HDA

LIFO Repeal: A Costly Proposal for Pharmaceutical Distributors and Patients

LIFO AND THE PHARMACEUTICAL DISTRIBUTION INDUSTRY

The last-in, first-out (LIFO) inventory accounting method is a common and well-established cost flow assumption used for financial and tax accounting that aligns the cost of goods sold and sales revenues. Under the LIFO method, it is assumed that the last items produced or acquired are the first items sold, allowing a taxpayer to match its current revenues against its current costs.

LIFO accounting is particularly prevalent in the pharmaceutical distribution industry; distributors used LIFO accounting for 98 percent of inventories and net sales in 2013. By maintaining large inventories of prescription medicines and healthcare products, pharmaceutical distributors minimize lags between the time an order is placed and the time it is fulfilled. They also create a buffer against uncertainties in supply and demand and can obtain competitive prices from suppliers by purchasing in bulk. Under LIFO, taxpayers defer the recognition of inflationary gains until inventory is drawn down.

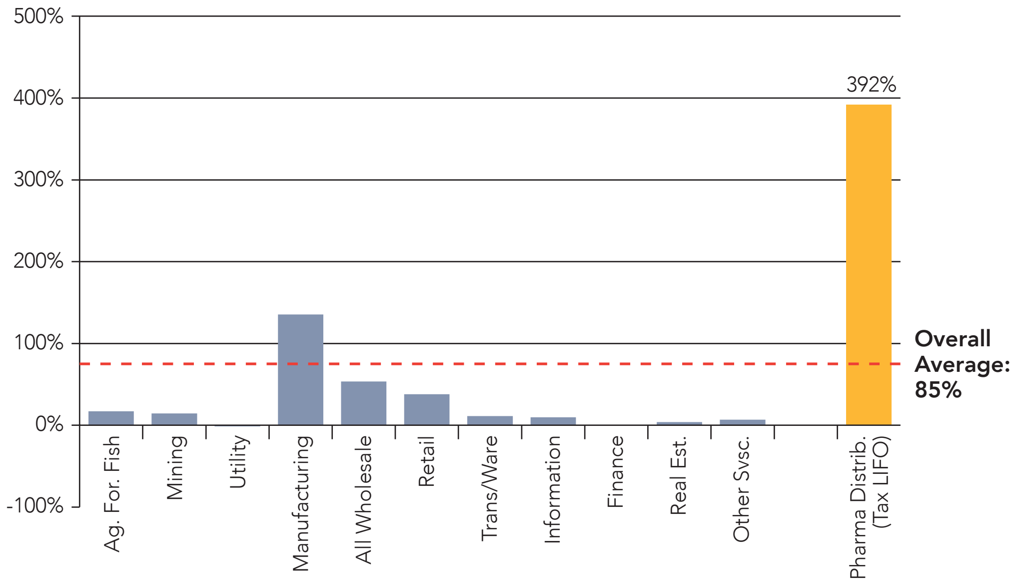
BACKGROUND

Recent legislative and regulatory proposals would repeal the ability of companies to continue using LIFO. If such measures were to be enacted, or if the LIFO election was made unavailable as a result of transitioning to international financial reporting standards, the pharmaceutical distribution industry would be disproportionately affected. According to a PwC analysis:

- For all public companies using LIFO, the one-time **recapture** tax triggered by conversion from LIFO to FIFO (first-in, first-out) is estimated to be 85 percent of reported current federal income tax liability at 2013 levels. However, within the pharmaceutical distribution industry, the recapture tax is estimated to be **392 percent of reported current federal income tax liability at 2013 levels.** (See Figure E-1)
- The **ongoing** tax increase resulting from repeal of the LIFO election would increase annual federal income tax liability within the pharmaceutical distribution industry by an estimated 45 percent — **nearly eight times more than the average industry.** (See Figure E-2)
- LIFO repeal would eliminate the ability of taxpayers to defer the taxation of inflationary gains attributable to their inventoried assets and would result in **higher tax burdens on investments in inventory as compared to equipment** (for which accelerated depreciation is allowed).
- Low profit margins and competition within the pharmaceutical distribution industry make it difficult for the industry to absorb increased tax burdens, leading to **increased prices to healthcare providers and ultimately to patients.**

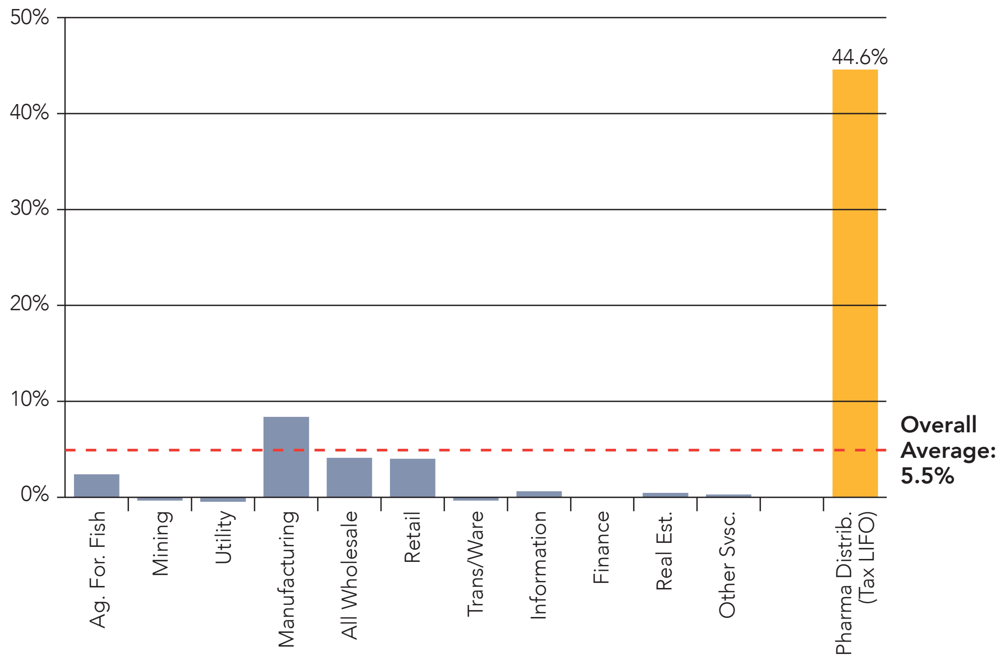
For more information on the effect of LIFO repeal on pharmaceutical distributors, visit www.hda.org/issues/taxes.

FIGURE E-1. Recapture Tax Attributable to LIFO Repeal as a Share of Current Federal Income Tax of Public Companies with a LIFO Reserve, 2013



Note: Based on estimated tax LIFO reserves for pharmaceutical distribution industry and book LIFO reserves for other industries. Sources: PwC calculations, Compustat®, and pharmaceutical distribution company financial reports.

FIGURE E-2. Ongoing Tax Increase Attributable to LIFO Repeal as a Share of Current Federal Income Taxes of Public Companies with a LIFO Reserve, 2013



Note: Based on estimated tax LIFO reserves for pharmaceutical distribution industry and book LIFO reserves for other industries. Sources: PwC calculations, Compustat®, and pharmaceutical distribution company financial reports.