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Is It Time to Liquidate LIFO?

by by

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This report discusses the role of the last-in, first-out (LIFO) inventory accounting method in the current tax system, both as a matter of practice and of policy. The authors examine the traditional justifications for LIFO and argue that LIFO, as it is administered, is inconsistent with both its own objectives and with broader income tax principles. LIFO, as practiced in the United States today, benefits only a narrow range of businesses; they in turn rely on it entirely for its tax benefits, rather than to complement normal business operations. Further, the evidence on LIFO suggests that it creates inefficiencies in business operations, and may facilitate earnings management. The authors conclude that any discussion of fundamental tax reform must consider the repeal of LIFO.

The views expressed in this article are those of the authors and do not necessarily represent those of their respective institutions. The authors thank Sarfraz Khan for research assistance and John Phillips and Michael Redemske for comments. Any errors are their own.

I. Introduction

In late April of this year, Sen Pete V. Domenici, R-N.M., proposed amending the Internal Revenue Code to prohibit companies from using the last-in, first-out method to account for their inventories for tax purposes. The plan itself was removed from consideration almost as soon as it was proposed, but talk of LIFO repeal in Congress did not end and the issue was revisited in hearings before the Senate Finance Committee in mid- June. This recent legislative interest in a targeted LIFO repeal raises the issue of whether LIFO should be permitted generally, a topic that has not been widely discussed in the tax policy literature.

This report summarizes and critically analyzes the key arguments in support of LIFO inventory accounting. We find that, as practiced today, LIFO accounting

amounts to a massive tax holiday for a select group of taxpayers. This tax holiday is inconsistent with larger income tax principles, cannot be justified even by the arguments usually advanced by its proponents, and is not supported by global best practices in financial accounting. We believe the proper response is for Congress to repeal the LIFO method of inventory accounting for tax purposes, preferably in the context of broad-scale corporate tax reform.

We estimate that the explicit LIFO reserves of publicly traded companies totaled no less than \$60 billion in 2004 and almost \$70 billion in 2005. Those figures underestimate the total LIFO reserve for all taxpayers using LIFO accounting, if for no other reason than because the data do not include privately traded firms. Indeed, the "LIFO Coalition," an ad hoc group of affected taxpayers dedicated to the retention of LIFO accounting for tax purposes, has published a paper claiming that the LIFO reserves of U.S. companies actually are "many times greater" than our estimate of explicit LIFO reserves. For purposes of argumentation, we can cheerfully accept the LIFO Coalition's emendation of our estimate and maintain that it proves only that Congress is presented not with one tree bearing low-hanging tax fruit, but rather with an entire orchard ripe for the picking.

We demonstrate in this report that there simply is no room in a principled income tax for LIFO accounting. *The purpose and effect of LIFO is to provide eligible taxpayers with a deduction for an expense that is never incurred.* The author of the leading treatise on the taxation of inventories (who is also the author of the memorandum submitted to the Finance Committee by the LIFO Coalition) acknowledged exactly this point at the beginning of his treatise's discussion of LIFO accounting:

The single most important factor that has influenced taxpayers to adopt the LIFO method is the tax savings that result from its use for tax purposes. Theoretically, use of the LIFO method results only in a deferral of taxes. However, as long as inflation continues and a taxpayer's LIFO inventories remain relatively constant or increase in size, the tax deferral is perpetuated and tends to become 'permanent.'

LIFO thus provides a permanent tax deferral — a *tax holiday* — for a select class of taxpayers. As such, it is inconsistent with the fundamental purpose of the income tax, which is to tax the entirety of a taxpayer's annual accretion to wealth, whether labeled "inflation-generated" or otherwise.

LIFO fails another fundamental principle of a well-designed income tax in that it is not available to all taxpayers in all industries, but rather only to those that maintain physical inventories and are not required to use another accounting method for those inventories. Thus, the services industries are almost entirely excluded from LIFO's tax holiday. Finally, LIFO serves no independent business or commercial purpose: As demonstrated below, companies that employ LIFO for tax purposes go to great lengths *not* to use LIFO for any observable nontax business purpose, such

as capital budgeting or management compensation.

The avowed purpose of LIFO is to permit taxpayers to defer inflation-related increases in inventory values. LIFO is described by its proponents as achieving a better matching than does first in, first out (FIFO) between current revenue and current expense, which in turn is said to further good tax policy, by "ameliorat[ing] the harmful effects of inflation on capital investment." Thus, the memorandum submitted to the Finance Committee by the LIFO Coalition early this summer argued that LIFO fulfills a function analogous to the purpose underlying the code's accelerated depreciation rules. As the remainder of this report describes in more detail, however, that argument rings hollow, for several reasons. First, even taken on its own terms, LIFO accounting for inventory is overgenerous because it immunizes companies from paying tax on inventory gains attributable to factors *other than* inflation. Second, LIFO accounting is not analogous to accelerated depreciation or other timing benefits because LIFO accounting amounts in practice to permanent, not temporary, reductions in tax liability. Third, unlike accelerated depreciation, LIFO does not provide broad-based benefits to all taxpayers with inventories.

More fundamentally, Congress rationally could have decided to encourage the investment in productive plant or equipment, to increase the productivity of American businesses and the collective wealth generated by the economy. As practiced, however, LIFO inventory accounting appears to encourage, through a tax subsidy, the systematic accumulation of inefficient levels of inventories, together with a mechanism to manage earnings reported to both shareholders and the tax authorities.

Our principal focus in this report is on tax policy, not financial accounting. We believe, however, that if LIFO were not permitted as a tax accounting method it quickly would be rendered extinct in the financial accounting landscape as well because LIFO, in practice, is a creature entirely of the tax ecosystem: The ecological niche it occupies is entirely that of a tax-savings strategy, not a robust alternative method to more fairly present companies' financial results.

The remainder of this report is organized as follows. Section II briefly describes the role of inventory accounting methods in an income tax (and in financial accounting systems). Section III lays out our core arguments as to why LIFO accounting for inventories is fundamentally inconsistent with a principled income tax. Section IV explains why LIFO accounting in fact fails to accomplish its own purported objectives. Section V demonstrates that the "book- tax" conformity that purportedly serves as a governor on the adoption of LIFO is illusory. Section VI describes how LIFO accounting can give rise both to poor physical inventory management and to financial accounting earnings management. Section VII reviews the available data on the use of LIFO inventory accounting today and considers how Congress might most productively go about excising LIFO from the code. Finally, Section VIII briefly

summarizes our conclusions.

II. Inventory Accounting Methods

To understand the arguments that follow, it is helpful to review briefly how LIFO and other inventory accounting methods operate.

Physical inventories generally are necessary to run a business that depends on the steady sale of similar goods to customers. The existence of physical inventories in turn means that a taxpayer typically is simultaneously selling its goods to the public and buying (or manufacturing) replacement goods — its inventories.

A taxpayer's net annual income from the sale of goods that it manufactures or purchases for resale simply equals its sales revenues minus its "cost of goods sold." The purpose of inventory accounting methods is to determine, since a taxpayer is selling its goods to customers and simultaneously buying (or spending money to manufacture) replacement goods, which of the taxpayer's total costs incurred during the year for the goods that it manufactures or purchases for resale relate to goods sold during the year, and which of those costs are attributable to the goods that remain on hand as inventory at the end of the year.

Every practical inventory accounting method makes that determination by adopting an arbitrary ordering rule that assigns in some mechanical fashion the costs incurred by the taxpayer during a year to manufacture (or purchase for resale) the goods that it sells to the public to (1) the goods that the taxpayer in fact sold during the year (that is, to the "cost of goods sold") and (2) to the taxpayer's goods remaining on hand (that is, in inventory) at the end of the year. Inventory accounting methods thus provide a *cost flow* assumption that in no way needs to relate to the *physical flow* of goods produced and sold by a business. Allocating a greater proportion of the taxpayer's total costs for the year to the cost of goods sold during the year reduces current income and simultaneously reduces the value assigned to the taxpayer's year-end inventories.

FIFO's arbitrary ordering rule for inventory costs is that the taxpayer's inventoriable goods are deemed to have been sold in the order purchased (or manufactured); the costs associated with acquiring those goods are tracked as prices change, and the earliest (first) costs incurred are assigned to the goods sold during the year. As a result, the taxpayer's ending inventory is deemed to comprise the taxpayer's most recently purchased or manufactured goods.

A collateral consequence of FIFO's ordering rule is that FIFO tends to value inventories on hand at year-end at levels that approximate their market values (replacement cost). That result is consistent with underlying income tax principles because those principles seek to include in income net annual increases in a taxpayer's wealth, to the extent those increases are visible and quantifiable through

"realization" events.

LIFO's arbitrary ordering rule is the opposite of FIFO's: It assumes that the taxpayer sells the most recently purchased (or manufactured) inventorable goods first, so that the taxpayer's first-acquired inventories are deemed *never* to be sold (unless the taxpayer shrinks its inventories below historic levels). In a world of increasing prices and constant (or increasing) inventory levels, a taxpayer that employs LIFO inventory accounting will report less income than an otherwise identical taxpayer employing FIFO because the LIFO firm will match its sales revenues against its most recently purchased or manufactured (and therefore most expensive) inventory costs. The difference in the amounts of income reported using FIFO or LIFO in turn is offset by the difference in the values of the inventories a business reports under the two methods on its balance sheet.

A taxpayer that employs LIFO carries its year-end inventories at values that can relate back to the taxpayer's adoption of LIFO — a date that often is decades in the past. For example, a taxpayer that adopted LIFO in 1976 and that has not shrunk its inventory levels since that date will carry its core inventories at values equal to their 1976 cost. When a taxpayer employs LIFO, "the day of reckoning is put off until the cost of replenishing the taxpayer's inventory or its volume declines."

To provide better (if still imperfect) information about the actual values of LIFO inventories to shareholders, financial statements ordinarily provide supplemental disclosures on the difference between the LIFO cost of inventory as reported on the balance sheet and what the value would be under FIFO or current cost. That difference is referred to as the *LIFO reserve* or *inventory valuation allowance*. The value of the LIFO reserve represents the cumulative amount of additional costs that have been expensed by the firm because of the choice of LIFO over its alternatives.

III. LIFO Is Inconsistent With Tax Principles

LIFO accounting is inconsistent with larger income tax principles in two fundamental respects. First, LIFO accounting's theme of "matching current revenues to current expenses" directly violates the principle that our income tax requires a taxpayer to account *annually* for the income (that is, all increases to the taxpayer's wealth, to the extent those increases are observable) the taxpayer derives during a year. LIFO accounting for inventory fails that standard because it typically yields a *permanent* deferral of tax — the equivalent of a deduction for a cost that is never incurred.

Second, even if LIFO were restricted in application to purely inflationary gains (which is not the case, as Section IV demonstrates), LIFO violates another fundamental tax principle because it is a *selective* partial immunization from inflation — one that is neither available to all taxpayers, nor applicable to all similar assets, in a consistent manner. The first part of this section expands on those two themes.

Congress of course often deviates from rigid income tax theory to advance a larger

economic or social agenda. The second part of this section demonstrates, however, that there is no countervailing business or economic rationale that can excuse LIFO's failures.

A. LIFO and Our Income Tax

One point on which even proponents of LIFO accounting agree with us is that the practical effect of LIFO accounting is to grant a taxpayer that uses the method a *permanent deferral* — a tax holiday — in respect of the income attributable to increases in the value (from whatever source) of inventory assets during the period held by the taxpayer.

According to Boris Bittker and Lawrence Lokken, "For taxpayers anticipating long-term inflation in their industries, LIFO is an appealing option because its effect is to postpone tax on inflationary gains in inventory *indefinitely*." Similarly, the authors of one of the leading financial accounting textbooks point out that "As long as the price level increases and inventory quantities do not decrease, a deferral of income tax occurs" under the LIFO method. Another volume on the tax aspects of LIFO accounting notes, "The major advantages of LIFO are in periods of rising prices in which LIFO eliminates 'inventory profits,' reduces federal income tax and improves cash flow." The LIFO Coalition's memorandum agrees, acknowledging that it would not be unusual for a company to have employed LIFO to defer its tax liability "for over 30 years." And the author of the LIFO Coalition's memorandum himself, in his treatise on the taxation of inventories, has acknowledged that this tax deferral "tends to become 'permanent.'"

Proponents of the LIFO status quo do not deny that LIFO operates in practice as a permanent deferral of tax liability attributable to increases in inventory values during the period a taxpayer holds those inventories. Those proponents seek to justify that result, however, on the basis that "when the proceeds of sale of an inventory item are reinvested in a corresponding replacement item of inventory, there has been no genuine economic realization event." Another way of making that point is to observe that *LIFO accounting treats every sale of inventory property for cash in effect as a partial tax-free exchange*. For example, if a retailer employing the LIFO method acquires an item of inventory for \$2 and sells it later at its market value of \$6, reflecting an increase in wholesale costs to the base price of \$3, and a retailer's markup of \$1, LIFO accounting permits the retailer permanently to avoid any tax liability on the \$3 in appreciation in wholesale values during the period the retailer held the asset.

Unfortunately for the proponents of LIFO, however, there in fact is a realization event when inventories turn over — a sale of property for cash. An important principle of our tax code is that income must be accounted for annually. We honor that principle, for example, by requiring that tax be paid in the same year that income is "realized" (and recognized) by selling property. We do not allow

businesses to avoid tax liability arising from the sale of property at a profit merely on the basis that the profit has been reinvested in more business assets — that is the essence of a consumption tax, not an income tax. Yet that is exactly the result that proponents of the LIFO status quo seek to preserve for themselves.

Returning to the earlier discussion in Section II, it might be argued that because both FIFO and LIFO are themselves arbitrary inventory ordering rules, objections to LIFO amount to nothing more than an arbitrary preference for the method that maximizes tax liabilities. To the contrary, FIFO in fact more clearly coincides with income tax principles. (We are agnostic, however, on the question of which inventory accounting method — other than LIFO — most accurately reflects the goals of GAAP accounting.) Regardless of the method that a taxpayer employs to account for its inventory, the taxpayer in fact owns an asset (the inventory itself). An ideal income tax would measure the values of a taxpayer's assets at the end of the year, compare those values with the corresponding values at the beginning of the year, and include the difference in income. By valuing closing inventories at figures that converge on current replacement cost, FIFO plainly comes closer to this ideal than does LIFO.

Another way of seeing that fundamental point is to imagine two otherwise identical taxpayers, one of which employs LIFO accounting for its 100 widgets in inventory, and the other of which has perfected "just in time" (JIT) physical inventory management, to the point where it never has any inventories on hand. Widgets in the past have always cost \$5; because the two taxpayers are otherwise identical, one can imagine that the first has \$500 tied up in widget inventories, and the other \$500 in cash in its sock drawer.

Now suppose that the price of widgets unexpectedly jumps to \$9. The two taxpayers are now no longer equally wealthy: The first could sell its widget inventory for \$900 (whether in liquidation of its business, or by adoption of equally efficient JIT physical inventory management methods), while the second still has just the same \$500 hidden in its sock drawer. Yet LIFO accounting treats the two taxpayers identically — as if the first enjoyed no greater accretion to wealth for its tax year than did the second.

In summary, the LIFO method partially suspends the application of the realization principle for some sales of property (LIFO inventories) for cash — and by doing so, deviates from a comprehensive effort to capture in the taxpayer's annual income current increases in a taxpayer's wealth (including increases in the value of inventories, like any other property), as documented through actual realization events. By turning sales of inventory for cash into effective tax-free exchanges, LIFO accounting for inventories functions as an effective *tax holiday* for those firms that employ it. In short, in this fundamental respect LIFO accounting produces results directly in opposition to the purpose of an annual income tax.

A second-order failing of LIFO when measured against income tax principles is that, even if it were restricted to accomplishing its purported objective of immunizing taxpayers only from purely inflationary inventory gains (which in fact is *not* the case, as demonstrated in Section IV, below), that objective would not be sufficient because it would be underinclusive. That is, this idealized inflation-immunization program would be available only to some taxpayers in some businesses — those with physical inventories and that are otherwise eligible for LIFO accounting.

Inflationary gains are not unique to inventories, yet even an idealized LIFO accounting system would reach only one class of assets. Any time the code privileges one class of assets over another, it distorts economic behavior. In this case, the distortion is to encourage taxpayers to maintain physical inventories beyond the levels they might otherwise need, simply to avoid recognizing layers of built-in (and as-yet indefinitely deferred) LIFO inventory gains. We return to this theme in Section VI.

To be clear, inflation is a very important issue in the design of any income tax system. Our tax system today largely deals with inflation by ignoring it, at least explicitly (with the exception of some tax bracket adjustments and the like). Our point in criticizing the argument that LIFO appropriately responds to inflation concerns is not to trivialize the importance of inflation, but rather to maintain that ad hoc and selective solutions like the LIFO accounting method distort economic decisionmaking even more than does not addressing the issue at all.

It might be argued that the LIFO method is a completely acceptable inventory accounting method under U.S. GAAP, which surely must mean that we must be mistaken in our argument that LIFO accounting is inconsistent with a principled income tax. It is true that LIFO is a recognized GAAP accounting method, but that fact does not mean that its purpose or effect necessarily is consistent with the goals of our income tax system. As the Supreme Court explained in a case dealing directly with inventory valuation methods, appropriate (or at least permissible) financial accounting inventory methods sometimes conflict with the design and purpose of our income tax. In those cases, the financial accounting method must be rejected for tax purposes.

In sum, once one sees LIFO for what it is — an ersatz basis indexation scheme available only to some taxpayers in some businesses — it becomes apparent that LIFO functions as just another preferential tax break available only to some taxpayers, but paid for by all, through the higher tax rates needed to raise the same aggregate revenues. LIFO is demonstrably inferior to FIFO in the core income tax objective of capturing a taxpayer's annual accretions to wealth, whenever those accretions are observable, and even a hypothetical idealized version of LIFO would distort economic decisionmaking through its incomplete scope.

B. LIFO Is Not Justified by Other Goals

If the code perfectly embodied only idealized income tax principles, it would be much shorter in length, but draconian in application. Congress frequently and consciously deviates from those principles to accomplish goals of administrative simplicity, or of fairness, or to encourage activities that are thought to advance larger economic or social agendas. Unfortunately for proponents of the LIFO status quo, however, the LIFO accounting method cannot be justified by any of those countervailing concerns.

Proponents of the LIFO status quo have argued that LIFO accounting results in a timing benefit, and as such is analogous to accelerated depreciation or other timing benefits conferred by Congress. In fact, the analogy is inapposite, for two reasons. First, as the preceding section demonstrated, in practice LIFO accounting operates as a *permanent* (or near permanent) deferral of tax liability — a true tax holiday. Second, and more fundamentally, what larger purpose is served by maintaining historic levels of inventories, simply to avoid LIFO recapture? Congress provides incentives for investment in productive plant and equipment because those investments improve the productivity of a broad range of American businesses, and with it the wealth of all Americans. None of us wins, however, by having capital tied up in inventories simply to perpetuate LIFO accounting's indefinite tax deferral scheme.

It has been suggested by the LIFO Coalition that "if the LIFO method were repealed . . . this would tend to cause businesses to try to increase the selling prices of their goods . . . thus further exacerbating inflationary tendencies." That argument plainly collapses under its own weight. Businesses today do not gratuitously refrain from taking advantage of price increases out of gratitude for the government's continuing to make LIFO available to them. The laws of supply and demand drive prices today, and will tomorrow, regardless of the accounting methods employed by businesses for their inventories. More generally, by removing a tax subsidy for one form of capital investment, LIFO repeal will lead to a more efficient allocation of capital across the economy. Further, LIFO repeal, coupled with other base-broadening provisions that could be adopted as part of fundamental tax reform, could facilitate a reduction in tax rates to all businesses, and thereby increase after-tax returns on *all* assets.

Nor can the LIFO accounting method be justified as advancing any nontax business or commercial objectives. Despite the arguments of proponents of the LIFO status quo that LIFO serves a nontax purpose, LIFO accounting thrives only in environments in which it is accompanied by associated tax benefits: It is entirely a creature of the tax ecosystem. LIFO is "grounded in its favorable impact on tax liabilities, rather than its theoretical merits for providing useful information to the capital markets." James Leisenring, an International Accounting Standards Board (IASB) member and former Financial Accounting Standards Board director, has publicly stated, "I don't think anybody thinks LIFO is a good inventory method for

anything except tax purposes." In a world without taxes, there is little evidence that any taxpayer would use LIFO accounting to fairly present its financial results.

In countries without LIFO tax accounting, LIFO financial accounting is rarely used. In this country, companies' creative avoidance of the only current governor on LIFO abuse, the book-tax conformity rule (discussed in Section V, below), shows that in fact they do not believe that unadulterated LIFO financial reporting conveys an accurate picture of their financial results.

If the use of LIFO were primarily motivated by nontax commercial objectives, we would expect LIFO to be an integral part of firms' operations, but that does not appear to be the case, as explained in a leading accounting textbook:

Many companies use LIFO for tax and external reporting purposes but maintain a FIFO, average cost, or standard cost system for internal reporting purposes. There are several reasons to do so: (1) Companies often base their pricing decisions on a FIFO, average, or standard cost assumption, rather than on a LIFO basis. (2) Record keeping on some other basis is easier because the LIFO assumption usually does not approximate the physical flow of the product. (3) Profit-sharing and other bonus arrangements are often not based on a LIFO inventory assumption. Finally, (4) the use of a pure LIFO system is troublesome for interim periods, for which estimates must be made of year-end quantities and prices.

If pricing decisions and management bonuses are not based on LIFO accounting results, the clear message is that companies do not consider LIFO a cost assumption appropriate in measuring their own performance.

IV. The Failures of the LIFO Method

LIFO accounting for inventories fails even its avowed purpose of properly immunizing taxpayers from paying tax on "phantom" inventory gains attributable to inflation. It does so by being overinclusive in the gains that it permits taxpayers to defer. In brief, the LIFO method of accounting permits taxpayers to defer income attributable to *all* cost increases in their inventory, including not only cost increases due to inflation, but those due to fundamental shifts in the equilibrium between supply and demand, or to years of incremental technological improvements to their inventoriable goods.

LIFO accounting thus simply is ineffective at distinguishing between pure inflationary increases in costs, fundamental supply/demand imbalances, or engineering or other technological enhancements, that in any case increase the cost (and the value) of a taxpayer's inventoriable goods — even in a hypothetical world of zero inflation. We term this phenomenon the "value creep" problem.

One recent and dramatic example has been the steep run-up in crude oil prices

over the last 24 months. That run-up is *not* commensurate with inflation rates, but rather reflects both global security issues and fundamental supply/demand imbalances. By one measure, the taxable income deferred by U.S. large integrated oil companies through LIFO accounting for 2005 alone through this "value creep" (that is, changes in the value of inventory that are not inflation-related) might have been on the order of \$19 billion.

LIFO — and in particular "dollar value" LIFO, as employed by many retailers and manufacturers — fails to account for value creep in other respects as well, particularly regarding retailers. The reason is that one purpose of dollar value LIFO is to obviate having to make distinctions between the nature of the goods that comprise closing inventories and those in beginning inventory, even though the goods in closing inventory "may, and generally do, differ considerably as to type, quality and price from those in the beginning inventory." Technological improvements over time may reduce a manufacturer's costs of manufacturing an item of inventory, but by the same token new standard features can increase both the value and the cost of inventory for retailers, in particular, by amounts that exceed any reductions attributable to lower manufacturing costs. As those new high-value improvements accumulate in an item of inventory without it being redefined as a new "item" for LIFO purposes, the taxpayer can defer ever-increasing amounts of income, not simply because of inflation, but because the taxpayer is matching the *expense of selling state-of-the-art goods against the revenues from selling older inventory*.

To see the value creep problem more clearly, imagine an automobile retailer that maintains an inventory of cars and had adopted LIFO accounting in 1976. Thirty years later, the engineering and build quality of cars have improved, standard features have been added, manufacturing has become more efficient, and there has also been inflation. For LIFO to isolate inflation, it must somehow separate all of those improvements and changes, even though they have occurred incrementally over time (such that each year's model is only a slight improvement over the prior year's). In the absence of separating out those different components of changing cost (and value) — which current law does *not* require, and which would be unadministrable if one were to attempt to do so — dollar value LIFO permits deferral of income attributable to all of those factors, not just inflation, unless and until the differences in degree of the nature of an item become so extensive as to require defining a new item.

To isolate price increases attributable solely to inflation, one must compare the costs of producing (or buying) apples in one year with the cost of producing (or buying) apples — or at least other forms of hand fruit — in other years. The purpose of the word "item" is to make sure that the production or acquisition costs being compared relate to the same kind of good — and not, to continue the analogy, to apples in 1976 but to steak in 2006. If a taxpayer's inventory tax accounting methods define apples as the same "items" as steak (for example, "foodstuffs"), the

increased acquisition cost of steak over apples would be caused by the substitution of goods, rather than inflation in the market for hand fruit. Very generally, therefore, a narrower definition and interpretation of the word "item" leads to a better isolation of the inflationary component of increased inventory costs, and also the risk of imposing higher administrative burdens on taxpayers.

The Tax Court wrestled with exactly this issue in a case involving a new car dealer at a time when automobiles were undergoing rapid technological evolution. In that case, the taxpayer was an automobile dealer; its items of LIFO inventory comprised new cars and new trucks. The question was whether the introduction of catalytic converters and new solid state ignition systems in 1975 meant that 1975 new cars were not sufficiently similar to 1974 new cars as to be the same item. As it happens, the Tax Court concluded that those engineering developments were not sufficient to make 1975 cars different items from 1974 cars. The Tax Court also rejected the taxpayer's argument that a "car is a car," but declined to offer any further guidance, other than to hold that the issue of the point when an original item has evolved (through value creep or otherwise) into a new item must be determined on a case-by-case basis — hardly a clear standard for future decisions.

As that summary suggests, it is very difficult to decide where to draw the line: Are 1976 new cars, for example, the same item as 2006 new cars in the hands of a new car dealer? The case-by-case approach used by the courts and the IRS in drawing the line is far too ambiguous in application to ensure that taxpayers will not use LIFO accounting to offset price increases unrelated to inflation. The tremendous practical difficulties in policing that distinction are sufficient by themselves to justify the repeal of the LIFO method of inventory accounting (or at least, its dollar value variant).

If in fact Congress wanted to mandate an inventory accounting method for tax purposes that immunized taxpayers from paying tax on "phantom" inventory gains attributable solely to inflation, rather than value creep, Congress could do so by repealing LIFO and replacing that accounting method with FIFO inventory accounting coupled with indexation of the basis of inventory assets — and no other class of property or investment — for inflation each period. Some 20 years ago, in the context of larger-scale corporate tax reform, the Treasury Department made just such a proposal.

This "indexed FIFO" system would be superior to LIFO in one critical respect, which is that it would include *only* inflationary gains in the deferral mechanism, and not the value creep that we described above. The result, however, would still be an effective deduction (the upwards indexation of the cost of goods sold) for an expense that is never incurred. Even indexed FIFO thus would appropriately be subject to the criticism that inflation affects all capital investment. If we are not to introduce new distortions into economic decisionmaking, inflation must be dealt with systematically throughout the code — not in a piecemeal manner.

V. LIFO Book-Tax Conformity Is Illusory

As Section III demonstrated, LIFO accounting provides a pure tax holiday for taxpayers that employ it. Congress implicitly recognized that fact when it first permitted LIFO accounting by adopting an artificial governor on a taxpayer's ability to adopt LIFO accounting — the book-tax conformity rule. The purpose of that rule was to dampen the attractiveness of adopting LIFO *tax* accounting, by requiring taxpayers that did so *also* to use LIFO *financial* accounting. The presumption was that if the nontax detriment to a taxpayer of employing LIFO accounting exceeded the tax benefit, the taxpayer would choose another accounting method.

Regardless of the wisdom of that original strategy, there is no real book-tax conformity in our tax system; it is illusory. In fact, in an April 13, 2001, letter to Treasury Secretary Paul H. O'Neill, Edmund Jenkins, then serving on FASB, argued for repealing LIFO conformity simply on the basis that conformity was not, in practice, taking place. A taxpayer can satisfy the conformity requirement even if it uses different LIFO submethods for its financial statement and tax accounting statements. Also, public corporations that use LIFO accounting methods for tax purposes almost invariably also disclose (in footnotes) what their profits would have been under a FIFO accounting method. Those footnotes are both clearly written and closely read by securities analysts, suggesting that those issuers perceive a great benefit in disclosing what they perceive to be their *real* book income, and in the process subverting the supposed conformity requirement. Most tellingly, a company that employs LIFO accounting for tax purposes need *not* use LIFO principles for internal capital allocations purposes, new project feasibility studies, management compensation, or any other genuinely commercial decisions.

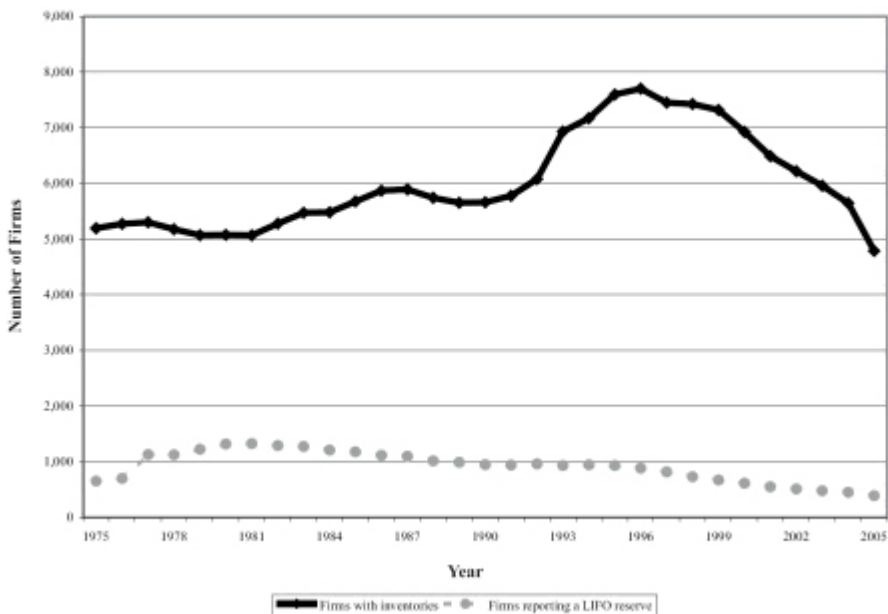
The accounting literature agrees with that assessment, noting, "The LIFO conformity rules set forth in IRS regulations permit numerous disclosures of financial information on a non-LIFO basis." For example, while the taxpayer must prepare the face of its financial accounting income statement using a LIFO inventory method, it may supplement that statement with a note or appendix, or publish news releases, hold press conferences, and pepper various sections of its annual report with alternative accounting methods. A company may also use alternative measures in its forecasts and in reported income statements covering periods under one year in duration. As a result, corporations that employ LIFO accounting to drive down their effective tax rates can give shareholders and creditors explicit information as to what their profits would be under FIFO accounting and still satisfy the conformity requirement of section 472(c).

Given all of those exceptions and loopholes, it is clear that book-tax conformity as it is currently practiced does not impose any material constraints on how public companies communicate their financial results to public investors or creditors. A larger question is, what purpose would be served by an efficacious book-tax

conformity rule? The rule appears originally to have been grounded in a notion that LIFO's adoption for tax purposes should be artificially constrained by requiring companies to "put their money where their mouth [is]" for financial statement purposes. But that rationale in turn is an implicit acknowledgement that LIFO accounting produces results that are undesirable for tax purposes — why else would an artificial governor on its scope be required?

The *real* conformity that Congress should employ as its lodestone is *conformity with nontax commercial decisionmaking*. In 1993, for example, when Congress required securities dealers to employ mark-to-market accounting for tax purposes, one of the principal rationales was that dealers consistently employed mark-to-market accounting for important commercial purposes. More recently, proposed Treasury regulations under section 475 that adopt a book-tax conformity "safe harbor" for securities dealer inventories also explicitly are premised on the fact that the real conformity at issue is not between "book" and "tax," but rather between book and tax, on one hand, and demonstrable nontax commercial decisionmaking on the other. The absence of consistent evidence that companies base management compensation or any other commercial decisions on LIFO financials again illumines LIFO's role as an artifice of pure tax avoidance.

Figure 1. Firms With Inventories and LIFO Reserves



VI. LIFO-Induced Distortions

LIFO accounting for inventories provides incentives for corporations to manage both their inventory levels and their financial statement earnings for artificial reasons. LIFO encourages poor physical inventory management by encouraging

corporations to maintain unneeded levels of inventories to avoid liquidating a LIFO layer, thereby protecting the lower cost of goods acquired in an earlier period from being matched against sales revenues from the current period. The implicit incentives that LIFO provides for tax-protective year-end purchasing are well understood in the academic literature. For example, the authors of one of the leading accounting textbooks state: "Because of the liquidation problem, LIFO may cause poor buying habits. A company may simply purchase more goods and match these goods against revenue to avoid charging the old costs to expense."

Micah Frankel and Robert Trezevant show that in practice, the LIFO method does in fact distort inventory choices. They examine the year-end purchasing decisions of firms as a function of the firm's inventory accounting methods and tax status and report that (1) high-tax LIFO firms are more likely to purchase extra inventory at year-end than low-tax LIFO firms, (2) LIFO firms are more likely to purchase extra inventory than FIFO firms, and, by contrast, (3) FIFO firms do not show differences in purchasing that are related to their tax status. The authors conclude that their finding "that additional year-end LIFO inventory purchases appear to be made for tax reasons suggests that permitting the LIFO method to be used for tax purposes leads to inventory management inefficiencies." For firms to purchase additional inventory despite the incremental costs shows how significant the tax benefits can be and further demonstrates the distortion in firm behavior LIFO can cause.

Second, instead of purchasing more at year-end to maintain inventories, corporations can use the LIFO method accounting to do the opposite, relying on the liquidation of LIFO layers to reduce inventories and thereby release earnings. In fact, Lawrence Revsine, Daniel Collins, and W. Bruce Johnson have shown how firms can use LIFO to manage multiple years' earnings (both up and down) to meet targeted levels through year-end purchases or liquidations. The authors of one of the leading accounting textbooks also note that phenomenon: "With LIFO, a company may attempt to manipulate its net income at the end of the year simply by altering its pattern of purchases." Even the author of the leading treatise on the taxation of inventories (and the author as well of the memorandum submitted to the Finance Committee by the LIFO Coalition) writes: "LIFO taxpayers may have a greater degree of control over earnings than taxpayers using another inventory method."

In addition to allowing for opportunistic inventory management to achieve financial reporting objectives, LIFO appears to also provide conflicting incentives for the adoption of more efficient management of *physical* inventories. On one hand, the ability to liquidate LIFO layers and generate additional reported income may facilitate some firms' adoption of JIT inventory methods because the additional income from LIFO liquidation can be used to offset the additional reported costs incurred in the same period to implement JIT. Taxable firms with large LIFO reserves, however, have been found to be *less likely* to adopt JIT because of the tax consequences of LIFO liquidations. Further, the evidence suggests that firms

with a history of managing their reported earnings were also less likely to adopt JIT. As a result, it appears that the adoption of new inventory management techniques may actually be hampered by the use of LIFO.

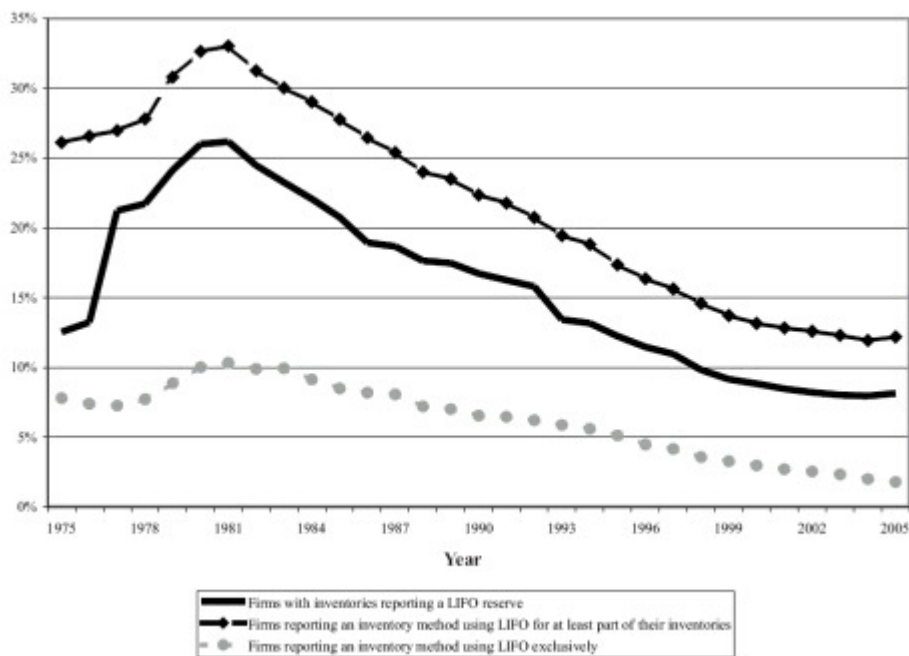
VII. Getting Serious About LIFO Repeal

A. What Is at Stake, and for Whom?

As we described in the opening paragraphs of this article, the explicit LIFO reserves of publicly traded U.S. firms total nearly \$70 billion, and at least one industry group newsletter has suggested that reserves could be an order of magnitude greater. Those reserves represent an extraordinary amount of forgiven tax for a relatively small number of companies and are lumpily distributed across the American economy. Like other outside analysts, we are limited by our lack of access to actual tax return information, and published IRS composite data do not allow us to determine the number of corporate tax returns containing inventories valued under any method. In this section, we nonetheless attempt to reconcile the data that are available from a number of public sources.

While a precise calculation of the number of companies using LIFO inventory accounting cannot be made with publicly available data, we have compiled data from several sources that imply that LIFO tax accounting is on the decline. We see that evidence as demonstrating that the extraordinary tax benefits of LIFO accounting are concentrated in fewer and fewer companies.

Figure 2. Use of LIFO by Firms With Inventories



Data on taxpayers' use of LIFO inventory accounting must be examined with care because of a seeming contradiction: Publicly available data will simultaneously *overstate* the use of LIFO as an inventory accounting method by businesses and *understate* the potential revenue effects of changes to LIFO. The understatement of revenue is easiest to understand, as publicly available data exclude both estimates of the value of LIFO to non-publicly-traded firms, and the LIFO reserves attributable to many companies that have been acquired in transactions accounted for under the "purchase method" but were not asset sales for tax purposes. The overestimate of the use of LIFO (when measured as a percentage of all firms) arises from what appears to be a greater incidence of LIFO use among publicly traded firms than by businesses generally.

To obtain the most precise estimate of the number of businesses that use LIFO would necessitate access to businesses' tax returns, which require both a disclosure of inventory methods and, if LIFO is used, the percentage of closing inventory valued under LIFO. Such a tabulation was apparently performed as part of the Reagan administration's initial tax reform study ("Treasury I") released in 1984. In discussing inventory accounting methods, Treasury reported, "Roughly 95 percent of firms with inventories use FIFO accounting for tax purposes." We note four specific implications from that simple statement: First, Treasury's analysis included *all* businesses, both public and private and regardless of their choice of entity (that is, the analysis included corporations and partnerships). That fact is important because publicly available entity-level data is limited to publicly traded corporations. Second, Treasury's tabulation restricted itself to those businesses that maintained inventories — a number far smaller than the number of businesses generally. Third, Treasury specifically identified FIFO-only firms and did not separately identify whether the remaining firms used LIFO-only, a combination of LIFO and FIFO, or some other inventory method. As a result, the statement suggests that the *maximum* percentage of all inventory-holding businesses that used LIFO for any portion of their inventories was 5 percent. Finally, as we explain below, it is likely that both the absolute number and the percentage of firms using LIFO would be substantially lower today, as the time period analyzed in Treasury I, the early 1980s, appears to represent a time when LIFO use reached a peak.

To estimate the use of LIFO by publicly traded firms we collected inventory data from the Compustat database of firms' annual 10-K filings for 1975 to 2005. In Figure 1, we graph the number of firms reporting any amount of inventory at the end of each year, along with the number of firms reporting a LIFO reserve. Over that time, the number of publicly traded firms with inventories ranged from 5,000 to 8,000, while the number reporting a LIFO reserve exceeded 1,000 from the late 1970s to the late 1980s, and steadily declined thereafter.

In contrast to Figure 1's presentation of aggregate data, Figure 2 provides information on the relative use of LIFO over the same period. The dark solid line in the middle of Figure 2 is the percentage of firms with inventories that report a LIFO

reserve, and is calculated from the data presented in Figure 1. The pattern in that line is clear: The relative use of LIFO peaked in the early 1980s and has steadily declined since, with fewer than 10 percent of firms with inventories reporting a LIFO reserve in 2005.

We present two additional tabulations of LIFO use based on a smaller sample of firms for which Compustat provides information on the inventory methods that the company reports it employs. First, the dark dashed line that appears at the top of Figure 2 represents the percentage of firms that report using LIFO for *any* of their inventories. That percentage can be higher than the one estimated from the data in Figure 1 if firms with inventory did not report a LIFO reserve because of materiality, or simply because of differences in the sample of firms. Second, the light dashed line shows the percentage of firms that report using LIFO exclusively.

Regardless of the data used, or the way in which it is analyzed, two conclusions are inescapable. First, the absolute and relative use of LIFO by U.S. firms peaked in the early 1980s and has been steadily declining ever since. Second, regardless of how it is measured, either by any use or exclusive use, LIFO inventory accounting is not widely employed by businesses. Taking the most generous estimates from Figure 2, at the end of 2005 only 12 percent of publicly traded firms used LIFO for any portion of their inventories, and fewer than 2 percent used LIFO exclusively.

Figure 2 relates to our observation made at the beginning of this section about the use of LIFO by all firms, public and private: Given that the percentage of publicly traded firms that used LIFO for any portion of their inventories peaked in the early 1980s, and their use of LIFO has steadily declined, it also seems likely that the use of LIFO among privately held firms would also have declined.

We conclude that the number of businesses that benefit from the use of LIFO is small, not only when compared with the business sector as a whole, but even when compared with businesses that maintain inventories. In that regard, we note that other reports of LIFO use do not clearly differentiate between *any* use and *exclusive* use. We also note that the goals of simplicity in compliance and administration are clearly violated when firms choose to employ multiple inventory accounting methods solely to maximize their tax benefits.

B. How Large Is the LIFO Deferral?

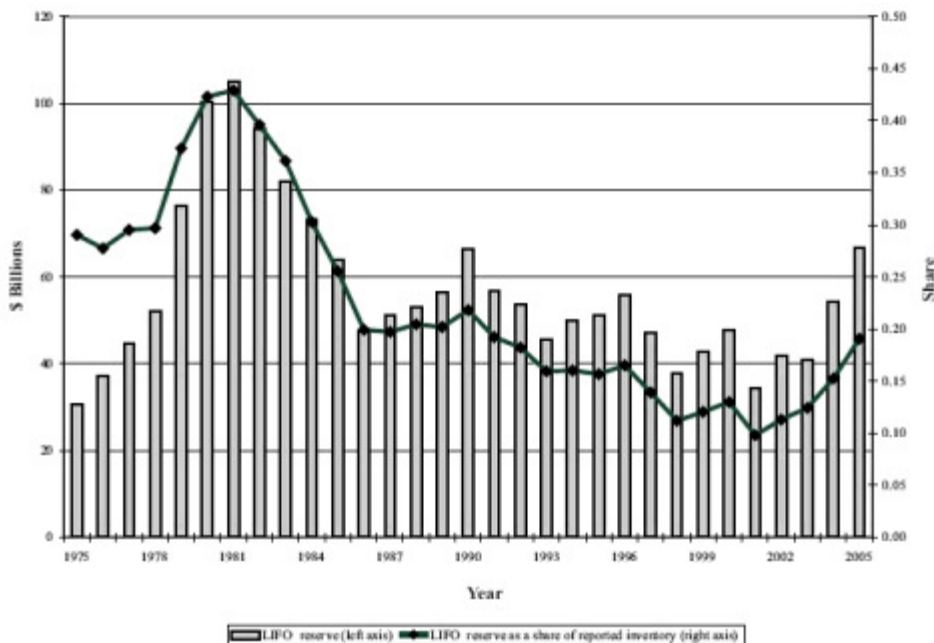
It is possible to estimate, with a fair degree of accuracy, what we have termed in this report as the "explicit" LIFO reserves of publicly held firms. Those data are incomplete, of course, in that they do not capture the magnitude of private firms' LIFO reserves, but for the reasons described below we do not believe that adding the data for privately held firms would materially affect our estimate.

A more important deficiency in our "explicit" LIFO reserve figures is that they probably understate the actual magnitude of the tax revenues that would be raised from a repeal of the LIFO method of inventory accounting because of the

application of "purchase" accounting principles to business combinations. Very simply, if one company acquires another in a transaction that is accounted for as a "purchase" but is not treated as a taxable asset acquisition for tax purposes, the effect of applying purchase method accounting to the acquired company's assets is to mark those inventories to their current value, thereby (phrasing matters colloquially) wiping out that company's financial statement explicit LIFO reserves at the time of its acquisition. At the same time, the acquired company's *tax* LIFO reserves would remain intact.

Before an acquisition, no material book-tax difference ordinarily would exist regarding the acquired company's inventory valuations because both would be computed under LIFO, typically following similar principles. The application of purchase method accounting to an acquired company, however, creates a significant book-tax difference, attributable to "marking-to-market" that company's inventories for financial accounting purposes, but not for tax purposes. That book-tax difference in turn gives rise to a new deferred tax liability: In other words, and again phrasing matters colloquially, the acquired company's former explicit LIFO reserve migrates to a component of the acquirer's deferred tax liability. While a firm is expected to describe in its financial statement footnotes the material components of its deferred tax liability, there traditionally has been a wide range of actual practice regarding deferred tax liability disclosure, and, in any event, we know of no publicly available database, such as Compustat, that aggregates firms' footnote disclosures of the components of their deferred tax liabilities. Moreover, for technical reasons, the aggregated 2004 Schedule M-3 data recently published also shed no light on the magnitude of former explicit LIFO reserves that, by virtue of acquisitions, are now a component of deferred tax liabilities.

Figure 3. The Magnitude of LIFO Reserves



Since 2001 GAAP has mandated the use of purchase accounting for all business combinations, and even before that date a large number of transactions were accounted for under those rules. Moreover, it is the norm in acquisitions of domestic companies (other than acquisitions of corporate subsidiaries) to structure the transaction to avoid triggering asset-level gain recognition to the acquired company. As a result, our \$70 billion estimate for the income that would be recognized from the repeal of the LIFO method of accounting must, as a practical matter, represent a *floor* on the actual amount at stake.

For the reasons described above, we cannot estimate the magnitude of the invisible (to the public) LIFO reserve attributable to the "migration" of former explicit LIFO reserves to deferred tax liabilities. We acknowledge, however, that the LIFO Coalition may be correct when it asserts that the effect of purchase method accounting in understating the actual LIFO reserves of public companies for *tax* purposes may be "many times" greater than the visible explicit reserves themselves.

Figure 3 presents annual data on the aggregate amount of explicit LIFO reserves reported by publicly traded firms (the gray bars, measured on the left y-axis) and is an estimate of the amount of income cumulatively deferred at the end of each year. Consistent with the use of LIFO documented in figures 1 and 2, the aggregate nominal value of explicit LIFO reserves also peaked in the early 1980s, but remains significant. In contrast to Figure 2, however, the aggregate value of explicit LIFO reserves does not appear to have declined in direct proportion to LIFO's use, suggesting that the benefit of LIFO has become more concentrated over time. As we described in the opening paragraphs of this article, explicit LIFO reserves for publicly traded companies in this country were nearly \$70 billion at the end of 2005. Assuming a tax rate of 35 percent, the inclusion of that reserve in taxable income would generate \$24.5 billion in federal corporate tax revenue from publicly traded firms alone.

We also plot the value of explicit LIFO reserves as a percentage of the end of year inventories of companies with a LIFO reserve (the solid line corresponding to the right y-axis). That line represents the extent, in percentage terms, that the inventory values reported by LIFO firms are understated relative to the market value of the inventory. While the figure was clearly much higher in the 1980s, at the end of 2005 the average LIFO firm's inventories were understated by nearly 20 percent.

As previously stated, without access to businesses' tax returns, it is difficult to know the extent to which private businesses will be affected by LIFO repeal but the proportion is likely small. The fact that the total number of companies using LIFO may be many times larger than the number of publicly traded firms using LIFO does not imply that the revenue effects of changing LIFO would be many times the amount inferred from data available from publicly traded firms. While there are a large number of businesses subject to the corporation income tax, aggregate

economic activity and inventories are concentrated among the very largest firms.

IRS data for 2003 (the most recent year available) show that 5.4 million corporate tax returns were filed and that those businesses reported a total of \$53.6 trillion in assets. Of those 5.4 million returns, only 2,018 returns (a miniscule 0.04 percent of the total) reported assets in excess of \$2.5 billion, yet those same 2,018 returns reported more than 75 percent of all assets and were responsible for 67 percent of the total amount of net income (less deficit). If the size threshold is lowered to returns with at least \$100 million in assets, there were 20,477 returns filed (0.38 percent of the total), and they reported 93 percent of all corporate assets and 85 percent of net income (less deficit).

Regarding inventories, the 2,018 largest returns reported 34 percent of all inventories, and the 20,477 largest returns reported 60 percent of all inventories. Those percentages are likely understated, however, because the balance sheets of firms using LIFO understate the value of inventory relative to other inventory methods (for example, FIFO). As described above, the understatement is likely greatest among the largest, publicly traded firms.

C. Consequences of LIFO Repeal

Even among publicly traded firms using LIFO, the effect of changes in LIFO will be concentrated among a relatively small number of firms. Based on 2004 financial statements, 50 percent of the total LIFO reserve was attributable to only 13 companies, and 80 percent was attributable to 56 companies. In the next year, 2005, 50 percent of the total LIFO reserve was attributable to a mere 8 companies, and 80 percent to 42. In short, as with many corporate tax changes, changes in revenue from the repeal of LIFO are likely concentrated among the largest, publicly traded firms.

Even without knowing what alternative inventory method(s) might be permitted, the repeal of LIFO accounting for inventories should have only minor financial reporting consequences. First, only a minority of publicly traded firms with inventories appear to use LIFO for any portion of their inventories. Second, as we demonstrated above, LIFO book-tax conformity has been so diluted over the years that only the most naïve reader of financial statements today analyzes a public company's results by reference to its LIFO numbers.

LIFO repeal should not adversely affect the balance sheets of business taxpayers because the consequence of LIFO repeal would (eventually) be to increase the carrying values of inventories to their current replacement cost values, or increase cash as firms more efficiently manage smaller inventories. If anything, it can be argued that balance sheets in general will look *stronger* after LIFO repeal.

LIFO repeal also should *not* affect international competitiveness, for the simple

reason that LIFO is almost entirely a creature of U.S. accounting practice. Because most foreign countries do not permit LIFO accounting for inventories, foreign subsidiaries of U.S. firms will be in exactly the same competitive position after LIFO repeal as they were before. The consolidated financial statements of U.S. firms attributable to the activities of those subsidiaries already reflects the inventories carried by those subsidiaries on a basis other than LIFO, and therefore would be completely unaffected to that extent by the repeal of LIFO.

As a result, it is difficult to imagine that U.S. firms that currently use LIFO would be at a disadvantage were they required to use the same accounting as their competitors. Further, firms using LIFO do not appear to use LIFO costs for pricing or other businesses decisions, implying that the ability of a U.S. firm to compete is already independent of the availability of LIFO.

Nevertheless, the repeal of LIFO by itself can be expected to present a cash flow issue for those companies that have employed LIFO for many decades. That cash flow problem is no different, however, than the cash crunch faced by individual tax shelter "junkies" in the 1970s, when the code was amended to foreclose most individual shelters, or the cash crunch faced by any other group of taxpayers that have enjoyed preferential tax treatment, when that preference is taken away.

The solution to that cash crunch issue is twofold. First, we believe that LIFO repeal most appropriately should take place in the context of fundamental corporate income tax reform, in which the income tax base is broadened and rates lowered. In that context, the cash costs of LIFO repeal will be mitigated, although the extent of that mitigation will vary from firm to firm.

Second, legislation to repeal LIFO also should permit taxpayers to pay the taxes attributable to the LIFO tax deferral that they previously enjoyed over a period of years. For example, when Congress added section 475 to the code in 1993 to require securities dealers to change to a mark-to-market system to account for their inventories of securities, the dealer community faced exactly the same sort of one-time cash crunch. Congress recognized the problem by permitting securities dealers to pay the back taxes attributable to the deferral benefits they previously had enjoyed ratably over five years (without any interest charge). We recommend that a similar rule be adopted in connection with LIFO repeal.

VIII. Summary and Recommendation

The repeal of LIFO as a permissible tax accounting method for inventories will impose transition costs on some taxpayers (in dollar terms, mostly a surprisingly concentrated number of our largest public corporations), but make major strides in achieving a more principled income tax by more closely approximating an economic measure of taxpayers' incomes. Repeal would eliminate the incentive to invest business resources in maintaining an inventory accounting system that would likely

not be chosen but for its tax benefits and otherwise serves no discernable nontax business or financial purpose. The LIFO method is not currently designed, and appears never to have been implemented, to achieve even its own avowed goal of deferring only inflation-generated increases to inventory values. At the same time, LIFO today is a significant source of economic distortions because it both privileges investment in some asset classes over others and encourages tax-motivated physical inventory management practices.

Proponents of the LIFO status quo argue that eliminating the ability of taxpayers to rely on LIFO inventory accounting is a veiled tax increase. (That argument of course implicitly acknowledges that LIFO accounting is not merely a deferral, but rather a permanent exemption from tax.) The response is that repealing LIFO would "increase" a business enterprise's taxes only in the sense that eliminating any special-interest tax break is described as a "tax increase" by those firms threatened by the loss of their preferential treatment. LIFO accounting is inconsistent with a principled income tax and simply creates tax forgiveness, largely concentrated in a handful of companies and industries.

Among the themes that the President's Advisory Panel on Federal Tax Reform identified as having guided their deliberations:

Tax provisions favoring one activity over another or providing targeted tax benefits to a limited number of taxpayers create complexity and instability, impose large compliance costs, and can lead to an inefficient use of resources. A rational system would favor a broad tax base, providing special treatment only where it can be persuasively demonstrated that the effect of a deduction, exclusion, or credit justifies higher taxes paid by all taxpayers.

In his closing statement at the June 13 hearing, Finance Committee Chair Chuck Grassley, R-Iowa, reiterated those basic ideas and outlined the benefits of the undertaking:

Beyond trying to improve today's code, the discussion about issues such as tax expenditures and fundamental problems with the tax system point the way for thinking about tomorrow's tax code. The comments we have heard calling for lowering the rates, broadening the base, and simplifying the tax code are good goals that should guide our work as we consider corporate tax reform.

Achieving these goals of tax reform will not only make the code fairer and more efficient, but it will also provide fiscal benefits to the budget. But of perhaps greatest importance, we've heard today that a system of lower rates, broader base and simplification will increase our nation's competitiveness in attracting capital for new and better jobs.

Grassley reiterated those themes in his closing statement at a recent hearing on business tax issues, and added an observation on the difficulties of the political

process:

Tax reform will take a bipartisan, national consensus. I think the consensus is there that the business tax system is in desperate need of reform. But we need to start building consensus on how to do it. The theme of lowering rates and broadening the base is easy to agree with in theory. The tough part will be figuring out how low and how broad. This committee will continue down the path of tax reform. This hearing sets the stage for future hearings that will examine specific aspects of business tax reform in greater depth as we work toward reforming the tax code.

The economic advantages of lower tax rates are well known, as are the distortions that follow from various features of the code that provide narrow benefits to a select class of taxpayers. There is a persuasive case for repealing the LIFO method of inventory accounting for tax purposes in the context of broad-scale corporate tax reform, based on income tax policy norms, fundamental fairness to all business taxpayers, revenue considerations, and the failure of LIFO's tax largesse to be restricted to its own purported objectives. Phrased differently, if we cannot succeed in liquidating LIFO, what hope do we have of ever getting serious about fundamental business tax reform?

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