Considerations for Dealers Facing Significant LIFO recapture

Due to the pandemic and supply chain issues, many automobile dealerships are anticipating significant decreases in inventories when compared to the same time last year. This has left many dealerships that use the LIFO method of accounting for inventory concerned about LIFO recapture. Dealers using the LIFO method of accounting for inventories, in years of increasing inventory levels and prices, have benefited by being able to consider the last units acquired to be the first ones sold. Over time this benefit builds up as a LIFO reserve and as inventories decrease the reserve is recaptured. Some dealerships are experiencing decreases of 60% to 70% or more in inventories when compared to their prior year-end. Under those circumstance, dealerships on LIFO could face a significant tax burden from LIFO recapture.

Estimation of LIFO Recapture
Generally, if inventory levels remain static or increase, there wouldn't be any recapture in the accumulated LIFO reserve. However, when inventory levels decrease there is the potential for prior year LIFO benefits to be recaptured. This does not occur pro rata with the decrease in inventory levels and is dependent on the individual dealer's history of accumulating inventory and inflation. Dealers should compute or request from their LIFO service provider an estimate now, in advance of year end, of their current year LIFO impact based on current or expected year-end inventory levels to understand the potential recapture for their specific circumstances. With that information, a dealer can work with their tax advisors to make decisions regarding implementing planning strategies to mitigate some of the negative impact.

Planning Strategies
What are some of the things a dealership should consider when faced with the possibility of a significant tax liability associated with a LIFO recapture?

Change in LIFO pooling
Some dealers that use the Alternative LIFO Method may still have two pools for cars and light duty trucks. Under Revenue Procedure 2008-31, dealers may combine cars and light-duty trucks into a single pool. Generally, the fewer pools a dealer has, the better off they are in mitigating LIFO recapture. This is especially the case where one inventory pool is experiencing a decrease in quantities where the other inventory is experiencing an increase in quantities. At a minimum, combined pooling simplifies the LIFO compliance going forward by eliminating some of the LIFO calculations. Making this change requires filing a Form 3115, Application to Change Accounting Method, to adopt the combined vehicle-pool method.

Change in LIFO method
Dealers may consider expanding their LIFO election and changing to a different method of computing LIFO. In most cases, dealers utilize the Alternative LIFO Method to compute their annual LIFO benefit which is limited to new vehicle inventory. The Inventory Price Index Computation (IPIC) method uses consumer or producer price indexes to determine inflation versus the actual invoice prices of inventory. One key advantage of the IPIC method is new vehicles, used vehicles and parts could be combined into a single LIFO calculation. Where a dealership only accounts for new vehicle inventory on the LIFO method, expanding the election to cover additional items may be beneficial. If a dealership is experiencing significant declines in new car inventory, expanding the LIFO election to cover used vehicle inventory and parts and then combining those into a single LIFO pool could offset the new vehicle decreases. Making this change would require the filing of a Form 970, Election to Use LIFO Method, to cover inventory not currently on LIFO and filing a Form 3115, to change to the IPIC method for all LIFO inventory and to combine LIFO pooling. This may be implemented with the filling of the current year tax return after year end, including extension. One key consideration is the fact that the financial statements need to reflect the expansion of the LIFO election to used vehicles and parts to maintain the book conformity requirement. In addition, dealers who are already accounting for used vehicles and/or parts using other

LIFO methods may see a similar benefit in this strategy by filing Form 3115 to adopt the IPIC method and combine all of their LIFO inventories into a single calculation. Generally, once the change is made, the dealership would be restricted in making another change in a LIFO method for a period of five years.

Discontinuance of LIFO method

One option is to discontinue the LIFO method of accounting through an accounting method change which results in a taxpayer recognizing into income the entire amount of the LIFO reserve. One benefit of the approach is the ability to defer the income recognition over a 4-year time frame versus current year LIFO recapture. In situations where a dealer is faced with a major decrease in inventory resulting in the recapture of 70% - 80% or more of the LIFO reserve, it is one way to defer the tax implications. Generally, this can be accomplished through the filing of a Form 3115. However, a dealership would be prohibited from re-electing LIFO for 5 years which may limit the appeal of this approach. For example, if inventory declined by 90% resulting in the recapture of 75% of a $5 million LIFO reserve, the increase to income would be $3.75 million (75% * $5 million). If the same taxpayer filed a method change to discontinue the LIFO method, the income recognized in the current year would be $1.25 million ($5 million * 25%). In the current year, filing the method change results in a reduction in taxable income of $2.5 million dollars. Under the LIFO termination option, the taxpayer will report the entire $5 million of LIFO reserve into income over 4 years resulting in more cumulative taxes being paid when compared to the $3.75 million income recognized due to the single year recapture event.

Possible Relief from Treasury

The NADA and others have been advocating for the US Treasury and IRS to utilize provisions under Internal Revenue Code Section 473 which provide relief for taxpayers that experience qualified liquidations of LIFO inventories resulting from major foreign trade interruptions that make it difficult or impossible to replace inventories on their ordinary course of business. Under this provision, if the taxpayer replaces inventory within the lesser of three years or other period as determined by the Treasury, the taxpayer can reduce gross income in the year of liquidation and potentially offset or eliminate its LIFO recapture. To date, Treasury has expressed hesitation to conclude that the pandemic and supply-chain disruptions qualify as events that warrant relief under Section 473. Recently, members of congress from both the House and Senate have written letters to the Treasury advocating for the applicability of Section 473 and urging Treasury to grant relief to LIFO taxpayers. Dealers should work with their tax advisors to monitor developments in this area but should be prepared in the case that Treasury does not issue any favorable relief.

Examine options

All dealers using the LIFO method to account for their new-vehicle inventories should consult with their tax advisers to review and discuss their year-end inventory level expectations, the impact on their LIFO reserves and taxable income, and available options.

Joseph Magyar
Managing Partner, Retail Dealer
+1 813 209 2435

David Strong
Partner, Washington National Tax
+1 616 752 4251

The foregoing summary is provided for informational purposes only and is not intended as legal or accounting advice. Consult your tax advisor for guidance on your particular situation.