NEW DEVELOPMENTS IN TAX ASPECTS OF

Accounting

EDITED BY PETER ELDER, CPA, & T. MILTON KUPFER, CPA

An analysis of the new Proposed Regs. on use of published indices for dollar-value LIFO

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Proposed Regulations recently issued by the IRS reflect a dramatic attempt at simplifying the use of dollar-value LIFO as well as broadening the base of potential users. The authors analyze the salient features of these new proposals and focus on possible weaknesses and considerations in their adoption by taxpayers.

THE RECENTLY ISSUED Proposed Regulations under Section 472 would permit taxpayers who value their inventories under the dollar-value LIFO method to use, at their option, indices prepared by the Bureau of Labor Statistics ("BLS") in measuring the inflation in their LIFO inventories. As such, these proposals represent a dramatic departure from past practice and reflect an attempt by the Service to simplify the LIFO method so that it can be more easily implemented by taxpayers, particularly small businesses. Unfortunately, as is the case with most novel concepts, the Proposed Regulations are not fully developed and leave open a number of important issues.

Background

When the LIFO method was originally enacted by the Congress as part of the 1939 Code, the IRS took the position that taxpayers were required to measure changes in their LIFO inventories with reference to specific units and could not employ the so-called "dollar-value" method.[1] Litigation over this issue ensued and culminated in the Tax Court's decision in *Hutzler Bros. Co.*, 8 TC 14 (1947) in which the Tax Court ruled that a dollar-value method could be used under the LIFO provisions.

In *Hutzler Bros.*, the taxpayer measured the change in its price levels with reference to price indices prepared by the National Industrial Conference Board under contract to the National Retail Dry Goods Association. The Tax Court's opinion suggested that the IRS consider issuing Regulations that would adopt procedures for determining an appropriate price index for department stores. The IRS ultimately issued Regulations which permitted retail department stores to use price indices prepared by the BLS.[2] These rules were incorporated into the Regulations issued under the 1954 Code.[3]

Unfortunately, the IRS has taken a very restrictive view of the use of published indices. Except for department stores and certain specialty stores,[4] taxpayers must develop price indices from their own inventory cost data and are barred from using externally developed or published price indices. This position is reflected in *Rev. Rul.* 75-181, 1975-1 CB 150, where the Service ruled that taxpayers other than department stores may not use BLS price indices unless they can independently demonstrate the reliability, suitabilty, and accuracy of such indices as applied to their own inventories.[5] Since such proof would require taxpayers to consistently develop a price index from their own cost data for comparative purposes, the Ruling represents a virtual prohibition against the use of published price indices as a practical matter.

The development of price indices under the dollar-value LIFO method serves two important functions. First, price indices are used to deflate the taxpayer's ending inventory at current-year cost back to base-year cost in order to determine whether an increment exists in a LIFO pool. Second, the price index is used by the taxpayer to restate the value of the increment at base-year cost to its LIFO cost.

The dollar-value LIFO Regulations provide three methods for determining a price index based on the taxpayer's internal inventory cost data: (1) the double-extension method, (2) an index or sampling method, and (3) a link-chain method.[6] While each of these methods varies in certain respects, they all require the taxpayer each year to cost the items in its inventory at two points in time in order to measure the inflation in its inventory. Such a procedure is frequently complex, time-consuming and expensive to implement, and it often represents a significant deterrent to the adoption of LIFO by many smaller businesses, particularly wholesalers and retailers who do not normally maintain detailed records of inventory quantities by units. The new Proposed Regulations represent an attempt to ameliorate these administrative problems.

Analysis of Proposed Regulations

Scope of election. The Proposed Regulations provide that for taxable years beginning after the date of adoption of the Regulations, a taxpayer using the LIFO method of inventory valuation may elect to determine its LIFO price indices based on indices published by the BLS. The Proposed Regulations further indicate at 1.472-8(e)(3)(i) that if such an election is made, it must cover all goods valued under the LIFO method. Thus, a taxpayer cannot be selective and exclude particular goods or pools of goods from the election. In addition, the Proposed Regulations deny eligibility for the election to taxpayers who are eligible to value their LIFO inventories pursuant to BLS indices prepared for a specific industry. Retail department stores, therefore, cannot use the indexing rules available under these newly Proposed Regulations.

If a taxpayer elects to determine his price indices under the dollar-value LIFO inventory method on the basis of indices published by the BLS, Prop. Reg. 1.472-8 (e)(3)(iii)(C) requires such a taxpayer to use either a selected BLS producer price index ("PPI") or a consumer price index ("CPI") depending upon the nature of the taxpayer's business. Under Prop. Reg. 1.472-8(e)(3)(iii) (B), the selected index must be the most detailed index or indices for the cate-

gory or categories of goods that most closely resemble the type of goods in a taxpayer's inventory pool. Thus, a taxpayer entitled to use the indices published in the *CPI Detailed Report* and having solely televisions in a single dollar-value LIFO inventory pool may not use the broad category index "Appliances including TV and sound equipment," but rather is required to use the detailed index for "Television" set forth as a subcategory under such broad category index.

Manufacturers, processors, wholesalers, jobbers, and distributors are required to select the appropriate PPI index. Retailers may select either a CPI or PPI index, but if equally appropriate indices could be selected from either grouping, a retailer must select a CPI index if he uses the retail inventory method or a PPI index if such retailer uses a cost-based inventory method. All taxpayers, other than a retailer using the retail inventory method, must convert any selected index into a cost price index *(i.e.,* one that does not reflect a profit element to such taxpayer).[7] Retailers using the retail inventory method must convert a selected index into a retail price index so as to be consistent with the particular nature of the retail inventory method. The Proposed Regulations further provide at 1.472-8(e)(3)(iii)(C) that seasonally adjusted indices may not be selected, nor can indices for specific cities, classes of cities, or regions be used. In the case of CPI indices, a taxpayer may only select an index from those applicable to all urban consumers.

In determining the appropriate CPI or PPI index, Prop. Reg. 1.472-8(e)(3)(iii)(C) also provides rules for selecting the proper published monthly index. Taxpayers using the retail inventory method must use the selected published index for that month which is the last month of the taxpayer's taxable year. Other taxpayers are required to select the appropriate published monthly index on a basis consistent with the method used by the taxpayer to determine the total current-year cost of items making up an inventory pool *(i.e.,* earliest acquisitions cost method, latest acquisitions cost method, average acquisitions cost method, or other appropriate method). The Proposed Regulations contain an example illustrating the choice of an appropriate monthly index with respect to a non-retail method taxpayer determining the current-year cost of items in an inventory pool by reference to the latest acquisitions cost method. In such example, if the goods most recently purchased by such a taxpayer were acquired in November of the taxpayer's taxable year, the selected published index should be the November index, even though such taxpayer determined its taxable income on the basis of a calendar year.

Eighty percent rule. Once the appropriate index has been selected, a taxpayer electing the method set forth at Prop. Reg. 1.472-8(e)(3)(ii) must determine its individual inventory price index on the basis of 80% of the percent change in the selected CPI or PPI index. Thus, if the selected published price index for a specific category of goods increased 10% during an appropriate 12-month measuring period, a taxpayer determining its inventory price index on the basis of the newly Proposed Regulations would be limited to a price index reflecting an increase of only 8% for purposes of its LIFO calculations.

In situations where it is necessary to select more than one CPI or PPI price index for a particular inventory pool,[8] the 80% limitation is to be applied against the weighted average percent change for all such published indices. Such weighted average is to be computed with reference to the relative amounts of costs in the inventory pool for each specific category of goods having a separate CPI or PPI index.

Special pooling rules. Prop. Reg. 1.472-8(e)(3)(iv) not only allows a taxpayer to determine its LIFO price index by reference to certain published indices, but also provides that such a retailer, wholesaler, jobber, or distributor may establish an inventory pool for any group of goods included within one of eleven general categories of consumer goods described in the *CPI Daily Report.* The eleven categories are: food and beverages; house maintenance and repair commodities; fuels (other than gasoline); house furnishings and housekeeping supplies; apparel commodities; private transportation (including gasoline); medical care commodities; entertainment commodities; tobacco products; toilet goods and personal care appliances; and school books and supplies.

These special pooling rules are only available to taxpayers who elect to use a published index as provided by these Proposed Regulations. However, a taxpayer using the published index rules is not required to establish its pools on the basis of the above-described eleven general categories of consumer goods.

Use of published price index considered a method of accounting. The use of an inventory price index computed on the basis of the CPI or PPI published indices is treated as a method of accounting under Prop. Reg. 1.472-8(e)(3)(v). Thus, once such method is adopted, a taxpayer must secure the consent of the Commissioner in order to change from this method or to change his selection of the specific index to be used.

The Proposed Regulations expressly provide that taxpayers permitted to adopt or change to the dollar-value LIFO inventory method without first securing the consent of the Commissioner may also adopt the published price index method prescribed by the Proposed Regulations incident to such adoption or change without first securing the consent of the Commissioner. Thus, taxpayers using a non-LIFO inventory method who subsequently adopt the LIFO inventory method can adopt the published price index method prescribed by the Proposed Regulations without securing the consent of the Commissioner.

As a general rule, all other taxpayers *(i.e.,* taxpayers other than those permitted to adopt or change to the dollar-value LIFO inventory method without securing the Commissioner's prior consent) require the Commissioner's consent to adopt or change to the published price index method set forth in the Proposed Regulations. However, the Proposed Regulations contain a special transition rule whereby such taxpayers may change to the published price index method for the first or second taxable year of such taxpayers beginning after the date of adoption of the Regulations without obtaining the Commissioner's consent to such change.[9] In addition, taxpayers qualifying for this special two-year transition rule and adopting the published price index method prescribed

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by the Proposed Regulations are not required to obtain the Commissioner's consent to change their method of pooling incident to such adoption or change, provided any such taxpayer is changing to the special pooling method (*i.e.*, determined on the basis of the eleven categories under the *CPI Detailed Report*) authorized by the Proposed Regulations.

In adopting or changing to the published price index method prescribed by the Proposed Regulations, a taxpayer must provide in a Form 970 a listing of each inventory pool, the type of goods included in each pool, and the CPI or PPI category or categories selected for each inventory pool. Such Form 970 is to be attached to the taxpayer's income tax return for the taxable year of adoption or change to the published price index method prescribed by the Proposed Regulations. With respect to changes where the Commissioner's prior consent is necessary, the Form 970 must be attached to a Form 3115 that is filed in accordance with the normal change in method of accounting rules set forth in Section 446(e) and the Regulations thereunder.[10]

The Proposed Regulations provide that a taxpayer changing to a published price index method under the Proposed Regulations shall treat the year of change as a new base year for purposes of determining the LIFO value of the inventory pool for the year of change and subsequent taxable years. Under this approach, layers of increment of prior years are retained and are not recomputed; however, the LIFO cost of such inventory must be restated in terms of the new base-year cost using the current-year cost as of the beginning of the year of change as the new base-year cost of such inventory. The adoption of a new base year is strictly for computational purposes, and if, in any year subsequent to the new base year, the ending inventory valued at the new base-year cost is less than the opening inventory at new base-year cost for the year of change, such deficiency is to be treated as a liquidation of prior years' LIFO layers and such layers will be liquidated at their original LIFO cost.[11]

Theoretical problem areas

The approach taken by the Treasury in these Proposed Regulations represents an attempt to simplify the use of the LIFO method so that a greater number of taxpayers may use the method. While the attainment of such a goal is commendable, some questions remain.

It is readily apparent after even the most cursory analysis of the Proposed Regulations, that the Treasury has attempted to provide "small businesses" with a short-cut means of obtaining the benefits of the LIFO method. While the preamble to these Proposed Regulations readily acknowledges that the Treasury lacks the authority to expressly limit the scope of these provisions to small businesses, it is certainly clear that most, if not all, larger taxpayers would not choose to use published indices in pricing their LIFO inventories because of the 80% limitation set forth in Prop. Reg. 1.472-8(e)(3)(ii). Hopefully, final Regulations on this subject will take a broader view of the simplification goal and extend the simplification effort to all taxpayers, both large and small, including those who currently use the existing LIFO provisions.

A second question posed by the Proposed Regulations is whether the published indices sanctioned by them should measure inflation under the same set of assumptions that are implicit in the existing dollar-value LIFO Regulations. Does not the concept of horizontal equity require that no substantive difference in result should occur from the use of an externally-prepared published index to eliminate the inflation element in a taxpayer's inventory as compared with the result obtained under the present internal index computation method? Any divergence should result purely from the substitution of any industry-wide norm as the measure of inflation for the more precise measure of inflation which is obtained under an internal index method. Unfortunately, the measure of inflation reached under the Proposed Regulations is, in many ways, materially different from that obtained under the existing Regulations.

The Proposed Regulations would rely on the CPI and PPI as a measure of inflation in a taxpayer's LIFO inventories. These indices are prepared by BLS under a set of assumptions which are in marked contrast to those employed by taxpayers who calculate their inventory inflation rate internally. Under the BLS method, changes in the prices of items are segregated into quality and price components. BLS removes the perceived quality change component of the total price change in an effort to isolate the inflation effect. In contrast, in *Wendle Ford Sales, Inc.*, 72 TC 447 (1979), *acq.*, the Tax Court held that an automobile dealer need not treat yearly changes in models (presumably including quality changes) as a new item and need not adjust for the effect of such changes on its LIFO price index. The entire price change (including any price changes attributable to a quality change in the item) would be taken as the measure of the inflation in the price of such item.

In the case of manufacturers, where LIFO taxpayers have attempted to separate the effects of technological changes from pure price inflation (as done by BLS) by using the so-called "component-cost" method of determining a price index, the Service has challenged the validity of such concept (see *Ltr. Rul.* 7920008). Is it logical to measure inflation through a published price index which separates quality changes from true inflation while attacking other taxpayers' efforts to reach the same result while using an internally-developed price index?

The Service's current position towards the propriety of the link-chain method offers another illustration of lack of consistency in result obtained under the Proposed Regulations and that obtained under the existing Regulations. In recent years, the National Office of the Service has challenged taxpayers' use of the link-chain method in cases where there is not an extremely high rate of turnover of new items.[12] Apparently, the Service's attitude towards the link-chain method stems from the fact that under the link-chain method the current rate of inflation experienced by the mix of items contained in any particular year's inventory is, in effect, used as a measure of the inflation which is deemed to have occurred within the LIFO pool for all items in the pool since the adoption of LIFO and for any new items entering the pool for the first time. In contrast to the Service's attitude towards the link-chain approach to developing an internal LIFO price index, the Service would approve under the Proposed Regulations the use of CPI and PPI indices which are both based on the very same link-chain concept that the Service has continually challenged in recent years.

The foregoing are but two illustrations of the Service's inconsistent position in permitting the use of published price indices as a substitute for an internally-developed index as a device to measure inflation in a taxpayer's LIFO inventories. Undoubtedly, as the BLS'

procedures are further analyzed and compared with traditional index approaches under the dollar-value LIFO method as currently accepted by the Service, additional inconsistencies will come to light.

Another issue posed by the Proposed Regulations is whether the simplified approach of using published price indices should be made inherently less favorable than the traditional LIFO method by limiting the LIFO benefit to 80% of the increase in the published price index. Would it not be more straightforward if the 80% limitation were eliminated and the simplified method were made more attractive to existing LIFO taxpayers? While this obviously increases the potential revenue loss which the Treasury seeks to avoid, it does not appear to create a prospect for a revenue loss which is significantly greater than that which would result under the 80% limitation, since there is likely to be merely a greater substitution of the new published indices for internal indices currently used by LIFO taxpayers.

A related issue is the fact that the Proposed Regulations leave unresolved the question of how to apply the 80% limitation to the inflation rate for a period of more than one taxable year. In the preamble, it is suggested that, if a selected consumer or producer price index for a specific category of goods increased 10% per year for two years, the 80% limitation could be applied either to the cumulative published inflation rate for the two-year period (*i.e.*, 80% of 21%) or annual published inflation rate (*i.e.*, 80% of 10%) which would be added together with all other inflation rates for prior years. On the basis of the above example, the cumulative approach would yield an inventory price index reflecting an increase of 16.8%, whereas the annual approach would result in a total increase of only 16.64% in the inventory price index.[13]

If the 80% limitation is retained, perhaps it should be applied to the cumulative published inflation rate for the entire period for which a taxpayer's inventory has been computed under the LIFO method. Under the annual approach, the cumulative effects of inflation are not fully removed from a taxpayer's inventory, and the effective benefit derived from LIFO essentially declines over time. For this reason, there does not seem to be any reason for imposing the 80% limitation on other than the cumulative published inflation rate.

The Proposed Regulations provide that a taxpayer using the published index method for determining its LIFO price index is required to use the most detailed published index available for the category or categories of goods that most closely resemble the type of goods in the taxpayer's particular inventory pool. On the other hand, taxpayers afforded the broad-based pooling rules of the Proposed Regulations are allowed to pool their goods on the basis of the broadest categories established under such published price indices. While it seems appropriate to have the measurement of an index based on narrower classes than those used to determine the scope of appropriate pools, it appears to be undesirable to require a taxpayer to use the most detailed subcategory for purposes of determining the appropriate index. Such a rule will exacerbate the problem of determining the proper procedure for weighting multiple indices for items in a single pool. Moreover, any requirement which increases the number of indices to be used in the LIFO computation will introduce a degree of complexity to the calculations under the Proposed Regulations which is antithetical to simplification. Furthermore, in those wholesale and retail industries where physical inventories are not maintained by specific quantities and these inventories contain items of many CPI or PPI subcategories, the viability of the index approach taken in the proposed rules may be questionable. It may, therefore, be more appropriate for the Proposed Regulations to adopt a safe-harbor approach by allowing taxpayers to determine the appropriate index on the basis of major subcategories, rather than the most detailed categories set forth in the CPI or PPI reports.

The liberalized rules for pooling set forth in the Proposed Regulations represent an important concession on the part of the Service, compared to its current litigating position.[14] The broad-based pooling rules would enable a taxpayer to retain the LIFO benefit associated with a particular dollar value of inventory which may be comprised of items which vary greatly from year to year. The one problem with the Proposed Regulations' approach, however, is that such pooling rules are limited to

[1] See Reg. 19.22(d)-3.

[2] See T.D. 5605, 1948-1 CB 16.

[3] Reg. 1.472-1(k); Reg. 1.472-8(e)(1).

[4] See *Rev. Rul.* 23, 1953-1 CB 34.

[5] See also *Ltr. Rul.* 7829135.

[6] Reg. 1.472-8(e)(1). For a more detailed analysis of these three methods of pricing dollar-value LIFO inventories, see Schneider, *Federal Income Taxation of Inventories*, Chapter 14 (1980).

[7] Prop. Reg. 1.472-8(e)(3)(iii)(C). The Proposed Regulations do not indicate how a selected price index is to be converted into a cost price index. Presumably a method similar to that set forth in *Rev. Rul.* 54-49, 1954-1 CB 32, would be used. Under that Ruling, the Service acknowledged that it would be "appropriate to derive a cost index by reference to the ratio between cost percentages derived by taking the complements of the gross profit ratios for a department." Alternatively, an external conversion rate might be published on the basis of certain industry averages.

[8] Such a situation would arise in cases where the items contained in a single inventory pool could be segregated into two or more categories which each had a separate detailed PPI or CPI index.

[9] While the Proposed Regulations do not limit this special two-year transition rule to taxpayers who are already using a dollar-value LIFO inventory method but with an internally developed index, such a limitation seems intended. Otherwise, non-LIFO taxpayers who would ordinarily be required to secure the Commissioner's consent before adopting the LIFO method could nevertheless adopt LIFO during this two-year period if a contrary interpretation of this transition rule is taken. Such a windfall to these taxpayers is certainly unwarranted. Accordingly, the use of the word "adopt" in this portion of the Proposed Regulations may be improper and is certainly misleading since the special two-year rule should only apply to taxpayers who are changing to this published index method from another index method currently sanctioned by the provisions of Reg. 1.472-8(e)(1).

[10] See *Rev. Proc.* 80-51, IRB 1980-48, 23, for the procedures to be followed in applying for the Commissioner's consent to change an accounting method. See also Bush and Flannery, *New accounting-method-change rules restrict availability of ten-year adjustment spread*, 54 JTAX 138 (March, 1981).

[11] For a more detailed discussion of this "new base-year cost" concept, see Schneider, *supra* note 6 at pp. 16-3 *et. seq.* See also *Ltr. Rul.* 8008012.

[12] With regard to the Service's attitude towards the link-chain method, see Schneider, *supra* note 6, at 14-36 to 14-41.

[13] If a selected consumer or producer price index for a specific category of goods increased 10% per year for two years, the cumulative published inflation rate for the two-year period is 21% (10% of 100 in year one plus 10% of 110 in year two). If the 80% limitation were applied to the 21% cumulative figure, the resulting price index would reflect an increase of 16.8% (80% of 21%). If the 80% limitation were applied to the annual inflation rate, the resulting price index would reflect an increase of 8% for each year and a cumulative increase of 16.64% (80% of 10% in year one plus 80% of 10% in year two plus 8% of the inflation rate (at 80%) from year one).

[14] In a case recently argued before Judge Wilbur in the Tax Court, *Fox Chevrolet, Inc.*, Docket No. 11483-77, the Service maintained that an automobile dealer was required to pool by model line. Such a requirement would have placed the dealer on a LIFO method which would be closely akin to specific goods LIFO. In fact, the Service argued on brief that the court should use the results obtained under specific goods LIFO as a measure of whether the particular pooling approach used by a taxpayer under dollar-value LIFO is appropriate.

[15] See *supra* note 7.

taxpayers who also choose to value their LIFO inventory on the basis of the published price indices provided by the Proposed Regulations. Is there any justification for tying these two concepts together? If broad-based pooling is acceptable with the use of published price indices, then perhaps it should also be acceptable without the use of such indices, since the index determination is certainly independent from the pooling issue.

Practical problem areas

One practical problem that the Proposed Regulations leave unresolved is how the published price indices should be weighted in instances where it is necessary to use more than one published price index with respect to the items in any given inventory pool. It would seem that the use of relative current-year costs of the items as a basis for weighting the separate indices is preferable, since such an approach would produce the result that is closest to that obtained under the link-chain method. However, there does not appear to be any theoretical justification for preferring such method over the other alternatives, and it is unlikely that the use of that method or any of the other possible methods noted in the preamble to the Proposed Regulations would yield consistently more favorable results either to taxpayers or to the Government. Accordingly, one possibility would be to allow taxpayers to use any reasonable weighting method, provided such method is used consistently from year to year.

Another unresolved practical problem is the requirement that a taxpayer, other than a retailer using the retail inventory method, convert any selected published price index into a cost price index. There is no guidance in either the preamble or the Proposed Regulations as to how to implement such a conversion. Presumably, the approach set forth in *Rev. Rul.* 54-69, 1954-1 CB 32, should be followed, although the Proposed Regulations give no indication that such Ruling even exists or that its approach is to be used under these proposed rules.

The Proposed Regulations also require taxpayers to select the appropriate published monthly index in a manner that conforms to the taxpayer's method of valuing LIFO increments. However, the Proposed Regulations' approach is simplistic in suggesting that a taxpayer can determine the appropriate index on the basis of when particular items in the taxpayer's inventory were purchased or produced. Only in exceptional circumstances will taxpayers be able to determine the specific monthly index to use on the basis of such a cursory review of inventory transactions during the year. Most taxpayers experience varying rates of turnover among items. Perhaps, a shortcut technique, such as the use of the average rate of turnover of all items in the pool, or all items in the particular price index category, would help.

Another problem in the Proposed Regulations is the apparent requirement in Prop. Reg. 1.472-8(e)(3)(iii)(B) that a taxpayer desiring to change his selection of the consumer or producer price indices must secure the consent of the Commissioner. The proposals seemingly take the position that any such change would be a change in method of accounting. As noted previously, the Proposed Regulations require that a taxpayer must select the most detailed index or indices for the specific category or categories of goods that most closely resemble the type of goods in the inventory pool to be valued. If the nature of the goods in a particular LIFO pool changes in a subsequent year, different indices would be required. It is unclear whether such a circumstance would constitute a change in underlying facts or a change in method of accounting which would give rise to a consent requirement. Obviously, the former interpretation should be instituted in the final Regulations.

Who should use these rules?

Certain classes of taxpayers will benefit immensely from the Proposed Regulations, while other classes of taxpayers will conclude that the Proposed Regulations' approach is disadvantageous. Taxpayers who will benefit under the Proposed Regulations include: (1) those who find it impractical or cost inefficient to use the existing LIFO methodology; or (2) those whose inventories have experienced a rate of inflation below an amount equal to 80% of the appropriate published price index that would apply to such items in inventory.

For taxpayers who currently do not use the LIFO inventory method because of the complexity of the current Regulations' requirements, the ability to effectively deduct as cost of goods sold 80% of the estimated inflation in any such taxpayer's inventory represents a significant benefit.

The approach taken in the Proposed Regulations also offers a potential avenue for tax savings for taxpayers whose individual rate of inflation in inventory has lagged behind that of the general rate of inflation in the industry as a whole. Taxpayers in high technology industries where the effect of technological breakthroughs have decreased rather than increased the unit costs of production will find the Proposed Regulations most useful. To the extent that such taxpayers can nevertheless impute an inflation rate based on external indices, they will be able to receive a windfall benefit not otherwise available.

Obviously, the Proposed Regulations would not be beneficial for taxpayers who experience an inflation rate substantially in excess of the 80% limitation and have the ability and cost-justification to develop internal indices. There is, in addition, another class of taxpayers which will find the approach of the Proposed Regulations as having little value. Taxpayers who require certified financial statements may find that the approach of the Proposed Regulations cannot be used when the internal index method is required for their certified statements. This is because certain large accounting firms may take the position that using external indices as allowed by the Proposed Regulations would not comply with Generally Accepted Accounting Principles. If such taxpayers must compute LIFO indices based on internal data for financial reporting purposes, it would negate the simplication effort of the Proposed Regulations. ☆

Business asset retention does not trigger recapture

THE PRESENCE of a business purpose for not transferring all of the assets needed in the taxpayer's business to a corporation as part of a Section 351 transfer prevented recapture of the investment tax credit in *Loewen,* 76 TC No. 5.

There, the assets were used in a farming operation that was run as an unincorporated business by the taxpayers. When the taxpayers decided to incorporate, they transferred all of the assets of the business to the corporation except for land and fixed structures, such as feeding facilities, sheds and irrigation wells. Instead, the taxpayer leased these assets to the corporation on a year-to-year basis. The apparent reason for this was the fact that state law (Kansas) placed restrictions on corporate owner-

ship of land that the taxpayers wished to avoid.

The IRS contended that the investment tax credit taken on the transferred assets should be recaptured due to Reg. 1.47-3(f)(1) which provides for recapture if, *inter alia,* substantially all of the assets needed to operate a trade or business are not transferred.

The taxpayers, however, contended that since they had transferred the use of the retained assets, they met the requirements for avoiding recapture.

The court agreed. It noted that the requirement that substantially all of the properties of a business be acquired under other Code sections was met when the transferee had the use of the retained property under a lease. See, *e.g., R. & J. Furniture Co.,* 20 TC 857 (1953), *rev'd on other grounds,* 221 F.2d 795 (CA-6, 1955) and *James Armour, Inc.,* 43 TC 295 (1964).

The court noted that for this purpose the term of the lease did not matter since even a long-term lease could have been terminated at will.

Significantly, the court pointed out that this was not a situation where it was possible to avoid recapture of the credit. If the transferred property is disposed of by the corporation, the taxpayers will have to pay the recaptured credit under Reg. 1.47-3(f)(5). The same Regulation imposes liability for investment credit recapture on the taxpayers if they dispose of a substantial interest in the business.

However, the court was careful to limit its decision to the special facts of this case. In a footnote, it stated that it was not expressing an opinion as to its possible conclusion had the special circumstances for not transferring the land been absent.

Thus, in order to avoid recapture when substantially all of the assets needed for a business are not transferred, the reason for the retention should be beyond the control of the taxpayer. ☆

Unclaimed insurance doesn't bar theft loss deduction

THE TAX COURT has allowed a theft loss deduction even though the taxpayers voluntarily failed to file an insurance claim for the loss, in *Hills,* 76 TC No. 42. The court, over four dissents, said that the loss was "not compensated for by insurance or otherwise" within the meaning of Section 165(a).

The Hills had filed claims for losses from three earlier burglaries at the same house, and they feared that a fourth claim would result in cancellation of their homeowner's coverage. Reacquiring fire insurance in a rural area lacking fire-fighting facilities might, they believed, be difficult.

The court refused to read "not compensated for by insurance" in Section 165(a) as identical to "not covered by insurance" saying the loss resulted from the theft, not from a voluntary failure to file an insurance claim. A taxpayer who fails to pursue a right of insurance recovery nevertheless sustains an economic loss, the court said, and a deduction should be allowed.

A taxpayer also may choose to forego insurance coverage by not maintaining insurance coverage at all. Yet clearly such a taxpayer's substantiated theft loss is deductible. The court said that to deny the deduction to the Hills would be to give an unjustifiable advantage to taxpayers who carry no insurance. Taxpayers already have considerable incentive for self-insuring or under-insuring, since the rate of reimbursement from the Government (via a loss deduction) can approach 70%, for those in the higher brackets.

The court also found support for its position in Reg. 1.165-1(d)(2)(i), which concerns the year in which the loss deduction may be claimed. In that situation, abandonment of a claim fixes the year for a deduction. The court said that the Regulation seems apropos to this situation, where reimbursement would be in the form of an insurance recovery.

The dissenters, on the other hand, said the operative fact resulting in the loss was not a theft, or any other unexpected event beyond the taxpayers' volition, but their voluntary act in refusing to accept reimbursement. The four judges characterized the majority's attempt to draw a distinction between "compensated" and "covered" by insurance as an unwarranted judicial amendment of Section 165(c)(3).

Years earlier the Sixth Circuit, in *Kentucky Utilities Co.,* 394 F.2d 631 (CA-6, 1968), *aff'g* 250 F. Supp. 265 (DC Ky., 1965), refused to allow a deduction to a taxpayer covered by insurance who claimed a tax loss without attempting to recover on the policy. That court's treatment of the issue was rather cursory, but the Tax Court followed it in *Miller,* TCM 1980-550, under its *Golsen* rule. Here however, in a case appealable to the Fifth Circuit, the Tax Court was free to use its own judgment and it reached the contrary conclusion. ☆

Shifting insurance risk to sub bars deduction

A TAXPAYER'S attempt to deduct insurance premiums failed, where the insurer reinsured the risk with the taxpayer's subsidiary, in *Carnation Company,* CA-9, 3/6/81. Taken together, the court said, the two agreements were void of insurance risk, and the taxpayer and the insurance company therefore never entered into an insurance agreement.

The agreements attempted ultimately to shift 90% of the risk to the subsidiary and 10% of the risk to the insurance company. But the insurance company had refused to enter into a reinsurance agreement with the subsidiary unless the taxpayer agreed to provide capitalization for the subsidiary, on demand, of $3 million. This capitalization agreement bound the taxpayer to an investment risk that was directly tied to the loss payment fortunes of the subsidiary, which in turn were wholly dependent on the amount of property loss suffered by the subsidiary. This neutralized the risk customarily inherent in the insurance policy.

Applying *Le Gierse,* 312 U.S. 531 (1941), the court pointed out that insurance must involve risk-shifting and risk distribution, and related documents must be considered together.

The court rejected the taxpayer's contention that the Tax Court's holding and *Rev. Rul.* 77-316, 1977-2 CB 53 (which sets forth a practically identical fact situation), conflict with recognition of the separate status of the corporations. The separate corporate status of the subsidiary and the taxpayer has no bearing, the court said, on whether the taxpayer shifted the risk to the insurance company or whether the insurance company shifted the risk to the subsidiary.

Because 10% of the risk was still held by the insurance company, the taxpayer was allowed to deduct that part of the payment to the insurance company. Since the subsidiary was a controlled foreign corporation, the change in the characterization of the amount it received, making it a contribution to capital rather than an insurance premium, required an adjustment in the taxpayer's income and foreign tax credit. ☆

New accounting decisions this month

Acquiescences and nonacquiescences.

The IRS has acquiesced in the following decisions: *Schoellkopf Products, Inc.*, 65 TC 640 (1975) (IRB 1981-9); *Buono*, 74 TC 187 (1980) (IRB 1981-5); *Magnon*, 73 TC 980 (1980) (IRB 1981-13) and *Tipps*, 74 TC 458 (1980) (IRB 1981-13).

The IRS has nonacquiesced in *Schoellkopf Products, Inc.*, 65 TC 640 (1975) (IRB 1981-9) (on change in method of depreciation).

DEDUCTIBILITY

Business expenses deductible by corporation only. (TCM)

Taxpayer deducted expenses incurred by his wholly-owned corporation engaged in the development and sale of FHA housing. No stock of the corporation was ever issued, directors' meetings were never held, and taxpayer was required to co-sign all notes of the corporation. He claimed that the corporate form should be disregarded since its sole purpose was to comply with FHA regulations and since formalities had been ignored.

Held: For the Commissioner. The corporation was formed for business reasons and engaged in substantial business activity. Expenses incurred in the business therefore, were deductible solely by the corporation. *Burgess*, TCM 1981-131.

★★Rev. Proc. which disallowed interest deduction withdrawn. (IR)

The Service has withdrawn *Rev. Proc.* 80-55, IRB 1980-50, 20, which disallowed deduction of interest paid by commercial banks on deposits of state and local funds secured by pledges of tax-exempt obligations. Section 265(2) will continue to apply where there is a direct connection between the borrowing and the tax-exempt obligations and where interest is paid on deposits incurred outside the ordinary course of the banking business. IR-81-42.

Straw corporation used to avoid usury law did not take deductions away from real estate partnership. (DC)

Taxpayer belonged to a real estate partnership that twice conveyed realty to X Co. for the purpose of securing a loan at a higher interest rate than local usury law permitted for partnerships. After the loans were obtained, X Co. returned the land to the partnership. The Service attributed interest and other deductions away from the partnership to the corporation.

Held: For taxpayer. The corporation did no active business, and the partnership paid off the loans. *Schlosberg*, DC Va., 3/5/81.

MITIGATION

Trusts failed to establish that mitigation provisions were applicable to time-barred refund suit. (DC)

Taxpayer-trusts were created by decedent approximately six months before death, on 6/16/71. The next day decedent transferred stock to the trusts. In August 1972, taxpayer-trusts sold the stock and used donor's basis plus applicable gift tax. On 11/19/76 the Tax Court entered a stipulated decision based on a settlement agreement which held that one half of the value of the trusts securities were includable in decedent's gross estate. Also a collateral agreement was entered into which provided that each share of stock would have a basis equal to 50% of fair market value pursuant to Section 1014 and 50% of the value determined under Section 1015. On 6/7/72, taxpayer-trusts filed a refund claim which sought to use the stock basis determined in the collateral agreement. The Commissioner held that the claims were barred by the statute of limitations while taxpayer argued that Sections 1311 to 1314 were applicable and therefore the limitations statute was mitigated.

Held: For the Government. The mitigation provisions apply to income determinations only and the stipulated decision of the Tax Court was a determination of estate taxes. Furthermore, the collateral agreement does not qualify as a determination under Section 1313. *Provident National Bank*, DC Pa., 1/29/81.

CAPITAL EXPENDITURES

Interest expense deduction denied for payments made under private annuity. (TC)

Taxpayer purchased stock from her father in exchange for her promise to pay him and his wife an annuity of $15,000 per year during their lives. The taxpayer claimed an interest expense deduction computed on the basis of the amount of the payment that was required to be treated by the recipient as ordinary income.

Held: For the Commissioner. The promise to pay annuity in exchange for property does not create an indebtedness within the meaning of Section 163. Rather each annuity payment constitutes part of the purchase price of the property, a capital expenditure, and no part is deductible as interest on an indebtedness. *Bell*, 76 TC No. 21.

Allocation of purchase price to covenant not to compete determined. (TC)

Taxpayer-purchaser agreed to purchase the stock of T from taxpayer-seller, for $800,000. A covenant not to compete was added to the contract with no additional money paid in exchange for the covenant. The taxpayer-purchaser deducted $12,500 for the year ending 5/31/72 and $50,000 for the year ending 5/31/73 as amortization of the covenant not to compete, and the Commissioner disallowed the deductions.

Held: For the Commissioner. The burden is on the purchaser to prove that any asserted allocation conforms to economic reality and the parties' intent at the time the contract was entered into. The purchaser has failed to sustain its burden. The fact that the agreement did not contain any specific allocation is good evidence that none was intended, and furthermore the parties agreed to the purchase price of the stock prior to the mention of any covenant *Major*, 76 TC No. 22.

ACCOUNTING METHODS

Balance of prior loss reserve includable as Section 481 adjustment. (Rev. Rul.)

Taxpayer, a freight transporter, deducted additions to a reserve for uninsured cargo losses and insurance expenses. The Service ruled that, since taxpayer used the accrual method, it could only take deductions based on actual, not estimated, expenditures for the years under examination. This constituted a change of accounting method. Taxpayer was required to include the beginning reserve balance for the year of change as an adjustment under Section 481. The Service declined to withdraw its nonacquiescence to *Schuster's Express, Inc.*, CA-2, 6/10/77. *Rev. Rul.* 81-93, IRB 1981-12.