[Vanderbilt Law Review](https://scholarship.law.vanderbilt.edu/vlr)

Volume 28
Issue 3 *Issue 3 - April 1975*

Article 3

4-1975

An Examination of Some Considerations Relating to the Adoption and Use of the Last-in, First-out (LIFO) Inventory Accounting Method

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NOTES

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I. INTRODUCTION

The recent dramatic increase in the rate of inflation has caused a corresponding increase in interest in the "last-in, first-out" (LIFO) method of inventory accounting. The principal reason for this increased interest in LIFO is that the traditional "first-in, first-out" (FIFO) method of inventory accounting reflects illusory or "fools"[1] profits, which, despite their illusory nature, nevertheless are subjected to the federal income tax. Under the FIFO method, utilized by most major corporations prior to 1974,[2] a company's inventories at the close of its fiscal year are identified and valued by assuming that the items first acquired are those first sold and that the items remaining on hand are those which were acquired most recently. The flow of costs under FIFO corresponds to the assumed physical flow of goods—earliest costs incurred are matched against present-year revenues. The problem with FIFO is that the forces of inflation tend to increase the prices of items that are components of inventory. In a period during which the rise in price levels is significant, the application of earliest and hence lowest costs to current revenues under FIFO may not reflect an appropriate matching of costs against revenues, but instead may distort profitability. For example, suppose that X Corporation, a calendar year taxpayer, purchased an inventory item in January and July, 1974. In each instance X Corporation purchased 100,000 units of the item, but in January the cost was $5 per unit and in July it was $8 per unit. X Corporation's sales were distributed evenly over the course of the year, and the sales price for the item in January was $10 per unit and on July 1st was raised to $16 per unit. The following table depicts X Corporation's financial performance for 1974 under the FIFO inventory accounting method:

Sales Revenues			
Jan.-June (50,000 units @ $10)	$500,000		
July-Dec. (50,000 units @ $16)	800,000		
Total			1,300,000
Opening Inventory			$0
Purchases During 1974			
January (100,000 units @ $5)	$500,000		
July (100,000 units @ $8)	800,000		
Total		(1,300,000)	
Closing Inventory (FIFO)			
(100,000 units @ $8)		800,000	
Cost of Goods Sold			
(100,000 units @ $5)			(500,000)

1. Arundel Cotter, *Fool's Profits*, Barron's (1939) cited in Barker, *Practical Aspects of Inventory Problems Under Current Conditions: LIFO, Involuntary Liquidations*, N.Y.U. 10TH INST. ON FED. TAX. 511, n.3 (1952).

2. Wall Street J., Jan. 7, 1975, at 6, col. 3; Wall Street J., Aug. 5, 1974, at 10, col. 1; *cf.* Bray, *More Companies Alter Accounting Methods to Neutralize Inflation*, Wall Street J., Oct. 7, 1974, at 1, col. 6.

Gross Income (Sales Revenues Minus Cost of Goods Sold)		800,000
Federal Income Tax Liability		
(22% x 25,000)	$5,500	
(48% x 775,000)	372,000	
Total		377,500
Net Income		$422,500

Not all of X Corporation's reported net income is available for dividend distributions, capital spending or expansion, however, because X Corporation, as an ongoing concern, must spend $800,000 to replace the 100,000 inventory items sold in 1974. The deduction for cost of goods sold provides $500,000 of the necessary $800,000, but the remainder must come from net income. Thus, reported net income under FIFO is $442,500, but $300,000 of that sum must be expended to replace inventory items, and only $122,500 actually is available for dividends, capital spending and so on.

The effect of FIFO inventory accounting in an inflationary period is reflected in the dramatic rise of corporate inventory profits in the past several years. According to the Department of Commerce,[3] inventory profits averaged five billion dollars per year during 1969-71, climbed to seven billion dollars in 1972, and jumped to 17.6 billion dollars in 1973. In 1974, inventory profits skyrocketed and it is estimated that thirty-six billion dollars of corporate pretax profits comprised illusory inventory profits. These profits represent a growing proportion of corporate earnings, increasing from seven percent of pre-tax earnings in 1972 to more than twenty-five percent of pre-tax earnings in 1974. Moreover, real tax dollars must be paid by corporate taxpayers when illusory inventory profits are reported.[4] In 1973 alone, corporate taxpayers paid approximately eight billion dollars in taxes on illusory or "fools" profits.[5]

The recent flood of corporate taxpayers declaring their intention to switch to the LIFO inventory accounting method, or at least indicating that a switch is under careful consideration, is a hopeful sign. LIFO may more accurately reflect a company's profitability during an inflationary period by matching the most recent, and therefore the highest, costs against present revenues. LIFO essentially is a flow-of-costs approach to inventory accounting rather than a flow-of-goods approach. The inventory items on hand at the

3. Merjos, *FIFO to LIFO: More and More Companies Are Making the Switch*, Barron's, Oct. 21, 1974 at 5.

4. These figures were obtained from data set forth in Merjos, *FIFO to LIFO*, Barron's, Oct, 21, 1974, at 5; and Clark, *Profits Deflation*, Wall Street J., Jan. 3, 1975 at 1, 11, col. 6.

5. Merjos, *FIFO to LIFO*, *supra* note 3.

end of a company's fiscal year are assigned costs applicable to items purchased or made during earlier periods, which allows the use of costs that more nearly approximate current replacement costs for these items, rather than historical costs, in determining cost of goods sold. In other words, recent high costs for inventory items are allocated to cost of goods sold, reducing taxable income for the period, while older, lower costs are attributed to the inventory on hand at the close of the period. To illustrate, suppose that X Corporation in the example above utilized the LIFO inventory accounting method. The following table depicts X Corporation's financial performance under LIFO for 1974:

Sales Revenues			
Jan.-June (50,000 units @ $10)	$500,000		
July-Dec. (50,000 units @ $16)	800,000		
Total			$1,300,000
Opening Inventory			$0
Purchases During 1974			
January (100,000 units @ $5)	$500,000		
July (100,000 units @ $8)	800,000		
Total		(1,300,000)	
Closing Inventory (LIFO)			
(100,000 units @ $5)	500,000		
Cost of Goods Sold			
(100,000 units @ $8)			(800,000)
Gross Income			
(Sales Revenues minus Cost of Goods Sold)			500,000
Federal Income Tax Liability			
(22% x $25,000) $5,500			
(48% x 475,000) 228,000			
Total			233,500
Net Income			$266,500

X Corporation's reported net income is lower under LIFO than it was under FIFO. Consequently, tax liability is $144,000 less. Moreover, under LIFO $266,500, as opposed to $122,500 under FIFO, is available for dividend distributions, capital spending and expansion. This $144,000 difference in the amount available for such purposes is attributable directly to the reduction in federal income tax liability that is a consequence of utilizing LIFO in an inflationary period. Net income need not be invaded to fund the replacement of the 100,000 inventory items sold in 1974 because the deduction for cost of goods sold provides all of the $800,000 necessary for this replacement.

The business and financial benefits attainable by a switch to LIFO in an inflationary period are clear. Moreover, the *magnitude* of the downward impact that a change to LIFO can have on earnings is startling; for example, DuPont reported that its change to LIFO will reduce 1974 gross earnings by approximately $300 million;[6] Eastman Kodak reported that its change to LIFO for domestic inventories will reduce 1974 earnings by $41 million;[7] and Texaco stated that its switch to LIFO will reduce net earnings by $165 million.[8] Thus, the reduction in corporate tax liability and consequent improvement in cash flow can have a dramatic effect on a company's financial health.

The LIFO inventory accounting method, however, is not a panacea. LIFO is a special statutory election available to taxpayers in lieu of the normal methods by which inventory identification and valuation is accomplished under section 471 of the Internal Revenue Code of 1954.[9] The applicable Code section, section 472, and the regulations thereunder are highly technical provisions containing many pitfalls for the unsuspecting. Furthermore, a LIFO election for tax purposes affects a company's financial reports to shareholders and creditors, and raises business considerations that must not be overlooked. In addition, special interpretive problem areas and deficiencies present in the statute should give pause to taxpayers contemplating a switch to LIFO. This Note will analyze various considerations pertinent to the adoption and use of the LIFO inventory accounting method—the technical requirements for a switch to LIFO, the conformity-of-financial-reports requirement, a special problem in the consolidated financial statement area, termination problems, a deficiency in the statute regarding involuntary liquidations, and the business considerations presented by this type of change.

II. Analysis of Technical Requirements and Conditions on the Use of LIFO

A. *Time and Manner of the LIFO Election*

The LIFO inventory accounting method may be adopted under section 472(a) by a taxpayer at the close of any taxable year. The taxpayer must file a statement of its election to use LIFO for specified inventory items with its income tax return for the taxable year

6. Bray, *New Set of Books: More Companies Alter Accounting Methods to Neutralize Inflation*, Wall Street J., Oct. 7, 1974, at 1, col. 6.

7. Merjos, *supra* note 3.

8. Sabin, *Major Oil Firms' Earnings Likely to Drop This Quarter After Long Series of Gains*, Wall Street J., Dec. 19, 1974, at 32, col. 1.

9. Hereinafter referred to as the "Code." All references are to the Internal Revenue Code of 1954 unless otherwise indicated.

in which LIFO is first used. The statement should be made on Form 970 (Application for the Adoption and Use of the Elective Method Provided By Section 472 of the Internal Revenue Code), or in such other manner as may be acceptable to the Commissioner.[10] The Internal Revenue Service recently has indicated another acceptable manner, stating in Revenue Procedure 74-2[11] that a taxpayer will be considered to have made a valid election to use LIFO even though the requisite Form 970 is not filed if that taxpayer includes all the information required on, or to be filed with, Form 970 on his timely filed Federal income tax return.

Due to the timing of the election, a taxpayer has the benefit of hindsight in determining whether, and to what extent, a LIFO election will be desirable. For instance, a company contemplating the election of LIFO for the 1974 taxable year need not make a decision until its 1974 tax return is due,[12] and thus can use 1974 financial statistics to compute the immediate impact of a switch to LIFO on taxable income. Because a corporation can obtain an extension for filing its tax return for a maximum of eight and one-half months after the close of its taxable year,[13] it may be possible to defer a LIFO election decision until that time.[14]

Although the prior approval of the Commissioner of the Inter-

10. Treas. Reg. § 1.472-3(a), *amended by* T.D. 7295, 1974 INT. REV. BULL. No. 1, at 14.

11. 1974 INT. REV. BULL. No. 19, at 21.

12. Treas. Reg. § 1.472-3(a), *amended by* T.D. 7295 1974 INT. REV. BULL. No. 1, at 14. Section 6072(b) of the Code requires that the returns of corporate taxpayers be filed on or before the fifteenth day of the third month following the close of its fiscal year. Accordingly, a corporate taxpayer on a calendar year basis must file its return by March 15th.

13. Section 6081(a) of the Internal Revenue Code of 1954 permits the Commissioner to grant a domestic corporation a reasonable extension of time for filing its income tax return, but in no event may the extension be for more than 6 months. Thus, domestic corporations may file their income tax returns up to 8 ½ months after the close of their fiscal year.

14. As a practical matter, the extent to which the LIFO decision may be delayed is limited by the time at which the annual report must he furnished to shareholders. This is because of the requirement that LIFO also be used for financial reports if it is used for tax purposes. For a discussion of the conformity-of-reports requirement *see* note 45 *infra*, and accompanying text. Corporate by-laws generally establish a time by which annual meetings of shareholders must be held, which is often the end of the fourth month following the close of the fiscal year. The rules in Regulation X-14, 17 C.F.R. § 240.14 (1974), promulgated under section 14 of the Securities Exchange Act of 1934, provide in effect that no proxy solicitation relating to an annual meeting of shareholders at which the election of directors is an item of business shall be made by management unless each shareholder solicited is furnished (prior to, or at the time of, solicitation) with an annual report containing financial statements for the last fiscal year. Since it takes approximately thirty days to obtain an adequate number of proxies, the proxy statement and annual report must be sent to shareholders by the end of the third month following the close of the corporation's fiscal year. Thus, as a practical matter, within three months following the close of a corporate taxpayer's fiscal and taxahle year a determination whether to elect LIFO must be made, because the conformity-of-reports requirement mandates that the annual report to shareholders be made on the LIFO basis if LIFO is elected for tax purposes.

nal Revenue Service is not necessary to the election of LIFO,[15] the manner in which LIFO is used and the extent to which it is used are subject to his review to insure that income is clearly reflected. Thus, a taxpayer can choose the class or classes of goods to which the LIFO inventory accounting method will apply (and thereby elect LIFO for part of its inventory and continue its prior inventory accounting method for the remainder) by appropriate descriptions of the LIFO and non-LIFO goods in Form 970, but the Commissioner may require that LIFO be used for goods other than those specified if necessary to clearly reflect income.[16] Furthermore, when a change is made to LIFO, the District Director may deem certain adjustments to the inventories necessary to clearly reflect income. A taxpayer may not change to LIFO unless it agrees to these adjustments[17] at the time of filing its statement of election.[18]

B. *Conditions for the Adoption and Use of LIFO*

1. LIFO Inventory Must Be Taken At Cost

Inventory items normally are valued in one of two ways—at cost, or the lower of cost or market value. If LIFO is adopted, however, inventory items must be taken at cost, regardless of market value, for tax purposes.[19] This prohibition against a write-down to market value for tax purposes when LIFO cost exceeds the market value of certain inventory items undoubtedly has deterred many taxpayers from adopting LIFO. Taxpayers lacking conviction that price levels for particular inventory items will continue to spiral upward cannot rely on a write-down to market value as protection under LIFO. If a LIFO election is made, and prices for LIFO inventory items later decline to a point below the cost of the basic LIFO layer,[20] matching latest costs against present revenues is no longer

15. John Wanamaker Philadelphia, Inc. v. United States, 359 F.2d 437 (Ct. Cl., 1966) (disposed of the "prior consent of Commissioner" issue by stating that under the 1939 Code the taxpayer had an absolute right to elect the LIFO inventory accounting method). Treas. Reg. § 1.472-3(d) does give the Commissioner the authority to exercise approval power after-the-fact in connection with his examination of a taxpayer's return.

16. Treas. Reg. § 1.472-3(c) (1958). For example, if a taxpayer confined its LIFO election to its raw materials and the raw materials content of work-in-process and finished goods, it would continue to value the direct labor and indirect overhead components of work-in-process and finished goods under its present method. The Commissioner, however, has the regulatory authority to compel a taxpayer to broaden its LIFO election to clearly reflect income.

17. Form 970 contains a representation of this type.

18. Treas. Reg. 1.472-4 (1958).

19. INT. REV. CODE OF 1954, § 472(b)(2); Treas. Reg. § 1.472-2(b) (1958).

20. The basic LIFO layer is the layer of LIFO inventory items established at the beginning of the first year in which the LIFO inventory accounting method was utilized.

more attractive for tax purposes than matching earlier costs. Absent the ability to write down LIFO costs to market, a taxpayer's only option is to consider seriously termination of the LIFO election in the event of a precipitous decline in the cost of inventory items.[21]

Not only must LIFO inventory items be valued at cost prospectively, but in computing income for the year preceding the first LIFO year, these items also must be taken at cost.[22] Accordingly, if a taxpayer elects to use LIFO for its 1974 taxable year, it must reexamine its 1973 inventory valuation with respect to the types of inventory items for which LIFO was adopted to determine whether any such items were written down to market value. If a write-down occurred, the taxpayer must restore the items in question to LIFO cost, which necessitates the recomputation of cost of goods sold, taxable income and tax liability for 1973. This adjustment in the year preceding the first LIFO year is necessary to prevent the taxpayer from realizing a windfall tax liability reduction in the first LIFO year because of a readjustment to cost for that year's opening inventory. To illustrate, suppose Y Corporation writes down its 1973 closing inventory from $1,000,000 (cost) to $700,000 (market value). Y Corporation later elects the LIFO inventory accounting method for its 1974 taxable year,[23] and adjusts its opening inventory for 1974 to cost, $1,000,000. 1974 closing inventory, valued at cost, is $1,200,000.[24] If no adjustment had been made to the cost of the 1974 opening inventory, the increase in inventory during 1974 would have been $500,000 ($1,200,000-$700,000 = $500,000). Because of the adjustment to cost, however, the increase in inventory for 1974 is only $200,000 ($1,200,000-$1,000,000 = $200,000), and the other $300,000 is allocated to cost of goods sold and reduces taxable income by a like amount, decreasing 1974 tax liability by $144,000.[25] To balance this windfall reduction in 1974 tax liability, Y Corporation is required to restate 1973 closing inventory at cost. Accordingly, 1973 closing inventory must be restored to $1,000,000. This increase in the valuation of closing inventory necessitates a reduction, by the same amount, in 1973 cost of goods sold. The $300,000 decrease in 1973 cost of goods sold causes taxable income to increase by $300,000 and results in a 1973 tax deficiency of $144,000 for Y Corpo-

21. Termination of a LIFO election is discussed in Part III, *infra*.

22. INT. REV. CODE OF 1954, § 472(d); Treas. Reg. § 1.472-2(f) (1958).

23. Y Corporation, a calendar year taxpayer, elects LIFO in its income tax return filed by March 15, 1975. *See* note 12 *supra* and accompanying text.

24. It is assumed, for purposes of this illustration only, that price levels remain the same.

25. This assumes that Y Corporation is subject to an effective corporate tax rate of 48% on the income in question.

ration.[26] Thus, the increase in cost of goods sold for the first LIFO year, caused by raising the opening inventory to cost, is "paid for" by a corresponding decrease in cost of goods sold for the preceding year.

Inventory items of the type identified for LIFO treatment in Form 970, which are included in the opening inventory of the first LIFO year, must be treated as having been acquired at the same time and their individual cost must be determined by dividing the actual cost of the aggregate by the number of items on hand. The actual cost of the aggregate is determined under the inventory method applicable to the taxpayer's previous taxable year, except that any write-down to market value the previous year must be restored to cost,[27] as discussed above.

2. Adjustments to the Inventory Cost System

The Commissioner often regards the adoption of LIFO as a good occasion to scrutinize the inventory cost system of an electing taxpayer, because an adjustment to the preceding year's closing inventory and the first LIFO year's opening inventory to reflect costs can be made pursuant to the taxpayer's agreement under section 1.472-4 of the regulations.[28] It is advisable that a taxpayer contemplating a switch to LIFO review its inventory costing practices to determine that all items of cost are properly included. Potential upward adjustments in inventory cost produce corresponding decreases in the cost of goods sold, resulting in increased taxable income. These potential adjustments should be considered in relation to the estimated benefits attainable by the adoption of LIFO, and a determination of the additional years under LIFO required to offset the adjustments should be made.

As to inventory costing, special attention should be given to the new final regulations under section 471 requiring manufacturers to use the full absorption method of inventory costing for tax purposes.[29] The full absorption method requires the inclusion of direct and certain indirect production costs in inventory costs. The indirect costs that must be included under the full absorption method may be much more extensive than the costs that some taxpayers presently take into account. Section 1.471-11(e)(1)(i) of the regulations provides, in part, that a taxpayer not using the full absorption

26. *Id.* A deficiency must be paid with interest from the due date of the return for the year preceding the first LIFO year.

27. Treas. Reg. § 1.472-2(c) (1958).

28. *See* note 18 *supra* and accompanying text.

29. Treas. Reg. § 1.471-11 (1973).

method of inventory costing must change to this method. If a taxpayer elects to change to this method during the transition period defined in the regulations,[30] the change is regarded as initiated by the Commissioner, rather than by the taxpayer, under section 481, and therefore no section 481 adjustments (Adjustments Required By Changes In Method of Accounting) for pre-1954 Code years are necessary.[31] The taxpayer is then eligible to employ any of the transition methods set forth in section 1.471-11(e)(3). Section 1.471-11(e)(3)(iii) of the regulations provides two special transition rules for taxpayers that use the LIFO inventory accounting method. One rule imposes rather onerous requirements on the taxpayer—all LIFO layers must be revalued under the full absorption method and the section 481 adjustments must be computed for all items in all layers of inventory, but no pre-1954 inventory balances need be taken into account as adjustments under section 481.[32] The alternative rule available for a taxpayer on LIFO is much more liberal and attractive—a cut-off method may be employed under which the full absorption method is applied only in costing layers of inventory acquired during or after the taxable year in which the full absorption costing election is made.[33] The cut-off method, according to the Commissioner, was intended to relieve LIFO taxpayers from the substantial administrative burden of having to recompute all items in all inventory layers that had been acquired in prior taxable years.[34] On the basis of the foregoing regulations, a taxpayer contemplating a switch to LIFO might think that a tax planning opportunity existed whereby the taxpayer could avoid an adjustment to his inventory costs resulting from a change to the full absorption method of inventory costing by first electing to use LIFO and then

30. The transition period is established in Treas. Reg. § 1.471-11(e)(1)(ii), and began on September 19, 1973 and runs to September 19, 1975. The election may be made on Form 3115.

31. Section 481 prescribes the rules to be followed in computing taxable income in cases in which the taxpayer utilizes a method of accounting different from that under which taxable income previously was computed. It addresses itself to the adjustments necessary to prevent income or deduction items from being duplicated or omitted because of a change in method of accounting. The section provides that if a change in the method of accounting is initiated by the Commissioner, no adjustments based on pre-1954 Code years need be made. If, however, the taxpayer initiates the change, adjustments based on pre-1954 Code years must be made.

The regulations under section 471 permit a taxpayer that makes a proper election during the transition period to take any section 481 adjustments into account ratably over a ten-year period. Treas. Reg. § 1.471-11(e)(3)(i) (1973).

32. Treas. Reg. § 1.471-11(e)(3)(ii)(A) (1973).

33. Treas. Reg. § 1.471-11(e)(3)(ii)(B) (1973). A special cut-off method is set forth for dollar-value LIFO taxpayers in paragraph (B)(2).

34. Rev. Proc. 74-21, 1974 INT. REV. BULL. No. 32, at 17.

electing, within the transition period, to use the cut-off method in effecting the change to full absorption costing. Revenue Procedure 74-21,[35] however, precludes this type of avoidance of an adjustment to inventory costs. The Commissioner has indicated that he will not consent to the use of the cut-off method for a taxpayer that has elected to change to LIFO for a taxable year ending on or after the beginning of the transition period, September 19, 1973. Rather, the Commissioner will consent only to the use of the more onerous transition rule set forth in section 1.471-11(e)(3)(ii)(A). Failure to use this more onerous rule will be regarded by the Commissioner as a violation of section 1.472-4, which constitutes grounds for denial of permission to change to the LIFO inventory accounting method. In effect, a taxpayer that has not employed the full absorption method of inventory costing and desires to change to the LIFO method of inventory accounting can expect to make some significant inventory cost adjustments at the time of the change to LIFO.

3. Election of a LIFO Valuation Method and Identification of Inventory Pools

Form 970 requires a taxpayer to identify which of the two basic LIFO valuation methods it will use: the unit method or the dollar-value method. Under the unit method, quantities of specific inventory items are measured in terms of physical units. The quantity of units at the close of each taxable year is compared with the quantity at the beginning of the year in order to determine whether a change has occurred in the inventory level during the year. The dollar-value method measures inventory amounts in terms of dollars, not physical units. A ratio generally is developed by "double extending" year-end inventory at both base-year costs and current-year costs;[36] the former costs are used as the denominator and the latter as the numerator. Comparing base-year costs of inventory on hand at the end of the taxable year with base-year costs of the opening inventory reveals whether inventory items have increased or decreased. In the event that an increase has occurred, the incremental increase is converted to current-year costs by the application of the above ratio. The dollar-value method generally is regarded as a simple, more

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35. *Id.*

36. Treas. Reg. § 1.472-8(e)(1) (1961). This provision, however, also permits the use of an "index" method to compute the LIFO value of a pool when the use of the double extension method is impractical because of technological changes, the extensive variety of items, or the extreme fluctuation in the types of items in a pool. Moreover, if both the double-extension and index methods are unsuitable in view of the nature of the pool, a taxpayer may be able to persuade the Commissioner to allow it to use a link-chain method for computing tbe LIFO value of a pool.

practical method for valuing a complex, multi-item industrial inventory than the unit method.

The taxpayer also must identify the pool or pools of inventory items it plans to use under the LIFO method.[37] Pools usually are established by grouping items into categories on the basis of similarities or common attributes that would make the groupings logical. Commonly accepted criteria for inventory pools are type of material, manufacturing process, and type of end product. Regulations on the dollar-value method permit a taxpayer to formulate a single pool for a "natural business unit" in certain situations.[38] Inventory pooling greatly simplifies the taxpayers task of evaluating the benefits and potential risks of a change to the LIFO method of inventory accounting. Not only do anticipated price and quantity trends become more readily predictable, but concern over the availability of material, technological change, and the mechanics of inventory balance are greatly reduced by the averaging effect of placing a large number of inventory items in a pool.[39]

4. Costing Inventory Increments

LIFO inventory items on hand at the close of a taxable year in excess of items on hand at the beginning of the taxable year must be included in the closing inventory at costs determined on the basis of one of four optional methods: earliest cost of acquisition or production during the taxable year, latest cost, average cost, or such other method that in the opinion of the Commissioner clearly reflects income.[40] Form 970 requires that a taxpayer select a method for determining the cost of increases in inventories, and a method must be selected even when no increase has occurred in the first LIFO year for any item subject to the LIFO inventory accounting method. Careful consideration should be given to the method adopted, for it must be followed consistently in all subsequent taxable years in which LIFO is used by the taxpayer.[41] Additionally, a change in the method of costing increases in LIFO inventory items

37. Treas. Reg. § 1.472-8(b), (c), (d) (1961); Form 970, Item 7a. Particular attention should be given to the formation of inventory pools because the pool or pools selected must be used for the year of adoption and for all subsequent taxable years unless a change is required by the Commissioner in order to clearly reflect income, or unless permission to change pools is obtained from the Commissioner under section 1.446-1(e) of the regulations. Treas. Reg. § 1.472-8(d) (1961).

38. Treas. Reg. § 1.472-8(b) (1961). Actually, unless a taxpayer elects the multiple pooling method, a pool "shall consist of all items entering into the entire inventory investment for a natural business unit of a business enterprise."

39. Asner, *A New Look at Dollar-Value LIFO*, 39 TAXES 930, 936 (1961).

40. Treas. Reg. § 1.472-2(d)(1)(i)(a)-(d) (1958).

41. Treas. Reg. § 1.472-2(d)(1)(ii) (1958).

can be made only with the *prior* permission of the Commissioner. This change constitutes a change in the "method of accounting" under section 1.446-1(e) of the regulations; that is, it represents a change in the treatment of a "material item" in an overall plan of accounting for which the prior consent of the Commissioner must be obtained.

The opening inventory for the year of adoption of LIFO is the basic LIFO "layer." At the end of the year, the quantity of goods on hand is compared with the opening quantity.[42] If no increase has occurred, the average cost of the basic layer is applied to the year-end quantity to determine LIFO inventory cost. If the quantity of goods on hand has increased, the increase is treated as having been acquired during the taxable year and must be reflected at costs determined under one of the four optional methods. From the tax standpoint, the most advantageous method of costing increases in LIFO inventory items is the earliest cost method. Assuming that the cost of inventory items has risen during the taxable year, the LIFO inventory cost will be lowest if the earliest costs of the taxable year are used, and consequently the cost of goods sold will be the highest possible. Furthermore, using earliest costs permits a determination early in the taxable year of the cost at which any inventory increment will be carried.

5. Commissioner's Power to Broaden the LIFO Election

If a taxpayer is engaged in more than one trade or business, the Commissioner may require that if the LIFO method of identifying and valuing inventories is used with respect to items in one trade or business, the same method must be used with respect to similar items in other trades or businesses. The Commissioner, however, must have determined that the LIFO inventory accounting method, with respect to such similar items in other trades or businesses, is essential to a clear reflection of the taxpayer's income.[43]

Because of its significance, the other condition for the use of LIFO, the conformity-of-reports requirement, will be dealt with in separate sections below.[44]

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42. This explanation assumes the use of the unit method of LIFO valuation for ease of discussion. The same principles are applicable to dollar-value LIFO.

43. Treas. Reg. § 1.472-2(i) (1958).

44. A condition not discussed below concerns the keeping by the taxpayer of such detailed supplemental inventory records and accounts as will enable the District Director of Internal Revenue to verify the taxpayer's inventory computations and compliance with the requirements of section 472. Treas. Reg. § 1.472-2(h) (1958).

C. *The Conformity-of-Reports Requirement*

The major condition precedent to the adoption and use of LIFO, frequently labeled the "conformity-of-reports" requirement, is set forth in section 472(c) and (e). Section 472(c) states:

> Subsection (a) [authorizing a LIFO election] shall apply only if the taxpayer establishes to the satisfaction of the Secretary or his delegate that the taxpayer has used no procedure other than that specified in paragraphs (1) and (3) of subsection (b) [the LIFO method of identifying inventory items on hand and requirements as to treatment of opening inventory in the first LIFO year] in inventorying such goods to ascertain the income, profit, or loss of the first taxable year for which the method described in subsection (b) is to be used, for the purpose of a report or statement covering such taxable year—
>
> (1) to shareholders, partners, or other proprietors, or to beneficiaries, or
> (2) for credit purposes.

The operation of section 472(c) is illustrated in Revenue Ruling 75-49.[45] In that Ruling the Service addressed the question whether a taxpayer that had issued annual financial statements to shareholders using FIFO for a certain taxable year nevertheless could elect to use LIFO beginning with that same taxable year. The Service held that the election to use the LIFO inventory accounting method was invalid because the taxpayer had failed to satisfy section 472(c). Moreover, it stated that the violation of section 472(c) could not be cured by reissuance of the annual financial statements on a LIFO basis for the year in question, nor by recall of the previously issued statements. Thus, the requirements of section 472(c) must be strictly observed by a taxpayer anticipating a LIFO election.

While section 472(c) applies only to reports or statements covering the first LIFO year, subsection (e) pertains to subsequent years and imposes the same reporting requirement as that set forth above.[46] In the event that a taxpayer employs LIFO for tax purposes but fails to employ the same inventory accounting method in annual reports to shareholders or creditors subsequent to the first LIFO year, the Commissioner has the discretionary authority under subsection (e) to require a change to another inventory accounting method in the year in which the violation occurs, or any year thereafter.

The conformity-of-reports requirement is applicable only to reports or statements that cover the *whole* taxable year. Although the conformity requirement at one time applied to both interim and

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45. 1975 INT. REV. BULL. No. 7, at 11.

46. Subsection (e) contains a statement that a violation of the conformity-of-reports requirement for any year following the first LIFO year may result in an order from the Commissioner to terminate the LIFO election.

annual reports to shareholders or creditors, the Revenue Act of 1942 amended the Internal Revenue Code of 1939 to cover only full taxable year reports. The Senate Finance Committee commented on the old conformity-of-reports requirement as follows:

> It now appears in administration that the report requirement is too exacting in so far as it pertains to reports developed quarterly, semiannually, or at any time prior to the close of the taxable year. Consequently the report requirement is revised so as to be applicable only to annual reports.[47]

Several important exceptions to the conformity-of-reports requirement are available. First, present regulations allow use of market value in lieu of cost, when the former is lower, for financial reporting purposes.[48] Congress and the Internal Revenue Service evidently recognized that in the event of a price decline below LIFO cost, conservative accounting practice would mandate that the goods affected be valued at the lower of LIFO cost or market for financial accounting purposes. Of course, for tax purposes the LIFO method still requires the use of cost in the valuation of inventory items.

The second exception to the conformity-of-reports requirement resolves a conflict between section 472(c) and Accounting Principles Board Opinion No. 20 (APB 20) issued by the Accounting Principles Board of the American Institute of Certified Public Accountants (AICPA) in July, 1971.[49] APB 20 deals with changes in accounting principles and their justification. It states that the presumption that an entity should not change an accounting principle may be overcome only if the enterprise justifies the use of an alternative accounting principle on the basis that it is preferable. For this reason, APB 20 requires that the nature and justification for a change in an accounting principle and its effect on income be disclosed in a company's financial statements for the period in which the change is made and that the statement of justification for the change clearly explain why the newly adopted accounting principle is preferable. Assuming that a taxpayer's financial statements are prepared in compliance with APB 20 with respect to the change from its present inventory accounting method to LIFO, disclosure of the

47. S. Rep. No. 1631, 77th Cong., 2d Sess. (1942), cited in 1942-2 Cum. Bull. 504, 567. Present regulations under the Code state that the issuance of reports or credit statements covering a period of operations less than the complete taxable year is not at variance with the conformity-of-reports requirement. Treas. Reg. § 1.472-2(e) (1958).

48. Treas. Reg. § 1.472-2(e) (1958).

49. 3 CCH AICPA Prof. Stands. AC § 1051 (1971). A taxpayer's financial statements must be prepared in compliance with applicable authoritative statements of accounting principle issued by the body designated by the AICPA if auditors are to render an unqualified opinion on the financial statements.

sort mandated by APB 20 in its financial statements for the first LIFO year apparently would violate section 472(c) of the Code. Revenue Procedure 73-37,[50] however, states that if a taxpayer is required by APB 20 to show in a footnote to its financial statements its income under the inventory accounting method previously used as a justification for the change to LIFO, the Service will not invoke the reporting requirements of section 472(c) to deny the taxpayer the use of LIFO.[51] The scope of Revenue Procedure 73-37 is limited to those taxpayers whose financial statements are prepared in compliance with APB 20, and therefore it is inapplicable both to taxpayers who adopt the LIFO inventory accounting method in their first taxable year and to taxpayers who previously have not had inventories for Federal income tax purposes. Further, APB 20 applies only to the year of change to LIFO, and Revenue Procedure 73-37 will not protect against the application of the provisions of section 472(e) to any similar disclosure in footnotes to the financial statements in subsequent LIFO years.

Recently, the Service significantly amplified Revenue Procedure 73-37 in order to prevent possible conflicts between Securities and Exchange Commission (SEC) financial disclosure principles and generally accepted accounting principles on the one hand, and the conformity-of-reports requirement on the other. Revenue Procedure 75-10[52] is designed to accomodate recent actions by the SEC and by the Financial Accounting Standards Board (FASB) relating to financial disclosures in the annual reports of taxpayers that elect the LIFO inventory accounting method. Revenue Procedure 75-10 provides that a taxpayer electing LIFO, re-electing LIFO, or extending an existing LIFO election to cover a greater portion of inventory items, will not have the election terminated because the taxpayer is subject to and complies with the disclosure requirements of APB 20,[53] APB 28,[54] FASB 3,[55] Accounting Series Release (ASR) No. 159,[56]

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50. 1973 INT. REV. BULL. No. 50, at 31.

51. The Service has indicated that language similar to the following is acceptable:

Footnote in Financial Statements—The company has changed its method of accounting for inventories to a last-in, first-out (LIFO) method. This was done because the rapid increase in prices during the year would result in an overstatement of profits if use of the first-in, first-out (FIFO) method was continued since inventories sold were replaced at substantially higher prices. The effect on reported earnings for the year was a decrease of $XXXX, or $XXX per share.

Rev. Proc. 75-10, 1975 INT. REV. BULL. No. 7, at 16.

52. 1975 INT. REV. BULL. No. 7, at 16.

53. *See* note 49 *supra* and accompanying text.

54. 3 CCH AICPA PROF. STANDS. AC § 2071 (1973).

55. 3 CCH AICPA PROF. STANDS. AC § 7003 (1974).

56. CCH FED. SEC. L. REP. ¶ 72,181 (1974).

Rule 3-07 of Regulation S-X,[57] and/or Securities Exchange Act Release No. 11079.[58] APB 28 deals with interim financial reports and, in part, applies the provisions of APB 20 to a change in an accounting principle during an interim period.[59] APB 28 also establishes minimum disclosure standards for interim reports,[60] and requires that, in the absence of a separate fourth quarter report or disclosure of the results for that quarter in the annual report, a change in an accounting principle must be disclosed in a note to the annual financial statements.[61] FASB 3, issued on December 31, 1974, amends APB 28 to provide specific disclosure requirements for both interim and annual statements when a LIFO election is made.[62] ASR 159 requires a public company to include in its filings with the SEC and in its annual report a "management's analysis section."[63] This analysis must include a statement explaining changes in accounting principles that have a material effect on reported net income. Accordingly, a taxpayer that changes to the LIFO inventory accounting method is required to explain the change and its effect.[64] Rule

57. 17 C.F.R. § 210.3-07 (1974). Regulation S-X, entitled "Accounting Rules," states the requirements applicable to the form and content of all financial statements required to be filed as a part of: registration statements under the Securities Act of 1933; registration statements under section 12 of the Securities Exchange Act of 1934; annual or other reports under sections 13 and 15(d) of the Securities Exchange Act of 1934; proxy and information statements under section 14 of the Securities Exchange Act of 1934; and certain other statements and reports under the Public Utility Holding Company Act of 1935 and under the Investment Company Act of 1940. Rule 3-07 is entitled "Changes in Accounting Principles and Practices and Retroactive Adjustments of Accounts."

58. CCH FED. SEC. L. REP. ¶ 79,996 (1974). Release No. 11079 is entitled "Notice of Adoption of Amendments of Rules 14a-3, 14c-3 and 14c-7 under the Exchange Act to Improve Disclosure in, and Dissemination of, Annual Reports to Security Holders and to Improve the Dissemination of Annual Reports of Form 10-K or 12-K Filed with the Commissioner under the Exchange Act."

59. 3 CCH AICPA PROF. STANDS. AC § 2071.23-29 (1973).

60. *Id.* § 2071.30-33.

61. *Id.* § 2071.31, *as amended* by FASB 3, 3 CCH AICPA PROF. STANDS. AC § 7003.14 (1974), effective for interim periods ending on or after December 31, 1974.

62. 3 CCH AICPA PROF. STANDS. AC § 7003.12-.13 (1974).

63. This requirement is a reflection of the SEC's recognition of the utility of a narrative explanation of financial statements. The purpose of the "management's analysis section" is to provide investors with a concise summary of the most significant elements of reported results in order to enable them to appraise the quality of earnings.

64. The Service will not terminate a taxpayer's LIFO election if substantially the same language used in the financial statements footnote to disclose the effect of the change to LIFO (pursuant to APB 20) is repeated in management's analysis of operations. Revenue Procedure 75-10 § 3.03 indicates that language similar to the following is acceptable:

> *Excerpt from Management's Analysis of Summary of Earnings*—In order not to overstate reported profits as a result of inflation during the year, the company changed its method of accounting for inventory from first-in, first-out (FIFO) to last-in, first-out (LIFO). This was necessary because of the rapid increase in prices in 197X which caused inventories sold to be replaced at substantially higher prices. The effect of the change was to decrease reported earnings by $XXXX, or $XXX per share.

3-07 of Regulation S-X requires the repetition of a disclosure made in the year in which an accounting principle is changed whenever the financial statements for the year of change subsequently are reported.[65] Further, Release No. 11079 requires that an annual report to shareholders include a five year summary of operations, which must disclose and discuss accounting changes that are significant. In light of this requirement, Rule 3-07 mandates a repetition of the disclosure and discussion of an accounting principle change in summaries of operations issued subsequent to the year of change.[66] All of the above disclosure requirements relate solely to a taxpayer's performance in the year in which LIFO is elected, reelected, or extended.[67] Revenue Procedure 75-10, like Revenue Procedure 73-37, does not protect a taxpayer from termination under section 472(e) in the event that similar financial disclosures are made for subsequent taxable years. The disclosures permitted under Revenue Procedure 75-10 may be made directly or indirectly in annual financial statements for the year of change, or in other annual reports of earnings, such as news releases, reports to creditors, the president's letter section of the annual financial statements, and oral and written statements at stockholder's meetings and security analysts' meetings.[68]

The third exception to the conformity-of-reports requirement resolves a conflict between section 472(c) and (e) and APB 16[69] concerning certain corporate business combinations, such as stock or asset acquisitions. APB 16 sets forth facts that determine whether a transaction should be treated as a "purchase," under which the acquired assets are recorded by the acquiring company at current fair market value, subject to specified adjustments, or as a "pooling

65. Accounting Series Release No. 169, CCH FED. SEC. L. REP. ¶ 72,191 (1975).

66. The allowable disclosure in the five year summary of operations is limited to the effect of the accounting principle change on the year of change included in the summary. For example, if a taxpayer elects LIFO for the 1974 taxable year, the effect of the change on earnings for 1974 may be reflected in 1974 and in years in which 1974 is included in the summary of earnings, but the effect of the change on earnings for 1975 and subsequent years may not be disclosed. Revenue Procedure 75-10 § 3.05, 1975 INT. REV. BULL. No. 7, at 17.

67. A taxpayer that extends an existing LIFO election must limit disclosure of the effect on earnings to the effect attributable to the portion of inventory subject to the extension. For example, if a taxpayer presently employing LIFO for division A and FIFO for division B elects to extend the LIFO election to division B, it may not disclose what earnings for division A would have been under FIFO. Revenue Procedure 75-10 § 3.04, 1975 INT. REV. BULL. No. 7, at 17.

68. Revenue Procedure 75-10 § 3.02, 1975 INT. REV. BULL. No. 7, at 16. For a discussion of the scope of the term "annual report" under section 472(c) and (e), *see* notes 73-82 *infra* and accompanying text.

69. 3 CCH AICPA PROF. STANDS. AC § 1091 (1970). APB 16 was issued in August, 1970 and generally is effective for business combinations initiated after October 31, 1970.

of interests," under which the acquired assets are recorded by the acquiring company essentially at the value reflected on the acquired company's books. Because the factors set forth in APB 16 that determine whether an acquisition should be treated as a purchase or pooling of interests for financial accounting purposes do not correspond to the factors that determine whether an acquisition is taxable or tax-free for Federal income tax purposes, situations can arise in which an acquisition is treated differently for tax and financial accounting purposes. If the acquiring and the acquired corporation have used the LIFO inventory accounting method and the acquisition is treated differently for tax and financial accounting purposes, a difference will arise between the LIFO procedures used by the acquiring corporation for tax and financial accounting purposes. For example, a merger that is tax-free under section 368(a)(1)(A) of the Code may be treated as a purchase under APB 16. Any LIFO inventories of the acquired corporation must be carried over to the acquiring corporation at the same cost and with the same LIFO layer structure for tax purposes. For financial accounting purposes, however, the LIFO inventories of the acquired corporation are treated as current year purchases by the acquiring corporation under APB 16 purchase treatment, and these inventories must be valued at present fair market value. Thus, for financial accounting purposes, neither the LIFO costs nor the LIFO layer structure is preserved, notwithstanding their preservation for tax purposes. Under section 472(c) and (e), such a variance between the LIFO procedures used for tax and book purposes gives the Commissioner the discretionary power to order termination of the LIFO inventory accounting method. Revenue Procedure 72-29,[70] however, provides that the Commissioner will not terminate a LIFO election simply because the financial accounting principles of APB 16 have been applied to an acquisition *if* certain disclosure requirements are satisfied. The acquiring company must disclose, in both its financial statements and its Federal income tax returns, the difference, for any taxable year, between taxable income and net income due to the application of APB 16 to LIFO inventories of the acquired company. Similar disclosure is required in any taxable year in which compliance with APB 16 results in a difference between the LIFO inventories reflected in the acquiring company's balance sheets for tax and financial accounting purposes.

The fourth and final exception to the conformity-of-reports requirement concerns the disclosure in a footnote to the balance sheet

70. 1972-1 CUM. BULL. 757.

of the amount of "LIFO reserve" attributable to LIFO inventories. LIFO reserve generally is defined as the dollar difference between the valuation of inventories on a FIFO basis and on a LIFO basis. This reserve reflects the cumulative benefit, in terms of lowering of taxable income, derived from the use of the LIFO inventory accounting method. Revenue Ruling 73-66[71] addressed the question whether a taxpayer could use a footnote or parenthetical statement such as the following on the balance sheet in its annual report:

> If the first-in, first-out (FIFO) method of inventory accounting had been used by the company, inventories would have been $ and $ higher than reported at December 31, 19 , and December 31, 19 , respectively.

The Internal Revenue Service held that the proposed footnote or parenthetical statement on the balance sheet may be used without violating the conformity-of-reports requirement of section 472(c) and (e). More recently, in Revenue Ruling 75-50,[72] the Service held that the footnote or parenthetical statement may disclose the excess of replacement or current cost over LIFO cost, rather than the excess of FIFO cost over LIFO cost, without violating the conformity-of-reports requirement. In all other aspects, the taxpayer may use only the LIFO inventory accounting method for the annual report and for all other financial statement purposes, including income statements and reports of earnings per share. Moreover, no further explanatory statements about LIFO inventories in the taxpayer's annual statements or reports will be permitted by the Service under Revenue Rulings 73-66 or 75-50. The information communicated by the above footnote, however, enables a sophisticated investor or analyst not only to determine the *cumulative* benefit of LIFO, but also to calculate the benefit of LIFO in the *past year*—a sophisticated investor can calculate the reduction in net income and earnings per share caused by the use of LIFO in the latest reporting period.

The Service recently released Revenue Ruling 74-586[73] regarding the enforcement of the conformity-of-reports requirement. The Ruling states that use by a LIFO taxpayer of footnotes or commen-

71. 1973 INT. REV. BULL. No. 6, at 8. Revenue Ruling 73-66 was issued, in part, in response to the 1972 amendments to Securities and Exchange Commission Regulation S-X. Rule 5-02(6)(b), effective for fiscal periods ended December 31, 1972 and thereafter, requires that registrants using the LIFO inventory accounting method disclose "the excess of replacement or current cost over stated LIFO value," if material, either parenthetically in the balance sheet or in a footnote to the financial statements. Revenue Ruling 73-66 provides only for disclosure of the excess of FIFO over LIFO cost, probably because the Service thought that replacement or current cost would not differ significantly from FIFO cost. For a broadening of Revenue Ruling 73-66, *see* note 72 *infra* and accompanying text.

72. 1975 INT. REV. BULL. No. 7, at 11.

73. 1974 INT. REV. BULL. No. 49, at 10.

tary in its annual report, annual financial statements, and annual news releases issued after January 8, 1974, other than those specifically permitted by Revenue Procedures 72-29,[74] 73-37[75] and Revenue Ruling 73-66,[76] that compare or state what net earnings or earnings per share would have been under any inventory accounting method other than LIFO, is a violation of the conformity-of-reports requirement of section 472(c) and (e) and may result in termination of the taxpayer's LIFO election. Revenue Ruling 74-586 was issued prior to Revenue Procedure 75-10[77] and Revenue Ruling 75-50,[78] and the scope of the former necessarily is narrowed by the amplification in the latter of the exceptions to the conformity-of-reports requirement contained in Revenue Procedure 73-37 and Revenue Ruling 73-66. Undoubtedly Revenue Ruling 74-586 is a reaction by the Service to the flood of reports in financial journals in the past several months that hundreds of companies are contemplating a switch or actually have switched to the LIFO inventory accounting method. A massive change by corporate taxpayers to LIFO will cost the U.S. Treasury an estimated four to five billion dollars in tax revenues in 1974 alone,[79] and the Service, whose primary purpose is to collect tax revenues, obviously is concerned. Actually, though, Revenue Ruling 74-586 is little more than a cursory review of the exceptions to the conformity-of-reports requirement and an expression of the Service's intent to enforce the requirement in a strict fashion—except for one surprising feature. The Service indicated that annual news releases are subject to the conformity requirement. Evidently, the Service regards annual news releases as commentary to the annual financial statements—in essence, a part of the financial statements. Thus, in the Service's view, income ascertainment on the basis of a method other than LIFO in an annual news release is essentially equivalent to such a computation appearing in the body of the financial statements. The Service also seems to be of the opinion that nonconformity of annual news releases violates the *purpose* of the

74. *See* notes 69-70 *supra* and accompanying text concerning the resolution of the conflict between APB 16 and section 472(c) and (e).

75. *See* notes 49-51 *supra* and accompanying text concerning the resolution of the conflict between APB 20 and section 472(c).

76. *See* note 71 *supra* and accompanying text concerning disclosure of the FIFO value of LIFO inventories in footnote to the balance sheet.

77. *See* note 52 *supra* and accompanying text.

78. *See* note 72 *supra* and accompanying text.

79. Wall Street J., Nov. 22, 1974, at 1, col. 5; Clark, *Profits Deflation*, Wall Street J., Jan. 3, 1975, at 1, 11, col. 4. Estimates of the total amount of corporate taxes deferred by changes to LIFO vary widely. Senator William Proxmire predicts a revenue loss of $6-$9 billion. The effect of such massive tax deferral, of course, is to increase the federal budget deficit.

conformity requirement. Upon reflection, one might respond that the Service had better attempt to buttress its violation of purpose argument, for nonconformity of annual news releases certainly does not appear to violate the *letter* of the conformity requirement, as found in the statute and the regulations. Section 472 (c) and (e) speaks in terms of annual reports or statements "(1) *to* shareholders, partners, or other proprietors, or *to* beneficiaries, or (2) *for* credit purposes."[80] Section 1.472-2(e) of the regulations contains language to the same effect. This language does not seem to encompass annual news reports that are issued for informational purposes to the world-at-large. Such news releases are not specifically designed to reach *only* shareholders and creditors of a LIFO taxpayer, nor is it certain that such releases will come to the attention of *every* shareholder and creditor of the taxpayer. Accordingly, under a reasonable interpretation of the language of section 472 and the regulations thereunder, it seems that the Service has overstepped its authority in extending the conformity-of-reports requirement to annual news releases.

Moreover, the Service's argument that extension of the conformity requirement to news releases is justified by the purpose of 472(c) and (e) is not supported by the legislative history of that provision. The purpose of the conformity-of-reports requirement has been the subject of considerable speculation during the past thirty years. In Revenue Ruling 74-586 the Service argued that legislative history[81] indicates that the purpose of the conformity-of-reports requirement is to give assurance that the LIFO method clearly reflects income. But the fact that LIFO is used for *both* tax and financial accounting purposes does not establish that income is clearly reflected. Rather, whether income is clearly reflected is a question that requires an analysis of the taxpayer's business and the propriety of the application of the LIFO method to such a business. The fact that income is reflected under the same method for two different purposes does not assure clarity, but merely assures consistency. In fact, the legislative history does not reveal the reasons for the adoption of the conformity-of-reports requirement. One scholar, familiar with the Congressional deliberations on LIFO in the late 1930's, suggests:

80. (Emphasis added).

81. The Service makes no specific reference to a Senate or House committee report to support its conclusion concerning the purpose of the conformity-of-reports requirement. A passage quoted in the paragraph preceding the statement about legislative intent is an excerpt from the Senate Report on the Revenue Bill of 1939; essentially it is a *description* of the requirements now contained in section 472(c) and (e), and does not shed any light on the *purpose* behind such requirements.

> Considerable discussion has taken place as to the reason for the outside report requirement in the statute. Certainly, it is the first and only time the revenue laws have been used specifically to control private accounting. *Perhaps the best answer is that the outside report requirement was put into the law as a deterrent to the use of the Lifo method of inventory valuation.* An influential group in the Treasury believed that *Lifo* was not an inherently sound accounting method except in certain fungible goods industries like the non-ferrous metal and tanning industries. It was apparently their belief, proved fallacious by subsequent events, that very few corporate taxpayers would be willing to supply their stockholders and the public with reports in which the inventories were valued on a *Lifo* basis.[82]

If deterrence originally was the purpose of the section 472(c) and (e) conformity-of-reports requirement, today one must question whether it is a *legitimate* purpose. LIFO no longer is regarded as an "inherently unsound" inventory accounting method, rather it is recognized, at least in the United States, as a valid and useful means of measuring a company's financial performance. An outdated deterrence purpose does not warrant an expansive interpretation of the conformity-of-reports requirement to reach annual news releases. On the contrary, this outdated rationale indicates that the requirement should be strictly construed.

Perhaps it is time to re-examine the conformity-of-reports requirement, evaluating its present effect and the validity of its purpose. As mentioned above, the information that the Service allows to be placed in a footnote or parenthetical statement on the balance sheet, described in Revenue Ruling 73-66,[83] is sufficient to enable sophisticated investors and analysts to determine the cumulative reduction in net income for the years that a taxpayer has used LIFO, the reduction in net income in the latest reporting period, and the decrease in earnings per share in the latest reporting period due to the use of LIFO. In other words, despite the conformity requirement, sophisticated persons have enough financial data to recalculate a taxpayer's current earning performance on a FIFO basis. Moreover, under the statute, regulations and present Revenue Rulings and Revenue Procedures, taxpayers are not prohibited from releasing interim financial statements or interim news releases portraying quarterly earnings performance on both a FIFO and a LIFO basis. From such interim information, persons who are financially sophisticated and sufficiently diligent can reconstruct a taxpayer's annual earnings performance on a FIFO basis. Thus, despite the

82. Barker, *Practical Aspects of Inventory Problems Under Current Conditions: LIFO, Involuntary Liquidations*, N.Y.U. 10TH INST. ON FED. TAX. 511, 512-13 (1952) (emphasis added).

83. *See* note 71 *supra* and accompanying text concerning disclosure of the FIFO value of LIFO inventories in footnote to the balance sheet.

conformity requirement, financially sophisticated persons easily can determine a LIFO taxpayer's financial performance using the FIFO inventory accounting method. Nevertheless, financially unsophisticated persons are limited in their understanding of a LIFO taxpayer's earnings performance because their evaluations necessarily are limited to conclusions drawn from the information that is presented in a straightforward fashion. In effect, a subtle form of differential disclosure is mandated by the tax laws. At a time when financial statements are being scrutinized by lay juries in securities law cases to determine their *fairness*,[84] and not simply to determine whether they conform to generally accepted accounting principles (GAAP), it is ironic that the federal tax laws require unfair disclosures of information by LIFO taxpayers.

The unfair differential disclosure promoted by the federal tax laws might be justified if the federal government could demonstrate a compelling interest in the conformity-of-reports requirement. But, as indicated above, the apparent purpose of the conformity requirement is to deter taxpayers from changing to the LIFO inventory accounting method and thereby avoid deferrals of tax revenues. This purpose or governmental interest hardly justifies the harmful effect of the conformity requirement.

Two possible solutions to this problem can be offered. First, the exceptions to the conformity requirement that give rise to differential disclosure might be abolished. Secondly, the conformity requirement itself might be abandoned. The former solution appears to create more problems than it solves. For instance, it would require the prohibition of nonconforming interim reports, yet the administrative and accounting burden this would impose on LIFO taxpayers and the policing burden it would impose on the Service was termed "too exacting" by the Senate Finance Committee in 1942.[85] Furthermore, the FIFO value of LIFO inventories could not be disclosed in a footnote on the balance sheet, and this would destroy comparability of financial ratios in two respects. First, financial ratios, such as the current, quick, inventory turnover and total asset turnover ratios, for a single taxpayer covering pre-LIFO and post-LIFO reporting periods would not be comparable. Secondly, unless all of the taxpayers in a given industry employed the LIFO inventory accounting method, the financial ratios developed for each taxpayer would not be comparable to the ratios developed

84. *See* Fiflis, *Current Problems of Accountants' Responsibilities to Third Parties*, 28 VAND. L. REV. 31, 67-80 (1975).

85. *See* note 47 *supra* and accompanying text.

for other taxpayers in the industry. Finally, it is conceivable that a situation could arise under the securities laws in which the standard of fair disclosure would require that the FIFO value or current replacement cost of inventories be disclosed to a taxpayer's shareholders.[86] Thus, given the problems attendant upon the abolition of the exceptions to the conformity-of-reports requirement, that course of action does not seem to represent a viable solution to the differential disclosure problem. Therefore, the alternative solution of abandoning the conformity requirement must be examined.

The basic purpose of financial accounting and financial statements is to provide quantitative financial information about a business enterprise that is useful in making economic decisions.[87] In contrast, the principal, though not the only, objective of the federal income tax laws is to raise revenues. By narrowly circumscribing the manner in which financial information may be presented to the investor, the conformity-of-reports requirement under section 472 (c) and (e) does violence to the basic purpose of financial accounting and financial statements in order to promote the principal objective of the federal income tax laws. Financial data computed using the LIFO inventory accounting method is useful for certain purposes, but for other purposes the same data computed on a FIFO basis is necessary. Accordingly, a reasonable conclusion is that the conformity-of-reports requirement should be abandoned. If Congress wishes to promote the purpose of deterring taxpayers from utilizing the LIFO inventory accounting method in order to prevent deferral of tax revenues, it should devise a deterrence technique that does not interfere with the valid purposes of financial accounting and financial statements.

86. For example, if a publicly-held company has used the LIFO method for a number of years, the book value of its inventories may be far below the replacement cost of such inventories. In the event that the company decides to "go private" by offering to exchange cash or debt instruments for outstanding equity securities, the non-tendering insiders promoting the going private scheme would have to disclose the FIFO value or replacement cost of LIFO inventories. Absent such disclosure, tendering shareholders might be misled to believe that the book value of their shares was an accurate reflection of their true value, when in fact the value of inventories on hand is grossly understated and therefore the book value of the company's common stock is distorted. Failure to disclose the FIFO value or replacement cost of inventories to enable shareholders to appraise the exchange offer intelligently probably would result in an actionable offense under Rule 10b-5. Yet, if all exceptions to the conformity requirements are abolished, disclosure of the FIFO value or replacement cost of inventories would result in a violation of section 472(e) and permit the Commissioner to terminate the LIFO election.

87. Levy, *Tax Aspects of Recent Accounting Developments: Tax and Financial Conformity*, N.Y.U. 30TH INST. ON FED. TAX. 1579, 1581 (1972).

D. *The Conformity-of-Reports Requirement and Consolidated Financial Statements—An Interpretive Problem*

Until 1970, certain affiliated groups of corporations were able to circumvent the practical restraint imposed on the use of the LIFO inventory accounting method by the conformity-of-reports requirement. The Service had held, in Revenue Ruling 69-17,[88] that the use of LIFO by one subsidiary of an affiliated group filing a consolidated federal income tax return did not preclude the affiliated group from using the FIFO inventory accounting method for the subsidiary's inventories in its consolidated financial statements. The Service evidently thought the section 472 (c) and (e) conformity-of-reports requirement literally was satisfied because the subsidiary reported to its creditors and shareholders (including its parent corporation) on a LIFO basis. Unquestionably, this view offered tax planning opportunities for a corporation contemplating a switch to LIFO for a portion of its operations. If that "portion of the operations" happened to be a line of business with independent manufacturing or sales facilities, the corporation might consider reorganizing so that the line of business for which a LIFO election was contemplated constituted a separate, wholly owned, subsidiary corporation. Alternatively, if the corporation already was organized on a divisional basis, and a LIFO election would be beneficial for a particular division, that division could be reorganized as a subsidiary. In either case, the subsidiary established would utilize LIFO for tax purposes and for reports to its creditors and its parent-shareholder, but its financial performance would be restated using the FIFO method by the parent corporation for consolidated financial statement purposes. After a year of observing the results of its position in Revenue Ruling 69-17, the Service reversed itself and stated, in Revenue Ruling 70-457,[89] that no basis exists for a parent corporation to convert the LIFO inventory valuation of a subsidiary to a different method of inventory valuation for purposes of consolidated financial statements. The Service contends that this conversion would tend to frustrate the statutory requirement that when the LIFO method is used for Federal income tax purposes it also must be used in reports to shareholders and creditors. Accordingly, Revenue Ruling 70-457 held that if a corporation uses the LIFO method for tax purposes, it also must be used with respect to the LIFO inventories to the extent these inventories are included in the consolidated financial statements of any other corporation. In 1973, Revenue Ruling

88. 1969-1 CUM. BULL. 143.
89. 1970-2 CUM. BULL. 109.

73-57[90] explicitly made Revenue Ruling 70-457 applicable to foreign as well as domestic parent corporations.

Despite the Service's good intention to prevent circumvention of the conformity-of-reports requirement, Revenue Ruling 70-457 seems vulnerable to attack. The argument that the literal standards of the conformity-of-reports requirement are met by a parent corporation that restates a LIFO subsidiary's financial performance on a non-LIFO basis for consolidated financial statement purposes seems legitimate and persuasive. Revenue Ruling 70-457 arguably extends the definition of "shareholders," as used in section 472(c) and (e), beyond its original intendment. The shareholders of a parent corporation generally are not regarded as the "shareholders" of a subsidiary corporation.[91] The definition of the term "shareholder" found in section 7701(a)(8) does not alter this accepted limitation on the term.[92] The Service's position, in effect, attributes the ownership of the subsidiary corporation to the shareholders of the parent corporation. Yet, in those instances in which Congress has intended to attribute ownership of a subsidiary by a corporation to that corporation's shareholders, it has made its intention explicit. For instance, in determining controlled corporation status for surtax exemptions, rules for attributing stock owned by a corporation to that corporation's stockholders are set forth in detail in section 1563(e)(4). Absent an explicit expression of Congressional intent in section 472, the term "shareholder" should be accorded its normal meaning and be subject to its accepted limitations.[93]

Arguments in support of Revenue Ruling 70-457 based on the purpose of the conformity-of-reports requirement are not persuasive. As stated above,[94] a deterrence purpose does not seem to justify an expansive reading of section 472(c) and (e). This is especially true when it is noted that, far from being regarded as a suspect

90. 1973-1 CUM. BULL. 218.

91. 18 C.J.S. *Corporations* § 475(h) (1939). The court in Albert v. McGrath, 104 F. Supp. 891, 897 (S.D. Cal. 1952) stated that "A stockholder in a corporation which owns all the stock of another is not a stockholder in the latter corporation, or the owner of its assets." *See also* Sabre v. United Traction & Electric Co., 225 F. 601, 603 (D.R.I. 1915).

92. Section 7701(a)(8) states that "The term 'shareholder' includes a member in an association, joint stock company, or insurance company."

93. The Service apparently has adopted the position elsewhere that reports to shareholders include consolidated financial statements. Treas. Reg. § 1.451-5(b)(2) (1971) provides that certain advance payment may he included in income "in the taxable year in which properly accruable under the taxpayer's method of accounting if the method used is not at variance with the method used by the taxpayer for purposes of all reports (including consolidated financial statements) to shareholders, partners, other proprietors, beneficiaries, and for credit purposes."

94. *See* notes 81-82 *supra* and accompanying text.

inventory accounting method, LIFO now is generally recognized as a valid and useful means of measuring income, particularly in an inflationary period. The Service's expansive reading of the term "shareholder" in section 472 (c) and (e), even when regarded as an attempt to protect the purpose of the statute, appears to exceed its authority to issue general interpretative regnlations and rulings on all Code sections.[95]

Revenue Ruling 73-57, which made the Service's position in Revenue Ruling 70-457 specifically applicable to foreign parent corporations, raises a special problem. LIFO is not a universally accepted method of inventory valuation. It is not permitted, for example, in Great Britain or France for either financial accounting or income tax purposes.[96] Thus, Revenue Rulings 70-457 and 73-57 attempt to impose a method of inventory accounting acceptable in the United States, LIFO, on parent corporations in foreign countries, which countries may not recognize LIFO for financial accounting purposes. The requirement that a foreign parent must utilize LIFO for its United States subsidiary's LIFO inventories for financial statement purposes may result in the foreign parent being forced to use an inventory accounting method unfamiliar to its shareholders and not comparable to the methods its competitiors employ to reflect their financial performance. In effect, the United States, via an interpretive ruling of a governmental agency, is attempting to extend its jurisdiction over accounting principles use into foreign nations.

In rebuttal, the Service might argue that it is not extending the United States' jurisdiction over foreign corporations and the inventory accounting methods they employ; rather, it merely is limiting the inventory accounting methods available to domestic corporations (for federal income tax purposes) whose foreign parent corporations do not or cannot use the LIFO method for consolidated financial statement purposes. This smacks of discrimination because its effect is to foreclose domestic corporations with foreign parents from an inventory accounting option available to corporations with domestic parents. Although this sort of discrimination may be reasonable in certain circumstances, it is a fundamental policy issue whose resolution should be the result of Congressional

95. Section 7805(a) confers upon the Commissioner the authority to prescrihe all necessary rules and regulations under the Internal Revenue Code of 1954. It might he argued that section 472(a) gives the Commissioner regulatory powers so broad as to he tantamount to legislative authority. Subsections 472(c) and (e), however, are specific as to the conformity-of-reports requirement, and rules and regulations in this area should be interpretive rather than legislative in nature.

96. Wall Street J., Jan. 7, 1975, at 6, World Report col.

deliberation and determination, and should not be within the ambit of the administrative or interpretive rule-making jurisdiction of the Internal Revenue Service.

The Service also should consider the reverse situation. Suppose the tax laws of a foreign nation required that a subsidiary corporation's United States parent use a particular accounting method for consolidated financial statement purposes as a condition to allowing the subsidiary to use that accounting method for tax purposes. Further, suppose that the deferral of tax liability associated with using the accounting method in question is significant. If the accounting method is not acceptable in the United States and yet is employed by the parent corporation, the parent corporation's accountants cannot render an unqualified opinion that the consolidated financial statements were prepared in conformance with GAAP. Because anything other than an unqualified opinion is an anathema to corporate executives, the parent corporation undoubtedly will inform the foreign nation that it cannot comply with the conformity requirement imposed by its tax laws, and, in turn, the foreign nation will inform the parent corporation that its subsidiary may not enjoy the significant tax deferral advantage associated with the accounting method in question. Consequently, the subsidiary corporation will discover that it is at a considerable financial disadvantage in relation to its competitors in the foreign nation. This financial disadvantage will adversely affect the subsidiary's financial performance, which will be reflected on the United States parent corporation's consolidated financial statements. United States parent corporations certainly would be outraged by such "discrimination" under foreign tax laws. Thus, perhaps the shoe does not fit the other foot well at all and this may be an indication that something new is needed.

This interpretive problem with the conformity-of-reports requirement reinforces the earlier conclusion that the requirement should be abandoned. Clearly, an attempt to tailor an exception to the conformity requirement for foreign parent corporations filing consolidated financial statements, or a resurrection of Revenue Ruling 69-17 allowing restatement of a subsidiary's LIFO inventories on a non-LIFO basis for consolidated financial statement purposes, would produce numerous tax planning schemes designed to avoid the requirement altogether.

The purpose of the conformity requirement, deterrence, is not sufficiently important to warrant continued attempts to save it by the creation of exceptions for a growing list of "unusual circumstances."[97] Moreover, attempts by the Service to preserve the deterrent effect of the conformity requirement by expanding it to include statements or reports seemingly outside its scope, such as annual news reports or consolidated financial statements of parent corporations, invite legal challenge and highlight the need for a legislative re-examination of its present day utility.

III. Termination of the LIFO Election

Section 1.472-5 of the regulations states that a LIFO election, once made, is irrevocable, and that the LIFO inventory accounting method, once used, must be used in all subsequent taxable years *unless*, (1) the Commissioner approves the taxpayer's request to change to a different method, or (2) the Commissioner determines that the taxpayer has violated the conformity-of-reports requirement for any taxable year and requires the taxpayer to change to a different method of inventory accounting. If a taxpayer violated the conformity-of-reports requirement, inadvertently or otherwise, the Commissioner has the *discretionary* power to terminate the taxpayer's LIFO election. It is important to recognize that a taxpayer obtains no vested right to discontinue LIFO for income tax purposes simply by violating the conformity requirement.

A taxpayer that decides, in some year subsequent to its first LIFO year, to request the Commissioner's permission to discontinue the LIFO inventory accounting method must make a written application on Form 3115 for such discontinuance. The Commissioner's permission is necessary to effect a change from LIFO to FIFO or to some other inventory accounting method because accounting for inventories is a "method of accounting" within the meaning of section 1.446-1(a)(1) of the regulations, and a change in a method of accounting for tax purposes requires the prior consent of the Commissioner under section 446(e) and section 1.446-1 (e)(2).[98] Form 3115 must be filed within the first 180 days of the taxable year of proposed change,[99] although a request for change filed within the first nine months may be considered as timely filed upon a showing of good cause by the taxpayer.[100] A taxpayer's request to change

97. This is the term used by the Service in Rev. Rul. 74-586 to describe the situations that have prompted exceptions to the conformity requirement.

98. Similarly, LIFO procedures such as the method of pooling, method of computing the LIFO value of a dollar-value pool, and the method of valuing inventory increments are methods of accounting and cannot be changed without the Commissioner's permission under section 446(e). Treas. Reg. § 1.472-8(g)(1) (1961); Treas. Reg. § 1.472-8(e)(1) (1961); Treas. Reg. § 1.472-2(d)(1) (ii) (1958).

99. Treas. Reg. § 1.446-1(e)(3)(i) (1961).

100. Rev. Proc. 70-27, 1970-2 Cum. Bull. 509.

from the LIFO method for federal income tax purposes to another acceptable inventory accounting method ordinarily will receive favorable consideration from the Commissioner,[101] provided that the taxpayer agrees, as a condition to the change, to take the necessary section 481 adjustments[102] into account ratably over an appropriate period of time.[103]

If a taxpayer has employed the LIFO inventory accounting method for a number of years, and then seeks permission from the Commissioner to change to FIFO, a bunching-of-income problem would occur unless provision were made for spreading the "positive adjustment" or "LIFO reserve," which would ordinarily be taken into taxable income in the year of change, over a period of time. Pursuant to sections 446 and 481, the Service has promulgated Revenue Procedures 72-24[104] and 71-17,[105] and the amendment thereto, to deal with the bunching-of-income problem. Revenue Procedure 72-24 provides that a taxpayer requesting permission to discontinue the LIFO inventory accounting method may, at the same time, request permission to allocate any positive adjustment resulting from the change over a period of up to ten years. Positive adjustment is defined as the excess of the inventory value under the new method at the beginning of the year of change over the LIFO value at the beginning of the year of change. If the taxpayer has used LIFO for two or more taxable years immediately before the year of transition, the positive adjustment will be spread over twice the number of taxable years for which LIFO has been used. If the LIFO method was used for less than two years, presumably the spreading period would be something less than twice the length of time LIFO was employed. The taxpayer's request for the ratable allocation of the positive adjustment over a period of years should be contained in a statement attached to Form 3115. Revenue Procedure 71-16 liberalizes the spreading of the positive adjustment in certain circumstances. It permits the allocation of the positive adjustment

101. *Id.* It should be noted that the Commissioner's refusal to consent to a change in a method of accounting ordinarily is within his administrative discretion (Brown v. Helvering, 291 U.S. 193, 203 (1934)), and is not to be disturbed absent a clear showing of abuse of discretion (Schram v. U.S., 118 F.2d 541, 544 (6th Cir. 1941); M. Pauline Casey, 38 T.C. 357, 386-87 (1962)). The Commissioner's authority in this regard is enhanced by the premium that is placed on *consistency* in the methods of accounting employed for tax purposes; consistency is deemed essential to a clear reflection of income. *See* Treas. Reg. § 1.446-1(a)(2) (1957); Treas. Reg. § 1.471-2(b) (1958).

102. *See* note 31 *supra*.

103. *See* Rev. Proc. 70-27, 1970-2 CUM. BULL. 509.

104. 1972-1 CUM BULL. 749, *superseding* Rev. Proc. 69-11, 1969-1 CUM. BULL. 401.

105. 1971-1 CUM. BULL. 682, *as amended* by Rev. Proc. 71-16, Amendment I, 1971-2 CUM. BULL. 527.

ratably over a period twice the number of years the LIFO inventory accounting method was used, but in no case over a period longer than *twenty* years, if LIFO has been used continuously for six or more years prior to the change and if the LIFO reserve at the beginning of the taxable year of change is greater than the average taxable income[106] for three of the preceding five years, excluding the years with the highest and lowest taxable incomes.

A taxpayer that perceives a tax planning opportunity in changing from LIFO to FIFO in order to utilize net operating loss carryovers against the LIFO reserve or positive adjustment that will be taken into income over a period of years is destined to be disapointed. The Service, as a policy matter, has refused to permit the inventory accounting method change when undertaken purely for tax reasons of this sort.[107] Each case, however, depends on its own facts. Permission for the change may be granted if the taxpayer has never realized any tax benefits during the period of the build-up of the LIFO reserve,[108] or if the taxpayer will consent to spreading the positive adjustment primarily over the fifth to tenth year after the year of change.[109]

Section 1.472-6 of the regulations establishes an order of priority for identifying the new inventory accounting method to which a LIFO taxpayer must change.[110] The section is applicable both to voluntary changes and to those changes resulting from a violation of the conformity requirement followed by the Commissioner's order to discontinue the LIFO method.

IV. Involuntary Liquidations—Consideration of a Statutory Deficiency

A liquidation of a LIFO layer occurs if the inventory quantity in a pool at the close of a particular year is reduced below the

106. Taxable income is defined in Amendment I to Rev. Proc. 71-16, 1971-2 CUM. BULL. 527, as taxable income before the net operating loss deduction but after special deductions, such as the deduction for dividends received. If the requesting corporation is a member of an affiliated group that files a consolidated return, the separate taxable income or loss of such corporation is used to compute average taxable income.

107. Levy, *Current Economic Climate Requires Reassessing the Use of LIFO in Valuing Inventory*, J. TAX., July 1974, 6, 10; Galliher, *LIFO: Technical Requirements, Method Changes and Transfers*, 74-2 BNA TAX MGT. PORT. 20 (1969).

108. *Id.*

109. Levy, *supra* note 107. Section 172(b)(1)(B) limits net operating loss carryovers to the 5 taxable years following the taxable year of loss.

110. Basically, the taxpayer must change to the inventory accounting method that he uses for items not included under the LIFO method, or if no such method exists, to the method which the taxpayer used prior to the adoption of LIFO, or if no previous method existed, to such method as the taxpayer selects and the Commissioner approves.

quantity on hand at the beginning of the year.[111] A liquidation generally results in the realization of an abnormally large amount of taxable income because the inventory cost, which is matched against present high prices, usually represents the low cost associated with the inventory items many years ago. Even if the liquidated quantity is replaced in the following year, present Code provisions do not permit any adjustment to the amount of taxable income realized in the year of liquidation. The replacement amount simply is treated as any other annual increment, and is carried in inventory at the cost the taxpayer incurred in making the replacement.

The Code has not always been without a provision affecting liquidations. As a result of conditions beyond the control of taxpayers during World War II, inventories were depleted and LIFO taxpayers were forced to liquidate low cost inventory layers that generated large amounts of income subject to an excess profits tax. Congress enacted section 22(d)(6) of the Internal Revenue Code of 1939[112] to provide relief. That section allowed LIFO taxpayers to elect adjustment of their income for the year of the liquidation by later taking the replacement items into inventory at the original cost of the liquidated items, charging the excess of replacement cost over original cost against income for the year of liquidation, and claiming a refund for that year. The liquidations to which section 22(d)(6) applied were termed "involuntary." The term involuntary liquidation was defined as the sale or other disposition of LIFO inventory items, either voluntarily or involuntarily, coupled with a failure on the part of the taxpayer to replace the items by the end of the same taxable year, due directly or exclusively:

(i) to enemy capture or control of sources of limited foreign supply;
(ii) to shipping or other transportation shortages;
(iii) to material shortages resulting from priorities or allocations;
(iv) to labor shortages; or
(v) to other prevailing war conditions beyond the control of the taxpayer.[113]

Thus, the involuntary liquidation provision of the 1939 Code was designed to provide a remedy for a LIFO taxpayer's physical inability to maintain a normal inventory quantity as distinguished from a financial or business disinclination to do so.

Section 1321 of the 1954 Code carried forward the basic remedy provided in section 22(d)(6), and expanded the definition of the

111. The terminology employed in this part assumes use of the unit method of LIFO valuation rather than the dollar-value method.

112. This provision was added by the Revenue Act of 1942 and was given retroactive effect to 1939.

113. Treas. Reg. § 1.1321-1(a) (1960).

term involuntary liquidation to include liquidation and failure to replace because of a disruption in normal trade relations between countries.[114] Furthermore, in view of the Korean Conflict, the interpretation of the terms "enemy" and "war" was broadened to apply to circumstances, occurences, and conditions, lacking a state of war, which are similar, by reason of a state of national preparedness, to those that would exist under a state of war.[115]

Section 22(d)(6) of the 1939 Code and section 1321 of the 1954 Code are largely of academic interest today, because the effectiveness of those provisions expired with years of liquidation beginning before January 1, 1955. One might ask, however, if an involuntary liquidation provision of some sort would not be justified today? Any analogy between 1975 and 1940-55 is bound to be imperfect because of the absence now of an excess profits tax and war conditions, but it is useful to compare the businessman's plight in both time periods. The businessman of the 1940-55 period was confronted with certain wartime conditions that were beyond his control and had an adverse impact on his ability to maintain normal inventory levels. The conditions beyond the businessman's control today are of a different nature than those of 1940-55, but the effect, in some instances, is the same—inability to maintain normal inventory levels. The conditions beyond the businessman's control today are in part the product of the dramatic escalation of the federal government's intervention in the private sector of the economy. Many governmental activities and programs, such as price controls, wage controls, allocation programs, safety standards, and environmental quality standards, create economic distortions and interruptions that may result in shortages causing the involuntary liquidation of certain inventory items. Other conditions beyond the businessman's control today that may result in involuntary liquidations include politically motivated embargoes imposed by foreign countries upon the shipment of certain raw materials, such as oil and basic metals, and domestic labor strikes. Thus, today many conditions obviously are beyond the control of the businessman in the same sense that the war and a state of national preparedness were beyond his control in 1940-55. It follows that an involuntary liquidation provision for LIFO taxpayers is warranted today.

Given the rapidly changing economic and political situation in the United States and abroad, the enactment of a statute that enumerates all of the conditions deserving relief under an involuntary

114. INT. REV. CODE OF 1954, § 1321(b).
115. *Id.*

liquidation provision would not be feasible. Congress could, however, establish a broadly worded provision with a nonexclusive list of conditions that constitute "conditions beyond the control of the taxpayer." The "Secretary or his delegate," i.e. the Commissioner of the Internal Revenue Service, could then be given the power to identify other conditions warranting the application of the involuntary liquidation provision as those conditions arise. The Commissioner could adopt procedures to ensure that a LIFO taxpayer could not take advantage of the relief provision if it had failed to replace liquidated LIFO layers merely for business or financial reasons, rather than for reasons of physical inability.

If an involuntary liquidation provision is not feasible, perhaps a "spreading rule" similar to that found in Revenue Procedures 72-24[116] and 71-16[117] should be considered. The liquidation of LIFO layers actually presents a bunching-of-income problem similar to that arising when a LIFO taxpayer terminates its LIFO election and changes to FIFO. A termination of the LIFO method would cause the inclusion of the LIFO reserve into income in the year of change, absent the spreading provisions. Similarly, the liquidation of LIFO layers causes the inclusion of the portion of the LIFO reserve attributable to those layers into income in the year of liquidation. If the liquidation and failure to replace the LIFO layer in the same taxable year were not due to a business or financial decision on the taxpayer's part, but to "conditions beyond its control," it seems unjust to provide no remedy for the bunching-of-taxable-income problem in this instance while providing a remedy upon termination of the LIFO election. If the taxpayer instead had changed to FIFO in the year of liquidation, the same income realized from matching low cost inventory against current high prices would have been spread over a period of up to twenty years.

Present statutory provisions clearly are inadequate because they do not deal with the involuntary liquidation problem for today's LIFO taxpayer. Given the narrowing scope of a businessman's control over his business enterprise in an age of escalating governmental presence in the private sector of the economy, a new statutory provision granting relief to LIFO taxpayers whose normal inventory levels cannot be maintained because of "conditions beyond their control" is necessary.

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116. *See* note 104 *supra* and accompanying text.

117. *See* note 105 *supra* and accompanying text.

V. General Business Considerations Relating to the LIFO Inventory Accounting Method

The business and financial benefits attainable by a switch to the LIFO inventory accounting method in an inflationary period are clear. By matching current high costs against current inflated revenues, a taxpayer's actual profitability is reflected more accurately, its taxable income is reduced, and lower federal tax liability results. Cash flow is improved and more internally generated funds are available for various corporate purposes. In a time of high interest rates and tight money, such an increase in funds is very important. Nevertheless, business and financial detriments, actual or apparent, may result from a change to LIFO. Obviously, the conformity-of-reports requirement represents a major negative factor to most corporate excecutives considering the switch to LIFO.[118] Moreover, the LIFO inventory accounting method often is perceived by these executives as a threat to certain important objectives. First, LIFO supposedly threatens the corporate objective of maximization of the price of the company's stock by reducing the net income and earnings per share reported on the company's financial statements. The myth has developed that the path to maximization of the common stock price is to maximize reported earnings per share. This view of the "path," however, is too narrowly quantitative, for it fails to acknowledge that the financial market attaches some degree of importance to the *quality* of the reported earnings per share. If high earnings and earnings per share do not reflect underlying real economic gain of a similar magnitude, the financial market will respond not with a high common stock price, but with a low price/earnings ratio—unless the market is "dumb". A "smart" market will not pay dearly for the common stock of a company that pays real taxes on illusory inventory profits. Although recent market observation might lead one to conclude that the market is indeed "dumb", because frequently the announcement that a company intends to change to LIFO has triggered immediate broad selling of the company's stock and a fall in its price,[119] an objective study concludes otherwise. A study by Shyam Sunder of the University of

118. This part assumes that the corporation is a publicly held concern. The conformity-of-reports requirement poses less of a problem for closely held companies because their shares are not traded on a national exchange or in the over-the-counter market. Nevertheless, some of the business considerations raised are equally applicable to publicly held and closely held companies.

119. For example, despite the fact that DuPont announced a 20% dividend increase along with its decision to switch to LIFO, the common stock plunged 16 ¾ points the week of the announcement. *See* Merjos, *FIFO to LIFO*, Barron's, Oct. 21, 1974, at 5, 14-15.

Chicago shows that, on the average, concerns that changed to the LIFO inventory accounting method, despite the effect of lower reported earnings, outperformed the market over a two-year span following public announcement of the change.[120] Apparently, the market is "smart" enough in the long-run to question the quality of reported earnings—do such earnings represent illusory inventory profits that must be reinvested in higher cost inventories if the company is to continue as a going concern, or do they represent real earnings that are available for continued growth and future dividends? Thus, LIFO should not be viewed as a threat to the corporate objective of maximization of the common stock price.

The second objective supposedly threatened by a switch to LIFO is the executive's personal goal of maximizing his financial reward for his business efforts, that is, receiving the highest possible bonus from the company. Executive bonuses often are tied to earnings per share as represented in the annual report. One cannot refute the contention that executive bonuses will be affected adversely by a switch to LIFO if they are dependent solely on the amount of earnings per share reported. One must question, however, whether the bonus program does not need restructuring if its effect, at least in this instance, is to cause executives to hesitate in the implementation of an accounting method that will improve the financial health of the company.

Certain legitimate business and financial considerations should, however, give pause to a company contemplating a switch to LIFO. First, a company with a very high rate of inventory turnover probably would not benefit much from LIFO because its inventory costs already are closely matched to present revenues.[121] Secondly, a company may market its products in such a way that the benefits normally associated with LIFO are inapplicable to its inventory. This is apparently the case in the rental business.[122] Thirdly, if the inventory cost increases in a particular industry have not been significant, the tax deferral benefits of LIFO may not be sufficient to justify the cost of installing a new inventory accounting method. The expense of changing inventory accounting methods is

120. This study is discussed in Wall Street J., Oct. 1, 1974 at 14, Review & Outlook col., and Merjos, *FIFO to LIFO*, Barron's Oct. 21, 1974 at 5, 15.

121. For example, Beatrice Foods reported that it was considering a change to LIFO for its nonfood divisions, but that such a change would not be necessary for the company's dairy-products division because of the speed at which inventories turn over.

122. Xerox has indicated that it will not change to LIFO because the benefits from such an inventory accounting method are not applicable to the office equipment rental business. Wall Street J., Nov. 15, 1974 at 30, col. 5.

considerable; one major corporation has reported that it expects the switch to LIFO to take between ten and twenty man-years to complete.[123] Fourthly, the expense of switching to LIFO also may be prohibitive if a company does not believe that the upward trend in inventory costs will sustain itself for more than a couple of years.[124] Finally, a company must be confident that a recession or a shortage of LIFO inventory items will not force voluntary or involuntary liquidations of LIFO layers.[125] These liquidations would match current high prices against successively older and lower inventory costs, obviating the advantages of the LIFO method.

Conceivably, a company effectively may be precluded from electing to change to the LIFO inventory accounting method, even though it would benefit greatly from the change. A company in a precarious financial position may not be able to adopt LIFO because the reduction in reported net income might result in a violation of restrictions placed on it by creditors. For example, a typical debt covenant or bond indenture declares an event of default if annual earnings fall below a certain percentage of fixed assets. Another circumstance in which a company effectively may be precluded from adopting LIFO concerns a potential takeover situation. A company that is aware of the possibility of a takeover, via tender offer or otherwise, may be reluctant to risk the initial downward pressure on stock prices that has greeted many companies recently switching to LIFO. Finally, a company with extensive overseas operations may find itself unable to elect the LIFO method for foreign inventories because many major industrialized nations do not permit its use for tax purposes.[126]

VI. CONCLUSIONS

In analyzing the various considerations that must be addressed by a corporate taxpayer contemplating the adoption of the LIFO

123. DuPont's comptroller made this estimate, quoted in Bray, *New Set of Books*, Wall Street J., Oct. 7, 1974, at 23, col. 6.

124. Sears decided to remain on FIFO rather than change to LIFO because it believed that the rate of inflation was slowing at a faster rate than expected. Wall Street J., Dec. 30, 1974, at 6, col. 6. Price volatility in inventory items also is a red flag in considering a cbange to LIFO.

125. An October survey of purchasing agents revealed that inventories of purchased materials were liquidated at the steepest one-month rate since November, 1971. This liquidation follows months of inventory accumulation, and indicates tbat the economy is some months into a recession. Wall Street J., Nov. 4, 1974, at 3, col. 1.

126. One reason that many other industrialized nations do not recognize LIFO for tax purposes is that they fear that the taxes deferred under LIFO will be deferred indefinitely. Assuming that a LIFO taxpayer remains a going concern and that inflation continues to drive the cost of inventory items higher, this is a valid concern from a tax revenue point of view.

inventory accounting method, this Note first examined the technical requirements and conditions imposed on LIFO taxpayers by section 472 of the Code. Particular attention was devoted to the conformity-of-reports requirement, and the question was raised whether the existence of this requirement is supported by a legitimate legislative purpose. An interpretive problem involving the conformity-of-reports requirement, consolidated financial statements, and foreign parent corporations also was analyzed. Next, the procedures for and conditions upon termination of a LIFO election were reviewed. Turning to a statutory deficiency, the absence of an involuntary liquidation provision was studied and an argument advanced for a new statutory provision granting LIFO taxpayers tax relief when normal inventory levels cannot be maintained because of "conditions beyond their control." Finally, general business considerations relating to a LIFO election were examined.

In a period of rapidly rising costs and high interest rates, the LIFO inventory accounting method warrants serious consideration by corporate taxpayers. Most companies cannot afford to continue paying real tax dollars for the privilege of reporting illusory inventory profits. Enthusiasm for LIFO in a period of high inflation rates, however, must be tempered by a recognition of the dangers that a recession may pose to a LIFO taxpayer—a general business contraction may cause a reduction in a taxpayer's level of inventories, resulting in a liquidation of LIFO inventory layers that distorts profitability. Moreover, a significant decline in the rate of inflation would make LIFO less attractive, and perhaps render the switch to LIFO unjustifiable in view of the potentially high cost involved in changing inventory accounting methods.

The major problem confronting taxpayers presently contemplating a change to LIFO is the conformity-of-reports requirement. The requirement is a carryover from a time when certain Treasury officials were antagonistic toward the concept of LIFO inventory accounting, and sought to deter the adoption and use of the method by imposing a restrictive reporting requirement on LIFO taxpayers. No legitimate basis exists today for this antagonism toward LIFO, yet the Internal Revenue Service is expanding the scope of the restrictive reporting requirement, apparently in a continuing effort to deter the adoption of LIFO. Although the Service's expansive interpretation of the conformity-of-reports requirement is subject to challenge in the courts, a more comprehensive solution to the problem is needed. In light of the financial and accounting communities' complete acceptance of LIFO as an inventory accounting method, Congress should re-examine the purpose and effect of the section

472(c) and (e) conformity-of-reports requirement. As it presently exists, the requirement fosters unfair differential disclosure to the detriment of the financially unsophisticated investor, with the sole justification for such an effect being an outdated deterrence purpose. The elimination of the statutory conformity-of-reports requirement represents the most sensible solution to this problem, yet it is a solution that only Congress can implement.

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