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CERTIFIED PUBLIC ACCOUNTANTS

Combatting High Inflation with LIFO

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Every taxpayer has felt the pain of soaring inflation in 2022 and there are no signs of relief coming soon. Taking advantage of the Last In First Out method (LIFO) can offer a great opportunity for businesses carrying inventory to adjust their inventory valuation method, and possibly save money on their taxes. To help assess if LIFO may be a beneficial strategy for you, we will cover the following:

- Understanding LIFO
- Candidates for LIFO
- Benefits and Downsides of LIFO
- LIFO Methods & Guidance

Understanding LIFO

LIFO is an accounting method that values inventory and calculates Cost of Goods Sold (COGS) by using the cost of the most recent (last) purchases. LIFO operates under the assumption that older, less costly inventory remains in warehouses while newer, more costly inventory is sold when calculating income. As opposed to the First In First Out (FIFO) method, or a weighted average method, LIFO helps reduce the effect of inflation on inventory costs because costs are being recognized in real-time as prices change.

Candidates for LIFO

Taxpayers in many industries could benefit from switching to LIFO. Candidates for LIFO generally need to be carrying $2,000,000 or more of inventory to recoup the cost and have significant benefits from LIFO. To obtain tax benefit, taxpayers also need to be profitable.

Example #1 C Corporation - Assuming a tax rate of 21% for C corporations and the current 7.4% inflation rate, a taxpayer with $2 million of inventory could see potential tax savings of around $28,939.

Example #2 S Corporation - For a passthrough entity like an S Corporation or Partnership, assuming a 37% tax rate for the shareholders or partners, the current 7.4% inflation and $2 million of inventory, a taxpayer could see potential tax savings of around $50,986.

Some industries that are affected by more than 7% inflation would have the possibility of even more significant benefits from using LIFO.

Benefits of LIFO

Inflation has surged to historic highs this year with the most recent rate of 7.4% released for November 2022 by the U.S. Labor Department. LIFO allows taxpayers to recognize inventory expenses in COGS at an amount equal to current market prices, rather than price at purchase which could be significantly lower than current market prices Treas. Reg. §1.472-2.

In times of ongoing inflation, LIFO can effectively operate as an interest free loan deferring gain recognition on the lower-valued inventory. However, taxpayers considering a sale of the company holding inventory in the near future should note that they would not have as much time to recoup the initial setup costs and some sale structures can trigger LIFO recapture at ordinary income tax rates.

Although the revocation of the LIFO method of valuing inventory for tax purposes appeared in previous tax reform discussions and negotiations, there seems to be a low likelihood of LIFO being revoked in the near future due to a lack of imminent tax reform.

Downsides of LIFO

While LIFO certainly has significant potential for benefit, there are some downsides to consider. Financial reporting and tax methods must be the same in the year of adoption and subsequent periods. Therefore, taxpayers with restrictive debt covenants and other stakeholders concerned with financial performance rather than taxable income may need to evaluate if LIFO is still economically beneficial.

If a taxpayer wishes to stop using LIFO, their CPA must file a change in accounting method using Form 3115 filed with the IRS. The difference between FIFO and the LIFO inventory valuation methods must be recaptured and paid back to the IRS using a §481(a) adjustment. Taxpayers must wait five tax years to elect LIFO again after terminating Treas. Reg. §1.472-3.

LIFO creates a greater reliance on accounting information systems to calculate inflation if using an internally calculated index. Companies should make sure they have the necessary skilled personnel and IT infrastructure to support calculating an internal index if they choose that method.

If a C Corporation under LIFO converts to an S Corporation, §1363(d) requires any increase in tax due on LIFO recapture (difference between ending FIFO and LIFO inventory valuations) to be paid in four equal installments. If the S Corporation files a final return before all four payments have been made, the remaining balance is immediately due.

LIFO Methods & Guidance

LIFO is adopted as an inventory valuation method at the close of any tax year. Taxpayers can choose from two LIFO methods, one using an external inflation index and the second by creating their own company specific index. Inventory Price Index Computation (IPIC) is the less labor-intensive method to compute the LIFO value of an inventory. IPIC uses the external index for inflation released by the Bureau of Labor Statistics (BLS). The IPIC method offers simplicity and audit protection by using an external, government calculated index. The traditional LIFO method would use an internally created index which requires more calculations.

For the LIFO calculation each year, taxpayers may need to separate their inventory into identifiable pools of substantially similar items to use an appropriate inflation index for each pool type Treas. Reg. §1.472-8(b). In addition to its own calculated index, each pool will have a separate LIFO reserve. A LIFO reserve is the difference between the FIFO method cost of inventory and the LIFO method. In times of rising inflation, a LIFO reserve is the amount by which a taxpayer's taxable income has been deferred for a given period, usually a year.

Each year after the year of adoption, taxpayers compute the current period cumulative index by adding each year's index to the prior years' indexes. Or taxpayers may use the applicable index from the BLS to calculate the value of each ending inventory pool at base year prices. The base year is the year of adoption of LIFO, which begins the series of years used in computing the cumulative index.

Next, taxpayers must compare the base year cost of ending inventory with the base year cost of the beginning inventory. When costs increase with inflation over the year, the increase is multiplied by the current year cumulative index to determine the LIFO costs' current year inventory increase. In turn, this increases COGS, and reduces taxable income. When costs decrease, prior year inventory reserve layers are eliminated beginning with the most recent. As these layers are eliminated, COGS is decreased, and taxable income is increased. The ending LIFO inventory value is calculated by adding the current year cost increase to the prior year ending LIFO inventory or subtracting the current year's decrease. In short, as inflation goes up, COGS will increase to reduce taxpayers' net income.

Closing

If you are interested in a more detailed discussion of how LIFO could affect your tax planning opportunities before the end of the year, please contact us to discuss further.

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