

Introduction to LIFO for Tax

Benefits of using LIFO to cost inventory:

- Current costs in income statement
- Reduce TI when inventory costs rise
- Old costs in inventory - keep prop tax down
- Save taxes, therefore have more money now for other expenditures
- Need not elect for all inventory items or for all separate divisions - as long as clearly reflects income

Drawbacks of using LIFO:

- Increases taxable income when inventory costs fall or an old LIFO layer is invaded
- More complex calculations, rules & procedures than for FIFO - greater administrative costs
- Could increase taxes in the year taxpayer switches from FIFO to LIFO because must restate inventory at cost and may have previously written down to LIFO 1.472-2(c)
- LIFO not allowed
- Can cause forecasting, bonus pay plans and profit sharing plans to be distorted if not all divisions use LIFO (but this can be corrected, if recognized)
- Reported financial statement earnings will be lower, assuming costs are rising, but can report the difference
- Recapture tax if C corporation on LIFO elects S status
- ACE adjustment - §56(g)(4)(D)(iii) - use §312(n)(4) adj which requires that FIFO be used for E&P
- Must also use LIFO for books

Overview to §472 - 474 & regs:

- **§472 -**
 - (a) - allows t/p to use LIFO provided use of and change to, if any is in accordance with IRS rules
 - (b) - explanation of LIFO
 - (c) - taxpayer must also use LIFO for reports to s/h, partners, or other owners, and for credit purposes
 - (d) - BI in first LIFO year is to be valued at cost. If previously have written any down to market, if lower, must adjust it and such increase is to be taken into income over 3 years (§481(a) adj)
 - (e) - once adopt or elect LIFO, must continue to use it until obtain IRS approval to change or IRS determines that t/p has not properly complied with §472(b) or (c).
- Rev Proc 88-15 (1988-1 CB 683) - procedure on how to obtain expeditious consent to discontinue LIFO
- Rev. Proc. 79-23 - examples of situations which will and will not warrant disallowance or termination of LIFO - NOTE - warrants termination, does NOT cause automatic termination - §472(e)(2)

(f) - IRS to provide in regulations which published government price indexes may be used to price inventory

typically every month, IRS issues Rev Proc stating that retail index may be used for dollar value LIFO retail method

(g) - "group of financially related corps" - treated as one t/p in applying 472(c) & (e)(2)

§473 - Qualified Liquidations of LIFO Inventories

- special rule where t/p has experienced a "qualified inventory interruption - see 473(c)(2) - alleviate effect of certain writedowns if replaced within certain time period
- elective
- added by Crude Oil Windfall Profit Tax Act of 1980
- no regs

Regulation §1.472

§1.472-1 - LIFO

- 472(a) & (b)
- need not have LIFO apply to all inventory - EX: may elect to have LIFO only apply to raw materials (see example)
- retail method described at 1.471-8 may also be used for LIFO, if elected

1.472-2 - Requirements incident to adoption and use of LIFO

- subject to following requirements:
 - a) must file application and specify which goods involved - Form 970 (in Supplement)
 - b) inventory must be taken at cost regardless of market value
 - c) revalue BI using average costs
 - d) need some method for valuing inventory increases - examples given
- Prop regs at 1.472-2(c) (2/83) further explain 3-year spread
- (e) - LIFO book conformity requirement
 - examples of situations not in variance with this requirement
 - treatment of supplemental and explanatory information in the financial statement generally, okay to disclose what taxable income would be under FIFO
 - t/p may be required to reconcile LIFO inventory balances between tax return and books to show that are in conformity (e)(9)
- (g)
 - §472(e)
 - if engaged in more than one trade or business, IRS may require that if LIFO used in one, must also be used with respect to similar goods in other trade or business, if doing so would more clearly reflect income

§1.472-3 - Time and manner of making election

- file Form 970 with tax return in which LIFO first used
- attach analysis of all inventories at beginning and end of tax year LIFO first used to show how amounts computed
- whether or not Form 970 is approved and whether or not LIFO may be continued, will be determined by IRS in connection with examination of return

• **Form 970** (available at IRS web site)

Be sure to review form and instructions.

- top - initial election or subsequent election - if adding items to previous election
 - line B consent agreement of t/p
 - lines 3,4,5 - required in order to adopt LIFO
 - line 6a - §1.472-2(d) requirement
 - line 7 - two ways to compute LIFO
 - unit method
 - dollar-value
 - line 8 - types of pools if using dollar-value
 - 1.472-8(b), (c), (d)
 - line 9 - choices of valuation if using dollar-value:
 - Double-extension 1.472-8(e)(1) & (2)
 - quantity of each *item* in pool at y/e are priced and extended twice - once at current-year unit costs and once at base-year unit costs
 - Link-chain 1.472-8(e)(1)
 - only usable if t/p can prove to IRS that use of either double-extension or index would be impractical in view of nature of the pool - items in inventory change frequently
 - quantity of each item in the inventory pool at year end is extended at both the beginning-of-the-year unit cost and the end-of-the-year unit cost
 - Index 1.472-8(e)(1) & (3)
 - may use if double-extension is impractical due to technological changes, extensive variety of items, or extreme fluctuations in the variety of the items
 - Retail method
 - use base year retail prices instead of cost to compute inventory changes in value
- Need to attach detailed statement to 970 if don't elect to use double-extension or published price index method

§1.472-4 - Adjustments to be made by t/p

- must agree to those specified by IRS in order to use LIFO

§1.472-5 - Revocation of election

- election irrevocable, unless get IRS consent

§1.472-6 - Change from LIFO inventory method

General rules

- Rev. Proc. 88-15 may apply, if it does not, use revenue procedure governing accounting method changes

- per Rev. Proc. 97-27, if discontinue LIFO, may not re-elect LIFO for 5 years unless taxpayer can show unusual and compelling circumstances
- must attach termination event statements to 3115

§1.472-7 - inventories of acquiring corporations:
see §381

§1.472-8 - Dollar value method of pricing LIFO inventories

- authorizes this alternative to unit cost method of LIFO
- §1.472-8(b), (c) & (d) - principles for establishing pools which are needed in order to use dollar-value
 - generally, use natural business pools - look at facts and circumstances:
 - separate production facilities
 - maintenance of separate profit and loss records
 - product lines
 - retailing operations versus manufacturing operations
 - see EX (1) - appliance manufacturer
- may elect to use multiple pools 1.472-8(b)(3)
 - each pool consists of group of inventory items which are substantially similar based on facts and circumstances
- (c) - pools for wholesalers and retailers, etc.
 - product lines
 - departments of a store - such as Sears
- (d) - pools chosen will be judged for their appropriateness upon audit by IRS
- (e) - methods of computing LIFO value of a dollar-value pool: (discussed earlier for Form 970)
 - double-extension - explained at (e)(2)
 - index method - explained at (e)(3) AND **Rev Proc 84-57**
 - link chain
 - retail method

What is an "item" as referred to in the pools and the dollar-value methods?

- EX - items in pool at beginning of tax year are 1974 Fords w/o solid-state ignitions and catalytic converters. Items in pool at end of tax year are 1975 Fords with those features. Are they the same items?
Tax Court in *Wendle Ford Sales v Comm'r* (1979) said YES - cost of the features was not separately stated on dealer's invoice and manufacturer decided on the features.

IRS has position paper for motor vehicle industry that cost of new features should be added to the beginning year cost.
- *Hamilton Industries* case & Ann 91-173 - treatment of bulk bargain (discounted) purchases of inventory likely to be considered new items EVEN IF taxpayer has substantially similar items already in inventory. Review the Tax Court's discussion of the lack of a definition of "item."

- Ability to use Components of Cost Method with LIFO
 - AICPA has suggested to IRS that should be allowable because is widely used and okay for GAAP

DOUBLE EXTENSION DOLLAR VALUE LIFO METHOD

Determine value of EI by computing it at both base year cost and current year cost to get 2 values of the EI

Compare BI base cost to EI base cost to determine if pool increased or decreased

If increment, compute ratio:

$$\frac{\text{current year cost of pool}}{\text{base year cost of pool}} = \%$$

Value of increment =
increment in base dollars x %

= layer of increment ---> keep separate from other layers

If decrement, liquidation occurred -
decrease layers in order, most recent first

EX based on regs §1.472-8(e)(2)(v)

- elect LIFO at 1/1/91
- revalue BI at cost - if cost higher than old value --> 3 year §481(a) adj

Pool #1 = items A, B, C

1/1/91	Item	Qty	\$/unit	total cost
	A	1000	\$5	\$5,000
	B	2000	\$4	\$8,000
	C	500	\$2	<u>\$1,000</u>
	Base year cost of BI			14,000

12/31/91 Item	EI Qty	current cost*	cost at base	cost at current
A	3000	\$6	\$15,000	\$18,000
B	1000	\$5	4,000	5,000
C	500	\$2.50	<u>1,000</u>	<u>1,250</u>
			\$20,000	\$24,250

Q - increment or decrement? increment (\$14,000 to \$20,000)
Next - value increment at current year cost:

$$\text{ratio} = \frac{\$24,250}{\$20,000} = 121.25\%$$

	EI at base	Ratio	EI at LIFO value
Base (1/1/91 layer)	\$14,000	100%	\$14,000

1991 layer added	6,000	121.25%	<u>7,275</u>
			\$21,275

* have choice of current year costing method per 1.472-8(e)(2):

- a) actual cost of goods most recently purchases or produced
- b) actual cost in order of acquisition for tax year
- c) average cost for tax year
- d) any other proper method in opinion of IRS

In 1992, t/p disposes of item C and adds item D which t/p determines belongs in same pool with items A & B.

When D is added, need to determine base price. Use current unless can reconstruct or establish cost. Here, determined to be \$2.

12/31/92

Item	<u>Qty</u>	<u>Current cost</u>	<u>EI base</u>	<u>EI current</u>
A	2,000	\$6.50	\$10,000	\$13,000
B	1,500	\$6.00	6,000	9,000
D	1,000	\$5.00	<u>2,000</u>	<u>5,000</u>
			\$18,000	\$27,000

Compare BI base cost of \$20,000 to EI base cost of \$18,000. This is a \$2,000 decrement, therefore, reduce most recent layer. This would be the \$6,000 layer added in 1991, which is now reduced to base cost of \$4,000.

	<u>EI at base</u>	<u>Ratio</u>	<u>EI at LIFO value</u>
base layer	\$14,000	100%	\$14,000
1991 layer	<u>4,000</u>	121.25%	<u>4,850</u>
	\$18,000		\$18,850

12/31/93:

Item	<u>Qty</u>	<u>Current cost</u>	<u>EI base</u>	<u>EI current</u>
A	2,000	\$7	\$10,000	\$14,000
B	2,000	\$6	\$ 8,000	\$12,000
D	2,000	\$6	<u>\$ 4,000</u>	<u>\$12,000</u>
			\$22,000	\$38,000

Increment of \$4,000 (\$22,000 - 18,000)

Next, compute ratio:

$$\frac{\$38,000}{\$22,000} = 172.73\%$$

	<u>EI at base</u>	<u>ratio</u>	<u>EI at current value</u>
Base layer	\$14,000	100.00	\$14,000
1991 layer	4,000	121.25	4,850
1993 layer	<u>4,000</u>	172.73	<u>6,909</u>
	\$22,000		\$25,759

Other LIFO dollar-value methods besides double extension:

Retail Inventory Method

- compute base year amounts at retail value
- compare EI at base year retail price to BI at base year retail prices to see if increment or decrement
- increment - convert base year retail of increment to current year retail value using BLS or other computed price index and convert to LIFO cost using factor:
$$\frac{\text{current year cost}}{\text{retail value}}$$
- BLS price indexes published monthly by IRS in a Rev Rul
- **Rev Rul 86-46** (1986-2 CB 739) - EX of how to use this method

Index Method

- see Rev Rul 84-57 (1984-2 CB 496) for guidance

§474 Simplified Dollar Value LIFO

- for Certain Small Businesses
- changed by TRA'86
- old law - allowed taxpayer average annual GR \leq \$2 M in prior 3 years to elect to use a single pool for all inventory items.
 - old law still applies if still have valid election in place and still meet GR req
 - after TRA'86, may revoke w/o consent of IRS
- reason for change - Congress felt LIFO considered more advantageous for inventories, particularly when costs are rising. However, complexities likely to prevent small t/p from using it, therefore, simplified method added
 - small - avg annual GR for 3 year period do not exceed \$5 million
 - elective
- may elect w/o IRS consent
- inventory previously written down below cost must be restored
- generally follow 1.472-8
- inventory must be grouped into pools as follows:
 - Retailers - 11 general categories of the "CPI for all Urban Consumers" Table 3 & 5, published monthly by BLS
 - All others - 15 general categories of the "Producers Prices & Price Indexes for Commodity Grouping & Individual Items" Table 6 by BLS
- select a month to use to measure annual change in index for all pools
 - if ever want to change month, need IRS consent
- first year of use = new base year

EX from Leg history

- FIFO t/p to elect §474 on 1/1/92
- non-retailer - PPI
- inv items/pools:
 - chemical

Pool #1

pulp, paper & allied products

Pool #2

Calculate index:

Pool	BI 1/1/92	EI 12/31/92	CY index	PY index	change	% change	Index
1	\$30,000	\$35,000	220	200	20	0.1000	1.1000
2	\$30,000	\$30,000	150	142	8	0.0563	1.0563

To determine increment or decrement, convert current value of inventory to base year dollars using the index:

#1

CY value	\$35,000 (inflated)
÷ index	<u>÷ 1.100</u>
Base yr value	\$31,818 (deflated)
Base yr amt	<u>\$30,000</u>
Increment	\$ 1,818
	(convert back to CY value to measure EI)

	<u>Base yr</u>	<u>Dollar index</u>	<u>Indexed \$ values</u>
Base yr layer	\$30,000	1.000	\$30,000
Yr 1 layer	1,818	1.1000	<u>2,000</u>
			\$32,000 EI

#2

CY value	\$30,000
÷ index	<u>÷ 1.0563</u>
Inv in base yr value	\$28,401
Base yr amt	<u>\$30,000</u>
Decrement	1,599

	<u>Base yr</u>	<u>Dollar index</u>	<u>Indexed \$ values</u>
Base yr layer	\$28,401*	1.000	\$28,401

* decrement will be to base year layer since it is the only layer in existence

Q - where does t/p get CPI & PPI figures?

best to subscribe to monthly publication, or data diskette or call, or computer tapes, or electronic news release

LIFO & ACE

Notice 94-27, 1994-14 IRB 13 - how to compute LIFO recapture adjustment to ACE for tax years beginning after 12/31/89 and before 12/19/92 if chose not to follow §1.56(g)-1(f)(3).

LIFO and S Conversions

Rev. Proc. 94-61, 1994-38 IRB 56 - how to compute and take LIFO recapture amount into gross income as required by §1363(d). Sec. 1363(d) does not terminate a LIFO election. It is okay to not take the recapture amount into gross income for financial statement purposes - no LIFO conformity problem (Q&A-3).

TD 8567 (10/94) - final rules on LIFO recapture after an S election (§1363(d)).