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## INTERNAL REVENUE CODE, SECTION 269: DOES THE LEFT HAND KNOW WHAT THE RIGHT IS DOING?

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One of the less palatable ingredients in that potpourri of wisdom and witlessness known as the Internal Revenue Code of 1954 is found at Section 269. This section is essentially a reenactment of Section 129 of the old Code with some additions to be discussed hereafter. Both sections provide that if any person or persons acquire control of a corporation and the principal purpose of the acquisition was evasion or avoidance of federal income tax by securing the benefit of an allowance not otherwise available, the allowance may be forfeited. It may also be forfeited if a corporation acquires property under circumstances where it takes the transferor's basis, and the principal purpose of the acquisition is the avoidance of such taxes.<sup>1</sup>

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1. INT. REV. CODE OF 1954, § 269 provides:

“(a) *In General.*—If—

(1) any person or persons acquire, or acquired on or after October 8, 1940, directly or indirectly, control of a corporation, or

(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,

and the principal purpose for which such acquisition was made is evasion or avoidance of Federal income tax by securing the benefit of a deduction, credit, or other allowance which such person or corporation would not otherwise enjoy, then such deduction, credit, or other allowance shall not be allowed. For purposes of paragraphs (1) and (2), 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

The objective of the Internal Revenue Code of 1954 was to create "the first comprehensive revision of the internal revenue laws since before the turn of the century and the enactment of the income tax."<sup>2</sup>

We might accordingly anticipate that definitive content would be given to statutes such as this, which purport to crystallize a distinction between allowable and forbidden arrangements of business transactions with a view to minimizing taxes. Section 129 had provided no such guide; Section 269 contributes affirmative confusion. The following study in legislative fumbling is undertaken to clarify, so far as possible, the theoretical scope and practical application of the latter section.

### THE BACKGROUND OF SECTION 129

The generality of Section 129 was such that it was impossible to forecast with any degree of assurance what transactions would be caught within the scope of the section.<sup>3</sup> One clue to its coverage may be found in the considerable emphasis placed in the legislative history of the statute upon the need to terminate the traffic in corporations which had net operating losses, the benefits of which were sought by

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at least 50 percent of the total value of shares of all classes of stock of the corporation.

"(b) *Power of Secretary or His Delegate to Allow Deduction, etc., in Part.*—In any case to which subsection (a) applies the Secretary or his delegate is authorized—

(1) to allow as a deduction, credit, or allowance any part of any amount disallowed by such subsection, if he determines that such allowance will not result in the evasion or avoidance of Federal income tax for which the acquisition was made; or

(2) to distribute, apportion, or allocate gross income, and distribute, apportion, or allocate the deductions, credits, or allowances the benefit of which was sought to be secured, between or among the corporations, or properties, or parts thereof, involved, and to allow such deductions, credits, or allowances so distributed, apportioned, or allocated, but to give effect to such allowance only to such extent as he determines will not result in the evasion or avoidance of Federal income tax for which the acquisition was made; or

(3) to exercise his powers in part under paragraph (1) and in part under paragraph (2).

"(c) . . . ."

INT. REV. CODE OF 1939, § 129, added by 58 STAT. 47 (1944), was substantially identical but for the addition of subsection (c) to § 269. See note 17 *infra*.

2. SEN. REP. No. 1622, 83d Cong., 2d Sess. 1 (1954); H.R. REP. No. 1337, 83d Cong., 2d Sess. 1 (1954). These are referred to hereafter respectively as SENATE REPORT and HOUSE REPORT.

3. The vagaries of § 129 have been exhaustively explored in a number of unusually penetrating law review and other articles. Rudick, *Acquisitions To Avoid Income or Excess Profits Tax: Section 129 of the Internal Revenue Code*, 58 HARV. L. REV. 196 (1944); Chase, *An Analysis of Section 129 of the Internal Revenue Code*, 30 CORNELL L.Q. 421 (1945); Barnard, *Acquisitions for Tax Benefit*, 34 CALIF. L. REV. 36 (1946); Shelton, *What To Do About Section 129*, in *HAND BOOK OF TAX TECHNIQUES* 558 (Lasser ed. 1951); Cohen, *Exemptions and Credits of Multiple Corporations: Sections 15 (c) and 129*, 1953 SO. CALIF. TAX INST. 1.

persons acquiring their control.<sup>4</sup> Otherwise, the legislative history of Section 129 is not very helpful in interpreting Section 269. It is clear, however, that Congress was well aware of the uncertainties involved in the legislation: it was observed in the Senate report that the effectiveness of the statute would depend on its administration,<sup>5</sup> and that the statute was not intended to control all types of potential tax avoidance.<sup>6</sup>

It was thus made clear at the beginning that the general principles of the business purpose and step transaction doctrines remained a part of the Commissioner's arsenal and would have to be taken into account by a taxpayer seeking the benefits of tax deductions. There is nothing in the legislative history of Section 269 of the Revenue Code of 1954 to the contrary.

The ineffectiveness of Section 129 was manifest from the time its application was made to depend upon a finding that "the principal purpose" of a transaction was the avoidance of taxes. Nevertheless, by the regulations the Commissioner pursued the potentialities of the statute by seeking, as best he might, to give some content to the term "principal purpose."<sup>7</sup> He also described, in the regulations, certain transactions which were said to be within the scope of the section. While the list is not exclusive, it is informative as to the nature of the cases to which the new section is potentially applicable.

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4. H.R. REP. No. 871, 78th Cong., 1st Sess. 23, 49 (1943), 1944 CUM. BULL. 901, 919-20, 938-39.

5. "The success of such a provision will depend upon a sane and intelligent administration. It should not be used to upset or overturn bona fide transactions or to harass and annoy taxpayers who have acquired such property in bona fide acquisitions with no intent to avoid or evade Federal income or profits taxes." SEN. REP. No. 627, *supra* note 4, at 27, 1944 CUM. BULL. at 994.

6. It was observed that "the law applicable to the older types of avoidance has acquired a definiteness which the law applicable to the newer types involving the acquisition of the control of a corporation has not." *Id.* at 59, 1944 CUM. BULL. at 1016-17. After commenting that the older types of tax avoidance were to be controlled by previously existing case law including such cases as *Higgins v. Smith*, 308 U.S. 473 (1940) and *Gregory v. Helvering*, 293 U.S. 465 (1935), the Senate committee observed that "by thus recognizing these different types (which types must necessarily be broad and which necessarily must overlap), your committee believes that the effectiveness of section 129 will be increased, not only in the prevention of avoidance schemes which defeat the basic policies of the several provisions of the income and excess profits tax law, but also in assisting and facilitating bona fide business transactions in accord with and effectuating such basic policies." *Id.* at 59, 1944 CUM. BULL. at 1017. The committee neglected to point out just how § 129 was to achieve this happy result.

7. "If the purpose to evade or avoid Federal income or excess profits tax exceeds in importance any other purpose, it is the principal purpose. This does not mean that only those acquisitions fall within the provisions of section 129 which would not have been made if the evasion or avoidance purpose was not present. The determination of the purpose for which an acquisition was made requires the scrutiny of the entire circumstances in which the transaction or course of conduct occurred in connection with the tax result claimed to arise therefrom." U.S. Treas. Reg. 118, § 39.129-3 (a) (2) (1953).

*Carryovers*

As might have been expected, the first illustration of the scope of the section concerned tax benefits arising from operating losses. Specifically, the regulation provided that the section applied in cases where a corporation with large profits acquired control of another corporation with present or potential credit deductions, net operating losses, unused excess profits credits or other allowances, if the acquisition were followed by bringing those credits into conjunction with the income.<sup>8</sup> However, judicial response to the regulation was something less than enthusiastic. In a series of four cases, the Commissioner tried to cause the forfeiture of operating loss credit or deduction under these circumstances. All were decided contrary to his position. In one case it was indicated by way of dicta that Section 129

“would seem to prohibit the use of a deduction, credit or allowance only by the acquiring person or corporation and not their use by the corporation whose control was acquired.”<sup>9</sup>

If this can be considered to represent the reasoned view of the Tax Court, it would seem that Section 129 could never be properly invoked to forfeit allowances arising from this kind of transaction.

In another case the Tax Court rejected a claim of the Commissioner that no net operating loss was available to a corporation which had been taken over by members of a partnership who channeled profitable business through the corporation and used a prior net operating loss of the corporation to prevent the accrual of federal income tax to it. In a very brusque and brief statement which did not refer to Section 129 and demonstrated no understanding of the defendant's plan to obtain a tax deduction, the court simply observed that “the Commissioner has adopted a scheme to increase taxes without authority and has erred.”<sup>10</sup>

In the two remaining cases, the court considered specific claims that Section 129 operated to restrict the device here in question; in both cases the evidence respecting a purpose to minimize payment of taxes seemed exceptionally strong and the commercial purposes for the transactions in question appeared dubious. The decisions placed considerable emphasis on the fact that the section was inoperative unless “the

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8. It must be said that the latter qualification on this transaction is really not a qualification at all. If a deduction becomes available to a taxpayer it is scarcely evidence of tax avoidance that he uses it.

9. *Alprosa Watch Corp.*, 11 T.C. 240, 245 (1948). Here the statute was not in effect at the time of the transaction under consideration and the claim was made that § 129 was declaratory of pre-existing law.

10. *A.B. & Container Corp.*, 14 T.C. 842, 846 (1950).

principal purpose" was to avoid taxes, although the court properly attempted no generalizations as to how a principal purpose should be ascertained.<sup>11</sup>

### *Corporate Divisions*

The Commissioner has also felt that Section 129 may properly be invoked with respect to corporate divisions. An obvious taxpayer response to excess profits taxes on a corporation, imposed at high rates when Section 129 was adopted, is to divide the corporation and consequently minimize the rates on its income and excess profits. Accordingly, a regulation was adopted to forfeit an allowance where

"a corporation with large profits transfers the assets of each of its branches or departments to newly organized corporations in order to secure the benefits of the minimum excess profits credit. . . ." <sup>12</sup>

Here again the Commissioner has found it impossible to surmount the barrier which required proof that the creation of divisions arose, as a "principal purpose," from a desire to avoid taxes.<sup>13</sup>

A variation of the foregoing practices likewise was condemned by the Commissioner under circumstances that seem so unusual as to present no practical problem in tax avoidance. A regulation was adopted which provided that, if a profit corporation split off its high earning assets to a new subsidiary and thereafter continued the old business at a loss which might be carried back to get a tax refund for prior years, this would be construed to be a violation of Section 129.<sup>14</sup> The concept of a taxpayer intentionally continuing the business at a loss in order to get a carryback for tax purposes is, at the least, intriguing.

### *The Purchase of Depreciation*

The foregoing observations deal with those provisions of Section 129 which provided for the forfeiture of deductions where any person or persons acquire control of a corporation. Subsection (a) (2) of the statute deals with the entirely different situation in which A Corporation

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11. *Wage, Inc.*, 19 T.C. 249 (1952); *Commodores Point Terminal Corp.*, 11 T.C. 411 (1948).

12. U.S. Treas. Reg. 118, § 39.129-3(b) (2) (1953).

13. *Alcorn Wholesale Co.*, 16 T.C. 75 (1951); *Chelsea Products, Inc.*, 16 T.C. 840 (1951), *aff'd*, 197 F.2d 620 (3d Cir. 1952); *Berland's Inc.*, 16 T.C. 182 (1951); *J. E. Dilworth Co. v. Henslee*, 98 F. Supp. 957 (M.D. Tenn. 1951). These cases are eloquently discussed, along with the implications arising from § 15(c) of the old Code (since expired) in Cohen, *supra* note 3.

14. U.S. Treas. Reg. 118, § 39.129-3 (b) (3) (1953).

acquires property of *B* Corporation and takes the basis of the latter corporation's property with the principal purpose of avoiding federal income taxes. Under the regulations this portion of the statute is intended to apply where a

"corporation acquires property having in its hands a substituted basis which is materially greater than its fair market value at the time of such acquisition in order to secure a larger excess profits credit or to utilize the property to create tax-reducing losses."<sup>15</sup>

To illustrate the statute further, let us assume that Corporation *A* exchanges its stock for substantially all the assets of Corporation *B* in a tax-free merger. The assets of Corporation *B* have a basis of \$100,000 but are worth only \$20,000. *B*'s financial situation is such that the depreciation deduction, or a loss on the sale of its assets is valueless to it. After the transaction, Corporation *A* will be able to depreciate the assets to the extent of \$100,000, or if sold for \$20,000 take a loss of \$80,000. In return for this privilege, Corporation *A* has paid, in the value of its stock, \$20,000 representing the value of the assets and, presumably, a further negotiated amount representing the value of the depreciation or capital loss deduction. Where such a transaction was entered into for the principal purpose of avoiding taxes, the Commissioner would be authorized to disallow the deduction.

#### DOCTRINE CONTROLLING THE APPLICATION OF SECTION 269 *Cases Involving the Purchase of Depreciation*

It has been noted in the preceding paragraphs that the provisions of Section 129(a)(2) were quite obviously designed to prevent, among other transactions considered improper, arrangements where a corporation with expectations of substantial income might reduce that income by the acquisition of assets with a high basis and low value. The absence of cases in this area under the old statute was not difficult to understand. The multiple factors in transfers of assets in tax-free reorganizations were so complex and the reluctance of courts to impute bad faith to a taxpayer in this area so generally pronounced in recent years that the prospects of the Commissioner for success in any transaction likely to be undertaken was remote. Clear cases might be imagined where the section would apply, but few taxpayers would undertake a transaction in such an event.

This difficulty in proof unquestionably motivated the adoption of supplementary provisions when Section 129 was reenacted as Section 269 of the new Code. The ineffectiveness of the section was a subject

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15. U.S. Treas. Reg. 118, § 39.129-3 (c) (1953).

of some concern by committees of Congress. In both House and Senate committee reports it was observed that

"The effectiveness of this provision [Section 129] has been impaired by the difficulty of establishing whether or not tax avoidance was the principal purpose of the acquisition."<sup>16</sup>

The language of the amendment indicates that it is aimed only at bargain purchases of depreciation. Essentially, it creates a presumption that the section has been violated where persons acquire the control of a corporation for a sum which is substantially disproportionate to (1) the adjusted basis of the property, and (2) the tax benefits not otherwise available to the acquirer.<sup>17</sup>

The purpose and function of the new subsection may be illustrated by restatement of the example given earlier. Let us assume that *A* Corporation merges with *B* Corporation, and that *B* Corporation has assets worth \$20,000 with a basis of \$100,000. If *A* Corporation gives *B* Corporation stock of the value of \$40,000, a presumption arises under Section 269(c) that *A* Corporation intended to buy a depreciation deduction. This is because the consideration was disproportionate to the \$100,000 basis of the property. Thus *A* is presumably buying an excessive depreciation deduction of \$80,000 and paying \$20,000 for it, this \$20,000 representing the difference between the value of the property and the value of the stock given for it. The committee reports make it clear that the foregoing interpretation is the one which was intended by Congress. Both the House and Senate reports specifically provide with respect to the amendment that

"This provision will apply to cases where the tax basis of the property acquired for depreciation and other purposes, together with the tax value of other tax benefits, such as operating loss carryovers, is substantially greater than the amount paid for the property. Disparities of this type generally arise where the old basis is continued in the hands of the new owner."<sup>18</sup>

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16. HOUSE REPORT 32; SENATE REPORT 39.

17. INT. REV. CODE OF 1954, §269(c) provides:

"(c) PRESUMPTION IN CASE OF DISPROPORTIONATE PURCHASE PRICE.—The fact that the consideration paid upon an acquisition by any person or corporation described in subsection (a) is substantially disproportionate to the aggregate—

(1) of the adjusted basis of the property of the corporation (to the extent attributable to the interest acquired specified in paragraph (1) of subsection (a)), or of the property acquired specified in paragraph (2) of subsection (a); and

(2) of the tax benefits (to the extent not reflected in the adjusted basis of the property) not available to such person or corporation otherwise than as a result of such acquisition,

shall be prima facie evidence of the principal purpose of evasion or avoidance of Federal income tax. This subsection shall apply only with respect to acquisitions after March 1, 1954."

18. HOUSE REPORT 32, A 67; SENATE REPORT 39, 228.

It may be noted in passing that under the House bill the presumption here created was required to be rebutted by a "clear preponderance" of the evidence; under the Senate bill, which was finally adopted, the transaction merely constituted "prima facie" evidence of a principal purpose to avoid the tax. Particularly should it be noted that on the basis of the reports the presumption arises only where the tax basis of the property acquired, plus other tax benefits, is "substantially greater" than the consideration. The statute itself requires only that the price paid be substantially "disproportionate" to the adjusted basis of the property received plus the other tax benefits.

### *Cases Involving Corporate Divisions*

It has been noted that Section 129 was broad enough to include within the scope of its operation cases in which corporate divisions were made with the purpose of evading or avoiding federal income tax. It has also been noted that the statute was totally ineffective for this purpose because of the difficulty of proving tax evasion or avoidance as the "principal purpose."<sup>19</sup>

The problem persists despite subsection (c) of Section 269. Corporate divisions simply are not involved in this subsection since the corporate entity which was carved from the original corporation would presumably surrender all of its stock for all of the assets which it received, in which case the value of the stock would be the same as the value of the assets and the consideration paid would thus be completely proportionate to the assets received.

The extent to which Section 269 can be invoked to disallow a deduction or a credit arising from corporate divisions is accordingly very doubtful. So far as Section 269 is concerned, such divisions are in precisely the same situation as they were prior to the adoption of the Revenue Act of 1954. That is, notwithstanding the wealth of comments in the committee reports respecting the ineffectiveness of Section 129, no move was made to strengthen it with respect to corporate divisions. This is particularly significant in view of the fact that the Tax Court had uniformly refused to invoke the section in this area prior to the adoption of the new Code.

It is logical to assume that in the face of these decisions Congress simply gave up trying to draft a means of applying a general statute to the corporate division problem and sought instead to find a solu-

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19. See text at note 13 and note 13 *supra*. Indeed the section had to be supplemented by § 15 (c) of the old Code which sought to control corporate divisions undertaken to avoid the effect of the excess profits tax in effect during the Korean War. See Cohen, *supra* note 3.



tion in specific provisions respecting corporate divisions which were incorporated elsewhere in the Internal Revenue Code of 1954. This is borne out by the fact that extensive Code provisions to handle problems of corporate divisions were adopted in the new Code. Section 368 defines the term "reorganization" to include

"a transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor, or one or more of its shareholders . . . is in control of the corporation to which the assets are transferred. . . ." <sup>20</sup>

By the terms of this section, however, the parent must distribute the stock of the subsidiary to the shareholders of the parent; if this is done,<sup>21</sup> there is no recognition of gain or loss to the corporations and no income would be taxed to the stockholder provided that the requirements of Sections 354, 355 and 366 were met.

Ultimately, the transaction is controlled by Section 355 which deals with the same problem which was formerly sought to be resolved under Section 129. Space does not permit an exhaustive discussion of Section 355. However, if tax consequences are not to be recognized, two basic conditions must exist. First, under Section 355(b), both of the corporations must be engaged in the active conduct of business immediately after the transaction, and each of such businesses must have been in existence for a period of five years prior to the transaction. Second, under Section 355(a)(1)(B), gain or loss shall be recognized upon distribution of the stock to the shareholders of the distributing corporation if the transaction was

"used principally as a device for the distribution of the earnings and profits of the distributing corporation or the controlled corporation or both (but the mere fact that subsequent to the distribution stock or securities in one or more of such corporations are sold or exchanged by all or some of the distributees (other than pursuant to an arrangement negotiated or agreed upon prior to such distribution) shall not be construed to mean that the transaction was used principally as such a device)." <sup>22</sup>

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20. INT. REV. CODE OF 1954, § 368 (a)(1)(D) provides: "a transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor, or one or more of its shareholders (including persons who were shareholders immediately before the transfer), or any combination thereof, is in control of the corporation to which the assets are transferred; but only if, in pursuance of the plan, stock or securities of the corporation to which the assets are transferred are distributed in a transaction which qualifies under section 354, 355, or 356."

21. If this is not done there is no reorganization. However, neither are there tax consequences at this point since, as between the two corporations, § 351 operates to prevent recognition of gain or loss on the transaction.

22. Section 356 imposes additional limitations on transfer of securities under these circumstances, as distinguished from transfer of stocks.

It should be noted that the foregoing subsection would cause a transaction to be taxable in the event that it was "used principally as a device for the distribution of the earnings and profits" and that Section 269 is broad enough to include corporate divisions within its scope where they are undertaken with the "principal purpose" of avoiding federal income tax. It is consequently apparent that there is an overlapping between these two sections. It seems doubtful that there is any difference between a device "used principally" to avoid a tax and one in which "the principal purpose" is to avoid a tax. There is no legislative history which will inform us respecting the scope of the term "used principally." The net effect of Section 269 on the corporate division section accordingly seems to be to weaken rather than strengthen it:

(a) A corporate division which will enable taxpayers to recoup their investment in a business without recognition of tax consequences by disposing of stock in a controlled corporation carved out of a distributor corporation is specifically authorized by Section 368(a)(1)(D) and Sections 354 and 355.

(b) One limitation on the use of this device is that distribution of stock by the distributor corporation to its stockholders is not tax free if the transaction was "used principally as a device for the distribution of the earnings and profits."

(c) Assuming that "principal purpose" as used in Section 269 (the same language of Section 129 of the old Code) is the same in meaning as the words "used principally" in Section 355, the cases dealing with corporate division problems under Section 129 of the old Code are relevant in interpreting the provision in Section 355. In view of the extensive attention paid to Section 129 of the old Code, it may hardly be argued that the use of the same basic language in Sections 269 and 355 was inadvertent.

(d) As has been indicated,<sup>23</sup> the term "principal purpose" in Section 129 of the old Code was given a most restrictive interpretation by the Tax Court.

(e) When the Revenue Code of 1954 was being considered, Congress was cognizant of the weaknesses of Section 129, but nevertheless did not see fit to strengthen control of tax avoidance by corporate divisions under Section 269, although they did create a prima facie presumption with respect to cases involving purchase of depreciation or loss assets.

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23. See cases cited in text at notes 9-13 *supra*.

(f) Accordingly, it appears not only that Section 269 has no effective force with respect to corporate divisions generally, but that congressional use of similar language may operate to encourage tax avoidance under Section 355.

*Application of Section 269 to Carryover Problems*

The avowed purpose of the Internal Revenue Code of 1954, as expressed in reports of both the House and Senate committees, was to

“remove inequities, to end harassment of the taxpayer and to reduce tax barriers to future expansion of production and employment.”<sup>24</sup>

Among other sections presumably intended to relieve the harassment and perfect the taxpayer in legislative grace is Section 381, which authorizes the carryover of many tax benefits from a corporation which is absorbed in a tax-free transaction to the corporation which absorbs it. In the words of the committee reports, it is the purpose of this section to

“enable the successor corporation to step into the ‘tax shoes’ of its predecessor corporation without necessarily conforming to artificial legal requirements which now exist under court-made law.”<sup>25</sup>

The importance of the section is attested by the number and the nature of the benefits which may carry over. Illustrative of these items are net operating losses, deficits in earnings and profits, capital losses, accounting methods (including those used in computing depreciation, installment sales, and amortization of discount or premium), credits for prepaid income, deductions with respect to pension plans, and deduction of expenses deferred by the transferor.

Carryover benefits are, however, limited by Section 382. That section purports to restrain potential tax avoidance through traffic in loss corporations in two circumstances. Where purchase of an interest in a loss corporation is undertaken, the loss carryover is forfeited

“if more than 50 percent of the stock of a corporation is purchased within a 2-year period and if the corporation thereafter engages in a different type of business.”<sup>26</sup>

The net operating loss of a transferor corporation is available to the new corporation without diminution only if the stockholders of the old loss corporation have twenty per cent of the stock in the new corporation

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24. HOUSE REPORT 1; SENATE REPORT 1.

25. HOUSE REPORT 41; SENATE REPORT 52.

26. This is the explanation of § 382(a) given in SENATE REPORT 53.

after the transaction. If they receive a smaller percentage, the amount of the carryover is reduced proportionately.<sup>27</sup>

The benefits of Section 381 are such that many taxpayers may be expected to arrange their commercial affairs so as to take advantage of it. For example, its benefits are limited to corporations. We may assume that an individual is operating a profitable enterprise, whereas, a corporation has accumulated a very substantial net operating loss. If the individual were to begin doing business as a corporation and were to merge with the loss corporation under the requirements of Section 381(a), he would be able to take advantage of the net operating loss. However, if he bought the assets of the loss corporation, there would be no carryover to him as an individual; if he bought the stock of the loss corporation, he would run afoul of Section 382(a) to the extent that the net operating loss of the loss corporation would be forfeited if there were a change in the business in which it engaged. Accordingly, he may incorporate. If (pursuant to Section 382(b)) the stockholders of the loss corporation own twenty percent of the stock of the combined corporations after this reorganization, the loss will carry over, under the explicit terms of the statute.

Under such circumstances it must be evident that the purpose of the taxpayer in entering the corporate form of business is to qualify under Section 381. In this sense it may be said that a principal purpose is to minimize his taxes. Moreover, he pursues that purpose by arranging his transaction to avoid the pitfalls of Section 382.

May he pursue such a course of conduct safely?

The problems posed by this question are generally familiar to the tax bar. He must consider the potential applicability of the so-called business purpose rule; he must avoid pitfalls inherent in the step transaction doctrine; and finally—to come to the danger which is the subject of these comments—he must avoid the strictures of Section 269. The operation of that section will first be considered in general terms. Thereafter, its application to representative transactions will be examined.

(a) *Arguments supporting the view that Section 269 may be invoked to disallow credits and deductions otherwise authorized in carryover cases by Section 381 and not prohibited by Section 382.*—The principal argument supporting application of Section 269 to carryover cases is simply that the statute, however obscure and poorly drafted, is expressed in very broad terms. That is, where a party engages in a transaction in which carryover is authorized by Section 381 and not

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27. *Ibid.*

impaired by Section 382 he may still be acquiring control of a corporation with the principal purpose of obtaining an allowance not otherwise available. The literal words of the statute are thus extensive enough so that the Commissioner might disallow a carryover in every case if he could show that the "principal purpose" of a transaction was to obtain the benefit. It is obvious that a basic objective of Sections 381 and 382 was to take the carryover situation off the "principal purpose" merry-go-round. Yet the ghost of Section 129 still rides it.

That the ghost may be something more than ectoplasm is shown by a paragraph concerning Section 382 in the Senate committee report. It was there observed that

"If a limitation in this section applies to a net operating loss carryover, section 269, relating to acquisitions made to evade or avoid income tax, shall not also be applied to such net operating loss carryover. However, the fact that a limitation under this section does not apply shall have no effect upon whether section 269 applies."<sup>28</sup>

For reasons stated hereafter, it is difficult to believe that the committee meant what was written. If it did mean it, then Section 269 conceivably could apply in any cases except those in which a forfeiture of a loss carryover is required under the terms of Section 382. We must assume that every taxpayer conducting a liquidation or merger under Section 381 will have in mind the tax consequences of his conduct. Is it possible that no matter how carefully the transaction is conducted to conform to that section there is a practical possibility that the tax benefit will be lost because it is determined that the principal purpose of the transaction was to obtain the benefit? The following comments cast substantial doubt on such a result.

(b) *Arguments supporting the view that Section 269 may not be invoked to disallow credits and deductions in carryover cases.*—(1) Arguments arising from Section 381. There is nothing in the legislative history of Section 381 with respect to its relationship to Section 269. However, both committee reports recite that Section 381 was adopted because practice under the old Code rested "on court-made law which is uncertain and frequently contradictory" and that

"whether or not the carryover is allowed should be based upon economic realities rather than upon such artificialities as the legal form of the reorganization."<sup>29</sup>

If stability and predictability constitute the *sine qua non* of legislative purpose here, it can hardly be argued that Congress intended a statute

28. SENATE REPORT 284.

29. HOUSE REPORT 41; SENATE REPORT 52.

as uncertain as Section 269 to apply to these transactions. Moreover, there is nothing in the legislative history of Section 381 which would indicate any qualification whatsoever upon its general operation. In cases where an exception exists, it has been expressly stated. For example, it was observed that the section was not intended to affect the carryover treatment of items or tax attributes in corporate transactions not described.<sup>30</sup> Since some exceptions are specifically noted, it may be argued that the general provisions of Section 269 should not be invoked to create exceptions not specifically expressed.

Finally, it may be significant that, with the exceptions noted, Section 381 itself contains no reservations whatsoever. Accordingly, it may be argued that the statute itself demonstrates that Congress intended the section to be freely and fully available at the option of the taxpayer and in all events. It is unquestionably true that every transaction conducted within the purview of Section 381 will be undertaken only after a consideration of the tax benefits involved. Even assuming that the purpose of obtaining a tax benefit is the principal purpose which motivates, for example, the liquidation of a subsidiary by a parent, it is dubious that the benefit would thereupon be lost. Should the benefit be denied by virtue of the terms of Section 269 under those circumstances, it would seem to be squarely in conflict with the observation respecting Section 381 in the committee reports that

“under this provision, a corporation which acquires substantially all of the property of another corporation in a tax-free distribution or transfer is to take into its accounts the specified items of the distributor or transferor corporation.”<sup>31</sup>

(2) Argument arising from Section 382. We have already noted the observation by the Senate committee that the mere fact that Section 382 does not apply is not evidence that Section 269 does not apply to a stated situation. This is itself inconsistent with other observations in the reports. For example, the failure of Section 129 was pointed out to justify the adoption of Section 382:

“This provision [Section 129] has proved ineffectual, however, because of the necessity of proving that tax avoidance was the primary purpose of the transaction. It has also been so uncertain in its effects as to place a premium on litigation and a damper on valid business transactions.”<sup>32</sup>

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30. HOUSE REPORT A 135; SENATE REPORT 277. Presumably this would include those cases in which the *Kimbell-Diamond Milling Co. v. Commissioner* (187 F.2d 718 (5th Cir.), cert. denied, 342 U.S. 827 (1951)) rule is to be applied under § 334(b)(1), and cases involving corporate divisions.

31. HOUSE REPORT 41; SENATE REPORT 52.

32. HOUSE REPORT 41-42; SENATE REPORT 53.

It would seem from these comments that Section 382 was intended to supplant, rather than supplement, Section 129. Surely Congress did not mean to reinvigorate a statute which had placed a "premium on litigation and a damper on valid business transactions." The purpose of this comment could only have been to justify the adoption of Section 382 as a substitute for Section 129 in the carryover cases.

(3) Arguments arising from the nature of Section 269. Another persuasive argument respecting the intention of Congress is found in the nature of Section 269(c). We have illustrated the application of the statute to a taxpayer buying depreciation. Let us now consider an example respecting its application to loss carryovers.

Assume that Profit Corporation acquires control of Loss Corporation. Both are in the same business. The latter has property with an adjusted basis of \$100,000 which is worth \$100,000. It also has a net operating loss which has a value to Profit Corporation of \$50,000. Consequently, Profit Corporation purchases all the stock of Loss Corporation for approximately \$150,000. It does so with a view to using the loss. This price is, however, substantially proportionate to

a. The adjusted basis of the property, and

b. The tax benefits not previously available to Profit Corporation. Accordingly, there is no presumption that a "principal purpose" of the transaction was tax avoidance.

This is, of course, reaffirmed by the observation in the committee reports that the subsection is to apply to cases where the tax basis for the depreciation of the property plus the value of the other tax benefits is substantially greater than the amount paid for the property.<sup>33</sup>

It is anomalous to conclude that the purchase of a net operating loss deduction is irrelevant to establish a prima facie violation of Section 269, but to say also that if purchase of the loss is the principal purpose of taking over the loss corporation, this deduction so carefully excluded from consideration under Section 269(c) shall be forfeited under Section 269(a). If Congress is providing that the purchase of a loss is irrelevant to prove a prima facie violation of the statute, it may well be argued that the purchase of a loss was likewise intended to be excluded from the purview of the very general language incorporated earlier in the statute.

Another approach to the interpretation of Section 269 may be found by examining general coverage of the statute in context with old Section 129 and other statutes concerning the same subject matter.

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33. HOUSE REPORT 32; SENATE REPORT 39.

The old section dealt with corporate divisions, purchase of depreciation benefits, and purchase of other tax benefits. The problem of corporate divisions is covered by Section 355 of the new Code. Provisions respecting purchase of depreciation have been strengthened by Section 269(c) and the section obviously is intended to be effective in that area. Transfer of tax benefits is likewise intended to be controlled by statutes dealing directly with the problem, Section 381 which authorizes such transfer and Section 382 which places specific limitations on it. All this suggests that Congress intended to reorient Section 129 by the amendment in Section 269 and aim it only at transactions where an acquiring corporation sought to buy a depreciation allowance or loss by obtaining property with a high basis and a low value in such a manner as to get the high basis at a disproportionate price.

In addition, it should be remembered that when subsection (c) was adopted—the only change in old Section 129—Congress emphasized that the statute was deficient because it was so difficult to show that tax avoidance was the principal purpose of an acquisition.<sup>34</sup> Yet no attempt was made to strengthen the section with respect to the carry-over problem, notwithstanding that the Commissioner had lost every case he had taken to the Tax Court on the operating loss issue.<sup>35</sup>

This leaves the Commissioner in an unenviable position. The very most that he can claim is that a net operating loss of one corporation, utilized by another corporation or its stockholders, may be disallowed under Section 269 if it could have been disallowed under Section 129. Consequently, he has the burden of proof in showing that the "principal purpose" in a transaction in which a net operating loss becomes available to a profit corporation or its shareholders was to obtain a tax advantage not otherwise available. As a practical matter, it is difficult to apply a statute which provides that a little purpose to save taxes is all right, but too much of such a purpose is fatal. The Tax Court very properly met this practical problem in a practical manner by refusing to apply the statute in specific cases which came before it, even where substantial tax-saving purpose was evident.

The presence of Section 269(c) thus weakens the case of the Commissioner: it was inserted to make old Section 129 effective and expressly excluded tax benefits other than purchase of depreciation from its scope. Under all standards of statutory interpretation, it must be said that Congress approved earlier judicial doctrine interpreting Section 129, except to the extent described by the amendment. The Commissioner found it impossible to win cases involving some commercial

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34. HOUSE REPORT 32; SENATE REPORT 39.

35. See text at notes 9-11 and notes 9-11 *supra*.



purpose under the old law. There is every reason to believe that his road will be even more rocky under Section 269.

Finally, it should be remembered that the scope of Section 129 of the old Code never has been clear. As we have noted earlier, there is dicta in the *Alprosa Watch*<sup>36</sup> decision that the old Section 129 prohibited deductions by those acquiring control of the corporation but not of the corporation whose control is acquired. On the basis of the same case, it may also be said that where the acquiring person or persons were individual stockholders, as distinguished from corporations, the transaction may not be covered by Section 129.<sup>37</sup>

In general, it must be doubted that Section 269 will have a substantial effect on purchase of tax benefits, other than depreciation, through obtaining control of a loss corporation by merger, liquidation or otherwise. Any forecast respecting how it will be used in specific cases is obviously subjective. Moreover, conclusions may be changed by regulations issued by the Commissioner. Subject to these qualifications, the following conclusions concerning a few representative cases are ventured.

#### EXAMPLES OF THE EFFECT OF SECTION 269

##### *Purchase of Stock Controlling Loss Corporation Followed by Continued Operation in the Same Business*

It is hard to conceive of any case where a purchase of stock controlling a loss corporation by persons seeking a loss deduction, followed by continued operation of the corporation in the same business, would permit the Commissioner to invoke Section 269. The cases hitherto decided under Section 129 resolved all doubts respecting the purpose of such a transaction in favor of the taxpayer even where unrelated businesses were involved. Where control of a related business is purchased, it would seem almost a practical impossibility for the Commissioner to demonstrate that tax avoidance was a "principal purpose" of the acquisition in view of these cases and the multiple business reasons which might justify it. In addition, when Section 129 was amended as Section 269 of the new Code, there was no attempt to strengthen the statute in this respect. Moreover, this device clearly is not prohibited by Section 382; by the terms of subsection (a)(1)(C), the section does not apply where the same line of business is continued by the loss company. Indeed, the Senate report emphasizes that this subsection was inserted to

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36. See note 9 *supra*.

37. See Cohen, *supra* note 3, at 9, 10; Shelton, *What to Do About Section 129*, in HANDBOOK OF TAX TECHNIQUES 558, 566, 567 (Lasser ed. 1951).

“limit the application of this provision [Section 382] . . . to those areas in which abuse has most often arisen, that is, the purchase of the stock of a corporation with a history of losses for the purpose of using its loss carryovers to *offset gains of a business unrelated to that which provided the losses.*”<sup>38</sup>

By a process of negative inference it may be argued—indeed it seems clear—that congressional approval has been given to use of loss carryovers to offset gains of a business which is in fact related to that which produced the losses. Indeed, the conference report recites that if the loss corporation

“continued to carry on substantially the same trade or business, the limitation would not be applicable even though the corporation also added a new trade or business.”<sup>39</sup>

#### *Merger of Profit Corporation with Loss Corporation*

It has been noted that Section 381(a) authorizes a loss carryover where a profit corporation exchanges its stock for substantially all the assets of a loss corporation under certain circumstances. It has also been noted that under Section 382(b) the loss will be forfeited in whole or in part if the stockholders of the loss corporation do not own twenty per cent of the fair market value of the stock of the profit corporation after the transaction. It is conceivable that persons controlling a profit corporation might cause that corporation to merge with a loss corporation for the “principal purpose” of obtaining a tax benefit. In such a case the application of Section 269 would not be completely foreclosed as a matter of theory since the statute does in fact still provide that the Commissioner may disallow a credit or deduction arising from the acquisition of control of a corporation by any person pursuant to an intent to avoid federal income tax.

For reasons discussed earlier, the realistic prospects for practical application of Section 269 to these circumstances are very slight. First and most important, it is evident that in any such reorganization, innumerable commercial purposes may be served by the merger. Even the most unimaginative taxpayer would be able to point to business purposes sufficient to satisfy the requirements of proof set up under the cases interpreting Section 129. In addition, the amendment of Section 129, Section 269(c), would seem to indicate that the current application of the section was limited to only those cases in which a taxpayer purchased tax benefits by way of depreciation or sale of assets.

38. SENATE REPORT 53 (emphasis added).

39. H.R. REP. No. 2543, 83d Cong., 2d Sess. 40 (1954).

This view is supported by repeated reference in the committee reports to the need to have restrictions on tax avoidance specifically stated. Finally, the flat terms of Section 381 authorize such a carryover without qualification of any sort. There is no warrant for reading the generalities of Section 269 as a gloss upon the specific authorization for carryover contained in Section 381.

One caveat should be entered here. Where a profit corporation and a loss corporation merge where there is no prior common control, the foregoing observations clearly would appear to be compelling. Let us consider, however, a case in which the stockholders of the profit corporation acquire all the stock of loss corporation by purchase from the original stockholders, and then they merge the two corporations. By so doing, they avoid the requirement of Section 382(b) that the stockholders in the loss corporation must own twenty per cent of the value of the stock in the acquiring corporation after merger. This is, of course, similar to the purchase by the profit corporation of the stock of the loss corporation, followed by liquidation, which is discussed in the following paragraphs. For the reasons there examined at length, it is doubtful that the requirements of Section 382 could thus be circumvented.

#### *Liquidation of Loss Subsidiary by Parent Corporation*

(a) *Where the loss corporation has been a subsidiary for some time.*—Section 381(a) authorizes a carryover of a loss from a liquidated subsidiary to a parent corporation under circumstances stated. Not infrequently a substantial purpose for liquidation—at least the principal reason for liquidation at the time chosen—will be to obtain the tax benefits of the subsidiary for the parent. Even more than in the case of mergers, the decided cases and the numberless commercial reasons for any liquidation will serve to insulate the transaction against application of Section 269. Other factors discussed in the merger context are equally applicable here: particularly it appears unlikely that a general statute such as Section 269 could impair a transaction so explicitly authorized under Section 381.

(b) *Where stock in the loss corporation was purchased shortly before liquidation or merger.*—Assume a case where a profit corporation purchases the stock of a loss corporation and liquidates it or, similarly, where persons purchase the stock and cause the loss corporation to be merged with a profit corporation which they likewise control. As long as the loss corporation remains in the same business, Section 382(a) does not, in terms, apply. Carryover through the next step—

liquidation or merger as the case may be—is specifically authorized by Section 381. We have noted that the purpose of the latter section was to “enable the successor corporation to step into the ‘tax shoes’ of its predecessor corporation” and that tax results of reorganizations and liquidations were intended to

“depend less upon the form of the transaction than upon the economic integration of two or more separate businesses into a unified business enterprise.”<sup>40</sup>

These purposes are satisfied by such a transaction. Consequently, there is ample room to argue that Section 269 may not be invoked to impair a carryover in such circumstances. In addition, all the other arguments hitherto made to show the general ineffectiveness of Section 269 may be asserted.

Arguments to the contrary, however, may not be ignored. In the first place, we must recall that the Senate report indicates that discontinuance of a substantial part of a business will have the same effect as changing it, so the transaction might be caught under the specific terms of Section 382. In addition, we must recall the observation in the Senate report that Section 269 might apply even where Section 382 did not, and remember that Section 269 is in terms broad enough to catch it. Most important, such a device would quite possibly run afoul of the so-called step transaction doctrine which has a vitality far beyond that of Section 269 in this area. Whether a doctrine of such uncertain bounds would in fact be applied is by no means clear, but the dangers inherent in it render dubious any attempt to circumvent it.

#### *Subdividing a Profit Corporation as a Preliminary to Merger*

Consideration should likewise be given to another method of arranging a merger so that the stockholders of the loss corporation will have a continuing interest in the profit corporation after merger, within the twenty per cent requirements of Section 382(b). Assume a case where the profit corporation is worth eight times as much as the loss corporation. If the corporations merged and the stockholders of the loss corporation received only one-ninth of the stock, the loss would be forfeited proportionately. Consequently, the profit corporation splits off one corporation so that the value of each of the corporations after the split-up is four times that of the loss corporation. Presumably, this would be followed, pursuant to Section 355, by a distribution of the stock in the split-off corporation to the stockholders of the original

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40. SENATE REPORT 52.

corporation. Profitable contracts of the corporations are likewise divided. Thereafter, one of the corporations merges with the loss corporation, the stockholders of the latter acquiring twenty per cent of the stock so that there is compliance with Section 382(b).

Does Section 269 operate to impair the loss deduction available to the acquiring corporation under these circumstances?

The foregoing question is not free from doubt. As in the other examples discussed, the carryover of a loss in mergers is specifically authorized in Section 381 and the transaction is not prohibited in Section 382. In the legislative history of the latter section, it has been observed that

“the 20 percent requirement cannot be watered down by inserting one or more corporate entities between the corporation with the loss and the corporation deducting the loss.”<sup>41</sup>

It would seem that the corporation which deducts the loss in the example could not, therefore, be merely a holding company. On the other hand, if it were an active operating company, it should be said to comply with the requirements of Section 382(b) even though it had the same stockholders as the original corporation and had recently been carved from it. As to future business, it would stand or fall on its own activities.

Here again the terms of Section 269(a) are broad enough to cause a disallowance of the deduction; the arguments against application of the section made in the preceding paragraphs are equally applicable here. It should be noted that the step transaction doctrine is likewise potentially applicable. On the other hand, multiple business purposes motivating a merger of the split-off corporation and the loss corporation may be alleged. Most important from a practical standpoint, a fair interpretation of Section 382 is that it is only intended to require a continuity of interest by stockholders of the loss corporation in the acquiring corporation. As long as the acquiring corporation is in fact a separate and independent operating entity, no perversion of congressional intent would arise from permitting the loss notwithstanding that the acquiring corporation was carved out from another.<sup>42</sup>

### *Carryovers Not Involving Net Operating Losses*

It has already been noted that Section 381 provides for carryover of many tax benefits in addition to net operating losses. The restric-

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41. SENATE REPORT 286.

42. If, as has been suggested (at page 586 *supra*), §269 does not apply to corporate divisions this would constitute additional evidence that a split-off followed by merger under §382 would not be impaired by §269.

tions of Section 382, however, are limited to the latter deductions. Neither that section nor Section 381 place restrictions on carryover of deficits, capital losses and other items.

What then, is the effect of Section 269 on carryover of these items?

All of the arguments urged to preclude application of Section 269 to net operating loss carryovers are applicable here. In addition, since Section 382 does not apply to any carryover except for net operating losses, any observation that Section 269 might operate to disallow net operating losses, where Section 382 did not, would be irrelevant in measuring the effect of Section 269 on non-operating loss deductions. In addition, Section 129 never was applied to these items and they were not included in the scope of the regulations under it. It is also appropriate to observe that here, as in the net operating loss cases, commercial purposes abound and decisions under the old Code denote great reluctance by the Tax Court to forfeit a deduction. This reluctance was recognized by a Congress which nevertheless did nothing to strengthen this portion of the statute. Instead, they adopted an amendment which created a presumption for the Commissioner in cases where a person might have been buying depreciation but specifically excluded purchase of other tax benefits—including these—from consideration in the creation of the presumption. It is appropriate to conclude as a practical matter that, given any commercial purpose at all, the acquisition of control of a corporation with such benefits, and subsequent use of them, is not threatened by Section 269.

#### CONCLUSION

It should be reiterated that these comments do not purport to interpret the present status of the business purpose and step transaction doctrines. Actually, the doctrines enunciated in the *Bazley*<sup>43</sup> and *Gregory*<sup>44</sup> cases may afford a sounder basis for a present Treasury attack on tax-saving devices than Section 269. This is because the extent to which Section 129 was nullified by the Tax Court is manifest. The vigor of the business purpose and step transaction doctrines may have been lessened in recent years but no one can doubt that there is still substantial vigor in them.

As long as Section 269 is on the books in its present form there is a prospect that it may be invoked at some time by the courts. Nevertheless, some showing of a business purpose is easy to make in all the examples discussed and the burden of proof on the taxpayer is slight under decided cases interpreting the language in the section. Accord-

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43. *Bazley v. Commissioner*, 331 U.S. 737 (1947).

44. *Gregory v. Helvering*, 293 U.S. 465 (1935).

ingly, the possibility of a court invoking Section 269 to disallow a deduction seems extremely remote in any carefully planned transaction involving carryover, whether or not Sections 381 or 382 apply. The possibility does, however, exist. This means that only the foolhardy will approach transactions which will eventuate in carryover of a loss without all available evidence, documentary if possible, of commercial non-tax motivations for the transaction.

A basic problem in interpreting Section 269 is that we have no consistent underlying philosophy of taxation manifest in this Code.<sup>45</sup> Beyond that, Congress might have rigidly forbidden the traffic in net operating loss carryovers by tightening the provisions of Sections 269 and 382, and refusing to adopt Section 381. It might have opened the door to such traffic by specifically providing that Section 269 did not apply to any cases except those involving purchase of high basis assets which had a low value. Either of these courses would clarify the rights of taxpayers and ease the path of court and counsel considering a transfer of such a loss. This objective was continually stressed in the committee reports. On the basis of all the circumstances discussed, it was probably intended that Section 269 should be emasculated, except as to cases involving purchase of depreciation or loss assets. However, the fact is that Section 129 was not repealed (except to the extent it was repealed by implication through the adoption of Section 269(c)), and it was observed in the Senate Report that the section might apply to cases not covered by Section 382.<sup>46</sup> Thus, through ignorance or inadvertence or both, Congress made threatening gestures in Section 269 toward the traffic in loss corporations encouraged in Section 381, permitted under Section 382, and excluded by Section 269(c) from relevance in showing a violation of other subsections. It would only be possible to further complicate such a result if the committee reports were filled with such contradictory comments as those to the effect that Section 269 was intended to stop bargain purchases of depreciation, against which may be compared the warning that a transfer of a net operating loss not caught under Section 382 might yet be caught under Section 269. Congress has disobliged the taxpayer in this respect as well.

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45. But see Reiling, *Developing a Law of Income Taxation*, 32 TAXES 546 (1954). This result in the new Code was inevitable if, as has been suggested, it was drafted primarily in response to taxpayer complaint filed with Congress and the Treasury Department.

46. The difficulty of interpreting this statute in the light of such comments is one frequently encountered in any legislation of a politically sensitive nature. Statutes having the obvious purpose of eliminating inequities (sometimes described as opening loopholes) are not always easy to explain. Sometimes Congress finds it expedient to pretend that some reason exists for a change which is not apparent in the statute itself: a little salesmanship is needed. Accordingly congressional reports do not always bear a close relation to the content or intended scope of the bill.