LIFO IN A NUTSHELL

What is LIFO? -- "LIFO" is an accounting method used to determine both book income and tax liability. The term refers to the assumption made by a business in establishing the value of its inventories. LIFO is an abbreviation for "last-in-first-out". This is opposed to the other common inventory accounting convention which is "FIFO" for "first-in-first-out."

Why LIFO? -- LIFO is considered a more accurate accounting method when inventory costs are rising, by taking into account the greater costs of replacing inventory. This gives a better measure of both the financial condition of the business and the economic income that should be subject to tax. If inventory costs are rising, use of the LIFO method will mean less tax liability in a given year than under the FIFO method.

Who uses LIFO? -- Manufacturers, extractive industries, wholesalers, and retailers of all sizes use LIFO.

To include small business? -- LIFO is all the more important to small business because of thin capitalization and sensitivity to rising supply and materials costs.

How long has the tax Code recognized LIFO? -- After thorough consideration of the issue by the Congress, LIFO came into the tax law in 1939.

What would happen if LIFO were repealed? -- LIFO repeal would mean a forced change in fundamental tax accounting for any business that uses the method. As a consequence, such taxpayers forced off LIFO would have additional taxable income pursuant to "reversing the LIFO reserve," in the year the change occurred. However, companies would have no economic income from such an accounting adjustment, meaning taxation without receipt of dollars.

What economic effects? -- Depending on the size of the LIFO reserve relative to its retained earnings, LIFO repeal could be devastating for a given taxpayer. For small businesses, the LIFO reserve could exceed retained earnings, in which case the business probably would liquidate, and might still owe tax. Larger companies with greater financial capacity would pay the tax, write down shareholder's equity, and see the value of their stock drop. After repeal, companies with rising supply and materials costs would pay greater tax liability in each year because of the loss of LIFO. Those taxpayers with falling costs would retain the tax advantage they already enjoy under FIFO.

What about phased-in repeal? -- The economic effects would remain the same, simply spread over whatever number of years. Businesses forced off LIFO would pay, essentially, an assessment against capital to the federal government, without regard to current earnings or other factors.

What's the background? -- A proposal for LIFO repeal for oil companies was discussed by tax writers early in 2006. In April 2006, the Senate Majority Leader offered a bill repealing LIFO for all companies, but meeting a fire storm of opposition, he withdrew the proposal immediately. However, even before the November elections, senior Members of the Finance Committee acknowledged that LIFO repeal would remain for reconsideration in the 110th Congress, either as a "tax reform" initiative or if revenue offsets were needed otherwise.

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