[JOINT COMMITTEE PRINT]

DESCRIPTION OF TAX BILLS
(S. 578, S. 768, S. 1276, and S. 1472)

SCHEDULED FOR A HEARING

BEFORE THE

SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT

OF THE

COMMITTEE ON FINANCE

ON SEPTEMBER 25, 1981

PREPARED FOR THE USE OF THE

COMMITTEE ON FINANCE

BY THE STAFF OF THE

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INTRODUCTION

The bills described in this pamphlet have been scheduled for a public hearing on September 25, 1981, by the Senate Finance Subcommittee on Taxation and Debt Management.

There are four bills scheduled for the hearing: S. 578 (relating to inventory writedowns and LIFO inventories) ; S. 768 and S. 1472 (relating to exclusion of research expenses from capital expenditure limitation on interest exemption for small issue industrial development bonds) ; and S. 1276 (relating to inventory writedowns).

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, and effective dates.

I. SUMMARY

1. S. 578 (Senators Moynihan, Melcher, Eagleton, East, Williams, Baucus, Inouye, and Sarbanes), and S. 1276 (Senators Durenberger, Melcher, Boschwitz, Zorinsky, and Grassley):

a. Section 1 of S. 578 and S. 1276—Inventory Writedowns

Present law

For income tax purposes, inventories are used as a method of determining the cost of goods sold and hence a taxpayer's gross income from the sale of goods. Under present law, a taxpayer may "write down" the value of its inventories (thereby decreasing gross income in the year of writedown) if the taxpayer uses the lower of cost or market method of inventory accounting or, in the case of "subnormal" goods, if the goods are actually sold below cost within a relatively short period after the inventory date (Reg. § 1.471–2(c)).

In 1979, the U.S. Supreme Court upheld the disallowance of inventory writedowns which failed to comply with these Treasury regulations, on the ground that such writedowns fail to clearly reflect income (*Thor Power Tool Co.* v. *Commissioner*). Subsequently, the Internal Revenue Service issued Revenue Procedure 80–5 and Revenue Ruling 80–60 to implement the *Thor Power* decision.

S. 578, Section 1

Section 1 of S. 578 would allow a taxpayer to write down portions of inventories to net realizable value based on a five-year average of items in that inventory that were disposed of at less than cost. This provision would apply to taxable years ending on or after December 25, 1979.

S. 1276

S. 1276 would allow a qualified small business to write off one-third of inventory held for more than 12 months, 50 percent of inventory held for more than 24 months, and 100 percent of inventory held for more than 36 months. This provision would apply to taxable years beginning after December 31, 1980. Also, S. 1276 would delay the effective date of Rev. Proc. 80–5 and Rev. Rul. 80–60 to taxable years beginning after December 31, 1980.

b. Sections 2 and 3 of S. 578—LIFO Inventories

Under present law, taxpayers that elect to use the LIFO method of accounting for inventories must use LIFO for purposes of their financial statements (sec. 472). Also, taxpayers electing LIFO must include in income inventory market writedowns taken for inventories that remain unsold. Under the Economic Recovery Tax Act of 1981, this income is to be taken into account ratably over the three-year period beginning with the taxable year of the LIFO election.

Section 2 of S. 578 would allow taxpayers to use LIFO accounting for tax purposes regardless of the method of inventory accounting used for purposes of financial statements. Section 3 of the bill would extend the three-year recapture of inventory writedowns to ten years. The provisions of sections 2 and 3 of the bill would be effective for taxable years beginning after the date of enactment of the bill.

2. S. 768—Senator Moynihan, and S. 1472—Senator Denton

Exclusion of Research Expenses From Capital Expenditure Limitation on Interest Exemption for Small Issue Industrial Development Bonds

Present law

Interest on certain State and local industrial development bonds is exempt from Federal income tax, pursuant to an exception under present law for "small issues," where the aggregate amount of outstanding exempt small issues plus capital expenditures (financed otherwise than out of small issue bond proceeds) does not exceed $10 million (Code sec. 103(b)(6)). Because research and experimentation expenditures are considered to be capital expenditures, such expenses are to be taken into account in determining whether the $10 million limitation is exceeded, whether or not the taxpayer elects to deduct currently or amortize research expenses under Code section 174 (Rev. Rul. 77-27, 1977-1 C.B. 23).

S. 768

Under the provisions of S. 768, research and experimental expenditures (within the meaning of sec. 174) would not be taken into account for purposes of the capital expenditure limitation on small issue industrial development bonds. The bill would apply to obligations issued after the date of enactment, and also to capital expenditures made after December 31, 1980.

S. 1472

Under the provisions of S. 1472, research or experimental expenditures which the taxpayer elects to deduct currently under section 174 (a) would not be taken into account for purposes of the capital expenditure limitation on small issue industrial development bonds. The bill would apply to research or experimental expenditures paid or incurred after March 11, 1981, with respect to obligations issued after that date.

II. DESCRIPTION OF BILLS

1. S. 578—Senators Moynihan, Melcher, Eagleton, East, Williams, Baucus, Inouye, and Sarbanes, and S. 1276—Senators Durenberger, Melcher, Boschwitz, Zorinsky, and Grassley

a. Section 1 of S. 578 and S. 1276—Inventory Writedowns

Present law

Background

Gross income from the sale of goods equals gross sales receipts less the cost of goods sold. The computation of cost of goods sold is made by taking the beginning inventory, adding the purchases made during the year, and subtracting the ending inventory. The resulting amount 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 ascribing a value to those goods. The valuation method is important because a higher value will result in a lower cost of goods sold and thus greater taxable income, while a lower value will result in a higher cost of goods sold and thus lower taxable income. For example, a decrease or "writedown" in closing inventory increases the cost of goods sold for the year of writedown, and hence reduces gross income.

For Federal income tax purposes, Code section 471 requires a taxpayer to account for inventories in a manner that conforms as nearly as possible to the best accounting practice in the taxpayer's trade or business and most clearly reflects the taxpayer's income. Treasury regulations provide that the two most commonly used bases for valuing inventories which satisfy these requirements are (1) cost and (2) the lower of cost or market (Reg. § 1.471–2(c)).

A taxpayer using the latter method is permitted to write down the value of inventory items from the cost of the items to market value. (In general, the market value of merchandise is the bid price prevailing in the marketplace for the goods.) In addition, a taxpayer using the lower of cost or market method may write down inventories to below market value if, in the regular course of business, the taxpayer offers merchandise for sale at less than the prevailing market price. If actual sales are made at prices which do not materially vary from offering prices, the goods may be written down to the offering prices, less any direct costs of disposition.

Taxpayers using either the cost or lower of cost or market method of valuation may write down subnormal goods (goods which cannot be sold at normal prices because of damage, imperfections, shop wear, and similar infirmities) to a bona fide selling price, less direct costs of disposition. The bona fide selling price is defined as the selling price at which the goods are actually offered for sale during a period ending not later than 30 days after the inventory date (generally, the taxpayer's year-end).

"Thor Power" decision

In *Thor Power Tool Co.* v. *Commissioner*,[1] decided January 16, 1979, the U.S. Supreme Court affirmed decisions of the Seventh Circuit and Tax Court upholding the disallowance of "excess inventory" writedowns which failed to satisfy the requirements under the section 471 regulations for writedowns of inventory below cost. The Court stated that the Congress has given the Internal Revenue Service broad discretion, under Code sections 446 and 471, to determine whether a particular method of inventory accounting clearly reflects the taxpayer's income. Citing the "well-known potential for tax avoidance that is inherent in inventory accounting," the Supreme Court stated that to permit writedowns without objective evidence of the inventory's value (e.g., actual sales prices during the year) would allow a taxpayer "to determine how much tax it wanted to pay for a given year."

The taxpayer in *Thor Power* manufactured hand-held power tools that contained from 50 to 200 parts. The company had a policy of manufacturing all estimated future replacement parts at the same time it manufactured a new product. In this way, the company sought to avoid the problem of having to retool at some future date in order to provide replacement parts to its customers. Therefore, the company had more replacement parts on hand than it would need in the immediate future.

In 1964, Thor Power's new management determined that a large portion of the parts inventory was in excess of any reasonably foreseeable future demand. Therefore, the company wrote the inventory down to scrap value for both financial statement purposes and tax purposes. The taxpayer did not attempt to sell these goods at reduced prices or to scrap them; instead, the parts were retained for possible future sales to customers at their original list price.

On audit, the Internal Revenue Service agreed that the company's method of accounting for its inventory was in conformity with the best accounting practice in its trade or business, because it was standard accounting policy to write down excess inventories to their net realizable value. However, the Revenue Service determined that the writedown did not clearly reflect the taxpayer's income. The Revenue Service contended that in order to clearly reflect income for tax purposes, the writedown had to conform to the requirements of the section 471 regulations regarding market writedowns, and that the taxpayer's writedown did not conform to those requirements.

The company's writedown of "excess inventory" reflected not a reduction in the market value of the individual replacement parts, but a judgment that less than all the parts would be sold. Also, the writedown did not reflect an offer to sell the replacement parts at less than market value or actual sales of subnormal goods. The "excess" inventories were physically indistinguishable from normal goods, and the company stated that it continued to sell the parts at their original list prices. The writedown, therefore, did not meet the requirements of the regulations, which provided only for writedowns to market value, writedowns to offering price below market value (less direct costs of disposition) and writedowns to bonafide selling price (less direct costs of disposition) for subnormal goods.

[1] 439 U.S. 522 (1979).

Upholding the Revenue Service's determination that the write-down did not clearly reflect income, as required by the regulations, the Supreme Court also rejected the taxpayer's argument that conformity to generally accepted accounting principles gave rise to a presumption of clear reflection of income. Because income tax rules have different objectives than accounting rules, the Court stated, tax issues are not controlled by accounting practices; the Court also observed that divergence between accounting and tax treatment is particularly great where a taxpayer seeks a current deduction for estimated future expenses or losses.

Revenue Procedure 80–5 and Revenue Ruling 80–60

On February 8, 1980, the Internal Revenue Service issued a news release (IR–80–19, I.R.B. 1980–6) announcing the publication of Revenue Procedure 80–5 and Revenue Ruling 80–60. Both pronouncements dealt with the Supreme Court's 1979 decision in *Thor Power* and the writedown of excess inventories. The pronouncements required full implementation of the *Thor Power* decision for taxpayers with 1979 calendar year-ends.

Under Code section 446, a taxpayer may not change the method under which it accounts for income unless it secures the consent of the Revenue Service. This procedure can have the result of requiring a taxpayer to continue to use an erroneous accounting method unless it secures consent to change.

With respect to the *Thor Power* decision, the Internal Revenue Service believed that many taxpayers would not request permission to change to the proper method of accounting for excess inventories and, under the requirement that they maintain their method of accounting, would continue improperly to write down excess inventories. This not only would give taxpayers the advantage of continuing to write off excess inventories until eventually challenged on audit, but it held out the prospect that the erroneous method of inventory accounting might never be discovered by the Revenue Service.

As a response to the possibility that taxpayers would not request permission to change erroneous methods of inventory accounting in accordance with the *Thor Power* decision, the Revenue Service issued Revenue Procedure 80–5 and Revenue Ruling 80–60 on February 8, 1980. Rev. Proc. 80–5 [2] granted blanket permission to all taxpayers to change their method of inventory accounting to conform with the *Thor Power* decision. Rev. Rul. 80–60,[3] which presented a fact situation regarding excess inventories, stated in its conclusion that if a taxpayer did not account for inventory in accordance with the *Thor Power* decision and Revenue Procedure 80–5, the taxpayer would be filing its tax return "not in accordance with the law." The implication of this last statement was that the taxpayer would be liable for various penalties for failure to file a proper tax return.

It is the position of many taxpayers that the retroactive application of the two Revenue Service pronouncements (issued in 1980 but to take effect in 1979) precludes them from being able to comply in 1979 with certain Treasury regulations that would have mitigated the income recapture required under the *Thor Power* decision. Under the

[2] 1980–1 C.B. 582.
[3] 1980–1 C.B. 446.

regulations, normal goods may be written down to below market value if the goods are offered for sale at below market prices in the taxable year the writedown is to be taken. The taxpayers claim that if they had had proper notice of the pronouncements in 1979, they would have offered a large part of their excess inventory for sale at reduced prices in 1979. Thus, they would have been in compliance with both the Treasury regulations and the *Thor Power* decision on such inventory writedowns and would not have had to recapture income with respect to that inventory.

Issues

The principal issue is whether taxpayers should be able to write down the value of excess inventories that continue to be sold at prices in excess of cost. A secondary issue is whether the application of Rev. Rul. 80–60 and Rev. Proc. 80–5 should be delayed from 1979 to 1981.

Explanation of provisions

S. 578, Section 1

S. 578 would allow taxpayers to value excess inventory at net realizable value. The bill would define excess inventory as that portion of the taxpayer's ending inventory which the taxpayer reasonably expects will be disposed of at less than full realization of its cost.

The amount of the excess inventory would be based on the taxpayer's five-year experience with each group of articles contained in the inventory. Thus, the taxpayer would look to each group of articles contained in its inventory and determine the average percentage of its inventory that was disposed of at less than cost for the past five years. The taxpayer would then apply that average percentage to the current amount in the ending inventory for that group; the resulting amount would be the taxpayer's excess inventory for that group. That amount of excess inventory would then be written down to its net realizable value.

S. 1276

S. 1276 would provide an election for qualified small businesses to write down, over a four-year period, inventory items which have been held by the taxpayer for more than 12 months.

Under the election, inventory items that have been held for more than one year but not more than two years could be written down by not more than one-third of their inventory value as of the time of the writedown. Items held for more than two years but not more than three years could be written down by not more than half their inventory value as of the time of the writedown. Inventory items held more than three years could be written down by not more than the full inventory value of the item as of the time of the writedown.

A qualified small business would be defined as a domestic trade or business with equity capital of $25 million or less. Special rules would be provided to treat commonly controlled trades or businesses as a single trade or business for purposes of determining whether the members of the group are qualified small businesses.

The bill also would delay the effective date of Rev. Proc. 80–5 and Rev. Rul. 80–60 from taxable years endiing after December 24, 1979, to taxable years beginning after December 31, 1980. A taxpayer which changed its method of accounting for a taxable year ending after

)ecember 24, 1979 and before January 1, 1981, in accordance with :ev. Rul. 80–60 and Rev. Proc. 80–5, would be able to change the ıethod of accounting for any such taxable year back to the method f accounting that had been previously used. This change could be ıade without the consent of the Revenue Service by filing an amended ıx return.

Effective date

'. 578, Section 1

This provision of S. 578 would apply to taxable years ending on or fter December 25, 1979 (the date on which Rev. Proc. 80–5 and Rev. :ul. 80–60 became effective to implement the *Thor Power* decision).

. 1276

The amendments made by S. 1276 relating to inventory writedowns ɔr qualified small businesses would apply to taxable years beginning fter December 31, 1980. The provisions relating to Rev. Rul. 80–60 nd Rev. Proc. 80–5 would apply to taxable years ending after De-ɜmber 24, 1979 and beginning before January 1, 1981.

b. Sections 2 and 3 of S. 578—LIFO Inventories

Present law

Background

Gross income from the sale of goods equals gross sales receipts less the cost of goods sold. The computation of cost of goods sold is made by taking the beginning inventory, adding the purchases made during the year, and subtractiing the ending inventory. The resulting amount 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 ascribing a value to those goods. The valuation method is important because a higher value will result in a lower cost of goods sold and thus greater taxable income, while a lower value will result in a higher cost of goods sold and thus lower taxable income.

There are several methods for valuing 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 principal methods are the average cost method, under which the costs of all goods owned during the year are averaged, and the specific identification method, under which the individual price of each item in inventory is determined.

LIFO

In 1938, the Congress allowed the use of LIFO by taxpayers in a few specified industries, and in 1939, by all taxpayers. However, it was unclear at that time whether the accounting profession accepted LIFO as clearly reflecting income for purposes of financial statements. Since clear reflection of income has always been the primary standard for approved methods of accounting, the use of LIFO for tax purposes was conditioned on the requirement (the "conformity requirement") that the taxpayer use LIFO in preparing its financial statements (sec. 472). At present, LIFO is an accepted method of accounting for inventories for financial statement purposes.

Since the use of LIFO in times of rising inflation results in lower taxable income than would be the case with FIFO, these comparatively lower earnings are also reflected in the taxpayer's published financial statements because of the conformity requirement. Inasmuch as the operating success of a business is measured in large part by its earnings, many taxpayers using LIFO feel at a competitive disadvantage with similarly situated taxpayers which do not use LIFO and thus report higher earnings on essentially the same income. Many of these businesses have not changed to LIFO because of this effect of the conformity requirement.

Two recent developments have ameliorated the adverse financial tatement impact of the conformity requirement. First, final Treasury egulations have been issued that allow taxpayers using LIFO to dislose in their financial statements the amount of earnings they would ıave had on a non-LIFO basis. However, although the regulations llow the taxpayer to prepare a supplemental income statement on a ıon-LIFO basis, the taxpayer must prepare its primary financial statements using LIFO (Reg. § 1.472–2(e)).

The second event was the decision of the Second Circuit in *Insilco Corporation* v. *Commissioner* (unpublished opinion dated April 17, 981), affirming a decision of the U.S. Tax Court that the conformity equirement applicable to a subsidiary using LIFO does not extend o the subsidiary's parent company which is not using LIFO. Thus, he parent company can incorporate the non-LIFO financial statements of the subsidiary in its consolidated financial statement.

Another requirement of the LIFO method is that the inventory nust be accounted for only at cost, while under FIFO, the taxpayer an elect to value inventory at the lower of cost or market. Thus, when he value of an item of inventory declines below cost, a taxpayer using FIFO may write off the decline in value ("market writedowns") and arry the inventory at its new lower value. Under LIFO, the taxpayer nay not take such a writedown. Moreover, if the ending inventory of he year immediately preceding the year of change to LIFO contains ıny items that have had market writedowns, the taxpayer must write he inventory back up to cost and include the entire write-up in income n such preceding year. Thus, in the year of change to LIFO all items of beginning inventory will be carried at cost.

In the Economic Recovery Tax Act of 1981 (P.L. 97–34), the Congress amended the rules relating to the recapture of market writedowns (sec 472(d)). For taxpayers adopting LIFO for taxable years beginning after December 31, 1981, market writedowns will be included in income ratably over a three-year period beginning with the year of change to LIFO. Thus, the taxpayer no longer will have o amend the return of the year preceding the year of the LIFO election and include the entire amount of market writedowns in income in hat year.

Issues

The issues are whether to eliminate the LIFO conformity requirement, and whether to allow taxpayers to spread the recapture of inventory writedowns over a ten-year period.

Explanation of provisions

Section 2 of the bill would eliminate the conformity requirement, so that taxpayers could use LIFO for tax purposes regardless of the method used for financial statement purposes. Section 3 of the bill would allow taxpayers to spread the recapture of inventory writedowns equally over ten years, beginning with the year of change, rather than spreading it over three years as was recently provided in the Economic Recovery Tax Act of 1981 (P.L. 97–34).

Effective date

The provisions of sections 2 and 3 of S. 578 would be effective for taxable years beginning after the date of enactment of the bill.

2. S. 768—Senator Moynihan, and S. 1472—Senator Denton

Exclusion of Research Expenses from Capital Expenditure Limitation on Interest Exemption for Small Issue Industrial Development Bonds

Present law

In general

Interest on State and local government obligations generally is exempt from Federal income tax (Code sec. 103(a)). However, subject to certain exceptions, interest on State and local issues of industrial development bonds is taxable (sec. 103(b)). An obligation constitutes an industrial development bond if (1) all or a major portion of the proceeds of the issue are to be used in any trade or business of a person other than a governmental unit or tax-exempt organization and (2) payment of principal or interest is secured by an interest in, or derived from payments with respect to, property or borrowed money used in a trade or business (see. 103(b)(2)).

Present law provides an exception for certain "small issues" to the general rule of taxability of interest paid on industrial development bonds (sec. 103(b)(6)). This exception applies to issues of $1 million or less if the proceeds are used for the acquisition, construction, or improvement of land or depreciable property.

At the election of the issuer, the $1 million limitation may be increased to $10 million. If this election is made, the exception is restricted to projects where the aggregate amount of outstanding exempt small issues and capital expenditures (financed otherwise than out of the proceeds of an exempt small issue) made over a six-year period [1] does not exceed $10 million. The combined issue amount/capital expenditure limitation of $10 million has the effect of precluding availability of an interest exemption where industrial development bonds would have a face amount not exceeding the $10 million dollar limitation but would be used in connection with large scale, high cost projects.

Both the $1 million and $10 million limitations are determined by aggregating the face amount of all outstanding related issues, plus, in the case of the $10 million limitation, certain capital expenditures for all facilities used by the same or related principal users which are located within the same county or same incorporated municipality. Under Treasury regulations, expenditures are treated as capital expenditures for this purpose if they are properly chargeable to the capital account of any person or State or local governmental unit. This determination is to be made without regard to any rule of the Internal Revenue Code that permits expenditures properly chargeable to capital account to be tretaed as current expenses (Reg. § 1.103–10(b)(2)(ii)(e)).

[1] The relevant six-year period is the period beginning three years before the date of the issue and ending three years after that date.

Treatment of research expenditures

As a general rule, business expenditures to develop or create an asset which has a useful life that extends substantially beyond the taxable year must be capitalized and cannot be deducted in the year paid or incurred. For example, research expenditures to develop a new consumer product must be capitalized, because such expenditures relate to an asset which will have a useful life exceeding one year. Such capital costs usually may be recovered on a disposition or abandonment of the asset, or through depreciation or amortization deductions over the useful life of the asset.

However, present law permits a taxpayer to elect to deduct currently the amount of research or experimental expenditures incurred in connection with the taxpayer's trade or business, even if such expenses are treated as capital account charges or deferred expenses on the taxpayer's books or financial statements (sec. 174(a); Rev. Rul. 58-78, 1958-1 C.B. 148). In the case of research expenditures resulting in property which does not have a determinable useful life (such as secret processes or formulae), the taxpayer alternatively may elect to deduct the costs ratably over a period of not less than 60 months (sec. 174(b)).[2]

Because research and experimentation expenditures constitute capital expenditures, such expenses are to be taken into account for purposes of determining whether the exempt small issue limitation of $10 million is exceeded, whether or not the taxpayer elects to deduct its research expenses currently or to amortize them over a period of 60 months or more (Rev. Rul. 77-27, 1977-1 C.B. 23).

In addition to the favorable deduction treatment provided under Code section 174 for research expenditures, the Economic Recovery Tax Act of 1981 provides a 25-percent tax credit for certain research and experimental expenditures paid in carrying on a trade or business of the taxpayer to the extent exceeding the amount of such expenditures during a base period (Code sec. 44F).

Issue

The issue is whether research and experimental expenditures should be counted toward the $10 million limitation for exemption of interest on "small issue" industrial development bonds.

Explanation of bills and effective dates

S. 768

Under S. 768, research and experimental expenditures (within the meaning of sec. 174) would not be taken into account for purposes of the capital expenditure limitation on small issue industrial development bonds. The bill does not expressly restrict such treatment to research expenditures which the taxpayer elects under section 174 to deduct currently or amortize.

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[2] If expenditures relating to development of a product are not eligible for these elections, or if the taxpayer chooses not to elect either current deductions or amortization for qualifying research costs, such expenditures must be capitalized. If the capitalized expenses relate to depreciable property, deductions may be taken in the form of depreciation allowances spread over the property's useful life. If the capitalized expenses relate to nondepreciable property, those costs cannot be recovered until disposition or abandonment of the property.

S. 768 would apply to obligations issued after the date of enactment in taxable years ending after that date. Also, the bill would apply to capital expenditures made after December 31, 1980, for purposes of applying the $10 million limitation in the case of obligations issued prior to the enactment date.

S. 1472

Under S. 1472, research or experimental expenditures which the taxpayer elects to deduct currently under section 174(a) would not be taken into account for purposes of the capital expenditure limitation on small issue industrial development bonds.

S. 1472 would apply to research or experimental expenditures paid or incurred after March 11, 1981, with respect to obligations issued after that date.