

# Clunkers Program Results in Potential LIFO Mess

Inventory levels are significantly lower this year-end due to the sales generated during the Car Allowance Rebate System (CARS or “cash for clunkers”). Consequently, dealers that account for inventory using the last in, first out (LIFO) method may need additional cash when filing 2009 tax returns.

“The government’s ‘cash for clunkers’ program may have created a LIFO nightmare for franchised new vehicle dealerships,” says Scott Gorden, principal-in-charge of dealerships at LarsonAllen. He’s concerned there’s not enough time to replenish depleted new vehicle inventories by the end of the year.

To avoid tax surprises, dealers should prepare projections on current inventory levels to assess whether they’ll recognize LIFO income for 2009 or LIFO expense. If recognizing income, the additional cash requirements could be significant.

## **How LIFO works and why CARS may have created troubles**

As prices and inventory levels rise, the LIFO method creates expense for dealerships by increasing the cost of goods sold on their income statements and decreasing the value of inventory on their balance sheets. As prices and inventory levels drop, the LIFO method results in income.

During the “cash for clunkers” program, many dealers sold nearly all of their new vehicles, along with some incoming units from the factory. To make matters worse, over the last six months, auto manufacturers like General Motors (GM) and Chrysler reduced factory production. Both occurrences result in a reduction in dealership inventories. So it is critical that dealers review their inventory levels as soon as possible due to the five-week or greater new vehicle ordering cycle with the manufacturer.

“Since LIFO could generate significant non-cash income to the dealership, plenty of dealers won’t be aware they’ll have to pay additional taxes in April 2010 on their 2009 LIFO adjustment,” says Gorden.

## **Reducing the LIFO Impact**

“LIFO could have a huge impact on a dealership’s cash flow, so year-end inventory management is key,” Gorden explains. LarsonAllen has conducted a significant number of 2009 LIFO calculations for our clients.

# Clunkers Program Results in Potential LIFO Mess (continued)

The results are summarized in the following table:

Example 2009 LIFO Projections:	12/31/2008 New Vehicle Inventory at Cost	8/31/2009 New Vehicle Inventory at Cost	2009 Estimated Inflation	Projected 2009 LIFO Income	Projected Tax on LIFO Income (40%)
Dealer A	\$13.5 m	\$6.5 m	3.53%	\$1,560,000	\$624,000
Dealer B	\$9.5 m	\$4.3 m	3.75%	\$200,000	\$80,000
Dealer C	\$7.0 m	\$3.9 m	3.07%	\$310,000	\$124,000
Dealer D	\$3.8 m	\$2.3 m	3.50%	\$110,000	\$44,000
Dealer E	\$9.0 m	\$4.8 m	0.90%	\$430,000	\$172,000

## Mitigating additional taxes

There are some options available to dealers to lessen the tax exposure from LIFO. They can increase inventory levels before year-end, which will help preserve some of the LIFO layers. They may also elect to stock in units with higher levels of inflation. If it's determined that these options are not possible, then filing an accounting method change to elect off LIFO may enable dealers to take the income in over four years. In addition, consider whether to elect the single-pool LIFO method. Combining car and light-truck LIFO pools into a single pool might result in substantial tax savings.

## How we can help

Using the LIFO method to value new inventory provides an excellent tax benefit to dealers; however, they need to manage their inventories in times of large fluctuations in the market. We can help you analyze your unique situation.

For more information, contact the dealership principals at LarsonAllen: Scott Strothkamp 314-336-3798.

