Take stock of your inventory accounting method's impact on your tax bill

If your business involves the production, purchase or sale of merchandise, your inventory accounting method can significantly affect your tax liability. In some cases, using the last-in, first-out (LIFO) inventory accounting method, rather than first-in, first-out (FIFO), can reduce taxable income, giving cash flow a boost. Tax savings, however, aren't the only factor to consider.

FIFO vs. LIFO

FIFO assumes that merchandise is sold in the order it was acquired or produced. Thus, the cost of goods sold is based on older — and often lower — prices. The LIFO method operates under the opposite assumption: It allocates the most recent costs to the cost of sales.

If your inventory costs generally rise over time, LIFO offers a definite tax advantage. By allocating the most recent — and, therefore, higher — costs first, it maximizes your cost of goods sold, which minimizes your taxable income. But LIFO involves more sophisticated record keeping and more complex calculations, so it's more time-consuming and expensive than FIFO.

Other considerations

LIFO can create a problem if your inventory levels begin to decline. As higher inventory costs are used up, you'll need to start dipping into lower-cost "layers" of inventory, triggering taxes on "phantom income" that the LIFO method previously has allowed you to defer. If you use LIFO and this phantom income becomes significant, consider switching to FIFO. It will allow you to spread out the tax on phantom income.

If you currently use FIFO and are contemplating a switch to LIFO, beware of the IRS's LIFO conformity rule. It generally requires you to use the same inventory accounting method for tax and financial statement purposes. Switching to LIFO may reduce your tax bill, but it will also depress your earnings and reduce the value of inventories on your balance sheet, which may place you at a disadvantage in comparison to competitors that don't use LIFO. There are various issues to address and forms to complete, so be fully informed and consult your tax advisor before making a switch.

The method you use to account for inventory can have a big impact on your tax bill and financial statements. These are only a few of the factors to consider when choosing an inventory accounting method.

Please contact Ceschini, CPAs at (631) 474-9400 for more information about this topic and other tax and business developments – such as new IRS regulations and court decisions.