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THE HAZARDS OF NON-GERMANE AMENDMENTS: THE NEW LIFO RECAPTURE RULES

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A book should not be judged by its cover; neither should legislation be judged by its short title. A case in point is the Crude Oil Windfall Profit Tax Act of 1980.[1]

The pitfall in judging the content of legislation by its title is that a non-germane amendment to a bill can leave one badly surprised at an extremely awkward moment. Non-germane amendments are far from uncommon. Indeed, the proclivity of the Senate in particular to convert a minor revenue bill into a vehicle for all sorts of tax provisions (usually favorable to taxpayers) has given rise to the apt phrase "Christmas Tree bill" as shorthand for a year-end bill ornamented by non-germane amendments.[2] As exemplified by the Crude Oil Windfall Profit Tax Act, these ornaments are not always pro-taxpayer and they may be hung on legislation any time of the year.

The self-acknowledged non-germane amendments to the Crude Oil Windfall Profit Tax Act are found in Title IV, which is named "Miscellaneous Provisions."[3] Two of the provisions of Title IV were fairly well-reported, not only in sources frequented by tax professionals but also in the more popular press. These are the repeal of carryover basis[4] and a limited

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[1] Crude Oil Windfall Profit Tax Act of 1980, Pub. L. 96-223, 94 Stat. 229 (to be codified in scattered sections of I.R.C.) (hereinafter referred to as *Windfall Profit Tax Act*).

[2] The epitome of Christmas Tree bills may be the Tax Reduction Act of 1980 reported by the Senate Finance Committee on September 15, 1980. S. REP. NO. 940, 96th Cong., 2d Sess. (1980). This bill, H.R. 5829, originally had but 4 lines providing that six bronze bells for the Foundry United Methodist Church of Washington, D.C. could be imported into the United States free of duty. The original provision now takes up only one page of the 138 pages making up the Finance Committee's bill.

[3] Windfall Profit Tax Act §§ 401-404.

[4] Windfall Profit Tax Act § 401.

tax-exemption for interest income.[5] A third provision largely escaped notice and provided for recapture of LIFO inventory tax savings on liquidations.[6] It is the subject here.

LIFO Recapture on Liquidation

Section 403(b) of the Act amends the Internal Revenue Code to require, in general, "recapture" of the tax savings from the use of LIFO inventory accounting instead of FIFO on complete or partial liquidations. This is done by providing for recapture on liquidating distributions or on sales otherwise not resulting in gain recognition under section 337 plans.[7] The sole exception provided to the new recapture rules is for liquidations of subsidiaries where the basis of the assets distributed carries over to the parent,[8] thus preserving the LIFO recapture potential for the future.[9] The new recapture provisions reverse the established position of the Internal Revenue Service that LIFO tax savings are not recaptured under the tax benefit rule, or otherwise, upon a liquidating distribution or a bulk sale of inventory under a plan of liquidation under section 337.[10] They eliminate the distinction under prior law between distributions in liquidation (no LIFO recapture under section 336) and distributions of inventory as dividends or in redemption of stock (LIFO recapture under section 311(b)). (A similar distinction,

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[5] Windfall Profit Tax Act § 404.

[6] Windfall Profit Tax Act § 403(b). The two remaining provisions of Title IV are at least colorably germane. One was the mechanism for Congressional disapproval of the imposition of oil import quotas imposed by the President. Windfall Profit Tax Act § 402. The other provision permits a taxpayer to recoup taxes paid on certain involuntary liquidations of LIFO inventories where the inventory is replaced. Windfall Profit Tax Act § 403(a). This provision is intended to ameliorate adverse tax effects of liquidations caused by actions of Department of Energy or foreign trade interruptions. *See* H.R. CONF. REP. No. 817, 96th Cong., 2d Sess. 159, *reprinted in* [1980] U.S. CODE CONG. & AD. NEWS 1307-1308. This provides a link of sorts to the rest of the Act for the LIFO liquidation rule discussed in this article. Titles II and III of the Act also are linked to the Crude Oil Windfall Profit Tax enacted by Title I by being energy-related. Title II provides energy conservation and production incentives, including tax credits and energy-related tax-exempt bonds, and Title III provides for low-income energy assistance. Given the Act's title, one may argue that except for Title I the entire bill is non-germane ornamentation.

[7] *See* new I.R.C. § 336(b), as added by Windfall Profit Tax Act § 403(b)(1), and new I.R.C. § 337(f), as added by Windfall Profit Tax Act § 403(b)(2)(A). A technical change also is made in I.R.C. § 453 (d)(4)(B) by Windfall Profit Tax Act § 403(b)(2)(B). A more detailed explanation of the workings of LIFO and the new recaptures, along with criticism of the provisions, may be found in Grossman, "Liquidations of LIFO Inventories After the Crude Oil Windfall Profit Tax Act of 1980," 58 *Taxes* 664 (Sept. 1980).

[8] New I.R.C. § 336(b)(2), as added by Windfall Profit Tax Act § 403(b)(1).

[9] *See* H.R. CONF. REP. NO. 817, 96th Cong., 2d Sess. at 161, *reprinted in* [1980] U.S. CODE CONG. & AD. NEWS 1310.

[10] Rev. Rul. 74-431, 1974-2 C.B. 107 (I.R.C. § 337); I.R.S. Letter Ruling 7839086 (I.R.C. § 336). I.R.S. Letter Ruling 8019118, a technical advice memorandum issued July 31, 1979, in which the IRS expressly applied Revenue Ruling 74-431 to an I.R.C. § 334(b)(2) liquidation, states that the IRS is reconsidering the position taken in Revenue Ruling 74-331, but will not modify or revoke it with retroactive effect.

between distributions in actual redemption and other distributions, remains in the case of in-kind distributions of appreciated property.[11]) Under the Senate version of the Act, the new recapture rules would have applied to distributions and dispositions pursuant to plans of liquidation adopted after the date of enactment.[12] The conferees delayed the effective date. As enacted, the new recaptures apply to distributions pursuant to plans of liquidation adopted after December 31, 1981.[13]

Is this legislation wise tax policy? Was it enacted in a wise way? Answering those questions is the subject of the remainder of this brief article.

The Wisdom of the New LIFO Recapture Rules

The LIFO liquidation recapture rules were enacted hastily. This legislation did not travel the well-worn route that requires hearings, mark-ups, and reports in both the House Ways and Means Committee and the Senate Finance Committee before floor action by either body. Rather, it simply was added to the bill on the floor of the Senate. The result is that there are only two pieces of legislative history. The first is a colloquy on the Senate floor among Senators Stevens (who introduced it), Long, and Muskie that does not go into substance but instead makes clear that the provision was added at the instigation of an unnamed Treasury official and that revenue raised would pay for the relief provision contained in the Act for taxpayers suffering certain involuntary LIFO inventory liquidations.[14] The other piece of legislative history is a one-page description in the Conference Report.[15]

The short gestation period of the new recapture rule when combined with the Senate's date-of-enactment effective date created a real trap for all but careful (and somewhat lucky) followers of Congress. After the Senate's action one could not plan on the conferees' delaying the effective date as they did. I know of one substantial transaction that had been in the works for several months that was jeopardized by the discovery of the Senate provision with its date-of-enactment effective date. It proceeded to closing with a wary eye on the conferees. The adverse effect of this legislative sprinting on taxpayers' expectations seems too obvious to belabor further.

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[11] I.R.C. § 311(d) by its terms applies only to actual redemptions. *See* Treas. Reg. § 1.311-2(a)(2) (1972).

[12] CONG. REC., H.R. 3919, (§ 404(d)), 95th Cong., 1st Sess., as passed by the Senate on December 17, 1979, 125 CONG. REC. S18779 (daily ed. Dec. 17, 1979).

[13] Windfall Profit Tax Act § 403(b)(3). H.R. CONF. REP. NO. 817, 96th Cong., 2d Sess. 161, *reprinted in* [1980] U.S. CODE CONG. & AD. NEWS at 1310.

[14] 125 CONG. REC. S18778-81 (daily ed. Dec. 17, 1979). *See* note 5 *supra* regarding the relief provisions in Windfall Profit Tax Act § 403(a).

[15] H.R. CONF. REP. NO. 817, 96th Cong., 2d Sess. 161, *reprinted in* [1980] U.S. CODE CONG. & AD. NEWS at 1310.

A more general flaw of the hasty enactment is that the substance of the provision was not subjected to the scrutiny that necessarily is involved in the full legislative process.[16] Congress rightly is not always inclined to enact proposals of the Treasury simply because, as Senator Stevens put it, "At Treasury, a gentleman raised a question to me, as to those companies which sell their assets in accordance with a plan for liquidation."[17]

In some cases, at least, it may be argued that the wisdom of the change is so self-evident that the panoply of the legislative process is unnecessary. This might be thought the case with recapturing LIFO tax savings on liquidation. After all, one can view the new rules as simply as an expansion of section 311(b).[18] However beguiling that sort of easy logic, viewing the substance of the new recaptures from two aspects should serve to illustrate that the recapture of LIFO tax savings on liquidation merits the scrutiny that accompanies the full legislative process.

Considered alone, the merits of the new recapture are not clear. The skimpy legislative history does not attempt an explanation. The committee reports to the 1954 Code, which introduced section 311(b), states that LIFO was viewed as "temporarily deferring" tax and that section 311(b) was necessary to prevent avoidance.[19] (The 1954 reports proffered no reason why the deferral must be recaptured on redemptions even though LIFO had been expressly made available to taxpayers generally since 1939.[20]) At least in the eyes of the Treasury, "deferral" does seem to have been the reason for the new recapture rules.[21]

This view assumes that LIFO, as compared to FIFO, involves a deferral of tax that if not ultimately recaptured amounts to tax avoidance. That is at least questionable. There is no doubt that in inflationary times LIFO reduces income because more recently acquired inventory is treated as sold before older inventory acquired at less-inflated cost. But that does not inevitably mean that LIFO is a loophole. Both LIFO and FIFO, after all, are accounting conventions for tracing when particular items in inventory are sold to

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[16] Similar objections were raised in letters to Senator Long from the Tax Section of the New York State Bar Association and from Arthur Andersen & Co. The Association's three-page letter dated January 8, 1980, is available from the Association as Report No. 240 and the Arthur Andersen letter is printed in Bureau of National Affairs, *Daily Tax Report* No. 11 (Jan. 16, 1980), at J-1. The Conference Report acknowledges that the delayed effective date is to permit hearings and allow planned transactions to go forward. H.R. CONF. REP. NO. 817, 96th Cong., 2d Sess. 161, *reprinted in* [1980] U.S. CODE CONG. & AD. NEWS 1310.

[17] 125 CONG. REC. S18780 (daily ed. Dec. 17, 1979).

[18] If extending current law were the reason, given the existence of I.R.C. § 311(d), it might seem equally apposite to have required recognition of gain (and loss?) on all in-kind distributions.

[19] H.R. REP. NO. 1337, 83d Cong., 2d Sess. 37 *reprinted in* [1954] U.S. CODE CONG. & AD. NEWS 4062. The Senate Report provides little guidance.

[20] Revenue Act of 1939, Pub. L. No. 155, § 219(a), 53 Stat. 877-78.

[21] *See* Bureau of National Affairs, *Daily Tax Report* No. 11 (Jan. 16, 1980), at G-5; *see also* Letter Ruling 8019118 (IRS reconsidering Revenue Ruling 74-431, *supra* note 9).

match sales revenues with an appropriate charge for cost of goods sold. Both are acceptable accounting practices.[22] As the IRS grandiloquently put it, LIFO "is a technique for sequencing the flow of costs through inventory in a manner that expels the most recent costs incurred into the cost of goods sold and retains the earliest costs in inventory."[23] Thus, it is possible to view LIFO not as deferring income, but, rather, as preventing overstating income because of inflation-induced increases in the cost of acquiring inventory. Isn't it possible that instead of enacting the new LIFO recapture rules, Congress should have repealed section 311(b)?

The second view I take to cast doubt on the new rules is one of high tax policy. Section 311(b) and the new rules are both exceptions to the general rule that a corporation does not recognize gain or loss on distribution to its shareholders.[24] This is the so-called *General Utilities* doctrine.[25] This doctrine is widely-viewed as one of the major policy failures in subchapter C.[26] For example, the opaque complexity of the collapsible corporation rules found in section 341 "is the illegitimate offspring of *General Utilities*."[27] More generally, liquidation results in permanent avoidance of tax at the corporate level. The American Law Institute's Federal Income Tax Project on Subchapter C, thus, has proposed, in general, repeal of the *General Utilities* rule.[28] Under the ALI proposal, the LIFO tax saving would be subject to recapture. It has been suggested that the tax impact of the rule in this case may be sufficiently severe that the tax should be payable over several years.[29] My point here is that this small change in the Code has broader implications going to the fundamental structure of the taxation of in-kind distributions to stockholders, yet there is no sign of any Congressional (or staff) awareness of this. It is not necessary, or even desirable, to re-examine every fundamental each time legislation is proposed, but this

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[22] AICPA Professional Standards, AC § 5121, Statement 4; A.P.B. No. 43, Chapter 4, Statement 4; *see also* I.R.C. § 472 (authorizing use of LIFO for tax purposes).

[23] Rev. Rul. 74-431, 1974-2 C.B. 107, 108. The drafter of Revenue Ruling 74-431 was guilty of worse than bureaucratic bombast. Since inventory costs are divided into two groups, the comparative adjectives, 'more recent' and 'earlier cost,' should have been used instead of the superlatives "most recent" and "earliest costs."

[24] I.R.C. §§ 311(a) and 336.

[25] The rule commonly is said to be established by the decision of the Supreme Court in General Utilities and Operating Co. v. Helvering, 296 U.S. 200, 206 (1935), but the rule is not particularly stated there. The Supreme Court assumed the rule. *See* Bittker and Eustice, *Federal Income Taxation of Corporations and Shareholders* (4th ed. 1979), at 7-51 n.126.

[26] Corporate Distributions and Adjustments (I.R.C. §§ 301-385).

[27] Ginsburg, "Collapsible Corporations—Revisiting an Old Misfortune," 33 Tax L. Rev. 309, 322 (1978).

[28] ALI, *Federal Income Tax Project—Subchapter C* (Tent. Draft No. 1 1977), at 108-123 (Proposal IV-A).

[29] ALI, *Proceedings of 54th Annual Meeting* (1977), at 348; *see* Beghe, "The American Law Institute Subchapter C Study—Acquisitions and Distributions," 33 Tax Lawyer 743, 771 n.106 (Spring 1980).

amendment touches on one of the raw nerves in the Code. I would prefer to see changes in the *General Utilities* rule made carefully.

The new LIFO recapture, then, not only risked denying taxpayers fair notice of a significant change, it involved a concept of tax policy where the applicable principle is the subject of debate. This is not legislation to have sprung full-blown from the floor of the Senate. Perhaps the delayed effective date adopted by the conferees will permit, as the conferees intended,[30] the full consideration that seems merited. This consideration should come well in advance of the January 1, 1982 effective date to avoid repeating the uncertainty caused by the initial Senate action.

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[30] H.R. CONF. REP. NO. 817, 96th Cong., 2d Sess. 161, *reprinted in* [1980] U.S. CODE CONG. & AD. NEWS 1310.