THE LIFO COALITION

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March 31, 2014

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

Dear Chairman Camp:

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 LIFO. A list of the Coalition members is attached.

We appreciate the opportunity to share our comments on the discussion draft of the Tax Reform Act of 2014. We share your commitment to fundamental tax reform and look forward to a continued dialogue as this process moves forward. However, we strongly oppose the draft's proposed repeal of the LIFO inventory accounting method and urge you to reconsider this provision.

Repeal of LIFO would significantly and permanently harm broad sectors of America's economy, endangering the viability of thousands of businesses and the livelihood of their employees and their families. LIFO repeal's damaging effects arise not just from the punitive retroactive recapture tax but also the prospective loss of the accounting method which most accurately and fairly states business income for businesses with ever-rising costs of replacing inventory. Recapturing up to 70 years of income simply in search of additional revenue to fund other tax priorities is unfair, and is unjustified under the rationale put forth in the discussion draft.

Executive Summary:

The Coalition is concerned with the justification for repeal provided in the proposal's background documents – a justification that we believe is fundamentally flawed.

The committee material states that:

Historically, the last-in, first-out (LIFO) inventory accounting method was designed to ensure that a business had enough essential inventories to continue business operations. However, with current just-in-time inventory methods, businesses are able to function without vast reserves of inventory, which renders LIFO outdated and less necessary.

LIFO Is a Response to the Effects of Inflation on the Pricing of Inventory and the Ability of a Company to Replace Inventory that Is Sold; LIFO Was Not Predicated on the Need to Increase Inventory Quantities

The assertion that LIFO was designed to enable companies to maintain large levels of inventory is historically incorrect. LIFO was designed to allow companies to deal with the effects of inflation on the *pricing* of inventory, not its *quantity*. Therefore, the justification for the proposal to repeal the LIFO method is based on a misunderstanding of the purpose and use of the method. (See pp. 4-5 of detailed discussion below for historical and academic citations.)

Just-in-Time is Not Widely Used and Would Not Diminish the Need for LIFO Even if it Were

The assertion that just-in-time inventory has made LIFO "outdated" and "less necessary" is also flawed. While both just-in-time and LIFO affect inventory, just-in-time deals with the efficiency of the flow of inventory through the supply chain, whereas LIFO deals with the value of that inventory.

Just-in-time is not widely used today; moreover, usage of just-in-time by some companies in the supply chain often results in *other* companies in the supply chain having to maintain larger inventories. Even if a company using just-in-time is able to reduce its inventory, that does not diminish the company's need for LIFO with respect to the inventory that remains. (See pp. 5-8 of detailed discussion below for further analysis and verbatim comments from LIFO users and experts on flawed assumptions about just-in-time inventory.)

LIFO Was Never Intended to Be a Temporary Tax Deferral

The proposal asserts that LIFO was intended to be only a temporary tax deferral and that LIFO taxpayers understood that to be the case. That assertion is incorrect. There is significant historical and academic work clearly showing that LIFO was not designed as a temporary deferral, but as a deferral intended to last for the life of the company. (See pp. 8-9 of the detailed discussion below for historical and academic citations.)

Repeal Imposing a Recapture Tax is Not Only Retroactive; It is More Egregiously So Than Any Provision Now in the Internal Revenue Code or Proposed in the Tax Reform Draft

The repeal proposal is a retroactive change to the *terms* of the tax benefit received by the taxpayer. LIFO benefits were designed to be given back *under specific circumstances* – going out of business, permanent reduction in inventory levels, etc. Under the proposal, the benefits would be required to be given back even when those circumstances were not present.

Further, the remedy of a reduced tax rate for specifically-defined taxpayers does not resolve the critical cash flow problem the proposal acknowledges repeal will cause because (1) that reduced tax rate could easily rise as additional revenue is needed to offset other priorities and (2) even a 7% tax on decades of LIFO reserves held by companies with slim profit margins would be crippling.

Also, many LIFO taxpayers accepted reduced reported earnings as a result of using LIFO for tax purposes. Repealing LIFO with a recapture tax effectively tells those LIFO taxpayers that, although they have met their end of the bargain, the government will not make good on its own end.

Finally, the tax reform draft singles out LIFO taxpayers for uniquely harsh treatment when compared to the taxpayers adversely affected by other provisions of the draft, including the provisions dealing with depreciation, the R&E tax credit, cash to accrual accounting, and deemed repatriation. (See pp. 9-12 of the detailed discussion below for comment on these issues.)

Prospective Repeal Would Impose Irreparable Harm on Companies

Prospective repeal of LIFO is flawed policy and significantly harmful to LIFO taxpayers. LIFO allows companies which sell goods that rise in price to earn sufficient after-tax profits to purchase replacement inventory. Without LIFO, companies would be forced to pay taxes on the illusory profits created by inflation, very possibly reducing their after-tax profits by amounts that would leave them without sufficient capital to purchase the replacement inventory they need to satisfy customer demands and to stay in business. Repeal of LIFO on a *prospective* basis would significantly threaten the viability of companies with slim profit margins. (See pp. 12-13 of the detailed discussion below for further comment.)

Detailed Discussion:

The Committee material states that:

Historically, the last-in, first-out (LIFO) inventory accounting method was designed to ensure that a business had enough essential inventories to continue business operations. However, with current just-in-time inventory methods, businesses are able to function without vast reserves of inventory, which renders LIFO outdated and less necessary.[1]

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[1] *The Tax Reform Act of 2014, Fixing Our Broken Tax Code So That It Works For American Families and Job Creators*, House Ways and Means Committee, p. 28

Because the just-in-time argument is new to the debate on LIFO, the Coalition sought the counsel of member companies which use LIFO, companies which install LIFO accounting systems, and a preeminent LIFO expert[2] to determine if this argument was valid. Based on historical research and the responses from these knowledgeable experts and companies which actually use LIFO – some for many decades – it is clear that the main premise of the proposal is incorrect.

<u>LIFO Is a Response to the Effects of Inflation on the Pricing of Inventory and the Ability of a Company to Replace Inventory that Is Sold; LIFO Was Not Predicated on the Need to Maintain Large Inventory Quantities</u>

The assertion that LIFO was designed to enable companies to maintain large levels of inventory is historically incorrect. LIFO was adopted as a generally accepted accounting principle ("GAAP") to allow companies to deal with the effects of inflation on the *pricing* of inventory, not its *quantity*. LIFO was designed to allow companies that sell inventory that is affected by inflation to match the increased cost of replacing the goods that they sold with the revenue from the sale of the replaced inventory, thus enabling companies to remain in business by maintaining (not increasing) inventory levels. Therefore, the justification for the proposal to repeal the LIFO method is based on a misunderstanding of the purpose and use of the method.

The history of the adoption of LIFO in the U.S. tax code makes it clear that it was the value, and not the quantity, of inventory that prompted LIFO adoption and usage.

In a 2008 article in *Tax Notes,* Jeremy Leonard summarized LIFO's essential purpose succinctly:

> A second point, even admitted by critics, is that in periods of inflation, LIFO accounting provides a better matching of current costs with current revenues because the cost of goods sold is valued at current market prices rather than the original cost of acquisition.[3]

The *Legislative History of the Allowance of LIFO for Tax Purposes*, by Morton Pincus, provides numerous historical citations, among them:

> Coincidentally, comments by Professor William Paton on *A Statement of Accounting Principles* appeared in the March 1938 *Journal of Accountancy*. LIFO, he said, 'represents nothing more nor less than a major device for equalizing earnings, to avoid showing in

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[2] Leslie J. Schneider, partner, Ivins, Phillips & Barker; numerous awards and publications including the three-volume treatise, *Federal Income Taxation of Inventories*, published by Matthew-Bender; Of Counsel to the LIFO Coalition

[3] Jeremy A. Leonard, ''A Closer Look at the U.S. Corporate Tax Burden,'' *Tax Notes*, Nov. 17, 2008

> the periodic reports the severe fluctuations which are inherent in certain business fields.' [4]

In *Inventories – Control, Costing and Effect on Income and Taxes,* the authors explain the theory of LIFO as follows:

> During an inflationary period the goods on hand at the beginning of the year will generally be sold at a higher price than contemplated at the time they were acquired. This increase in sales proceeds will be reflected in the income for the year; but if the inventory is maintained at the same level in terms of physical quantities, the additional dollars received from the sales transactions will have been expended to a substantial extent in acquiring the replacement units.
>
> Dollars of earnings needed to maintain the inventory so that the business operations may continue are not available for plant expansion, the payment of dividends, or any of the other purposes to which funds derived from sales at a profit are applied.
>
> LIFO has been developed as a modification of other accepted inventory cost theories to give a more meaningful income statement. [5]

And a Tax Court decision in 1981 explained the theory of LIFO as follows:

> The theory behind LIFO is that income may be more accurately determined by matching current costs against current revenues, thus eliminating from earnings any artificial profits resulting from inflationary increases in inventory costs.
>
> At the heart of the LIFO method is the principle that income is more clearly reflected by matching current costs with current revenues.[6]

Additional citations on the inventory-value purpose of LIFO are readily available; the Coalition found no references to LIFO as a means to facilitate maintaining large *quantities* of inventory in a review of the accounting and legislative history of its adoption.

<u>Just-in-Time is Not Widely Used and Would Not Diminish the Need for LIFO Even if it Were</u>

The assertion that just-in-time inventory has made LIFO "outdated" and "less necessary" is also flawed. While both just-in-time and LIFO affect inventory, just-in-time deals with the efficiency

[4] Legislative History of the Allowance of LIFO for Tax Purposes, by Morton Pincus, Washington University, published in Accounting Historians Journal, Vol 16, No 1, June, 1989
[5] Hoffman & Gunders *Inventories – Control, Costing and Effect on Income and Taxes*, (2d ed.1970),
[6] *Fox Chevrolet, Inc. v. Commissioner,* 76 T.C. 708 (1981)

of the flow of inventory through the supply chain, whereas LIFO deals with the value of that inventory.

One of the most serious flaws in the Committee's justification for the repeal of LIFO is the assumption that just-in-time is widely used today and has resulted in actual reductions in companies' inventory levels, thereby diminishing the need for LIFO. That assumption is not correct. Based on the response from LIFO Coalition members, just-in-time is in fact not widely – much less universally – used today. Moreover, usage of just-in-time by some companies in the supply chain often results in *other* companies in the supply chain, frequently small businesses, having to maintain larger inventories to meet the needs of just-in-time customers.

This phenomenon is demonstrated by the fact that if inventory levels experienced actual reductions in quantities (while maintaining stable levels of sales), companies' inventories would turn over more quickly as a result of the use of just-in-time inventory techniques. However, a just-released analysis of inventory turns in wholesale distribution – an industry obviously dependent on inventory and in which LIFO is widely used – clearly demonstrates that inventory turns have not increased. The analysis, conducted by the Profit Planning Group, covered inventory turns from 1999 to 2012 in 40 lines of trade in distribution, covering durable and non-durable goods, selling to construction, industrial and consumer customers. Inventory turns have not increased overall in the 40 lines of trade included in the study, but have actually decreased. Overall, inventory turns have fluctuated in each category reported in the 12-year analysis, making it clear that regardless of the use of just-in-time techniques, inventory levels have not been reduced and inventory turns have not become more frequent.

Dr. Albert D. Bates, President and CEO of the Profit Planning Group and a highly respected expert on business financial performance, concludes that "the real driver of inventory turnover is economic activity. In recession years (see especially firms selling in the construction market in 2009) inventory turnover falls. In strong economies (1999, 2000, 2005, 2006), turnover rises somewhat."[7]

Moreover, even if a company that is using just-in-time techniques to manage its supply chain is able to reduce its inventory such that it results in a reduction in the amount of the company's LIFO reserve, it would be appropriate to pay the recapture tax in this circumstance because capital to pay the tax would be freed up as a result of the reduction in inventory levels. However, that does not diminish the company's need for LIFO with respect to the inventory that remains.

Verbatim comments from a preeminent LIFO expert[8] and a sampling of LIFO users make the case with respect to just-in-time techniques very clearly:

[7] Profit Planning Group, Dr. Albert D. Bates, President and CEO: ttp://www.profitplanninggroup.com/index.shtml; summary of data in the referenced study available here: http://www.naw.org/files/turnoverbylineoftrade.pdf
[8] Supra, note 2

"The only impact that just-in-time has on LIFO is that it enables a company to maintain a lower inventory level to support a given level of sales. In that case, a company's LIFO inventory would have decreased over time and their LIFO reserve would thus be smaller, but that is the only effect of just-in-time on LIFO. . . . In the past, I have seen commentators mistakenly assert that if a company's inventory turns over more quickly, which it would under just-in-time, the company might not need LIFO. However, that is a complete misunderstanding of how LIFO works. A faster inventory turnover would not reduce the need for a company to use LIFO, if inventory replacement prices are increasing."

"While it is true that our more modern world provides for better efficiencies than, say, 50 years ago that does not change the fact that many taxpayers require significant amounts of inventory to operate their businesses. Every wholesaler-distributor, for instance, needs to deliver product to its customers every day. Just-in-time inventory will not change that fact. One needs to review the balance sheet of a wholesaler-distributor and see that significant inventory amounts are in fact required to operate the business [typically, 40% of all assets are in inventory for these firms]. Just-in-time allows businesses to deliver product more timely to their customers, it does not reduce the need to have those products on its shelves ready for delivery. This is true for small and large wholesaler-distributors."

"To the extent just-in-time and other modern inventory management practices allow companies to reduce inventories, LIFO actually and naturally results in a reversal of LIFO reserves. This reduces the tax deferral effect that LIFO repeal proposals attack. However, as the economy grows and companies become more successful, they generally need to increase inventories to support their customers. Since there are many other factors affecting inventory levels, isolating just one is not only misguided but misleading."

"The LIFO method of accounting for inventory was mainly designed to offer entities a way to more clearly reflect income in a period of rising prices. Most entities require a minimum level of inventory volumes to efficiently manage the flow of goods to customers. In a period of rising prices, maintaining those minimum levels requires ever increasing amounts of capital as goods sold are replaced by more expensive goods. . . Many major industries cannot avoid having significant volumes of inventories on hand."

"The House Ways & Means Committee comment that `with current just-in-time inventory methods, businesses are able to function without vast reserves of inventory, which renders LIFO outdated and less necessary' indicates a lack of understanding of the total manufacturing process. Yes, a large number of manufacturers have moved to just-in-time manufacturing processes where they no longer store large parts and raw

> *materials inventories themselves. However, this change has only moved the inventory maintenance responsibilities down one or two links in the manufacturing supply chain to the second tier suppliers and distributors."*
>
> *"Using LIFO does not presuppose either the need for, nor does it result in, a `vast reserve' of inventory on hand. LIFO does not mean there is any more inventory available than any other inventory system. Rather,* ***it is a way to measure the value of inventory, not its quantity****."*

LIFO Was Never Intended to Be a Temporary Tax Deferral

In its section-by-section analysis of the discussion draft's LIFO repeal provision, the proposal states, in effect, that: Because LIFO taxpayers, in choosing the LIFO method, accepted that the tax benefits they received from LIFO would have to be returned to the government at some point, there is no retroactivity associated with triggering the recapture that the taxpayers have known all along was inevitable.

The argument that LIFO users understood that the tax deferral was only temporary is incorrect. LIFO was not designed as a temporary deferral, but as an indefinite or permanent deferral intended to last for the life of the company. The Senate Committee Report on the 1942 tax act makes that point inescapably clear:

> In the case of most taxpayers using the elective inventory method, the base stock inventory has been carried at the relatively low cost figures reflected in the purchases of 1938, 1939, and 1940. ***Under the elective inventory method, and so long as conditions remained normal and the taxpayer continued in the same business, these low cost figures would never enter, for tax purposes, into the computation of the cost of goods sold.*** The goods on hand at the close of the taxable year are treated as being those on hand at the beginning of the taxable year.
>
> As the direct consequences of prevailing war conditions beyond the control of taxpayers, many base stock inventories are now being depleted. Taxpayers are not able, or are not permitted by the Government, to maintain their normal stock of merchandise. The enforced liquidation of the low cost base stock inventory would subject the taxpayer under the present provisions of the Code to a tax burden not contemplated by Congress in the enactment of the elective inventory provisions. Your committee believes that the taxpayer should not be subjected to an increased tax burden by reason of the unavoidable liquidation or the change in form of its base stock inventory.[9]

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[9] S Rep No 1631, 77 Cong, 1st Sess, 1942-2 CB 504, 567 (emphasis added)

More recently, in Jeremy Leonard's 2008 Tax Notes article, he wrote that "Some firms have LIFO reserves attributable to original inventory purchased several decades ago and therefore ***as long as a firm retains its inventory at a constant level, the inflationary gain attributable to that historical inventory can be deferred indefinitely***."[10]

Labelling the tax benefits from LIFO as "temporary" does not make them so. Since a company using LIFO did not expect to repay such taxes until the company went out of business or was sold, a reasonable business person would not characterize such benefits as "temporary."

Repeal Imposing a Recapture Tax is Not Only Retroactive; It is More Egregiously So Than Any Provision Now in the Internal Revenue Code or Proposed in the Tax Reform Draft

Even if one were to accept the draft's assumption that LIFO taxpayers expected the deferral to be temporary – which historical analysis refutes – it would not follow that there is therefore no retroactivity in the draft's approach or that the retroactivity is not uniquely objectionable in its concept and effect. Under that assumption, we believe that the repeal proposal must still be viewed as a retroactive and seriously adverse *change* to the terms of the tax benefit previously received by the taxpayer.

The draft's argument that LIFO repeal is not a retroactive tax increase ignores basic facts and developments. LIFO repeal with a full recapture tax would require companies using LIFO to recapture into income all of the reductions in taxable income they received during all the years they properly used LIFO – some for many decades. It would essentially require LIFO taxpayers to return tax benefits received from the government as long as 70 years ago. The tax burden associated with that action would require companies to repay their tax savings without having the capital from the sale of inventory to provide a source of funding to pay the increased tax burden. This is not simply changing a tax rate or repealing a tax deduction. Removing an inventory valuation method and requiring companies to give back to the government tax benefits they have received for decades is unarguably a retroactive tax increase.

The tax benefits conveyed by the original LIFO provisions over 70 years ago admittedly were not unconditional. Those benefits were granted subject to the condition that they would have to be given back *under specific circumstances* – going out of business, permanent reduction in inventory levels, etc. It is important to note that those circumstances all involve situations where the taxpayer's capital investment in inventory is reduced or eliminated, thereby freeing up the capital with which to pay the recapture tax. The LIFO repeal proposal unquestionably would change that condition to the taxpayer's detriment. Under the proposal, the benefits would be required to be given back even when those circumstances were not present and the taxpayer still needs its capital to maintain current levels of inventory. That would be a

[10] Supra note 1 (emphasis added)

retroactive and adverse *change* in the original benefit – and an overwhelmingly huge one at that – even if the original benefit were considered temporary.

Put another way, even asserting that there is no retroactivity because the original *benefit* was temporary, the proposal still must be viewed as acknowledging that the *terms* of the original benefit were permanent; so the requirement of the repeal proposal to give it back over eight years would be retroactive. We do not see a relevant conceptual difference, however, between (i) arbitrarily reaching back and changing a permanent benefit to a temporary one, and (ii) arbitrarily reaching back and changing the terms and conditions of a temporary benefit to make it even more temporary. If the first is retroactive, it is impossible to argue that the second is not.

It follows that by any reasonable standard, the repeal provision is an unfair and unwarranted retroactive tax increase. It runs contrary to the key principles of tax reform of equity and certainty. Moreover, the scope, extent and impact of the retroactivity imposed make the proposal to repeal LIFO particularly – and we would argue uniquely – objectionable as compared to other retroactive provisions in the tax code and the current reform proposal.[11] The following observations support this view.

First, the departure from reasonable taxpayer expectations – a feature of most retroactive legislation – is in this case enormous. Clearly, most business owners have never thought of their LIFO benefits as subject to reversal at any time. Business owners typically and rightfully expect that their businesses will continue indefinitely and therefore that their LIFO reserves will remain free of recapture until inventory is sold. The current provision would depart dramatically from those expectations and totally undermine what the taxpayers reasonably believed would be the consequences of adopting the LIFO method.

Second, as noted, the LIFO provision not only would retroactively reach back to negatively impact taxpayer benefits received before enactment of the repeal provision, it would reach back to benefits received *several decades* before that enactment.

Third, the proposal notes that repeal of LIFO will cause cash flow problems, and attempts to address those problems by providing a reduced tax rate to taxpayers that meet a specific definition in the proposal. While the coalition appreciates the proposal's acknowledgement of the cash flow problem that LIFO repeal would cause, the lower-rate remedy unfortunately does not resolve the problem. For starters, there is no assurance that the proposed 7% rate would

[11] In making this statement regarding the Internal Revenue Code, we intend to include within the provisions we are comparing with the proposed LIFO repeal provision such retroactive provisions as those relating to required changes from the cash method to the accrual method of accounting, requirements for UNICAP accounting, restrictions on passive loss deductibility – all enacted in the Tax Reform Act of 1986 – and mark-to-market requirements for securities dealers – enacted in the Omnibus Budget Reconciliation Act of 1993. These are the provisions we have most often heard cited – and criticized – as principal examples of congressional retroactive tax legislation.

not be raised as negotiations on a reform proposal progress and additional revenue is needed to offset other priorities. Further, for companies with very slim profit margins – and many LIFO users have margins of as little as 1–2 percent – even a 7% tax on decades of LIFO reserves would be crippling.

Fourth, many LIFO taxpayers have complied with the LIFO conformity rules to their detriment for financial reporting. As a condition of using LIFO for tax purposes, taxpayers must also use LIFO for book purposes, thereby making the company's financial results appear weaker than they would otherwise appear during periods of rising prices. This requirement may be reasonably viewed as a "bargain" between the affected taxpayers and the government, under which taxpayers gave up more favorable financial accounting treatment over the years in return for the favorable tax treatment they received using LIFO under the Internal Revenue Code.

The proposal to repeal LIFO would have the effect of telling LIFO taxpayers that, although they have met their end of the bargain, the government will not make good on its own end. While the taxpayers endured the adverse effects of LIFO on their financial statements over many years, the government would now reverse the LIFO tax benefits of the taxpayers over a short period of time.

Finally, the tax reform draft singles out LIFO taxpayers for uniquely harsh treatment when compared to the taxpayers adversely affected by other provisions of the draft. For example, if the rationale for LIFO recapture were applied to the changes proposed for depreciation, taxpayers would be required to recompute their adjusted bases in their existing assets, and pay tax on the amount of basis previously deducted through allowable depreciation expense. This same approach could also be applied to the proposed changes in treatment of Research and Experimentation (R&E) expenses and advertising, but that approach is not being applied to any of these other proposed accounting method changes.

Moreover, in those few situations where the proposal adopts a transition rule comparable to that which is proposed for LIFO repeal, the harmful effects of such approach in those other areas are not nearly as great as in the case of LIFO repeal. For example, in the proposal to require certain companies to change from the cash to the accrual method, a section 481(a) adjustment would be required that is comparable to the recapture of a LIFO taxpayer's LIFO reserve when changing to FIFO. However, in the context of a change from the cash to the accrual method, in most cases income would be accelerated as a result of the change by only a year or two. Thus, exempting prior income and deductions from the effects of the method change would postpone those effects for only one or two years. In contrast, for LIFO taxpayers, a requirement to repay the previously-built up LIFO reserve accelerates income that likely would not have been reported for decades, if not longer. Thus, the transition rules for LIFO, even taking into account the extended spread period for paying the recapture tax, are much worse than for any of the other accounting method changes included in the proposal.

Further, the LIFO repeal provision is significantly more harmful to affected taxpayers than even the draft's other *retroactive* provisions. Apart from LIFO repeal, the draft's most retroactive proposal is arguably its "deemed repatriation" provision, under which pre-enactment overseas earnings that U.S. taxpayers had been told would not be taxed unless repatriated to the U.S. would now be taxed whether repatriated or not. Yet, that proposal is less harmful to affected taxpayers than LIFO repeal in two critical respects. First, it would apply a much lower tax rate to the taxed pre-enactment earnings than the tax rate imposed by LIFO repeal on pre-enactment LIFO reserves. Second, and more important, the deemed repatriation proposal may reasonably be viewed as part of the draft's transition to a territorial tax system – a system highly favored by the same U.S. international business community that would be taxed retroactively on its overseas earnings. That is why that community as a whole largely supports the draft's territorial tax package – retroactive tax and all – while the nation's LIFO taxpayers universally oppose the draft's LIFO repeal requirement.

For all of the reasons just discussed, we adhere to the position we have taken in the past on the retroactivity of LIFO repeal. We are not aware of any provision in the Internal Revenue Code or the current tax reform draft that is as egregiously retroactive in its concept and effect as the LIFO repeal proposal now under consideration.

<u>Prospective Repeal Would Impose Irreparable Harm on Companies</u>

While the retroactive tax increase that would be imposed by the recapture tax is excessive, the damage that will be imposed on companies by prospective repeal cannot be ignored. The reform proposal would require current LIFO users to switch to First-in, First-out (FIFO), and FIFO does not lead to a clear or accurate reflection of income for LIFO taxpayers. For businesses selling a product which declines in price, e.g., firms in the technology sector, FIFO most accurately reflects their income and most closely matches the cost of the goods sold to the cost of purchasing replacement inventory. For companies which sell products which are subject to inflation, LIFO accomplishes the same goal.

In other words, LIFO and FIFO serve the same purpose for differently-situated taxpayers by allowing a calculation of cost of goods sold on the basis that best reflects actual inventory replacement costs for that particular business, each therefore reflecting most accurately the income of a given taxpayer. Requiring LIFO users to use the FIFO method is patently unfair.

LIFO allows companies which sell goods that rise in price to earn sufficient after-tax profits to purchase replacement inventory. Without LIFO, those companies would be forced to pay taxes on the illusory profits created by inflation, very possibly reducing their after-tax profits by amounts that would leave them without sufficient capital to purchase the replacement inventory that allows them to stay in business.

In his legislative history of LIFO, Morton Pincus captured this argument:

> LIFO, it was argued, should be permitted for tax purposes because by purging inventory profits from the calculation of income, it yielded the most accurate reflection of the way firms in the industry operated . . .[12]

Further, Jeremy Leonard commented that:

> In this sense, LIFO allows indexing for firms whose inventory costs tend to rise in much the same way the personal income tax is indexed for inflation. Eliminating it would allow inflation to artificially increase corporate taxable income, essentially taxing income that is not real.[13]

In other words, repeal of LIFO on a *prospective* basis would significantly threaten the viability of companies with slim profit margins.

Finally, the proposal makes the case that a lower tax rate and a growing economy will help all taxpayers, and that taxpayers negatively impacted by specific proposals should consider the package as a whole in that context. First, for many successful pass-through LIFO users, the tax rate reduction is negligible – 39.6% to 35% – and in fact their effective tax rates could be higher under the proposal than they are today after phase-outs and modifications to adjusted gross income are taken into account. Moreover, a growing economy overall will not help companies that LIFO repeal would force out of business.

We appreciate the opportunity to express our concerns with the LIFO repeal provision within the proposal and encourage you to evaluate the information we have provided as you consider the effect LIFO repeal will have on companies and the economy. We urge the Committee to remove LIFO repeal from the current proposal and not to include repeal in any subsequent tax reform initiatives.

Sincerely,

Jade West

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

cc: Members of the House of Representatives

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[12] Supra note 2
[13] Supra note 1

THE LIFO COALITION

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Aeronautical Repair Station Association
American Apparel & Footwear Association
American Foundry Society
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
Auto Care Association
Automobile Dealers Association of Alabama
Brown Forman Corporation
Business Roundtable
Business Solutions Association
California Independent Grocers Association
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 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
Petroleum Marketers Association of America
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 and Spirits Wholesalers of America
Wine Institute
Wisconsin Grocers Association, Inc.
Wood Machinery Manufacturers of America