

## **Reasons for Congress to Keep the LIFO Inventory Method**

The last-in, first-out (LIFO) inventory method has been an important provision of the U.S. tax code for the past 70 years however the Obama administration has proposed eliminating the LIFO method in their budgets for 2010-2014. Their proposal would not allow the use of the LIFO method after 2013 and would also require the recapture of all LIFO tax deferrals from prior years which is, in effect a retroactive tax increase.

The reason that Congress enacted legislation allowing the use of the LIFO inventory method in 1938 was to help businesses defer income taxes on the portion of their income subject to taxation that is the result of inventory purchases price inflation. The tax deferral provided by the LIFO method is especially important to U.S. businesses because of the high U.S. top tax rate of 35% (the top tax rate for S corporations is now 39.6% thanks to the late 2012 Fiscal Cliff deal) which is the highest of all developed countries except Japan and most states have a top tax rate exceeding 5% which means that 40% of U.S. business earnings are lost as a source of financing to these businesses.

With the benefit of many years of hindsight, it is clear that this tax legislation has been one of the most beneficial income tax provisions in terms of achieving the desired result by Congress. The use of the LIFO method has had a very significant positive effect on businesses using this method and the tax deferrals provided by using LIFO provide considerable help to all businesses and especially small business in financing their investment in inventory.

The required investment in inventory for the manufacturing, retail, wholesale and processing industries is substantial. The greatest need for business financing for these industries is to finance their inventory investment. Businesses in these industries typically require substantial investment in three types of assets which are property, plant and equipment (PPE), accounts receivable and inventory. The most difficult of these three asset types to finance is inventory. Multiple long-term financing options are available for PPE including mortgage or other specific collateral loans, leasing and renting. Accounts receivable is an intangible asset however most receivables are near-cash assets that qualify for factor financing or bank working capital line financing at relatively high loan-to-value ratios (often up to 80%). The long term financing options are not available for inventories and since most inventories are not near-cash assets, working capital line financing is available at substantially lower loan-to-value ratios, usually 50% or less.

An example of how the use of the LIFO method by businesses to finance inventories follows. A single full service grocery store (with a pharmacy department) in a metropolitan area requires an ongoing investment in inventories of approximately \$2 million. For the past 20 years, the average annual CPI inflation rate for a grocery store inventory has been 2%. This means that the cost of this store's inventory increases by an average of \$40,000 each year increasing the financing needs regardless of the profitability of the store or the ability for the retailer to pass their higher costs on to their customers. If this store uses the LIFO inventory method and their inventory quantities do not decrease much from the prior year, their taxable income for the year will be reduced (deferred) by the \$40,000 representing the

current year inflation and at a combined federal and state marginal income tax rate of 40%, \$16,000 of income taxes have been deferred which means that the federal and state governments have provided for financing of \$16,000 of the \$40,000 increase in financing needs so this store will only need to finance the remainder of \$24,000 instead of the entire \$40,000. For both 2007 and 2008, the rate of inflation for grocery stores increased and was about 5% for each of these years. This means that the financing need for this grocery store owner increased by \$100,000 (\$2 million times 5%) in each of these years or \$200,000 in total. Because this company used the LIFO inventory method, they received income tax deferrals from the federal and state government in the amount of \$80,000 (\$200,000 times 40% combined marginal tax rate) so that the net of LIFO benefit necessary for new inventory financing was reduced from \$200,000 to \$120,000.

The long term benefit to this company from using LIFO is described below. The example assumes the company adopted LIFO in 1969 with \$1 million in inventory investment at that time and an annual 2% inflation rate for their inventory purchases and the inventory quantities do not increase, i.e. the replacement cost of the inventory increases only by the 2% inflation per year. If this company used the LIFO method for 40 years, the current replacement cost of the inventory in 2008 would have grown to be about \$2.2 million and the LIFO reserve (the cumulative amount of income tax deferral) would be about \$1.2 million or 55% of the current replacement cost. The cumulative tax savings at the end of the 40 years assuming a combined marginal income tax rate of 40% is about \$483,000 which is 22% of the 2008 inventory investment.

If LIFO were repealed for this company in 2009, they would be negatively affected in two ways:

1. They would lose the \$16,000 current year tax deferral (\$40,000 LIFO reserve increase assuming 2% inflation and a 40% combined marginal tax rate).
2. Their taxable income for each of the next 8 years will increase by the 2008 LIFO reserve of \$1.2 million divided by 8 years which is \$150,000 per year which will increase the annual combined income tax liability by another \$60,000 to \$76,000 per year for each of the next 8 years.

This example shows that this company's cash available will decrease by a total of \$76,000 per year for each of the next 8 years which is a total of \$608,000 as a result of their loss of the use of the LIFO method despite the fact that the company needs to finance their \$2 million investment and that this amount grows by another \$40,000 every year. Unless this company is more profitable than normal for this industry, there is not a cash source available to pay this tax liability. This is because the prior year tax savings resulting from the use of the LIFO method did not go into the owners' pockets because it was required for the increased inventory investment caused by inflation. Unless a company has been unusually profitable in the past, the loss of the LIFO method would be devastating to a company because of the significance of the increased tax liability to the size of the company (the cumulative LIFO tax savings for many small companies exceeds the net worth of the company). For a company with a large LIFO reserve in relation to their net worth, a forced sale of the company (most likely to a larger competitor) or liquidation and possibly bankruptcy are distinct possibilities. They could also reduce the amount of inventory they

carry but this would decrease the company's profitability. A grocery store of this size will have at least 20 full or part-time employees and some or all of these jobs would be lost depending on whether the store is sold or liquidated.

Larger companies will not be adversely affected as greatly by the loss of the use of the LIFO method compared to the effect on small businesses because their access to capital is much greater. All large publicly traded supermarket chains have access to capital through stock and debt offering in addition to bank financing. The latter is the only capital source available to a small business other than accumulated wealth of owners which will also be subject to higher income tax rates starting in 2011.

The success of the various tax policies enacted by Congress should be measured by these criteria:

1. Achieves the desired result in terms of having a positive effect on the U.S. economy in terms of job creation and helping to create a competitive advantage for U.S. taxpayers relative to foreign competitors.
2. Avoids negative unintended consequences.

The LIFO inventory method would rank very high compared to other income tax provisions judged by the criteria listed above. An example would be the IRS Section 179 write off allowances for business equipment. Most business people would agree that this is a very effective way to stimulate business equipment investment however the limits for these write-offs are completely arbitrary and are not consistent from year to year (adding to the complexity of the tax code). The LIFO inventory reserve balance changes are directly correlated to the annual inflation applicable to the inventory purchases and inventory balances.

Retention of the LIFO inventory method is particularly important in now because the benefits provided by the use of this method has a positive effect on the most important of the primary goals of the federal government in fighting the adverse effects of the current severe recession on our economy. These goals include the following which are described below along with the effect the use of the LIFO method has on each:

**Stimulus effect** – The loss of future and past income tax savings (this would, in effect be a retroactive tax increase) provided by LIFO would significantly decrease business capital available.

**Jobs creation or loss** – The loss of the LIFO method would clearly lead to significant job losses and the only question about this is not whether jobs would be lost but how many millions of jobs would be lost.

**Credit availability** – This is one of the main problems resulting from the huge losses bank and other credit providers have suffered and the loss of LIFO wipes out a very important financing source, especially for small businesses.

**Competitive disadvantage for U.S. manufacturers** – The loss of the LIFO method which provides a significant advantage to many U.S. manufacturers hurts their ability to compete with foreign competitors which all (except Japan) have lower income tax rates imposed on them.

**Harmful effect on small businesses** – The loss of the LIFO method would be more harmful to small businesses than to larger companies for the reasons described above.

# Frequently asked LIFO questions

## **How many companies use the LIFO method?**

There are approximately 20,000 businesses that use the LIFO method based on IRS statistics. Approximately 500 publicly traded companies use the LIFO method which means that 97% of the businesses that use the LIFO method are not publicly traded companies. Of these 20,000 businesses, the approximate breakdown by broad business types is 5,000 manufacturers, 5,000 wholesalers and 10,000 retailers and other industries.

## **Which type of businesses use LIFO?**

Businesses that benefit from using LIFO share three characteristics:

1. Significant investment in inventory
2. The business is profitable
3. Consistent price inflation for the type of goods in inventory

## **Which industries use LIFO?**

LIFO is used by a majority of profitable businesses that carry inventories. Examples of businesses in which LIFO is heavily used include manufacturing companies of all types, wholesalers of all types, auto & truck dealers, farm equipment dealers, construction equipment dealers, supermarkets and convenience stores.

## **How long has the LIFO method been used?**

Income taxes were first imposed in the U.S. on a permanent basis in 1913 and in 1918 Congress passed tax legislation requiring accounting for inventories as current assets (rather than expensing the purchase of all goods). Congress enacted legislation in 1938 specifically allowing for the LIFO inventory method. Using this timeline, the use of the LIFO method has been allowed for 70 years of the 90 years for which inventory accounting has been required.

## **Does the use of the LIFO method provide preferential treatment to certain industries?**

In a broad sense, yes but almost all income tax provisions treat one class of taxpayers differently than others. The home mortgage deduction is available only to homeowners and only to those homeowners within a certain income range and if the amount financed is great enough. Some individual taxpayers pay tens of thousands of dollars in income taxes while some pay nothing. Taxpayers pay income tax at greatly different marginal rates depending on income levels. The use of the LIFO inventory method can help businesses requiring inventory investment defer a portion of their income taxes but only when inflation increases their cost of purchases which increases that businesses' need for inventory financing. Companies that do not require investment in inventories do not have this financing need.

## **Does the use of the LIFO method provide tax benefits to a company every year?**

Not necessarily because when there is deflation, taxable income increases for companies using LIFO. The taxable income deferral can also be reduced when inventory quantities decrease and all previous income deferrals are taken into income when the assets of a business are sold.

**Is LIFO a tax loophole?**

The Merriam-Webster dictionary definition of a loophole is “an ambiguity or omission in the text through which the intent of a statute, contract or obligation may be evaded”. Congress enacted legislation in 1938 specifically allowing for this method, so by definition, LIFO is not a tax loophole.

**Why would a company want to adopt LIFO prior to the proposed repeal for years after 2013 if they believe the LIFO method will actually be repealed?**

The budget proposal to repeal LIFO provides for the recapture of the LIFO benefits over a ten year period, so significant LIFO taxable income deferrals are still possible for LIFO elections prior to 2014 depending on the rate of inflation and inventory values.

**Who is LIFO-PRO, Inc.?**

We are a small Omaha based company in business since 1992 that developed and sells the only LIFO calculation software for non-auto dealer industries. We provide LIFO calculation and consulting services to companies all over the U.S. to businesses ranging in size from companies with less than \$1 million in inventory investment to Wal-Mart and many other large companies. The company was started by Lee Richardson (lee@lifopro.com) who has over 50,000 hours of non-auto dealer LIFO experience and he is the only CPA whose practice is devoted solely to non-auto dealer LIFO. The inventory balance total for which the LIFO-PRO software is used exceeds \$100 billion and the combined sales of LIFO-PRO, Inc. clients are approximately \$1 trillion.

**Is there an organized effort to oppose the repeal of LIFO?**

There is an organized effort called the LIFO Coalition that was formed to help businesses fight for the retention of the LIFO inventory method. The LIFO Coalition is an ad hoc group of more than 115 trade associations representing hundreds of thousands of businesses which was formed in 2006 to oppose proposals by the U.S. Congress to repeal or restrict the use of the LIFO inventory accounting method under U.S. tax laws. Members of the coalition represent a wide variety of businesses, including manufacturers, wholesaler-distributors, retailers and producers. Jade West (jwest@nawd.org) with the National Association of Wholesale-Distributors in Washington, DC is the chairperson for the LIFO Coalition.

SaveLIFO.org is a website created by a member of the LIFO Coalition which describes reasons the Coalition is fighting against LIFO repeal and it provides links to correspondence sent to the U.S. Congress arguing against LIFO repeal.