OPINION

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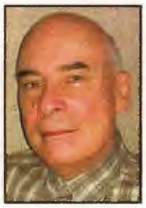
Dealing with a drop in LIFO reserves

Willard J. De Filipps

Many dealers know that LIFO stands for the "last-in, first-out" inventory valuation method and that it produces sizable interest-free loans from the U.S. Treasury. These loans last as long as moderate inflation continues and inventory levels do not drop considerably.

At the end of 2020, you may have had significantly lower ending new-vehicle inventories than you had the year before. This may have caused you to incur significant reductions in your LIFO reserves — also known as LIFO reserve recapture or repayment — and this may have caused you to have a significant increase in your taxable income for 2020.

But, unlike Paycheck Protection Program loans, this repayment is not likely to be forgiven. That compels me to offer some alternatives you can discuss with your advisers if you're in a quandary over what to do.



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1. Stay on LIFO. Grin and bear it. Pay the tax on the increase in taxable income caused by the recapture of the LIFO reserve. Whether there is a significant increase in taxable income depends upon your specific LIFO layer history.

Dealers are often surprised to see how small the LIFO recapture is, even though their inventory levels have dropped significantly at year end. Others may be shocked at the size of their LIFO reserve recapture. The result depends on the buildup of your inventory over recent years and how much inflation is embedded in the calculations.

2. Get off LIFO. Terminate your LIFO election effective for 2020. If you do this, the entire amount of your LIFO reserve as of the beginning of the year (i.e., as of Dec. 31, 2019) is reported in your tax returns over four years, pro rata, 25 percent per year, for 2020-23. In tax-speak, this is known as a positive Section 481(a) adjustment.

Getting off LIFO spreads the impact of the repayment of the entire LIFO reserve as of Dec. 31, 2019, over four years, instead of reflecting 100 percent of the large impact of the reduced 2020 year-end inventory in your 2020 tax return. Thus, the difference between these alternatives is that by staying on LIFO, you will take the big hit in your 2020 tax return, rather than terminating the LIFO election for 2020 and leveling the impact of recapturing the LIFO reserve at the beginning of the year over four years.

If you're going to stay on LIFO, there are some ways to at least partially offset the increase in income in your 2020 tax return due to LIFO reserve recapture on new vehicles. One is to consider expanding the LIFO election to used vehicles for 2020. Another is to consider changing to a Bureau of Labor Statistics variation LIFO method. A third way is to eliminate certain inventory costs if you are not already doing so.

Tax strategies

Are there dealers in your 20 Group who have had very profitable operations in 2020? The last thing they want now is to have more income from piling the recapture of a LIFO reserve on top of their already sizable income for 2020. They are probably looking for ways to reduce their taxable income. For that fortunate group, there are other alternatives to consider.

Right off the bat, if they are not already on LIFO, perhaps they should consider electing it. However, one hurdle here involves dealing with the financial statement conformity requirements, and they need to be carefully considered.

Another income-reducing strategy can be considered by dealers regardless of whether they are using LIFO. That is to make a change to eliminating certain costs such as floorplan assistance payments, other trade discounts and certain advertising costs from the ending inventory. But first you have to see if the dealership's accounting practice for recording factory invoices does not already eliminate them. If the dealer is already on LIFO, this change can really be a powerhouse!

For a dealer already applying LIFO to new vehicles, expanding an existing LIFO election for new vehicles to include used vehicles may be an option. For 2020, inflation rates for used-vehicle inventories are ranging between 7 and 10 percent. That may make this strategy attractive. But some dealers we have talked to prefer to avoid this alternative because used-vehicle prices tend to fluctuate unpredictably and this could turn around and bite them in a year or two.

Also, there are other factors to consider including whether lower-of-cost-or-market writedowns are involved and just how strenuously the dealer is trying to reduce 2020 taxable income.

Another scenario: Many dealers are already using the Alternative LIFO Method for New Vehicles. For them, another option to consider is changing to use the inflation indexes computed by the Bureau of Labor Statistics. This is known as the Inventory Price Index Computation Method. This method is tricky once you get into the details, and it involves several sub-elections, including choosing which inflation index will be used.

Other suggestions

1. Get an extension to file your 2020 tax return. Delay filing your 2020 tax return for as long as possible. The further you get into the year, the more information you will have about what's happened in 2021 and the shorter the length of time between when you pull the trigger and commit to the alternative you select and the end of the year.

2. Reduce the alternatives you are considering to dollars and cents. Calculate the exact amount of LIFO recapture. Your CPA should be able to do this and explain it all to you.

3. Run some projections based on different scenarios using assumed future inflation rates and inventory levels. Adopt a short-term perspective — two or three years at most. In evaluating alternatives, you should be absolutely sure of the facts and math and probably be on the conservative side with the assumptions.

4. Consider including a statement to elect relief under Section 473 in your 2020 income tax return. NADA and others (including me) are trying to convince the Treasury and the IRS that dealers should be granted some form of tax relief where the impact of LIFO reserve recapture is severe.