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Changing an Impermissible LIFO Method

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The risk of using an impermissible LIFO inventory method is that the IRS or a court may require the inclusion in income of some or all of the taxpayer's LIFO reserve. This article discusses the *Mountain State Ford Truck Sales* case, in which such inclusion occurred, and explains how use of Rev. Proc. 97-27 may avoid this result.

The dollar-value, last-in, first-out (LIFO) inventory system is complex and presents many opportunities for error. Taxpayers with significant LIFO reserves[1] may suffer nightmares over an inadvertent LIFO termination. The possibility of having to recognize a large LIFO reserve as income in a single prior year, along with the penalties and interest that usually accompany such adjustments, is frightening.

A recent case, *Mountain State Ford Truck Sales, Inc.*,[2] illustrates the significant negative tax consequences of employing impermissible LIFO inventory accounting procedures. The purpose of this article is to illustrate how taxpayers employing an impermissible LIFO method may be able to transform it into a "permissible" one at a modest (or possibly no) tax cost.

Background

Mountain State Ford (MSF) was a heavy truck dealer that had elected to use the LIFO inventory method for its parts and accessories (parts) inventory. On its Form 970, Application to Use LIFO Inventory Method, MSF indicated that it would price its parts inventory "at actual cost regardless of market value." The application also stated that MSF would determine the cost of parts in the closing inventory in excess of those in the opening inventory (i.e., an "increment") on the basis of "most recent purchases."

However, MSF's actual method of valuing an increment in its parts inventory involved the computation of a price index based on the manufacturer's (Ford Motor Company's) year-end parts prices, as reported by Ford in its published parts catalogs.[3] Ford's year-end parts prices were the prices MSF would have had to pay to replace the parts in its inventory at year-end (i.e., replacement cost). Thus, unless MSF actually purchased a part at a price listed in the last catalog of the year, that price did not reflect MSF's actual cost for the part.

IRS Position

The IRS argued that MSF's use of replacement cost in pricing LIFO increments was not really a cost-based system and, thus, violated Sec. 472(b)(2) and Regs. Sec. 1.472-2(b). The IRS proposed a $463,515 adjustment, MSF's entire LIFO reserve. The IRS did not recalculate MSF's LIFO inventory value based on actual invoice prices, because the records were not available. The Tax Court held that MSF's use of replacement cost was inappropriate and did not clearly reflect income.

Editor's note: Prof. Davis served as an expert witness in the *Mountain State Ford* case.

[1] A "LIFO reserve" is the difference between a taxpayer's ending inventory value using a LIFO method and its value had the inventory been priced using the first-in, first-out (FIFO) method. When a taxpayer changes from the LIFO method to the FIFO method, whether voluntarily or involuntarily, the LIFO reserve must be recognized as income, under Sec. 481(a). LIFO reserves are often very substantial.

[2] *Mountain State Ford Truck Sales, Inc.*, 112 TC 58 (1999).

[3] The catalogs were revised between four and six times a year.

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Much, if not all, of MSF's LIFO reserve probably resulted from the basic difference between the LIFO and FIFO costflow assumptions, not MSF's impermissible use of replacement cost to price its LIFO increments. The "problem" occasioned by MSF's impermissible LIFO accounting existed only in those years in which a LIFO increment was created. The "problem," to the extent it existed in a LIFO layer, would disappear with a liquidation of that layer. In fact, if most parts prices were rising over time, MSF's computational approach would probably overprice LIFO layers (i.e., MSF's method would have been more likely to overstate income than to understate it). In short, the bias in MSF's LIFO method was probably in the government's favor (if prices were rising).

The IRS proposed an adjustment that recognized MSF's entire LIFO reserve (built up over 10 years) as income; the Tax Court agreed with this approach. The same result would have occurred had the IRS terminated MSF's LIFO election; however, because the IRS did not propose a LIFO termination, the Tax Court allowed MSF to remain on LIFO. In terms of additional tax cost relative to the tax years in issue, it did not matter whether MSF's LIFO election was terminated.

The Tax Court noted that MSF had used replacement cost in valuing its parts inventory since its inception in 1968, and that it was the method used by the heavy truck dealer industry. However, the court further noted that, at the time MSF adopted the LIFO inventory method,

> [it] made no attempt to determine whether it could have modified its perpetual inventory recordkeeping system so that it could have used invoice prices...in valuing its parts inventory. Nor did it determine whether it could have created a new inventory recordkeeping system that could have used invoice prices...in that inventory valuation process.[4]

Instead, MSF continued to use replacement cost in valuing its parts inventory under the LIFO method. MSF was not attempting to (and did not) determine or approximate the invoice prices of the parts it purchased.

The IRS argued that the term "cost," as used in Sec. 472(b)[5] and Regs. Sec. 1.472-2(b),[6] means actual cost; the use of replacement cost in determining current-year inventory cost contravenes Code and regulation requirements. As a result, the use of replacement cost did not clearly reflect income. The Tax Court agreed with the IRS.

Taxpayer Position

MSF argued that its use of replacement cost qualified as "any other proper method" under Regs. Sec. 1.472-8(e)(2)(ii)(d),[7] such that the use of actual cost was not required. Further, MSF argued that the history of LIFO makes it clear that the statutory and regulatory "cost" requirement is simply an expression of the rule that the lower of cost or market (LCM) method may not be used in conjunction with the LIFO method.

The Tax Court looked to dictionary definitions of the term "cost" and concluded that "the common and ordinary meaning of the word 'cost' is actual cost or the price paid for something." The court also stated:

> The accounting profession generally defines the word "cost" as used in inventory accounting "as the price paid or consideration given to acquire an asset."[8]

[4] *Mountain State Ford Truck Sales, Inc.*, note 2 supra, n. 12.

[5] Sec. 472(b)(2) provides that, in inventorying goods specified in the LIFO application, the taxpayer shall "Inventory them at cost..."

[6] Regs. Sec. 1.472-2(b) provides that, under the LIFO inventory method, "The inventory shall be taken at cost regardless of market value."

[7] Regs. Sec. 1.472-8(e)(2)(ii)(d) provides that the total current-year cost of items making up a LIFO pool may be determined "[p]ursuant to any other proper method which, in the opinion of the Commissioner, clearly reflects income."

[8] *Mountain State Ford Truck Sales, Inc.*, note 2 supra, n. 8, citing Acct'g Res. Bull. No. 43, "Restatement and Revision of Accounting Research Bulletin," Ch. 4, Stmt. 3 (June 1953).

EXECUTIVE SUMMARY

- **Under Rev. Proc. 97-27, the Service is not precluded from changing an impermissible method in an earlier year just because a taxpayer changes a sub-method within the impermissible method in a later year.**
- **Taxpayers should scrutinize their LIFO method and, if impermissible, change it before the IRS challenges it and attempts to include the LIFO reserves in income.**
- **Under a cut-off method, taxpayers using an impermissible LIFO method or sub-method generating substantial prior advantages need not recognize them in the form of a Sec. 481(a) adjustment.**

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The court further relied on Regs. Sec. 1.471-3, stating:

> Application of the definition of cost in [Regs. Sec. 1.471-3]...which is based on what we have concluded is the common and ordinary meaning of the word "cost," will result in a determination of the actual cost of merchandise or goods purchased or produced during the taxable year, or in certain instances an approximation of such cost determined upon a reasonable basis (reasonable approximation).

Another major issue was whether the IRS could interpret the regulations in a way that would impose unreasonable administrative burdens on taxpayers wanting to employ the LIFO method. The court observed that:

> [The IRS] has no discretion to deviate from the requirements of the Code and the regulations even if such requirements were to impose administrative burdens on [MSF]...[MSF] acknowledges that it is not impossible for [it] to use actual cost, and not replacement cost, in valuing its parts inventory. In fact...[MSF's] expert on computerized inventory-tracking systems admitted that the reason why there is no inventory recordkeeping system currently available in the automobile and truck dealer industry that uses actual cost in that valuation process is because there has been no demand for such a system in that industry.[9]

The Teachings of *Mountain State Ford*

At least two lessons can be drawn from *Mountain State Ford.* The first is probably obvious: Taxpayers that fail to strictly conform to the rules in their adoption and application of LIFO place their LIFO reserves and elections in jeopardy. Second, judges do not have consistent views of the gravity of various LIFO violations and the manner in which to treat them. Thus, it is almost impossible to predict how a particular LIFO shortcoming may be viewed by a particular court without knowing which judge will decide a controversy over the method.[10]

As illustrated by *Mountain State Ford,* if a taxpayer has a significant LIFO reserve and is aware of a LIFO accounting violation, the cost of continuing the impermissible accounting method could be steep, even if the use of the impermissible method makes little difference in the reported taxable income from year to year. Fortunately, Rev. Proc. 97-27[11] provides relief to certain taxpayers in this position.

Rev. Proc. 97-27

Voluntary Accounting Method Changes

How do taxpayers mitigate LIFO problems like those in *Mountain State Ford*? For certain taxpayers, an excellent solution to resolve potential problems with the use of a LIFO method may be relatively simple to achieve. For many others, there is a solution, but some planning is necessary. Unfortunately, for taxpayers like MSF, failure to act in a timely fashion precludes an acceptable solution. Much depends on whether the taxpayer has been contacted for an examination, or is under examination, in Appeals or before a Federal court.

Rev. Proc. 97-27 and its predecessors were designed to encourage taxpayers using impermissible accounting methods to voluntarily change to permissible methods. The following discussion assumes that a taxpayer's impermissible accounting method produces a taxpayer advantage (in the form of income deferral) relative to a permissible accounting method.

An impermissible method of accounting should include a method proscribed by, or that does not conform to one mandated by, the Code, regulations or a U.S. Supreme Court decision.[12] A permissible method of accounting clearly includes one that is specifically required or permitted by the Code, regulations or a U.S. Supreme Court decision. While not defined by Rev. Proc. 97-27, a permissible method of accounting should also include one that meets all three of the following:

1. It is not prohibited by the Code, regulations or a U.S. Supreme Court decision.
2. It conforms to generally accepted accounting principles (GAAP).
3. It has been properly adopted and consistently employed.[13]

The following discussion assumes that any change from an impermissible method of accounting is to a permissible one.

The Cost of Not Changing an Impermissible Accounting Method

The "encouragement" to change from an impermissible method provided by Rev. Proc. 97-27 takes the form of "incentives" (i.e., favorable "terms and conditions") for making the change. The failure to make a voluntary change from an impermissible method to a permissible one can be very costly. For example, if the change from an impermissible method would result in a $1 million increase in income, under Rev. Proc. 97-27, Section 5.02(3)(a), a taxpayer-initiated voluntary change would usually result in a $250,000 annual increase in taxable income for the four-year period beginning with the year in which the method was changed. Further, there would be no penalties or interest.

On the other hand, if the impermissible method was discovered in an IRS examination, the entire $1 million

[9] *Mountain State Ford Truck Sales, Inc.,* note 2 supra, n. 12.

[10] The task is probably impossible if the judge to whom the case is assigned has never rendered a published decision in a LIFO case.

[11] Rev. Proc. 97-27, 1997-1 CB 680.

[12] Rev. Proc. 92-20, 1992-1 CB 685, the predecessor of Rev. Proc. 97-27, went to some lengths to define "impermissible" methods of accounting. Rev. Proc. 92-20 defined "Category A" methods of accounting, clearly improper methods, as those methods proscribed by, or not conforming to methods mandated by, the Code, regulations or a U.S. Supreme Court decision.

[13] Consistency is a hallmark of a good accounting method; see, e.g., Rev. Proc. 97-27, Section 2.01(2) and Regs. Sec. 1.446-1(a).

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would usually be treated as income in the earliest year under examination. Further, penalties and interest would usually be imposed, beginning in the earliest year under examination. Obviously, the incentives for the taxpayer to initiate a change in this case are very significant.

Audit Protection

Another significant incentive for eligible taxpayers to initiate a change from an impermissible accounting method under Rev. Proc. 97-27 is that they are afforded "audit protection." Rev. Proc. 97-27, Section 9.01, states that:

> when a taxpayer timely files a Form 3115 pursuant to this revenue procedure, the Service will not require the taxpayer to change its method of accounting for the same item for a taxable year prior to the year of change.

However, Rev. Proc. 97-27, Section 9.02(2), provides an exception, as follows:

> *Change in sub-method.* The Service may change a taxpayer's method of accounting for prior taxable years if the taxpayer is changing a sub-method of accounting within the method. For example, an examining agent may propose to terminate the taxpayer's use of the LIFO inventory method during a prior taxable year even though the taxpayer changes its method of valuing increments in the current year.

At first blush, this exception seems to undermine the audit protection afforded by Section 9.01. However, Section 9.02(2) does not confer on the Service an unfettered right to change a method of accounting in an earlier year simply because a taxpayer changes a sub-method within the method.

The proper interpretation of Section 9.02(2) is that the Service is not precluded from changing an impermissible method in an earlier year because a taxpayer changes a sub-method within the impermissible method in a later year. However, it is well established that the Service cannot compel a taxpayer to change a method that clearly reflects income to another method that, in the Service's opinion, "more clearly" reflects income.[14]

A Rev. Proc. 97-27 change in method of accounting affords a taxpayer audit protection.

Example: If a LIFO taxpayer requests a change from a specific method of valuing LIFO increments (e.g., use of replacement cost) to another specific method (e.g., most recent acquisitions), audit protection is afforded the method of valuing LIFO increments. However, audit protection would not be afforded an improper method of constructing LIFO pools because of the change in the method of valuing LIFO increments.

Consent Procedures

Generally, taxpayers need IRS consent to change an accounting method; Rev. Proc. 97-27 sets forth the procedures to be followed. Unless permission is deemed granted under some "automatic" change procedure, permission to change methods is requested by a taxpayer on Form 3115, Application for Change in Accounting Method, filed during the year for which the method change is requested.[15] While taxpayers may be required to seek permission to change an accounting method, the IRS cannot deny a taxpayer's properly filed request to change from an impermissible method to a permissible one, nor can it attach unreasonable "terms and conditions" to such a change. To do so has been ruled an abuse of IRS discretion.[16]

Rev. Proc. 97-27, Section 2.07, implies that the IRS is not obligated to allow a taxpayer to change from one permissible accounting method to another.

Scope

Rev. Proc. 97-27, Section 4.02, states that the procedure is generally not available if a taxpayer:

- Must make the method change under a published automatic change procedure.
- Is under examination.
- Is before an Appeals office and the method to be changed is an issue under consideration by Appeals.
- Is before a Federal court and the method to be changed is an issue before the Federal court.
- Is or was a member of a consolidated group that is under examination, before an Appeals office or before a Federal court for a year that the taxpayer was a member of the group.
- Is an entity treated as a partnership or S corporation for Federal income tax purposes and the method to be changed is an issue under consideration in an examination of a partner's, member's or shareholder's Federal income tax return or an issue under consideration by Appeals or a Federal court with respect to a partner's, member's or shareholder's Federal income tax return.

The fact that a taxpayer is in Appeals or before a Federal court does not, by itself, preclude use of Rev. Proc. 97-27. For these taxpayers, access to Rev. Proc. 97-27 is barred only if the method to be changed is an issue before Appeals or before the court. For taxpayers under examination, exceptions (discussed below under "Taxpayers Under Examination") may permit them to initiate method changes under Rev. Proc. 97-27. For purposes of the

[14] See *Ansley-Sheppard-Burgess Co.*, 104 TC 367 (1995).

[15] According to Rev. Proc. 97-27, Section 5.01(2), normally, the filing date for Form 3115 will not be extended under Regs. Sec. 301.9100, except in unusual and compelling circumstances.

[16] See *National Bank of Fort Benning*, MD Ga. (1979).

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current discussion, assume that a taxpayer is clearly entitled to employ Rev. Proc. 97-27 (i.e., the taxpayer does not come within any of the six exclusions listed above).

Sec. 481(a) Adjustments

In most accounting method changes (voluntary or otherwise), the taxpayer must make a Sec. 481(a) adjustment. This adjustment prevents omissions or duplications of income and deductions occasioned by the method change. Basically, a "Sec. 481(a) adjustment" is the cumulative difference in income under the old and the new methods of accounting, as of the beginning of the year of change. A "positive Sec. 481(a) adjustment" is an increase in taxable income; a "negative Sec. 481(a) adjustment" is a decrease in taxable income. Under Rev. Proc. 97-27, Section 2.05(a), when Sec. 481(a) applies, income for the year preceding the year of change is determined under the old method of accounting; income for the year of change and the following years is determined under the new method of accounting as if that new method had always been employed.

When a taxpayer seeks a voluntary change of accounting method (i.e., from an impermissible method or a permissible one), a positive or negative Sec. 481(a) adjustment is usually spread equally over a four-year period beginning with the year of change. Rev. Proc. 97-27, Section 2.02, provides that the "year of change" is usually the year during which the application for a change is filed. If a Sec. 481(a) adjustment is less than $25,000, the taxpayer can elect to recognize the entire adjustment in the year of change, under Section 7.03(1).

Accounting Method Changes Using a "Cut-off"

For taxpayers not under examination, Rev. Proc. 97-27, Section 5.02(3)(b), provides a particularly attractive approach to changing most LIFO accounting methods (or sub-methods). Under that provision, "any change within the LIFO inventory method must be made using a cut-off method," unless there is other published guidance requiring a Sec. 481(a) adjustment.

Under the cut-off approach, there is no Sec. 481(a) adjustment. Thus, if there would otherwise be a large positive Sec. 481(a) adjustment, any increase in income need not be recognized until the item(s) involved work their way out of the accounting system using the old method of accounting. For a LIFO-related item, it could be many years before the item involved exits the system. According to Rev. Proc. 97-27, Section 2.06,

> Under a cut-off method, only the items arising on or after the beginning of the year of change (or other operative date) are accounted for under the new method of accounting. Any items arising before the year of change (or other operative date) continue to be accounted for under the taxpayer's former method of accounting.

A major reason for the cut-off approach in most LIFO method change settings is that it would often be very difficult (sometimes impossible) to determine what a taxpayer's income would have been in prior years had the new method of accounting always been employed (e.g., trying to recast LIFO computations under a different method of accounting for the past 20 or 25 years).

Under a cut-off method, taxpayers that had employed an inappropriate LIFO method or sub-method generating substantial prior advantages (e.g., a method that produced significantly inadequate indices to price a LIFO increment) need not recognize them in the form of a Sec. 481(a) adjustment. (This assumes the change is a change within the LIFO method.) Further, and very significantly, the LIFO transgression is "buried" in prior layers, provided that a LIFO liquidation does not occur after the method change has been effected.[17]

Uncertainties

Based on the above analysis, it may initially seem that a change from valuing a LIFO increment at replacement cost to another valuation method (such as latest acquisitions) would require a cut-off approach. However, the IRS would probably rule that such a change is not a change within the LIFO inventory method, because a non-LIFO taxpayer could also change from the use of replacement cost to an actual cost method. The IRS would likely conclude that the change from a noncost method to a cost method requires a Sec. 481(a) adjustment.[18]

Rev. Proc. 97-27, Section 3.09, provides that

> [a] change within the LIFO inventory method is a change from one LIFO inventory method or sub-method to another LIFO inventory method or sub-method. A change within the LIFO inventory method *does not* include a change in method of accounting that could be made by a taxpayer that does not use the LIFO inventory method (for example, a method governed by sec. 471 or sec. 463A). (Emphasis added.)

The authors believe that the IRS should permit a taxpayer to use the cut-off approach when it changes its method of valuing a LIFO increment from replacement cost to another valuation method (e.g., latest acquisitions). The IRS has been granted such authority in Rev. Proc. 97-27, Section 1.06. Rev. Proc. 97-27 was designed to provide incentives for taxpayers to voluntarily change from an impermissible method of tax accounting to a permissible one. The objective of promoting voluntary method changes is frustrated when a taxpayer using an impermissible LIFO method simply does not know how large a potential Sec. 481(a) adjustment might be (e.g., the *Mountain*

[17] LIFO liquidations can always be "managed" to accommodate or mitigate undesirable tax consequences.

[18] A specific example of a situation requiring a Sec. 481(a) adjustment is a change involving certain bulk purchases of inventory to comply with *Hamilton Industries, Inc.*, 97 TC 120 (1991), as detailed in Ann. 91-173, IRB 1991-47, 29.

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State Ford situation). Obviously, taxpayers will be discouraged from requesting a voluntary change if the Sec. 481(a) adjustment is difficult to estimate or compute. Taxpayers requesting a voluntary change on Form 3115 should be able to elect a cut-off approach in the situation described above, particularly when only a small part of the LIFO reserve may be due to the impermissible method.

Taxpayers Under Examination

Generally, taxpayers under examination cannot use Rev. Proc. 97-27. In *Mountain State Ford*, the Sec. 481(a) adjustment was the entire LIFO reserve. If MSF had submitted an application to change to a permissible method of valuing its LIFO increments before it was contacted for an examination, the change would have been effected in the year of the change application. If required, a Sec. 481(a) adjustment would have been spread over four years and related only to the change in valuing MSF's LIFO increments. In the *Mountain State Ford* setting, the Sec. 481(a) adjustment would probably have been relatively small (and may well have been negative).

Two significant exceptions allow taxpayers under examination to request an accounting method change under Rev. Proc. 97-27, and still receive the favorable terms and conditions available to taxpayers not under examination. Thus, certain LIFO taxpayers under examination can obtain a current-year change with a four-year forward spread of any Sec. 481(a) adjustment. (Or, if the change is effected via a cut-off approach, the income effect of an impermissible LIFO method will be buried in prior LIFO layers.) While neither of these exceptions would have been available to MSF, many taxpayers could benefit from one of them. Taxpayers under examination with a known LIFO shortcoming should seriously consider these exceptions; with a little planning, many should be able to take advantage of them.

Taxpayers under examination may qualify to file Form 3115 to request an accounting method change under the "90-day window" and "120-day window" rules.

The 90-Day Window

A 90-day window period is described in Rev. Proc. 97-27, Section 6.01(2). It provides that a taxpayer under examination may file Form 3115 to request a method change if the following conditions are met:

1. The taxpayer has been under examination for at least 12 consecutive months as of the first day of the tax year.
2. The request is made during the first 90 days of the tax year.
3. The method of accounting the taxpayer is requesting to change is not an issue under consideration or placed in suspense by the examining agent at the time Form 3115 is filed.

This provision allows taxpayers under examination for an extended period to change an impermissible accounting method under Rev. Proc. 97-27, provided such method has not been discovered by the examining agent(s).

The 120-Day Window

A 120-day window period is described in Rev. Proc. 97-27, Section 6.01(3). To qualify to file Form 3115, the following conditions must be met:

1. The taxpayer's examination has ended (the fact that a subsequent examination may have commenced is of no consequence).
2. The request is made during the 120-day period following the end of the examination.
3. The method of accounting the taxpayer is requesting to change is not an issue under consideration or placed in suspense by the examining agent at the time Form 3115 is filed.

This provision is useful for taxpayers aware of an impermissible method and fortunate that the method was not discovered during a recently concluded examination.

For taxpayers under examination that are employing impermissible LIFO inventory accounting methods, the 90-day and 120-day window provisions of Rev. Proc. 97-27 provide an opportunity to cure those impermissible methods as if the taxpayer were not under examination. The IRS National Office determines the appropriateness of the change and applies the same rules to taxpayers under examination as to those not under examination.[19]

Conclusion

A taxpayer with an impermissible LIFO inventory accounting method puts its entire LIFO reserve at risk if it cannot recalculate the proper LIFO inventory value. Even though a particular LIFO transgression might not have produced any major income distortions (e.g., use of replacement cost instead of actual cost to price LIFO layers in a *Mountain State Ford*-type fact setting), it is always possible that a judge might regard the transgression as being sufficiently serious to warrant recognition of the entire LIFO reserve or termination of the LIFO election.

Mountain State Ford is not the exception. In *Consolidated Manufacturing, Inc.*,[20] the taxpayer (a manufacturer) used natural business unit (NBU) pooling, but did not include all raw materi-

[19] There is a third method under which a taxpayer under examination may request an accounting method change under Rev. Proc. 97-27. Section 6.01(4) states: "The district director will consent to the filing of the Form 3115 unless, in the opinion of the district director, the method of accounting to be changed would ordinarily be included as an item of adjustment in the year(s) for which the taxpayer is under examination. For example, the district director will consent to the filing of a Form 3115 to change from a clearly permissible method of accounting. The district director will also consent to the filing of a Form 3115 to change from an impermissible method of accounting where the impermissible method was adopted subsequent to the years under examination." However, this option would not be advisable for a method that the agent might raise as an issue. For example, a taxpayer might not want to request a method change under this provision for a *Mountain State Ford*-type change, because the agent could refuse to consent, then raise the issue.

[20] *Consolidated Mfg., Inc.*, 111 TC 1 (1998).

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als. The Tax Court agreed with the IRS that under NBU pooling, all costs of the items must be included in the LIFO election. The Tax Court held that this violated the pooling requirements. Because the taxpayer could not recompute its inventory values under an acceptable LIFO method, the IRS was permitted to terminate the LIFO election; the entire LIFO reserve was recaptured.

However, if the taxpayer "confesses its LIFO sins" by applying for a change in its LIFO method (usually, before it has been contacted for an audit examination) to a permissible method, the IRS will grant relief. In these cases, the Service will allow the taxpayer to change to a new permissible LIFO method (or sub-method). If the IRS permits the change to be effected using the cut-off approach, any tax benefits resulting from the impermissible LIFO method remain embedded in prior LIFO layers. If the IRS requires a Sec. 481(a) adjustment, it will relate only to the change; most of the LIFO reserve should be allowed to continue. Even better, audit protection will prevent a revenue agent from raising the issue for a prior tax year.

If the IRS requires a Sec. 481(a) adjustment, and it turns out to be negative rather than positive, the taxpayer is a clear "winner." This could easily occur in a *Mountain State Ford*-type situation, if parts prices are rising. If so, the computational approach used by MSF would probably overprice LIFO layers; the method could easily overstate income. As discussed previously, the bias in MSF's LIFO method was likely in the government's favor. If MSF had requested consent to change its accounting method before being examined by the IRS, MSF could have received a negative adjustment (i.e., a decrease in income) if the IRS required a Sec. 481(a) adjustment.

For the specific method change addressed in *Mountain State Ford* (i.e., from replacement cost valuation of increments to a permissible incremental method), in a voluntary method change context, the IRS should require a cut-off approach. This would be much simpler, because the taxpayers would not have to look back and attempt to recalculate LIFO values on the new method (conceivably, an impossible task). It would encourage taxpayers to come forward to request the method change, and eliminate adverse selection problems, in which taxpayers with negative adjustments might request the change, but taxpayers with positive adjustments might not come forward.

The authors recommend that taxpayers undertake a very serious examination of their LIFO method, and change impermissible methods before the IRS challenges them and attempts to include the entire LIFO reserve in income. **TTA**

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