

LIFO REPEAL MEANS MASSIVE TAX INCREASE ON LARGE AND SMALL AMERICAN BUSINESSES

EXECUTIVE SUMMARY

- In late April 2006, Senate leaders proposed repealing the LIFO inventory accounting method to pay for a \$100-per-family gas tax rebate.
- LIFO repeal was apparently proposed in part due to a mistaken belief that LIFO is a “tax loophole” or that it is set to disappear from use.
- In fact, LIFO is an established, widely-accepted inventory accounting method that has been used by large and small companies throughout the U.S. economy since the 1930s.
- Repealing LIFO would be a massive tax increase on hundreds of thousands of large and small American businesses, and could force many smaller ones to close.
- Congress should reject any effort to repeal LIFO.

DISCUSSION

- **What is LIFO?** LIFO (which stands for “last in, first out”) is an inventory accounting method used by companies throughout the U.S. economy to determine both book income and tax liability. Book income is the amount of earnings shown on business financial statements. Tax liability is the amount of income tax owed to the government
- **Why do businesses use LIFO?** If inventory costs are rising (i.e., there is inflation), LIFO is a more accurate way of measuring financial performance and calculating tax. LIFO takes into account the greater costs of replacing inventory, thereby giving both a more conservative measure of the financial condition of the business and the economic income to which tax should apply. Absent LIFO, phantom profits would be taxed.
- **Is LIFO a loophole that companies use to avoid taxes?** No. If inventory costs are rising, using the LIFO method will mean less tax liability in a given year than under the FIFO (“first in, first out”) method. However, if prices fall, the taxpayer would repay the LIFO benefit through greater tax liability. Moreover, taxpayers may not change between LIFO and FIFO without approval of the Internal Revenue Service (IRS). Thus, once they elect to use the LIFO method, taxpayers assume the risk of artificially increased tax liability if inventory costs should fall.
- **Can you provide some examples of how LIFO works?** *Example One:* Assume that Company A must maintain \$2 million of inventory in order to operate its business. At the beginning of a taxable year, Company A acquires \$2 million worth of inventory. Company A sells the inventory, and at the end of the taxable year, pays \$2.1 million to acquire an equivalent quantity of inventory. Under the FIFO method, the extra \$100,000 cost of acquiring inventory would be included in taxable income in the current taxable year. Under

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the LIFO method, the extra cost of acquiring replacement inventory would not be included in taxable income in the current year.

Example Two: Assume that Company B purchases 1,000 widgets at a cost of \$10 per unit and resells them for \$15 per unit. Assume that after other expenses, Company B earns a profit of 15 percent, or \$1.50 per unit. Further assume that the widgets increase in cost to \$11 per unit. In order to stay in business at the same level of operations, Company B must now purchase 1,000 widgets at \$11 per unit. If Company B is forced to use the FIFO inventory method, it would show a profit of \$1.50 per unit and pay tax on that \$1.50 per unit of profit. In that situation, where would Company B get the funds to pay for the \$1 per unit increase in the price of widgets in order to replace them? The \$1.50 per unit profit measured on a FIFO basis is a phantom profit if Company B must reinvest \$1 per unit of that profit to simply stay in business at the same level of operations. The LIFO method is intended to allow Company B to treat the \$11 per unit replacement cost of the widgets as its cost of goods sold in the initial sale, thereby giving a truer picture of the real economic profit on the transaction, which is \$.50 per unit instead of \$1.50 per unit.

These examples demonstrate how the FIFO method imposes taxes on inflationary (“phantom”) gains associated with the taxpayer’s investment in inventory, while the LIFO method is fairer because inflationary gains associated with inventory are taxed only as the taxpayer reduces its inventory levels. Under the FIFO method, during an inflationary period where the taxpayer’s cost of acquiring or producing inventory is increasing, the aggregate difference between the replacement cost of the taxpayer’s inventory and the original acquisition cost of the inventory is taxed entirely in the current taxable year. In contrast, under the LIFO method, the difference between the replacement cost of the taxpayer’s inventory and the acquisition cost of the inventory is taxed when the taxpayer liquidates its investment in inventory.

- **Is the use of LIFO limited to a certain sector of the economy?** No. LIFO is used by manufacturers, mining companies, and energy producers, as well as by wholesaler-distributors, retailers, and other types of companies that sell every imaginable product. Literally hundreds of thousands of large and small American companies that maintain inventories use LIFO.
- **Is LIFO something new?** No. LIFO has been used and accepted as a legitimate accounting method by accountants, tax lawyers, the IRS, and Congress since the 1930’s. In fact, when LIFO was officially recognized almost three quarters of a century ago, Congress imposed a financial reporting conformity requirement making the use of LIFO for financial reporting a condition of its use for tax purposes.
- **Is it true that LIFO is obsolete or that international agreements will mean the end of LIFO for U.S. tax purposes?** No. While LIFO has been a part of U.S. financial accounting standards since the 1930s, LIFO has not been widely used in Europe and is not recognized as acceptable method under international accounting standards. However, the Financial Accounting Standards Board (FASB), which promulgates U.S. accounting standards, and the International Accounting Standards Board (IASB), which promulgates

international accounting standards, meet periodically to discuss convergence of U.S. and international accounting standards. The FASB and IASB recently announced the agenda of topics that they would consider through 2008 concerning the convergence of international and U.S. accounting standards. The subject of inventories is *not* listed on that agenda. Moreover, before any action can be taken on the subject in the U.S., the FASB must hold hearings and take comments from interested parties. Given the widespread use of LIFO for financial reporting purposes in the U.S., there is no reason to think at this point that the use of LIFO as an acceptable accounting principle will be rejected in the U.S. Moreover, there are a number of alternative means of accommodating disparities between U.S. and international accounting standards on this subject, including disclosure in the footnotes to a company's financial statements. Such an approach would allow for comparability between U.S.-based and international-based financial statements without violating the LIFO conformity requirement under U.S. tax laws.

- **Why has LIFO become an issue now?** On April 26, the Senate leadership offered a package of energy provisions in response to increased gasoline prices. The revenue offset under the bill was repeal of LIFO. (A provision in the Senate budget reconciliation bill had *partially* repealed LIFO, but only for the five major oil companies. The April 26 package repealed LIFO for all businesses, permanently.) The LIFO provision met with intense opposition from the business community and was dropped. However, because of apparent misunderstanding as to the status and direction of talks with respect to "convergence" of U.S. and European accounting conventions, some seem to have made an assumption that LIFO will soon disappear for financial accounting purposes, and by extension for calculation of tax liability.
- **What would be the impact of LIFO repeal?** Repealing LIFO would force companies currently using the accounting method to report their LIFO reserves as income, resulting in a massive tax increase for large and small businesses spread across the economy. Additionally, repealing LIFO would mean potentially higher future tax bills and would make it harder for companies to manage inflation. Congress should reject any effort to repeal LIFO.