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FIFO, LIFO, Weighted Average – A Tax Perspective

By Daniel Flores

Have you ever wondered if you should choose FIFO, LIFO or the Weighted Average Method when setting up your fund? You're not alone. The tax experts at Richey May have created the following guide to help you learn more about the different methods.

There are three main inventory costing principles in accounting: First-in-First-Out (FIFO), Last-in-First-Out (LIFO), and the Weighted Average method. The IRS allows you to elect among one of these three costing methods, and they each have their own advantage dependent on your investment strategies.

When deciding on which methodology to use for your fund, there are many things to consider. What is the trading strategy (long vs short)? Is minimizing gains/losses now, as opposed to later, important to the fund? How long does the fund want to defer gains/losses? Each disposal methodology has its pros and cons, but proper planning can help check the box for the items most important for your fund.

What is FIFO and where is it practical?

FIFO is the default method with most brokers, and it is the most common. The concept here is when you buy a few shares of the same security on different dates and subsequently sell them, you are using the cost basis of the first shares you purchased. For example, if you purchased 10 shares of XYZ for $25 on March 1st, two months later, bought 10 more shares for $35, and you proceeded to sell 5 shares for $50 then your gain would be reported as $25 per share based on the first tax lot purchased.

The advantage in electing this costing method is for long-term capital gain rates. Long-term investors are the primary beneficiaries of the FIFO method because the holding period is always greater with FIFO. When a security is held for over 1 year, you are given preferential tax treatment on gains. The savings in your tax liability could be substantial and choosing FIFO increases your chances of the sold security falling into the long-term capital bucket. If the holdings have appreciated and the assets first in have unrealized gain, electing this methodology recognizes more gain now when compared to later.

Is LIFO the appropriate method for my fund?

LIFO is the opposite of FIFO, and it comes with its own advantages. First, it is important to know that you must specifically elect this method with your broker and IRS when reporting your gains. Using the example from the FIFO segment, the sale of 5 shares for $50/share would trigger a gain of only $15/share. While LIFO is less likely to obtain lower tax rates from a long-term holding period, this method is advantageous to high volume traders who want to minimize their tax liability from higher short-term tax rates. For a position that has appreciated over time using this methodology defers gains from older positions held since the first position entered is the last position to be closed.

What about the Weighted Average method?

The weighted average method is uncommon, but it has its own advantages as well. First, the formula for calculating the average cost per unit is straightforward. It functions as follows, Cost per share = Total Cost/ Total Units. In the very first example, the average cost per unit is calculated as, [(10x25) + (10x35)]/20 Shares, which equals a weighted average cost of $30/share. When sold for $50/share, your gain is $20/share. The gain reported is greater than LIFO and less than FIFO; however, there are a few advantages here.

First, with weighted average cost, you are permitted to use the first-in-first-out basis for calculating your holding period. Not only can you lower your capital gain amount, but with proper planning, preferential tax rates are able to be had. Secondly, through averaging, this method allows the fund manager to reduce potential extremes in cost basis that may lead to larger capital gains.

The biggest disadvantage here is the additional administrative aspect. There is more work in tracking all the different components to weighted average to ensure accuracy in reporting. Because of this, the weighted average methodology is not used very often with funds.

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If you have questions or are in need of a surprise examincation, please contact Steve Vlasak.