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ATR Obama Budget Analysis: Energy Tax Hike Series

LIFO Explained

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Current Law

When companies purchase items to sell later, they are accumulating an “inventory.” When a good is sold, the profit is the sales price minus the inventory cost. Since 1938, companies have had a choice when determining which parts of their inventory they report to calculate the profit on a good sold. Under “first-in, first-out” (FIFO), the oldest parts of the inventory are what are used to make this determination. Many companies, however, choose to use the “last-in, first-out” (LIFO) method, whereby the newest inventory purchased is what’s used in the profit calculation.

The LIFO method is most valuable for companies that see the prices of their inventory rise over time. Let’s say I have a \$10 item I bought several years ago, and a \$12 item I bought this year. I want to sell an item for \$15. FIFO inventory gives me a profit of \$5 (\$15-\$10). LIFO inventory gives me a profit of \$3 (\$15-\$12). I would only pay taxes on \$3 of profit, not \$5.

The difference between the FIFO profit (\$5) and the LIFO profit (\$3) is \$2. This \$2 becomes part of a “LIFO reserve.” Companies must keep track of this LIFO reserve, which in recent years has been the target of tax increase proposals by members of both political parties.

Obama Proposal

The FY 2010 Administration Budget calls for requiring companies to pay taxes on this “LIFO reserve.” It’s unclear how this would be accomplished, since the ten-year score for this tax increase is only \$61.05 billion. Various estimates have scored full LIFO repeal at several multiples of this score.

ATR Analysis

Companies should not have to pay taxes merely on inflation. Yet that is exactly what forcing companies to use FIFO would do. At the very least, companies using a long-standing and perfectly-reasonable inventory accounting standard should not be punished after the fact by being taxed on phantom “reserves.”

LIFO is used most often by energy companies. Taxing LIFO reserves is a clear attempt to slap an unfair tax on energy manufacturers merely to exact a political price. The economic price will be borne by the American people, who will end up paying this “inventory tax” in the form of higher energy prices. The most likely scenario is that taxing LIFO reserves and requiring FIFO going forward will be imposed strictly on energy manufacturers. It’s the ultimate goal of tax increasers, though, to repeal LIFO altogether.

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