THE LIFO COALITION

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June 7, 2022

TO: Congressional tax-writing staff

The Tax Policy Center published an article on May 12, 2022, "Inflation and Oil Price Spikes Revive Case for LIFO Repeal," written by Thornton Matheson and Thomas Brosy, calling for the repeal of the last-in, first-out (LIFO) inventory accounting method. The article includes a number of statements and assertions that are incorrect or overlook the sound economic policies that were the genesis of LIFO and remain relevant 80 years later and that the LIFO Coalition believes should be addressed.

The LIFO Coalition is a coalition of more than 130 business groups and companies that was organized in 2006 to advocate for retention of LIFO in the tax code (see membership list HERE).

LIFO was adopted as a generally accepted accounting principle ("GAAP") to allow companies to deal with the effects of inflation on the pricing of inventory. LIFO was designed to allow companies that sell inventory that is affected by inflation to match the increased cost of replacing the goods that they sold with the revenue from the sale of the replaced inventory, thus enabling companies to remain in business by maintaining inventory levels. LIFO was added to the tax code in 1939. The LIFO Conformity Rule requires companies using LIFO for tax purposes to also use the method for financial reporting purposes.[1]

The justifications for the recommendation that LIFO be repealed in the Tax Policy Center article are based on an apparent misunderstanding of the purpose and use of the method. Please see below the arguments made in the Tax Policy Center article and the Coalition response.

The current high inflation justifies the case for repeal of LIFO, and LIFO "exaggerates deductions and understates income tax liability relative to FIFO"

Not only is the current inflationary environment not the right time to repeal LIFO, it is the worst time. LIFO functions precisely to mitigate the effects of inflation, so companies facing rising input costs and prices of finished products are able to continue operating without scaling back on operations, reducing product availability, laying off employees, or imposing higher prices on the consumer at this sensitive time.

[1] 26 CFR § 1.472-2 - Requirements incident to adoption and use of LIFO inventory method

The example in the article about petroleum prices actually makes the case *for* LIFO, not for its repeal. In the example, a company bought a widget for $25 in 2020, bought another for $50 in 2021, sold one for $100 in 2022, and made a smaller taxable profit under LIFO than it would have earned under FIFO. The difference between LIFO and FIFO taxable profit is characterized as a subsidy and an exaggerated deduction. However, the example fails to address the continuing business cycle: that company must buy additional widgets to sell in order to remain in business, and those replacement widgets will cost even more in 2022; the LIFO method provides additional after-tax cash flow to help cover the additional cost of replacement inventory and keep employees on payroll when labor costs are rising.

It is worth noting that LIFO and FIFO are inventory accounting methods that track costs, not physical products, and both LIFO and FIFO achieve the same purpose. For a company that sells products that decline in price – like technology – FIFO allows the company to maximize cash flow by matching higher purchase prices with sales. For companies selling products that rise in price, LIFO achieves the same purpose, allowing them to maximize their cash flow by matching higher purchase prices with sales. Both inventory accounting methods allow the companies to retain sufficient after-tax profit to purchase replacement inventory and keep their labor force intact so they can remain in business. Repealing LIFO would unfairly discriminate against businesses facing rising costs, while FIFO taxpayers experiencing declining prices would continue to benefit from the ability to maximize their cash flows.

The USA is the only country that allows the use of LIFO

When the United States was considering adopting the International Financial Reporting Standards ("IFRS") – a decade ago, not actually in "recent years" – it was an often-repeated myth that the USA is the only country that allows the use of LIFO. That statement was factually incorrect then and remains so today.

The Tax Foundation published updated data in 2020 showing that, in fact, LIFO is widely used in Europe. Significantly, their 2020 study included a map showing which inventory accounting methods are used in the countries they studied and concluded that the map "reflects the best inventory valuation method available in the 27 countries covered, ***with LIFO (11 countries) the most preferred one***, Weighted-Average Cost (10) second, and FIFO (six) last."[2] (Emphasis added)

"LIFO use is now concentrated among large companies in a few industries with large inventories," "Although C-Corporations account for less than 40 percent of US net business income, they receive about 80 percent of LIFO tax benefits" and "the petroleum industry is the largest beneficiary"

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[2] Tax Foundation, *Inventory Valuation in Europe*, August 13, 2020, A. Kristina Zvinys. The Tax Foundation study and map [HERE]

These assertions are misleading at best, and in very significant aspects, entirely incorrect. It is logical that very large corporations would have the largest LIFO reserves, a result of more sales and revenue compared to smaller LIFO users. However, the assertion that 80 percent of LIFO tax benefits accrue to the largest companies is questionable, and unprovable since the data on the tax benefit to non-publicly traded companies is not available. Further, the Coalition disputes the assertion that LIFO is used by only a few industries and primarily by very large corporations – the breadth of the industries and companies represented in the Coalition membership is ample proof that LIFO usage is not so limited.

The extrapolation from large companies having large reserves to the assertion that only those large companies benefit from LIFO is deeply flawed. Companies of all types and sizes, publicly traded and privately/family-owned, C-corporations and pass-through entities, all use the LIFO method. And it is an appropriate inventory accounting method for all of them. In fact, as the Coalition has observed and reported to Congress and Administrations over the years, grave harm from LIFO repeal would fall on companies both large and small.

Of interest, the Tax Policy Center article notes that C-Corporations produce less than 40 percent of net business income. The remaining 60 percent of net business income, therefore, is produced by pass-through businesses, generally S-Corporations that also employ more than 62 percent of the nation's workers.[3]

These are generally privately held businesses, much smaller than the C-Corporations referenced in the TPC article, which would struggle to stay in business and avoid lay-offs while absorbing the tax increase that LIFO repeal would impose on them. Given that there are more than 4 million S-Corporations today, and studies that have shown that as many as a third of all businesses use the LIFO method, repeal of LIFO would impact millions of companies outside of the largest C-Corporations, and a significant number of these companies would not survive.

Taxing LIFO reserves, which reflect past activity, would also be highly efficient; LIFO provides a permanent tax holiday

The TPC article correctly notes that LIFO reserves have been accumulated through past activity by companies using the LIFO method but fails to observe that this "past activity" was specifically authorized by the tax code and, in some cases, can date back decades, all the while serving the policy purposes of LIFO.

Further, LIFO does not provide a permanent tax holiday. LIFO reserves are taxed when the company reduces those reserves during economic downturns (as with oil and gas prices in

[3] (See S Corporation/EY study from November 2021.)

2014), by selling off inventory or experiencing supply chain shortages, or going out of business. To tax today these legally acquired reserves would be the most dramatic and damaging retroactive tax hike ever contemplated by Congress. It would essentially require taxpayers to be treated as if they were never on LIFO to begin with and to give back all the benefits they had ever received from their use of the method – including those decades-old benefits.

Given the oil industry's record profits and concerns about addressing global climate change, now may be an ideal time to repeal the expensive and inefficient LIFO tax preference

Targeting particular industries because of their size or the nature of their business, or seeking a source of revenue, is a weak justification for repealing LIFO. As noted, LIFO worked exactly as designed when prices dipped, and oil and gas industry companies were required to recapture a portion of their LIFO reserves. The ability to depend on sound tax policy should not depend on the type or size of a business. Using LIFO to arbitrarily punish certain industries will unnecessarily risk supply chains, consumer costs, and jobs.

The Tax Policy Center article authors assert that the current inflationary economy argues for repeal of LIFO. In fact, the opposite is true. The post-COVID recovery, supply chain disruptions, reduced profit margins, and increased labor costs all contribute to the current economic challenges. If LIFO were repealed, companies would have to find ways to absorb those additional tax costs, and in many cases would have no choice but to try to pass those costs on through higher prices to their customers.

The LIFO Coalition would be happy to further discuss all of the aspects of LIFO, so please feel free to let us know if you would like more information.

Sincerely,

Jade West

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