APPEALS

INDUSTRY SPECIALIZATION PROGRAM

SETTLEMENT GUIDELINES

INDUSTRY: All Industries

ISSUE: Dollar-Value LIFO
Segments of Inventory

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SETTLEMENT GUIDELINES

DOLLAR-VALUE LIFO SEGMENTS OF INVENTORY

STATEMENT OF ISSUE

Whether a LIFO index developed by double-extending one segment of the inventory can be applied to another segment of the inventory that was not double-extended.

BACKGROUND

This coordinated issue of the Examination Industry Specialization Program (ISP), as framed above, was approved by the Office of the Assistant Commissioner Examination in June of 1995. This issue was developed by the National Examination Inventory Issue Specialist. The issue is coordinated generically for all industries.

Generally, this coordinated ISP issue may be present with taxpayers who use the index method or the link-chain method where a sampling technique is used to compute the current year index. A pure double-extension method by its very nature does not employ sampling techniques, since all of the inventory must be considered in the detailed computations and therefore the coordinated issue should not be present. Similarly, the issue will not be present for link-chain method taxpayers who do not use a sampling technique because they double-extend 100 percent of all inventory items.

This coordinated ISP issue stands for the proposition that the LIFO index cannot be applied to a segment of inventory that was not included in the taxpayer's universe of inventory items sampled, unless the taxpayer establishes that the index is appropriate for the unsampled inventory.

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EXAMINATION DIVISION POSITION

The Service's self instructional LIFO training text, LIFO Method of Inventory Valuation, Training 3127-01 (Rev. 12-87) at page 5-9 paragraph 1 states: "Treas. Reg. Sec. 1.472-8(e)(1) describes two sampling method approaches that can be used in connection with the index method. The index may be computed by double-extending a representative portion of the inventory in a pool or by use of other sound and consistent statistical methods." The LIFO training text goes on to state in the next paragraph the following: "There are no published rulings as to what sample size constitutes a 'representative portion of the inventory'."

According to the Exam ISP paper on this issue, statistical methods require that every item has a known, non-zero chance of selection. If some portion of the population has no chance of selection, defensible statistical projections cannot be made to that segment or portion of the inventory pool.

During examinations, it has been discovered that some taxpayers may attempt to circumvent or bypass the requirements of the regulations. This is accomplished in particular ways, for example: double-extending only the large dollar items in the inventory and applying the derived index to the entire inventory; using samples that are not statistically valid and applying the derived index to the entire population; not including new items in the sample for the computation of their index and applying the index to the entire inventory which includes new items; and determining an index for one segment of the inventory, for example a warehouse and applying that index to other segments of the inventory, such as its stores.

Exam's position is the LIFO index cannot be applied to a segment of inventory which was not represented when the index was computed unless the taxpayer can demonstrate that the index is representative of the price movements of such segment, generally by reconstruction. The deliberate exclusion of whole

segments of the inventory from a sample does not usually satisfy the requirements for a representative or statistical sample. The Service has held adverse to taxpayers in several technical advice memorandums on designed omissions of segments of inventory. Further, some taxpayers have used a sample from one pool to develop an index for another pool(s) or another related taxpayer in a similar business, such as an affiliate entity. This so-called, "borrowing" of a price index is not an acceptable price index methodology.

A more difficult sampling issue surfaces when items or sub-assemblies of inventory go "down stream" in the manufacturing process to form further complex sub-assemblies or finished goods. Generally, taxpayers can compute an accurate price index for the individual items in bulk, but it is extremely difficult to "explode" a complex sub-assembly or finished product into dozens, hundreds or thousands of individual items of inventory. Taxpayers quite often reassign the items down stream in the manufacturing process (sub-assemblies or finished goods) back to the transferor divisions and develop a price index for that segment of downstream inventory. It may be computed properly based on mix of the inventory and proper mathematical formulas or it may be based on an estimate that is subject to scrutiny and further analysis.

The propriety of such methods for downstream inventory turns on the demonstration by the taxpayer that the nonsampled items were not appreciably different from the segments that were sampled. It can be expected that Exam will pursue this nonsampled downstream segment of inventory more routinely, since this issue has been approved by the National Office as a coordinated ISP issue. This is an untested position, which will be discussed below.

If the taxpayer is unable to substantiate the LIFO index for a segment of its inventory pool, then the district director has the authority to hold that the base-year cost of that segment of inventory is equal to the current-year cost (1.0 index). The district director could assume no inflation for that segment of

inventory until the taxpayer meets its required responsibility or reconstructs an alternative index that is acceptable.

In essence, this will require the taxpayer to compute a separate index to substantiate the taxpayer's claimed index for that segment of inventory within the pool that was not sampled. If the taxpayer's method of accounting is changed, I.R.C. Sec. 481(a) requires an adjustment to prevent duplications or omissions of amounts. If the taxpayer does not furnish the required substantiation for this segment of the inventory the examiner may reconstruct the index based on the best available evidence or allow no inflation on that segment of inventory, in accordance with the LIFO regulation explained below. This later approach of allowing no inflation will cause the unsampled inventory segment's index to be weighed at 1.0 in the overall computation of the pool(s).

TAXPAYER'S POSITION

Taxpayers and practitioners have criticized the Service for failure to issue any definitive official guidelines with respect to appropriate techniques for sampling under the dollar-value LIFO method. This lack of guidance or "safe harbor" frustrates taxpayers and the practitioner community because the Service is taking a more exacting position than what taxpayers and practitioners believe the regulations require. This is particularly so on downstream complex sub-assemblies or finished goods where it is impractical to "explode" the good(s) into its many items of inventory.

Many taxpayers or their tax advisers believe that judgmental sampling (also called conventional or representative sampling) will be acceptable if it is established on a minimum of 50 percent of the items in inventory and it equates to 70 percent of the dollars. This is an unscientific process and is not based on a mathematical formula or method. There appears to be no authoritative publications on judgmental sampling, but it is generally acceptable for GAAP based on the facts and circumstances of each use. Practitioners point out that

judgmental sampling has been accepted by the Service in older letter ruling requests, with the qualification that its propriety is subject the satisfaction of the district director. Several respected tax accounting authors refer to the "50 percent of the items and 70 percent of the dollars", in their writings, but the exact source of this so-called "rule of thumb" cannot be established by these authors or anyone in the Service or other government agencies.

Statistical sampling is the Service's preferred method and generally accepted, assuming there is no systematic exclusion of items of inventory.

The tax practitioner community (ABA, AICPA and TEI) have complained that they worked with the Service for several years on a statistical sampling revenue procedure specifically for LIFO and the project was abandoned by the Service in 1993 without publication or other official guidance. Taxpayers and practitioners have relied on the only guidance the Service has given to date on this statistical sampling problem in another area of the tax law relative to the installment method for revolving credit sales which is the subject matter of Rev. Proc. 64-4, 1964-1 CB 644 (the use of the installment method for revolving credit plans was repealed in the Tax Reform Act of 1986).

Taxpayers and practitioners feel that this segments of inventory ISP issue would not be found to constitute a method of accounting, and therefore no I.R.C. Sec 481(a) adjustment is required. They feel this is a substantiation issue and each year stands on its own. This argument is particularly heightened where the taxpayer can substantiate previous LIFO examinations and or adjustments proposed to their indexes because of other LIFO issues and a sampling concern was never raised.

It is further argued by the tax community that if the Service would concentrate on what is an acceptable method prospectively the issue would be resolved more readily. Taxpayers believe the Service has the authority under I.R.C. Sec. 7805(b) to grant relief retroactively. Further, taxpayers believe that since there has been no

official guidance, and the practitioner community was enticed to believe for several years that a pronouncement was imminent, the Service should allow I.R.C. Sec. 7805(b) relief.

LEGAL DISCUSSION AND ANALYSIS

Treasury Regulation Section (Treas. Reg. Sec.) 1.472-8(e)(1) of the dollar-value LIFO regulations describe three methods for developing indexes from the taxpayer's actual cost records or experience: (1) double-extension method; (2) index method; and (3) link-chain method. These three methods apply different techniques to accomplish the following two objectives: (1) determine the base-year costs of current-year inventories; and (2) compute an index to price increments of base-year costs occurring during the current year. The use of the phrase "index method" can be misunderstood because each of the three LIFO pricing methods, i.e., double-extension, index and link-chain are methods of determining an overall price index for the pool(s).

The double-extension method requires that each item of inventory (100 percent) is priced at its base-year unit cost as well as its current-year unit cost. The sum of all extended base year costs is divided into the sum of all extended current-year costs to obtain a dollar-value index. Generally, the subject ISP issue will not be present with a pure double-extension method taxpayer since the taxpayer is required to double-extend 100 percent of the items in its inventory pool(s).

The index method is an allowable method where indexes are developed by double-extending a representative portion of the inventory in a LIFO pool(s) or by using other sound and consistent statistical methods. In contrast to the double-extension method, the index method divides the sample index into total current-year costs to obtain total base-year costs in the current inventory. This projection technique is necessary because the index method does not double-extend the entire current-year inventory. This index is also used

to value increments (increases) in inventory, which is another step in the overall LIFO computation.

The use of the index method is allowed where the double-extension method is impractical because of technological changes, extensive variety of items, or extreme fluctuations in the variety of items in a dollar-value pool(s). Technically, a taxpayer not double extending 100 percent of its inventory is using an index method. The Service is critical of a taxpayer claiming on their Form 970 LIFO election to be on a certain method, e.g., 100 percent double extension, but in practice are doing something different, e.g., less than 100 percent double extension (hybrid index method). The taxpayer must affirmatively elect to use the index method on their Form 970 LIFO election. The accounting method propriety of the taxpayer changing from the double extension method to the index or link-chain methods and variations thereof will not be discussed in this ISP guideline paper.

The link-chain index method is a cumulative index which considers all annual indexes dating back to the year of the LIFO election and must be computed every year to keep the cumulative index current. It is used to restate current-year inventory to base year costs and to value increments (increases in inventory) of base-year cost when they occur.

The taxpayer's link-chain method may double-extend all items in ending inventory. The ending inventory must be priced at their beginning and end-of-year costs in order to obtain the annual index that is "linked" (multiplied) to the prior year cumulative index to arrive at the current year cumulative index. In actual practice, it will be found that the procedures used by most large taxpayers are to double-extend a representative portion of the inventory by some type of sampling technique, similar to what a taxpayer on the index method performs. The use of a sampling technique to compute the link-chain index is allowable, assuming it was properly elected and the appropriateness of the inventory pool(s) sampled is sound.

I.R.C. Sec. 472(a) allows a taxpayer to elect the LIFO inventory method. The use of LIFO, however, must be in accordance with the regulations, must be applied on a consistent basis, and must clearly reflect income. In addition, inventories on LIFO must not be valued lower than cost.

Treas. Reg. Sec. 1.472-3(d) states "Whether or not the taxpayer's application for the adoption and use of the LIFO inventory method should be approved, and whether or not such method, once adopted, may be continued and the propriety of all computations incidental to the use of such method, will be determined by the Commissioner in connection with the examination of the taxpayer's income tax returns."

Treas. Reg. Sec. 1.472-4 states that "(a) taxpayer may not change to the LIFO method of taking inventories unless, at the time he files his application for the adoption of such method, he agrees to such adjustments incident to the change to or from such method, or incident to the use of such method, in the inventories of prior taxable years or otherwise, as the district director upon the examination of the taxpayer's returns may deem necessary in order that the true income of the taxpayer will be clearly reflected for the years involved."

Treas. Reg. Sec. 1.472-8 prescribes the operating rules for the use of the dollar-value method of pricing LIFO inventories. Treas. Reg. Sec. 1.472-8(d) states, in part, that "whether the number and the composition of the pools used by the taxpayer is appropriate, as well as computations incidental to the use of such pools, will be determined in connection with the examination of the taxpayer's income tax returns. Adequate records must be maintained to support the base-year unit cost as well as the current-year unit cost for all items priced on the dollar-value LIFO inventory method, regardless of the method authorized by paragraph (e) of this section which is used in computing the LIFO value of the dollar-value pool."

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Treas. Reg. Sec. 1.472-8(e)(1) states, in part, that "(a) taxpayer may ordinarily use only the so-called 'double-extension' method for computing the base-year and current-year cost of a dollar-value inventory pool." This regulation also provides that an index may be computed by double-extending a representative portion of the inventory pool or by the use of other sound and consistent statistical methods. The index used must be appropriate to the inventory pool to which it is to be applied. The appropriateness of the method of computing the index and the accuracy, reliability, and suitability of the use of such index must be demonstrated to the satisfaction of the district director in connection with the examination of the taxpayer's income tax returns.

Treas. Reg. Sec. 1.472-8(e)(2) prescribes the operating rules for the use of the double-extension method. Under the double-extension method, the quantity of each item in the inventory pool at the close of the taxable year is extended at both base-year unit cost and current-year unit cost. The respective extensions are then each totaled. The first total gives the amount of the current inventory in terms of base-year cost and the second gives the amount of such inventory in terms of current-year cost.

Treas. Reg. Sec. 1.472-(8)(e)(2)(ii) states that the taxpayer is allowed to determine the current-year cost of items making up the pool by reference to (a) the actual cost of the goods most recently purchased during the year, (b) the actual cost of the goods purchased during the year in order of acquisition, (c) the average cost of the goods purchased during the year, or (d) any other proper method which clearly reflects income. The regulations also include examples as to how LIFO inventories should be computed under the double-extension method.

Where the use of the double-extension method is impractical, the taxpayer may use the index method or the link-chain method. There are no examples or other regulations that relate specifically to the use of the index or link-chain methods.

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Even though the regulations do not provide specific rules for the link-chain or index methods, it is commonly agreed by the Service and respected tax accounting authors that those methods are conceptually comparable to the double-extension method. Except for the sampling techniques used in both the link-chain and the index methods and the use of a cumulative index in the link-chain method, the principles, concepts, and operating rules in the double-extension regulations are conceptually applicable to taxpayers on the index or link-chain methods.

Thus, a taxpayer using the index or link-chain method may compute an index by double-extending a representative portion of the inventory in a pool or by the use of other sound and consistent statistical methods. The index used must be appropriate to the inventory pool to which it is to be applied. The appropriateness of the method of computing the index and the accuracy, reliability, and suitability of the use of such index must be demonstrated to the satisfaction of the district director in connection with the examination of the taxpayer's income tax returns. Treas. Reg. Sec. 1.472-8(e)(1) requires that the appropriateness of the method of computing the index and the accuracy, reliability, and suitability of the use of such index must be demonstrated to the satisfaction of the district director in connection with the examination of the taxpayer's income tax returns. The LIFO regulations impose a heavy burden on the taxpayer.

There appears to be no primary authority specifically addressing the proper treatment of items transferred from one plant or division of a taxpayer to another plant or division when the plants or divisions are in the same LIFO pool. The regulations only provide the general rule that an index may be computed from "a representative portion of the inventory in a pool." Treas. Reg. Sec. 1.472-8(e)(1).

In the case of Basse v. Commissioner, 10 T.C. 328 (1948), the Tax Court did not allow a taxpayer to apply an index, computed without reference to a material segment of inventory, to the total inventory. Many

taxpayers have situations similar to Basse in that they also do not double-extend a representative portion of a segment of the inventory when they compute the index for their pool(s). Basse was a retailer under the LIFO method of valuing inventory. Basse had a pool containing inventory at both a warehouse and a number of stores. The goods found at the warehouse were the same as the goods at the stores, but in a different ratio. Basse double-extended 100 percent of the warehouse goods in order to determine an index of inflation for the year. None of the goods at the stores were double-extended. The end-of-year costs at the stores were divided by the warehouse index in order to determine the beginning-of-year costs for the stores.

The Service challenged the application of Basse's warehouse index to the stores on the grounds that the flow of costs at the warehouse was different from the flow of costs at the stores, and application of the warehouse index to the stores would not clearly reflect income. The court agreed with the Service on this point, holding that Basse could not use the warehouse index to compute the beginning-of-year costs of the stores. The Service took the position of allowing no inflation or increase in price index for the stores portion of the inventory. The court rationalized the petitioner had some inflation and allowed 50 percent of the claimed amount, under the so-called "Cohan" rule based on the case of Geo. M. Cohan v. Commissioner, 39 F2d 540 (2d Cir. 1930).

The court suggested that Basse could have applied the classification indexes at the warehouse to the stores inventory if they had taken the dollar value of the stores inventory according to the twenty-seven classifications used in the warehouse inventory. Some taxpayers argue that the suggestion or dicta in Basse supports their position, but dicta is not law. In Basse, the court suggested how the taxpayers could have used the information available from the warehouse:

Obviously the petitioners (Basse), without changing from the retail method of taking the retail stores inventory (which was no small part of their total inventory, since

it was approximately one-third of the whole), could have made the percentages of increase in the cost of goods in the warehouse applicable to the goods in the retail stores simply by taking the dollar value of the stores inventory according to the twenty-seven classifications used in the warehouse inventory, which classifications petitioners so convincingly defended and showed to have actually been copied from the groupings of goods in retail stores. Id. at 341.

In other words, by focusing on the mix of items in the retail stores' inventory, proper weight could have been given to each classification of the items in that inventory. Where taxpayers assign an index by weighted product mix the acceptability of such technique only be accepted on a case by case analysis. This technique will only yield an appropriate index under particular facts and circumstances. Contact your inventory or a statistical specialist for assistance.

It should be pointed out, the Basse case was decided in 1948 when the courts were routinely applying the "Cohan" rule in many areas of the tax law, particularly with business or entertainment deductions. It is not envisioned that currently decided segments of LIFO inventory cases would be decided on a "Cohan" rule approach as the Basse case was decided. It is believed the court would apply sound, informed reasoning in an opinion of an intermediate amount between the Service's notice of deficiency determination and the taxpayer's per return position, i.e., alternative computations, expert(s) opinions, evidence introduced by the parties etc. It should not be implied that the court would always reach an intermediate solution to this segments of LIFO inventory issue just because it was raised in the notice of deficiency. Naturally, the court could find totally in favor of the Commissioner or the taxpayer. In fact, the taxpayer may have a formidable claim to increase their claimed price index. The court would be required to rule on this claim.

The facts and circumstances of many taxpayers are similar to Basse in that the taxpayers fail to double-extend a substantial portion or segment of the

inventory, particularly down stream sub-assemblies or finished goods. It can be expected that closer scrutiny will be given on examination than in the past. This is a factual issue and the Service is free to resolve cases based on reconstruction or the best available evidence using sound and practical judgement. This LIFO issue is basically a substantiation issue.

The taxpayer clearly has the burden of proving its LIFO index is an accurate reflection of its inflationary price increases. The LIFO regulations are legislative which gives them the effect of law. These regulations place a strong burden of proof on the taxpayer. See Boecking v. Commissioner, TC Memo 1993-497 where the petitioner failed to meet its burden and their LIFO election was terminated and the accumulated LIFO reserve was required to be reported into income. The Supreme Court, in Commissioner v. Houston, 283 U.S. 223, 228 (1931), stated "The impossibility of proving a material fact upon which the right to relief depends, simply leaves the claimant upon whom the burden rests with an unenforceable claim, a misfortune to be borne by him, as it must be borne in other cases, as the result of a failure of proof." The Houston case was not a LIFO case, but a substantiation case. There are a myriad of substantiation cases that turn based on the facts and circumstances of the respective issues.

The treatment of inventories for tax purposes is governed by I.R.C. Sections 446, 471 and 472. These sections grant the Commissioner broad discretion in matters of inventory accounting and give wide latitude to adjust a taxpayer's method of accounting for inventory so as to clearly reflect income. Thor Power Tool Co. v. Commissioner, 439 U.S. 522 (1979). The Commissioner's determination with respect to the clear reflection of income is given more than the usual presumption of correctness, and the taxpayer bears a heavy burden of overcoming a determination that a method of accounting does not clearly reflect income.

Once the Commissioner determines that a taxpayer's method of accounting does not clearly reflect income, he may select for the taxpayer a method which, in

his opinion, clearly reflects income. The taxpayer has the burden of showing that the method selected by the Commissioner is incorrect or arbitrary, and such burden is extremely difficult to carry. Photo-Sonics, Inc. v. Commissioner, 357 F.2d 656 (9th Cir. 1966). The Commissioner's determination as to the proper method of accounting for inventory must be upheld unless shown to be plainly arbitrary. Lucas v. Kansas City Structural Steel Company, 281 U.S. 264 (1930); Ford Motor Company v. Commissioner, 71 F.3d 209 (6th Cir. 1995); and the LIFO case of E.W. Richardson v. Commissioner, T.C. Memo 1996-368.

A change in method of accounting (voluntary or involuntary) also includes the application of the I.R.C. Sec. 481(a) adjustment (although some voluntary accounting method changes are made using a cut-off method, see Rev. Proc. 97-27, Sec. 2.06, 1997-21 IRB 10, 12). The purpose of I.R.C. Sec. 481 is to prevent a distortion of income or windfall to the taxpayer as a result of a change in method of accounting that would otherwise be barred by the statute of limitation. The I.R.C. Sec. 481(a) adjustment includes amounts that would be otherwise barred by the statute of limitations. The taxpayer receives the benefit of the "timing" of the income or deductions relative to interest on the deficiency up until the year of the I.R.C. Sec. 481 adjustment. Treas. Reg. Sec. 1.446-1(a)(1) provides that the term "method of accounting" includes not only the overall method of accounting of the taxpayer, but also the accounting treatment of any item. See also, Treas. Reg. Sec. 1.446-1(e)(2)(ii)(a).

The leading case on a challenge to the statute of limitations being barred versus the application of I.R.C. Section 481(a) is Graff Chevrolet Company v. Campbell, 343 F.2d 568 (5th Cir. 1965). In the case of Graff Chevrolet Company, a retail auto dealer, the petitioner had not included in income amounts credited to a dealer reserve account by a finance company in 1956 and 1957, years closed by the statute of limitations. The taxpayer was required to include in income in 1958, the year in which the Commissioner required it to change its accounting method, amounts credited to its reserve

account from closed years. This 1958 change was based on a then recent Supreme Court case that ruled on the issue causing it to be reportable income. See Commissioner v. Hanson, 360 U.S. 446 (1959). A subsequent case, W. S. Badcock Corp. v. Commissioner, 59 T.C. 272 (1972), not only supports the Graff Chevrolet Company holding, but it is also interesting to note that there were prior audits and the adjustment was not proposed on examination until a subsequent year.

SETTLEMENT GUIDELINES

This is a facts and circumstances generic issue that will be taxpayer specific - it is generally a substantiation issue and should be treated accordingly. It is not the type of issue that a "pro-forma" settlement guideline can be recommended for all taxpayers. Although the Basse case may lend some guidance, there is generally no case law on point. Further, as stated above, the Service has not published any official guidance on this issue. A primary goal for settlement should be that the taxpayer is on a sound and acceptable sampling method prospectively and the years under consideration are settled appropriately. Contact your Appeals coordinator for guidance.

The LIFO index cannot be applied to a segment of inventory which was not represented when the index was computed unless the taxpayer can demonstrate that the index is representative of the price movements of such segment. Taxpayer's generally accomplished their burden through reconstruction of the segment of inventory that was not sampled. Again, this is the taxpayer's burden to reconstruct to the satisfaction of the district director, not the examination division's burden. Taxpayers excluding whole segments of the inventory do not generally satisfy the requirements for a representative or statistical sample. The Service has held adverse to taxpayers in several technical advice memorandums on intentional or inadvertent omissions of segments of inventory. Adverse findings by National Office have also been found where taxpayers have used a sample from one pool to develop an index for another pool(s) or another related taxpayer in a similar business, such as an

affiliate entity. This so-called, "borrowing" of a price index is not an acceptable methodology even though the inventory is the same type. The mix of inventory may have a dramatic affect on the price index. Generally, the examples in this paragraph would be strong cases for the government, assuming the taxpayer failed to reconstruct a price index.

Reconstruction by the Service is resource intensive and is generally the taxpayer's burden. The taxpayer is custodian of the records, not the district director. The Service may want to perform this task to corroborate or rebut the taxpayer's assertion, especially where they have employed outside expert(s). Reconstruction or lack thereof is not required of the district director and should not be a barrier for acceptance of jurisdiction by Appeals. Reconstruction may be necessary for rebuttal where the taxpayer has obtained expert opinion(s) as to the validity of the taxpayer's sampling methodology. It may be found that this reconstruction is necessary to formulate a position for a notice of deficiency determination - either as a primary or alternative position. Reconstruction may be necessary when in Appeals jurisdiction because the taxpayer presents new evidence. Appeals is required under IRM 8223 to have Exam review new evidence and Exam may opine on its relevancy. An expert opinion that was not previously seen by Exam generally meets the new evidence criteria. As with any issue, inability to rebut new evidence or lack of resources to obtain rebuttal expert will bear heavily on the Appeals evaluation and ultimate settlement.

The appeals officer or team chief may want to meet early in the Appeals process with counsel and Exam relative to retaining an expert in the field. Lack of availability of an expert generally increases the government's hazards of litigation. It is imperative that the first cases considered for a notice of deficiency be good litigating vehicles since there is no legal precedent for this issue other than the old case of Basse. The use of judgmental versus statistical sampling is untested.

A practical approach that can be used for a "reality check" is the producer price indexes (PPI) or consumer price indexes (CPI) published by the Bureau of Labor Statistics (BLS). This is a nonregulatory approach to resolving this segments of inventory issue, but may be sensible and conserve resources. Taxpayers may only use the PPI or CPI tables published by BLS if they have formally elected the Inventory Price Index Computation (IPIC) method under Treas. Reg. Sec. 1.472-8(e)(3). If BLS is used for a reality check, caution should be taken that the appropriate detailed PPI or CPI categories are used to compare similar inventory. The use of the BLS published PPI or CPI tables as a settlement tool should be used sparingly and only after consultation with the inventory specialists. PPI or CPI tables should not generally be used where the taxpayer has no records or missing year(s) of records. There could be other LIFO issues present in the missing year(s) that taxpayers are attempting to conceal, i.e., a bargain purchase issue, definition of item issue, improper accounting method change, etc.

In unagreed cases, Exam should have included an I.R.C. Sec. 481(a) adjustment in the examiners proposal. The majority of the revenue adjustment is generally found in the I.R.C. Sec. 481(a) adjustment. Where the appeals officer, team chief or case manager evaluates that the issue is best served by settlement at less than proposed, there are several approaches to accomplish such compromises. One approach to settlement might be to limit the "look-back" period of the I.R.C. Sec. 481(a) adjustment or to eliminate it altogether in exchange for the taxpayer's concession of the current year proposal and the agreement for future compliance. Based on the respective hazards of litigation, a percentage reduction of the claimed price index for the segment of inventory that was not sampled may be the most appropriate.

Rev. Proc. 97-27, 1997-21 IRB 10, supersedes Rev. Proc. 92-20, 1992-1 CB 685. The integrity of Rev. Proc. 97-27 or any successor revenue procedure(s) must be respected. This principle cannot be over-emphasized. It should be recognized that the taxpayer could have obtained "cut-off" from the I.R.C. Sec. 481(a) adjustment

if they had voluntarily requested a change of accounting under Rev. Proc. 97-27. Taxpayers counter with the fact that the Service has not published any official guidance relative to what is a proper sampling method or "safe harbor" to request a method change.

The use of "cut-off", "limited look-back" and spread forward of the I.R.C. Sec. 481(a) adjustment ("spreads") can send an unintended message that voluntary filings of Form 3115, Application For Change in Accounting Method, are not necessary. Time value of money (present or future value) may be accomplished by several of these techniques, but a percentage yearly reduction of the I.R.C. Sec. 481(a) adjustment is preferred to cut-off, limited look-back or spreads.

All fact situations cannot be covered in a guideline paper such as this. Different factual situations or variations may arise that cause the above guidelines to be inappropriate for your case. IRM 8760 explains the approval procedures for appeals officers and team chiefs. Delegation Order 247 requires examination case managers to obtain the approval from both the Exam and Appeals ISP specialist/coordinator.