

**Office of Chief Counsel
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Memorandum**

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subject: LIFO conformity violation

This memorandum responds to your request for assistance. This advice may not be used or cited as precedent.

LEGEND

Date 1 =

Date 2 =

Foreign Parent =

Taxpayer =

ABC =

ABC Consolidated Group =

Tax Year 1 =

ISSUES

Does the Taxpayer have a LIFO conformity violation related to its provision of financial statements prepared using IFRS to its lending bank?

CONCLUSIONS

The provision of financial statements prepared using IFRS to the lending bank violated the LIFO conformity requirements.

FACTS

Background

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

ABC is wholly-owned by Foreign Parent, a foreign entity. Foreign Parent reported its worldwide consolidated financial statements using the International Financial Reporting Standards (“IFRS”) for Tax Year 1. Foreign Parent required the Taxpayer to adopt the IFRS standards to facilitate the process of preparing these worldwide consolidated financial statements. Therefore, the Taxpayer adopted IFRS for the first time for Tax Year 1. This marked the first year that the Taxpayer issued any IFRS based financial statements. Prior to the adoption of IFRS, the Taxpayer used U.S. GAAP as its accounting standard.

The last-in, first-out (“LIFO”) inventory method is not an allowable method under IFRS. The Taxpayer has used the LIFO inventory method for accounting for a portion of its inventory since Date 2 for both tax and financial reporting purposes. The Taxpayer continued to use the LIFO inventory method for Tax Year 1.

The Taxpayer provided financial statements to its foreign parent based upon IFRS standards for Tax Year 1. These financial statements included a balance sheet and income statement based upon IFRS standards. The Taxpayer also provided the IFRS-only balance sheet and income statement to its lending bank.

Along with the IFRS-only balance sheet and income statement, the Taxpayer provided its lending bank with tabulated versions of its balance sheet and income statement whereby each was presented on an IFRS and U.S. GAAP standard. Specifically, the tabulated financial statements made adjustments (including LIFO adjustments) to the IFRS column to arrive at U.S. GAAP. The IFRS version of the profit/income of the Taxpayer was based on a method that did not include LIFO principles in inventorying goods. The Taxpayer did not make a distinction between primary or supplemental information within these financial statements related to the change from IFRS to U.S. GAAP reporting standards; nor did it include explanatory footnotes regarding the change. The Taxpayer provided these financial statements to the lending bank in accordance with lending requirements imposed by the bank related to a letter of credit.

LAW AND ANALYSIS

Applicable Law

Internal Revenue Code section 472(c) provides that a taxpayer who elects to use the LIFO inventory method for federal income tax purposes must establish to the satisfaction of the Secretary that it has used no method other than LIFO in inventorying such goods to ascertain the income, profit, or loss of the first taxable year for which LIFO is to be used, for the purpose of a report or statement covering such taxable year to shareholders, partners, or other proprietors, or to beneficiaries, or for credit purposes.

Section 472(e)(2) imposes a requirement similar to that contained in section 472(c) for taxable years subsequent to the year of the LIFO election and provides that the taxpayer may be required to discontinue the use of the LIFO inventory method if this requirement is violated.

Section 472(g) provides that all members of the same group of financially related corporations shall be treated as one taxpayer for purposes of the LIFO conformity requirements contained in subsections (c) and (e)(2). The term “group of financially related corporations” means any affiliated group as defined in section 1504(a), determined by substituting “50 percent” for “80 percent” each place it appears and without regard to section 1504(b), and any other group of corporations that consolidate or combine for purposes of financial statements.

Treasury Regulation section 1.472-2(e)(1) provides, in part:

The taxpayer must establish to the satisfaction of the Commissioner that the taxpayer, in ascertaining the income, profit, or loss for the taxable year for which the LIFO inventory method is first used, or for any subsequent taxable years, for credit purposes or for purposes of reports to shareholders, partners, or other proprietors, or to beneficiaries, has not used any inventory method other than that referred to in § 1.472-1 or at variance with the requirements of § 1.472-2(c).

Section 1.472-2(e)(1)(i) provides that the taxpayer’s “use of an inventory method other than LIFO for purposes of ascertaining information reported as a supplement to or explanation of the taxpayer’s primary presentation of the taxpayer’s income, profit, or loss, for a taxable year in credit statements or financial reports” is not considered at variance with the requirements § 1.472-2(e)(1).

Section 1.472-2(e)(1)(ii) provides that the “use of an inventory method other than LIFO to ascertain the value of the taxpayer’s inventory of goods on hand for purposes of reporting the value of such inventories as assets” is not considered at variance with the requirements of § 1.472-2(e)(1).

Section 1.472-2(e)(1)(iii) provides that the taxpayer's "use of an inventory method other than LIFO for purposes of ascertaining information reported in internal management reports" is not considered at variance with the requirements § 1.472-2(e)(1).

Section 1.472-2(e)(4) provides:

Under paragraph (e)(1)(ii) of this section, the use of an inventory method other than LIFO to ascertain the value of the taxpayer's inventories for purposes of reporting the value of the inventories as assets is not considered the ascertainment of income, profit, or loss and therefore is not considered at variance with the requirement of paragraph (e)(1) of this section. Therefore, a taxpayer may disclose the value of inventories on a balance sheet using a method other than LIFO to identify the inventories, and such a disclosure will not be considered at variance with the requirement of paragraph (e)(1) of this section. However, the disclosure of income, profit, or loss for a taxable year on a balance sheet issued to creditors, shareholders, partners, other proprietors, or beneficiaries is considered at variance with the requirement of paragraph (e)(1) of this section if such income information is ascertained using an inventory method other than LIFO and such income information is for a taxable year for which the LIFO method is used for Federal income tax purposes. Therefore, a balance sheet that discloses the net worth of a taxpayer, determined as if income had been ascertained using an inventory method other than LIFO, may be at variance with the requirement of paragraph (e)(1) of this section if the disclosure of net worth is made in a manner that also discloses income, profit, or loss for a taxable year. However, a disclosure of income, profit, or loss using an inventory method other than LIFO is not considered at variance with the requirement of paragraph (e)(1) of this section if the disclosure is made in the form of either a footnote to the balance sheet or a parenthetical disclosure on the face of the balance sheet. In addition, an income disclosure is not considered at variance with the requirement of paragraph (e)(1) of this section if the disclosure is made on the face of a supplemental balance sheet labelled as a supplement to the taxpayer's primary presentation of financial position, but only if, consistent with the rules of paragraph (e)(3) of this section, such a disclosure is clearly identified as a supplement to or explanation of the taxpayer's primary presentation of financial income as reported on the face of the taxpayer's income statement.

Section 1.472-2(e)(3) provides specific rules related to the exception of the conformity requirement for supplemental or explanatory information.

Section 1.472-2(e)(3)(i) provides:

Information reported on the face of a taxpayer's financial income statement for a taxable year is not considered a supplement to or explanation of the taxpayer's primary presentation of the taxpayer's income, profit, or loss for the taxable year in credit statements or financial reports. For purposes of paragraph (e)(3) of this section, the face of an income statement does not include notes to the income statement presented on the same page as the income statement, but only if all notes to the financial income statement are presented together.

Section 1.472-2(e)(3)(ii) provides, in part:

Information reported in notes to a taxpayer's financial income statement is considered a supplement to or explanation of the taxpayer's primary presentation of income, profit, or loss for the period covered by the income statement if all notes to the financial income statement are presented together and if they accompany the income statement in a single report.

Section 1.472-2(e)(3)(iii) provides:

Information reported in an appendix or supplement to a taxpayer's financial income statement is considered a supplement to or explanation of the taxpayer's primary presentation of income, profit, or loss for the period covered by the income statement if the appendix or supplement accompanies the income statement in a single report and the information reported in the appendix or supplement is clearly identified as a supplement to or explanation of the taxpayer's primary presentation of income, profit, or loss as reported on the face of the taxpayer's income statement. . . . For purposes of paragraph (e)(3)(iii) of this section, information is considered to be clearly identified as a supplement to or explanation of the taxpayer's primary presentation of income, profit, or loss as reported on the face of the taxpayer's income statement if the information either--

(A) Is reported in an appendix or supplement that contains a general statement identifying all such supplemental or explanatory information;

(B) Is identified specifically as supplemental or explanatory by a statement immediately preceding or following the disclosure of the information;

(C) Is disclosed in the context of making a comparison to corresponding information disclosed both on the face of the taxpayer's income statement and in the supplement or appendix; or

(D) Is a disclosure of the effect on an item reported on the face of the taxpayer's income statement of having used the LIFO method.

For example, a restatement of cost of goods sold based on an inventory method other than LIFO is considered to be clearly identified as supplemental or explanatory information if the supplement or appendix containing the restatement contains a general statement that all information based on such inventory method is reported in the appendix or supplement as a supplement to or explanation of the taxpayer's primary presentation of income, profit, or loss as reported on the face of the taxpayer's income statement.

Section 1.472-2(e)(5), which is supposed to provide specific rules related to the exception of the conformity requirement for internal management reports, has been reserved.

Analysis

Because the Taxpayer elected the LIFO method of accounting for federal income tax purposes, it is subject to the LIFO conformity requirements. See I.R.C. § 472(c), (e)(2); Treas. Reg. § 1.472-2(e)(1).

With respect to the financial statements provided to its lending bank, the Taxpayer violated the LIFO conformity requirements if (1) it used an inventory method other than LIFO to ascertain its income, profit or loss in the financial statements; (2) the financial statements were "for credit purposes"; and (3) the financial statements are not within any of the exceptions to the LIFO conformity requirements.

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

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

There is no question the IFRS-only versions used a method other than LIFO to ascertain income, profit, or loss, as IFRS is a non-LIFO method and was the only method used. Arguably, the tabulated versions of the financial statements provided to the lending bank comply with the LIFO conformity requirements as they used U.S. GAAP to determine income, profit, and loss. However, they also used IFRS. The LIFO conformity requirements do not merely require the use of a LIFO inventory method; they

require that no method other than LIFO be used. See I.R.C. § 472(c), (e)(2); Treas. Reg. § 1.472-2(e)(1).

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

It could be argued that the use of IFRS was for purposes of supplementing or explaining the Taxpayer's primary U.S. GAAP position and, thus, the tabulated financial statements meet the exception for supplemental or explanatory information. See Treas. Reg. § 1.472-2(e)(1)(i). However, the provision of information using IFRS was not presented as either supplemental or explanatory.

With respect to the tabulated balance sheet, the disclosure of income, profit, and loss using IFRS was not made in the form of a footnote to the balance sheet or a parenthetical disclosure on the face of the balance sheet. See Treas. Reg. § 1.472-2(e)(4). Even if the disclosure qualified as a parenthetical, despite the lack of parentheses, or other punctuation or formatting to indicate the IFRS information is an aside, there is still the problem of the tabulated income statement. Section 1.472-2(e)(3)(i) clearly provides that "[i]nformation reported on the face of a taxpayer's financial income statement for a taxable year is not considered a supplement to or explanation of the taxpayer's primary presentation of the taxpayer's income, profit, or loss." The IFRS information was reported on the face of the income statement and not as part of a note to the income statement. See Treas. Reg. § 1.472-2(e)(3).

Moreover, even if the tabulated financial statements conformed to the requirements of section 472(e) and the regulations thereunder, the Taxpayer also provided the lending bank with the same balance sheet and income statement it provided to the Foreign Parent. These documents were prepared based solely on IFRS. These documents were not identified as supplemental, explanatory, or appendixes. For instance, the balance sheet was not clearly identified as a supplement to or explanation of the taxpayer's primary presentation. See Treas. Reg. § 1.472-2(e)(4). Similarly, the income statement was not marked as an appendix or otherwise clearly identified as a supplement to or explanation of the taxpayer's primary position. See Treas. Reg. § 1.472-2(e)(3)(iii).

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

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

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Please call (313) 237-6440 if you have any further questions.

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