THE LIFO COALITION

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April 9, 2013

RE: Comments, Energy Tax Reform Working Group

The LIFO Coalition submitted a statement for the record in response to the Ways and Means Committee Hearing on Tax Reform and the U.S. Manufacturing Sector in July, 2012. I am attaching that statement as our submission to the Energy Tax Reform Working Group.

The LIFO Coalition, which represents trade associations and businesses of every size and industry sector that employ the LIFO method, was organized in April 2006, when LIFO repeal was first proposed in the Senate as a revenue offset to fund unrelated policies. Since then, the Coalition membership has grown to include more than 120 members including trade associations representing a wide swath of American industry – including manufacturing, wholesale distribution, and retailing – and companies of all sizes.

While the Coalition membership is not limited to the energy sector, the subject of LIFO repeal is often raised in relation to the oil and gas industry, and it is often incorrectly assumed that LIFO usage is concentrated in the energy industry. That is not the case, as the wide range of industries active in the Coalition demonstrates.

We appreciate the opportunity to provide the Energy Tax Reform Working Group with the attached comprehensive analyses of LIFO and its use across industry groups.

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Statement for the Record

HOUSE WAYS AND MEANS COMMITTEE

Hearing on Tax Reform and the U.S. Manufacturing Sector

July 19, 2012

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The LIFO Coalition (the Coalition), which represents trade associations and businesses of every size and industry sector that employ the LIFO method, was organized in April 2006, when LIFO repeal was first proposed in the Senate as a revenue offset to fund unrelated policies. Since then, the Coalition has grown to include more than 120 members including trade associations representing a wide swath of American industry – including manufacturing, wholesale distribution and retailing – and companies of all sizes. The Coalition's mission is to preserve the option of companies to value their inventories pursuant to the LIFO method for federal income tax purposes. A list of the Coalition members is attached to this document, and can be found at http://www.savelifo.org/pdf/LIFOMemberList.pdf

The LIFO Coalition respectfully submits this Statement for the Record to the House Ways and Means Committee in connection with the hearing on "Tax Reform and the US Manufacturing Sector." The LIFO Coalition membership is not limited to the manufacturing sector, but the issue of LIFO repeal has been considered in a number of recent discussions of broad-based tax reform. The tax reform debate is therefore critically important to all of the industries represented by the Coalition, and we very much appreciate the opportunity to provide our views to your committee.

OVERVIEW OF 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 LIFO Coalition does not believe that repeal of the LIFO method should be a part of any tax reform proposal for two primary reasons: ***the LIFO method is not a tax expenditure, and repeal would be an unprecedented retroactive tax increase.*** The Coalition has previously prepared detailed analyses of these issues, both of which are attached as part of this submission, along with the Coalition's response to a letter from Jeffrey Zeints, Acting Director of OMB, to 22 members of the House of Representatives defending the Administration's call for repeal of the LIFO method.

Repeal of LIFO would have a devastating effect on many of the companies which use it, 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 over ten years. ***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.)

Ironically, proponents of repeal often base their call for repeal on the completely erroneous belief that the companies that use LIFO are large, publicly-traded corporations, primarily gas and oil companies.   In fact, in testimony in February before the House Budget Committee, in response to a question from Mr. Yarmuth, OMB Deputy Director for Management Jeffrey Zients made that incorrect claim when he said: "On the LIFO, that disproportionately benefits oil and gas producers who have record profits."

LIFO is not a tax expenditure, is not used exclusively or even primarily by "big oil" or other large corporations but by hundreds of thousands of smaller companies, and its repeal would be a devastating retroactive tax increase that would force many small businesses into insolvency. This is surely not what tax reform is intended to accomplish.

<u>THE COALITION'S PRINCIPAL ARGUMENTS</u>

<u>***LIFO repeal would be an unprecedented retroactive tax increase:***</u>

The LIFO repeal proposal in the President's FY 2013 budget is estimated to generate about $74 billion.   It is important to note, however, that , most of the revenue generated by this proposal would come not from prospective repeal of the LIFO method but rather from the proposal's retroactive effect. 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 – the total benefit that they received from the use of the LIFO method over the taxpayer's entire lifetime – often many decades. (For a detailed explanation of the LIFO reserve, please see attached LIFO Coalition papers on retroactivity and tax reform.)

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 the 10-year period provided by the Administration's LIFO repeal proposal, would severely harm large numbers of businesses and would render many of them insolvent.

The LIFO Coalition is not aware of any other serious revenue raising proposal that has this type of retroactive effect. For example, no proposal for the elimination of accelerated depreciation or the research credit or the mortgage interest deduction includes a requirement that taxpayers pay back the taxes that they saved from the prior use of these methods. No proposal to increase tax rates on dividends and/or capital gains ever suggests that taxpayers pay back the benefits of reduced rates on those types of income for past years.

The income tax liability associated with recapturing the LIFO reserve into taxable income would severely harm most companies and potentially bankrupt many of them. It should be noted that the savings represented by a company's LIFO reserve is not sitting in a liquid investment awaiting the repayment; instead, the savings are 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.

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, as would occur if LIFO were repealed retroactively as proposed, cash will not be readily available from the sale of inventory to pay the increased tax burden caused by the recapture of LIFO reserves. 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 borrowings, assuming that credit is available, or it would go out of business.

It should further be emphasized that if Congress properly rejects the imposition of an unprecedented retroactive tax increase for the reasons noted above, consideration of LIFO repeal in the context of comprehensive tax reform makes little sense – the amount of revenue generated in exchange for reduced rates would be a small percentage of the amounts that have typically been associated with LIFO repeal proposals. Any such amount would not come close to justifying the disruption and other adverse economic and policy consequences that would inevitably result from prospective repeal. For these reasons, therefore, the Congress should reject any tax reform proposal that includes either total (i.e.,prospective and retroactive) repeal or prospective-only repeal of the LIFO method.

<u>LIFO is an accepted inventory valuation method, not a tax expenditure:</u>

It is the position of The LIFO Coalition that the LIFO inventory method is not a tax expenditure. It differs significantly from the other provisions now classified as tax expenditures in the Joint Committee on Taxation (JCT) Staff's annual list of tax expenditures, should not be classified as a tax expenditure and should not be eliminated from the Internal Revenue Code in exchange for a reduction in income tax rates as part a tax reform program.

According to a 2010 OMB publication, "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 has been part of the Internal Revenue Code since 1939, but for more than 33 years following the enactment of the 1974 Budget Act, LIFO was not classified as a tax expenditure by JCT Staff. It was not until a 2008 JCT reexamination of the criteria for defining tax expenditures that JCT Staff began classifying the LIFO inventory method as a tax expenditure. The JCT reexamination was not prompted by any change in the 1974 Budget Act; the JCT staff simply invented a new class of tax expenditures labeled "Tax-Induced Structural Distortions" and included the LIFO inventory method in this new class of tax expenditures.

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.

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 1974 Budget Act definition.

The Office of Management and Budget ("OMB") publishes its own list of tax expenditures, and has not classified the LIFO inventory method as a tax expenditure either prior to 2008 or subsequent thereto. See Office of Management and Budget, *Analytical Perspectives, Budget of the U.S. Government*, *Fiscal Year 2013*.

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.

In fact, 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 indispensible. Moreover, a system for assigning costs to merchandise that is sold and to the merchandise that remains in ending inventory would also be essential.

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 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 LIFO method, as well as any other generally accepted method of inventory accounting, thus should be viewed as a rational response to the need for effective tax treatment of inventories. It should not be viewed as a tax expenditure, a "loophole," or any other aberration from the norm. Repeal of the method thus has no place in a tax reform regime that is designed essentially to lower rates – and perhaps deficits -- by repealing tax expenditures or loopholes. It is therefore distinguishable from the many other base-broadening elements of recent tax reform proposals in this regard, as well in the retroactivity uniquely associated with LIFO repeal and discussed earlier.

OTHER MAJOR CONSIDERATIONS

<u>Repeal of the LIFO method is not an appropriate offset to reduced business tax rates:</u>

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 contemplated by tax reform. 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.

Most Companies Using the LIFO Inventory Method are Pass-Through Entities:

Given that there are approximately 30 million pass-through entities today and fewer than 2 million C corporations and that approximately 36% - 40% of the companies in all industries that maintain inventories use the LIFO method, it is not an exaggeration that hundreds of thousands of companies use the LIFO method. The overwhelming majority of those companies using LIFO are privately-held, and the overwhelming majority of them are not organized as C corporations, but as pass-through entities, and are therefore taxed under the individual rather than the corporate tax code.

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.

International Financial Reporting Standards and U.S. Competitiveness Considerations:

Both of these issues are covered in depth in the attached coalition document, *Reasons Why The Lifo Method Should Not Be Repealed In The Context Of Business Tax Reform*, but both warrant a brief mention in this statement.

First, for the last several years the Securities and Exchange Commission (SEC) has been considering the adoption in the U.S. of the International Financial Reporting Standards (IFRS), which do not permit the use of LIFO. Accordingly, if the use of IFRS were to be 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 was 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, a move by the SEC to adopt IFRS is not imminent, as was made clear in the July 13, 2012 Staff Report on the subject released by the SEC. Further, it is equally clear from the Report that the Commission is unlikely to fully adopt IFRS even if they move in that direction; rather, they are more likely to incorporate IFRS into U.S. GAAP with FASB retaining an active role in the standard setting process. Under such an endorsement process, local deviations from IFRS, such as the use of LIFO, could be accommodated.

The Staff Report specifically notes 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*." See "Work Plan for the Consideration of Incorporating International Financial Reporting Standards into the Financial Reporting System for U.S. Issuers Final Staff Report" at 14.

Second, repeal of LIFO, especially in the context of a tax reform initiative to increase the competitiveness of U.S. Corporations, simply makes no sense. Since only U.S. companies use LIFO, it is one of the very few provisions of U.S. tax law that give companies that use it a competitive advantage against their foreign competitors. This is of great significance now with the U.S. corporate tax rate the highest among industrialized economies; and even if broad-based tax reform is enacted in the U.S. in the near term, it is highly unlikely that our business tax rate will be reduced to a rate lower than that of most of our competitors.

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.

CONCLUSION

LIFO is a 70-year-old, long-accepted inventory accounting method which, just like first-in, first-out (FIFO), allows a company to most closely match cost of goods sold with cost of purchasing replacement inventory to allow the company to stay in business. LIFO is neither a tax expenditure nor a tax preference under any rational definition of those terms. Repeal of the LIFO method would be an unprecedented retroactive tax increase that would cause economic harm, cost jobs, and put a significant number of companies out of business. The members of the LIFO Coalition strongly urge the members of the Ways and Means Committee not to consider repeal of the LIFO method in tax reform legislation.