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Repealing LIFO Will Stifle US Job Creation and American Energy Production

The tax law requires taxpayers with inventory to value their ending balances in order to determine which costs are included in the cost of goods sold over the course of the year. One of the main methods for valuing ending inventory is the LIFO (last in/first out) accounting method.

LIFO accounting is based on the assumption that the last goods brought into inventory are the first goods sold. Therefore the cost of the last goods manufactured or purchased is associated with the goods sold to generate current revenue. This allows for a clear reflection of income as current costs are matched with current income – especially for taxpayers dependent upon commodities as part of their business operations.

LIFO is a well-accepted accounting method used by many American industries and has been approved by the IRS as an appropriate way to value ending inventories since the 1930s. It is not some "gimmick" or "loophole" to inappropriately lower one's taxable income. A taxpayer employing LIFO to value ending inventories for tax purposes must also follow this method to calculate their book income. As a result, there is limited impetus for taxpayers to try and exploit or arbitrage the system - efforts to lower tax income are tied to book income results for shareholders and bondholders.

Impact of Repeal

Repealing LIFO would result in a significant impact on any taxpayer currently employing that method to value their ending inventories. The impact stems from the fact that the proposal deems a reduction in previously reported cost of sales to have occurred and gains to be recognized without any real profit being generated.

Therefore, repeal of LIFO accounting would result in a significant up-front tax burden for businesses associated with a *deemed* retroactive reduction of cost of sales. No actual transaction would take place to generate operational cash. The proposal would effectively require affected taxpayers to pay the tax with cash taken from capital reserves or ongoing operations – meaning reductions in investments in business expansion and jobs.

Like taxpayers in other industries, many oil and natural gas companies with refining operations properly elected to use LIFO many years ago to value and account for their inventory. Since the industry continued to grow and needed to purchase a volatile commodity as a raw material, LIFO was the best method to allow current costs to offset income for the current year.

It has been suggested that LIFO constitutes some type of tax abuse, but no specific tax abuse or other policy reason for changing the LIFO rules has been credibly advanced. LIFO is not a gimmick. It is simply an accounting method that clearly reflects taxable income for companies that anticipate inflation or rising prices.

Repeal Without Retroactive Effect

There is no reason for Congress to retroactively deem a reduction in cost of sales. A shift from LIFO need not be accompanied by retroactivity; retroactivity is needed only if the policy goal is to maximize government revenue. When Congress changed the tax reserve rules for casualty insurance companies in the tax reform act of 1986 – an accounting change similar to repealing LIFO -- Congress made the change without the retroactive effect. That "fresh start" accomplished the goal of implementing new reserve rules without treating insurance companies as if they had underpaid federal income tax in preceding years. Congress should seek that same result for LIFO.

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