Reco Industries, Inc. v. Commissioner, 83 T. C. 912 (1984)

A taxpayer using the completed contract method may use LIFO inventories to compute contract costs if it clearly reflects income.

Summary

Reco Industries, a manufacturer of custom steel products, used the completed contract method for tax accounting and LIFO for inventory valuation. The IRS challenged this, arguing that LIFO inventories and the completed contract method are incompatible. The Tax Court, following its precedent in Peninsula Steel, held that Reco's use of LIFO inventories was permissible and clearly reflected income. The decision emphasized the consistency of Reco's accounting method and its compliance with both tax regulations and generally accepted accounting principles, reinforcing that such methods are not inherently incompatible.

Facts

Reco Industries, Inc. , a steel products manufacturer, used the completed contract method for long-term contracts and valued its inventories using the LIFO method from 1974 to 1976. The IRS challenged this, asserting deficiencies and claiming that using LIFO with the completed contract method did not clearly reflect income. Reco maintained raw materials and work-in-process inventories, and its contracts typically required advance payments. The company consistently used inventories to compute costs since at least 1970, and its inventory values significantly increased during the years in question due to LIFO adjustments.

Procedural History

The IRS determined deficiencies in Reco's taxes for 1974, 1975, and 1976, leading Reco to petition the U. S. Tax Court. The court considered the case alongside its prior decision in Peninsula Steel Products & Equipment Co. v. Commissioner, which had similar facts and issues. The Tax Court ultimately followed Peninsula Steel in its decision.

Issue(s)

1. Whether a taxpayer using the completed contract method of accounting may use LIFO inventories to compute its contract costs.
2. Whether Reco's use of LIFO inventories clearly reflected its income.

Holding

1. Yes, because nothing in the regulations prohibits the conjunctive use of inventories and the completed contract method, and the methods are not inherently incompatible.
2. Yes, because Reco's method conformed to both the regulations and generally

accepted accounting principles, and was consistently used.

Court’s Reasoning

The court rejected the IRS’s argument that inventories and the completed contract method are mutually exclusive, finding no such prohibition in the regulations. It noted that the completed contract method addresses the timing of income recognition, while inventories determine the amount of deductible costs. The court found Reco’s method consistent with generally accepted accounting principles and its consistent use weighed in favor of Reco. The court also addressed the IRS’s contention that LIFO accelerated deductions, clarifying that LIFO adjustments reflect the valuation method rather than the timing of deductions. The decision followed Peninsula Steel, emphasizing that LIFO, authorized by statute, was available to taxpayers properly maintaining inventories, and Reco’s use of it clearly reflected income.

Practical Implications

This decision confirms that manufacturers using the completed contract method can use LIFO for inventory valuation if it clearly reflects income, which is determined by consistency and conformity with both tax regulations and accounting principles. Practitioners should analyze similar cases by ensuring the method’s consistency and compliance with both sets of standards. This ruling may influence how businesses in similar industries approach their tax accounting, particularly in volatile markets where LIFO can mitigate inflation effects. Subsequent cases, like Spang Industries, Inc. v. United States, have distinguished or challenged this holding, indicating ongoing debate over inventory methods with the completed contract approach.