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FACT SHEET: Last-In, First-Out Accounting

As policymakers debate fiscal issues, including deficit reduction efforts, some have called for a retroactive repeal of the "last-in, first-out" – or "LIFO"— inventory accounting method for the oil and gas industry. AFPM strongly opposes singling out the oil and gas industry for repealing this generally accepted accounting method. AFPM also encourages policy makers to consider the impacts on domestic manufacturing jobs from the repeal of LIFO when judging the trade-offs between base-broadeners and rate reduction in comprehensive tax reform.

- For U.S. fuel manufacturers, repealing LIFO would amount to a retroactive tax hike totaling nearly $25 billion in accelerated tax liability. Refiners and petrochemical manufacturers are the first purchasers of crude oil and natural gas off the world market and are therefore particularly sensitive to crude oil price inflation and volatility.

- LIFO is not a "tax loophole." It is a textbook accounting method that has been taught in business schools since 1939 and used by a variety of businesses, such as manufacturing, wholesalers, retailers, newspapers, automobile and equipment dealers.

- In fact, according to studies by the Georgia Institute of Technology and American Institute of Certified Public Accountants, 36-40 percent of all businesses use LIFO to determine both book income and tax liability.

- LIFO refers to the assumption made by a business in establishing the value of its inventories when calculating the cost of producing manufactured goods. It is considered a more accurate accounting method because it takes into account the greater costs of replacing inventory when inventory costs are rising, as well as taking into account the lower costs of replacing inventory when costs are falling. This gives a better measure of both the financial condition of the business and the economic income that should be subject to tax.

- The difference between LIFO and FIFO accounting values is known as the "LIFO reserve." The reserve simply represents the difference in the valuation of the cost of producing goods.

- However, there is not – nor has there even been – actual cash in a company's LIFO reserve. Therefore, retroactively repealing LIFO will force companies to divert their operating cash flows away from productive investments or borrow funds (using up part of a company's borrowing finite borrowing capacity) to pay the recapture tax. This will likely result in reduced capital investment in new productive assets and projects (meaning fewer jobs) or higher prices at the pump.

- This could make the US more reliant on foreign imports of refined product, as well as cause U.S. consumers to pay higher prices at the pump.

How does LIFO work?

For simplicity's sake, imagine a refiner has 5 barrels of crude oil in its inventory, each acquired in different years, and plans to refine 3 of those into gasoline. At 42 gallons per barrel, that totals 126

gallons.[1] Assume that the refiner then sells the gasoline at $3.00/gallon, for a revenue total of $378.00. The refiner will now be taxed on its income, which is calculated by subtracting the "cost of goods sold" from its revenue.[2] The cost of goods sold is calculated using either LIFO or FIFO. The following two example show how each would work.

Example A

Year	Crude Cost	
2008	40	FIFO
2009	50	FIFO
2010	60	LIFO
2011	70	LIFO
2012	80	LIFO

Example B

Year	Crude Cost	
2013	80	FIFO
2014	90	FIFO
2015	85	LIFO
2016	80	LIFO
2017	80	LIFO

In Example A, FIFO accounting would assume that the refiner used the book value of the barrels purchased in 2008, 2009 and 2010 (in that order) to calculate "cost of goods sold," which would total $150 in this scenario. In LIFO accounting, the refiner assumes that it used the barrels purchased in 2012, 2011, and 2010 (in that order) to calculate a total "costs of goods sold" of $210.

In Example B, FIFO accounting would assume that the refiner used the barrels purchased in 2013, 2014 and 2015, in that order, for a total "cost of goods sold" of $255. In LIFO accounting, the refiner assumes that it used the barrels purchased in 2017, 2016, and 2015, in that order, for total "costs of goods sold" of $245. Therefore, the income and tax liability[3] for each example would be the following:

Example A:

FIFO: $378-$150= $228 in taxable income, for a total tax liability of $79.80
LIFO: $378-$210= $168 in taxable income, for a total tax liability of $58.80

Example B:

FIFO: $378-$255= $123 in taxable income, for a total tax liability of $43.05
LIFO: $378-$245= $133 in taxable income, for a total tax liability of $46.55

In other words, while the refiner is better off using LIFO for tax purposes when costs are generally rising, as they are in Example A, the company also runs the risk that prices will fall, like they do in example B. The decision to use LIFO is one for individual companies, based on their business model. It is clear, however, that LIFO is in no way a "tax loophole" that benefits oil and gas companies or somehow needs to be addressed in tax reform legislation.

Conclusion

Congress should reject calls to repeal the LIFO accounting method, which would place an enormous retroactive tax on refiners and other businesses. Congress should instead seek to grow U.S. manufacturing by lowering the tax and regulatory burdens on U.S. job creators, like the U.S. fuel and petrochemical manufacturing industries.

[1] For simplicity's sake, we will assume we only produce gasoline from a barrel of crude. In reality, many products are made from a barrel of oil.
[2] "Cost of goods sold" is the accounting term for production costs. For simplicity's sake in illustrating how LIFO works, we are assuming that the only production cost is the crude oil.
[3] We assume an average corporate tax rate of 35%.