THE LIFO COALITION

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THE ADMINISTRATION'S LIFO REPEAL PROPOSAL: HISTORICALLY UNPRECEDENTED RETROACTIVITY

A Brief Background on LIFO.

LIFO is an accounting method used by businesses which maintain inventory to clearly determine both "book" income and tax liability and has been an accepted and established accounting method in the United States for 70 years. LIFO and FIFO (first-in, first-out) in fact achieve the same purpose: most closely matching cost of goods sold with cost of purchasing replacement inventory. LIFO is used extensively by both publicly-traded and privately-held companies, manufacturers, extractive industries, wholesaler-distributors, retailers, newspapers, automobile and equipment dealers, and a wide range of other businesses. According to two separate recent studies, one by Georgia Institute of Technology and the other by the American Institute of Certified Public Accountants, LIFO is used by between 36% and 40% of businesses in every industry sector that maintains inventories. It is widely used by small businesses and is particularly important to businesses which have thin capitalization, small profit margins, and/or particular sensitivity to rising materials costs. Many of these companies have been on LIFO for decades, creating many years of LIFO reserves.

The Repeal Proposals.

The Obama Administration has continued to call for LIFO repeal in its annual Budget submissions to Congress, including the Fiscal Year 2013 Budget. The Administration's proposal would not, however, simply prohibit the use of the method prospectively. Rather, it would require each LIFO taxpayer to take into income over a 10-year period the full amount of the taxpayer's LIFO "reserve," which, as will be discussed more fully below, is equivalent to the amount of all deductions of the taxpayer attributable to the LIFO method ever since that method was first adopted by the taxpayer. In effect, therefore, it would retroactively repeal all of those deductions – in some cases deductions taken by the taxpayer as many as 50, 60 or 70 years ago. The extent of this retroactive reach by the government appears to be unprecedented in the history of the Internal Revenue Code.

The FY 2013 proposal has been scored by the Joint Committee on Taxation as generating approximately $74 billion in revenue for the federal treasury over 10 years. What is often not understood, however, is that by far the most significant portion of that revenue would come from the retroactive feature of the proposal just described. The adoption of that feature would be analogous to a repeal of the tax code's bonus and other accelerated depreciation provisions not only for future acquisitions of depreciable property, but also for all previous acquisitions for which tax savings had been enjoyed by the taxpayer under the provisions – i.e., the taxpayer would be required to pay back all of those tax savings retroactively. It is hard to imagine the Congress adopting an accelerated depreciation repeal so configured.

The purpose of the discussion that follows is to attempt to describe the mechanism by which this retroactivity would come about under the LIFO proposal and how that retroactivity would result in excessively harsh – it is fair to say punitive – treatment of taxpayers during already challenging times.

The LIFO "reserve" – What is it?

The retroactive repeal of decades-old deductions referred to above would result from the proposal's requirement that a LIFO taxpayer's LIFO "reserve" must be "recaptured" under the terms of the proposal. An understanding of this result may be facilitated by an explanation of the concept of a LIFO "reserve." To begin, the value of the LIFO method to a tax paying company is that, in periods of rising prices such as those typically experienced since the LIFO method was included in the tax code more than 70 years ago, the method allows the company to assume that the inventory sold during any given year is the company's higher-priced inventory – the "last in" – rather than the company's lower-priced inventory – the "first in" – which the company would be required to assume had been sold during the year if the company were on the alternative FIFO method. The company therefore is typically permitted to take a higher deduction under LIFO during a given year for the cost of the goods sold by the company in that year than would be permissible under FIFO.[1] The "reserve" the company is required to establish – which is not an actual accumulation of company funds, but rather a figure the company is simply required to compute and record – represents the difference between these two deduction amounts. The company is required to add each year to the reserve the difference between the amount of its cost-of-goods-sold deduction under LIFO and the amount of the deduction that would have been allowed to the company under FIFO. At any given time, therefore, the company's LIFO reserve is the cumulative amount over the years of these "incremental deductions" permissible under LIFO but not under FIFO. [2]

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[1] A taxpayer's cost of goods sold as a technical matter is not actually a deduction from gross income but is rather an element of gross income that reduces the gross income amount before adjustments and deductions are applied to that amount. Treas. Reg. § 1.61-3. Since that cost operates in a manner similar to a deduction, however, and is often referred to in common parlance as a deduction, this paper will refer to it as such.

[2] It is worth repeating that there *neither is nor ever was* any cash in a company's LIFO reserve. The tax savings the company received were invested back into the company to purchase replacement inventory, thus contributing to economic growth and job creation. With no actual cash in the reserve, repeal of LIFO

<u>"Recapture" of the reserve – Why it amounts to unprecedented retroactivity.</u>

A significant feature of the reserve requirement is that it provides a mechanism for the "recapture" – or the taking into income – by the taxpayer of the amount of the reserve in certain defined circumstances. When the reserve is taken into income, this has the effect of undoing, or retroactively repealing, the deductions that were responsible for the build-up of the reserve. The deductions that are repealed are, as noted, the amount by which the deductions allowed the taxpayer under LIFO exceed those that would have been allowed under FIFO. Recapturing the reserve effectively puts the taxpayer in the same position as if the taxpayer had been on FIFO all along and had never had the tax benefits of LIFO accounting.

The tax code currently provides that a taxpayer's LIFO reserve will be totally recaptured only under certain conditions. Principal among these is when the company undergoes a complete liquidation of its assets, including its inventories. LIFO taxpayers have long been aware that the very significant consequences of recapture would be triggered by any such action by the company. Taxpayers have *not* operated on the assumption, however, that such consequences would be triggered by an act of law, and that all of the deductions associated with their use of the LIFO method over the life of the company would be retroactively repealed by such legislation. Yet the Administration's proposal to recapture existing LIFO reserves over a 10-year time frame would produce just such a repeal. The taxpayers would be treated as if they had been on FIFO all along and would be deprived retroactively of all the tax benefits they had received – sometimes over the course of many decades – from their use of LIFO accounting.

Moreover, they would be required to pay back those tax benefits at a time when they have generated no cash to enable them to do so. While a company's liquidation of its inventories and other assets under current law typically can be expected to produce substantial amounts of cash with which to pay the resulting LIFO recapture tax bill, the proposed repeal will generate no cash whatever. Affected taxpayers, accordingly, will be forced to borrow very large sums of money, if indeed they can obtain such financing at all. The impact of such a significant and retroactive tax increase on economic recovery and job creation cannot be overstated.

<u>Retroactivity would be extremely unfair and extremely harsh to affected companies.</u>

The proposal is unfair because it departs so dramatically from the taxpayer expectations just described. As noted, existing law has long provided that reserves will be recaptured only under certain conditions, and it is now proposed to require recapture even in the absence of those conditions. The harshness of the proposal results from the magnitude of the reserves involved.

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would require affected companies to find or borrow the funds to pay the recapture tax. With 36- 40 % of U.S companies using LIFO, the resulting huge demand for credit to pay recapture taxes would in many circumstances have a damaging impact on credit availability and interest rates. A seriously adverse macroeconomic impact could also be expected, since available credit resources would be tapped not to help create jobs and grow the economy, but to transfer funds in payment of retroactive taxes.

Because the LIFO method has been authorized for more than 70 years, many companies have accumulated extraordinarily large reserves over time. In many cases these reserves are greater than the net worth of the company. The tax liability associated with taking those reserves into income, even over a 10-year period, would severely harm large numbers of businesses and would render many of them insolvent. Enacting the legislation in the midst of the nation's current adverse economic circumstances no doubt would add to the disruption by creating a serious chilling effect on competitiveness and job creation at a fragile time.[3] While the Administration's proposal would not trigger recapture until 2014, the prospect of these very large tax liabilities for affected companies inevitably would reduce available credit and investment capital for these companies immediately upon enactment of the proposal.

Conclusion.

For the reasons discussed, the Administration's and other similarly configured proposals to repeal LIFO should be strongly opposed. This discussion has focused solely on the problems associated with the retroactive effect of the Administration's proposal, which is perhaps that proposal's most undesirable feature. The proposal should be rejected, however, for other reasons as well. LIFO is an accepted and longstanding accounting method that remains as conceptually sound as it was when it was first approved by the Congress. There would be no justification for repealing the method, especially in the current economic and employment circumstances, even if the repeal were prospective only. The fact that the proposed repeal involves a degree of retroactivity not seen elsewhere in the tax code, however, provides sufficient reason by itself to reject the proposal.

[3] For thinly capitalized closely-held companies, the requirement to recapture a company's LIFO reserve would probably exhaust all working capital and, notwithstanding a 10-year spread of the tax on recapture, would prevent bank borrowing and might force insolvency and shut down of the company, thereby eliminating jobs.