THE LIFO COALITION

1325 G Street N.W., Suite 1000, Washington, DC 20005 TEL: 202-872-0885

July 24, 2013

The Honorable [Fullname]
United States Senate
Washington, DC 20510

Dear Senator [Lastname]:

I am writing on behalf of the LIFO Coalition in response to the request from Finance Committee Chairman Baucus and Ranking Member Hatch for input from their colleagues regarding their "blank slate" tax reform initiative.

The LIFO Coalition was organized in April 2006 when LIFO repeal was first proposed in the Senate as a revenue offset to fund unrelated policies. Today the Coalition's more-than-120 members represent hundreds of thousands of businesses of every size and industry that employ the last-in, first-out (LIFO) inventory accounting principle. A list of the Coalition members is attached to this document.

The LIFO Coalition believes that repeal of LIFO should not be a part of any tax reform proposal. Addressing the specific criteria raised by Chairman Baucus and Ranking Member Hatch in their "Dear Colleague" letter, repeal of LIFO would have a measurable negative impact on economic growth and job creation and would make the tax code less, not more, fair.

First, as explained below, LIFO and FIFO (first-in, first out) serve the same purpose, and repealing of one while retaining the other would introduce a significant new *unfairness* into the tax code. If LIFO were repealed, companies selling products which rise in price would be required to pay taxes on the phantom profits caused by inflation, while companies selling products which decline in price would pay taxes only on their real profits. Such an approach would clearly disadvantage the sellers of some products over the sellers of other products and would in no way make the tax code fairer.

In addition, repeal of LIFO would have a measurable negative impact on economic growth and job creation. It would, in fact, put some companies out of business – particularly small, privately-held companies. This point was made emphatically by the Small Business Administration's Office of Advocacy in their September 29, 2009, letter to the Tax Reform Subcommittee of the Presidential Economic Recovery Advisory Board (PERAB). In their letter, they wrote:

> "The longer that the business uses LIFO, the larger its reserves will be relative to its inventory. If LIFO were no longer permitted, these reserves would be taxed at rates up to 35 percent, even though the reserves reflect nothing more than the impact of economic inflation on the value of the business' inventory … ***Ultimately, eliminating the ability to use LIFO would result in tax increases for small business that could ultimately force many small businesses to close."*** (Emphasis added.)

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Finally, and fundamental to any discussion of LIFO, repeal would be an unprecedented retroactive tax increase.

The bulk of the revenue that would be raised from repeal of LIFO would come not from denying its use on a prospective basis, but by far would result from, in effect, repealing its use retroactively. LIFO users would be required to recalculate their income for all the years in which they used LIFO and "recapture" into taxable income their entire LIFO reserve, which is the total benefit that they received from the use of the LIFO principle over the taxpayer's entire lifetime – often many decades. The LIFO principle has been authorized for more than 70 years. The tax liability associated with taking those reserves into income, even over the 10-year period provided in some proposals, would severely harm large numbers of businesses and would render many of them insolvent. An offsetting reduction in tax rates would in no way compensate for the loss of such a significant accounting method.

To provide a more in-depth analysis:

The Baucus/Hatch "Dear Colleague" letter presumes the elimination of all tax expenditures and asks Members to identify which tax expenditures should be retained in a reformed tax code. LIFO was recently added to the Joint Committee on Taxation's list of tax expenditures, but it is not a tax expenditure in the normal sense of the term. In fact, it is not considered a tax expenditure by the Office of Management and Budget. Rather, it has been an accepted and established inventory accounting principle in the United States for more than 70 years. The LIFO method was initially added to the tax law in 1939 because of its acceptance as part of generally accepted accounting principles.

The use of LIFO is broad-based; it is used by literally hundreds of thousands of businesses which sell products that tend to rise in price to prevent the crippling taxation of inflation-caused phantom profits. While there is a common misperception that LIFO is used almost exclusively or primarily by large companies in the oil and gas industry, it is also used extensively by both publicly-traded and privately-held companies in a wide variety of other industries, including manufacturing, extractive industries, wholesale distribution, retailing, newspapers, and automobile and equipment dealers. According to two separate recent studies, one by the 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 that maintain inventory. Moreover, LIFO is widely used by small businesses and pass-through corporations, many of which have been using LIFO for decades.

The economic theory behind LIFO is that if a company is to remain in business, it must earn a sufficient profit on the sale of inventory to finance the purchase of replacement inventory. If prices of merchandise are rising 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, there may simply be insufficient after-tax profit to enable the purchase of replacement inventory, in which case the company must discontinue its operations.

It has been pointed out that many, particularly those concentrated in such industries as technology, use accounting principles other than LIFO. However, the products those companies sell tend to decrease in cost as the technology evolves, and a company which sells a product which declines in price would want to use the exact opposite accounting method from LIFO, or first-in, first-out (FIFO). Accordingly, in lieu of the specific identification method (which is not practical for companies with fungible products), accounting theory and tax law logically permit the use of either LIFO or FIFO because both principles accomplish the same purpose: most closely matching cost of goods sold with the cost of replacement inventory to generate sufficient after-tax earnings to keep the company in business.

With regard to the retroactivity of LIFO repeal, use of the LIFO principle carries with it the obligation to maintain a cumulative LIFO reserve – the difference between the LIFO and FIFO value of inventory reported annually by LIFO users. Some LIFO repeal proposals, including the Administration's, require this reserve to be recaptured, thus retroactively requiring LIFO taxpayers to return to the government all of the benefits they have ever received from the LIFO method. Since these taxpayers may have been on LIFO for as many as 50 or 60 years, we believe these proposals would incorporate into the Internal Revenue Code a degree of retroactivity unprecedented in the history of that statute. Moreover, it is critically important to note that there is no pot of money or separate account from which a LIFO user could draw funds to pay the recapture tax. The tax that would be levied on a company's LIFO reserve is not sitting in a liquid investment awaiting the repayment; those funds will have been reinvested in the purchase of replacement inventory. Even with a 10-year amortization period for the payment of the retroactive tax burden, a company would be faced with the choice of either shrinking its business or financing its inventory through additional borrowing, assuming that credit is available. Some companies would go out of business due to the increased capital requirements necessitated by the increased tax burden for which additional cash flows cannot be generated. The impact on the economy of any of those results would clearly be damaging.

The many LIFO users that operate in "pass-through" form would not benefit from one of the main stated objectives of tax reform – broadening the corporate tax base while lowering the corporate tax rate. Repealing LIFO in exchange for a reduction in *corporate* tax rates would not benefit the hundreds of thousands of pass-through entities which use LIFO but pay taxes through the individual tax code, and would undoubtedly lead to a significant number of business failures.

Finally, it was previously assumed that the Securities and Exchange Commission (SEC) would adopt the use of International Financial Reporting Standards (IFRS) in the United States and that since IFRS does not permit the use of LIFO, Congress should move to repeal its usage to capture the revenue that repeal would generate. However, a July 13, 2012, SEC Staff Report made clear that full adoption of IFRS is not only not imminent, but in fact unlikely, specifically noting that LIFO usage is one of several "fundamental differences" between IFRS and U.S. GAAP, concluding that, *"In some cases, the resolution of these differences will be individually challenging (e.g., removal of, or any change to, LIFO), and any attempt by the SEC or others to resolve these differences in a time period even as long as five to seven years may prove to be difficult."*

For all of the above reasons, we urge you to ask Chairman Baucus and Ranking Member Hatch to include the LIFO tax accounting principle in their proposal to reform the Internal Revenue Code.

Sincerely,

Jade West

Jade West, Executive Secretariat
The LIFO Coalition

Attachment

THE LIFO COALITION

Alabama Grocers Association
American Apparel & Footwear Association
American Chemistry Council
American Forest & Paper Association
American Fuel and Petrochemical Manufacturers
American Gas Association
American International Automobile Dealers Association
American Petroleum Institute
American Road & Transportation Builders Association
American Supply Association
American Veterinary Distributors Association
American Watch Association
American Wholesale Marketers Association
Americans for Tax Reform
AMT-The Association for Manufacturing Technology
Associated Equipment Distributors
Association for High Technology Distribution
Association for Hose & Accessories Distribution
Association of Equipment Manufacturers
Automobile Dealers Association of Alabama
Automotive Aftermarket Industry Association
Brown Forman Corporation
Business Roundtable
Business Solutions Association
California Independent Grocers Association
Caterpillar Inc
Ceramic Tile Distributors Association
Connecticut Food Association
Copper & Brass Servicenter Association
Deep South Equipment Dealers Association
Deere & Company
East Central Ohio Food Dealers Association
Equipment Marketing & Distribution Association
Far West Equipment Dealers Association
Farm Equipment Manufacturers Association
Financial Executives International
Food Industry Alliance of New York State
Food Marketing Institute
Forging Industry Association
Gases and Welding Distributors Association
Greater Boston Chamber of Commerce
Health Industry Distributors Association
Healthcare Distribution Management Association
Heating, Airconditioning & Refrigeration Distributors International
Illinois Food Retailers Association
Independent Lubricant Manufacturers Association
Industrial Fasteners Institute
Industrial Supply Association
International Foodservice Distributors Association
International Franchise Association
International Sanitary Supply Association
International Sealing Distribution Association
International Wood Products Association
Iowa Grocers Industry Association
Iowa Nebraska Equipment Dealers Association
Jewelers of America
Kansas Food Dealers Association
Kentucky Association of Convenience Stores
Kentucky Grocers Association
Louisiana Retailers Association
Maryland Retailers Association
MDU Resources Group
Metals Service Center Institute
Mid-America Equipment Retailers Association
Midwest Equipment Dealers Association
Minnesota Grocers Association
Minnesota-South Dakota Equipment Dealers Association
Missouri Grocers Association
Missouri Retailers Association
Montana Equipment Dealers Association
Moss Adams LLP
NAMM-The International Music Products Association
National Association of Chemical Distributors
National Association of Convenience Stores
National Association of Electrical Distributors
National Association of Manufacturers
National Association of Shell Marketers
National Association of Sign Supply Distributors
National Association of Sporting Goods Wholesalers
National Association of Wholesaler-Distributors
National Auto Dealers Association
National Beer Wholesalers Association
National Electrical Manufacturers Association
National Federation of Independent Business
National Grocers Association
National Lumber and Building Material Dealers Association
National Paper Trade Alliance
National Roofing Contractors Association
National RV Dealers Association
Nebraska Grocery Industry Association
New Hampshire Grocers Association
New Jersey Food Council
North American Equipment Dealers Association
North American Wholesale Lumber Association
Ohio Grocers Association
Ohio-Michigan Equipment Dealers Association
Paperboard Packaging Council
Pet Industry Distributors Association
Petroleum Equipment Institute
Power Transmission Distributors Association
Printing Industries of America
Professional Beauty Association
Retail Grocers Association of Greater Kansas City
Retail Industry Leaders Association
Safety Equipment Distributors Association
SBE Council
Security Hardware Distributors Association
Society of Independent Gasoline Marketers of America
SouthEastern Equipment Dealers Association
Southern Equipment Dealers Association
SouthWestern Association
Souvenir Wholesale Distributors Association
SPI: The Plastics Industry Trade Association
State Chamber of Oklahoma
Textile Care Allied Trades Association
Tire Industry Association
U.S. Chamber of Commerce
Washington Food Industry Association
Wholesale Florist & Florist Supplier Association
Wine & Spirits Wholesalers of America
Wine Institute
Wisconsin Grocers Association, Inc.
Wood Machinery Manufacturers of America