Last-in, first-out inventories, automobile dealers. A franchised automobile dealer that elected the LIFO inventory method violates the LIFO conformity requirement of Code section 472 by providing to the credit subsidiary of its franchisor an income statement that fails to reflect the LIFO inventory method in the computation of net income.

Rev. Rul. 97–42

ISSUE

Whether a franchised automobile dealer that elected the last-in, first-out (LIFO) inventory method for federal income tax purposes violates the LIFO conformity requirement of § 472(c) or (e)(2) of the Internal Revenue Code by providing certain monthly income statements to the credit subsidiary of its franchisor (an automobile manufacturer).

FACTS

A, *B*, and *C* are franchised automobile dealers engaged in the purchase, sale, and service of automobiles manufactured by *X*. *A*, *B*, and C regularly finance their purchases of new automobiles through *Y*, a subsidiary of *X*.

For federal income tax purposes, *A*, *B*, and *C* use the accrual method of accounting and a calendar taxable year. Each dealer elected to use the LIFO inventory method to account for its automobile inventory beginning with its taxable year ended December 31, 1970.

Pursuant to the terms of the franchise agreements with *X* and the financing agreements with *Y*, *X* and *Y* must receive balance sheets and income statements from *A*, *B*, and *C* within 10 days after the end of each month. The income statements are prepared in a format required by *X* or on pre-printed forms supplied by *X* and present the dealers' operating results for both the month and the calendar year-to-date.

During 1996, *A*, *B*, and *C*'s monthly financial statements were received by *X* and *Y*. In the January through November income statements, *A*, *B*, and *C* calculated their Cost of Goods Sold using the specific identification inventory method instead of the LIFO inventory method. Under the specific identification method, the cost of the dealers' beginning and ending inventories is determined by reference to *X*'s actual invoice price for the automobiles on hand.

Situation 1 — LIFO Reflected in Gross Profit. *A* provided the following income statement to *X* and *Y* for the month of December:

INCOME STATEMENT
December 1996

	Month	*Year-to-Date*
Sales of Automobiles	$ 300x	$ 3,600x
Cost of Goods Sold	(255x)	(2,400x)
Gross Profit	$ 45x	$ 1,200x
Variable Expenses	(12x)	(144x)
Fixed Expenses	(18x)	(216x)
Net Income	$ 15x	$ 840x

A calculated its Cost of Goods Sold for the year and the month as follows. First, *A* used the specific identification inventory method to calculate a tentative cost of goods sold for the year ($2,340x) and the month ($195x). Then, *A* made an adjustment of $60x (representing a $60x increase in *A*'s LIFO reserve for 1996) to the tentative cost of goods sold to arrive at Cost of Goods Sold for the year ($2,400x) and the month ($255x), respectively.

Situation 2 — LIFO Reflected in Net Income. *B* provided the following income statement to *X* and *Y* for the month of December:

B used the specific identification inventory method to calculate its Cost of Goods Sold and Gross Profit for both the year and month without adjusting for a $60x increase in *B*'s LIFO reserve for 1996. On

INCOME STATEMENT
December 1996

	Month	Year-to-Date
Sales of Automobiles	$ 300x	$ 3,600x
Cost of Goods Sold	(195x)	(2,340x)
Gross Profit	$ 105x	$ 1,260x
Variable Expenses	(12x)	(144x)
Fixed Expenses	(18x)	(216x)
Operating Profit	$ 75x	$ 900x
Other Income & Expenses	(60x)	(60x)
Net Income	$ 15x	$ 840x

the Other Income and Expenses line, B reduced Operating Profit in the Year-to-Date column by $60x (representing the $60x increase in *B*'s LIFO reserve for 1996) and in the Month column by $60x to arrive at *B*'s Net Income for the year ($840x) and the month ($15x), respectively.

Situation 3 — LIFO Not Reflected on the Income Statement. *C* provided the following income statement to *X* and *Y* for the month of December:

INCOME STATEMENT
December 1996

	Month	Year-to-Date
Sales of Automobiles	$ 300x	$ 3,600x
Cost of Goods Sold	(195x)	(2,340x)
Gross Profit	$ 105x	$ 1,260x
Variable Expenses	(12x)	(144x)
Fixed Expenses	(18x)	(216x)
Operating Profit	$ 75x	$ 900x
Other Income & Expenses	–0–	–0–
Net Income	$ 75x	$ 900x

C used the specific identification inventory method to calculate its Cost of Goods Sold, Gross Profit, and Net Income for the year and month without adjusting for a $60x increase in *C*'s LIFO reserve for 1996. Thus, the December 1996 income statement does not reflect *C*'s use of the LIFO inventory method.

LAW AND ANALYSIS

Section 472(a) authorizes a taxpayer to use the LIFO inventory method in accordance with regulations prescribed by the Secretary.

Section 472(c) provides that a taxpayer may not elect to use the LIFO inventory method unless it establishes to the satisfaction of the Commissioner that it used no method other than the LIFO method in inventorying goods to ascertain the income, profit, or loss of the first taxable year for which the LIFO method is to be used, for the purpose of a report or statement covering that taxable year to shareholders, partners, other proprietors, or beneficiaries, or for credit purposes.

Section 472(e) provides that a taxpayer electing to use the LIFO inventory method must continue to use the LIFO inventory method unless the taxpayer: (1) obtains the consent of the Commissioner to change to a different method; or (2) is required by the Commissioner to change to a different method because the taxpayer has used some inventory method other than LIFO to ascertain the income, profit, or loss of any subsequent taxable year in a report or statement covering that taxable year (a) to shareholders, partners, other proprietors, or beneficiaries, or (b) for credit purposes.

Section 1.472–2(e)(1) of the Income Tax Regulations provides that a taxpayer electing to use the LIFO inventory method must establish to the satisfaction of the Commissioner that the taxpayer, in ascertaining the income, profit, or loss of the taxable year for which the LIFO inventory method is first used, or for any subsequent taxable year, for credit purposes or for purposes of reports to shareholders, partners, other proprietors, or beneficiaries, has not used any inventory method other than LIFO.

Section 1.472–2(e)(1) generally provides exceptions to the LIFO conformity requirement. Under § 1.472–2(e)(1)(iv), a taxpayer is not at variance with the LIFO conformity requirement if it uses an inventory method other than LIFO in a report or statement covering a period of less than an entire taxable year.

However, § 1.472–2(e)(6) provides that a series of credit statements or financial reports is considered a single statement or report covering an entire taxable year if the statements or reports in the series are prepared using a single inventory method and can be combined to disclose the income, profit, or loss for the entire taxable year. For this purpose a taxable year includes any one-year period that both begins and ends in a taxable year for which the taxpayer used the LIFO inventory method. § 1.472–2(e)(2). Thus, income statements prepared on the basis of a calendar year may be subject to the LIFO conformity requirement even though the taxpayer employs a fiscal year for federal income tax purposes.

Under § 1.472–2(e)(2)(vi), a taxpayer is not at variance with the LIFO conformity requirement if it uses costing methods or accounting methods to ascertain income, profit, or loss in financial statements for credit purposes if such methods are not inconsistent with the LIFO inventory method. The use of cost estimates is an example of a costing method that is not inconsistent with the LIFO inventory method. § 1.472–2(e)(8)(ix).

The financial statements received by *Y* are "for credit purposes" within the meaning of §§ 472(c) and (e)(2) because they were issued to a creditor with whom *A*, *B*, and *C* maintain continuing credit relationships. Thus, under §§ 472(c), 472(e)(2), and § 1.472–2(e)(1), *A*, *B*, and *C* violated the LIFO conformity requirement if they used a method other than LIFO in inventorying goods to ascertain the income, profit, or loss for the taxable year covered by the financial statements provided to *Y*.

In *Situations 1 and 2*, *A* and *B* did not violate the LIFO conformity requirement in their statements to *Y* because they used the LIFO method in inventorying goods to ascertain their net income in the

Month and Year-to-Date columns of the December income statement. The results in *Situations 1 and 2* would be the same if the $60x LIFO adjustment reflected in the Month and Year-to-Date columns of the December 1996 income statement had been a reasonable estimate of the change in LIFO reserve for the year. Further, if *A* or *B* had employed a fiscal taxable year, the results in Situations 1 and 2 would be the same if *A* or *B* made either an adjustment for the change in the LIFO reserve that occurred during the calendar year in the Month and Year-to-Date column of the December income statement or an adjustment for the change in the LIFO reserve that occurred during the fiscal year in the Month and Year-to-Date columns of the income statements provided for the last month of the fiscal year.

In *Situation 3, C* violated the LIFO conformity requirement in its statements to *Y* because *C* used a method other than LIFO in inventorying goods to ascertain its net income in the Year-to-Date column of the December income statement. Further, *C* violated the LIFO conformity requirement because the January through November income statements can be combined with the December income statement to ascertain *C*'s net income for the year using a single inventory method other than LIFO. The result in *Situation 3* would be the same even if *C*'s December 31, 1996 Balance Sheet had reflected a 1996 adjustment to *C*'s LIFO reserve.

HOLDING

A franchised automobile dealer that elected the LIFO inventory method for federal income tax purposes violates the LIFO conformity requirement of § 472(c) or (e)(2) by providing to the credit subsidiary of its franchisor (an automobile manufacturer) an income statement for the taxable year that fails to reflect the LIFO inventory method in the computation of net income.

DRAFTING INFORMATION

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