APPEALS

INDUSTRY SPECIALIZATION PROGRAM

COORDINATED ISSUE PAPER

INDUSTRY: Motor Vehicle

ISSUE: Dollar-Value LIFO
Definition of an Item

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SETTLEMENT GUIDELINES

DOLLAR-VALUE LIFO DEFINITION OF AN ITEM

STATEMENT OF ISSUE

Whether an item, for purposes of calculating the value of the taxpayer's inventory under the dollar-value LIFO method as authorized by Treasury Regulation 1.472-8, is defined by reference to the particular vehicle as to make, year, model, body style, standard equipment, options, and other factors.

BACKGROUND

This coordinated issue of the Examination Division Industry Specialization Program (ISP), as framed above, was approved by the Office of Chief Counsel in July of 1989. Although it may have application in other industries, the national coordination of this issue and this guideline paper are applicable only to automobile dealers.

Approximately 75 percent of the 24,000 auto dealers in the United States utilize the Last-In, First-Out (LIFO) method of computing inventory under IRC Section 472. The purpose of this method is to eliminate inflation from inventory by valuing comparable items in terms of constant dollars. Accordingly, the definition of an "item" is of critical importance in achieving a clear reflection of income.

Due to the complexity, and lack of guidance on the issue, the National Automobile Dealers Association (NADA) contacted the Commissioner and the Office of Chief Counsel for a more workable approach to this issue. There had been no specific regulations, rulings, or other official announcements on this subject until the release of Revenue Procedure 92-79, 1992-39 IRB (September 8, 1992).

Rev. Proc. 92-79 establishes a "safe-harbor" approach for retail auto dealers. NADA is recommending its members adopt the Alternative LIFO Method prescribed in this revenue procedure which simplifies the dollar-value LIFO rules for auto dealers. The Service believes, based on preliminary filings and discussion with the industry, that the majority of the auto dealers will elect this new Alternative LIFO Method.

The Commissioner will waive strict adherence to the comparability requirement of Treas. Reg. 1.472-8, for taxpayers utilizing the Alternative LIFO Method. Taxpayers must use the compensating sub-methods described in the revenue procedure to ensure that the Alternative LIFO Method clearly reflects income. The issue discussed in this position paper only applies to those taxpayers that do not elect to use the Alternative LIFO Method.

If taxpayers fail to timely elect the new Alternative LIFO Method, the waiver of IRC Section 481(a) adjustment generally will not be allowed after the deadline. Based upon facts and circumstances, an intermediate settlement of the Section 481(a) adjustment may be appropriate. However if no agreement is reached, a Statutory Notice of Deficiency will be issued which takes the position, consistent with the Examination Division Position Section below, that vehicles with significant differences in optional equipment or having other material qualitative differences should be treated as separate items.

FACTUAL DISCUSSION

Automobiles and light trucks are manufactured in a wide variety of makes, models, body styles, colors, and options. These factors are specified on the sales order form prepared for each vehicle by a consumer, a dealer, a distributor, or the manufacturer.

Retail automobile dealers purchase new cars in one of two basic ways. The first method is when cars are "presold," in which case the cars are not in inventory, and therefore this LIFO issue does not apply to those vehicles. The second method is when dealers purchase cars for "floor plan" which are sold from the dealers' lots after delivery. The makes, models, colors, and the options and accessories on these vehicles are typically selected by the dealer. Manufacturers can control the selection of options by offering them in groupings, called packages.

Automobile manufacturers make annual changes to vehicles to enhance their marketability and to meet federal and state requirements. Changes include: interior and exterior trim, minor exterior body parts, major structural design and styling, drive train, and body family or platform (as it is called in the manufacturing industry).

The change to the body family or "platform" occurs when an entirely new vehicle is designed and involves a redesign of most parts of a vehicle. This is important as platform changes are mentioned in Revenue Procedure 92-79 in the content of what constitutes a new item. A good example of a platform change is the Ford Escort in 1991 contrasted against the 1990 model.

Currently, there are over forty different domestic body families for passenger cars, which include more than 250 different models. Foreign import passenger cars sold in the USA have more than 300 different models. Within each model, there generally is at least two submodels and sometimes up to five. Examples of submodels or names of submodels are custom, limited, sport coupe, hatchback, and convertible. These changes do not always cause a price change.

Manufacturers generally change the prices of vehicles when the model year changes, which usually occurs around October 1. Occasionally, manufacturers introduce new models mid-year that may change the base price, the price of options, the warranty provisions, or options that become standard equipment.

LEGAL DISCUSSION

The purpose of the LIFO inventory method is to permit taxpayers to match current costs, reflecting price increases attributable to inflation, with current revenue from comparable items. Under the LIFO inventory method, the flow of costs is sequenced so that the last costs incurred are expensed in the cost of sales, and the earliest costs are retained in inventory.

IRC Section 472(a) provides that taxpayers may use the LIFO inventory method if it clearly reflects income. IRC Section 472(b)(2) provides that the goods must be valued at cost.

When LIFO was first extended in 1939 to all taxpayers, only the specific unit method could be used. Taxpayers with diverse and non-homogeneous inventories could not, as a practical matter, use this specific unit method. To solve this problem, a dollar-value approach was developed that approximated the results of the specific unit LIFO method. This method measures changes in inventory pools by reference to standard base-year dollars and inflation indexes relating back to the base-year dollars. Under this method, the inventory is measured in dollars, rather than in units.

The retail department store industry was the first to adopt the dollar-value approach. However, upon examination the Service would not allow this method. The issue was tested in the Tax Court in Hutzler Brother vs. the Commissioner, 8 TC 14 (1946), which held that the dollar-value LIFO method was valid. In 1949, the Treasury Department approved the use of dollar-value LIFO in T.D. 5756, 1949-2 C.B. 21.

In 1961 the dollar value regulations were published. Treas. Reg. 1.472-8 provides that any taxpayer may elect to determine the cost of its LIFO inventories under the so-called "dollar-value" LIFO method, provided such method is used consistently and clearly reflects income. The dollar-value method is a method that determines costs by using "base-year" costs expressed in terms of total dollars, rather than the quantity and price of specific goods.

Treas. Reg. Sec. 1.472-8(e)(1) provides that taxpayers ordinarily may only use the "double-extension" method for computing the base-year and current-year cost of a dollar-value inventory pool. When the use of the double-extension method is impractical, because of technological changes, the extensive variety of items, or extreme fluctuations in the variety of items, the taxpayer may use an index method for computing all or part of the LIFO value of the pool. An index may be computed by double-extending a representative portion of a pool or by use of other consistent statistical methods.

The taxpayer must be capable of demonstrating that the method of computing the index, and the accuracy, reliability, and suitability of the index, clearly reflect income. The use of the "link-chain" method will be approved only in those cases where the taxpayer can demonstrate that the use of either the index method or the double-extension method would be impractical or unsuitable due to the nature of the pool. Generally, the Accounting Method and Periods Branches in the Income Tax and Accounting Division of the National Office has allowed automobile dealers to use the link-chain method.

The link-chain method uses a cumulative index which consists of the products of annual indexes dating from the year of the LIFO election. The cumulative index is used to restate current year inventory costs in terms of base-year costs. The cumulative index is also used to value increments stated at base-year cost. For example, if the year of the LIFO election is 1985, the 1987 link-chain index is computed as follows: 1985 index times 1986 index times 1987 index equals 1987 link-chain index.

The link-chain method generally requires all items in ending inventory (or a representative portion of the items in ending inventory) to be priced at beginning and end of the year costs to obtain the current year annual index. In actual practice, taxpayers sometimes use sampling techniques to compute the link-chain index. These techniques must follow sound statistical methodologies.

In Wendle Ford Sales, Inc. v. Commissioner, 72 T.C. 447 (1979), acq., 1980-1 C.B. 1, the Tax Court, based on the facts, found that the conversion to an ungraded solid state ignition system, together with the addition of a catalytic converter, did not create a new item from the prior-year vehicle within one of the taxpayer's five new car categories. Moreover, in reaching this conclusion, the court noted that "apart from the reduction in emissions, neither the addition of the catalytic converter nor the solid-state ignition had any appreciable effect on the 1975 model vehicle's performance, value or otherwise, when compared to the 1974 model vehicle." 72 T.C. at 460. However, the court also recognized that "over a period of time, an automobile or truck may undergo a number of modifications which collectively make that vehicle a different item from a vehicle in existence in the base year." id at 461. Clearly, a significant enough change even over a one year period can render a vehicle a new item.

Subsequently, the Tax Court heard the cases of two other retail automobile dealers computing inventory under the dollar-value LIFO method. Fox Chevrolet, Inc. v. Commissioner, 76 T.C. 708 [1981]; and Richardson Investments, Inc. v. Commissioner, 76 T.C. 736 [1981]. In Fox Chevrolet, supra, the government argued that each model line of vehicles should be placed in separate pools. The Tax Court decided, in reviewing Treas. Reg. 1.472-8, that each model line did not have to be in a separate pool, but that new cars and new trucks had to be placed in separate pools. The court in Richardson, supra, followed the same rationale.

The threshold point of determining when a new item is created has not been addressed by the courts. The facts of each case will determine when changes and improvements in a product are sufficiently substantial to render a "new item."

Another case, Amity Leather Products Co. v. Commissioner, 82 T.C. 726 (1984) dealt with the definition of an item. There, the Tax Court approved a more narrow definition of an "item." The Tax Court required the petitioner to treat identical goods produced by two divisions, one in the United States and one in Puerto Rico, as separate items in the pool. The Court stated: "under this approach, the impact of inflation on petitioner's inventory is more accurately eliminated and its income is more clearly reflected."

Hamilton Industries, Inc. v. Commissioner, 97 T.C. 120 (1991), is another LIFO case where the Tax Court held that identical inventory items were different "items" because their cost was different (bulk sale purchase versus subsequently manufactured).

EXAMINATION DIVISION POSITION

The current position of the National Office is consistent with the position set forth in issue 5 of PLR 8906001. That pronouncement essentially establishes a general comparability standard. Although PLR 8906001 does not indicate exactly the differences in options and accessories between vehicles that are necessary to constitute a new item, it does conclude that the comparison of an automobile in current-year inventory that includes every available option with an automobile that has no options may result in a distortion in the computation of the LIFO index. The National Office has distinguished the comparability problem as it relates to options and accessories from the issue in Wendle Ford, stated in general terms by the Tax Court as "whether minor modifications in the composition of a product by a manufacturer require the retailer of the product to make yearly adjustments to its base-year cost of its dollar-value inventory." 72 T.C. at 456. The National Office has concluded that options and accessories can comprise a significant cost of a vehicle when compared to the "minor modifications" present in Wendle Ford. However, the National Office recognizes that under the Tax Court's holding in Wendle Ford taxpayers computing internal price indexes appear to have some degree of tolerance with respect to minor variations in physical attributes, not constituting a "new item."

The availability of the relatively simple and easy-to-implement Alternative LIFO Method substantially diminishes arguments that establishing items based on differences in the array of optional equipment and accessories creates an unduly complex computational and administrative burden. Thus, the National Office advocates a relatively narrow definition of an item for those taxpayers using an internally computed index and not using the Alternative LIFO Method, while at the same time acknowledging the litigating hazards associated with embracing too narrow of a definition. Clearly, differences in significant option packages will require separate item treatment. On the other hand, if the only difference between two vehicles is an insignificant option, this difference may be equivalent to a "minor modification" (either in terms of utility to the consumer or cost to the retailer) within the meaning of the court's holding in Wendle Ford.

ADMINISTRATIVE RELIEF - REVENUE PROCEDURE 92-79, 1992-39 IRB

[SEPTEMBER 8, 1992]

Revenue Procedure 92-79, Section 1.02(1) allows Appeals to grant the same relief for taxpayers in Appeals as whose who are under examination. NADA has urged all dealers presently on or considering LIFO to review the Alternative LIFO Method set out in Rev. Proc. 92-79 and to seriously consider its election.

Rev. Proc. 92-79 provides an alternative LIFO method for determining the value of new automobiles and light-duty trucks held in inventory by dealers. It also provides procedures which allow certain automobile dealers to obtain expeditious consent to change their method of accounting to the Alternative LIFO Method. The principles of Revenue Procedure 92-20 generally apply to a change in method of accounting made under Revenue Procedure 92-79. In addition, Revenue Procedure 92-79 affords taxpayers protection for years before the year of change, if elected timely, by allowing a "cut-off" method which does not have an I.R.C. Section 481(a) "catch-up" adjustment.

Rev. Proc. 92-79 sets forth a "safe harbor" definition for an "item" in new vehicle inventory and gives guidance about how new items of inventory must be handled. Under Rev. Proc. 92-79, new items of inventory must be assigned an index of 1.0, this is offset by the government's concession (waiver) of strict adherence to the comparability requirement of the regulations.

•<u>Highlights of Rev. Proc. 92-79</u>

* A simplified comprehensive dollar-value, link-chain based approach.

* Use of manufacturers base model code numbers to define items of inventory.

* Use of the current-year cost of a new item as the prior-year cost for the new item. New items include:

  - Any new or reassigned manufacturers model code number caused by a change in existing model.

  - Manufacturers model code created or reassigned because the classified vehicle did not previously exist.

  - A change to a vehicle platform resulting in a change in track width or wheelbase.

* Use of actual base vehicle cost for each specific vehicle in ending inventory to compute the pool index. No adjustment for any options, accessories, or

other costs. The pool index computed from the base vehicle cost of vehicles is applied to the total cost, including options, accessories, and other costs, of all vehicles in the pool at the end of the taxable year.

* New automobiles in one pool, new light-duty trucks in another.

* A transitional rule which "protects" past practices and special transitional procedures for dealers under audit (the cut-off method or no IRC Section 481(a) catchup adjustment is required).