Tax IFRS Readiness Series

The uncertain future of LIFO*

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For over 70 years, US taxpayers have been able to value the cost of their inventories using the last-in, first-out inventory method of accounting (LIFO). In general, to use LIFO for federal income tax purposes, taxpayers must also use LIFO for financial reporting purposes (herein referred to as the LIFO conformity requirement).

The use of LIFO for financial reporting purposes is not permitted under International Financial Reporting Standards as promulgated by the International Accounting Standards Board (IFRS). As a result, a conversion from US generally accepted accounting principles (GAAP) to IFRS likely will eliminate a taxpayer's ability to use LIFO for federal income tax purposes.

Moreover, the fact that LIFO is not permissible under IFRS has led many policymakers to debate whether LIFO should be permitted for tax purposes, irrespective of IFRS conversion. As a result, Congress and the Obama Administration are considering a repeal of LIFO, while taxpayers and practitioners are defending the merits of LIFO as sound tax policy and are seeking an administrative exception to the LIFO conformity requirement.

The transition from LIFO to an alternate inventory method will have a direct impact on many companies' cash taxes. This article explores the uncertain future of LIFO, examines a potential exception to the LIFO conformity requirement that could allow the use of LIFO for qualifying companies even after their conversion to IFRS, and discusses planning opportunities that may be available to US taxpayers to help them alleviate the tax burden caused by a LIFO termination.

The uncertain future of LIFO

Conversion to IFRS in the United States

Under current US tax law, a taxpayer that elects to use LIFO for federal income tax purposes must use no method other than LIFO to ascertain income, profit, or loss for the purpose of a report or statement to shareholders, partners, or other proprietors, to beneficiaries, or for credit purposes. Moreover, a taxpayer may be required to discontinue use of the LIFO inventory method if this requirement is violated.[1]

Under LIFO, ending inventory is deemed to consist generally of goods purchased in the order of acquisition. As a result, LIFO serves to match current sales revenue with current inventory costs, effectively expensing inflation. While some view LIFO as providing better matching on a company's income statement, the global movement toward IFRS has renewed the focus on a company's balance sheet for financial reporting purposes.

A consequence of this balance sheet focus for financial reporting is the prohibition of LIFO under IFRS, and a violation of the LIFO conformity requirement for taxpayers currently using LIFO. As a result, taxpayers currently using LIFO for federal income tax purposes would, upon conversion to IFRS, be required to change from LIFO unless they qualify for an exception to the LIFO conformity requirement. Many US companies with a foreign parent that have already converted, or are in the process of converting, to IFRS have already faced this issue.

[1] Sections 472(c), 472(e)(2) and 472(g). All references to "section" or "§" are to the provisions of the Internal Revenue Code of 1986, as amended (the Code or IRC). In addition, all "Prop. Treas. Reg." and "Treas. Reg." references are to the proposed and final regulations respectively, promulgated thereunder (collectively the Regulations).

Potential legislative repeal of LIFO

In addition to the uncertainty about the future of LIFO resulting from the US conversion to IFRS, the future of LIFO also has been placed in doubt by possible federal legislative repeal. While Congress has yet to take up the issue during its current session, it has considered the repeal of LIFO in the past.

Recently, the Treasury Department released its “Green Book” outlining President Obama’s fiscal year 2010 budget, which includes a proposal to repeal LIFO for taxable years beginning after 2011. The explanation accompanying this proposal states the Administration believes that LIFO provides an unfair tax deferral opportunity for taxpayers holding inventories with costs that increase over time. The explanation also provides that the repeal of LIFO would remove possible impediments to the potential adoption of IFRS in the United States. Under the proposal, if a taxpayer’s change from LIFO results in higher inventory values, the resulting one-time increase in gross income would be taken into taxable income ratably over eight taxable years.

Many taxpayers and practitioners have speculated that Congress wants to repeal LIFO prior to the US conversion to IFRS so that they can score the repeal as a revenue raiser. As a result, US taxpayers may be forced to terminate their LIFO election before their conversion to IFRS.

Potential administrative relief

In attempts to avoid the termination of LIFO as a result of IFRS conversion, taxpayers and practitioners have requested that Treasury issue guidance related to the adoption of IFRS in the United States. Specifically, proponents of LIFO point out that in the past, when the LIFO conformity rule conflicted with SEC disclosure rules for financial reporting or foreign reporting requirements, Treasury issued guidance to remove the conflicts.

Beyond administrative guidance, proponents of LIFO also contend that Treasury has the authority to go further by modifying regulations to address the conflict between the LIFO conformity requirement and IFRS. Faced with a similar situation in the early 1980s when the Securities and Exchange Commission required increased disclosure for companies on LIFO, Treasury responded by issuing regulations that relaxed the LIFO conformity requirement.[2]

Alternatively, proponents believe that Treasury also has the authority to issue regulations specifically allowing LIFO without a conformity requirement. Section 471 allows Treasury to prescribe the use of inventories that conform to the best accounting practices used in a trade or business. When LIFO was originally enacted in 1939, Treasury was initially reluctant to prescribe LIFO as an acceptable inventory method under Section 471 because the inventory method was new and not commonly used. In 1939, when Congress enacted a new code section for LIFO, it preserved Treasury’s authority to allow the method under Section 471 if it later considered LIFO to be an acceptable inventory method.[3] Accordingly, Treasury could preserve the use of LIFO and address the LIFO conformity requirement issue by acknowledging use of the LIFO inventory method under Section 471.

By taking this route, Treasury could proactively alleviate pressures currently faced by US companies as they convert to IFRS, while still producing the best results from both a financial reporting and tax reporting perspective. That is, since IFRS is balance sheet focused, the use of the first-in, first-out inventory method (FIFO) for financial reporting purposes would accurately reflect the cost of a taxpayer’s inventory at year end. Likewise, since tax returns are income statement focused, the use of LIFO for tax reporting purposes would most accurately reflect the cost of a taxpayer’s inventory incorporated into that year’s cost of goods sold calculation.

However, given that the Obama Administration has proposed in its fiscal year 2010 budget to repeal LIFO altogether, Treasury may not be inclined to preserve LIFO through any of these means.

Existing exception to the LIFO conformity requirement

Absent any legislative or administrative action that would remove the LIFO conformity requirement or repeal LIFO altogether, companies facing IFRS conversion should consider if they may be eligible to use LIFO even after they adopt IFRS for financial reporting purposes.

In Rev. Rul. 78-246, the Internal Revenue Service (IRS) held that the LIFO conformity requirement is not violated as a result of consolidated financial statements issued by a foreign parent corporation that are not prepared on a LIFO basis, provided that the foreign parent owns,

[2] See Treas. Regs. §1.472-2(e).
[3] Sen. Rep. No. 648, 76th Congress, 1st Sess. 6 (1939).

either directly or through members of its consolidated group, operating assets of substantial value that are used in foreign operations. For this purpose, a foreign parent corporation is deemed to own substantial foreign assets if the total value of such assets constitutes 30 percent or more of the total operating assets of the consolidated group. This determination is made annually and, normally, will be made on the basis of the asset valuation reflected in the consolidated financial statements of the group for the year (e.g., IFRS).

A US company that qualifies under this ruling must report to its foreign parent on a LIFO basis, but the foreign parent can convert to FIFO for purposes of its worldwide financial statements, which therefore would comply with IFRS. Many US subsidiaries with foreign parents that issue non-LIFO consolidated financial statements have invoked the exception provided by Rev. Rul. 78-246 and, therefore, use LIFO for federal income tax purposes.

In promulgating this ruling, Treasury and the IRS relied on the legislative history of the LIFO conformity requirement. Legislative history reveals that the LIFO conformity requirement was enacted to ensure that LIFO conforms as nearly as possible to the best accounting practice in the taxpayer's trade or business, determined on the basis of US standards of accounting practice. Because Congress was concerned solely with domestic accounting practice, Treasury and the IRS determined that the LIFO conformity requirement should not extend to determine what would be the best accounting practice in foreign countries.

However, if LIFO is determined to be an impermissible method when domestic accounting practice converges with IFRS, it is unclear whether the IRS would reverse the exception provided in Rev. Rul. 78-246, particularly in light of the fact that the ruling can be viewed as unfairly disadvantaging US-based companies. Furthermore, if a US subsidiary of a foreign parent company is required to issue separate standalone financial statements on an IFRS basis, the exception found within Rev. Rul. 78-246 would not apply and the LIFO conformity requirement would be violated.

Planning considerations for LIFO termination

In the event a taxpayer is required to terminate its LIFO election, they should consider the opportunities available to help alleviate the potential cash tax impact resulting from the termination of the company's LIFO election, including differing Section 481(a) adjustment periods and selecting favorable methods for valuing the company's FIFO inventory.

Section 481(a) adjustment period

Under current IRS administrative procedures, if a taxpayer changes its tax method of accounting from LIFO to another acceptable inventory method, and the change results in a higher inventory value, the positive adjustment to income is taken into account over four taxable years. In contrast, the Obama Administration's fiscal year 2010 budget proposal provides that if the change from LIFO caused by the legislative repeal of LIFO results in an increase to a taxpayer's inventory value, the resulting increase to gross income would be spread over eight taxable years. Thus, the impact of changing from LIFO to another acceptable method of accounting for inventories may be mitigated under a legislative repeal of LIFO, as compared to the mandatory termination of a company's LIFO election effectively required upon adoption of IFRS.

Valuation of FIFO inventory for US tax purposes

While companies may not be able to avoid unfavorable adjustments to taxable income as a result of changing from LIFO to FIFO, either upon conversion to IFRS or following a legislative repeal of LIFO, companies may be able to mitigate the impact by selecting favorable valuation methods of accounting for their FIFO inventories. Under LIFO, taxpayers must value their inventories at cost. Under FIFO, taxpayers have the advantage of being able to value their inventories below cost, including using the lower of cost or market (LCM) method and the subnormal goods method.[4]

[4] A change to the LCM method or to value subnormal goods below cost may not be available at the time of conversion, however, because the Obama Administration has proposed to repeal both of these methods as well.

For example, a taxpayer changing from LIFO to FIFO may want to adopt the LCM method to value its ending inventory for US tax purposes. For normal goods, the LCM method allows taxpayers to analyze each item or component in ending inventory and value it at “market,” defined as reproduction or replacement cost, to the extent market is less than cost. This approach differs from financial accounting LCM rules, which generally do not apply on an item-by-item basis, and generally define market based on selling prices.

As a result, financial accounting rules generally do not allow an LCM adjustment to the extent that the company anticipates earning a profit on the item, whereas US federal tax rules allow the inventory to be written down to “market” regardless of net realizable value. For example, under the tax LCM rules, a company may write down the component of its ending inventory attributable to the raw materials used in its production process (whether in the form of raw materials, work in progress, or finished goods) to the extent those raw materials have declined in value from the time of purchase to the end of the year, regardless of whether the finished goods, which contain said raw materials, will be sold at a profit.

With respect to subnormal finished goods, taxpayers may value them at bona fide selling prices less the direct costs of disposition. However, if the taxpayer merely intends to scrap those finished goods, they generally can be written down to scrap value without having to offer the goods for sale. If such subnormal goods consist of raw materials or partly finished goods held for use or consumption, they may be valued based upon a reasonable basis taking into consideration the usability and the condition of the goods, but in no case shall such value be less than scrap value.

Thus, while taxpayers may not be able to avoid the unfavorable tax adjustments that typically result from a change in tax accounting method from LIFO to FIFO, they may be able to mitigate the impact through the selection of favorable inventory valuation methods, such as electing to value their inventories below cost, which likely will have the effect of reducing their Section 481(a) adjustment.

What this means for your company

Regardless of whether a company changes from LIFO to FIFO as a result of adopting IFRS or because of legislative repeal, such change is likely to have a significant impact on its cash taxes. Assuming LIFO is not repealed through legislation, in certain situations a company may qualify for an exception from the LIFO conformity requirement. As a result, the company may be able to continue to use LIFO for tax reporting purposes even after they convert to IFRS for financial reporting purposes.

In other instances, taxpayers may have no choice but to terminate their LIFO election. However, through proper planning, companies may be able to mitigate the cash tax impact resulting from termination through the use of favorable Section 481(a) adjustment spread periods and selection of favorable inventory valuation methods, which may have the effect of reducing Section 481(a) adjustments and alleviating the tax burden resulting from the LIFO termination.

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Clients of PricewaterhouseCoopers may want to open a dialogue about IFRS with their PwC engagement partner or the primary authors of this paper who welcome any questions about the tax implications of IFRS.

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