Pending Legislation Would Recover Tax Paid by New Car Dealers

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Key Takeaways

- New motor vehicle dealers should consider including a tax-saving contingency in their cash plans for pending federal income tax legislation affecting inventory accounting.
- If enacted, dealers using the last-in-first-out inventory ("LIFO") method of accounting may elect to claw back taxable income that they reported for 2020 and 2021 on inflated profits. The prospect for passage appears good.

Bipartisan bills[1] have been introduced in the House and Senate to grant federal income tax relief to motor vehicle dealers using the LIFO accounting method for their inventories of new motor vehicles. To calculate income for the current year, LIFO offsets a dealer's current vehicle sales revenue with the dealer's cost of the most recently purchased vehicles. First-in-first-out ("FIFO") is an alternative accounting method that offsets a dealer's current vehicle sales revenue with the dealer's cost of the oldest vehicles that the dealer had in inventory.

Most motor vehicle dealers elect LIFO because the cost of new vehicles typically is greater than the cost of older vehicles, resulting in a greater offset to annual revenue and consequently lower taxable income for the year. Moreover, dollars, rather than cars, constitute the units of inventory ("dollar-value LIFO"). When LIFO is first elected ("base year"), cars remaining in inventory are valued at their base-year cost. For each succeeding year, the current cost of ending inventory is deflated to base-year cost. If the deflated cost of the current-year ending inventory exceeds the base-year cost of all existing inventory layers for preceding years, an incremental layer of inventory is added for the current year and then repriced at current, inflated costs. The composition of the ending inventory of a dealer that elected dollar-value LIFO 50 years ago may have many inventory layers, with the cost in each layer reflecting annual inflation for the year that the layer was added to inventory.

LIFO works to a dealer's benefit if the dealer can replace inventory sales with new vehicle purchases by year-end. But the taxable income of a dealer using LIFO increases if, by year-end, the dealer cannot replace the sales with new vehicle purchases. Without inventory replacements, the dealer offsets its vehicle sales revenue for the current year with earlier years' vehicle costs, which typically are lower, thus increasing taxable income for the current year. For example, a dealer that elected LIF0 in 1970 and sold all its inventory in 2020, may have offset 2020 vehicle sales revenue with costs in inventory layers going back as much as 50 years, when the cost of cars was very much less than inventory costs in 2020.

This is what occurred when COVID took hold of the economy and automotive manufacturers could not produce and deliver new vehicles to dealers. As dealers sold down their inventories in 2020 and 2021, they reached the earliest – and lowest – vehicle costs from past years that they had in inventory. The bipartisan bills provide a longer period for tax years 2020 and 2021 to retroactively replace inventory depleted in these two years. Dealers generally have through the end of 2025 to purchase replacement vehicles.

The bills provide that a dealer that has already filed its 2020 and 2021 returns – and thus already paid income tax for those years on inflated profits – may elect the longer replacement period on the first return for the taxable year ending after the date of enactment. If the legislation is enacted in 2023, the election will be made on the return for that year. The election is treated as a change in method of accounting for 2020 or 2021, which decreases taxable income for 2020 and/or 2021 by the inflated profits.[2]

The prospects for passage of a bill appear good. The Senate passed the same version of the bill in the prior Congress. The House version in the prior Congress had 175 cosponsors, but the House did not have enough time before the end of the session to act on the bill. New motor vehicle dealers may want to consider including a contingency in their 2023 cash plan for enactment of the bill by the current Congress, and they may want to encourage their Congressional representatives to act on the bills.

Please contact the authors of this alert or your Miller Canfield attorney to discuss further.

[1] H.R. 700 (February 1, 2023); S. 443 (February 15, 2023).

[2] The Treasury Department would be expected to publish guidance for calculation of the income adjustment.