ACQUISITION OF LOSS CORPORATIONS AND RETENTION OF LOSS CARRY-OVERS

Ordinarily taxable income is determined on the basis of an annual accounting period. One important exception to the ordinary treatment, found in Section 172 of the Internal Revenue Code of 1954, involves "net operating loss". If at the end of a taxable year a taxpayer has business deductions in excess of the income for that period he may have a net operating loss. Since 1957 this loss may be "carried back" to the three immediately preceding taxable years to offset taxable income earned in those periods; to the extent not absorbed it may then be "carried forward" up to five years following the loss year and applied as a business deduction.

The benefits of "loss carry-forwards" are available only if the taxpayer earns profits sometime during the five subsequent years. If prognosis for profits is bleak, the owner of the "loss" may be tempted to purchase a profitable operation and merge it with his loss-producing activity. Or he may be willing to sell his "loss" operation to someone who owns a profitable enterprise. For example, if Corporation *A* had a net operating loss in 1959, which could be carried forward, and in 1960 Corporation *B* purchased *A's* stock from its owners and combined *A's* and *B's* assets, could *A's* loss be deducted against *B's* income? Discussion of the utilization of a loss carry-over by a stranger to the original loss requires consideration of the law prior to enactment of the 1954 Code and of the changes made in that Code and the subsequent amendments thereto.

BEFORE THE 1954 CODE

Allowance of deduction of net operating losses for tax years beginning after December 31, 1939, was permitted by Sections 23(s) and 122 of the Internal Revenue Code of 1939, the ancestors of Section 172 in the 1954 Code.[1] After several years experience Section 129 was added to prevent one taxpayer from obtaining the beneficial tax attributes of a corporation by acquiring the stock or the assets of that corporation when the *principal purpose* for such acquisition was tax avoidance.[2] Section 269 of the 1954 Code substantially re-enacts the provisions of Section 129.

Section 129's test was subjective, and proved of little value to the Commissioner's attempts to deny deductions of loss.[3] Section 23(s) merely authorized the deduction of "the net operating loss computed under Section 122." Thus the major guide in regulating loss carryovers was Section 122, which permitted "the taxpayer" to take advantage of the carryover. However, difficulties arose when the courts sought to define "the taxpayer".

The Supreme Court's first definition resulted in what may be referred to

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1 Use of a net operating loss deduction was first permitted in 1918, when a one year carryback and one year carryforward was provided for. From 1921 to 1931 only a two year carryforward was allowed; this was reduced to one year in 1932, and eliminated in 1933. In 1938 a one year carryover was permitted for limited purposes. Harrow, *Income Averaging by Loss Carry-over and Carry-back*, in PROCEEDINGS, 13TH ANNUAL N.Y.U INSTITUTE ON FEDERAL TAXATION 771, 772 (1955).

2 INT. REV. CODE OF 1939 § 129, added by 58 STAT. 47 (1944).

3 See Rice, *Internal Revenue Code, Section 269: Does the Left Hand Know What the Right is Doing?* 103 U. PA. L. REV. 579, 580 (1955).

as the "entity" concept.[4] Under this approach the important test in allowing a carry-over was which of the corporations involved was the survivor.[5] If the corporate shell of the loss enterprise was preserved, then the carry-forward was allowed regardless of the fact that it was now owned by totally different shareholders and no longer pursued its former business interests.[6] Conversely, if the corporate existance of the profitable corporation was maintained, then the loss carry-over was disallowed even though in substance it was the same business as that which had sustained the loss.[7] This concept denied carry-overs to successor corporations after mergers,[8] consolidations,[9] creditors' reorganizations,[10] and reincorporations in the same or different states.[11]

The "entity" concept was first modified in 1949, in a case involving interpretation of "the taxpayer" who could carry forward certain excess profits credits, under the excess profits tax. The Second Circuit adopted a substantive approach, and allowed the carry-forward to a successor corporation after a statutory merger.[12]

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[4] New Colonial Ice Co. v. Helvering, 292 U.S. 435 (1934). In this case a corporation in financial trouble transferred its assets to a new corporation in exchange for stock which was distributed to the old stockholders. The creditors, capital structure and business of the new corporation were substantially the same as those of its predecessor. But the change in corporate charter was fatal to the carryover. Similar cases and rulings are: Brandon Corp. v. Commissioner, 71 F.2d 762 (4th Cir. 1934); Elliott Granite Linen Corp., 26 B.T.A. 936 (1932) (tax-free reorganization); Hartford Empire Co., 26 B.T.A. 134 (1932); West Point Marion Coal Co., 19 B.T.A. 945 (1930) (reincorporation in the same state); I.T. 2554, X-1 CUM. BULL. 162 (1931).

[5] An often cited case is Alprosa Watch Corp., 11 T.C. 240 (1948). A partnership which imported watches purchased the stock of a corporation manufacturing gloves. All the glove manufacturing machinery was sold and the corporation's name changed to Alprosa Watch Corporation. Despite this the corporation was entitled to carry over the losses of the former glove enterprise. Other cases include: WAGE, Inc., 19 T.C. 249 (1952); A. B. & Container Corp., 14 T.C. 842 (1950); Northway Sec. Co., 23 B.T.A. 532 (1931).

[6] WAGE, Inc., A. B. & Container Corp., and Alprosa Watch Corp., *supra*, note 5.

[7] New Colonial Ice Co. v. Helvering, 292 U.S. 435 (1936); Franklin v. United States, 83 F.2d 1010 (3d Cir. 1936); Weber Flour Mills v. Commissioner, 82 F.2d 764 (10th Cir. 1936) (corporate charter had expired); Brandon Corp. v. Commissioner, 71 F.2d 762 (4th Cir. 1934); Follansbee Steel Corp. v. United States, 109 F. Supp. 635 (W.D. Pa. 1953); J. M. Smucker Co. v. Keystone Stores Corp., 12 F. Supp. 286 (W.D. Pa. 1935).

[8] Pennsylvania Co. v. Commissioner, 75 F.2d 719 (3d Cir. 1935); J. M. Smucker Co. v. Keystone Stores Corp., *supra*, note 7.

[9] Brandon Corp. v. Commissioner, 71 F.2d 762 (4th Cir. 1934); National Bank of the Republic, 31 B.T.A. 680 (1934).

[10] Follansbee Steel Corp. v. United States, 109 F. Supp. 635 (W.D. Pa. 1935).

[11] Weber Flour Mills v. Commissioner, 82 F.2d 764 (10th Cir. 1936).

[12] Stanton Brewery, Inc. v. Commissioner, 176 F.2d 573 (2d Cir. 1949). The court allowed a surviving parent holding company to carry over pre-merger excess profits credits of its wholly-owned subsidiary, for excess profits tax purposes. The decision was limited, however, because the court rested its decision on the fact that this was an operation of law transfer under the state merger statutes. Further, no economic interest of the shareholders' relations was altered and the prior business of the subsidiary was continued.

Several courts followed this step away from the "entity" approach. E. & J. Gallo Winery v. Commissioner, 227 F.2d 699 (9th Cir. 1955) (tax benefits allowed after statutory merger even though prior to merger the two corporations were not affiliated, and the resulting stock ownership was altered); Koppers Co. v. United States, 133 Ct. Cl. 22, 134 F. Supp. 290 (1955) (the corporations involved had filed consolidated returns during prior years). But another court refused to do so, in Libson Shops, Inc. v. Koehler, 229 F.2d 220 (8th Cir. 1956).

In 1957 the Supreme Court was again confronted with the question of who is "the taxpayer", in *Libson Shops, Inc. v. Koehler*.[13] In this case sixteen corporations had been merged into a seventeenth. Prior to the merger all these corporations had been owned by the same shareholders in the same proportions. After merger the economic interests and business pursuits remained the same. Three of the merging corporations had net operating losses which the survivor claimed were available to it as carry-overs under Section 122. Stating that the provisions of Section 122 "were designed to permit a taxpayer to set off its lean years against its lush years and to strike something like an average taxable income computed over a period longer than one year,"[14] the Court denied the carry-over to the successor corporation. It refused to decide whether the successor was the same or a different taxable entity, but held that continuity of business enterprise was prerequisite to claiming a loss carry-over; this may mean that had the successor been able to operate the business of any of the loss corporations at a profit, that corporation's loss carry-over would have been available to apply against that profit.[15] The Court also expressly disavowed any intent to pass on those cases where the loss corporation was legally the successor, but the business it formerly carried on was discontinued.[16]

Although the Court rejected the opportunity to pass on the situation of a continuation in form rather than in substance, it appears to be the developing trend of the lower courts to reject in its entirety the "legal entity" approach and to apply the substantive rules adopted by the Court in *Libson Shops*, or, in the alternative, to disallow a loss carry-over under the tax avoidance provisions of section 129.[17] The Internal Revenue Service, construing *Libson Shops*, has indicated in a ruling that it would allow the loss carry-over following a statutory merger or consolidation only to the extent that it offsets income of the resultant corporation which is attributable to assets acquired by it from the absorbed corporation and "used in continuing the prefusion business of such absorbed constituent."[18]

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[13] 353 U.S. 382 (1957).

[14] *Id.* at 386.

[15] The Court said, *id.* at 390, "We conclude that petitioner is not entitled to a carryover since the income against which the offset is claimed was not produced by substantially the same businesses which incurred the losses." Each of the subsidiaries had been a separate retail outlet. After the merger the three outlets which had operated at a loss continued to do so. See Guterman, *Substance v. Form in the Taxation of Personal and Business Transactions*, *in* PROCEEDINGS, 20TH ANNUAL N. Y. U. INSTITUTE ON FEDERAL TAXATION 951, 1076-78 (1962).

[16] 353 U.S. 382, 390 n. 9: "We do not pass on situations like those presented in *Northway Securities Co. v. Commissioner*, . . .; *Alprosa Watch Corp. v. Commissioner*, . . . ;*A. B. & Container Corp. v. Commissioner*, . . .; *W A G E, Inc. v. Commissioner*, ... In these cases a *single* corporate taxpayer changed the character of its business and the taxable income of one of its enterprises was reduced by the deductions or credits of another."

[17] Haberman Farms v. United States, 305 F.2d 787 (8th Cir. 1962); F. C. Publication Liquidating Corp. v. Commissioner, 304 F.2d 779 (2d Cir. 1962); J. G. Dudley Co. v. Commissioner, 298 F.2d 750 (4th Cir. 1962); Snyder Sons Co. v. Commissioner. 288 F.2d 36 (7th Cir. 1960); James Realty Co. v. United States, 280 F.2d 394 (8th Cir. 1960); Commissioner v. British Motor Car Distributors, 278 F.2d 392 (9th Cir. 1960); J. G. Dudley Co. v. Commissioner, 36 T.C. No. 112 (1961) ("Nevertheless, we think the Supreme Court in *Libson* was looking beyond the legal niceties and was persuaded by the substance of the transaction before it."); Frank Springolo Warehouse Co. v. Commissioner, 37 T.C. No. 1 (1961); Kelker Bros. Inc. v. Commissioner, 35 T.C. No. 38 (1960).

[18] Rev. Rul. 59-395, 1959-2 CUM. BULL. 475, 476.

THE 1954 CODE PROVISIONS

Two sections of the 1954 Code, 172 and 269, have been adapted with slight modifications from the sections of the 1939 Code just discussed. Two other sections, 381 and 382, are completely new attempts to deal with various problems in handling net operating losses (and other tax benefits), including those with which this article is concerned. There has as yet been little judicial interpretation of these sections; the principal aids to interpretation at present are the words of the sections, the Regulations, comments by various writers, and cases decided under prior law.

Section 172. This section defines "net operating loss", and authorizes deduction of net operating loss carrybacks and carryovers. It contains the substance of 1939 sections 23(s) and 122. However, any discussion whether it should be interpreted as Section 122 was in *Libson Shops* requires consideration of the effect of Sections 269, 381 and 382.

Section 269. As did 1939 Section 129, Section 269 disallows carryovers if a person acquires control of a corporation,[19] or if one corporation acquires property of another, unrelated[20] corporation, for the purpose of claiming the benefit of a deduction, credit, or other allowance which would not otherwise be available, when the principal motive for the acquisition was the evasion or avoidance of Federal income tax.[21] Subsection (c), added in 1954 to strengthen the Section, provides that prima facie evidence of the tax avoidance motive will exist if the consideration paid upon acquisition is substantially disproportionate to the sum of (1) the adjusted basis of the acquired corporation's assets, and (2) "the tax benefits (to the extent not reflected in the adjusted basis of the property) not available to [the acquiring] person or corporation otherwise than as a result of such acquisition." However, as the Commissioner's conclusion has been presumed correct when he assessed a deficiency,[22] the litigating taxpayer has always had the burden of proving absence of a tax avoidance principal purpose. The burden seems to have been minimal, as courts usually have allowed the deduction if *some*

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[19] INT. REV. CODE OF 1954 § 269: "(a) If (1) any person or persons acquire, or acquired on or after October 8, 1940, directly or indirectly, control of a corporation . . . . control means the ownership of stock possessing at least 50 percent of the total combined voting power of all classes of stock entitled to vote or at least 50 percent of the total value of shares of all classes of stock of the corporation." The use of the words "directly or indirectly" suggests incorporation of the policy of § 318 relating to constructive ownership of stock. Incorporation of this policy is specified in § 382, but is not by the literal terms of § 269.

[20] INT. REV. CODE OF 1954 § 269: "(a) If . . . (2) any corporation acquires, or acquired on or after October 8, 1940, directly or indirectly, property of another corporation, *not controlled, directly or indirectly, immediately before such acquisition, by such acquiring corporation or its stockholders,* the basis of which property, in the hands of the acquiring corporation, is determined by reference to the basis in the hands of the transferor corporation, ..." [Italics supplier.]

[21] Disallowance of the carryover is not always a necessary consequence of violation of § 269(a). Under § 269 (b) the Secretary of the Treasury or the Commissioner of Internal Revenue has power to allow any deduction, credit or allowance that otherwise would be disallowed, in whole or in part, where this will not result in evasion or avoidance of Federal income tax for which the acquisition was made. In addition, he may distribute, apportion, or allocate the deductions, credits, or allowances between or among several corporations, properties, or parts thereof.

[22] American Pipe & Steel Corp. v. Commissioner, 243 F.2d 125 (9th Cir. 1957).

bona fide business purposes can be shown.[23] Unless a very weak or doubtful support for business purpose is available, this section may be unlikely to cause disallowance of a loss carryover.

At one time the Tax Court indicated it thought the loss benefit belonged to the acquired corporation if it remained in existence, and therefore Section 269 (then 129) did not operate to deny the loss. This view is no longer adhered to.[24]

Section 381. This section provides that a successor corporation may acquire certain tax features or benefits (including net operating loss carryovers) of a predecessor, after certain enumerated transactions.[25] The transactions enumerated are:

> (1) acquisitions by a parent corporation after complete liquidation of a subsidiary, except in cases where the subsidiary's stock was bought within two years before the liquidation in order to obtain its assets, so that the basis of the assets takes the basis of the stock under Code Section 334(b)(2);[26]
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> (2) acquisitions in certain types of reorganizations which under the Code are "nontaxable", including:
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> (a) a statutory merger or consolidation;
> (b) a "C" reorganization, under Code Section 368(a)(1)(C);
> (c) some "D" reorganizations, under Code Section 368(a)(1)(D); and
> (d) a mere change of identity, form, or place of organization, under Code Section 368(a)(1)(F).[27]

Section 381 does not apply to partial liquidations, nor to split-up, split-off, or spin-off reorganizations, or others of a divisive nature. It also provides that only in the case of "F" reorganizations can the successor use post-reorganization losses to offset pre-reorganization income.[28]

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23 Hawaiian Trust Co., Ltd. v. United States, 291 F.2d 761 (9th Cir. 1961), *rev'g* 178 F. Supp. 637 (D. Hawaii 1959); Baton Rouge Supply Co., Inc., 36 T.C. No. 1 (1961); W A G E, Inc. v. Commissioner, 19 T.C. 249 (1952). But see Armstrong, *New Barriers To Utilization of Operating Losses,* 40 TAXES 867 (1962). One case in which despite evidence to support a business purpose the taxpayer was unsuccessful is Elko Realty Co. v Commissioner, 29 T.C. 1012, *affirmed* in 260 F.2d 949 (3d. Cir. 1958).

24 Alprosa Watch Corp., 11 T.C. 240 (1948) (dictum), is in line with the early approach. Examples of the current attitude are: James Realty Co. v. United States, 280 F.2d 394 (8th Cir. 1960); Coastal Oil Storage Co. v. Commissioner, 242 F.2d 396 (4th Cir. 1957). See also cases in note 17, *supra.*

25 The tax features or benefits referred to, in INT. REV. CODE OF 1954 § 381 (c), are: net operating loss carryovers, earnings and profits; capital loss carryovers; method of accounting; inventories; depreciation methods; prepaid income (stricken soon after adoption); installment method; amortization of bond discount or premium; deferred exploration and development expenses; unused deductions for contributions to an employees' trust or annuity plan; bad debt recoveries; involuntary conversions; dividend carryover to personal holding company; indebtedness of certain personal holding companies; deductible items arising from assumed obligations; deficiency dividends of personal holding companies; percentage depletion on mine tailings; unused charitable contributions deduction carryover; unused pension trust deductions; pre-1954 adjustments resulting from change in method of accounting; certain amounts which successor life insurance companies must take into account under the Life Insurance Company Income Tax Act of 1959.

26 INT. REV. CODE OF 1954 § 381 (a)(1).

27 INT. REV. CODE OF 1954 § 381 (a)(2)

28 INT. REV. CODE OF 1954 § 381(b)(3); Treas. Reg. § 1.381(c)(1)-1(b) (19). A recent case applying § 381 to the disadvantages of the taxpayer, possibly because of the peculiar fact situation, is Lodge & Shipley Co. v. United States, 305 F.2d 643 (6th Cir. 1962).

Where transfer of a loss carry-over across corporate lines under Section 381 is contemplated, the provisions of the section must be strictly complied with. This also requires compliance with Section 368. Regulations under Section 368 require that a reorganization, to be tax-free, must have been motivated by a business purpose.[29] Several cases suggest that the showing of any "business purpose" may be sufficient to satisfy this requirement.[30] The Internal Revenue Service has indicated that a loss carry-over in a reorganization described in Section 381(a) will not be disallowed on the basis of *Libson Shops*, but the disallowance rules reflected in Sections 269 and 382(b) will be applied.[31] One writer, examining the arguments for and against application of Section 269 to a situation within Section 381, seems to feel that Section 269 will not have a substantial effect.[32]

Section 382. This section provides certain limitations on loss carry-overs in two instances: (a) where there is a change of ownership of a corporation as the result of purchase of fifty percent or more of its stock; and (b) where there is a change of ownership of a corporation as the result of certain reorganizations.[33]

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29 Treas Reg. § 1.381-1 (19): "(b) 440 Requisite to a reorganization under the Code are a continuity of the business enterprise under the modified corporate form, and . . . a continuity of interest therein on the part of those persons who, directly or indirectly, were the owners of the enterprise prior to the reorganization. . . . (c) . . . Such transaction and such acts must be an ordinary and necessary incident of the conduct of the enterprise and must provide for a continuation of the enterprise. A scheme, . . . such as a mere device that puts on the form of a corporate reorganization as a disguise for concealing its real character, and the object and accomplishment of which is the consummation of a preconceived plan having no business or corporate purpose, is not a plan of reorganization."

30 Chisholm v. Commissioner, 79 F.2d 14 (2d Cir. 1935); General Motors Corp., 35 B.T.A. 523 (1937); George Whittell & Co. v. Commissioner, 34 B.T.A. 1070 (1936).

31 Rev. Rul. 59-395, 1959-2 CUM. BULL. 475, at 480: "The principle announced in [*Libson Shops*] . . . will not be relied upon by the Service as to a merger or any other transaction described in Section 381 (a) of the 1954 Code."; Rev. Rul. 58-603, 1958-2 CUM. BULL. 147. See also Graichen, *The Net Operating Loss*, in PROCEEDINGS, 16th ANNUAL N.Y.U. INSTITUTE ON FEDERAL TAXATION 865, 874 (1958). Despite this, there is some indication that the *Libson Shops* approach may be being used. Guterman, *Substance v. Form in the Taxation of Personal and Business Transactions*, in PROCEEDINGS, 20th ANNUAL N.Y.U. INSTITUTE ON FEDERAL TAXATION 951, 1078 (1962). See also cases in note 17, *supra*.

32 Rice, *Internal Revenue Code, Section 269: Does the Left Hand Know What the Right is Doing?* 103 U. PA. L. REV. 579, 589-95 (1955).

33 Section 382(a): "(1) If, at the end of a taxable year of a corporation

(A) Any one or more persons described in paragraph (2) own a percentage of the total fair market value of the outstanding stock of such corporation which is at least 50 percentage points more than such person or persons owned at—
   (i) the beginning of such taxable year, or
   (ii) the beginning of the prior taxable year,

(B) the increase in percentage points at the end of such taxable year is attributable to —
   (i) a purchase . . . of such stock . . . or
   (ii) a decrease in the amount of stock outstanding . . . and

(C) Such corporation has not continued to carry on a trade or business substantially the same as that conducted before any change in the percentage ownership of the fair market value of such stock, the net operating loss carryovers . . . of such corporation to such taxable year and subsequent taxable years shall not be included . . . ."

Section 382 (b): "If, in the case of a reorganization specified in paragraph (2) of section 381 (a), the transferor corporation or the acquiring corporation

In the first instance a loss carry-over will be disallowed by the section only if three enumerated requirements are concurrently met:

> (1) If at the end of a taxable year of a corporation, any one or more of certain "designated persons" own a percentage of the total fair market value of the outstanding stock of the corporation which is fifty percent points more than such persons owned at the beginning of either the taxable year or the prior year;[34] and
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> (2) this increase is attributable to a purchase by the "designated individuals" of such stock, the stock of another corporation owning stock in the corporation, or an interest in a partnership or trust owning stock in the corporation, or to a decrease in the amount of stock outstanding;[35] and
>
> (3) the corporation must not have continued to carry on substantially the same trade or business as that conducted before the requisite change in ownership.[36]

"Designated persons" include the ten shareholders (or all, if the corporation has less than ten) owning the greatest percentage of the fair market value of outstanding stock at the end of the taxable year.[37] If stockholder 10 and stockholder 11 own the same percentage, both would be included in the group of "designated persons".[38] Constructive ownership rules are generally applicable so that purchases by other individuals who under the rules are sufficiently related to a member of the group will be treated as purchases by that member.[39] The percentage point increase requirement of Section 382(a) does not mean a fifty percent increase in one member's holdings. Thus, a stockholder owning ten percent of the stock has a fifty percent increase when his holdings increase to fifteen percent, but he has not realized a fifty percentage point increase until he owns sixty percent of the fair market value of the total outstanding stock.[40]

The second requirement of Section 382(a) providing that the increase in holdings must be attributable to a purchase or to a decrease in outstanding stock, does not apply where the causing decrease resulted from a Section 303 redemption.[41] The purchase requirement may exclude acquisitions resulting from gifts, exchanges under Section 351, devises or inheritance.[42]

The third condition, "the corporation has not continued to carry on a trade or business substantially the same as that conducted before," may

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(A) has a net operating loss which is a net operating loss carryover to the first taxable year of the acquiring corporation ending after the date of transfer, and

(B) the stockholders (immediately before the reorganization) of such corporation . . . as the result of owning stock of the loss corporation, own (immediately after the reorganization) less than 20 per cent of the fair market value of the outstanding stock of the acquiring corporation . . ."

34 INT. REV. CODE OF 1954 § 382(a) (1) (A).

35 *Id.* § 382(a) (1) (B).

36 *Id.* § 382(a) (1) (C).

37 *Id.* 382(a) (2): "The person or persons referred to in paragraph (1) shall be the 10 persons . . . who own the greatest percentage of the fair market value of such stock at the end of such taxable year; . . . ."

38 *Ibid.*

39 *Id.* § 382(a) (3).

40 SEN. REP. No. 1622, 83d Cong. 2d Sess. 285 (1954); C C H FED. TAX SERV. ¶ 2578.01 (editorial comment).

41 INT. REV. CODE OF 1954 § 382(a) (1) (B).

42 Beck, *Inheritance of Tax Attributes by Successor Corporation,* in PROCEEDINGS, 14th ANNUAL N.Y.U. INSTITUTE ON FEDERAL TAXATION 852 (1956).

present the greatest problems. Courts might adopt a *Libson Shops* approach in defining what is the same business. Perhaps the best tentative guide can be found in the Senate Finance Committee Report: "If . . . the corporation shifts from one type of business to another, discontinues any except a minor portion of its business, changes its location or otherwise fails to carry on substantially the same trade or business as was conducted before such an increase."[43] The Conference Committee has stated that if the corporation continues to carry on substantially the same trade or business as before the acquisition, the mere *addition* of another line of business will not violate the section.[44] At best the section is vague, and may be the basis for much litigation.

Section 382(b), referring to reorganizations, in substance provides that unless the pre-reorganization shareholders of the corporation with the loss carry-forward receive twenty percent or more of the fair market value of the stock in the new corporation, in the case of certain designated reorganizations, the carryover will be subject to a percentage decrease pursuant to a formula provided in the section.[45] Stock means all shares except those nonvoting shares limited and preferred as to dividends.[46] If the reorganization involves two corporations owned by the same economic interests the subsection is inapplicable.[47] The apparent theory behind this subsection is that the former owners must retain a sufficient equity ownership so that the loss is not availed of wholly by outsiders.

General considerations of the 1954 sections. An important consideration in this area is the interrelationship of Sections 382 and 269. Section 382 provides for disallowance or reduction of a loss carry-over, but only in certain specified cases. Section 269 is much broader and can serve as the basis for disallowance upon showing of the requisite motivation. Thus, even though the limitations of Section 382(a) are not applicable, a loss carry-over might still be disallowed under Section 269. The Senate Finance Committee's report states, however, "if a limitation in this section applies to a net operating loss carry-over, Section 269 . . . shall not also be applied to such net operating loss carry-over."[48] This seems to indicate that a loss reduced under Section 382(b) would not be further eliminated under Section 269. However, a strict reading of the statute itself does not compel this result, and the Committee report may be disregarded in disallowing such a loss.

Other problems which may arise under these statutes will depend on the extent to which courts will allow substance of the transaction to govern over form. For example, Section 381 deals only with tax attributes of a transferor

[43] SEN. REP. No. 1622, 83d Cong., 2d Sess. 285 (1954).
[44] H. R. REP. No. 2543, 83d Cong., 2d Sess. 40 (1954).
[45] INT. REV. CODE OF 1954 § 382(b)(1)(B), (b)(2). If the described shareholders receive twenty per cent or more of the fair market value of the stock, no reduction in loss carryover will result from this subsection. The formula employed for reducing the loss carryover is to multiply by five the percent of the fair market value of the stock owned by the shareholders of the loss corporation in the successor, subtract this product from one hundred percent, and reduce the carryover by the percentage figure so determined. INT. REV. CODE OF 1954 § 382(b)(2).
[46] INT. REV. CODE OF 1954 § 382(c).
[47] *Id.* § 382(b)(3).
[48] SEN. REP. NO. 1622, 83d Cong., 2d Sess. 285 (1954).

corporation. So, if *A* Corporation transfers its assets to *B* Corporation in exchange for the voting stock of *B*, only the tax history of *A* is affected by 381. But the provisions of Section 382(b) and 269 might apply to disallow *B's* use of *A's* carry-over.

Section 382(b) requires the stockholders of the loss corporation to own twenty percent or more of the stock of the acquiring corporation, immediately after the reorganization. This might mean that a pro rata distribution of he acquiring corporation's stock be made to *all* former stockholders of the loss corporation. However, this result is not compelled, as the usual test applied in reorganizations is whether the group as a whole has received the requisite percentage.[49] Further, the reference to "immediately after the reorganization" might permit shareholders of the loss corporation to receive the necessary twenty percent, and then transfer some of it back to the acquiring corporation. As this would tend to render useless the provisions of Section 382(b), a substantive test probably would be applied in that case.

CONCLUSION

It appears that the desire of Congress is to have economic realities govern the transfer of loss carry-overs. The new sections were enacted to create an objective test to control in situations formerly governed by the "continuity of business" approach. Although the sections may, if strictly read, be avoided by the careful planner, it is logical that courts will interpret the provisions in the light of the problem area which they were enacted to regulate and in so doing to look to the substance of each individual transaction. The statutory provisions will not in and of themselves solve the problems but they do provide direction and objectivity with which the courts can effect the obvious Congressional intent.[50]

BRIAN P. WILLIAMS (June 1962)

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[49] Reilly Oil Co. v. Commissioner, 189 F.2d 382 (5th Cir. 1951).

[50] For a detailed discussion of the law and its effects upon various transactions, see Note, *Net Operating Loss Carryovers and Corporate Adjustments: Retaining an Advantageous Tax History under Libson Shops and Sections 269, 381, and 382*, 69 YALE L. J. 1202 (1960). See also: Armstrong, *New Barriers to Utilization of Operating Losses*, 40 TAXES 867 (1962); Guterman, *Substance v. Form in the Taxation of Personal and Business Transactions*, in PROCEEDINGS, 20th ANNUAL N.Y.U. INSTITUTE OF FEDERAL TAXATION 951, 1073-78 (1962); *Levine & Petta, Libson Shops: A Study in Semantics*, 36 TAXES 445 (1958); Manning, *"In Pursuance of the Plan or Reorganization": The Scope of the Reorganization Provisions of the Internal Revenue Code*, 72 HARV. L. REV. 881 (1959); *Rice, Internal Revenue Code, Section 269: Does the Left Hand Know what the Right is Doing?* 103 U. PA. L. REV. 579 (1955); Summers, *A Critique of the Business-Purpose Doctrine*, 41 ORE. L. REV. 38 (1961): *How to Buy and Sell a Business*, in PROCEEDINGS, 17TH ANNUAL N.Y.U. INSTITUTE ON FEDERAL TAXATION 717, 754 (1959); Current Developments, 35 TAXES 956 (1957).