[JOINT COMMITTEE PRINT]

DESCRIPTION OF TAX BILLS

RELATING TO

LIFO INVENTORY RECAPTURE

(H.R. 4717 AND H.R. 5011)

AND

NET OPERATING LOSS TREATMENT OF THE FEDERAL NATIONAL MORTGAGE ASSOCIATION (H.R. 5013)

SCHEDULED FOR A HEARING

BEFORE THE

COMMITTEE ON WAYS AND MEANS

ON DECEMBER 9, 1981

PREPARED FOR THE USE OF THE

COMMITTEE ON WAYS AND MEANS

BY THE STAFF OF THE

JOINT COMMITTEE ON TAXATION

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INTRODUCTION

The House Committee on Ways and Means has scheduled a hearing on December 9, 1981, regarding (1) the deferral of the LIFO inventory effective date (H.R. 4717 and H.R. 5011), and (2) the net operating loss treatment of the Federal National Mortgage Association (H.R. 5013).

The first part of the pamphlet is a summary of the bills. This is followed by a more detailed description of the bills, including present law, issues, explanation of the provisions of the bills, effective dates, and estimated revenue effects.

I. SUMMARY

1. H.R. 4717—Mr. Jenkins

and

H.R. 5011—Mr. Gradison

Deferral of LIFO Recapture Effective Date

Under present law, a liquidating corporation does not recognize any gain or loss on the transfer of its inventory to its shareholders as part of the liquidation. Similarly, a corporation which sells its assets during a 12-month liquidation (section 337) does not recognize any gain or loss on the bulk sale of its inventory. In either situation, if the liquidating corporation uses LIFO, any gain attributable to the corporation's LIFO reserve (i.e., the excess of the inventory's FIFO basis over its LIFO basis) will not be subject to corporate tax. However, if a subsidiary corporation liquidates into a parent corporation and the adjusted basis of the subsidiary's assets, including inventory, carry over to the parent corporation, the LIFO reserve is subject to corporate taxation when the inventory is disposed of in a taxable sale or exchange. Since FIFO inventory represents the most current costs of the inventory and LIFO inventory represents the oldest costs of the inventory, the LIFO reserve can represent a significant amount of income, depending upon how long LIFO has been used and the inflation rate of the products in the inventory.

In the Crude Oil Windfall Profit Tax Act of 1980 (P.L. 96-223) Congress included a provision which required that a liquidating corporation must recognize the inventory's LIFO reserve as ordinary income. Also, a corporation that sells its LIFO inventory in the course of a 12-month liquidation (section 337) must recognize the inventory's LIFO reserve as ordinary income. The provision does not require the recognition of the LIFO reserve on corporate liquidations where the adjusted basis of the LIFO inventory in the hands of the acquiring corporation is carried over from the liquidating corporation.

The effective date of this provision was applicable to distributions and dispositions which are made pursuant to plans of liquidation adopted after December 31, 1981. The effective date was delayed to allow time for Congressional hearings on the provision and would permit transactions in the planning stage to be completed.

The bills (H.R. 4717 and H.R. 5011) would extend the effective date for one additional year, through December 31, 1982.

2. H.R. 5013—Messrs. Rostenkowski and Conable

Net Operating Loss Treatment of the Federal National Mortgage Association

Under present law, taxpayers generally may carry back a net operating loss (NOL) for 3 years and carry forward an NOL for 15 years. Banks and certain other financial institutions are permitted a special 10-year carryback and 5-year carryover. The Federal National Mortgage Association (FNMA) is not eligible for the special 10-year NOL carryback, and thus must use the 3-year carryback and 15-year carryover rule.

The bill would provide a 10-year carryback and a 5-year carryover for NOL's of the FNMA. Thus, the carryback period would be lengthened by 7 years and the carryover period would be shortened by 10 years. The bill would be effective for NOL's for incurred in taxable years beginning after December 31, 1981.

II. DESCRIPTION OF THE BILLS

1. H.R. 4717—Mr. Jenkins

and

H.R. 5011—Mr. Gradison

Deferral of LIFO Recapture Effective Date

Present Law

Inventories

In calculating taxable income for the year, the determination of year-end inventories is necessary in order to compute the cost of goods sold during the year. The computation of the cost of goods sold is made by adding the goods on hand at the beginning of the year to the purchases made during the year and subtracting the amount of goods on hand at the end of the year. The resulting cost is the amount of goods that were disposed of during the year and are presumed sold.

The dollar value of the ending inventory is determined by actually counting the goods on hand at the end of the year and then assigning a value to those goods. The method of assigning a value to the ending inventory is extremely important because a high value assigned to the ending inventory will result in a low cost of goods sold and thus a high taxable income. Conversely, a low value assigned to the ending inventory will result in a high cost of goods sold and a low taxable income.

There are several methods that can be used to value ending inventories. The first-in, first-out ("FIFO") method presumes that the earliest acquired goods are sold first and that the ending inventory consists of the most recent purchases. The last-in, first-out ("LIFO") method presumes that the goods most recently purchased are sold first and that the ending inventory consists of the earliest acquired goods. Other inventory methods are the average cost method, where the cost of all goods owned during the year are averaged, and the specific identification method, where the individual price of each item in inventory is determined.

Example.—The following example illustrates the results of accounting for inventory under these various methods. Assume that X Corporation began business on January 1, 1979, and for its taxable year ended December 31, 1979 it had $650 of sales income. Also assume that of the 40 units purchased for sale during the year 30 units were actually sold during the taxable year and 10 units remained in inventory.

Example

Date purchased	Units purchased	Price per unit	Total purchase price	Ending inventory			
				LIFO	FIFO	Average cost	Specific ident.[1]
February 1	10	$10	$100	$100	.....	.....	$20
April 1	4	11	44	.....	.....	.....	22
June 1	6	12	72	.....	.....	.....	24
August 1	8	13	104	.....	.....	.....	26
October 1	12	15	180	.....	$150	.....	30
Total	40		$500	$100	$150	$125[2]	$122

[1] Assume 2 units from each lot purchased were specifically identified as being in the ending inventory.

[2] Total cost of $500 divided by 40 units equals $12.50 average cost per unit. This cost times the 10 units in inventory equals $125.

	LIFO	FIFO	Average cost	Specific ident.
Cost of goods sold:				
Beginning inventory	0	0	0	0
Plus: Purchases	$500	$500	$500	$500
Less: Ending inventory	(100)	(150)	(125)	(122)
Cost of goods sold	$400	$350	$375	$378
Taxable income:				
Sales income	$650	$650	$650	$650
Less: Cost of goods sold	(400)	(350)	(375)	(378)
Taxable income	$250	$300	$275	$272

As can be seen from this example, the taxable income of X Corporation varies according to the method by which it computes its inventories. As is typical in times of rising prices, the LIFO method of accounting for inventories results in the lowest taxable income whereas use of the FIFO method generally results in the highest taxable income.

Liquidation rules

Under present law gain or loss is generally not recognized to a liquidating corporation on the exchange of its assets for the stock held by its shareholder (sec. 336). Additionally, under section 337, a corporation which adopts a plan of complete liquidation and sells its assets within 12 months from the date such plan was adopted, will also not recognize gain or loss on the disposition of its assets. (The nonrecognition rule of section 337 applies to the sale of inventory only if the inventory is sold in bulk rather than piecemeal.)

There are several exceptions to the nonrecognition rule of sections 336 and 337. These exceptions include recapture of depreciation (secs. 1245 and 1250), certain mining exploration expenditures (sec. 617), excess deductions accounts with respect to certain farm property (sec. 1251), certain deductions with respect to farm land (sec. 1252), and certain intangible drilling and development costs with respect to oil and gas properties (sec. 1254). In general, part or all of the deductions previously taken would be included in income upon liquidation, under these provisions.

In either a section 336 or section 337 liquidation, if the liquidating corporation uses LIFO, any gain attributable to the corporation's LIFO reserve (i.e., the excess of the inventory's FIFO basis over its LIFO basis) will not be subject to corporate tax. Since FIFO inventory represents the most current costs of the inventory and LIFO inventory represents the oldest costs of the inventory, the LIFO reserve can represent a significant amount of income, depending upon how long LIFO has been used and the inflation rate of the products in the inventory.

However, if a subsidiary corporation liquidates into a parent corporation and the adjusted basis of the subsidiary's assets, including inventory, carry over to the parent corporation, the LIFO reserve will be subject to corporate taxation when the inventory is disposed of in a taxable sale or exchange. Also, if a corporation makes a nonliquidating distribution of LIFO inventory, it is required to include the inventory's LIFO reserve in income in the year the distribution is made (sec. 311(b)).

In Rev. Rule. 74-431, the Internal Revenue Service held that a corporation liquidating under section 337 did not recognize income in the amount of its LIFO reserve (i.e., the excesss of the ~~LIFO~~ FI basis of the inventory over the LIFO basis of the inventory) under the tax benefit rule. The ruling held that the use of LIFO does not create a deduction that can be recovered.

The IRS has also issued private rulings which held that there was no recognition of the LIFO reserve under the tax benefit rule on a section 336 liquidation. However, these private rulings did provide a caveat that the Service was reconsidering its position regarding the recognition of the LIFO reserve.

Although a liquidating corporation does not recognize gain (other than certain items of recapture) on the disposition of any of its assets (including inventory) under a section 336 or section 337 liquidation, the shareholder of the corporation recognizes gain on the disposition of the stock in the liquidating corporation. The shareholder recognizes gain equal to the excess of the amount received for the stock over his adjusted basis in the stock. Generally this gain is taxed as capital gain. Thus, with respect to a corporate liquidation, the general rule has been that there will only be a capital gain tax at the shareholder level and there will be no tax at the corporate level.

If, in the inventory example set out above, it is further assumed that A is the sole shareholder of X Corporation with an adjusted basis in his stock of $50 and that the corporation is liquidated in March 1980 when the price of the inventory is $16 per unit and the 10 units in inventory are the corporation's only assets, the results would be as follows:

	LIFO	*FIFO*	*Average cost*	*Specific ident.*
Inventory:				
Fair market value	$160	$160	$160	$160
Adjusted basis	100	150	125	122
Realized gain [1]	$60	$10	$35	$38

[1] This gain would not be recognized by the liquidating corporation under sections 336 or 337.

Shareholder's capital gain:	
Fair market value	$160
Adjusted basis in stock	50
Recognized capital gain	$110

LIFO reserve recapture

In the Crude Oil Windfall Profit Tax Act of 1980 (Public Law 96–223) Congress included a provision which required that a corporation which distributes its LIFO inventory in a partial or complete liquidation of the corporation must recognize the inventory's LIFO reserve as ordinary income. Also, a corporation that sells its LIFO inventory in the course of a 12-month liquidation (sec. 337) must recognize the inventory's LIFO reserve as ordinary income. The provision does not require the recognition of the LIFO recapture amount on corporate liquidations where the adjusted basis of the LIFO inventory in the hands of the acquiring corporation is carried over from the liquidating corporation.

Congress believed that the LIFO recapture amount of a corporation's inventory should be subject to tax upon a corporate liquidation unless the LIFO recapture amount is preserved in the corporation's inventory by virtue of a carry-over basis. Otherwise, corporations could convert the tax deferral provided by LIFO into an outright exclusion from tax.

Thus, in the example of the liquidation of X Corporation, if X Corporation uses LIFO, it will have a recapture of LIFO reserves of $50 (the difference between the inventory's adjusted basis on LIFO ($100) and its adjusted basis on FIFO ($150)). There will be no recapture of the additional $10 between the FIFO adjusted basis and the inventory's fair market value. If X Corporation uses average cost or specific identification there will be no recapture of the difference between the adjusted basis of the inventory under these methods and its FIFO adjusted basis ($25 for average cost and $28 for specific identification).

The effective date of this provision was postponed to distributions and dispositions which are made pursuant to plans of liquidation adopted after December 31, 1981. The effective date was postponed to allow time for Congressional hearings on the provision. Also, the delayed effective date would permit transactions in the planning stage to be completed.

Issue

The issue is whether the effective date of the LIFO recapture provision should be delayed for one year, through December 31, 1982.

Explanation of the Bills

H.R. 4717 and H.R. 5011 would delay the effective date for one year (i.e., to December 31, 1982) of the provisions in the Crude Oil Windfall Profit Tax Act which require the recapture of LIFO reserves in certain corporate liquidations.

Effective Date

The bills would be effective upon enactment.

Revenue Effect

It is estimated that these bills would reduce fiscal year budget receipts by $15 million in 1982, $260 million in 1983, and by a negligible amount thereafter.

2. H.R. 5013—Messrs. Rostenkowski and Conable

Net Operating Lose Treatment of the Federal National Mortgage Association

Present Law

Prior to enactment of the Economic Recovery Tax Act of 1981 (ERTA), taxpayers could carry back a business net operating loss (NOL) against income for the 3 taxable years preceding the loss year and carry forward any remaining unused losses to the 7 years following the loss year (sec. 172). ERTA generally increased the carryover period to 15 years and retained the 3-year carryback.

There are a number of exceptions to the general 3-year carryback and 15-year carryover rule for certain industries or categories of taxpayers. One exception allows a 10-year carryback and a 5-year carryover for NOLs of financial institutions to which section 585, 586, or 593 (relating to the bad debt treatment of commercial banks, small business investment corporations, and savings and loan associations, respectively) applies, including banks and savings and loan institutions (sec. 172(b)(1)(F)). In the Tax Reform Act of 1969, which added the special NOL rule applicable to financial institutions, Congress generally reduced the allowable deductions for additions to bad debt reserves for those financial institutions. Section 172(b)(1)(F) was added to ensure that, after reduction of the bad debt deduction, there would be adequate protection against substantial losses due to any future downtrends in the economy.[1]

Since the Federal National Mortgage Association (FNMA) is not described in sections 585, 586, or 593, it is not eligible for the 10-year carryover treatment, and thus must use a 3-year carryback and a 15-year carryover. FNMA is a corporation chartered by Congress to provide assistance, liquidity, and stability to the home mortgage market.[2]

Issue

The FNMA typically provides a secondary market for mortgages by borrowing on a short-term basis and investing in long-term mortgages. In this respect, the FNMA operates similarly to certain of the financial institutions which are eligible for the 10-year carryback of net operating losses.

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[1] The 10-year carryback provided by the Tax Reform Act of 1969 was effective for financial institutions other than cooperative banks for losses incurred in taxable years beginning after December 31, 1975, and for cooperativebanks for losses incurred in taxable years beginning after December 31, 1969.

[2] FNMA serves two related functions. First, it helps housing by providing a secondary market for mortgages. Also, where mortgage banks are concerned, FNMA generally functions as a primary source of financing, since mortgage bankers are not depository institutions and generally make loans only if they have commitments from FNMA to buy them.

FNMA also offers mortgage lenders a way to hedge against changes in interest rates. It does this by making commitments to buy mortgages at a fixed price 4 months in the future.

The issue is whether the FNMA should have 10-year carryback and 5-year carryover periods similar to the rule applicable to certain other financial institutions.

Explanation of the Bill

The bill would amend section 172(b) to provide a 10-year carryback and a 5-year carryover of the NOL's of the FNMA. Thus, the carryback period would be lengthened by 7 years, and the carryover period would be shortened by 10 years.

Effective Date

The bill would be effective for NOL's for taxable years of the FNMA beginning after December 31, 1981. Thus, for example, a net operating loss for calendar 1982 could be carried back as far as 1972.

Revenue Effect

It is estimated that this bill will reduce fiscal year receipts by $14 million in 1983 and increase fiscal year receipts by $14 million in 1984.

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