How Can Switching to the LIFO Inventory Method Benefit Your Business?

LIFO: What is It?

LIFO (Last-in, First Out) is an inventory valuation method. Traditionally, companies have used FIFO (First-in, First Out) to value their inventory. Under the traditional FIFO method, inventory items acquired first by the company are the first to be deducted as cost of goods sold. LIFO turns this concept on its head, as under the LIFO method, the company considers the most recently acquired inventory items to be sold first. Note that this is solely an accounting concept and has no impact on day-to-day business, but does offer potential tax benefits.

How Can Switching to the LIFO Method Benefit My Company?

Switching to LIFO provides an opportunity for inventory-intensive companies to produce substantial tax savings. LIFO allows a business to deduct the most recently purchased items of inventory which in times of price inflation allows for a greater cost of goods sold deduction than could be realized under the FIFO method.[1] Consider the example presented below.

Inventory Value 12.31.21	2021 Inflation Rate	Year 1 LIFO Reserve	Potential Year 1 Tax Savings [1]
5,000,000	7%	350,000	$146,965

The inventory value depicted above is based on FIFO cost assumptions. Had LIFO been used, ending inventory would be $350,000 lower and cost of goods sold would be correspondingly higher. This is because the same physical goods counted in the ending inventory would be valued at beginning of the year costs as opposed to end of year costs.

Assuming further inflation over subsequent years, the opportunity for tax savings extends beyond the year of the change. Expanding on the example above, we can measure the potential tax savings in the years after the switch, using a more modest 3% rate of inflation across those years.

	2022	2023	2024	2025
Previous Year LIFO Valuation	5,000,000	5,150,000	5,304,500	5,463,635
Increase in LIFO Reserve	150,000	154,500	159,135	163,909
Potential Tax Savings [1]	$62,985	$64,875	$66,821	$68,825

What is the Potential Downside?

As with many tax-saving techniques, using the LIFO method is a deferral of income and tax rather than a permanent deduction. If there is ever a period of deflation or if inventory is completely liquidated, then the previously accelerated cost of goods sold deduction will have to be reversed and the related tax paid. In addition, there is a requirement to keep the company's financial

[1] Assuming a combined 37% federal and 4.99% Georgia tax rate

statements on the LIFO method, reducing reported financial statement earnings. Lastly, under the LIFO method, inventory must be valued at cost. Companies keeping inventory on the "Lower of Cost" or "Market Method" must restore previous adjustments to taxable income over a period of three years.

Why LIFO, Why Now?

Inflation is at an all-time high. While inflation has made life more difficult for many businesses and consumers, it has made switching to the LIFO method that much more attractive for companies, as it increases their potential tax savings. Using LIFO can mitigate the deleterious effects of price increases and improve cash flow through income tax savings.

Learn More

For more information on the updated K-1 reporting requirements, please contact your Bennett Thrasher tax advisor by emailing bennett-thrasher@btcpa.net.