THE LIFO COALITION

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March 26, 2015

The Honorable Randall DeValk
Acting Assistant Secretary for Legislative Affairs
U.S. Department of the Treasury
1500 Pennsylvania Avenue, N.W.
Washington, D.C. 20220

Re: Response to Senator Donnelly et al re Administration's Proposal to Repeal the LIFO Inventory Method

Dear Mr. De Valk:

On October 21, 2014, Senators Donnelly and Enzi co-authored a bi-partisan letter on behalf of themselves and 12 additional Senators to Secretary Lew. In this letter, the Senators expressed their opposition to one of the Administration's FY 2015 Budget proposals – the proposal to repeal the LIFO method of inventory valuation and to require the recapture of taxpayers' existing LIFO reserves into taxable income over a ten-year period. The Senators' letter gave a number of reasons for their opposition to the Administration's proposal.

By letter dated January 30, 2014 [sic], you responded to the Senators' letter, in which you offered a defense of the Administration's proposal. Moreover, subsequent to the date of your letter, in its FY 2016 Budget proposals, the Administration renewed its proposal to repeal the LIFO method with the same transition rules.

In defending the Administration's proposal, your letter briefly rejects the reasoning behind the Senators' objections to the proposed repeal of LIFO. However, your letter mainly focuses on the Senators' objection that the Administration's proposal would be retroactive in its effect because the proposal would require taxpayers to recapture into their taxable incomes their previously-accumulated LIFO reserves. The LIFO Coalition feels compelled to respond to your letter's analysis of this point.

Your letter offers a number of reasons why the Administration believes that its proposal to repeal the LIFO method would not be retroactive in its effect. First, you indicate that the LIFO method of accounting was not intended to provide a permanent exclusion from taxable income and, therefore, repealing such a method simply affects the timing of when items are included in taxable income. Your letter further points out that repeal of the LIFO method without making provision for the recapture of taxpayers' existing LIFO reserves would be tantamount to granting such taxpayers a permanent exclusion from taxable income, which would unfairly shift the tax burden from users of the LIFO method to other taxpayers. Your letter also notes that the tax law already contains provisions requiring a taxpayer to recapture its existing LIFO reserve into taxable income in other circumstances, arguing that those existing provisions of law support the Administration's contention that a requirement to recapture existing LIFO reserves does not cause the repeal of the LIFO method to be retroactive in its effect.

Finally, while acknowledging the potential financial burden that a recapture of existing LIFO reserves might have on taxpayers that currently use the LIFO method, your letter points out that the Administration's proposal would permit the recapture tax to be paid over a 10-year period, rather than immediately. Your letter indicates that this relief provision is substantially more liberal than would otherwise be the case and ought to ease the financial burden on taxpayers that would be adversely affected by the Administration's proposal.

For the reasons explained below, The LIFO Coalition submits that none of the explanations in your letter about the retroactive effects of the Administration's proposal are valid. Instead, the reasoning in the letter reflects a complete misconception about how to determine whether a proposed change in the tax laws would be viewed as having retroactive effect. Moreover, the letter reflects a misunderstanding about what transition approach would need to be adopted for a provision such as the repeal of the LIFO method to be truly prospective in effect.

Finally, the notion that spreading the tax liability resulting from the repeal of the LIFO method over a period of time, ten years or even longer, adequately compensates taxpayers for the financial burden of prohibiting the use of LIFO in the future, as well as requiring the recapture of past benefits from the use of LIFO, is totally misplaced. The response in your letter fails to appreciate the extent of the financial burden that the Administration's proposal would impose on users of the LIFO method, even in the context of fundamental tax reform accompanied by a reduction in tax rates, let alone in isolation, as the Administration has proposed. These points are addressed in more detail below.

1. Does the Administration's proposal to require the recapture of existing LIFO reserves cause the proposal to repeal the LIFO method to be retroactive in its effect?

The main reason that your letter offers in support of the proposition that the Administration's proposal to repeal the LIFO method is not retroactive in effect is the suggestion that because the LIFO method is a mechanism for *deferring* a portion of the tax on the gain from the sale of inventories and taxpayers using the LIFO method would eventually have to pay that deferred tax on their accumulated LIFO reserves, requiring taxpayers to pay that tax sooner than they would otherwise be required to under current law does not cause the Administration's proposal to be retroactive in its effect.

That proposition is incorrect for several reasons. First, the LIFO Coalition acknowledges that the LIFO method is a mechanism that enables a taxpayer to defer the tax on the portion of its gain from the sale of inventories that is the result of inflationary increases in the cost of replacement inventory. This deferral of tax is intended to enable taxpayers to finance the increase in the cost of replacing inventory that was sold, so as to enable taxpayers to continue to operate at the same level of business. Second, The LIFO Coalition acknowledges that the deferral of tax under the LIFO method does not result in an outright exclusion from income and the tax on the deferral must eventually be paid. Thus, The LIFO Coalition agrees with the Administration that the LIFO method is a timing provision.

However, the fact that a provision involves timing does not automatically avoid the issue of retroactivity. In the case of the LIFO method, the duration of the intended deferral from the use of LIFO is essentially for the life of the taxpayer, as long as the taxpayer remains in business and continues to maintain the same or greater levels of investment in inventory. This point could not be made more clearly than in the following excerpt from the Senate Finance Committee Report accompanying the Revenue Act of 1942. In this Act, a provision was enacted to provide relief for users of the LIFO method that were unable to replenish their inventories due to the constraints imposed by World War II:

> "In the case of most taxpayers using the elective inventory method [LIFO], 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.
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> "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 of the change in form of its base stock inventory."

S. Rep. No. 1631, 77th Cong., 1st Sess. (1942), reported in 1942-2 C.B. 504, 567. (Emphasis added).

In this sense, LIFO is unique in comparison to virtually every other accounting method permitted by the tax law. In the case of other accounting methods, the use of a particular method of accounting, in lieu of another method of accounting, normally produces a difference in the time for reporting income or deductions that lasts for a relatively brief period of time and reverses within a few short years. For example, in a typical case where the Internal Revenue Service challenges the timing of the deduction of employee bonuses, the reversal in the timing of the deduction occurs as soon as the accrued bonuses are paid, which is normally in the year immediately following the accrual of the bonus.

In contrast, in the case of the LIFO method, in comparison to its approved alternatives – the FIFO and average cost methods – the reversal of a taxpayer's LIFO reserve (i.e., the accumulated difference between its income reported under the LIFO method and either the FIFO or average cost method) normally occurs only when the taxpayer terminates its trade or business and thus when the taxpayer ceases to need the tax deferral associated with its accumulated LIFO reserves to maintain its normal inventory levels. Accordingly, the deferral under LIFO is about as permanent as one could get without providing for an outright exclusion from income.

In such circumstances, it is disingenuous to argue that, because a taxpayer using the LIFO method would eventually have to pay the tax on its accumulated LIFO reserve when it goes out of business and sells all of its inventory, requiring that tax to be paid sooner is not a retroactive application of the repeal of the LIFO method. We are not talking in the case of the Administration's proposal about an acceleration of tax of a year or two, but instead the difference between paying a deferred tax liability over a ten-year period versus paying the tax liability only when the taxpayer goes out of business and can thus afford to pay the tax because the taxpayer has sold its entire inventory.

In such circumstances, it is difficult to imagine a tax proposal having a more retroactive effect than the Administration's proposal to require recapture of taxpayers' existing LIFO reserves, regardless of the length of the repayment period. Even in the context of fundamental tax reform, there is no proposal that is comparable in effect to the transition rules reflected in the Administration's proposal to repeal the LIFO method.

To place the Administration's proposal in its proper context, a close analogy to what the Administration is proposing for users of the LIFO method are proposals being considered in connection with fundamental tax reform, involving lengthening depreciation schedules for depreciable property by disallowing accelerated depreciation and requiring the use of longer depreciation lives based on the actual useful lives of property. Even in the case of such proposals, no one has remotely suggested the idea that if such a proposal were enacted, taxpayers would be required to recapture into taxable income the difference between their adjusted basis in their depreciable property on hand on the effective date of the enactment of the new depreciation schedules and the adjusted basis that such property would have had if the new methods of depreciation had always been used by taxpayers.

Any reasonable person would acknowledge that such a recapture proposal would constitute an extreme example of retroactivity. No one would suggest that merely because depreciation involves the *timing* of deductions, it would be appropriate to impose the new depreciation regime on pre-existing property and recapture the entire difference between the depreciation claimed under current law and the lesser amount of depreciation that would be allowed under the new regime. However, that is exactly what the Administration is proposing in the case of LIFO repeal.

Accordingly, the mere fact that the LIFO method results in the deferral of tax in comparison to other approved inventory methods, rather than an outright exclusion from income, in no way avoids the issue of retroactivity. The Administration's proposed transition rules for the repeal of the LIFO method could hardly be more retroactive.

2. What would be required in order for the Administration's proposal to be prospective in its effect?

While The LIFO Coalition is strongly opposed to the repeal of the LIFO method under any circumstances, your letter completely misrepresents what the Senators' letter and The LIFO Coalition contend would be required in order for the Administration's proposal to at least be considered prospective in effect. Your letter suggests that the only alternative transition rule to the recapture of existing LIFO reserves if the LIFO method is repealed would be the outright exclusion of taxpayers' existing LIFO reserves from taxable income.

Neither the Senators' letter, nor The LIFO Coalition, has ever suggested that taxpayers using the LIFO method be excused permanently from paying tax on their existing LIFO reserves. Such an approach would be patently absurd, since excusing existing LIFO reserves from taxation altogether would create a net revenue loss in comparison to present law, even if the LIFO method were repealed prospectively.

Instead, the alternative to the Administration's proposal which would universally be regarded as eliminating retroactivity would be a cut-off transition rule. Under a cut-off transition rule, the LIFO reserves held on the effective date of repeal of the LIFO method would continue to be deferred until they would otherwise be recaptured under current law. In other words, with respect to a taxpayer's existing LIFO reserve, that reserve would only be recaptured when and if that reserve would have been recaptured if the LIFO method were not repealed. Thus, with respect to their existing LIFO reserves, taxpayers would be treated no better or worse than if the law were not changed with respect to taxpayers' existing inventories. That approach is the only approach that would satisfy a policy of prospectivity in the case of the repeal of the LIFO method.

The LIFO Coalition recognizes that the vast majority of the revenue raised from LIFO repeal would come from the feature in the Administration's proposal requiring the recapture of existing LIFO reserves. Even if that feature were eliminated in order to make the proposal strictly prospective in effect, The LIFO Coalition submits that it would be both unfair and unwise to repeal the LIFO method.

The LIFO method is simply a mechanism for matching the cost of goods sold with the revenue derived from such sales, so as to better enable companies to afford the increased cost of replacing inventory in order to remain in business. Critics of LIFO contend that the LIFO method does not match the physical flow of a company's goods through inventory. However, the FIFO method could be criticized on the same grounds.

In fact, any inventory method other than the specific identification method adopts an assumption regarding inventory flow. However, the specific identification method is not feasible for most companies because their goods are fungible and are not susceptible to physical tracking. That is one reason why inventory flow assumptions are permitted.

However, approximating the physical flow of goods is not the principal goal of either the LIFO or FIFO methods. Instead, the goal of both methods is to better match the cost of goods sold with the revenue derived from the sale of goods. When prices are increasing, the LIFO method better accomplishes that matching; when prices are decreasing, the FIFO method, particularly in conjunction with the lower of cost or market method, better accomplishes that matching. In either case, choosing the inventory method most appropriate to a company's pricing environment better enables a company to afford the replacement of goods when prices are increasing or decreasing. Accordingly, companies facing an inflationary environment would be unfairly disadvantaged by the repeal of LIFO, while companies operating in a deflationary environment, such as companies operating in the technology and electronics sectors, would continue to reap the benefits of the FIFO, lower of cost or market method.

3. Does the existence of provisions in the tax law requiring recapture of LIFO reserves when a C corporation converts to S corporation status bolster the Administration's argument that its proposal to repeal the LIFO method is not retroactive in its effect?

This argument is another example of the failure of the Administration to understand the difference between deferral and exclusion. A number of years ago, when Congress repealed the previous feature in the tax law that enabled C corporations to pay only a single level tax when a C corporation sold its assets and then liquidated (i.e., the so-called "*General Utilities* doctrine"), Congress became concerned that assets with built-in gain in a C corporation might escape a second level of tax on the eventual sale of those assets if the C corporation converted to S corporation status prior to selling the assets with built-in gain. Because LIFO inventories are carried at their historical cost basis, they are viewed as having built-in gain.

Accordingly, Congress became concerned that C corporations holding LIFO inventory might convert to S corporation status and thus pay only a single level tax upon the sale of inventory that had built-in gain at the time of enactment of the new statutory provisions. To prevent such built-in gain from being excluded from the corporation's taxable income when the inventory was sold, Congress enacted a requirement that a C corporation recapture into taxable income over four years the corporation's LIFO reserve on the date of the conversion to S corporation status.

Again, this provision is an example of a legislative provision designed to prevent a taxpayer's LIFO reserve from being *permanently* excluded from tax. This provision has absolutely nothing to do with *deferral* and the timing of the recognition of benefits of deferral under the LIFO method. Accordingly, this example in your letter offers no support whatsoever for the Administration's position that the recapture of a taxpayer's existing LIFO reserves does not constitute a retroactive imposition of tax.

4. Does a ten-year spread of the tax liability resulting from the recapture of taxpayers' existing LIFO reserves adequately compensate users of the LIFO method for repeal of the LIFO method?

Your letter indicates that the Administration considers a ten-year spread of the tax liability resulting from the recapture of existing LIFO reserves that would not otherwise be due until a taxpayer went out of business as adequately offsetting the burden of LIFO repeal. Your letter does not indicate how the Administration reached that conclusion and whether that conclusion reflects the Administration's examination of the financial and tax condition of users of the LIFO method.

However, in the context of the Administration's FY 2016 budget proposal, it seems totally illogical to think that merely spreading out a tax liability that would otherwise not result unless and until a taxpayer went out of business could possibly offset the burden imposed by the Administration's proposal. After all, nothing in the Administration's proposal is being offered as an offset to such additional tax liability. Moreover, under the Administration's proposal, taxpayers would lose the right to use the LIFO method in the future, as well as having to accelerate the recapture of the benefits derived from the use of LIFO in the past. How could the amortization of that additional tax liability be reasonably seen as offsetting the financial burden from LIFO repeal? After all, taxpayers are not proactively planning to reduce their inventory levels and go out of business. Where will the money come from to pay the additional tax, regardless of the number of years over which the tax may be paid?

Even in the context of fundamental tax reform, if the repeal of LIFO were accompanied by a reduction in a LIFO users' rate of tax in the future, recapture of existing LIFO reserves, regardless of the amortization period, would impose an insurmountable financial burden on taxpayers. Many taxpayers have used the LIFO method for between 50 and 70 years. Their LIFO reserves have increased incrementally to exceedingly large amounts relative to taxpayers' net worth. Moreover, for small and medium size businesses, the accumulated LIFO reserve over the lifetime of the businesses is reflected in their investment in inventories, which have increased due to inflation, as well as from growth in operations. Thus, the tax on a business' accumulated LIFO reserves is an extraordinary amount of money relative to the business' net worth.

This money is not sitting on the sidelines waiting to be used to pay the tax on the recapture of LIFO reserves; the tax savings has been reinvested in replacement inventory. Thus, any tax payments required by the repeal of LIFO could be financed by many companies only by selling their inventories and going out of business. Surely the Administration does not want that result.

Accordingly, the repeal of the LIFO method is a terrible idea even in the context of fundamental tax reform. Outside of that context, which is what the Administration's budget proposals represent, the financial burden imposed on most taxpayers would be insurmountable.

Respectfully submitted,

Jade West
The LIFO Coalition