March 29, 2002

Internal Revenue Service
Motor Vehicle Technical Advisor
Automotive Alert!

Safe Harbor Revenue Procedure Allows Dealers' Continued Use of Replacement Cost

Introduction

On March 11, 2002, the IRS released the long anticipated resolution to the replacement cost LIFO issue. Revenue Procedure 2002-17 describes a safe harbor method of accounting for vehicle parts inventory that allows automobile dealers to approximate the cost of their parts inventory using the replacement cost of the parts. The revenue procedure also includes procedures for dealers to receive automatic consent to change to the replacement cost method.

Discussion

Automobile dealerships normally carry a significant inventory of parts for use in the dealership service department and for retail sales. Dealers are generally required by their franchiser (manufacturer/distributor) to value their parts inventory at replacement cost rather than at the historical purchase cost of each part. To assist dealers in valuing parts at replacement cost, the manufacturer or other parts supplier provides the dealer with periodic price updates. Once the dealership process the price updates, the historical purchase price of the parts is not maintained by the computer system.

In 1999, the Tax Court ruled in Mountain State Ford V. Commissioner, 112 T.C. 58 (1999) that a heavy truck dealership that used the LIFO method of accounting for its parts inventory was not entitled to determine the current-year cost of those parts using replacement cost. In reaching its decision, the Court determined that the use of replacement cost was not allowable because it does not determine current-year cost on the basis of actual cost as required by IRC §472.

Shortly after the Mountain State ruling, the National Auto Dealers Association (NADA) provided the IRS with several recommendations for resolving the issue. The NADA also provided a discussion of the potential impediments to an auto dealer's compliance with the historical cost requirements of LIFO.

According to the industry, the use of replacement cost is long-standing industry practice and is required by the dealer's franchiser. Industry representatives also stated that changing to actual cost would impose a substantial burden on automobile dealerships. After careful consideration of the auto dealership industry's unique circumstances and data provided by the industry that indicates that replacement approximates cost, the Service developed the Replacement Cost Method for valuing parts inventories of auto dealerships.

Overview of the Method

The method described in Revenue Procedure 2002-17 applies to a specific group of taxpayers. To qualify, a taxpayer must be engaged in the trade or business of selling vehicle parts at retail and must be authorized by one or more manufacturers or distributors to sell new automobiles or light, medium or heavy trucks. The replacement cost method may be used in conjunction with either the First-in, First-out (FIFO) inventory method or the Last-in, First-out (LIFO) method.

The method authorizes a qualifying taxpayer to "determine the cost of vehicle parts in inventory by reference to the replacement cost of the part[s]…". Replacement cost is defined as the amount provided in a "standard price list" on the date of the dealer's inventory. The price list must be one that is widely recognized, used for business purposes in the industry, and used by the dealer to purchase vehicle parts. In addition, a dealership that elects the Replacement Cost Method must satisfy the conformity requirement and use the method for financial reports and tax.

Changing to the Method

Qualifying dealers that are using the replacement cost method described in Revenue Procedure 2002-17 on March 12, may continue to use the safe harbor method without filing a Form 3115, Application for Change in Method of Accounting. The revenue procedure also provides audit protection for years ending before December 31 2001. If the dealer is under examination and the issue is currently under consideration, the revenue procedure mandates that the issue will not be pursued.

Dealers that are not using the replacement cost method on March 12, 2002 must follow the automatic change provisions of Revenue Procedure 2002-9 with certain modifications. Modifications include making the change on a cut-off basis, i.e. without a §481(a) adjustment. Dealers that comply with the election requirements will receive audit protection, with respect to the method of determining the cost of parts, for any tax year prior to the year of change.

In addition to normal recordkeeping requirements supporting all aspects of its inventory valuation, dealers electing the Replacement Cost Method must maintain copies of the price lists used in the applying the method.

Conclusion

The Replacement Cost Method provided in Revenue Procedure 2002-17 provides clear guidance for franchised automobile dealers and resolves a long standing issue in the industry without imposing significant additional burden on the dealerships.

Finally, although the safe harbor method in the revenue procedure is available only to qualifying automobile dealerships, the Service is willing to consider safe harbor requests from other industries with similar facts.

For further information on the Replacement Cost method, refer to Rev. Proc. 2002-17 or contact the Motor Vehicle Technical Advisor Program at 616-235-1725 or by e-mail at Terri.S.Harris@irs.gov