Death and Taxes: Auto Dealers Face Their Final Reckoning

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Introduction

With all the recent talk about economic "recovery," it is easy to overlook the fact that auto retailers, who have weathered the worst downturn in auto sales in history, now face an even more ominous financial challenge with the repeal of last-in, first-out (LIFO) inventory accounting. For many dealers on the cusp, this may be the final deathblow after having survived drastically lower sales, tightening credit, greater capital requirements from the auto manufacturers, and the elimination of recognized brands such as Oldsmobile, Plymouth, Pontiac, Saturn, Hummer, and now Mercury.

While a paring down of the auto retail industry, particularly the domestic dealer networks, may be necessary and even welcomed by surviving dealers and the manufacturers they represent, the impact of this sector of the economy cannot be understated. Despite its importance, it has been often overlooked, as the government and public have focused their attention on large individual corporations, such as banks and the auto manufacturers themselves. While even the largest private dealerships in the nation, and even the large publicly-traded dealers such as Auto Nation and J.D. Buyrider, are relatively small in comparison with the likes of General Motors, Chrysler, AIG, Bank of America, etc., collectively they make up the single largest portion of the retail sector of the economy at 17%, accounting for $789B in annual sales in 2008[1] and 1,114,500 jobs with an annual payroll of $54B in 2007[2]. Moreover, many dealers represent the backbone of small business, especially in small and rural communities throughout the country, paying some $20B in annual sales taxes to state and local municipalities.[3]

Driven to Despair

A recent article in the Wall Street Journal[4] describes the extreme efforts many dealers are taking in order to stay afloat. In many cases, dealers are financing their floor plan out of their own pockets, borrowing from friends and family, and selling off assets such as buildings and land, all of which was virtually unheard of for a reputable new car retailer before the recession. In the mean time, specialty lenders such as GMAC Financial Services and Chase Auto Finance have restricted financing by 12% from the fourth quarter of 2008 to fourth quarter of 2010, from $225B to $198B. Overall auto loans have dropped by $47.2B in that same period. With so many dealers increasingly leveraged, the elimination of the favorable LIFO inventory accounting convention may push many over the edge.

The Perfect Political Storm

Automobile dealers find themselves caught up in a political storm centered on inventory accounting. LIFO, which has been an established practice for nearly 70 years, is an inventory accounting method used by many companies throughout the United States to mitigate income tax liability. Essentially, as long as there is inflationary pressure on the cost of goods sold, companies that maintain inventory are able to report smaller income by basing sales on the newest inventory. Table 1 presents the annual inflation for new vehicles.

Table 1: Average Vehicle Price and Inflation from 1996 through 2010

Year	Average Selling Price	Change Over Prior Year	Change Over Base Year	Average Inflation Over Base Year
1996	$ 21,900			
1997	$ 22,650	3.4%	3.4%	3.4%
1998	$ 23,600	4.2%	7.8%	3.9%
1999	$ 24,445	3.6%	11.6%	3.9%
2000	$ 24,923	2.0%	13.8%	3.5%
2001	$ 25,797	3.5%	17.8%	3.6%
2002	$ 26,163	1.4%	19.5%	3.2%
2003	$ 27,565	5.4%	25.9%	3.7%
2004	$ 28,060	1.8%	28.1%	3.5%
2005	$ 28,381	1.1%	29.6%	3.3%
2006	$ 28,451	0.2%	29.9%	3.0%
2007	$ 28,797	1.2%	31.5%	2.9%
2008	$ 28,350	-1.6%	29.5%	2.5%
2009	$ 28,966	2.2%	32.3%	2.5%
2010	$ 29,487	1.8%	34.6%	2.5%

*Data from NADADATA: NADA's Annual State of the Industry Report

Many industries have benefited from this accounting convention, including automobile dealers who are allowed to group all cars and light trucks under 14,000lbs into new and used pools under the "Vehicle Pool Method" (IRS Revenue Procedure 2008-23). "The LIFO method of valuing inventory has been a long-time friend to dealers", according to John Donaldson, a senior accountant with Larson Allen, a consulting firm specializing in auto retailing.

Unfortunately, automobile dealers are not the only beneficiaries of LIFO accounting, and they have found themselves caught in the crossfire, as congress has become increasingly hostile towards the oil industry. After a number of years of posting record profits, coupled with rising fuel prices at the pump, public sentiment has turned away from the oil industry and has given members of congress the political courage to seek a "windfall profits" tax back in 2008. Repealing what the general public views as an accounting loophole and eliminating a tax break for Big Oil has become increasing popular across political party lines. With the recent Gulf Coast oil spill and the resulting political fallout, it is unlikely that members of congress will offer any concessions, not even to automobile dealers.

The repeal of LIFO has been kicked around in congress and on the radar of business and trade groups opposed to such measures for several years. Former House Ways and Means Chairman, Charles Rangel (D-NY), first introduced a major tax reform bill (H.R. 3970), which included a repeal of LIFO for all industries, back in 2007. Although industry groups, including the National Automobile Dealers Association (NADA), managed to thwart that proposal, and similar subsequent proposals, pressure to achieve "budget neutrality" after a massive jobs spending program is now driving the move to eliminate LIFO. The Obama administration has included the LIFO repeal in its 2011 budget and estimated that the repeal will generate an additional $59B in tax revenues over the fiscal years 2011 through 2020.

Despite protestations by the LIFO Coalition representing businesses across a wide swath of American industry, including the NADA, to remove this item from the budget or at least offer exemptions to certain industries likely to be hard hit by its repeal, there are global forces also pushing for its repeal that are unlikely to ease. For years, there has been a push towards convergence of U.S. Generally Accepted Accounting Principles (GAAP) and International Financial Reporting Standards (IFRS). Since LIFO has never been an accepted practice under IFRS, and with the rest of the world moving towards IFRS –even the SEC has begun allowing certain companies to report under IFRS without the mandatory 20-F reconciliation – it is unlikely that the pro-LIFO establishment will be able to push back the tide.

Government syndics have warned that LIFO is likely to phase out of existence even without the actions of congress, which are nothing short of playing up to the populist movement. The reason for this belief is because of a US Tax Code requirement for financial conformity as provided in section 472(c). The "financial conformity rule" requires companies electing the LIFO inventory valuation method for tax purposes must use the LIFO method for financial reporting to certain parties.[5] IFRS, on the other hand, prohibits LIFO and so by not allowing for a LIFO inventory accounting, any company switching to IFRS must abandon the LIFO convention because the LIFO book/tax conformity requirement would not be met. With most companies looking to raise capital in global markets, and with the cost of reconciling US GAAP to IFRS prohibitively high, it is likely that many more companies will adopt IFRS in the coming years as the SEC opens up the ability for all companies to report their financial performance under IFRS[6] and the current political tide towards repealing LIFO inventory accounting method.

Currently, there is a Department of Treasury proposal prohibiting the use of the LIFO inventory accounting method for Federal income tax purposes.[7] The proposal would require those taxpayers currently using LIFO method to write their beginning LIFO inventory to its FIFO value beginning after December 31, 2011. This one time income charge, however, would be taken into account ratably over ten years, beginning with the first taxable year after December 31, 2011. The Service cites as one of its reasons for a change that International Financial Reporting Standards do not permit the use of the LIFO method, and their adoption by the Securities and Exchange Commission would cause violations of the current LIFO book/tax conformity requirement. Repealing LIFO would remove this possible impediment to the implementation of these standards in the United States.[8] In the end, any effort to save LIFO may simply be delaying the inevitable.

The Dealer Case

With the repeal of LIFO eminent, industry groups, such as the NADA, have changed their lobbying strategy to focus on how LIFO will be phased out. The current proposal would have companies cease reporting inventory on a LIFO basis for its first complete tax year after December 31, 2011, but ratably account for the increased income over a 10 year period. However, this effectively means that LIFO will be completely eliminated for the 2012 tax year.

For the NADA, how the phase-out will occur remains an arena for positive lobbying outcomes. At this point, there are three basic scenarios, with the first being adopted by the Department of Treasury, for how dealers will phase out their LIFO reserves starting in 2012:

1. Taxed as ordinary income over a 10-year period.
2. Recaptured and taxed at a "special", negotiated rate.
3. Left "frozen" on the books, but eliminated for future use.

The authors had the opportunity to meet with both the Operations and Sales Managers of one of the largest volume Ford dealers in Michigan to discuss how they are accounting for inventory and what, if any, effect the repeal of LIFO will have on their operations. For the purposes of this discussion, we will hence refer to this particular dealer as "The Dealer". According to the NADA, nearly 75% of automobile dealers currently use LIFO for inventory valuation purposes.[2] The Dealer is no exception to this rule, and adopted LIFO sometime back in the early 1990s when advised to do so by their accounting firm. The Dealer estimates that they maintain roughly $300K of land and property on their books, along with $18M in new car and $600K in used car inventory. Since the allowance for inventory pooling began in 1998, the Dealer has continued to build up its LIFO reserves on new car inventory. Currently the Dealer estimates that its LIFO reserve is over $7M, or 40% of their total new car inventory value.

This dealer is consistent with industry norms. Table 2 below shows the sales data and LIFO reserves for Ford's top 25 dealers by volume nationwide. The number one dealer has nearly $20M in LIFO reserves, which could be taxed at a rate as high as 35% if required to recapture these reserves as operating income.

Table 2: LIFO Reserves for Ford's Top 25 Volume Dealers

2010 LIFO Reserves				
Rank	Description	Annual Volume	Sales Value*	LIFO Reserve (000)
1	Dealer 1	5,010	$ 147,732	$ 19,582
2	Dealer 2	4,551	$ 134,197	$ 10,464
3	Dealer 3	4,127	$ 121,694	$ 8,642
4	Dealer 4	3,898	$ 114,942	$ 763
5	Dealer 5	3,587	$ 105,771	$ 7,259
6	Dealer 6	3,584	$ 105,683	$ 7,161
7	Dealer 7	3,177	$ 93,681	$ 5,118
8	Dealer 8	3,096	$ 91,293	$ -
9	Dealer 9	2,973	$ 87,666	$ 6,568
10	Dealer 10	2,953	$ 87,076	$ -
11	Dealer 11	2,881	$ 84,953	$ 2,028
12	Dealer 12	2,706	$ 79,793	$ -
13	Dealer 13	2,630	$ 77,552	$ -
14	Dealer 14	2,628	$ 77,493	$ -
15	Dealer 15	2,432	$ 71,713	$ -
16	Dealer 16	2,424	$ 71,477	$ 4,524
17	Dealer 17	2,349	$ 69,266	$ 3,295
18	Dealer 18	2,327	$ 68,617	$ -
19	Dealer 19	2,274	$ 67,054	$ -
20	Dealer 20	2,193	$ 64,666	$ 2,147
21	Dealer 21	2,175	$ 64,135	$ -
22	Dealer 22	2,141	$ 63,132	$ 3,447
23	Dealer 23	2,135	$ 62,956	$ 4,193
24	Dealer 24	2,118	$ 62,454	$ (16)
25	Dealer 25	2,114	$ 62,336	$ 4,352
	Total			**$ 89,527**
	Average			**$ 3,581**

*Estimated by average selling price times actual volume

Prior to the Inventory Pool Method, dealers would maintain inventory values based on body code, which is not necessarily model-specific. Consider the Ford Taurus later became the Ford Five Hundred (code name D258), and only recently did it return again as a Taurus. Although we are talking about three very different models, with several design iterations of the original Taurus, they are all tallied under the same body code. Since the Vehicle Pooling Method was adopted in 1998, any older layers of LIFO reserves prior to pooling may have been mixed in with other body codes.

In the past 15 years, annual vehicle inflation has averaged 2.5% according to the NADA. While a 2.5% annual rate of inflation may not seem that high, especially given the fact that vehicle content and safety has substantially improved over that period, it has the potential to create an enormous tax liability in a short time frame. Table 3 presents a simple example of a company that starts business in year one by purchasing 20 units of inventory and selling ten. Now, assume this company sells ten units each subsequent year and replaces them, maintaining an inventory of ten units. Even under the assumption of a rather mild 2.5% inflation, LIFO reserves exceed 40% of the total value of inventory within a 15 year period.

Table 3: LIFO Reserve Example

Year	Purchased Quantity	Cost/Unit*	Ending Inventory Value	Total Cost of Goods Sold	Reserve	Reserve as % of Inventor Value
1	20	$ 1.00	$ 10.00	$ 10.00	$ -	0%
2	10	$ 1.03	$ 10.00	$ 10.25	$ 0.25	3%
3	10	$ 1.05	$ 10.00	$ 10.51	$ 0.51	5%
4	10	$ 1.08	$ 10.00	$ 10.77	$ 0.77	8%
5	10	$ 1.10	$ 10.00	$ 11.04	$ 1.04	10%
6	10	$ 1.13	$ 10.00	$ 11.31	$ 1.31	13%
7	10	$ 1.16	$ 10.00	$ 11.60	$ 1.60	16%
8	10	$ 1.19	$ 10.00	$ 11.89	$ 1.89	19%
9	10	$ 1.22	$ 10.00	$ 12.18	$ 2.18	22%
10	10	$ 1.25	$ 10.00	$ 12.49	$ 2.49	25%
11	10	$ 1.28	$ 10.00	$ 12.80	$ 2.80	28%
12	10	$ 1.31	$ 10.00	$ 13.12	$ 3.12	31%
13	10	$ 1.34	$ 10.00	$ 13.45	$ 3.45	34%
14	10	$ 1.38	$ 10.00	$ 13.79	$ 3.79	38%
15	10	$ 1.41	$ 10.00	$ 14.13	$ 4.13	41%

* Assuming 2.5% inflation

Even under the best case scenario for the Dealer, where LIFO reserves are simply “frozen” and not recaptured as income, the elimination of LIFO accounting may have a major impact on how all dealers order vehicles. In the past, dealers across the country have ordered heavier near the end of the year on new models, especially since new models typically come with a price increase at year-end. Even though they might not sell them until the following year, the tax benefit of being able to cost goods sold at the new higher rate was an incentive to ordering at the end of the year. This behavior has only strengthened the industry tradition of the end-of-summer-model-year-change-over, with new models being delivered in the fall and early winter months.

Pruning the Dealership Network

While the Dealer has the capital to weather the coming change in tax law, both the Sales and Operations Managers question whether many small and medium-sized dealers will be able to take the hit, especially if LIFO reserves are to be taxed as ordinary income over 10 years. They believe that this change in tax policy will have a larger effect on thinning out the dealer ranks than the efforts by GM and Chrysler to use bankruptcy protection to challenge state franchise laws and close nearly 2,000 dealerships nationwide.

In fact, the repeal of LIFO may prove a unique opportunity for the automobile manufacturers to rid their dealership network of smaller, marginal dealers without having to compensate the owners. In the past, state franchise laws made it difficult to eliminate dealers. When GM decided to eliminate the Oldsmobile franchise, they had to shell out nearly $1B in what they called the Transition Financial Assistance Package (TFAP). Part of this package, was specifically to address the issue of LIFO reserves dealers would have to capture as income. In order to compensate dealers and offset the tax consequences, GM offered dealers between $1,695 and $3,100 for each vehicle sold during the best year between 1998 and 2000. From Ford's perspective, compensation for the LIFO tax consequences of closure have long been an impediment to negotiating with dealers.

The LIFO repeal may have an unintended consequence of making many smaller, family-owned dealerships more willing to consider a compensation package for closure, especially as 2012 draws near. While this may prove a positive leverage for the automobile manufacturers in their efforts to prune down their dealership networks, it will no doubt be a major blow to the many communities and employees who rely on these small businesses.

The impact on the automobile retail landscape by a LIFO phase-out cannot be diminished. Automobile retail sales are the single largest portion of the largest sector of the American economy, the retail sector. While the argument from the manufacturer's perspective is that many of these jobs will be reabsorbed by the more profitable dealerships, the elimination of much of the smaller dealerships will no doubt have a huge impact on competition and customer service, not to mention the many community benefits of having a small town dealer. How many more economic blows can this sector of the American economy absorb without being completely knocked out? It seems that what the "Great Recession", brand elimination, and the credit crunch could not kill, may finally fall to a tax law change. As the proverbial old saw goes, "nothing is certain, except for death and taxes". In the case of auto dealers, they may be the same thing.

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[1] Annual Retail Trade Report available at www.census.gov
[2] Bureau of Labor Statistics Annual survey of professions at www.bls.gov
[3] NADA Annual Report at www.nada.org
[4] Ransom, D, "Driven to Despair", The Wall street Journal, Monday, June 21, 2010
[5] Financial conformity is not the same as the book conformity requirement of section 446(a) because financial conformity looks to the taxpayer's financial statements rather than the taxpayer's internal books and records.
[6] On February 24, 2010, the Commission voted to delay implementation of IFRS until 2015. The earlier plan was to implement IFRS in 2014.
[7] General Explanations of the Administration's Fiscal Year 2011 Revenue Proposals, page 37.
[8] General Explanation at 37.