THE LIFO COALITION

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January 15th, 2014

Honorable Max Baucus, Chairman
Senate Committee on Finance
219 Dirksen Senate Office Building
Washington, D.C. 20510

Honorable Dave Camp, Chairman
House Committee on Ways and Means
1102 Longworth House Building
Washington, D.C. 20515

Honorable Orrin Hatch, Ranking Member
Senate Committee on Finance
219 Dirksen Senate Office Building
Washington, D.C. 20510

Honorable Sander Levin, Ranking Member
House Committee on Ways and Means
1106 Longworth House Office Building
Washington, D.C. 20515

Dear Chairmen Baucus and Camp and Ranking Members Hatch and Levin:

I am writing on behalf of The LIFO Coalition in response to the inclusion in Senate Finance Chairman Baucus' "Staff Discussion Draft" of a proposal to repeal the LIFO method of inventory valuation. We understand that a similar proposal may also be included in the Ways and Means Committee tax reform proposal.

The LIFO Coalition (the Coalition), organized in April 2006, has more than 125 members including trade associations representing hundreds of thousands of businesses in the manufacturing, wholesale distribution, and retail sectors, as well as companies of every size and industry sector that use the LIFO method. A list of the Coalition members is attached to this document.

The LIFO Coalition has on numerous occasions expressed its opposition to the repeal of the LIFO inventory method. In most instances, The Coalition was responding to "one-off" proposals to repeal LIFO as a revenue raiser, in order to offset proposed increases in spending, such as for example in the context of the Obama Administration's annual budget proposals. However, in this instance, The LIFO Coalition is responding to the suggestion that the LIFO method be repealed as part of fundamental tax reform – the premise being that certain corporate tax expenditures should be eliminated from the Internal Revenue Code in exchange for a reduction in the corporate income tax rate to somewhere between 25 and 30 percent, from its current 35 percent rate. For the reasons explained below, the repeal of LIFO in the context of fundamental tax reform is no more desirable from a policy or economic standpoint than in the case of prior proposals to repeal LIFO to fund spending increases.

The most obvious question in the context of fundamental tax reform is: Why is LIFO even on the list of tax expenditures being considered? LIFO is not characterized as a tax expenditure by the Office of Management and Budget. Moreover, until 2008, some 70 years after it was first enacted, LIFO was not classified as a tax expenditure by the Joint Committee on Taxation ("JCT"). Up until that time, there really was no category of tax expenditure into which LIFO could fit. However, in 2008 then-chief of staff, Edward Kleinbard, created an entirely new category of tax expenditures into which he placed LIFO.

In addition to LIFO, Dr. Kleinbard added lower of cost or market to the JCT list of tax expenditures, despite the fact that lower of cost or market is a creation of regulation, not statute, and thus could never qualify as a tax expenditure as that term is defined by statute. Dr. Kleinbard's actions lead to the inescapable conclusion that his often publicly-stated objection to LIFO prompted his action despite LIFO and lower of cost or market not qualifying as tax expenditures in any objective analysis of the term. The point here is that LIFO is in no sense a tax expenditure. (See our detailed analysis of this issue at: http://www.savelifo.org/pdf-2012/LIFO-Coalition-White-Paper-re-Tax-Reform-Updated.pdf.)

Every company that maintains an inventory of merchandise needs to distinguish the cost of merchandise that has been sold from the cost of merchandise that remains on hand at the end of the year. However, given the tens of thousands of items in a typical inventory, there is no administratively feasible way to track the movement of individual items of physical inventory. This gives rise to the need for every company to adopt some type of inventory ordering and valuation convention. The three generally accepted methods of determining the identity and cost of inventory are FIFO, LIFO and average cost. These alternative methods have each been acceptable for federal income tax purposes for decades. Repealing LIFO, while leaving the FIFO and average cost inventory ordering conventions in the tax code, would be extremely unfair and would penalize industries that experience inflation.

Some proponents of LIFO repeal have questioned the foregoing premise and note that companies rarely follow a pattern of retaining their oldest inventory and selling the newest inventory first. However, that comment ignores the fundamental purpose of LIFO, which has nothing to do with the physical tracking of goods. Of course, no company is actually holding inventory from 30 or 40 years ago. That is not the point of LIFO. The policy underlying LIFO is to preserve capital (through reduced taxes) in order to enable a company to replace the inventory that it has sold, when the cost of the replacement goods exceeds that of the goods that have been sold. As the maxim is frequently observed "most companies have their entire profit tied up in inventory." Taxing that inventory profit when a company still has that profit invested in its inventory will simply erode a company's capital and force it to reduce the scale of its operations. That is hardly the result intended by fundamental tax reform.

A number of commentators on the LIFO method have observed that LIFO is used by as many as a third of all companies. However, even this commonly cited statistic seriously understates the extent of usage of LIFO. This measure of LIFO usage ignores the fact that many American companies are engaged in conventional service businesses that do not have any inventories and do not need to use any type of inventory valuation method. Moreover, many companies, particularly in the high tech industry, have increasingly subcontracted out the manufacture of their products to foreign manufacturers and have turned themselves into IP companies, so that these U.S. companies have no inventory to which the LIFO method could apply. In addition, although companies in the aerospace and defense industries produce products for sale, they typically must use the percentage of completion method, which is also a non-inventory method of accounting. When all of these companies are eliminated from the population of potential LIFO users, the extent of usage of the LIFO method becomes substantially higher than is generally noted.

The foregoing analysis reinforces the conclusion that the repeal of LIFO would do serious harm to the very wide swath of businesses that use the method and to the economy as a whole. The negative impact of this proposal is especially severe because the bulk of the revenue derived from the repeal of LIFO comes from the retroactive aspect of recapturing companies' existing LIFO reserves built up in years prior to the effective date of any repeal of the method.

There are several problems with the application of retroactivity in the case of LIFO repeal.

First, from an economic point of view, most companies have used the LIFO method for many years, some for as long as five or six decades. As a result, the cumulative effect of inflation on the value of a company's inventory has resulted in a LIFO reserve build-up that is so significant that it could well exceed the company's entire taxable income for a year, if not its total net worth.

Proponents of LIFO repeal have suggested that the combination of lower corporate tax rates, in conjunction with an eight-year spread of the resulting adjustment to income, would provide an adequate offset to the burden imposed by the additional tax liability accompanying the recapture of a company's existing LIFO reserve. However, for the overwhelming majority of LIFO users, especially small and mid-sized businesses, that is simply not the case.

In fact, the recapture tax on the LIFO reserve built up in prior years will be enormous for most companies. An eight-year spread of a tax liability that no one was expecting to pay until a revenue event occurred, i.e., a company was sold or went out of business, does not create any additional source of capital to enable a company to pay the unexpected tax, regardless of how many years are provided in transition relief. Furthermore, the overwhelming majority of LIFO users are not C Corporations, but pass-through entities that pay taxes on the individual side of the tax code. While The LIFO Coalition supports the effort to pursue comprehensive reform that lowers both the individual and corporate rates, it remains far less than certain that Congress will be able to lower both tax regimes to the same rate. The revenue to finance lower rates for taxpayers subject to individual tax rates will come from such politically sensitive deductions as the home mortgage interest deduction and the charitable contribution deduction. If the political opposition to repealing such individual deductions proves insurmountable, the result will be an individual income tax rate measurably higher than the corporate rate. The hundreds of thousands of pass-through entities that use the LIFO method would be doubly harmed by reform that repeals LIFO, while leaving them with a tax rate higher than C Corporations would be paying.

Thus, most companies would face a crippling retroactive tax bill with no inventory sale to generate the cash flow with which to pay it. As a result, repeal would force companies to take economic action to generate sufficient cash flow to pay the retroactive tax bill. The actions that a company would be required to take to generate the necessary cash flow to pay the taxes would have an inescapable adverse impact on the economy. Companies have told The LIFO Coalition that they would have to generate cash by canceling planned capital investments, canceling or postponing expansions, postponing hiring or reducing their workforce, and/or discontinuing funding of employee 401(k), health care plans or ESOPs – all producing economic contraction and job loss. It bears repeating here that for the overwhelming majority of LIFO users, especially the small and mid-sized companies, *no income tax rate reduction will offset the harm of LIFO repeal.*

The economic domino effect is likely to reach consumers as well. LIFO usage is product-driven, and manufacturers, wholesaler-distributors and retailers of those products could all put upward pressure on prices to raise revenue in order to pay the recapture tax. Small and mid-sized companies that can't raise prices and still remain competitive could well be forced to simply close their doors – a result that was predicted by the Small Business Administration Office of Advocacy in its letter to the President's Economic Recovery Advisory Board in 2006 recommending against LIFO repeal. (You can read the SBA letter here: http://www.savelifo.org/pdf-2011/SmallBusAdministrationLetter.pdf.)

Moreover, the use of the revenue from LIFO repeal to arguably finance lower tax rates would be fiscally irresponsible. Since the bulk of the revenue from LIFO repeal comes from a one-time recapture of the deferred taxes attributable to a company's existing LIFO reserve, that one-time revenue source cannot hope to finance lower tax rates on a permanent basis into the indefinite future. As such, LIFO repeal should not even be considered as a revenue source to fund a permanent tax rate reduction.

Finally, and perhaps most importantly, it should be noted that the repeal of LIFO with a full "recapture tax" is *uniquely* retroactive from the standpoint of *fairness*. That is because companies that have properly and legally used LIFO for many decades would be required to recalculate their earnings for all the years they have valued their inventory using LIFO and pay taxes as if LIFO had never been permitted in the tax code. It is this required *pay-back of prior tax benefits* that most clearly distinguishes full LIFO repeal from other provisions that have been criticized for their retroactivity and that makes repeal so much more objectionable even than those provisions.

It should be noted in this regard that three major provisions of the Baucus discussion drafts have been accurately characterized as being "retroactive" in one way or another – (i) LIFO repeal, (ii) depreciation revision, and (iii) the "deemed repatriation" of the overseas earnings of U.S.-owned companies. While we wholeheartedly agree with that characterization of all three proposals, we also wish to point out that only in the case of LIFO repeal do the drafts require *the effective revocation of tax benefits received by affected taxpayers years ago.* It is this feature of LIFO repeal that makes the proposal uniquely offensive. We believe the effective repeal of deductions taken 50, 60 or 70 years ago puts LIFO repeal in a class by itself when it comes to the unfairness it would impose on taxpayers. In fact, we are not aware of any provision in the Internal Revenue Code that is as egregiously retroactive in its concept and effect as the LIFO repeal proposal now under consideration.

As a separate and final matter, some proponents of LIFO repeal, including the Obama Administration, assert that the forthcoming adoption of International Financial Reporting Standards ("IFRS") by the U.S. will ultimately have the effect of repealing LIFO through the back door application of the LIFO conformity requirement. These proponents assert that since LIFO is not permitted under IFRS, Congress may as well claim credit for the revenue that will be generated by the adoption of IFRS and the repeal of LIFO through the application of the LIFO conformity requirement. If that analysis was ever valid, it has long passed into obsolescence. All of the recent indications from the U. S. Securities and Exchange Commission ("SEC") are that if IFRS is ultimately adopted in the U.S., the version that will be adopted will follow the pattern of recent adoptees and permit individual country exceptions for accounting principles that are unique to the financial reporting fabric of the adopting country. Since LIFO has long been a part of U.S. generally accepted accounting principles, it is expected that the use of LIFO will continue for U.S. companies' financial reporting.

In conclusion, the harm that repeal of LIFO will cause companies that are denied its use cannot be ignored by Congress, nor can the collateral damage that a retroactive tax hike would cause. The quest for new revenue that has put LIFO repeal into the tax reform cross-hairs could well be short-sighted: companies that cease investing, expanding or hiring slow the economic growth that generates tax revenue, and companies that close their doors and workers who lose their jobs pay no income taxes. A slower economy, fewer jobs, and potentially much less revenue than estimated are all likely results of LIFO repeal, regardless of the offsetting benefits from lower rates.

The LIFO Coalition urges you to eliminate LIFO repeal from consideration in your tax reform effort. LIFO is not a tax expenditure and therefore should not be considered a source of revenue for tax reform. Furthermore, its use does not distort income as some have suggested, but most accurately reflects income to create after-tax earnings sufficient for a company to purchase replacement inventory and remain in business. Without question, LIFO repeal would be an economic disaster.

Sincerely,

Jade West

Jade C. West
Executive Secretariat, The LIFO Coalition
Senior Vice President-Government Relations
National Association of Wholesaler-Distributors

Enclosure:
The LIFO Coalition Membership List

cc: All Members of the U.S. Senate and U.S. House of Representatives

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American Forest & Paper Association
American Fuel and Petrochemical Manufacturers
American Gas Association
American International Automobile Dealers Association
American Iron & Steel Institute
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 Fabriactors Council
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 Automobile 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
National Stone, Sand & Gravel 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
Services Station Dealers of America and Allied Trades
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