The following comments are the individual views of the members of the Section of Taxation who prepared them and do not represent the position of the American Bar Association or of the Section of Taxation.

The comments were prepared by members of the Tax Accounting Committee of the Section of Taxation. Principal responsibility was exercised by Barbara J. Young. Substantive comments were made by Frank Devlin, Scott Vance, and Dwight Mersereau. The Comments were reviewed by Robert E. Liles, II, of the Section’s Committee on Government Submissions and by Stanley L. Blend, Council Director for the Tax Accounting Committee.

Although the members of the Section of Taxation who participated in preparing these Comments may have clients who would be affected by the federal tax principles addressed by these Comments or have advised clients on the application of such principles, no such member (or the firm or organization to which such member belongs) is currently being engaged by a client to make a governmental submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these Comments.

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Executive Summary

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Executive Summary

We appreciate the opportunity to provide comments regarding the proposed regulations under section 472. Overall, we are pleased with the simplification that would be achieved through the proposed regulations. We believe the proposed modifications of these rules generally provide additional clarity and efficiency under the inventory price index computation ("IPIC") method of accounting for last-in, first-out ("LIFO") inventories. However, we also suggest modification of some aspects of the proposed regulations to maintain the objectives of simplification and clear reflection of income. Combined with the inherently objective nature of the IPIC method, these modifications should reduce controversies regarding the LIFO method, thus saving limited government resources. The following is a brief summary of our comments:

- We recommend that taxpayers be permitted to elect use of the IPIC method on a trade or business basis.

- We recommend that the ten percent rule for index categories be retained (but agree that the Bureau of Labor Statistics ("BLS") weighting requirement should be eliminated).

- We recommend that the regulations provide a detailed explanation of the factors that determine the "appropriate month" for index selection and include more examples.

- We recommend that retailers continue to be permitted to select indexes from either the Consumer Price Indexes ("CPI") or Producer Price Indexes ("PPI"),
regardless of whether the retail inventory method is used. We further recommend that retailers using either CPI or PPI indexes be permitted to pool according to the general categories of the CPI or PPI.

- We recommend that final regulations require taxpayers to assign work in process ("WIP") to the most detailed PPI categories for those items that the taxpayer actually sells in the ordinary course of business (instead of those items that are in a salable state).

- We recommend that the preamble indicate that no inference with respect to the determination of base year costs for non-section 381 transfers is intended for years prior to the effective date of the regulation. We also recommend that the regulations be clarified to indicate that the transferee's base year cost may be based on the transferor’s first-in, first-out ("FIFO") cost for the year immediately preceding the transfer.

- We recommend that calculation of updated base years and adjustment of each year’s LIFO layer be required if an involuntary change to IPIC is asserted.

- We recommend that the final regulations include a provision permitting the use of a dual index method.

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I. Introduction

Taxpayers are permitted to account for inventories using the last-in, first out (LIFO) inventory method. Under the LIFO method, taxpayers treat inventory goods on hand at the end of the year as consisting first of inventory on hand at the beginning of the year and then of inventories acquired during the year.

Under the dollar-value LIFO inventory method, taxpayers account for inventories in terms of dollars of cost rather than in terms of specific goods. Taxpayers measure increases or decreases in inventory quantities by comparing the total cost of the quantity of goods on hand at the beginning and end of the taxable year in terms of equivalent-value dollars, i.e., base-year dollars. Taxpayers also can convert the current-year cost of the beginning and ending inventories into base-year cost by using indexes.

Taxpayers may compute the necessary indexes based on actual costs. Alternatively, under the Inventory Price Index Computation (IPIC) method (described in Treas. Reg.
§1.472-8(e)(3)), taxpayers may compute the indexes with reference to consumer or producer price indexes published by the United States Bureau of Labor Statistics.

Although the IPIC method generally achieves the goal of simplifying the calculation of LIFO indexes, the current IPIC regulations require taxpayers in many instances to convert and weight the published indexes. Furthermore, the current IPIC regulations also contain several rules requiring clarification.

In REG-107644-98, the Treasury Department and the Service promulgated proposed regulations concerning a number of issues falling under the LIFO method of accounting for inventories. In general terms, the proposed regulations address two major areas:

1. Modifications to the IPIC method under section 1.472-8(e)(3) of the regulations are intended to achieve goals of simplicity, clarity, and clear reflection of income.

2. The clarification of the treatment of LIFO inventories received in non-section 381 transfers.

Overall, we are pleased with the simplification that would be achieved through the proposed regulations and believe that the proposed regulations generally provide additional clarity and efficiency under the IPIC method. However, we believe some modification of the proposed regulations is necessary to maintain the objectives of simplification and clear reflection of income. The following are our recommendations for modifying the proposed regulations.

II. Recommendations

A. IPIC as an Overall Method of Accounting for LIFO Inventories

Section 446(d) allows a taxpayer engaged in more than one trade or business to use different methods of accounting for each trade or business. Thus, taxpayers may elect different overall accounting methods for different trades or businesses and may elect different specific methods for each trade or business. For example, a taxpayer may elect to use the LIFO method to account for the inventories of one trade or business and elect the FIFO method to account for the inventories of a different trade or business that is conducted by the same entity. Treas. Reg. §1.446-1(d). Indeed, even within a single trade or business, taxpayers in many cases may use different accounting methods for different
inventory goods. For example, a taxpayer may account for certain inventory goods using the FIFO method, and account for other goods using a specific goods LIFO method, and account for still other goods using a dollar-value LIFO method. Treas. Reg. §1.472-1. Thus, taxpayers have considerable flexibility to choose the inventory methods that are most appropriate for their inventory items.

The current and proposed regulations provide that a taxpayer that wishes to use the IPIC method must elect to do so to determine the value "of all goods for which the taxpayer has elected to use the dollar-value LIFO method." Prop. Reg. §1.472-8(e)(3)(ii) [emphasis added]. The only exception is to permit a department or specialty store that uses the BLS Department Store Inventory Price Indexes to limit the scope of its IPIC election to those inventory items that are not described in any of the major groups in that index.

We believe that this requirement that a taxpayer use IPIC for all of its dollar-value LIFO inventories is inconsistent with section 446(d), is inconsistent with the general rules regarding inventory methods, and will discourage many taxpayers from using the IPIC method.

The requirement that a taxpayer using IPIC use the method for all of its dollar-value LIFO inventories may impose particular difficulties for a taxpayer that is comprised of multiple legal entities that are disregarded for federal income tax purposes. These separate legal entities frequently operate as separate trades or businesses and often have very different inventories. Therefore, we recommend that taxpayers be permitted to elect to use the IPIC method on a trade or business basis so long as "maintaining different methods of accounting does not create or shift profits and losses between the trades or businesses of taxpayer" as provided in section 1.446-1(d) of the regulations.

B. **Elimination of Requirement to Use Ten Percent Categories and BLS Weights**

In computing an inventory price index, the current regulations provide that items are first assigned to the most detailed index category listed in the appropriate CPI or PPI detailed reports. Whenever a specific inventory item comprises ten percent or more of total inventory value, such item must be placed in its own, separate index category. For items that represent less than ten percent of total inventory value, the taxpayer must investigate successively less detailed index categories until it reaches an index category for which the ten percent threshold is satisfied. If the taxpayer’s inventory does not include items that would have been included in each of the most detailed index categories
subsumed by the selected category, the taxpayer must compute a weighted average of the published indexes using the BLS weights listed for the detailed index categories.

Under the proposed regulations, taxpayers would not use the ten percent categories or BLS weights. Instead, each item in a pool would be assigned the most detailed index in the CPI or PPI detailed reports, and a weighted average index would be computed accordingly. While eliminating the BLS weighting requirement will simplify taxpayer computations, eliminating the ten percent rule will increase complexity for some taxpayers. Therefore, we recommend that taxpayers be allowed (a) to use the ten percent rule to identify a less detailed category and (b) to use the index for that category if the taxpayer’s inventory includes items that would have been included in each of the most detailed index categories subsumed by the selected category.

Many taxpayers, such as grocery stores and drug stores, have thousands of items in inventory, but may not have sufficiently detailed records to properly identify each item for purposes of assigning an index. Using the example in the preamble to the proposed regulations, a grocery store may very well have each of the subsidiary items for the index for "fresh fruits," (apples, bananas, oranges, citrus fruit other than oranges, and other fresh fruits), but under the retail method may not be able to identify each fruit individually. If such detail is required, many taxpayers may find that the burden of obtaining and maintaining the necessary information too costly and thus may not use the IPIC method.

We strongly suggest that the final regulations continue the ten percent rule as discussed above. We believe that this will increase simplicity and encourage taxpayers to use the IPIC method, without any significant reduction in the accuracy of the index. We believe that an even simpler approach would be to retain the ten percent rule and eliminate the BLS weighting even in situations where the taxpayer does not have in inventory all of the items within the index category.

C. Selecting Indexes as of an Appropriate Month

Under the current regulations, a retailer using the retail method must use the indexes as of the last month of its taxable year. All other taxpayers must select indexes as of the month (or months) most appropriate to the method of determining the current-year cost of the inventory pool (i.e., earliest, latest, or average acquisition cost). Alternatively, a taxpayer may make a one-time
binding election on Form 970 to select an index based on an appropriate representative month during the taxable year.

Under the proposed regulations, a retailer using the retail method would continue to use the indexes as of the last month of its taxable year. The proposed regulations would clarify, however, that taxpayers not using the retail method would have a choice between annually selecting indexes as of the month (or months) most appropriate to the method of determining the current-year cost of the inventory pool (i.e., earliest, latest, or average acquisition cost), or making a one-time binding election on Form 970 to select an index based on an appropriate representative month during the taxable year.

The proposed regulations state that a taxpayer not using the retail method may annually select the appropriate month. The proposed regulations provide an example in which a calendar year taxpayer chooses the month of October one year and the month of November the next year. To clarify when it would be appropriate to use indexes from different months and avoid future controversies concerning the "appropriate month," we recommend that the regulations provide a detailed explanation of the factors that determine the "appropriate month" and include more examples as guidance.

II. Recommendations, continued

D. Selection From “CPI Detailed Report” or “PPI Detailed Report”

The current regulations mandate that manufacturers, processors, wholesalers, jobbers, and distributors select indexes from only Producer Prices and Price Indexes ("PPI"). Retailers are currently permitted to select indexes from either the PPI or the CPI Detailed Report ("CPI"). However, if equally appropriate indexes could be selected from either publication, a retailer using the retail inventory method ("RIM") must use the CPI, and a retailer not using RIM must use the PPI. Treas. Reg. §1.472-8(e)(3)(iii)(C). The proposed regulations remove this choice; manufacturers, processors, wholesalers, jobbers, and distributors not using RIM would be required to select PPI indexes; retailers using RIM would be required to select CPI indexes. Prop. Reg. §1.472-8(e)(3)(iii)(C).

The preamble to these proposed regulations indicates that this departure from the current regulations eliminates the need for retailers to determine whether the CPI or the PPI is more appropriate. However, as a practical matter, a retailer’s choice between the CPI and the PPI presents no particular complexity.
On the other hand, mandating the use of one or the other for a particular retailer presents the following significant issues:

- Much like individual retailers, the CPI and PPI track commodities in significantly different manners. This trait is largely attributable to the mechanisms by which the BLS compiles CPI and PPI data. Thus, one of the sets of indexes will inherently provide a closer match to how a particular taxpayer tracks its inventories. Experience suggests that most retailers find that the CPI is more appropriate, but certainly a significant number find that the PPI is more appropriate. Presumably, if the proposed regulations were finalized as drafted, many taxpayers would need to change methods of accounting and, more significantly, modify how their own inventory items are mapped to the government index categories. These steps would prove onerous to such taxpayers.

- The proposed regime places great weight on determining whether a particular company actually uses RIM. In some cases, this distinction may be difficult, depending on, for example, the determination of whether retail prices are reduced to cost before or after LIFO indexes are applied. Mandatory index assignment based on whether the taxpayer uses RIM would create uncertainty.

- Furthermore, index assignment must be looked at in light of other proposed regulatory changes. The current regulations mandate that: if a retailer using RIM selects an index from the PPI, then that index must be converted to a retail price index; if a retailer not using RIM selects an index from the CPI, then that index must be converted to a cost price index; and manufacturers, processors, wholesalers, jobbers, and distributors must convert selected indexes into cost price indexes. Treas. Reg. §1.472-8(e)(3)(iii)(C). The proposed regulations eliminate this index conversion requirement because (as indicated in the preamble to the proposed regulations) of the inability of many taxpayers to determine gross profit percentages at the detailed index category level, the relative constancy of many gross profit percentages and the administrative burden of compliance. We agree that the elimination of index conversion is a sound policy choice. Additionally, and for the same reasons enunciated immediately above, we believe that allowing retailers to choose between the CPI and PPI without the requirement of index conversion would provide general consistency with the published indexes without undue administrative burden.

- An additional related problem is the treatment of vertically integrated retailers, that is, those that maintain warehouses as well as retail stores in a single trade or business. In many such cases, the store inventory is
maintained on a RIM basis, while the warehouse inventory is maintained on a non-RIM basis. Under the proposed rules, as read literally, use of the CPI would be required for the store inventory, while use of the PPI would be required for the warehouse inventory. This result creates computational difficulty.

For these reasons, we recommend that retailers continue to be permitted to select indexes from either the CPI or PPI, regardless of whether RIM is used. We further recommend that retailers using either CPI or PPI indexes be permitted to pool according to the general categories of the CPI or PPI.

E. Indexes for Work-In-Process

The current regulations are silent with respect to the assignment of work in process ("WIP") inventory to detailed PPI categories. The proposed regulations mandate that manufacturers and processors assign WIP inventory items to the most detailed PPI category that includes the finished good into which the item will be manufactured or processed. For this purpose, "finished good" is defined as a good that is in a salable state. The proposed regulations further provide an example involving a gasoline engine manufacturer; finished pistons not yet affixed to an engine block would be assigned to the most detailed PPI category that includes pistons, while finished pistons that have been affixed to an engine block would be assigned to the most detailed PPI category that includes the engine. Prop. Reg. §1.472-8(e)(3)(iii)(C)(2).

While we laud the effort to bring more certainty to the treatment of WIP, we believe that there is a simpler and more practicable means of achieving this result. Taxpayers do not generally track fine distinctions between units of WIP; in a fact pattern matching the example given in the regulations, many if not most taxpayers would as a practical matter maintain general ledger systems categorizing both affixed and non-affixed pistons as engine WIP, but would not distinguish whether or not a piston was affixed to an engine block. A requirement that would mandate detailed tracking beyond what would be performed for business and management purposes would be onerous. Furthermore, it would neither contribute to the accuracy of, nor support the policies behind, the inventory price index method, as it may reflect items that the taxpayer does not sell separately. We therefore recommend that final regulations require taxpayers to assign WIP to the most detailed PPI categories for those items that the taxpayer sells in the ordinary course of business. For this purpose, we recommend that if a taxpayer manufactures products comprised of component parts that are manufactured by the taxpayer, and the taxpayer also sells the component parts as replacement parts, then the PPI
categories for the larger manufactured item (rather than the PPI categories for the component parts) be assigned to the WIP of component parts. Thus, in the example in the proposed regulations, all pistons would be included in the most detailed index category that includes gasoline engines, regardless of whether the taxpayer sells pistons as replacement parts.

F. **Inventories Received in a Nonrecognition Transaction**

A taxpayer may receive inventories in certain non-recognition transfers that do not qualify under section 381 (including certain section 351 and 721 transactions) from a transferor that uses the LIFO method. If the transferee taxpayer adopts the LIFO and IPIC methods in the year of transfer, it will recognize an artificial increment unless it values the base-year cost of its beginning inventory at current-year cost. The artificial increment would result because the taxpayer’s ending inventory is reduced by one year of inflation. Thus, for a comparison of equivalent-value dollars, the beginning inventory must be valued at current-year cost. The proposed regulations make clear that the transferee taxpayer must so value its beginning inventory.

The preamble to these proposed regulations, in describing the operation of the current authorities, suggests that the regulations provide for a change to the current regime and that the transferee’s base year cost is generally defined under the current rules with reference to the transferor’s basis, i.e., LIFO carrying value. The regulations thus ostensibly remove the potential for artificial increments that may arise from the introduction of new items or the immediate election of IPIC if the base-year cost is the transferor’s basis. We believe clarification of this issue is helpful. However, given that there was uncertainty under the existing provisions, that in our experience taxpayers and representatives of the Service have used both approaches, and that the proposed regulations recognize that the loss of LIFO benefits due to mechanical computation issues following a section 351 or similar transfer is inappropriate, it seems unnecessary to include language in the preamble that might make it more difficult for taxpayers with non-section 381 transfers prior to the effective date of the regulations to obtain a result that is consistent with the policy underlying section 351 and section 721. We therefore recommend that the preamble to the final regulations indicate that no inference with respect to the issue is intended for years prior to the effective date of the regulation.

Furthermore, if a company uses earliest acquisition cost to determine the value of LIFO increments, the proposed regulations as written seem to suggest that this earliest acquisition cost is the basis for determining base-year cost for the transferee. This would seem to distort the transferee’s inventory computation,
as the index for the transferee would be based on the month immediately preceding the first day of the tax year, but base-year costs would be based on the transferee’s earliest acquisition cost. This divergence could result in an artificial increment or decrement where there has been inflation or deflation during the last pre-transfer year. We therefore suggest that the regulations be clarified to indicate that the transferee’s base year cost may be based on the transferor's FIFO cost for the year immediately preceding the transfer. This treatment may result in a hypothetical zero-valued layer as of the transfer date with an index of 1.00 and a pre-transfer layer with positive base-year costs and an index different from 1.00 but would resolve the issue mathematically. Such a step, taken in order to avoid the omission of price changes occurring between the layer valuation period (e.g., earliest acquisitions) and the transfer date, would determine an appropriate index for the final actual layer and would facilitate the base-year restatement required under Prop. Treas. Reg. §1.472-8(e)(3)(iv)(C). Alternatively, the regulations could be clarified to indicate that the appropriate month for determining base-year indexes is the month in which base-year costs were determined.

G. New Base Year For IPIC Method Changes

There is no specific provision in the current regulations regarding involuntary changes to IPIC. Under the proposed regulations, the Commissioner may require a taxpayer to change to the IPIC method if the Commissioner determines that the taxpayer’s current LIFO method does not clearly reflect income. If the taxpayer cannot compute a section 481 adjustment, the Commissioner may require the taxpayer to change to the double-extension IPIC method on a cut-off basis with no new base year.

To the extent that taxpayers may be required to change to the IPIC method on audit, the cut-off method might appear beneficial. However, failure to update the base year and then apply the adjustment to all layer years can result in a significant loss of the reserve entirely in the year of change. The preamble to the proposed regulations states that agents will be given flexibility to choose between updating the base year and not updating the base year. This flexibility to choose whether or not to adjust the base year could provide unequal treatment between taxpayers. Because of the potential for unequal treatment of taxpayers in similar situations, we recommend that agents be required to calculate an adjusted base year where an involuntary change to IPIC is asserted. Once the adjusted base year is computed, the new and old base years should be compared and the difference applied to adjust each year’s LIFO layer. As a practical matter, it can be anticipated that such changes will be imposed effective as of the earliest open year under examination in which the subject
inventories were valued under the LIFO method. Use of an updated base year would promote consistency as between voluntary changes, involuntary changes, and inventory transfers in certain nonrecognition transactions.

H. The Use of Dual Indexes

The Service permits taxpayers using the double extension method to use a dual index method, provided the taxpayers properly compute each index. See PLR 8138005 (May 29, 1981), PLR 8437004 (May 16, 1984). Under a dual index computation, the current-year cost of the inventory is reduced to base-year cost using a deflator index that is generally computed with reference to the latest acquisitions cost of the inventory. Then, if there is an increment in the inventory, the increment is inflated to current-year cost using an index computed with reference to the earliest acquisitions cost of the inventory.

Under the proposed regulations, taxpayers using the IPIC method would not be permitted to use a dual index method. However, because the only limitation on the use of a dual index computation has been that the indexes be properly computed, taxpayers using the IPIC method should be permitted to use a dual index computation. Under the IPIC method, taxpayers use external indexes; therefore, there should be no concerns regarding the computation of the indexes.

If dual indexes are not permitted, many taxpayers using the IPIC method may effectively be unable to use the earliest acquisitions cost method. Many taxpayers using the IPIC method value their ending inventory using FIFO costs. If they cannot also value their inventory at an earliest acquisitions cost, these taxpayers are essentially required under the proposed regulations to choose indexes from later in the year.

We believe that use of IPIC eliminates the potential computational difficulties that might be an issue in the context of an internal index. Furthermore, prohibiting taxpayers using IPIC from using a dual index method also may make it impractical for them to use another generally available method, the earliest acquisitions cost method. Therefore, we suggest that the final regulations permit the use of a dual index method.

As stated above, overall we are pleased with the proposed regulations. We are making the above outlined suggestions to maintain the objectives of simplification and clear reflection of income. We appreciate the opportunity to provide these comments.