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February 17, 2012

MEMORANDUM

TO: The LIFO Coalition

FROM: Les Schneider
Ivins, Phillips & Barker
Tax Counsel to The LIFO Coalition

RE: Current Developments with Respect to U.S. Adoption of IFRS and Impact on LIFO Conformity

Executive Summary

It is increasingly unlikely that the Securities and Exchange Commission (SEC) will fully adopt the International Financial Reporting Standards (IFRS) or disallow LIFO as an inventory accounting method in the United States. Therefore, the LIFO conformity requirement is not likely to be the cause of the discontinuance of the use of the LIFO method for federal income tax purposes.

Without the threat of imminent repeal of the LIFO method as a result of convergence with IFRS, any Congressional reconsideration of the use of the LIFO method for tax purposes should be based on the merits of the method as a structural part of the tax law and not as a response to external actions on the part of financial accounting authorities, such as the SEC or the International Accounting Standards Board (IASB).

Therefore, from the point of view of revenue scoring, there is no reason for the Congress to rush any reconsideration of the LIFO method. The LIFO method may safely be assumed to be part of existing law; and that assumption is unlikely to change in the near future and may in fact never change.

The purpose of this memorandum is to provide members of The LIFO Coalition with an update on the progress of the Securities and Exchange Commission's ("SEC") consideration of a requirement that SEC registrants adopt International Financial Accounting Standards ("IFRS") in their financial reports to the SEC and the impact that such a requirement would have on taxpayers' ability to comply with the LIFO conformity requirement contained in sections 472(c) and (e)(2) of the Internal Revenue Code ("IRC"). As explained below, I am happy to report, based on recent developments, that it is *unlikely* that the potential acceptance by the SEC of the use of IFRS in financial reports of SEC registrants will pose a threat to the continued availability of the LIFO method for federal income tax purposes.

Background

As you are aware, IRC sections 472(c) and (e)(2) require that in order for a taxpayer to be able to use the LIFO inventory method to compute taxable income for federal income tax purposes, the taxpayer must use no method other than the LIFO method in computing its net income for financial reporting purposes (the so-called "LIFO conformity requirement"). Currently, under U.S. generally accepted accounting principles ("GAAP"), the LIFO method is a permissible method of inventory valuation for financial reporting purposes. Accordingly, taxpayers desiring to use the LIFO method for federal income tax purposes are able to use the LIFO method in their financial statements and thereby comply with the LIFO conformity requirement in the tax law.

However, under the version of IFRS that has been adopted throughout most of Europe, the LIFO inventory method is not recognized as an acceptable method of valuing inventory for financial reporting purposes. IAS 2, IN 13 (Dec. 2004). Accordingly, if a U.S. taxpayer were to become subject to IFRS in the form that it has been adopted in Europe, that taxpayer would have difficulty complying with the LIFO conformity requirement in the U.S. tax law. In such circumstances, the Internal Revenue Service ("IRS") would require the taxpayer to discontinue its use of the LIFO method for tax purposes and report as taxable income its entire LIFO reserve (i.e., the cumulative difference between the value of the taxpayer's inventory on the LIFO method compared with the FIFO method). While The LIFO Coalition has advocated that the U.S. Treasury Department take administrative action to avoid such a result, to date no action on this subject has been taken by either the Treasury or IRS.

In its annual budget proposals, the Obama Administration has repeatedly requested that Congress repeal the availability of the LIFO inventory method for U.S. taxpayers. One of the main reasons offered by some proponents of the repeal of the LIFO method for tax purposes is that, in their view, the adoption of IFRS by the SEC for SEC registrants is inevitable and, thus, the LIFO method is likely to be effectively repealed through the application of the LIFO conformity requirement to taxpayers that must use IFRS in their financial statements. Accordingly, these proponents of LIFO repeal reason that if the use of the LIFO method for tax purposes is likely to be eliminated eventually through the application of the LIFO conformity requirement, Congress may as well take revenue scoring credit for the elimination of the LIFO method by statutorily repealing the method in advance of the adoption of IFRS in the U.S.

Historical Approach to Converging GAAP and IFRS

Up until a few years ago, the sentiment among financial accounting authorities and the business community in the U.S. was that the principles contained in U.S. GAAP and IFRS should be conformed and a single, world-wide set of accounting principles should be adopted. Accordingly, the Financial Accounting Standards Board ("FASB"), the organization responsible for promulgating U.S. GAAP, and the International Accounting Standards Board ("IASB"), the organization responsible for promulgating international accounting standards, agreed to periodically establish joint projects, wherein the two organizations would jointly review the financial accounting treatment of a particular subject or category of transactions in an attempt to narrow or eliminate the differences in accounting rules between U.S. GAAP and IFRS by establishing a single, unified, set of accounting principles. It was thought that this approach might eventually result in the complete elimination of any differences between the U.S. GAAP and IFRS accounting principles, thereby avoiding the need for formal action to converge the two sets of rules.

However, due to the numerous differences between U.S. GAAP and IFRS, the foregoing project-oriented approach progressed very slowly and, in some cases, resulted in the two authorities being unable to agree completely on a single set of rules. It also became readily apparent that it might take many years before the accounting principles under U.S. GAAP and IFRS were substantially conformed. Accordingly, in late 2008, the SEC announced that it would consider whether to speed up the convergence process and lend an official regulatory blessing to convergence by adopting a rule requiring SEC registrants to convert their financial statements to IFRS, without waiting for the respective accounting boards to narrow or eliminate the differences between U.S. GAAP and IFRS. SEC "Roadmap for the Potential Use of Financial Statements Prepared in Accordance with International Financial Reporting Standards by U.S. Issuers," Securities Act Release No. 33-8982, Exchange Act Release No. 34-58960 (Nov. 14, 2008).

Commentators in the U.S. and abroad interpreted the foregoing announcement as a precursor to the eventual replacement of U.S. GAAP by IFRS. It was also thought that this action would have the additional consequence that the FASB would cease to exist and the U.S. would play no independent role in the development of financial accounting principles in the future. Finally, commentators speculated that such event would take place over a relatively short time frame, with the replacement of U.S. GAAP by IFRS occurring by 2015 or 2016, at the latest.

It was thought that this outcome would have two main consequences for users of the LIFO method for federal income tax purposes. First, it would mean that beginning in 2015 or 2016, users of the LIFO method would be forced to terminate their use of the LIFO method for federal income tax purposes and recapture into taxable income a very substantial additional amount of taxable income that would be tantamount to a retroactive tax increase. Second, this anticipated schedule for convergence of U.S. GAAP with IFRS would impose a very short deadline on Congress to take affirmative action to statutorily repeal the use of the LIFO method for federal income tax purposes, if Congress wanted to take revenue scoring credit for the tax savings resulting from the elimination of the LIFO method.

Recent Developments with Regard to Convergence of U.S. GAAP and IFRS

However, two events have recently transpired that cast considerable doubt on the foregoing scenario. First, the SEC announced that it needed additional time to make a decision about a requirement to compel SEC registrants to adopt IFRS in preparing their financial statements. However, this delay is temporary and the SEC is considered likely to announce its decision concerning convergence between U.S. GAAP and IFRS later this year.

Second, and even more importantly, the form of convergence between U.S. GAAP and IFRS that the SEC is contemplating endorsing is not the previously-anticipated complete elimination of U.S. GAAP and the substitution of IFRS for U.S. GAAP. Instead, indications from representatives of the SEC are that the type of convergence between U.S. GAAP and IFRS that the SEC is likely to bless will take the form of "condorsement." SEC Staff Paper, "Work Plan for the Consideration of Incorporating International Financial Reporting Standards into the Financial Reporting system for U.S. Issuers – Exploring a Possible Method of Incorporation" (May 26, 2011). *See, also.*, M. Lamoreaux, "Beyond Convergence SEC Staff Floats Compromise on Transition to IFRS,: J. ACCNTCY (Aug. 2011) (Under the convergence approach, jurisdictions do not adopt IFRS as issued by IASB or incorporate IFRS into their accounting standards directly, according to the SEC staff paper. Instead, these jurisdictions maintain their local standards but make efforts to converge those bodies of standards with IFRS over time."). Thus, under this form of convergence, the FASB would remain in place and the FASB would consider for each type of transaction whether to adopt for U.S. GAAP purposes the

IFRS reporting position based on its own merit. Under that approach to convergence, for a given type of transaction, the FASB might decide to adopt only a portion of the IFRS reporting position, it might adopt the entire position, or no portion of the IFRS position.

In the end, such an approach might result in partial convergence of U.S. GAAP with IFRS, or even a convergence of a preponderance of the two sets of rules, but not necessarily complete convergence between the U.S. GAAP and IFRS rules. Moreover, such an outcome would not result in the total subservience to the IFRS reporting rules that would have occurred if the use of IFRS in U.S. financial statements were simply mandated by the SEC.

Instead, under the form of convergence that is now being contemplated by the SEC, U.S. accounting authorities might very well preserve the option under U.S. GAAP to use the LIFO method to value inventory, notwithstanding its prohibition under IFRS. Given the long-standing support for such method among U.S. accounting authorities and the dramatic adverse economic impact that the prohibition of the use of LIFO for financial reporting purposes would have on companies' federal income tax liability, the retention of the LIFO method for U.S. GAAP seems increasingly likely under the "condorsement" approach.

Conclusions

The foregoing developments have considerable import for Congressional reconsideration of the LIFO method, either as part of general tax reform or as a separate revenue raising measure. First, the elimination of the LIFO method for financial reporting purposes is by no means inevitable. As a result, the LIFO conformity requirement is not likely to be the cause of the discontinuance of the use of the LIFO method for federal income tax purposes.

Second, without the threat on the horizon of imminent repeal of the LIFO method for tax purposes as a result of widespread LIFO conformity violations, any Congressional reconsideration of the use of the LIFO method for tax purposes should be based on the merits of the method and not as a response to external pressure from financial accounting authorities, such as the SEC or IASB.

Third, from the point of view of revenue scoring, there is no reason for the Congress to rush any reconsideration of the LIFO method. By whatever standard one uses to determine existing law, for purposes of estimating the revenue effect of potential Congressional action to reconsider the availability of the LIFO method, the LIFO method may safely be assumed to be part of existing law. That assumption is unlikely to change in the near future and may in fact never change.

"Leslie J. Schneider is a partner in the tax firm of Ivins, Phillips & Barker, in its Washington office. His practice concentrates in accounting methods, in particular inventories. Mr. Schneider is most often recognized for his three-volume treatise, *Federal Income Taxation of Inventories*, published by Matthew-Bender. Mr. Schneider has a reputation as the premier attorney in the United States in the field of tax accounting and inventories. He has represented over half of the companies in the Fortune 500, as well as most of the leading accounting firms in the United States."