

THE LIFO COALITION

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REASONS WHY LIFO METHOD SHOULD NOT BE REPEALED IN THE CONTEXT OF BUSINESS TAX REFORM

I. Background

The LIFO Coalition has previously provided its views as to why the LIFO inventory method, presently contained in section 472 of the Internal Revenue Code, is a proper method of accounting and should not be repealed as part of any general deficit reduction effort. These views were provided in connection with proposals by members of the Senate Finance Committee to repeal the LIFO inventory method in 2006 and in response to proposals by the Obama Administration to repeal the LIFO inventory method as part of the Administration's budget proposals for 2010 and 2011. The LIFO Coalition also provided its views on the propriety of the LIFO inventory method in the context of deliberations concerning possible tax reform by the President's Economic Recovery Advisory Board and the President's Deficit Reduction Commission.

Tax reform is prominently being mentioned as a subject that may be considered during the 112th Congress. In this context, the theme that has been discussed by the Obama Administration and some members of Congress is that business tax expenditures should be curtailed in exchange for a reduction in the business income tax rates in an effort to promote tax reform in a revenue neutral environment.

It is important to note that while the President and some in Congress were originally discussing reform only of corporate taxes, Subchapter S corporations and other pass-through business entities pay taxes at individual and not corporate rates. Reforming the corporate tax code while leaving individual rates unchanged would have dire consequences on the approximately 30 million Subchapter S corporations, as will be addressed later in this document.

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Since the LIFO inventory method is characterized as a tax expenditure in the list of tax expenditures prepared annually by the Staff of the Joint Committee on Taxation (“JCT Staff”), the propriety of retaining the LIFO inventory method in the Internal Revenue Code is again likely to be considered. However, in contrast to prior consideration of this subject, in the present circumstances, the use of the LIFO inventory method is not being singled out for possible elimination, but instead, the possible repeal of the LIFO inventory method is being considered together with other tax provisions that are included in the JCT Staff list of tax expenditures of businesses.

It is the position of The LIFO Coalition that the LIFO inventory method should not be classified as a tax expenditure and should not be eliminated from the Internal Revenue Code either as part of any deficit reduction effort or in exchange for a reduction in income tax rates as part of a revenue neutral tax reform program. While The LIFO Coalition takes no position on the desirability of tax reform generally, The LIFO Coalition submits that the elimination of the use of the LIFO inventory method for federal income tax purposes, whether or not in the context of a tax reform effort that entails broadening the business tax base in exchange for a reduction in tax rates, would be extremely damaging to users of the LIFO inventory method and cause lasting damage to the economy and job creation in the United States.

The reasons for The LIFO Coalition’s position are set forth below.

II. Summary of Reasons for Opposition to Repeal of the LIFO Inventory Method in the Context of Corporate Tax Reform

1. If tax expenditures are going to be the main category of provisions that will be considered as offsets for reductions in business tax rates in the context of tax reform, the system of classifying tax provisions as tax expenditures needs to be reviewed and drastically revised. The present criteria for including particular tax provisions in the annual list of tax expenditures reported by JCT Staff are neither logical nor internally consistent.

2. Whatever criteria are ultimately adopted for classifying tax provisions in the Internal Revenue Code as tax expenditures, the LIFO inventory method should not be classified as a tax expenditure. The LIFO inventory method is not a tax expenditure; it differs significantly from the other provisions now classified as tax expenditures in the JCT Staff’s annual list of tax expenditures.

3. The overwhelming majority of the revenue that would result from the repeal of the LIFO inventory method comes from the recovery of income taxes that were deferred in taxable years prior to the effective date of any repeal of the LIFO inventory method. Accordingly, in contrast to other tax expenditures that might be eliminated with prospective effect, the repeal of the LIFO inventory method would single out users of the LIFO inventory method for a unique *retroactive* increase in taxes.

4. Future tax rate reductions would in no way compensate companies for the damaging effects to their capital base resulting from the recapture of LIFO reserves into taxable income as a result of repeal of the LIFO inventory method. In addition, the damage to companies' capital base would not be eliminated by the allowance of an amortization period to recapture deferred taxes resulting from the repeal of the LIFO inventory method.

5. A majority of the businesses using the LIFO inventory method are smaller companies organized in the form of pass-through entities, such as partnerships or S corporations. The real owners of these entities are taxed at individual tax rates. Accordingly, any reduction in corporate income tax rates that might accompany a repeal of the LIFO inventory method and other tax expenditures employed by both non-corporate and corporate taxpayers would not provide any offsetting relief for pass-through entities. While this option was initially proposed by the Administration, it no longer appears to enjoy Administration support. It should be recognized, however, that should the option reemerge, its consequences for the small business community would be more devastating than any other alternative yet proposed.

6. Once companies' LIFO reserves are fully recovered through amortization into taxable income by reason of the repeal of the LIFO inventory method, the ongoing annual revenue savings from the elimination of the LIFO inventory method would not be significant. Thus, in contrast to other provisions listed as tax expenditures by JCT Staff, the repeal of the LIFO inventory method represents primarily a "one-shot" boost to federal revenues and would not pay for business tax rate reductions in taxable years outside the budget horizon.

7. Some commentators have mentioned that the LIFO inventory method may be repealed in the near future without Congressional action because of the forthcoming adoption of International Financial Reporting Standards ("IFRS") in the U.S. IFRS does not recognize the LIFO inventory method and taxpayers using the LIFO inventory method for federal income tax purposes must use that same method for financial reporting purposes, which would not be permissible if IFRS were adopted in the U.S.. However, such concerns are premature. The potential convergence between U.S. Generally Accepted Accounting Principles ("GAAP") and IFRS may not occur at all and, if convergence does occur, it may occur in a way that does not result in the elimination of the LIFO method for financial reporting purposes, thus avoiding a conflict between IFRS and the LIFO conformity requirement in sections 472(c) and (e) of the Internal Revenue Code.

8. Repeal of the LIFO inventory method will harm U.S.-based companies and benefit their foreign competitors. Since, as noted above, U.S. accounting standards (“U.S. GAAP”) permit the use of the LIFO inventory method, but international accounting standards (“IFRS”) do not permit the use of the LIFO inventory method, at present only U.S.-based companies are able to use the LIFO inventory method. As a result, if the LIFO inventory method is repealed, this action would raise taxes on U.S. companies, but not their foreign competitors. A compelling reason in support of retaining the LIFO inventory method is that it is one of the few tax incentives that enhances the competitiveness of U.S.-based companies in the global marketplace without violating the United States’ international trade obligations.

Each of these points is discussed in detail below.

III. Detailed Reasons for Opposing the Repeal of the LIFO Inventory Method

1. The Present System for Classifying Tax Expenditures by JCT is Not Logical, Uniform or Fair

Section 3(3) of the Congressional Budget and Impoundment Control Act of 1974 (the “1974 Budget Act”) defines “tax expenditures” as:

[T]hose revenue losses attributable to provisions of the Federal tax laws which allow a special exclusion, exemption, or deduction from gross income or which provide a special credit, a preferential rate of tax, or a deferral of tax liability . . .

Pub. L. No. 93-344, 93d Cong., 2d Sess., § 202(d) (1974).

The legislative history of the 1974 Budget Act further provides:

The term ‘tax expenditures’ means those Federal revenue losses attributable to provisions of the Federal tax laws which allow a special exclusion, exemption, or deduction from the taxpayer’s gross income, or which provide a special credit, a preferential rate of tax, or a deferral of tax liability representing a deviation from the normal tax structure for individuals and corporations.

S. Rep. No. 93-688, 93d Cong., 2d Sess. *reported in 1974 U.S.C. Congressional & Administrative News 3504, 3532 (1974).*

However, nowhere in the statute or legislative history of the 1974 Budget Act is there any description of what constitutes the “normal structure” of a tax law. There is no uniform definition of a “normal” income tax, so that deviations from such norm may be identified as tax expenditures. What is a special deduction, credit or preference may vary from one country’s tax laws to the next. Thus, there is no consensus as to what constitutes a tax expenditure.

This conclusion is confirmed by the following acknowledgement from a 2010 publication of the Office of Management and Budget:

A tax expenditure is an exception to baseline provisions of the tax structure that usually results in a reduction in the amount of tax owed. The 1974 Congressional Budget Act, which mandated the tax expenditure budget, did not specify the baseline provisions of the tax law. As noted previously, deciding whether provisions are exceptions, therefore, is a matter of judgment.

OMB, Analytical Perspectives, Budget of the U.S. Government, Fiscal Year 2010, at 298 (2010).

The LIFO inventory method is a perfect example of the imprecise nature of the concept of tax expenditures. While the LIFO inventory method has been part of the Internal Revenue Code since 1939, for over 33 years following the enactment of the 1974 Budget Act, the LIFO inventory method was not classified as a tax expenditure by JCT Staff.

However, in 2008, the JCT Staff performed a reexamination of the criteria for defining tax expenditures and JCT Staff issued a revision to its criteria. See Staff of the Joint Committee on Taxation, *A Reconsideration of Tax Expenditure Analysis* (JCX-37-08) (May 12, 2008). As a result of this reconsideration, JCT Staff began classifying the LIFO inventory method as a tax expenditure starting with the 2008 taxable year. Staff of the Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 2008-2012*, 21 (Oct. 31, 2008).

The JCT Staff’s reexamination of the concept of tax expenditures in 2008 was not prompted by any change in the 1974 Budget Act. Instead, as part of this reexamination, the JCT Staff on its own initiative simply invented a new class of tax expenditures that JCT Staff labeled “Tax-Induced Structural Distortions.” The JCT Staff then included the LIFO inventory method in this new class of tax expenditures. The actions of JCT Staff to include the LIFO inventory method in this new class of tax expenditures has had the effect of raising the profile of the LIFO inventory method and making it appear that this long-accepted method of inventory accounting that is permissible for GAAP is suddenly an exception from a “normal” income tax law.

The foregoing invention by JCT Staff of a new category of tax expenditures and the inclusion of the LIFO inventory method in such category of tax expenditures is surprising for several reasons. First, the Office of Management and Budget (“OMB”) publishes its own list of tax expenditures and the estimated revenue effects resulting from the inclusion of such provisions in the income tax laws. However, the OMB has not classified the LIFO inventory method as a tax expenditure either prior to 2008 or subsequent thereto, even though the JCT Staff now includes the LIFO inventory method in its list of tax expenditures. See Office of Management and Budget, *Analytical Perspectives, Budget of the U.S. Government, Fiscal Year 2010* (2010). This inconsistency in classification between two branches of government is particularly significant considering that the OMB under the Obama Administration has proposed that Congress repeal the LIFO inventory method. Thus, even though the Obama Administration favors the repeal of the LIFO method, the Obama Administration does not classify the LIFO inventory method as a tax expenditure.

Second, in conducting its reexamination of tax expenditures, JCT Staff was mindful of the criticism that would be attached to any effort to redefine tax expenditures in a way that was considered politically motivated. In this regard, JCT Staff noted in its initial implementation of new criteria for defining tax expenditures:

The concept of a normal tax baseline as the underpinning of tax expenditure analysis has evoked serious and continuous criticism, however, since its introduction in the late 1960s. Numerous tax academics and policy experts have rightly observed that the ideal “normal” tax system does not correspond to any generally accepted formal definition of net income. Instead, many observers view tax expenditure analysis, in the form envisioned by Stanley Surrey, as a thinly veiled agenda for a specific form of tax reform. Under this view, the normative tax system is not simply an analytical tool but is also an aspirational goal of the political process.

Tax expenditure analysis cannot serve as an effective and neutral analytical tool if the premise of the analysis (the validity of the “normal” tax base) is not universally accepted. The “normal” tax is admittedly a commonsense extension (and cleansing) of current tax policies, and not a rigorous framework developed from first principles. As a result, the normal tax cannot be defended from criticism as a series of ultimately subjective or pragmatic choices, and its use as a baseline has diminished the utility of tax expenditure analysis.

Staff of the Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 2008-2012*, 5 (Oct. 31, 2008).

Notwithstanding its own admonitions to the contrary, the JCT Staff embarked on what can only be perceived as a politically-motivated endeavor to create a new category of tax expenditures that it labeled “Tax-Induced Structural Distortions.” JCT Staff defines “Tax-Induced Structural Distortions” as follows:

Tax-induced Structural Distortions are structural elements of the Internal Revenue Code (not deviations from any clearly identifiable general tax rule and thus not Tax Subsidies) that materially affect economic decisions in a manner that imposes substantial economic efficiency costs.

Id. at 7.

The foregoing definition of a new category of tax expenditure bears no relationship to the definition of a tax expenditure contained in the 1974 Budget Act. The JCT Staff makes no effort to reconcile its definition of tax expenditures with the definition in the 1974 Budget Act. Any doubts as to JCT Staff’s motivations for adding this new category of tax expenditures are reinforced by JCT Staff’s decision to include the lower of cost or market inventory method in this new category of tax expenditures at the same time that it added the LIFO inventory method to the list of tax expenditures.

The specific definition of “tax expenditures” in the 1974 Budget Act clearly requires that in order to be classified as a “tax expenditure,” a tax provision must be reflected in a special provision in the tax statutes. However, the lower of cost or market inventory method has never been prescribed by statute. Thus, the inclusion of the lower of cost or market inventory valuation method in the JCT Staff’s list of tax expenditures is clearly inconsistent with the express terms of the 1974 Budget Act, which limits tax expenditures to provisions in a tax statute, not in income tax regulations.

The history of the lower of cost or market method is that the tax law in Code section 471, and its predecessors, dating back to 1918, simply contains a general authorization to the Secretary of Treasury to promulgate regulations stipulating which generally accepted inventory methods will be acceptable for federal income tax purposes. In 1918, the Treasury acted on this authorization to issue regulations accepting the use of the lower of cost or market method for federal income tax purposes. Moreover, apart from the fact that the lower of cost or market method is not a creature of statute, such method is part of the foundation of GAAP and has been an accepted method for federal income tax purposes for over 90 years. Such method was not classified as a tax expenditure by the JCT Staff for over 33 years following the enactment of the 1974 Budget Act. However, in 2008, the lower of cost or market method suddenly appeared in JCT’s annual list of tax expenditures.

JCT Staff's analysis of tax expenditures is rife with such inconsistencies. While the lower of cost or market method, which is not even specifically authorized by statute, is classified by JCT Staff as a tax expenditure, special *statutory* provisions such as the allowance of a reserve for inventory shrinkage in section 471(b) of the Code, the amortization of goodwill in section 197 of the Code and the amortization of business organizational expenses in section 248 of the Code are not classified as tax expenditures by JCT Staff.

Moreover, if Congress had intended the definition of tax expenditures in the 1974 Budget Act to include methods of accounting that are authorized by regulation or other administrative action of the Treasury Department, rather than expressly by statute, then why hasn't JCT Staff classified the progressive or rolling average inventory costing method permitted in Rev. Proc. 2008-43, 2008-2 C.B. 186, and the replacement cost method permitted in Rev. Proc. 2002-17, 2002-1 C.B. 676, and Rev. Proc. 2006-14, 2006-1 C.B. 350, as tax expenditures? Why isn't the retail inventory method authorized in Treas. Reg. § 1.471-8 classified as a tax expenditure? Why aren't all of the special inventory costing methods contained in the regulations under section 263A of the Code classified as tax expenditures?

The point of this exercise is not to cast aspersions on any of these other special methods of accounting for inventories, but rather to highlight the fact that a "normal" income tax law may accommodate a wide variation in accounting and inventory methods. What is special, or an exception from the norm, is an extremely vague standard. About the only conclusion one could draw from examining JCT Staff's list of tax expenditures is that methods of accounting seem to be included in, or excluded from, the list of tax expenditures depending on the whim of JCT Staff, rather than on the basis of a logical and consistent standard. In fact, an objective analysis of JCT Staff's list of tax expenditures might lead an observer to conclude that whether a method of accounting is singled out for inclusion in JCT Staff's list of tax expenditures depends more on whether the method is in or out of favor with JCT Staff, rather than on the nature of the method itself.

In conclusion, if Congress is going to use JCT Staff's list of tax expenditures as the starting point in looking for offsets to pay for a reduction in business tax rates, Congress needs to reevaluate the criteria being used by JCT Staff to determine what provisions are and are not classified as tax expenditures.

2. Under Any Rational Classification System, the LIFO Method Should Not be Classified as a Tax Expenditure

If the criteria for classifying provisions in the federal income tax law as tax expenditures are developed in an objective and logical way, the LIFO inventory method would surely be excluded from classification as a tax expenditure. Under any type of rational income tax system,

a reasonable method for distinguishing between merchandise that is sold and merchandise that remains in ending inventory would be absolutely indispensable. Moreover, a system for assigning costs to merchandise that is sold and to the merchandise that remains in ending inventory would also be essential.

One could argue that the “norm” for an income tax statute ought to be based on the specific identification and actual cost of the merchandise in ending inventory and the specific identification and actual cost of the merchandise that is sold, thus rendering any methods that deviate from such norm as tax expenditures. However, use of the specific identification method to identify merchandise in ending inventory or the tracking of the actual cost of merchandise in ending inventory are not possible in most cases. Most merchandise within a product category is homogenous in nature and tracking the actual cost of such merchandise is not feasible. Accordingly, any rational income tax system must permit the use of cost flow assumptions. Moreover, such cost flow assumptions need to be adaptable to accommodate the software systems commonly in use under modern computer technology.

There are presently in use for federal income tax purposes four different cost flow assumptions apart from the specific identification method: (1) the first-in, first-out method or “FIFO”; (2) the last-in, first-out method or “LIFO”; (3) the average cost method; and (4) the replacement cost method. Each of these methods reflects a reasonable, but significantly different, cost flow assumption. When prices of merchandise are rising, the LIFO method, followed by the replacement cost method, produces the largest cost of goods sold and the lowest amount of taxable income of the four methods. In contrast, when prices of merchandise are declining, the FIFO method, followed by the average cost method, produces the largest cost of goods sold and the lowest amount of taxable income of the four methods. When prices of merchandise are relatively stable, all four methods yield approximately the same result. Nevertheless, while all four cost flow assumptions are now permitted for tax purposes, only the LIFO inventory method is singled out for inclusion in JCT Staff’s list of tax expenditures. Moreover, for totally inexplicable reasons, the specific identification method for homogeneous merchandise is also listed as a tax expenditure, albeit with minimum revenue loss associated with such method.

In a 2010 study conducted by the Congressional Research Service (“CRS”) and published by the Senate Budget Committee, CRS offered several reasons for the inclusion of the LIFO inventory method in JCT Staff’s list of tax expenditures. See S. Rep. No. 111-58, TAX EXPENDITURES Compendium of Background Material on Individual Provisions, prepared by Congressional Research Service, 111th Cong., 2d Sess. 517-19 (Dec. 2010). In most respects, these reasons mirror those offered in JCT Staff’s initial classification of the LIFO inventory method as a tax expenditure in Staff of the Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 2008-2012*, 21 (Oct. 31, 2008).

First, CRS notes that while the specific identification method would be the norm for valuing inventory (while ignoring the fact that this method is listed as a tax expenditure), due to its impracticality in the case of homogeneous merchandise, CRS asserts that the FIFO inventory method should be considered the norm based on the expectation that companies would sell their oldest merchandise first. Second, CRS contends that all of the cost flow assumptions permit taxpayers to reduce their tax burden for the difference between the sales price and cost of the merchandise, but the FIFO inventory method comes closest to valuing inventory at its market value, whereas the LIFO inventory method permits inventory to be valued at a level below its market value. Finally, CRS asserts that the use of the LIFO inventory method facilitates tax planning opportunities that are not available to taxpayers using the FIFO inventory method. As examples, the CRS suggests that firms expecting a high tax liability may be able to purchase additional inventory at year end to increase costs and reduce taxable income, whereas firms expecting losses may reduce taxable income by shrinking inventory.

The reasons offered by the CRS are completely invalid and in some instances demonstrate a complete lack of understanding of how the inventory rules in general and the LIFO inventory method in particular operate. For example, the first reason that CRS offers to support the classification of the LIFO inventory method as a tax expenditure is that the method does not mirror the expected pattern of sales of merchandise by companies. However, in the case of homogeneous merchandise, there is no evidence that companies necessarily sell their oldest merchandise first. Moreover, the CRS' reasoning is internally inconsistent, as the CRS notes in its own study that "[a]llowing specific identification permits firms to select higher cost items and minimize taxable income."

The second reason that CRS offers as support for treating the LIFO inventory method as a tax expenditure is that the FIFO inventory method comes closest to valuing inventory at its fair market value, whereas the use of the LIFO inventory method permits companies to value their inventory at below its fair market value. However, no inventory system values inventory at its market value except for a "mark-to-market" system, such as is required by section 475 of the Code for securities dealers. Moreover, CRS cites nothing to support its unstated premise that valuing inventory at market value is a desirable goal that would be part of any normal income tax system. In fact, the "realization" concept, which is a cornerstone of the U.S. income tax system, is flatly inconsistent with the concept of valuing inventory at its market value. Moreover, one should not confuse offering prices for merchandise with its fair market value. The fact that a company offers its merchandise for sale at a particular price does not insure that a customer will actually buy the merchandise at that selling price or at any other price at which the merchandise is offered for sale. In fact, no one can say what is the fair market value of merchandise in inventory until someone actually buys the merchandise.

The final reason that the CRS offers for treating the LIFO inventory method as a tax expenditure confirms that the CRS does not understand how the LIFO inventory method operates. CRS suggests that companies expecting a high tax liability may purchase inventory at year end to lower their tax liability, whereas companies expecting losses can reduce their taxable income by shrinking inventory.

Taking CRS' first point, under any inventory system, the cost of purchases near year end that are included in ending inventory offset each other and have a neutral effect on taxable income except where the additional purchases are valued at less than their cost. However, under the LIFO inventory method, purchases of merchandise at the end of a taxable year are typically included in an increment in a taxpayer's LIFO inventory, which would be valued at the current-year cost of the purchased merchandise and thus would have no impact on taxable income. Alternatively, if decrement in LIFO inventory would otherwise be expected, taxpayers would not purchase additional inventory to *reduce* taxable income, as CRS claims. Moreover, the tax law is replete with provisions and court decisions that prevent taxpayers from engaging in tax-motivated purchases of LIFO inventory to manipulate their income. Thus, the CRS' concerns in this regard are totally misplaced.

The main reason in support of the LIFO inventory method is that if a company is to remain a going concern, the company must replenish or replace the inventory that it sells. If prices of merchandise are increasing and a company must pay an income tax based on the *historical* cost of the merchandise that is sold, but must pay for replacement merchandise at its higher *replacement* cost, the capital for such replenishment is eroded by the income tax that the company must pay on the inflationary increase in the cost of its inventory. Most merchants would not consider themselves enriched simply because they have the same quantity of inventory as in the previous year, but the inventory is now valued at a higher replacement cost. The LIFO method enables companies to finance the replacement of inventory that is sold by using the increased after-tax profit that results from employing the LIFO inventory method.

The CRS responds to this argument with two criticisms, neither of which is persuasive. First, the CRS argues that the LIFO inventory method defers or excludes *real* gains from income. However, the CRS fails to explain or justify its definition of *real* gains. The CRS illustrates its contention by focusing on the substantial increase in oil prices that occurred during the first half of 2008. In fact, most observers would regard the increase in oil prices that occurred during the first half of 2008 as a temporary aberration, in light of the sharp drop in oil prices that occurred thereafter. The LIFO method is designed to defer taxes on permanent increases in the replacement cost of merchandise that must be reinvested in a business in order for that business to remain a going concern. Moreover, the LIFO inventory method is an annual system that measures the change in the price of merchandise from one year end to the next year end. Temporary fluctuations in prices of merchandise within a year, such as the situation illustrated by CRS, have no real effect on companies' income tax liabilities when the LIFO inventory method is employed.

CRS' second argument against permitting the continued use of the LIFO inventory method is that the LIFO inventory method represents a form of indexation of inventories for inflation, a concept that CRS argues the federal income tax law does not permit for any other type of property. However, the CRS overlooks the role that the allowance of accelerated depreciation and MACRS depreciation periods play in the case of depreciable plant and equipment. While the allowance of accelerated depreciation and shorter MACRS depreciation periods may not represent indexation in form for capital equipment, these methods produce the same overall effect as indexation for capital investment. See Viard, "Why LIFO Repeal is not the Way to Go," TAX NOTES, 574 (Nov. 6, 2006).

Most merchandising companies' two largest investments that are necessary to remain a going concern are investment in plant and equipment and investment in inventory. Thus, it is appropriate to compare the tax treatment of these two investments. As Mr. Viard so eloquently explains in the above-cited article, the LIFO method of valuing inventories and the allowance of accelerated depreciation for plant and equipment may be viewed as equivalent tax treatment in substance, if not in form, of these two major asset classes.

In conclusion, the criticisms leveled at the LIFO inventory method by CRS in its recent study are not valid and should be rejected when considering the subject of tax reform.

3. The Repeal of the LIFO Inventory Method Would Represent a Unique Retroactive Tax Increase on Companies Using the LIFO Method

In marked contrast to the other provisions listed as tax expenditures in JCT Staff's annual study, the repeal of the LIFO inventory method would have a retroactive effect on users that would be unique in the annals of tax reform. Since any legislation to eliminate tax expenditures, including the LIFO inventory method, that might be enacted as an offset to lower income tax rates would undoubtedly have a prospective effective date, one might question how this form of legislation could be retroactive in effect insofar as the legislation might apply to the repeal of the LIFO inventory method.

To answer this question requires a brief explanation of how the LIFO inventory method works. Each year that a company employs the LIFO inventory method for federal income tax purposes, the taxpayer starts out by valuing the portion of its ending inventory equal in quantity to the quantity of merchandise in its beginning inventory at the original cost of the merchandise in beginning inventory. To the extent the quantity of merchandise in the ending inventory exceeds the quantity of merchandise in the beginning inventory, that increase or increment in quantity of merchandise is valued at its current-year cost. Over time, the effect of this methodology is to value the ending inventory at the historical cost of the merchandise when additional quantities of merchandise were first added to the company's ending inventory.

In addition to valuing its ending inventory under the LIFO inventory method, as described in the preceding paragraph, a company using the LIFO inventory method must also maintain a parallel record of what its inventory value would be each year if the company had used the FIFO inventory method. The cumulative difference between the value of a company's inventory based on the LIFO inventory method and the FIFO inventory method is referred to as a company's "LIFO reserve." Thus, the LIFO reserve represents the cumulative reduction in a company's ending inventory (and hence taxable income) that resulted from the use of the LIFO inventory method instead of the FIFO inventory method.

However, the term "LIFO reserve" is misleading in the sense that it does not represent actual funds set aside by a company to pay back the tax deferral reflected in the company's LIFO reserve. Instead, the LIFO reserve is merely a memorandum account that tracks the cumulative difference between the value of the company's inventory using the LIFO and FIFO inventory methods.

In the past, all of the legislative proposals to repeal the LIFO inventory method have included as a key feature the requirement that a company repay all of its cumulative prior tax savings from the use of the LIFO inventory method by including the amount of its LIFO reserve in taxable income when the use of the LIFO method is discontinued. Under some tax reform proposals, relief is provided in the form of an amortization of the amount of the recapture of the company's LIFO reserve over a period of years, such as 10 years.

Thus, the effect of the repeal of the LIFO inventory method would not be limited to the future use of the LIFO inventory method, but companies would have to pay back all of the historical tax savings that they enjoyed from the use of the LIFO method over the entire history of the company. As noted above, the LIFO inventory method has been part of the federal income tax law since 1939, so that for some companies, the LIFO reserve was built up over a period of more than 70 years.

There is no other provision listed as a tax expenditure by JCT Staff which, if repealed, would entail this type and degree of retroactivity. For example, if the use of accelerated depreciation and shorter MACRS depreciation periods were repealed to offset a reduction in business income tax rates, no one would suggest that taxpayers repay the tax savings that they enjoyed in all prior years by virtue of having claimed depreciation deductions on productive property for federal income tax purposes that exceeded straight line depreciation over the physical useful life of the productive property.

Moreover, it is unlikely that there is any other type of tax provision which could have the potential for this degree of retroactivity. The longest lived type of depreciable property has a MACRS depreciation period of 39.5 years, whereas most property is depreciated over a much shorter life. In theory, a company's LIFO reserve could have been built up over 70 years. In practice, the lion's share of companies adopted the LIFO inventory method in the early 1970s, meaning that for the typical company the LIFO reserve is at least 40 years old.

Based on inflation over this length of time, the typical company's LIFO inventory is valued at less than half of its FIFO value and its LIFO reserve could easily exceed the company's net worth. The income tax liability associated with recapturing this amount of LIFO reserve into taxable income would severely harm most companies and potentially bankrupt many of them. As noted above, the savings represented by a company's LIFO reserve is not sitting in a liquid investment awaiting the repayment; instead, the savings is reinvested annually in the company's inventory. In this sense, a company's LIFO reserve is different from a depreciation reserve that reflects tax savings which companies are expected to set aside in order to be available to replace plant and equipment that becomes obsolete. The tax savings from a company's LIFO reserve has already been spent because the savings is continually reinvested in replacement inventory.

These circumstances might cause an observer to wonder why anyone proposing the repeal of the LIFO inventory method would require the recapture of a company's LIFO reserve. The answer to that question is: "That's where the money is." The overwhelming share of the revenue raised by the repeal of the LIFO inventory method results from the recapture of companies' LIFO reserves. As an offset to reduced business tax rates, it's not worth repealing the LIFO inventory method if such repeal is not accompanied by a recapture of companies' LIFO reserves. Moreover, the complete forgiveness of companies' LIFO reserves as part of a repeal effort would amount to a revenue loss under current budget assumptions because, under current law, such reserves would have to be repaid if a company's assets were sold or the company went out of business and permanently reduced its inventories.

Therein lies the dilemma; the LIFO inventory method is the only tax expenditure listed by JCT Staff that needs to be repealed retroactively in order to raise the type of money needed to finance a significant reduction in income tax rates. For that reason, tax reformers will not relinquish retroactivity as part of the proposed repeal of the LIFO inventory method, but for that same reason, tax reform should not include the repeal of the LIFO inventory method.

4. Neither a Reduction in Business Tax Rates, Nor Amortization of the Recapture of LIFO Reserves, Would Eliminate the Damaging Effect of Recapture of a Company's LIFO Reserve

The premise of proponents of the idea of repealing the LIFO inventory method as part of business tax reform is that the additional income triggered by the requirement to recapture a company's LIFO reserve would be offset by the reduction in future income tax rates and the amortization of the recapture of the LIFO reserve over a period of years. Both of these premises do not withstand analysis.

First, with respect to the offset for reduced business tax rates, as noted above, the size of a company's LIFO reserve, particularly if the company has used the LIFO inventory method for an extended period of time, is likely to dwarf the future tax savings resulting from the reduction in tax rates. If one multiplies the annual inflation rate over the past several decades on a compounded basis by the amount of a company's inventory each year, it is not difficult to see how a company's cumulative LIFO reserve might exceed the company's entire taxable income for a taxable year, if not the company's entire net worth. No realistic amount of rate reduction will significantly ameliorate the size of that additional tax burden. Thus, while the impact of the ongoing disallowance of the LIFO method on future years' taxable income might be offset by future tax rate reductions, the tax burden of recapture of a company's entire LIFO reserve on top of the loss in the annual benefit from the LIFO inventory method cannot possibly be offset by future annual tax rate reductions.

Second, the fact that a LIFO repeal proposal permits amortization of the amount of recapture of a company's LIFO reserve will not materially ease the tax burden that accompanies the recapture of a company's LIFO reserve. Apart from the size of the typical company's LIFO reserve, the main reason why amortization would not materially ease a company's tax burden is because of the way that the LIFO inventory method operates. Companies using the LIFO inventory method do not expect to recapture their LIFO reserve, except as a result of transactions that generate cash to pay the resulting recapture tax.

The LIFO inventory method is designed to indefinitely defer the tax on any inflationary gain in the value of inventories that remains reinvested in replacement merchandise. As noted in the preceding section, as long as actual deflation does not occur, if a company's ending inventory equals or exceeds its beginning inventory in real quantity terms, a company's LIFO reserve will either increase in amount or remain steady and, accordingly, will not be recaptured into taxable income.

Recapture of a company's LIFO reserve into taxable income ordinarily occurs only when a company experiences a permanent decline in the level of its inventories. In such circumstances, cash is freed up from the sale of inventory that is not replenished, so that repayment of the prior tax savings from the use of the LIFO inventory method at such time is both logical and appropriate.

In contrast, if a company must repay the tax savings from the prior use of the LIFO inventory method at a time when the company's inventory is not declining in real quantity terms, such as by reason of the repeal of the LIFO inventory method, cash will not be readily available from the sale of inventory to pay the increased tax burden caused by the recapture of LIFO reserves. In such circumstances, amortization over a period of years of the tax burden resulting from recapture of LIFO reserves is not a sufficient offset to enable a company to finance its increased tax burden because the tax savings from the prior use of the LIFO inventory method remain invested in the company's inventory in these circumstances. Thus, a company would be faced with the choice of either shrinking its business or financing its inventory through additional borrowings, assuming that credit is available.

Accordingly recapture of a company's LIFO reserve in a setting where inventories are not reduced is a recipe for disaster. Companies will be forced to either shrink in size or go out of business in order to pay the tax on the recapture of LIFO reserves. Business tax rate reductions and amortization of the LIFO reserve recapture amount will not eliminate the significant additional tax burden placed on companies by the repeal of the LIFO inventory method.

5. Many Companies Using The LIFO Inventory Method Do Not Operate In Corporate Form And Would Not Benefit If Only Corporate Tax Rate Reductions Are Considered To Offset The Repeal Of The LIFO Inventory Method And Other Tax Expenditures Employed By Both Non-Corporate And Corporate Taxpayers

The use of the LIFO inventory method is not restricted to large, publicly-held corporations; the method is available to all taxpayers with inventories. See S. Rep. No. 648, 76th Cong., 1st Sess., 1939-2 C.B. 524, 528. Moreover, as the CRS notes in its study of tax expenditures, apart from its use in certain basic manufacturing industries such as petroleum, chemicals and metals, the LIFO inventory method is most prevalent in industries such as motor vehicles (i.e., dealers), food and beverage and general merchandise retailers. See S. Rep. No. 111-58, TAX EXPENDITURES Compendium of Background Material on Individual Provisions, prepared by Congressional Research Service, 111th Cong., 2d Sess. 517, 518 (Dec. 2010).

In fact, as the membership of the LIFO Coalition underscores, LIFO is used by a far broader range of businesses and industries than CRS identified. (A copy of the membership list of the Coalition is appended to this document.) As reported in a study by Georgia Tech, more than a third of U.S companies (36%) use the LIFO inventory system. Clearly, repeal of LIFO would not be removal of a narrowly-used tax deduction or preference and would have widespread consequences.

http://smartech.gatech.edu/bitstream/handle/1853/26316/fal_ga_tech_cf_lifo_2008.pdf?sequence=1)

Many of the businesses operating in these industries, as well as other industries where the use of the LIFO inventory method is prevalent, are relatively small businesses. The use of the LIFO inventory method by small businesses is manifested in the composition of the membership of The LIFO Coalition. The lion's share of the trade associations that make up the core of the membership of The LIFO Coalition represent small businesses that employ the LIFO inventory method.

Many, if not most, of these small businesses are organized in non-corporate form. For example, many of the businesses that employ the LIFO inventory method are organized as pass-through entities and are taxed either as S corporations or partnerships. Businesses organized as S corporations or partnerships are not taxed at the entity level at the rate of tax imposed on corporations. Instead, the individual owners of these businesses are taxed and they are taxed at individual tax rates.

Accordingly, the main premise of one type of tax reform that has been discussed, which is to broaden the tax base for corporations while lowering the rate of tax on corporations, would simply be inapplicable to many users of the LIFO inventory method . Repealing that method in exchange for a reduction in corporate tax rates which does not benefit a user of the LIFO inventory method would impose an enormous burden on small businesses not taxed as corporations and would undoubtedly lead to a significant number of business failures.

As noted above, The LIFO Coalition submits that even for corporate taxpayers, tax reform that entails a reduction in corporate tax rates in exchange for the repeal of the LIFO method and other provisions listed as tax expenditures by JCT Staff, will not make corporations whole, given the size of the typical LIFO reserve relative to a company's net worth. For non-corporate businesses, repeal of the LIFO inventory method in exchange for rate reductions that benefit only corporate entities would be an unmitigated disaster in financial terms. It's hard to conceive of another tax provision the repeal of which would destroy more businesses and eliminate more jobs than repeal of the LIFO inventory method so constructed.

6. The Repeal of the LIFO Inventory Method Will Not Pay for Lower Business Tax Rates in the Long Term

As noted above, the vast majority of the revenue raised from the repeal of the LIFO inventory method comes from the recapture of companies' existing LIFO reserves. A much smaller portion of the revenue that would be raised from the repeal of the LIFO inventory method would come from the ongoing effects of the elimination of the LIFO inventory method.

This disparity in revenue sources derives from the fact that for companies that have used the LIFO inventory method for many years (which is the case for most companies), the amount of the company's LIFO reserve is usually a significant multiple of the annual increase in the company's LIFO reserve. Thus, for example, assuming relatively uniform inflation rates over time of between three to five percent and relatively constant inventory levels over the period of usage of the LIFO inventory method, one would expect that the annual revenue gain from the repeal of the LIFO inventory method for a company that employed the LIFO inventory method for 40 years would be small fraction of the company's cumulative LIFO reserve.

In addition, the rate of inflation in the United States for the past few years has been relatively modest. In contrast, the inflation rate in the United States over the past forty years has greatly exceeded the recent rate of inflation. Accordingly, a company's cumulative LIFO reserve is likely to greatly exceed the result of multiplying the current inflation rate by the number of years that the LIFO method has been employed and multiplying that amount by the average cost of inventory at the company.

One additional reason why projected future savings from the repeal of the LIFO inventory method is comparatively modest is the fact that companies have been reducing the levels of inventory that they maintain by relying on computerized order and record keeping systems, such as just-in-time inventory systems, in order to minimize the capital tied up in inventory. Accordingly, future revenue projections do not take into account much growth in the levels of LIFO inventories.

The conclusion that consideration of all of these factors leads to is that once current LIFO reserves are fully included in taxable income through amortization over some period of time, ongoing revenue savings from the repeal of the LIFO inventory method will not be available in significant enough amounts to balance out the long-term costs of business tax rate reductions. This is in marked contrast to other tax expenditures listed by JCT Staff which display consistent or increasing revenue gains resulting from their repeal. This point is masked in the Obama Administration's proposal to eliminate the LIFO inventory method because the projected revenue gains from the proposal are shown through only the budget time horizon of ten years.

Accordingly, the repeal of the LIFO inventory method would prove to be a highly temporary and unreliable source of significant revenue after the amortization of companies' LIFO reserves is completed.

7. The Potential Impact of Convergence with IFRS Should Not Affect or Influence Decisions About the Retention of the LIFO Inventory Method

One final reason that the Obama Administration has offered in support of its proposal to repeal the LIFO inventory method is that the Securities and Exchange Commission ("SEC") is giving serious consideration to requiring SEC registrants to issue their financial statements in compliance with IFRS. Because it is based primarily on European accounting standards where the LIFO method is not widely used, IFRS does not permit the use of the LIFO inventory method in reporting net income for financial reporting purposes. However, section 472(c) and (e)(2) of the Internal Revenue Code require as a condition for companies to use the LIFO inventory method for federal income tax purposes that they use no method other than the LIFO method in reporting their net income for financial reporting purposes.

Accordingly, if the use of IFRS is required for SEC registrants, those companies may be barred from continuing to use the LIFO inventory method for federal income tax purposes. Thus, the argument is made that the LIFO method may well be eliminated as a practical matter in the near future and Congress should take action before this happens in order to take credit for the revenue gain that would result from the repeal of the LIFO inventory method.

However, this reasoning is flawed and, in any event, is premature. As to the timing of any decision about IFRS, the SEC is still deciding whether to require the use of IFRS by SEC registrants and, if so, on what timetable. In addition, there have been recent pronouncements by SEC officials suggesting that even if the SEC decides to mandate a conversion from U.S. GAAP to IFRS, the SEC might require the use of IFRS on a piecemeal basis so that U.S. GAAP would be preserved. Since the LIFO inventory method is clearly an accepted inventory valuation method under U.S. GAAP, these pronouncements leave open the possibility that even if IFRS were ultimately adopted in the U.S., the adoption of IFRS would not result in a prohibition against the use of the LIFO inventory method for financial reporting purposes.

In addition, wholly apart from the uncertain timing and scope of any decision concerning the possible adoption of IFRS in the U.S., any requirement that U.S. companies follow IFRS and discontinue using the LIFO inventory method in computing net income in the body of their financial statements would not automatically result in the termination of the use of the LIFO inventory method for federal income tax purposes. Under the Internal Revenue Code, the Treasury has broad discretion to permit the continued use of the LIFO inventory method in these circumstances. Accordingly, it does not necessarily follow that adoption of IFRS in the U.S. will result in the termination of the LIFO method for tax purposes.

In sum, the possibility of changes in the financial accounting world should not influence any decision on whether to repeal the LIFO inventory method based on its own merits.

8. Repeal of the LIFO Inventory Method will Harm U.S.-Based Companies and Benefit their Foreign Competitors.

Under the U.S. worldwide system of taxation, U.S.-based companies face both a high U.S. statutory tax rate and remain subject to tax on their foreign earnings when repatriated to the United States. It is well established that these factors contribute to U.S.-based companies that operate worldwide bearing effective tax rates that are among the highest in the world. *See, e.g.,* Chen and Mintz, “New Estimates of Effective Corporate Tax Rates on Business Investment,” Cato Institute (Feb. 1, 2011) reported in TAX NOTES TODAY, 2011 TNT 37-17 (Feb. 24, 2011). Chen and Mintz note that the effective U.S. tax rate on corporations was 34.6 percent in 2010, which was the highest rate in the Organization for Economic Cooperation and Development and the fifth highest rate among 83 countries in the world. Moreover, this study is not just based on statutory tax rates, but takes into account such tax provisions as accelerated depreciation and inventory allowances:

This bulletin presents estimates of effective corporate tax rates on new capital investment for 83 countries. “Effective” tax rates take into account statutory rates plus tax-base items that affect taxes paid on new investment, such as depreciation deductions, inventory allowances, and interest deductions.

Id.

One can infer from the Chen and Mintz study that the detrimental impact of such high effective tax rates on the competitiveness of U.S.-based companies is mitigated to a limited degree by the LIFO inventory method. As noted above, only U.S. companies use the LIFO inventory method, which allows them to better compete against foreign-based companies who are generally subject to lower effective tax rates, but cannot use the LIFO inventory method under international accounting standards.

As the Congress and the Administration consider how to revise the tax code to encourage the competitiveness of U.S.-based companies, the United States must be mindful that any export subsidies it considers must be consistent with the United States' international trade obligations, particularly those imposed by the World Trade Organization (“WTO”). Indeed, a number of prior export subsidies, such as the foreign sales corporation and extraterritorial income regimes, have been found to violate these obligations and were required to be repealed. The LIFO inventory method, by contrast, has not been subject to challenge by the WTO and, therefore, remains a permissible means to encourage U.S.-based companies to manufacture and export domestic products in the global marketplace.

In light of the fact that the LIFO inventory method: (i) allows U.S.-based companies to better compete against foreign-based companies that are generally subject to lower effective tax rates, and (ii) is consistent with the United States' international trade obligations, it is essential that the LIFO inventory method be retained in the tax code, regardless of any tax reform effort. Moreover, as the Chen and Mintz study confirms, repeal of the LIFO inventory method, along with other tax expenditures, in exchange for lower business statutory tax rates, will still leave corporations with an effective tax rate that is among the highest in the world.

IV. Conclusion

In the final analysis, repeal of the LIFO inventory method, in the context of business tax reform that involves base broadening in exchange for lower statutory tax rates, will not accomplish the goal of lowering the *effective* tax rate on businesses. Repeal of the LIFO inventory method will not enhance the competitiveness of U.S. businesses in the worldwide marketplace and, in fact, will damage the capital position of businesses in many industries that rely on the LIFO inventory method to finance their replacement of inventory in an inflationary environment. Finally, even if individual tax rates are reduced for businesses operating in non-corporate form, such as pass-through entities, repeal of the LIFO inventory method will severely damage such businesses, which are the life-blood of job creation in the United States. Moreover, without such rate reductions, the effect of the repeal of the LIFO method on small businesses would be devastating.