T.C. Memo. 1986-476

A taxpayer's election of the Last-In, First-Out (LIFO) inventory method must clearly specify the goods covered, and a subsequent writedown of inventory value, even if correcting a prior error, constitutes a change in accounting method requiring IRS consent.

Summary

First National Bank of Gainesville, as trustee for Hall Paving Co., Inc., challenged the IRS's determination of income tax deficiencies. The Tax Court addressed whether Hall Paving's LIFO election included soil aggregate, and if a writedown of soil aggregate inventory was a permissible correction of error or an unauthorized change in accounting method. The court held that the LIFO election encompassed soil aggregate due to ambiguous language in Hall Paving's application and that the writedown was an unauthorized change in accounting method requiring IRS consent, which was not obtained. Additionally, a deduction for calculators was disallowed due to lack of substantiation.

Facts

Hall Paving, a nonmetallic mining company, produced pure aggregate and soil aggregate. Soil aggregate was initially considered a byproduct and not inventoried. In 1976, Hall Paving included soil aggregate in inventory at an arbitrary $1/ton value and used the FIFO method. In 1977, Hall Paving elected the LIFO inventory method for "all inventory of stone" without specifically excluding soil aggregate. In 1979, due to changes in Georgia Department of Transportation specifications, the market value of soil aggregate decreased significantly. Hall Paving wrote down the value of soil aggregate inventory from $1 to $0.10 per ton without IRS consent. Hall Paving also deducted expenses for 125 calculators as business gifts.

Procedural History

The IRS determined deficiencies against Hall Paving for 1978 and 1979, asserting that the soil aggregate writedown was an unauthorized change in accounting method and disallowing the calculator deduction. First National Bank of Gainesville, as transferee of Hall Paving, petitioned the Tax Court to contest these deficiencies.

Issue(s)

1. Whether Hall Paving's inventory of soil aggregate was included within its election to adopt the Last-In, First-Out (LIFO) inventory method.
2. Whether Hall Paving's writedown of soil aggregate constituted a change in accounting method requiring IRS consent.
3. Whether Hall Paving is entitled to an ordinary business deduction for the purchase of 125 calculators.

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Holding

1. Yes, because Hall Paving's application to use LIFO was ambiguous in defining "stone" and did not explicitly exclude soil aggregate, and Hall Paving's subsequent actions indicated an intent to include all inventory under LIFO.
2. Yes, because the writedown was a change in the method of valuing inventory under LIFO, requiring IRS consent, which Hall Paving did not obtain.
3. No, because Hall Paving failed to provide adequate substantiation for the business purpose and recipients of the calculators as required by Section 274(d).

Court's Reasoning

Regarding the LIFO election scope, the court emphasized that the Form 970 Application to Use LIFO Inventory Method stated "All inventory of stone." While petitioners argued "stone" excluded soil aggregate, the court found this ambiguous. The court noted Hall Paving listed "parts" and "repair" as exclusions, implying all other inventory, including soil aggregate, was included. The court stated, "Though 'stone' may not technically include soil aggregate for purposes of the construction and mining industries, it is clear that soil aggregate is neither 'parts' nor a 'repair.' Thus, the Form 970 requires us to read the word 'stone' expansively." The court also pointed to Hall Paving's tax returns and internal records indicating LIFO was applied to all inventory.

On the writedown, the court held that under Section 472(e), once LIFO is elected, it must be used unless a change is authorized by the IRS. The court stated, "Hall Paving's subsequent attempt to write down soil aggregate to $0.10 a ton constitutes a change in accounting method requiring the Secretary's authorization as described in section 472(e)." Even if the writedown corrected a prior error, it still constituted a change in accounting method requiring consent. The proper recourse for the error was to amend prior returns or request adjustments with the LIFO election, neither of which occurred.

Regarding the calculator deduction, the court found a lack of substantiation. Petitioners failed to provide records or evidence to support the business purpose of the gifts or the business relationship with recipients, as required by Section 274(d).

Practical Implications

This case highlights the importance of specificity in tax elections, particularly for inventory methods like LIFO. Taxpayers must clearly define the scope of their LIFO election to avoid ambiguity and potential disputes with the IRS. Furthermore, it underscores that any change in inventory valuation under LIFO, even to correct prior errors, is considered a change in accounting method requiring IRS approval. This case serves as a reminder for businesses to maintain meticulous records to substantiate deductions, especially for business gifts, and to adhere strictly to

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procedural requirements for changing accounting methods.

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