Background and Bill Analysis – Support for the "Supply Chain Disruptions Relief Act"
S. 443/ H.R. 700
September 20, 2023

Background on Present Law Related to LIFO - The Internal Revenue Code authorizes alternative methods of accounting, such as first in, first out (FIFO) and last in, first out (LIFO), for taxpayers to compute the cost of goods sold for inventory and ascertain taxable income. FIFO taxpayers expense the oldest inventory first, and LIFO taxpayers expense newly acquired inventory first. Additionally, the Code permits LIFO taxpayers to use the dollar-value method to track inventory costs by dollar value rather than by the number of units.

LIFO produces net income that more closely reflects the difference between sale proceeds and current market costs of inventory. When inventory costs rise due to inflation, the LIFO method produces a higher cost of goods sold and, consequently, a lower taxable income compared to the FIFO method. However, LIFO is just a different tax cost-flow assumption for the same amount of costs, so every LIFO taxpayer ultimately must account for the difference between LIFO income as compared to FIFO income (LIFO recapture).

LIFO taxpayers must establish a LIFO reserve to track the difference between the cost of goods sold under FIFO and the cost of goods sold under LIFO. A taxpayer's LIFO reserve = (FIFO inventory costs) - (LIFO inventory costs). The LIFO reserve is an entry for accounting purposes (not a funded, segregated business account) that is computed as of the end of each tax year.

When inventory falls during a tax year, the LIFO reserve may fall. A decline in the LIFO reserve triggers LIFO recapture by matching lower historical costs against current sales revenues, which can generate onerous tax consequences. LIFO recapture is taxed as ordinary income (<u>not</u> as a capital gain), due in full for the tax year in which the recapture occurs and is paid in addition to all other income taxes due. In normal business conditions, taxpayers can easily replenish inventory to control the adverse consequences of LIFO recapture.

Special Rule for Qualified Liquidations of LIFO Inventories - Congress has recognized that market conditions may render taxpayers powerless to replenish inventory sufficiently to avoid LIFO recapture. Sec. 473 of the Internal Revenue Code grants the Secretary of the Treasury regulatory discretion to provide LIFO relief for taxpayers that cannot replace inventory due to a major foreign trade interruption. If Treasury makes such a determination, taxpayers could treat these uncontrollable shortfalls of inventory as qualified inventory liquidations that do not trigger LIFO recapture if the taxpayer replaces the inventory within a specified period.

Need for the "Supply Chain Disruptions Relief Act" (S. 443/ H.R. 700) - Congress has acknowledged that vehicle assembly plants and suppliers across the globe ceased or slowed production during the pandemic, drastically curtailing inventory for new vehicle dealers. <u>The shortfall worsened with the worldwide shortage of microchips, which are essential to complete every vehicle manufactured today</u>. These dramatic supply constraints and the continued U.S. consumer demand for vehicles have created the lowest level of dealer inventories in 50 years. With no way to replenish inventory in 2020 and 2021 due to circumstances beyond their control, dealers using LIFO face major unanticipated tax liability due to LIFO recapture that would strip much needed working capital from closely held dealerships, particularly small family-owned dealerships.

Members of the House and Senate have sent multiple bipartisan letters to Treasury urging the agency to grant Sec. 473 regulatory relief for the auto sector. In response, Treasury has declined to implement existing law and instead suggested the need for additional legislative authority as reflected in the bill.

Key Provisions of S. 443/ H.R. 700: In general, the bill would allow new vehicle dealers to delay the recognition of income triggered by LIFO recapture for tax years 2020 and 2021 when dealers faced uncontrollable, pandemic-driven inventory shortfalls of new vehicles. In particular, the bill would:

- provide a statutory determination that the requirements for a qualified liquidation under Sec. 473 have been satisfied for new motor vehicle dealers that have had a reduction of new vehicles held in LIFO inventory;
- expand the period to replenish inventory and compute LIFO reserve/recapture until the tax year ending before January 1, 2026;
- permit taxpayers to file amended returns or offset tax liability on future returns to claim relief; and
- direct Treasury to provide regulatory guidance to enable dealers to calculate LIFO during the expanded replacement period.

Analysis of S. 443/ H.R. 700:

Subsection (a) **provides a statutory determination[1] that two key elements of a major foreign trade interruption as defined in Sec. 473(c) of the Internal Revenue Code are deemed satisfied for new motor vehicle dealers that faced unavoidable "qualified liquidations" (decreases in inventory) of new motor vehicles.** The bill states that two of the three threshold requirements for a "qualified liquidation" under Sec. 473(c) [2] are deemed satisfied:

- There has been a "qualified inventory interruption," and
- The taxpayer's decrease in inventory is directly and primarily attributable to that "qualified inventory interruption" (essentially, the dealer was powerless to replenish inventory).

The third requirement to claim relief appears in Sec. 473(c)(1)(A): A taxpayer must demonstrate that inventory has decreased and that the inventory was held under LIFO. In practical terms, this requires a dealer to document decline in inventory and current LIFO status.

Thus, enactment of the bill will satisfy the first two requirements of Sec. 473 on an industry-wide basis, and an individual new motor vehicle dealer will need to satisfy the third requirement to document a decrease in new motor vehicles inventoried under the LIFO method during the eligible tax years defined in Subsection (c)(1).

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[1] The bill does not amend the Internal Revenue Code but determines that certain conditions for applying Sec. 473 have been met.

[2] The bill specifically cites paragraphs (1)(B) and (2) of Sec. 473(c) which includes these requirements.

Subsection (b)(1):
Directs Treasury to issue regulatory guidance to enable dealers to defer income otherwise subject to LIFO recapture. This subsection permits dealers to defer income that is "solely attributable" [3] to the "qualified liquidation" of inventory. Without this additional deferral election, Sec. 473 would require dealers to include the LIFO recapture in income, pay the tax, and claim a refund to the extent they replace the liquidated inventory. In general, this election would instead permit dealers to defer the LIFO recapture in the liquidation year and include the LIFO recapture on a return at the end of the replacement period only to the extent the dealer doesn't replace the liquidated inventory. (If a dealer already filed the original return for the liquidation year before S. 443/ H.R. 700 is enacted, the dealer can file the election on the first tax return filed after the date of enactment).

Directs Treasury to provide guidance (either regulations or lesser guidance) in 90 days.

Provides a "replacement period" through December 31, 2025, although that period would end early if "the dealer does not inventory new motor vehicles under the LIFO method."[4] The expansion of the replacement period is essential to relief because the additional time will enable dealers to replenish inventory in the ordinary course of business.

Subsection (b)(2) provides pro rata relief. Dealers that do not replace all liquidated vehicles must recognize LIFO recapture income with respect to vehicles that were not replaced. To determine the amount of income that must be recognized, the bill requires taxpayers to apply the provisions of Sec. 473, and Sec. 473(b) determines the treatment for liquidated goods that "are replaced (in whole or in part) during any replacement year. " Apparently, the "aggregate amount of income" means the net amount of income that would have been recognized with adjustments under Sec. 473 (b) but clarifying language would resolve ambiguity.

Subsection (b)(3) establishes parameters for electing relief. Dealers must make an election by the extended due date for the tax return filed for a specified taxable year.[5]

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[3] Statutory Interpretation. The meaning of "solely attributable" should not be interpreted to give Treasury any discretion to reduce the scope of intended relief. Treasury has no discretion to determine whether or the extent to which dealers have experienced a qualified inventory interruption because Subsection (a) establishes that determination by statute. "Solely attributable" is only relevant to determine which type of income relates to a qualified liquidation of inventory. For example, any decrease in new vehicle inventory would create income eligible for deferral, but any increase income for other reasons (service income, the sale of parts, etc.) would not be eligible for deferral.

[4] Statutory Interpretation. The phrase "no longer inventories new vehicles under the LIFO method" means that the dealer has affirmatively chosen to terminate the use of LIFO by filing Form 3115 or has ceased doing business entirely. The mere absence of inventory, even the complete absence of inventory during a given year, would not trigger the earlier replacement period end date.

[5] If the return has already been filed as of the date of enactment of the relief bill, the dealer may make the election for the next filed return and treat the election as a change in method of accounting under Sec. 481(a), which provides an adjustment with respect to the timing for taking the LIFO recapture income into account. This allows the dealer the option to obtain relief without filing an amended return for the specified taxable year.

Subsection (c)(1) **defines "specified taxable year" essentially to include tax years 2020 and 2021.** The years eligible for relief under the bill include any liquidation year ending after March 12, 2020, and before January 1, 2022. Most dealerships are calendar year taxpayers, so the relief will be available for tax years 2020 and 2021. A liquidation year is simply a tax year in which inventories are liquidated.

Subsection (c)(2), **by cross referencing a portion of Sec. 163(j)(9)(C) of the Code, defines "new motor vehicle"** as "any self-propelled vehicle designed for transporting persons or property on a public street, highway, or road" and "the original use of which has not commenced" (new vehicles not used).

Subsection (c)(3) **defines "Secretary"** as the Secretary of the Treasury or the Secretary's delegate(generally, the IRS Commissioner).

Subsection (c)(4) **provides that terms used in the bill that are also used in Sec. 473 have the same meaning as defined in Sec. 473.** This is relevant for key terms such as qualified liquidation.