LIFO—A Short Drive To Increased Cash Flow

President Reagan has pledged a tax cut. Your tax rate will probably be lower when you file next year’s tax return. Do you know one profitable contractor that will intentionally pay more tax by using the old higher rates? We don’t.

Yet most contractors in the United States will overpay their income tax when they file their next tax return. Why? Because they will report inventories in the same old way. What is the best inventory method for most contractors?

To answer that question, Construction Dimensions interviewed one of the nation’s top tax authorities, Irving L. Blackman, C.P.A., senior tax partner of the Chicago accounting firm of Blackman, Kallick & Company, Ltd.

**DIMENSIONS:** If you were to pick the single greatest tax savings opportunity for today, what would you choose?

**BLACKMAN:** LIFO—a method for valuing inventory on the last-in, first-out basis.

**DIMENSIONS:** Why LIFO? Hasn’t it been around for more than 40 years?

**BLACKMAN:** Yes, it has. Actually, there are two basic methods of valuing inventory. One is an assumption that says, first-in, first-out (FIFO). This means you value your inventory on the basis of the cost of the last item placed in stock. The other method is last-in, first-out (LIFO). This means you value your inventory on the basis of the cost of the first item placed in stock. Under LIFO, the last items purchased—presumably at higher prices due to inflation—are assumed to be the first items sold. LIFO eliminates phantom profits by removing the inflation rate from your inventory value. The result is delightful. LIFO reduces your taxable income, cuts your income tax, and, therefore, increases your cash flow.

Assume your inventory consists partly of x’s that cost you $50 apiece five years ago and partly of x’s that cost you $75 this year. Under FIFO, you would have a $50 profit on each old x used. Under LIFO, you would show any $25 profit no matter which x you used.

**DIMENSIONS:** Okay, LIFO can be used as a hedge against the steady rise in inventory replacement costs. But why is LIFO so much in the spotlight now?

**BLACKMAN:** Double-digit inflation rates are the reason. Contractors are socked a second time by double-digit interest rates. But there is another reason why LIFO is catching on. New IRS regulations now permit a business to show the figures for both LIFO and FIFO in the same financial statement. In short, you can use LIFO for tax purposes and FIFO for reporting purposes.

**DIMENSIONS:** How can LIFO provide cash flow relief?

**BLACKMAN:** If you pay less income tax, you improve your net cash flow. It’s as simple as that.

Improved cash flow also relates to a dealer’s ability to compete. If you stick with a traditional inventory method like FIFO, you pay more income tax. Therefore you can’t match your competitor’s cash flow. And you don’t have the cash to invest in new people, new inventory, or whatever your company needs most. You must borrow money and pay 15% to 20% to finance what your competition is saving from LIFO. You’re at a distinct disadvantage.

**DIMENSIONS:** Where does the decision to switch to LIFO start?

**BLACKMAN:** LIFO essentially starts with Section 472 of the Internal Revenue Code and the regulations.**

**DIMENSIONS:** If a contractor must switch to LIFO based on information found in the Code, very few will ever do it. Doesn’t it take a highly experienced accountant to decipher the law and make LIFO work?

**BLACKMAN:** True, the law is quite confusing. In fact, there’s nothing in the Code or the regulations that tells you exactly how to institute the different methods or make the various elections that the IRS will accept. It’s done on a taxpayer-by-taxpayer basis, and it does require a professional.

**DIMENSIONS:** Have the big companies taken advantage of LIFO?

**BLACKMAN:** Only a few of the Fortune 500 companies aren’t on LIFO. That has given the mistaken impression that LIFO is an election for the giants—that it’s too complex, too involved for the mid-sized or smaller company. But that myth has been perpetuated only because the expertise that was necessary to implement it was transferred from one very sophisticated tax person to another. As a practical matter, the little guy can take advantage of LIFO under exactly the same rules as the giant.

**DIMENSIONS:** Who are you calling the “little guy”? What’s the cutoff point?

**BLACKMAN:** Opinions vary. Some experts suggest that a business

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shouldn’t consider LIFO unless it has at least $1 million in inventory. Others believe that a business with as little as $100,000 in inventory can elect LIFO.

Let’s just run some numbers. The savings formula is the rate of inflation times your ending inventory times your tax bracket. So if you have $1 million in inventory at 10% inflation, you’re talking profits that are overstated by $100,000. If you’re in a 46% tax bracket, you’ve spent $46,000 in income taxes that you didn’t need to pay. Every dealer should run his own numbers.

**DIMENSIONS:** When can a contractor make the switch?

**BLACKMAN:** You can’t adopt LIFO for a previous year once you’ve filed a tax return for that year. If you’ve already filed your return for 1980, for example, you can’t amend it. You’ll have to wait until next year to elect LIFO. But if you haven’t filed yet, it’s not too late for 1980.

**DIMENSIONS:** How does a company elect LIFO?

**BLACKMAN:** You simply attach a Form 970 to your tax return. In effect, you can file retroactively for one year.

**DIMENSIONS:** How long can a company wait to make an election?

**BLACKMAN:** Let’s use an example. You’re a corporate taxpayer on a calendar year. Your initial tax return is due on March 15, 1981. You get an automatic extension for 90 days, which brings you to June 15. You can get a second extension with Uncle Sam’s permission, which takes you to September 15. As long as you attach the 970 to that return, the IRS must grant you your election to adopt LIFO.

It’s the only election I know of in the tax law where you can look backward after the year is over and save dollars.

**DIMENSIONS:** Is it possible to create a tax refund?

**BLACKMAN:** Yes. If a contractor has paid estimated taxes anticipating a profit, and it then elects LIFO which reduces profits, it can go back and reclaim in the estimated tax by adjusting future payments.

Furthermore, if the contractor not only reduces its profits but creates a loss, it can then get a loss carryback.

Let’s summarize this point: If LIFO reduces the current year’s profits, it can reduce taxes; if LIFO causes a loss in the current year, the government will send you a check for your carryback loss. Oh yes, the IRS will pay you interest on this refund.

**DIMENSIONS:** Once a company elects LIFO, is the decision irreversible?

**BLACKMAN:** No, you can drop LIFO if it isn’t working to your advantage for some reason.

**DIMENSIONS:** Does a company ever have to pay back what it saves if it sticks with LIFO?

**BLACKMAN:** Rarely, it’s a perpetual deferral as long as you stay in business and maintain your LIFO inventory level. The typical business is passed from generation to generation, so as a practical matter, the business may never pay back what it saves by using LIFO.

**DIMENSIONS:** Are there any restrictions in the works?

**BLACKMAN:** There’s nothing pending in Congress to change the LIFO law. It’s well entrenched, both historically and economically, as an acceptable method of valuing inventory. If anything, changes by both the IRS and the Congress have been toward facilitating LIFO. For example, the IRS, on its own, changed the regulations to meet the financial needs of business by allowing companies to report both FIFO and LIFO on the same year-end statement.

**DIMENSIONS:** So LIFO is here to stay?

**BLACKMAN:** Absolutely. It’s one of the greatest weapons in the artillery of the business taxpayer. When a contractor regardless of size, analyzes LIFO’s benefits, it will find that it can’t afford not to adopt the last-in, first-out method of inventory valuation.

(Table assumes 46% tax rate and 10% inflation.)

<table>
<thead>
<tr>
<th>Year-End Inventory</th>
<th>Increased Cash Flow From LIFO Election</th>
<th>10-Year Compound Increase in Cash Flow (20% Return)</th>
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<tr>
<td>$100,000</td>
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**EDITOR’S NOTE:** Irving Blackman has written a new manual that offers step-by-step LIFO implementation instructions. The LIFO-SAVE Implementation Manual explains the specific methods for adopting LIFO, inventory pooling, reporting requirements, and pertinent IRS Code sections and regulations.

If you are interested in obtaining a manual, attending a LIFO seminar or need help converting to LIFO, write Blackman, Kallick & Company, Ltd., LIFO Auto Dept., 180 North LaSalle Street, Chicago, Illinois 60401.