

Taxpayers should consider immediate action to adopt the LIFO inventory method to expense high inflation

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In brief

A taxpayer required to maintain inventories must determine which items remain in ending inventory using a cost flow method. Permissible cost flow methods include specific identification, first-in, first-out (FIFO), and last-in, first-out (LIFO). Under the LIFO method, the goods most recently produced or acquired are deemed to be sold first. Thus, when costs are rising, LIFO generally results in higher cost of goods sold and lower taxable income.

For consideration: Taxpayers using the specific identification or FIFO method and experiencing rising inventory costs should consider adopting the LIFO method. Because of a requirement for financial reporting conformity, taxpayers must make this decision before issuing financial reports to be eligible to use the LIFO method for federal income tax purposes. US companies with a foreign parent must issue LIFO statements to the foreign parent, but the foreign parent may be able to report on a FIFO basis in its worldwide financial statements.

In detail

The specific identification method tracks each individual item in inventory from the time the item is acquired until the item is sold. The FIFO method assumes that goods sold come first from beginning inventory and then from goods acquired or produced during the year. Under LIFO, goods sold during the year are deemed to come first from goods purchased or produced during the year and then from beginning inventory. As a result, under a LIFO method, inflation on items in ending inventory is included in cost of goods sold, which could reduce taxable income significantly.

Observation: Products that have experienced substantial inflation during the past year include grains (44%), slaughter livestock (27% - 63%), processed poultry (26%), seafood (27% - 262%), eggs (82%), butter (40%), fats and oils (42%), cotton (48%), yarn (30%), natural gas (110%), propane (93%), crude oil (49%), petroleum products (44% - 69%), industrial chemicals (28% - 94%), agricultural chemicals (49%), plastic products (25% - 84%), hardwood lumber (34%), wood pulp (43%), recyclable paper (78% - 137%), metals and metal products (26% - 230%), and manufactured mobile homes (30%).

Taxpayers adopting the LIFO method may measure inflation using indexes based on changes in internal inventory costs or indexes published by the Bureau of Labor Statistics under the inventory price index computation (IPIC) method.

Observation: Computations under the IPIC method are relatively easy.

A taxpayer must value all LIFO inventory, including beginning inventory, at cost. The taxpayer must take into account adjustments resulting from valuing beginning inventory at cost ratably over a three-year period, beginning with the tax year of adoption.

Under the LIFO conformity rule, a taxpayer that uses LIFO for tax purposes must use LIFO in computing book income. Accordingly, financial statements issued to shareholders, creditors, or other parties must reflect income based on inventory computed under the LIFO method. Although US companies that are members of foreign consolidated groups with substantial foreign operating assets must issue LIFO statements to the foreign parent, the foreign parent may be able to issue non-LIFO statements for purposes of worldwide financial reporting.

A taxpayer adopts LIFO by attaching Form 970, Application to Use LIFO Inventory Method, to its federal income tax return.

Let's talk

For a deeper discussion of how these issues might affect your business, please contact one of the PwC professionals listed below, or your local [Accounting Method Services](#) contact:

Accounting Method Services

April Estes
(404) 271-9150
april.l.estes@pwc.com

Christine Turgeon
(973) 202-6615
christine.turgeon@pwc.com

Jim Martin
(540) 455-8416
james.e.martin@pwc.com

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