current Last In-First Out (LIFO) inventory is a historic accumulation of quantity and price changes from the taxpayer's initial year of the LIFO election. Therefore, the taxpayer must maintain supplemental and detailed LIFO inventory records that support the current value of the inventory and the clear reflection of income. The LIFO regulations underline the importance of these historic records by specifically requiring that taxpayers maintain them. See Treas. Reg. 1.472-2(h).

The taxpayer must maintain a current cost detail listing in its supplemental records for every year in which it employs the LIFO election. See Treas. Reg. 1.472-8(e). The detailed product listing includes the stock-keeping unit (SKU) number, item description, quantity, and current cost of each item in inventory. These listings are necessary so that the examiner can verify the LIFO computation at any time during the duration of the LIFO election and verify when new items enter the inventory and the current cost of such items.

The taxpayer must maintain detailed records of the current cost and the base cost of the items in inventory and the detail of all index determinations. Treas. Reg.1.472-2(e)(9)(h).

The Service may terminate a taxpayer's LIFO election if the taxpayer does not maintain adequate books and records for its LIFO inventory and all computations. See Rev. Proc. 79-23. However, termination in these situations is not automatic due to the Service's discretionary authority in IRC 472(e)(2) and the underlying regulations.

Detailed Explanation of the Concept

LIFO Records

Analysis	Resources
<p>The taxpayer must maintain historic LIFO inventory records to verify the current value of its LIFO inventory. The regulations clearly call for the taxpayer to maintain historic records, but they do not specifically identify or define what records the taxpayer must maintain. The LIFO computational methodology sheds light on the type of information necessary for the examiner to verify the appropriateness of the inventory valuation. Please see the LIFO computational methodology shown below.</p> <p>Regardless of the LIFO sub-method, the taxpayer computes LIFO inventory on a pool by pool basis, which consists of six basic steps:</p> <ol style="list-style-type: none">1. Determine the current cost of the inventory.2. Determine the base cost of the inventory.3. Determine whether the inventory quantity has increased (increment) or decreased (decrement).4. Value the increment at current cost or value the decrement at the appropriate layer current cost.5. Compute the total ending LIFO inventory value.6. Determine the LIFO reserve.	

Detailed Explanation of the Concept (cont'd)

LIFO Records	
Analysis	Resources
<p>The examiner will need records for the first two steps to reproduce or verify the amounts. Steps three through six are mathematical; the examiner can reproduce and verify these steps without taxpayer records. However for steps one and two, it is essential the taxpayer maintain sufficient records to enable the examiner to verify the annual current and base cost of the inventory, and the original base cost of the inventory.</p> <p>The taxpayer's detail product listing of each item or good in the pool is fundamental to the verification process, because Treas. Reg. 1.472-8(e)(2) requires the taxpayer, under the dollar-value double-extension method, to extend the quantity of each "item" or "good" in the inventory pool at the close of the taxable year at both base-year unit cost and current-year unit cost.</p> <p>Although Treas. Reg. 1.472-8(e)(2) does not specifically define the term "item," a SKU would generally meet the definition. A SKU is a unique number for each item in the taxpayer's inventory. A SKU identifies a product's details, such as color, size, style, price, manufacturer, and brand. Under the double-extension method, Treas. Reg. 1.472-8(e)(2)(ii) uses the term "good." Although a "good" (or "item") under the double-extension method might arguably be a single SKU, many taxpayers group similar SKU's together to identify a good for LIFO purposes.</p>	<ul style="list-style-type: none">▪ Treas. Reg. 1.472-8(e)(2)▪ Treas. Reg. 1.472-8(e)(2)(ii)

Detailed Explanation of the Concept (cont'd)

LIFO Records	
Analysis	Resources
<p>The double-extension method is comparable to the link-chain, Inventory Price Index Computation (IPIC), and index methods and the taxpayer must maintain the same records for such methods.</p> <p><u>Determine Current Cost</u></p> <p>The taxpayer needs to:</p> <ul style="list-style-type: none">▪ Maintain a detailed current cost listing for every year it uses the LIFO method. The detailed current cost listing should include the quantity on hand of each item at the end of the tax year and the unit cost of each item.▪ Maintain the annual detailed current cost listings for the duration of the LIFO election.▪ Maintain the invoice documentation of the unit costs for the duration of the statute of limitations, plus extensions. Please see <i>Hamilton Industries, Inc. v. Commissioner</i>, 97 T.C. 120 (1991). <p>The examiner needs to:</p> <ul style="list-style-type: none">▪ Identify the current cost of new items as they enter the inventory.▪ Use the detailed current cost listing to verify the total value of the individual items in the inventory and the current cost of the inventory.	<ul style="list-style-type: none">▪ <i>Hamilton Industries, Inc. v. Commissioner</i> - 97 T.C. 120 (1991)

Detailed Explanation of the Concept (cont'd)

LIFO Records	
Analysis	Resources
<p><u>Determine Base Year Cost</u></p> <p>The taxpayer must maintain records necessary to verify the base cost of the goods in inventory. These records include the detailed current cost listing of the items in the taxpayer's ending inventory for the year prior to the election of the LIFO method, adjusted as required by IRC 472(b)(2) in order to reflect inventory at cost, such as restoring prior write downs.</p> <p>The listing should include the quantity of each item on hand at the end of the tax year prior to the LIFO election, and the unit cost of each item. The taxpayer must maintain this listing for the duration of the LIFO election.</p> <p><u>Additional Records</u></p> <p>As part of its supplemental and detailed inventory records, the taxpayer must maintain records of the double extensions used to compute the base cost of the inventory, under either the double-extension method or another index method, such as the link-chain method. See Treas. Reg. 1.472-2(e)(9)(h). Please see Practice Unit - <i>Introduction to Dollar Value LIFO</i>. Treas. Reg. 1.472-8(e)(1) states that the taxpayer must maintain adequate records to support the appropriateness, accuracy, and reliability of an index or link-chain method.</p>	<ul style="list-style-type: none">▪ IRC 472(b)(2)▪ Treas. Reg. 1.472-2(e)(9)(h)▪ Treas. Reg. 1.472-8(e)(1)

Detailed Explanation of the Concept (cont'd)

LIFO Records	
Analysis	Resources
<p><u>Termination of LIFO Election</u></p> <p>The Service may terminate a taxpayer's LIFO election in certain situations set forth below. See Rev. Proc. 79-23. However, termination in these situations is not automatic due to the Service's discretionary authority in IRC 472(e)(2) and the underlying regulations.</p> <ol style="list-style-type: none"> 1. The taxpayer does not meet the conformity requirements contained in IRC 472(c) or (e). 2. The taxpayer does not properly elect the LIFO method and make the necessary adjustment required by IRC 472(d). 3. The taxpayer does not value its LIFO inventory at cost for federal income tax purposes, for the year preceding the year of the LIFO election, the year of the LIFO election, and all subsequent taxable years. However, in determining cost for the year of the LIFO election and any subsequent year, if the taxpayer does not include (or exclude) an item of cost in accordance with the full absorption inventory rules of Treas. Reg. 1.471-11, this will not warrant disallowance or termination. 4. The taxpayer does not maintain adequate books and records for its LIFO inventory and all computations. Rev. Proc. 79-23, Section 3.01(d), discusses the necessity for the taxpayer to maintain adequate books and records for its LIFO inventory and all computations. 	<ul style="list-style-type: none"> ▪ IRC 472(e)(2) ▪ IRC 472(c) ▪ IRC 472(e) ▪ IRC 472(d) ▪ Treas. Reg. 1.471-11

Detailed Explanation of the Concept (cont'd)

LIFO Records	
Analysis	Resources
<p><u>Termination of LIFO Method (cont'd)</u></p> <p>In <i>Boecking v. Commissioner</i>, T.C. Memo. 1993-497, the Tax Court conferred broad authority on the Service to terminate a taxpayer's LIFO election because of inadequate books and records. In this case, the taxpayer's LIFO methodology contained a few deficiencies relating to the calculation of current-year cost and base-year cost. On audit, the taxpayer was unable to correct these deficiencies to the Service's satisfaction. The Service terminated the taxpayer's LIFO election rather than attempting to estimate or extrapolate a corrected calculation and the Tax Court upheld the termination. (See <i>Schneider, Federal Taxation of Inventories</i>, chapter 10.02[2][d]. release 38, 1998.)</p>	<ul style="list-style-type: none">▪ <i>Boecking v. Commissioner</i> - T.C. Memo. 1993-497▪ <i>Schneider, Federal Taxation of Inventories</i> - chapter 10.02[2][d]. release 38, 1998

Detailed Explanation of the Concept (cont'd)

LIFO Records	
Analysis	Resources
<p><u>Termination of LIFO Method (cont'd)</u></p> <p>The Commissioner's determination with respect to clear reflection of income is entitled to 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. <i>Hamilton Industries v. Commissioner</i>, 97 T.C. 120 (1991).</p> <p>Whether a method of accounting clearly reflects income is a question of fact which must be decided on a case-by-case basis. <i>Peninsula Steel Products & Equipment Co. v. Commissioner</i>, 78 T.C. 1029, 1045 (1982).</p> <p>The Commissioner's determination as to the proper method of accounting for inventory must be upheld unless shown to be plainly erroneous. <i>Lucas v. Kansas City Structural Steel Co.</i>, 281 U.S. 264, 271 (1930). The Service provided that the taxpayer should keep adequate records pertaining to LIFO calculations including supporting accounting data, and invoices and records. The taxpayer's failure to maintain all invoices since the first year of the LIFO election is not, by itself, sufficient to terminate an election. But failure to maintain original inventory records sufficient to enable the Service to verify LIFO calculations could fail the record keeping requirement and allow termination.</p>	<ul style="list-style-type: none"> ▪ <i>Hamilton Industries v. Commissioner</i> - 97 T.C. 120(1991) ▪ <i>Peninsula Steel Products & Equipment CO. v. Commissioner</i> - 78 T.C. 1029, 1045 (1982) ▪ <i>Lucas v. Kansas City Structural Steel Co.</i> - 281 U.S. 264, 271 (1930)

Detailed Explanation of the Concept (cont'd)

LIFO Records	
Analysis	Resources
<p><u>Method of Accounting</u></p> <p>When an adjustment is warranted due to the taxpayer incorrectly computing the valuation of the current LIFO inventory, it is probable that there is a change in a method of accounting.</p> <p>If a change from the improper method to a proper method is not voluntary, IRC 481(a) requires a computation beginning with the first year in which the error occurred and making appropriate adjustments to each LIFO year from that first year to the current year. The IRC 481(a) amount is the cumulative adjustment from the first day of the tax year that the error first occurred.</p> <p>Although Rev. Proc. 97-27 allows the Service to estimate an IRC 481(a) adjustment, such an estimate may not uncover other errors that may have occurred in those prior years. Also, a court of law may consider the Service's computation arbitrary. Therefore, the examiner should consider termination of the LIFO election in situations where the taxpayer has failed to maintain adequate records and the IRC 481(a) adjustment is not resolved.</p> <p>A change in the value of closing inventory, including a change in the treatment of "items" within a LIFO pool, constitutes a change in method of accounting. <i>Hamilton Industries</i>, 97 T.C. 120 (1991); <i>Pacific Enterprises v. Commissioner</i>, 101 T.C. 1 (1993).</p>	<ul style="list-style-type: none">▪ IRC 481(a)▪ Rev. Proc. 97-27▪ <i>Hamilton Industries</i> - 97 T.C. 120 (1991)▪ <i>Pacific Enterprises v. Commissioner</i> - 101 T.C. 1 (1993)

Detailed Explanation of the Concept (cont'd)

LIFO Records	
Analysis	Resources
<p><u>Method of Accounting (cont'd)</u></p> <p>The taxpayer in <i>Consolidated Manufacturing, Inc. v. Commissioner</i>, 111 T.C. 1 (1998), aff'd in part, rev'd in part, 249 F.3d 1231 (10th Cir. 2001), maintained records for their method but did not maintain the basic records for current and base cost detail. If the Service raised the issue with the use of summarized items, the court may require the taxpayer maintain cost detail at the SKU level to substantiate clear reflection of income. The Tax Court concluded:</p> <ol style="list-style-type: none">1. The taxpayer is required to maintain supplemental and detailed inventory records of the current cost and the base cost of the items in inventory, and the detail of all index determinations.2. If the taxpayer does not maintain proper records, the Service may terminate the LIFO election and require the taxpayer to use a method (such as the First-in First-out inventory method) that clearly reflects income.3. It is within the Service's discretion to determine whether a taxpayer's application for the adoption and use of the LIFO inventory method should be approved and continued.4. The Service did not abuse its discretion in terminating the taxpayer's LIFO method election.	<ul style="list-style-type: none">▪ <i>Consolidated Manufacturing, Inc. v. Commissioner</i> - 111 T.C. 1 (1998), aff'd in part, rev'd in part, 249 F.3d 1231 (10th Cir. 2001)

Detailed Explanation of the Concept (cont'd)

LIFO Records	
Analysis	Resources
<p><u>Change 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) and 446. A change in accounting method is made under IRC 446.</p> <p>If the Service terminates a taxpayer's LIFO election, the taxpayer must follow the rules outlined in Treas. Reg. 1.472-6. Under a Service-imposed LIFO termination, the taxpayer must value the inventory using the below ordering rules:</p> <ul style="list-style-type: none"> ▪ In conformity with the method the taxpayer used under IRC 471 for inventories not included in its LIFO computations, or ▪ If all the inventory was valued under LIFO, then the inventory method the taxpayer used prior to its adoption of the LIFO method, or ▪ If there were no prior inventories and no inventories valued by a method other than LIFO, then the taxpayer may select a method as long as it is approved by the Commissioner as a clear reflection of income. <p>If the Service terminates a taxpayer's LIFO election, the taxpayer will not be entitled to any special relief provisions. The termination adjustment is a change in accounting method under IRC 446 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 (YOC). In addition, there would be a current year adjustment for the method determined above under Treas. Reg. 1.472-6.</p>	<ul style="list-style-type: none"> ▪ IRC 446 ▪ IRC 471 ▪ IRC 481(a) ▪ Treas. Reg. 1.472-6

Detailed Explanation of the Concept (cont'd)

LIFO Records		
Analysis	Resources	
<u>Change in Accounting Methods (cont'd)</u>		
The LIFO reserve is the difference between the ending inventory valued using LIFO and ending inventory valued at current year cost.		
Example:	Beginning of year in YOC	End of year in YOC
LIFO cost	900,000	800,000
Current year cost	<u>1,000,000</u>	<u>1,200,000</u>
LIFO Reserve	100,000	400,000
<ul style="list-style-type: none"> ▪ IRC 481(a) adjustment of \$100,000 ▪ Current year adjustment of \$300,000 ▪ Total adjustment of \$400,000, which equals the total LIFO reserve 		

Detailed Explanation of the Concept (cont'd)

LIFO Records	
Analysis	Resources
<p><u>Change in Accounting Methods (cont'd)</u></p> <p>In Rev. Proc. 2015-13, the Service reaffirmed that, absent unusual circumstances, a taxpayer may not readopt the LIFO method for at least five taxable years after terminating the election.</p> <p>When the Service determines a taxpayer is using an impermissible method of accounting, the Service may change the taxpayer's inventory method of accounting to a permissible inventory method. Please see Chapters 1, 5, and 6 of the Change in Methods book within the Servicewide Virtual Library, Examination Floor, Corporate/Business & Credits Knowledge Base (KB), Methods of Accounting and Timing shelf.</p>	<ul style="list-style-type: none"> ▪ Rev. Proc. 2015-13 ▪ Corporate/Business Issues & Credits KB, Change in Methods Book, Ch. 1 - <i>Basic Method of Accounting Concepts</i> ▪ Corporate/Business Issues & Credits KB, Change in Methods Book, Ch. 5 - <i>IRC 446(b): Service-Imposed Method Change Issues</i> ▪ Corporate/Business Issues & Credits KB, Change in Methods Book, Ch. 6 - <i>IRC 481(a) Adjustments</i>

Detailed Explanation of the Concept (cont'd)

LIFO Records	
Analysis	Resources
<p><u>Audit Techniques</u></p> <p>During the exam, follow the steps below:</p> <ul style="list-style-type: none"> ▪ Request copies of all Forms 3115, <i>Application for Change in Accounting Method</i>, and the Form 970, <i>Application to use the LIFO Inventory Method</i>. ▪ Ask how many years of detailed product listings the taxpayer retained. ▪ Request the detailed LIFO workpapers from the date of election until the end of the audit year. Request the formulas for the computations shown on the LIFO workpapers. ▪ Request the detailed product listings from the date of election until the end of the year under examination. ▪ Request a sample of invoices from the detailed product listings for the year under exam and the previous year to verify cost. Concentrate on those items that have unusually high indexes. Make sure that the products are identical in both years and the SKU number of the products is the same for both years. ▪ When examining the detailed product listing, ensure that the method used is the same method set forth in the Form 970. 	<ul style="list-style-type: none"> ▪ Form 3115, <i>Application for Change in Accounting Method</i> ▪ Form 970 – <i>Application to Use the LIFO Inventory Method</i>

Index of Referenced Resources

LIFO Records
IRC 446
IRC 471
IRC 472(b)(2)
IRC 472 (c),(d),(e)
IRC 481
IRC 481(a)
Treas. Reg. 1.471-2(e)(9)(h)
Treas. Reg. 1.471-11
Treas. Reg. 1.472-6
Treas. Reg. 1.472-8(e)(1)
Treas. Reg. 1.472-8(e)(2)
Treas. Reg. 1.472-8(e)(2)(ii)

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LIFO Records
Rev. Proc. 97-27
Rev. Proc. 2015-13
Form 970 - <i>Application to Use the LIFO Inventory Method</i>
Form 3115 - <i>Application for Change in Accounting Method</i>
<i>Boecking v. Commissioner</i> - T.C. Memo. 1993-497
<i>Hamilton Industries, Inc. v. Commissioner</i> - 97 T.C. 120 (1991)
<i>Consolidated Manufacturing, Inc. v. Commissioner</i> - 111 T.C. 1 (1998), aff'd in part, rev'd in part, 249 F.3d 1231 (10th Cir. 2001)
<i>Lucas v. Kansas City Structural Steel Co.</i> - 281 U.S. 264, 271 (1930)
<i>Pacific Enterprises v. Commissioner</i> - 101 T.C. 1 (1993)
<i>Peninsula Steel Products & Equipment Co. v. Commissioner</i> - 78 T.C. 1029, 1045 (1982)
Corporate Business Issues & Credits K. B., Changes in Methods Book, Ch 1 - <i>Basic Method of Accounting Concepts</i>
Corporate Business Issues & Credits K. B., Changes in Methods Book, Ch 5 - <i>IRC 446(b): Service-Imposed Method Change Issues</i>
Corporate Business Issues & Credits K. B., Changes in Methods Book, Ch 6 - <i>IRC 481(a) Adjustments</i>

Training and Additional Resources

LIFO Records	
Type of Resource	Description(s)
Other Training Materials	<ul style="list-style-type: none">▪ <i>Section 472 LIFO - 2019-07 CPE</i>▪ <i>Audit Tool - Job Aid - Audit Questions - Initial Review of LIFO</i>▪ <i>Audit Tool - NOPA - Maintenance of Adequate Books and Records & Termination for Failure to Maintain Proper Records</i>

Glossary of Terms and Acronyms

Term/Acronym	Definition
IPIC	Inventory Price Index Computation
IRC	Internal Revenue Code
KB	Knowledge Base
LIFO	Last In-First Out
Rev. Proc.	Revenue Procedure
Service	Internal Revenue Service
SKU	Stock-Keeping Unit
Treas. Reg.	Treasury Regulation
VL	Virtual Library

Index of Related Practice Units

Associated UIL(s)	Related Practice Unit
00472.01-00	<i>Adopting LIFO</i>
00472.08-00	<i>Introduction to Dollar Value LIFO</i>
00472.05-00	<i>LIFO Conformity Requirement</i>