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## Loss Carryovers and Corporate Alterations: Toward a Uniform Approach

James B. Loken\*

### I. INTRODUCTION—THE AVERAGING CONCEPT

Sections 1 and 11 of the Internal Revenue Code of 1954 impose a tax on the taxable income earned by individuals and corporations in each "taxable year." The decision to levy the tax on income annually is administratively logical; it is also equitable to average each taxpayer's instantaneous financial ups and downs over a reasonable period of time. However, accumulation of taxable income not only fluctuates, but fluctuates differently with each taxpaying entity. Consequently, a graduated tax imposed inflexibly over a one year period will be disproportionately burdensome to some taxpayers. For example, a corporation that earns \$100,000 in year A and loses \$100,000 in year B will pay more annual tax than a corporation that breaks even each year.

The federal tax laws have long recognized the potential inequities of too rigid adherence to the taxable year concept. A number of current Code provisions permit some form of "averaging" beyond a single tax year. The lower rate on capital gains, for example, is partially justified by a notion that, because capital assets are sold infrequently, increases in their value should not be taxed heavily in the year of sale.<sup>1</sup> A more obvious example of averaging is the Code's treatment of transactions within the definition of installment sales.<sup>2</sup> Additional, rather limited averaging benefits have been legislatively conferred, perhaps in response to rather harsh judicial decisions,<sup>3</sup> upon certain taxpayers who receive prepaid subscription income or dues.<sup>4</sup> Another example of the averaging principle can be

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1. See *Commissioner v. Gillette Motor Transp., Inc.*, 364 U.S. 130, 134 (1960). However, the 25% tax rate and the definition of long-term capital gains seem far too arbitrary to make this a wholly satisfactory rationale for present law.

2. Only that portion of gain received each year is taxed. See INT. REV. CODE of 1954, § 453(b) [1954 Code provisions hereinafter cited by section numbers only].

3. See, e.g., *Automobile Club v. Commissioner*, 353 U.S. 180 (1957). But see *Beacon Publishing Co. v. Commissioner*, 218 F.2d 697 (10th Cir. 1955).

4. Sections 455, 456. Broader averaging benefits had been conferred in 1954, but Treasury insistence led to a retraction. Act of June 15, 1955, ch. 143, 84th Cong., 1st Sess., 69 Stat. 134. See *Schlude v. Commissioner*, 372 U.S. 128 (1963).

found in cases setting forth the "tax benefit rule,"<sup>5</sup> which states, basically, that recovery of losses such as bad debts will not be treated as income to the extent that the previous deduction did not reduce taxes. Congress has recently demonstrated further willingness to adopt the averaging concept to promote fairness in the federal tax laws. The Revenue Act of 1964 amended sections 1301-1307 of the 1954 Code to permit individual taxpayers to reduce the tax impact of a year of extraordinarily high income through a complex averaging formula based on the previous four years' income.<sup>6</sup>

These examples illustrate the degree to which averaging provisions permeate the tax laws. But the most important adoption of the averaging concept is also the oldest—the net operating loss deduction defined in section 172 of the Code. Under present law, a taxpayer receives a deduction for a net operating loss in a given year which may be carried back three years and then forward five years to offset taxable income of those other years.<sup>7</sup> Loss carryovers<sup>8</sup> are available both to individual and corporate taxpayers,<sup>9</sup> and a taxpayer may offset income from one source with a net operating loss from another.<sup>10</sup>

There has been very little criticism of the net operating loss carryover as a form of income averaging,<sup>11</sup> but there has been

5. See Note, *The Tax Benefit Rule and the Loss Carryover Provisions of the 1954 Code*, 67 YALE L.J. 1394, 1399 n.26 (1958). This doctrine is codified in § 111.

6. Act of Feb. 26, 1964, Pub. L. No. 88-272, § 232(a), 78 Stat. 19.

7. Sections 172(b)(1)(A)(i), (b)(1)(B). The net operating loss deduction equals the excess of deductions over gross income, with important modifications set forth in § 172(d). The mechanics of computing the deduction and of applying it to present, past, and future income are beyond the scope of this Article. See generally 5 J. MERTENS, *LAW OF FEDERAL INCOME TAXATION* §§ 29.02a-d (rev. ed. 1963). See also § 1212, which creates the "capital loss carryover," an analogous creature beyond the scope of this Article.

8. The author will use "carryover" when referring to carryforwards and carrybacks taken as a unit. "Carryforward" and "carryback" will be used only when either individually is being discussed. In § 172, "carryover" means carryforward.

9. Certain taxpayers, such as common trust funds (§ 584(g)), partnerships (§ 703(a)(2)(E)), regulated investment companies (§ 852(b)(2)(B)), and real estate investment trusts (§ 857(b)(2)(E)), are not allowed a net operating loss deduction.

10. There are some exceptions. Insurance companies, for example, cannot offset insurance income with operating losses from other businesses, §§ 804(c)(5)(C), 822(c)(8)(B), 832(b)(5), 832(c)(4); non-resident aliens may offset taxable income only with losses related to United States income, § 873.

11. Arguments against this type of averaging are set forth in Lanning, *Tax Erosion and the "Bootstrap Sale" of a Business—II*, 108

almost total disagreement on the extent to which a net operating loss carryover should survive fundamental alteration of the taxpayer which incurred the loss. Basically, the problem is whether (and when) a loss carryover may be transferred from one taxpaying entity to another. This difficult question arises whenever any tax attribute, whether it be a deduction, the basis of assets, or the earnings and profits of a corporation, is transferred. However, because operating losses reduce taxes only to the extent that the taxpayer has income against which to offset them, free transferability of such losses to profitable taxpaying entities would result in more net operating loss deductions being used.<sup>12</sup> Consequently, the problem is economically more serious than when a deferral of taxes (carryover basis) or the characterization of gain (earnings and profits) is at issue. Protection of federal revenues dictates that transferability be limited to those cases in which the averaging purposes behind the net operating loss deduction will be furthered.

The subject of this Article, stated most broadly, is the status of a net operating loss carryover after an alteration of the corporate taxpayer which incurred the loss. Alteration can involve a change of business, a change in identity (such as reincorporation in another state), a change in ownership, or any combination of the foregoing. Altogether, the topic has been divided into five parts. Part II will outline the judicial and legislative history of the problem; Part III will seek a theoretical solution based upon the averaging concept underlying this deduction and the economic factors surrounding its application; Part IV will discuss in further detail specific problems in the current legislative and judicial approach to loss carryovers; and Part V will examine the author's proposal for statutory reform.

## II. HISTORICAL DEVELOPMENT

The most notable characteristic of the law applicable to loss carryover transferability, both past and present, is the extent to which the Congress and the federal courts have experimented in their search for a suitable set of governing principles. The resulting doctrinal melange makes it difficult to understand, much less to summarize, the current status of loss carryover law. It

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U. PA. L. REV. 943, 948-49 (1960). Lanning admits, however, that this is an accepted form of tax relief.

12. See C. R. Peterson, *Corporate Distributions and Adjustments: A General Survey*, 3 TAX REVISION COMPENDIUM 1611, 1616 (House Comm. on Ways and Means 1959).

is, therefore, analytically necessary to give a general and roughly chronological summary of the various doctrines which have been used to solve problems in this broad field before examining through leading recent cases the current state of affairs.

#### A. THE TAXPAYER ENTITY DOCTRINE

Congress enacted the first loss carryover provision as part of the Revenue Act of 1918. Section 204(b) of that Act provided that "any taxpayer" who thereafter sustained a net loss might deduct such loss "from the net income of *the taxpayer* for the preceding year [and then from] the net income for the succeeding taxable year."<sup>13</sup> Although the timespan over which a carryover could be applied was frequently altered, subsequent loss carryover provisions prior to the Internal Revenue Code of 1939 contained substantially identical language.<sup>14</sup>

In the early cases which arose under these provisions, the courts seized upon the term "the taxpayer" when confronted with the problem of whether loss carryovers should survive various corporate alterations. Ignoring such factors as continuity of interest and change of business, they focused only on whether the corporate entity seeking to carry over a net loss was the same corporate entity which had sustained it. The Supreme Court in the then leading case of *New Colonial Ice Company v. Helvering*<sup>15</sup> reasoned that Congress, in specifying that only income of "the taxpayer" could be offset by a loss carryover, had simply made explicit the general purpose of the tax laws "to confine allowable losses to the taxpayer sustaining them." Because deductions are a matter of "legislative grace," the Court added,<sup>16</sup> it had no authority to permit a loss carryover to survive a change in the taxpaying entity. Similar emphasis on the statu-

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13. Revenue Act of 1918, ch. 18, § 204(b), 40 Stat. 1061 (emphasis added).

14. The numerous statutes are cited in Note, *Net Operating Loss Carryovers and Corporate Adjustments: Retaining an Advantageous Tax under Lisbon Shops and Sections 269, 381 and 382*, 69 YALE L.J. 1201, 1202 n.5 (1960).

15. 292 U.S. 435, 440 (1934), *aff'g* 66 F.2d 480 (2d Cir. 1933), *aff'g* 24 B.T.A. 886 (1931).

16. *Id.* at 440. *New Colonial* is apparently the first pronouncement of the legislative grace doctrine, a generalization as objectionable as its converse—that revenue laws are to be strictly construed in favor of the taxpayer. See Griswold, *An Argument Against the Doctrine that Deductions Are To Be Narrowly Construed as a Matter of Legislative Grace*, 56 HARV. L. REV. 1142 (1943).

tory phrase "the taxpayer" can be found in a host of loss carryover cases of this era.<sup>17</sup>

#### B. THE ACQUISITION TO AVOID TAXES DOCTRINE

The *New Colonial* taxpayer entity doctrine was concerned wholly with form rather than with the economic significance of particular alterations in a loss corporation. Although it was woefully arbitrary, there was little governmental pressure to change the doctrine because it typically worked to the Commissioner's advantage. However, on its face it would permit loss carryovers to survive purchase of the stock of a losing corporate enterprise, termination of that enterprise, and transfer of a profitable business to the loss corporation "shell" by the new owners, since such a transaction would leave intact the corporate entity that first incurred the net operating losses.

For some reason, the early loss carryover cases did not involve such transactions, although one decision strongly indicated that the taxpayer entity doctrine would not prevent carryover survival.<sup>18</sup> Nonetheless, Congress was not unaware of this tax avoidance danger, and World War II brought the matter to a head. The war created a need for increased revenue, and an excess profits tax was enacted.<sup>19</sup> Included in this law was an averaging device, the unused excess profits credit, which reduced the inequitable impact of the excess profits tax on taxpayers with sharply fluctuating incomes.<sup>20</sup> When the practice of purchasing

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17. See, e.g., *Weber Flour Mills Co. v. Commissioner*, 82 F.2d 764 (10th Cir. 1936); *General Fin. Co.*, 32 B.T.A. 949 (1935), *aff'd*, 85 F.2d 846 (3d Cir. 1936); *May Oil Burner Corp.*, 27 B.T.A. 1281 (1933), *aff'd*, 71 F.2d 644 (4th Cir. 1934); *Athol Mfg. Co.*, 22 B.T.A. 105, *aff'd*, 54 F.2d 230 (1st Cir. 1931); *Maytag Co.*, 17 B.T.A. 182 (1929); *Phillip C. Donner*, 16 B.T.A. 758 (1929).

18. *Northway Sec. Co.*, 23 B.T.A. 532 (1931).

19. Act of Oct. 8, 1940, ch. 757, tit. II, 54 Stat. 975, *as amended*, 55 Stat. 17 (1941).

20. The details of the unused excess profits credit are beyond the scope of this Article. In general, the excess profits credit, based on a taxpayer's average income, was subtracted from "excess profits net income" in determining "adjusted excess profits net income" upon which the tax was imposed. If excess profits net income did not exhaust the credit for a given year, a taxpayer was permitted to carry over the unused portion to past and future years. INT. REV. CODE OF 1939, § 710 (c), added by ch. 10, § 2, 55 Stat. 17 (1941). See generally 7A J. MERTENS, *supra* note 7, §§ 42.32-.34, 42.37 *et. seq.* If an unused excess profits credit survived corporate acquisitions, transferees could acquire a substantial tax benefit. Since the purpose of the carryover was averaging, this Article, like most courts, will treat the issue of transferability like that of loss carryovers. A distinction should be noted, however, in

loss corporations with an eye toward utilizing an unused excess profits credit or a loss carryover was publicized, Congress responded by enacting section 129 of the 1939 Code (now section 269 of the 1954 Code).<sup>21</sup> This provision called for the disallowance of any deduction or credit possessed by a corporation the control of which had been acquired for "evasion or avoidance of Federal income or excess profits tax by securing the benefit" of such deduction or credit which the acquirer "would not otherwise enjoy."

The tax avoidance possibilities in prior law were almost immediately demonstrated by *Alprosa Watch Corp.*<sup>22</sup> Owners of a shipment of imported watches acquired a loss corporation, changed its name and sold off its old assets, and transferred the watches to it. Despite the changes in corporate name, business, owners, and location, the Tax Court permitted prior losses to offset income from the watch business. The taxpayer entity remained the same, explained the court, there was a business purpose for the alterations, and section 129 did not apply to the tax years in question.<sup>23</sup> In addition, the Tax Court, in a dictum that was reaffirmed in later cases,<sup>24</sup> set back the law's development a few years when it declared that section 129 would not in any event disallow deductions or credits claimed by the *acquired* corporation. This anomalous distinction was not accepted by

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the case of a company that sustains losses during protracted dissolution. The excess profits credit envisions a going business; to permit a dying company with greatly reduced capacity to carry back unused portions of its credit to its normal years would encourage the obvious abuse of extended dissolutions. The loss carryover, on the other hand, is intended to average profit and loss years of a taxpayer regardless of the cause of a bad year. A loss carryback, therefore, should be allowed from the dissolution period to a prior profitable year. Compare *Acampo Wineries & Distilleries, Inc.*, 7 T.C. 629 (1946), with *Wier Long Leaf Lumber Co.*, 9 T.C. 990 (1947), and *Winter & Co.*, 13 T.C. 108 (1949).

21. Revenue Act of 1943, ch. 63, § 128, 58 Stat. 47 (1944). The legislative history of this statute is interesting and instructive. See H.R. REP. No. 871, 78th Cong., 1st Sess. 24 (1943); S. REP. No. 627, 78th Cong., 1st Sess. 26 (1943).

22. 11 T.C. 240 (1948).

23. The Tax Court placed principal reliance on the *New Colonial* taxpayer entity doctrine and specifically on *Northway Sec. Co.*, 23 B.T.A. 532 (1931), which could have been distinguished on the ground that it involved a relatively small change in the ownership of the loss corporation. When one considers that the taxpayer entity doctrine was a product of judicial fear of loss carryover transfer, its rote application in *Alprosa* seems remarkable. See Tarleau, *Acquisition of Loss Companies*, 31 TAXES 1050 (1953).

24. See *Wage, Inc.*, 19 T.C. 249 (1952); *A.B. & Container Corp.*, 14 T.C. 842 (1950). See also *Westover Co. v. Smyth*, 99 F. Supp. 488 (N.D. Cal. 1951).

the federal courts of appeals,<sup>25</sup> however, and many years later the Tax Court finally overruled itself and held that section 129, if applicable, would disallow a carryover in the *Alprosa* situation.<sup>26</sup>

The section 129 doctrine is very much alive today in the loss carryover area. It has been applied in a large number of cases, both before and after 1954, to disallow loss carryovers where the courts have been able to infer that a principal purpose behind the acquisition of assets or stock of a loss corporation was to gain the benefit of an existing carryover.<sup>27</sup> Like the sham transaction rule of cases like *Gregory v. Helvering*,<sup>28</sup> however, it is a doctrine of general applicability. Thus, while it is of great significance to the tax planner, it provides little help in the search for a workable treatment of the specific problem of loss carryover transferability.

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25. See *Commissioner v. British Motor Car Distribs., Ltd.*, 278 F.2d 392 (9th Cir. 1960), *rev'g* 31 T.C. 437 (1958); *Mill Ridge Coal Co. v. Patterson*, 264 F.2d 713 (5th Cir. 1959) (alternative holding); *Coastal Oil Storage Co. v. Commissioner*, 242 F.2d 396 (4th Cir. 1957). This last case denied an extra surtax exemption for an acquired subsidiary. The multiple surtax exemption question is now covered specifically by § 1551, which denies an exemption if a "major purpose" of an intercorporate transfer was to secure such a benefit. The application of this provision has been criticized. See B. BITTKER, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS* 57-61 (1959).

26. See *Thomas E. Snyder Sons Co.*, 34 T.C. 400 (1960), *aff'd*, 288 F.2d 36 (7th Cir.), *cert. denied*, 368 U.S. 823 (1961).

27. See, e.g., *Pauline W. Ach*, 42 T.C. 114 (1964), *aff'd*, 358 F.2d 342 (6th Cir. 1966), *cert. denied*, 385 U.S. 899 (1966); *J. T. Slocomb Co.*, 38 T.C. 752 (1962), *aff'd*, 334 F.2d 269 (2d Cir. 1964); *Temple Square Mfg. Co.*, 36 T.C. 88 (1961).

Overruling of the *Alprosa* dictum is not the only judicial strengthening of § 129 and § 269 in recent years. In later cases, the Tax Court has been much more willing to weigh the various motivations for a particular transaction and to conclude that tax avoidance was a "principal purpose." Compare *T.V.D. Co.*, 27 T.C. 879 (1957), with *Frank Spingolo Warehouse Co.*, 37 T.C. 1 (1961), and *Urban Redevelopment Corp.*, 34 T.C. 845 (1960), *aff'd*, 294 F.2d 328 (4th Cir. 1961). Taxpayers who survive this provision today generally can show a bona fide attempt to operate the acquired loss corporation business and an ignorance of tax advantages at the time of acquisition. See *John B. Stetson Co.*, 33 P-H Tax Ct. Mem. 965 (1964); *Baton Rouge Supply Co.*, 36 T.C. 1 (1961). These events have proven wrong those who once suggested that § 269 was a dead letter. See, e.g., *Hearings Before the House Comm. on Ways and Means, Advisory Group Recommendations on Subchapters C, J, and K of the Internal Revenue Code*, 86th Cong., 1st Sess. 876, 877 (1959) (statement of Stanley H. Ruttenberg, Director, Dept. of Research, AFL-CIO) [hereinafter cited as *Advisory Group Hearings*]; *Susser, Tax Consequences of the Net Operating Loss Deduction*, 5 *TAX L. REV.* 211, 221-22 (1950).

28. 293 U.S. 465 (1935).



## C. THE STATUTORY MERGER DOCTRINE

At the same time the Commissioner was faced with the unfavorable *Alprosa* decision, the rigid taxpayer entity doctrine was creating tensions on the other side of the tax litigation dialogue. A host of loss corporations found that some innocent or perhaps compulsory alteration in form, such as reincorporation in another state or merger with a wholly owned subsidiary, had put in jeopardy their valuable loss carryover deductions. Such taxpayers fought in every available forum to avoid the broad grasp of *New Colonial's* emphasis on "the taxpayer," but, until 1949, to no avail. *New Colonial* was applied by rote despite the fact that the words "the taxpayer" had been eliminated in the 1939 Code and then re-inserted in 1942 all with no explanation,<sup>29</sup> and despite the fact that the courts allowed other valuable tax attributes to survive identical alterations in corporate entity whether or not there was express statutory direction.<sup>30</sup>

This illogical and unjust doctrine was first rejected by the Second Circuit in *Stanton Brewery, Inc. v. Commissioner*.<sup>31</sup> At issue was an unused excess profits credit which the Commissioner disallowed because of an intervening corporate merger. To avoid the Commissioner's potent reliance on the *New Colonial* argument that a different "taxpayer" survived the merger, the court noted that Stanton Brewery was formed by a statutory merger whereas *New Colonial* had involved a purchase of assets.<sup>32</sup> In addition, the court found the Commissioner's "taxpayer" argument unrealistic and thus held for the taxpayer.

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29. Compare Revenue Act of 1942, ch. 619, § 153(a), 56 Stat. 847, with Revenue Act of 1939, ch. 247, § 211(b), 53 Stat. 862. This oddity surely emphasizes the natural reaction that this phrase was not intended to be of substantive significance.

30. See *Helvering v. Metropolitan Edison Co.*, 306 U.S. 522 (1939), where a parent corporation was permitted to inherit its subsidiary's unamortized bond discount after a de facto merger through liquidation.

31. 176 F.2d 573 (2d Cir. 1949), *rev'g* 11 T.C. 310 (1948).

32. The court relied on *Helvering v. Metropolitan Edison Co.*, 306 U.S. 522 (1939). Although *Metropolitan Edison* involved the unrelated problem of the survival of unamortized bond discount after a merger, the Supreme Court's language about a transferor being "drowned" in its successor after a statutory merger was congenial to the Second Circuit's position in *Stanton Brewery* and permitted the lower court to "distinguish" *New Colonial*. Arguably, only subsequent interpretations of *New Colonial* had supplied its inflexible gloss, and it seems unfortunate that the *Stanton Brewery* court was not more courageous in seeking a better rationale. On the other hand, considering the lack of authority for any workable test as of 1949, an invitation to the Supreme Court to clarify *New Colonial* might have been disastrous.

The statutory merger doctrine has had little significance beyond its importance as the first judicial break from unthinking application of the *New Colonial* taxpayer entity doctrine. The Tax Court and the Commissioner did not accept the statutory merger distinction.<sup>33</sup> Only a few such cases reached the other federal courts. A number supported the Second Circuit, but more out of distaste for the entity concept than out of analytical enthusiasm for the unsatisfactory emphasis on the form of a merger under state law.<sup>34</sup> The Supreme Court eventually downgraded the doctrine without disapproving it.<sup>35</sup> Because the Congress enacted other solutions to the loss carryover problem in the 1954 Code, the statutory merger doctrine today plays only a marginal role in the few cases remaining which involve the 1939 Code's tax years.<sup>36</sup>

#### D. THE 1954 CODE PROVISIONS

In the 1954 Code, Congress for the first time addressed itself explicitly to the problem of loss carryover transferability. The committee reports<sup>37</sup> lamented the "uncertain and frequently contradictory" court-made law which emphasized the form rather than the economic substance of corporate alterations. Congress also complained that section 129 had failed to halt "trafficking in loss corporations," no doubt with *Alprosa* and its revenue-damaging dictum in mind.

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33. See Eleanor H. Vendig, 22 T.C. 1127 (1954), *rev'd on other grounds*, 229 F.2d 93 (2d Cir. 1956); California Casket Co., 19 T.C. 32 (1952); cf. Standard Paving Co., 13 T.C. 425, 446 (1949), *aff'd*, 190 F.2d 330 (10th Cir. 1951). Literature of the period, however, was quick to point out the new tax advantages to statutory mergers. See, e.g., Note, *Statutory Mergers are Tax-Favored*, 6 TAX L. REV. 102 (1950). As *Alprosa* and *Stanton Brewery* were decided almost simultaneously, they together must have sparked considerable interest among businessmen and their tax counsel over the possibility of successfully "trafficking in loss corporations." See Note, *Net Operating Loss Carryovers*, 69 YALE L.J. 1201 n.1 (1960).

34. See *F.C. Donovan, Inc. v. United States*, 261 F.2d 470 (1st Cir.) (Magruder, C. J.), *rev'g* 159 F. Supp. 1 (D. Mass. 1958); *Newmarket Mfg. Co. v. United States*, 233 F.2d 493 (1st Cir. 1956) (Magruder, C. J.), *cert. denied*, 353 U.S. 983 (1957), *rev'g* 130 F. Supp. 706 (D. Mass. 1955); *E. & J. Gallo Winery v. Commissioner*, 227 F.2d 699 (9th Cir. 1955); *Koppers Co. v. United States*, 134 F. Supp. 290 (Ct. Cl. 1955), *cert. denied*, 353 U.S. 983 (1957); *Moldit, Inc. v. Jarecki*, 1953-2 U.S. Tax Cas. ¶ 9551 (N.D. Ill. 1953).

35. See *Libson Shops, Inc. v. Koehler*, 353 U.S. 382 (1957), *aff'g* 229 F.2d 220 (8th Cir. 1956).

36. See Rev. Rul. 59-395, 1959-2 CUM. BULL. 475.

37. H.R. REP. NO. 1337, 83d Cong., 2d Sess. 41 (1954); S. REP. NO. 1622, 83d Cong., 2d Sess. 53, 284-86 (1954).

In response to these problems, Congress created a whole new statutory scheme. The phrase "the taxpayer" was eliminated from section 172, which established the net operating loss carryover. Section 129 was substantially reenacted as section 269. Then, Congress added two new provisions to subchapter C, the corporate "adjustments" subchapter. The first, section 381, enumerates twenty-two specific tax attributes to which an acquiring corporation succeeds if it acquires the assets of another corporation in a section 332 liquidation or in a section 368(a)(1)(A), (C), (D) ("but only if the requirements of subparagraphs (A) and (B) of section 354(b)(1) are met"),<sup>38</sup> or (F) reorganization. Among the attributes listed are net operating loss carryovers, but a carryback of net operating losses is denied in all section 381 cases except the (F) reorganization.<sup>39</sup> In the second new provision, section 382, Congress codified "special limitations on net operating loss carryovers." Basically, section 382(a) covers taxable alterations—it eliminates carryovers when, in general, there is a substantial change in the ownership of a loss corporation within the previous two years *and* the corporation has not continued to carry on substantially the same trade or business. Section 382(b) refines the loss carryover rules applicable to most tax free reorganizations—it reduces carryovers otherwise allowed in full by section 381 if the original owners of the loss corporation do not own at least twenty per cent of the resulting corporation's stock as the result of their prior ownership of the loss corporation.

One can infer that Congress in 1954 focused primarily on anomalies created by the confrontation between the taxpayer entity and the statutory merger doctrines and on the loophole created by *Alprosa's* rigid adherence to the entity concept and its weakening of section 129 of the 1939 Code. Sections 381 and 382(b) now replace the entity and merger doctrines, and sections 382(a) and 269 plug the *Alprosa* loophole. However, because Congress failed to embrace a single doctrine in the 1954 Code provisions and because it failed to anticipate many issues,<sup>40</sup> the

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38. This limitation is primarily intended to exclude "divisive" (D) reorganizations from coverage under § 381. See text accompanying notes 129-131 *infra*.

39. Sections 381(b)(3), (c)(1).

40. For example, the Senate substantially revised § 382, adding the change of business requirement in § 382(a)(1)(C) and the 20% continuity of ownership requirement in § 382(b). Yet the Senate Committee Report, S. REP. No. 1622, 83d Cong., 2d Sess. 35, 284-86 (1954), contained at least two troublesome comments: that § 269 is inapplicable to any transaction covered by § 382, and an intimation that a § 382

new provisions simply substituted new confusion and uncertainty for the old, though concededly on a more satisfying analytical plane. Thus, the 1954 Code should be viewed as a still embryonic treatment of loss carryover transferability.<sup>41</sup>

#### E. THE LIBSON SHOPS DOCTRINE

When the Supreme Court granted certiorari in *Libson Shops, Inc. v. Koehler*,<sup>42</sup> it appeared that the statutory merger-taxpayer entity confrontation would be resolved.<sup>43</sup> In that case, eight individuals owned sixteen retail corporations and one common management corporation. These merged into one corporation which carried on all operations thereafter. Three of the sixteen had sustained net operating losses prior to merger, and the resultant corporation attempted to carry forward these losses to post-merger income derived from the other stores. The Commissioner relied on the *New Colonial* "the taxpayer" doctrine, while the taxpayer based its argument for carryover survival on the *Stanton Brewery* statutory merger doctrine.

Mr. Justice Burton for the majority began, quite predictably, by stating that "[t]he contentions of the parties require us to decide whether it can be said that petitioner, a combination of 16 sales businesses, is 'the taxpayer' having the pre-merger losses of three of those businesses."<sup>44</sup> The Court's answer was a complete surprise. Accepting an alternative argument made by the Government, the Court held that petitioner was not the

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(a) change of business must *result from* the requisite change of ownership. The Treasury has apparently rejected the first comment, cf. Rev. Rul. 58-603, 1958-2 CUM. BULL. 147, and no one has taken the second seriously.

41. The House minority report applauded the attempt to obtain rules of mechanical certainty in Subchapter C but expressed doubt that these provisions had been drafted with sufficient understanding, a necessity "in this field of ingenious adaptation [requiring lines] . . . drawn beyond the shadow of easy manipulation." H.R. REP. NO. 1337, 83d Cong., 2d Sess. at B22.

42. 353 U.S. 382 (1957).

43. Although *Libson Shops* reached the Supreme Court in 1957, provisions of the 1939 Code were applicable because Congress had not given retroactive effect to §§ 381 and 382 of the 1954 Code. See § 394. That *Libson Shops*, the most significant decision under the 1939 Code, was not decided until after passage of the 1954 Code has added to the confusing status of loss carryover law—*Libson Shops* adopted a novel doctrine, and no one can say with certainty whether the 1954 Congress would have approved of that doctrine. One can answer this question with some confidence, however. See text accompanying notes 113-14 *infra*.

44. 353 U.S. at 385.

same taxpayer because it lacked "continuity of business enterprise" with the pre-merger loss corporations. This continuity was lacking, explained the Court, because the companies before merger had filed separate tax returns and because, given post-merger losses by the losing businesses, the carryovers could not have been utilized without the merger. The Court distinguished the statutory merger cases on the ground that they had involved business continuity, and it added in a footnote that it was not passing on cases that involved alterations of a "single corporate taxpayer," such as *Alprosa*.<sup>45</sup>

*Libson Shops* was a thunderbolt. With no warning, taxpayers suddenly faced a new overriding doctrine which would govern the transferability of loss carryovers. Not only was the "continuity of business enterprise" doctrine unpredicted, but it also did not seem to reflect the thinking of Congress manifested in the 1954 Code enacted just three years earlier,<sup>46</sup> nor did it parallel the continuity-of-interest tests which had been applied to other, admittedly distinguishable corporate reorganization problems.<sup>47</sup> The two major questions following *Libson Shops* were what effect it would have on factually distinguishable cases under the 1939 Code, and whether it would have an impact on cases under the 1954 Code. The first question was for the most part answered, unfavorably to taxpayers, by subsequent cases and rulings dealing with 1939 Code years.<sup>48</sup> The second and more important question remains unresolved and is a major source of the confusion surrounding the current law.<sup>49</sup>

#### F. RECENT CASES AND RULINGS UNDER THE 1954 CODE

Despite the multiplicity of standards which the 1954 Code provisions apply to various loss carryover situations, they have in many respects functioned smoothly and effectively. Section 269's proscription of acquisitions motivated by a tax avoidance

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45. 353 U.S. at 390 n.9.

46. See text accompanying notes 113-14 *infra*.

47. See, e.g., *LeTulle v. Scofield*, 308 U.S. 415 (1940); *John A. Nelson Co. v. Helvering*, 296 U.S. 374 (1935).

48. See, e.g., *Federal Cement Tile Co.*, 40 T.C. 1028 (1963), *aff'd*, 338 F.2d 691 (7th Cir. 1964); *Norden-Ketay Corp.*, 31 P-H Tax Ct. Mem. 1457 (1962), *aff'd*, 319 F.2d 902 (2d Cir.), *cert. denied*, 375 U.S. 953 (1963); *J.G. Dudley Co.*, 36 T.C. 1122 (1961), *aff'd*, 298 F.2d 750 (4th Cir. 1962); Rev. Rul. 59-395, 1959-2 CUM. BULL. 475.

49. Problems raised by *Libson Shops* are rather deprecatingly summarized by Judge Friendly in *Julius Garfinckel & Co. v. Commissioner*, 335 F.2d 744 (2d Cir. 1964), *cert. denied*, 379 U.S. 962 (1965), *aff'g* 40 T.C. 870 (1963).

purpose has been frequently invoked to disallow loss carryovers after loss corporation acquisitions.<sup>50</sup> It is perhaps the broad sweep of this section combined with the more objective and understandable standards in section 382 which have led to a gradual diminishing of loss carryover litigation under the 1954 Code.

Section 382(b), which requires that owners of an acquired loss corporation receive twenty per cent ownership of the resultant corporation "as the result of owning stock of the loss corporation," has had little judicial interpretation. However, the recent Tax Court decision in *Commonwealth Container Corp.*<sup>51</sup> is most instructive. There, a loss corporation was merged into a larger profit corporation. Prior to the merger, owners of the loss corporation also owned seventy-five per cent of the stock of the profit corporation, and they received some additional profit corporation stock as a result of the merger. The Tax Court admitted that there was significant continuity of ownership but felt compelled to apply the objective test of section 382(b). That test compelled disallowance of thirty-five per cent of the carryover because the loss corporation's owners received only thirteen per cent of the profit corporation's stock "as the result of" the merger. The Tax Court was not even dissuaded by its opinion that the phrase "as the result of" was most likely inserted in section 382(b) to guard against unrelated abuses: "there is no ambiguity in the words used in the statute, and if they are applied literally here, the reduction provided in section 382 must be applied."<sup>52</sup>

If *Commonwealth Container* is any indication, it would seem that the relatively innocent-sounding section 382(b) in fact has a significant bite—it prevents the use of tax free transactions to realign commonly owned corporations so that full utilization of loss carryovers can be realized, except in those few cases where the narrow ambit of section 382(b)(3) controls.<sup>53</sup>

Section 382(a) establishes another, completely independent limitation on loss carryover transferability, totally disallowing loss carryovers when a corporation has a 50 per cent change in

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50. See, e.g., *H.F. Ramsey Co.*, 43 T.C. 500 (1965); *Pauline W. Ach*, 42 T.C. 115 (1964), *aff'd*, 358 F.2d 342 (6th Cir.), *cert. denied*, 385 U.S. 899 (1966); *Herbert Luke*, 33 P-H Tax Ct. Mem. 1122 (1964), *aff'd*, 351 F.2d 568 (7th Cir. 1965). However, the peculiar presumption inserted into this provision as § 269(c) to strengthen the statute has, as commentators predicted, proved unworkable. See B. BITTKER, *supra* note 25, at 57; *Wallace Corp.*, 33 P-H Tax Ct. Mem. 43 (1964).

51. 48 T.C. 483 (1967).

52. *Id.* at 492.

53. Text accompanying notes 122-25 *infra*.

ownership by "purchase" and does not continue "to carry on a trade or business substantially the same" as that conducted prior to the ownership change. The change of ownership standards of this section, though complex, are thoroughly treated by Treasury Regulations<sup>54</sup> and have led to little litigation. An indication of how courts interpret this subsection is *Glover Packing Company v. United States*.<sup>55</sup> By agreement, Mr. Glover purchased ten per cent of plaintiff loss corporation's stock and ninety per cent was placed in a voting trust. The device was admittedly intended to avoid the criteria of section 382(a): control of the corporation passed immediately to Glover, and one-seventh of the voting trust stock was to be transferred to the corporate treasury in each of the next seven years. The Court of Claims held that there was a section 382(a) change of ownership because that section measures change by fair market value of stock outstanding. It noted that the voting trust arrangement placed Glover in control and ruled that the voting trust stock was, therefore, rendered relatively worthless and not "outstanding" within the meaning of the statute.<sup>56</sup> As the court also found the requisite change of business, the loss carryovers were disallowed.

The bulk of litigation under section 382(a) has involved the question of whether a substantial change of business occurred after a change in the loss corporation's ownership. Taxpayers have enjoyed frequent success on this issue.<sup>57</sup> Although radi-

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54. See Treas. Regs. §§ 1.382(a)-1(c) to (g) (1962). Section 382(a) applies only if, essentially, any one or more of the ten persons who own the greatest percentage of the fair market value of a loss corporation's stock have increased their holdings, by "purchase," 50 percentage points within the two previous years. Purchase is defined in § 382(a)(4) as a stock acquisition after which basis is determined by reference to the acquirer's cost. In addition, the attribution rules of § 318 are, with some modifications, made applicable by § 382(a)(3).

55. 328 F.2d 342 (Ct. Cl. 1964).

56. Compare *Maxwell Hardware Co. v. Commissioner*, 343 F.2d 713 (9th Cir. 1965), where common stock of a loss corporation was placed in a voting trust, and assets of a potentially profitable business were transferred to the corporation for a short period of time in exchange for preferred stock. Though the arrangement was undoubtedly devised to avoid § 382(a), the court of appeals held that statute inapplicable without considering an argument that the common had been stripped of over 50% of its value. Admittedly, the argument is more tenuous than in *Glover Packing*.

57. See *Koppers Co. v. United States*, 229 F. Supp. 159 (W.D. Pa. 1964); *Wallace Corp.*, 33 P-H Tax Ct. Mem. 43 (1964); *Goodwyn Crockery Co.*, 37 T.C. 355 (1961), *aff'd*, 315 F.2d 110 (6th Cir. 1963). Of course, a logical reason why taxpayers have been successful in § 382(a) cases is that clear examples of trafficking are attacked under

cal changes in business undertakings have not escaped section 382(a) disallowance,<sup>58</sup> a guiding principle of these decisions is that, since rehabilitation of a losing enterprise usually requires some revamping of operations, the requirement of business "continuity" of section 382(a)(1)(C) should be satisfied if the new owner can show that relatively minor changes were made in a bona fide attempt to revitalize the losing business. The few disagreements over proper interpretation of this standard do not seem particularly significant.<sup>59</sup>

Although sections 269 and 382 effectively disallow carryovers in a large number of tax-motivated situations, transactions can be structured to avoid the objective criteria of these provisions. Because Congress made such a complete break with past treatment of this area in 1954, the difficult question now is how courts should deal with such transactions and specifically whether the continuity of business doctrine developed by the Supreme Court after 1954 in *Libson Shops* should be followed. Had *Libson Shops* been governed by the 1954 Code, section 381 would have allowed the carryovers in question to survive.<sup>60</sup> As Congress in section 382(a) adopted the change of business doctrine only in conjunction with a change of ownership test, most commentators have argued that *Libson Shops* should be inapplicable to 1954 Code tax years.<sup>61</sup>

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§ 269; when it is difficult to establish that business has been altered, it is almost, *a fortiori*, more difficult to demonstrate that tax benefits were the principle purpose behind a change in ownership.

58. See John S. Taft, 30 P-H Tax Ct. Mem. 1239 (1961) (alternative holding), *aff'd*, 314 F.2d 620 (9th Cir. 1963).

59. Some disagreement has arisen over whether carryovers should survive when new owners reactivate a loss corporation's dormant business. Compare *Clarksdale Rubber Co.*, 45 T.C. 234 (1965), and *H.F. Ramsey Co.*, 43 T.C. 500 (1965), with *Commissioner v. Barclay Jewelry, Inc.*, 367 F.2d 193 (1st Cir. 1966), and *United States v. Fenix & Scisson, Inc.*, 360 F.2d 260 (6th Cir. 1966), *cert. denied*, 386 U.S. 1036 (1967), and *Fawn Fashions, Inc.*, 41 T.C. 205 (1963). The Internal Revenue Service considers disallowance appropriate. See *Treas. Reg. § 1.382(a)-1(h)(6)* (1962); *Rev. Rul. 67-186*, 1967 INT. REV. BULL. No. 24, at 9.

60. Section 382(b) would not have disallowed the carryovers because all the corporations were "owned substantially by the same persons in the same proportion." Section 382(b)(3).

61. Commentators sympathetic to loss carryover transferability advocated a narrow reading of *Libson Shops*. See, e.g., Arent, *Current Developments Affecting Loss Corporations*, 35 TAXES 956 (1957); Levine & Petta, *Libson Shops: A Study in Semantics*, 36 TAXES 445 (1958); Sinrich, *Libson Shops—An Argument Against Its Application Under the 1954 Code*, 13 TAX L. REV. 167 (1958). Later articles have reluctantly predicted that *Libson Shops* will be given a far broader interpretation. See Speiller, *Acquisitions by Loss Corporations of Profit-*



The Internal Revenue Service apparently agrees. It first announced that it would not apply *Libson Shops* to transactions expressly covered by section 381,<sup>62</sup> and that it would not apply the continuity of business test to any post-1954 transaction if there "has been little or no change in the stock ownership of the corporation during or after the period in which the losses were incurred. . . ."<sup>63</sup> Following a particularly unsettling defeat in the Ninth Circuit,<sup>64</sup> however, the Service retreated somewhat, announcing that it will apply the "fundamental type of statutory analysis" found in *Libson Shops* to post-1954 cases. The *Libson Shops* "rationale" will be applied, according to this later ruling, "where there has been both a fifty per cent *shift in the benefits of a loss carryover* . . . and a change in business as defined in section 382(a) and the regulations thereunder."<sup>65</sup>

What this ruling means, of course, is that the Commissioner wishes *Libson Shops* to plug the leaks in sections 269 and 382(a). Two recent cases graphically illustrate why the Commissioner feels need for this added weapon. In each case, however, the court of appeals rejected his position.

In *Maxwell Hardware Company v. Commissioner*,<sup>66</sup> a potentially profitable real estate development was transferred to an old but failing hardware corporation. The owners of the real estate business received preferred stock in the hardware company and, pursuant to a complex agreement, the common stock was placed in a voting trust. The right to manage each business remained with its original unrelated owners; real estate profits were tied to the preferred stock and hardware profits to the common. The agreement was to terminate and the businesses to separate when the development was completed. Although the owners of the development had good reason to incorporate their

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*able Businesses*, 40 TAXES 22 (1962). See also *Advisory Group Hearings* 568.

62. Rev. Rul. 58-603, 1958-2 CUM. BULL. 147.

63. Rev. Rul. 63-40, 1963-1 CUM. BULL. 46, 47. Questions posed to the Service involved whether carryovers would survive if a loss corporation after 1954 purchased assets of a profit corporation (partly with cash contributed by its shareholders), sold its former assets, and continued the new business, and whether the result would change if profit corporation's stock were purchased and profit corporation were immediately liquidated. The Service held that carryovers would survive in either case.

64. *Maxwell Hardware Co. v. Commissioner*, 343 F.2d 713 (9th Cir. 1965).

65. T.I.R. No. 773 (Oct. 13, 1965) (emphasis added).

66. 343 F.2d 713 (9th Cir. 1965), *rev'g sub nom.* Arthur T. Beckett, 41 T.C. 386 (1963).

risky venture, their choice of the hardware corporation was obviously motivated by the latter's substantial loss carryover. Nevertheless, sections 269 and 382(a) were technically inapplicable because there had not been an acquisition or a change in ownership<sup>67</sup>—owners of the loss corporation retained possession of all common stock. The Tax Court, relying squarely on *Libson Shops*, denied the carryover of prior hardware losses to post-unification real estate income, but the Ninth Circuit reversed. That court first held that *Libson Shops* "is not controlling precedent for judicial interpretation" of the 1954 Code because the result in *Libson Shops* would have been different under the new statute. It also ruled that neither section 382(a), nor section 269, nor section 482<sup>68</sup> was applicable to disallow the carryover in question. Finally, the court of appeals rejected the Commissioner's argument that the carryover should be disallowed under some nonstatutory "judge-made" rule governing loss carryover transferability:

An expression like 'trafficking in loss carryovers' is a question-begging epithet which clouds reason. A dispassionate consideration of the 1954 Code must lead to the conclusion, we believe, that Congress has deliberately sanctioned such so-called 'trafficking' in those situations where it is not expressly abjured.<sup>69</sup>

The taxpayer was equally successful in *Jackson Oldsmobile, Inc. v. United States*.<sup>70</sup> General Motors' (GM) lending division finances its franchised automobile dealers by supplying up to three-fourths of their needed capital in exchange for all class A, voting common stock of a proposed dealer corporation. The individual dealer is given management of the enterprise and class B, nonvoting common for his cash investment. If the dealership is successful, profits must be used to buy up GM's class A common; thus, eventually the dealer becomes sole owner. In this case, a Colorado Buick dealership failed before GM stock had been significantly retired. GM bought up the dealer's interest and closed operations. Three years later, the corporation was refinanced by GM and a new Georgia Oldsmobile dealer; the name was changed and the business continued as a Georgia

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67. *But see* note 56 *supra*.

68. Section 482 provides that the Commissioner may allocate deductions among two or more commonly controlled businesses if such allocation "is necessary in order to prevent evasion of taxes or clearly to reflect the income" of the businesses. Like § 269, it is a provision of general application, but it is seldom if ever relevant to loss carryover cases.

69. 343 F.2d at 719.

70. 237 F. Supp. 779 (M.D. Ga. 1964), *aff'd*, 371 F.2d 808 (5th Cir. 1967).

enterprise with entirely different management and employees. When it proved profitable, the corporation attempted to offset prior Colorado losses against its income. The District Court found sections 269 and 382(a) inapplicable because GM had at all times retained ownership of voting stock. The taxpayer contended that *Libson Shops* did not apply to transactions after 1954. Avoiding this question, the district court held that *Libson Shops* did not bar carryovers because prior cases had applied the change of business rationale to a single corporation only when there was no continuity of ownership. Thus, the taxpayer prevailed. The Fifth Circuit affirmed in a short opinion.

Although certiorari was not authorized in either *Maxwell Hardware* or *Jackson Oldsmobile*, the Commissioner does not acquiesce in either decision.<sup>71</sup> Thus, as happened just prior to *New Colonial* and then *Libson Shops*, a serious conflict between the courts of appeals and the Commissioner appears to be brewing which only the Supreme Court or Congress can resolve.

Even in those areas where the courts and the Commissioner are in apparent accord, the current law presents a confusing array of doctrines. Depending upon the transaction at issue, the test for loss carryover survival may be tax avoidance purpose (section 269), continuity of ownership (section 382(b)), continuity of business (assuming some vitality for *Libson Shops*), or continuity of ownership and business (section 382(a)). Also, the carryover may be disallowed in whole or in part, depending upon the applicable provision, with additional variations in the manner of determining a partial disallowance.<sup>72</sup> In so complex and inconsistent a scheme, anomalies are certain to appear and already exist, as will be shown in Part IV. Reform is badly needed, and Congress and the courts have been bombarded with an awesome variety of proposals. With the problem so muddled, it seems necessary to return to the basic purposes behind loss carryovers to see if principles relevant to the question of

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71. See T.I.R. No. 773 (Oct. 13, 1965), as to *Maxwell Hardware*, and 6 P-H FEDERAL TAXES ¶ 56,400 (1967), as to *Jackson Oldsmobile*.

72. Compare § 382(b), with the treatment of loss carryovers in the consolidated returns context, Treas. Reg. §§ 1.1502-1(f)(1), -21(c); 1.1502-31A(b)(3) (1966). (The consolidated returns problem is treated in greater detail in Section IV, F. *infra*.) In addition, the Internal Revenue Service adopted a tracing test under *Libson Shops* for dealing with statutory mergers under the 1939 Code, Rev. Rul. 59-395, 1959-2 CUM. BULL. 475, a position adopted by a number of courts. See, e.g., *Foremost Dairies, Inc. v. Tomlinson*, 238 F. Supp. 258 (M.D. Fla. 1963), *aff'd per curiam*, 341 F.2d 580 (5th Cir. 1965).

carryover transferability can be extracted from the averaging concept.

### III. A THEORETICAL APPROACH

The argument one frequently hears for limiting loss carryover transferability is that free transfer would permit persons who did not incur the economic detriment of a net operating loss to reap the benefits of the resulting carryover.<sup>73</sup> But this argument is inadequate. If it is safe to assume that Congress did not and does not intend to achieve a system of averaging whereby the Treasury pays out (to someone) the full tax value of *all* net operating losses, the argument less justifiably assumes that, were carryovers freely transferable, their market value would not equal the potential tax savings they represent. Were the market value equal or nearly equal, the "owner" of the net operating loss would in fact reap the benefit of his carryover, but through transfer rather than through a reduction of taxes. As proponents of restricted transferability seldom explore this question, one suspects they fear a discomforting answer.<sup>74</sup> In addition, proponents of restricted transferability tend to use this quasi-moralistic argument to support decisions to which it simply does not apply; in *Libson Shops*, for example, the *people* who incurred the losses were deprived of the benefits of the carryovers, because different taxpaying entities were technically involved. What all this means is that there is no easy answer to the loss carryover transferability problem and no glib rationale which can convincingly support a proposed answer. It remains to be seen whether an arbitrary solution is the only alternative.

An individual taxpayer (other than a nonresident alien) may offset a net operating business loss against taxable income from any source. Likewise, he may use a loss carryover to offset past or future taxable income from any source. Although an

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73. See, e.g., *Advisory Group Hearings* 836 (Statement of Bernard Wolfman).

74. The market value of loss carryovers has been estimated at anywhere from 10-30% of the dollar value of the losses. Cf. *Advisory Group Hearings* 840-41 (Statement of Bernard Wolfman). Commentators have suggested that even freely transferable carryovers would sell at a significant discount because of the losing businessman's unfavorable bargaining position and the risk that a purchaser will fail to generate sufficient offsetting profits. See ALL, INCOME TAX PROBLEMS OF CORPORATIONS AND SHAREHOLDERS 41 (1958). Whether or not that is true, greater certainty in the law of carryover transferability would surely improve the marketability of those carryovers which can legally be transferred.

individual may not sell a carryover to another taxpayer, he may raise additional capital through loans or gifts and offset carryforwards against income derived from that capital. And he may join a partnership and offset his share of partnership income with his own loss carryovers.<sup>75</sup> The previous historical survey makes clear, however, that corporations do not enjoy so presumptively free a use of net operating loss carryovers. Certain inherent differences between a corporation and an individual may explain this different treatment. First, ownership of a corporate taxpaying entity may be transferred through sale of stock; since an individual and his "tax attributes" cannot be sold, this adds a new dimension to the transferability of a loss carryover. Second, a corporation has greater potential for utilizing carryovers because it is usually able to expand its capital more rapidly and to a larger extent than can an individual. And this expansion is more likely to come from outside sources which assume an ownership position.

There is only one provision in the Internal Revenue Code of 1954 which creates a net operating loss deduction and carryover (section 172); it applies to individuals and to corporations alike. Therefore, the most sensible and fairest standard for developing rules governing corporate loss carryover transferability is to give corporations, to the greatest degree possible, the same freedom to "transfer" (and no more) that individual taxpayers have.<sup>76</sup> With this fundamental guideline, the problem is to determine what additional restrictions must be imposed because of the greater freedom to transfer inherently provided by the corporate form of doing business. The problem will be approached by hypothesizing a corporation having substantial loss carryovers and little prospect of generating future income with its existing operations.

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75. That individuals should have such free use of loss carryovers is not an inevitable concomitant to such a deduction. In England, for example, prior law permitted an individual to carry forward business losses for one year against income from unrelated sources but indefinitely against subsequent income of the business that incurred a loss. See G. WHEATCROFT, *THE LAW OF INCOME TAX, SURTAX AND PROFITS TAX* ¶ 1-666, 1-667 (1962). However, the author accepts the present United States law as economically and socially sound.

76. The position that corporations should have less freedom to transfer loss carryovers than individuals seems hard to justify. That the corporation is an inanimate "person" with fragmented ownership makes it a less appealing entity upon which to bestow averaging benefits. But the basic structure of our federal tax laws gives to the extent possible the same deductions, credits, and allowances to all business entities.

## A. SALE OF ASSETS

If the corporation, with no ownership change, sells its present business and uses the proceeds to buy another, analogy to averaging benefits conferred upon individuals dictates retention of the carryover. In economic terms, also, it seems sound that any taxpayer should not be discouraged from discarding a losing venture and beginning a new business.<sup>77</sup> Finally, since one corporation can average losses from one business with gains from another business in the same year, does not the basic purpose of the loss carryover require that the same averaging be permitted across the tax year barrier?

Some commentators, particularly labor groups, have contended that allowance of carryovers in this situation stimulates unemployment and premature termination of businesses needing only additional capital to survive.<sup>78</sup> But the same can be said when the carryover is allowed to an individual under these circumstances. Whether the tax laws should act affirmatively to discourage dissolution of unprofitable businesses (and, if so, how) is a political question; the averaging concept as enacted thus far has not adopted this view, and the argument seems analytically misplaced when directed solely at restricting corporate loss carryovers. The courts have not shown a propensity to disallow carryovers in this change-of-business situation. Although the doctrine of *Libson Shops* could arguably be so interpreted, neither the Treasury,<sup>79</sup> the courts,<sup>80</sup> nor the Congress<sup>81</sup> has adopted such an extension.

## B. INVESTMENT OF ADDITIONAL CAPITAL

If the loss corporation's shareholders invest additional capital to create carryover-offsetting income, should carryovers be eliminated? The averaging concept envisions additions to capital as a means of reversing carryover-producing failures. A contrary law might discourage rehabilitation. While the greater

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77. "[T]he recoupment of a loss by the expansion or change of an unsuccessful business is a legitimate business purpose and one which the loss carryover provision is intended to assist." Tarleau, *Acquisition of Loss Companies*, 31 TAXES 1050, 1055 (1953). See S. REP. NO. 627, 78th Cong., 1st Sess. 58 (1943); Speiller, *supra* note 61, at 28.

78. *Advisory Group Hearings* 879-80 (Statement of Textile Workers Union of America).

79. See Rev. Rul. 63-40, 1963-1 CUM. BULL. 46.

80. See, e.g., *Maxwell Hardware Co. v. Commissioner*, 343 F.2d 713 (9th Cir. 1965).

81. Compare § 382(a).

ability of a corporation to generate such an influx of capital has been noted, this difference in structure between corporations and individuals does not seem great enough to justify a different rule as to carryover survival so long as survival furthers the purpose of equitable income averaging. Finally, contributions to capital of a modern corporation take many forms; a rule eliminating carryovers in all cases would be patently unjust while a rule attempting to isolate certain "suspect" contributions would create uncertainties that would plague the managers of a loss corporation.

### C. CHANGE IN OWNERSHIP

The issue is more difficult when a losing corporate enterprise undergoes a change in ownership. The economic burden of a net operating loss falls, it might be supposed, upon the shareholders of a corporation. Taking this view, it is arguable that a corporation with new owners should be equated with any newborn business by eliminating carryovers. One question is immediately provoked: how great a change of ownership, given the diverse ownership of at least publicly-owned corporations, should necessitate elimination of carryovers? Even cursory consideration of this question forces recognition that the corporation is indeed an entity distinct from its shareholders, transfer of which does not normally affect its independent existence. In general, our tax laws recognize this corporate entity by leaving corporate tax attributes unaltered when stock is transferred.

No one has seriously contended that carryovers should be eliminated by minor, everyday shifts in the ownership of a publicly-held corporation.<sup>82</sup> There have been proposals, however, to terminate carryovers after a substantial shift signifying transfer of control.<sup>83</sup> By ignoring the corporate entity, such a rule would in some cases destroy averaging of gains and losses of a single business enterprise. Furthermore, such a proposal seriously oversimplifies economic realities: for one thing, the burden of a net operating loss may not have "fallen" by the time of sale on those who happened to own stock when the loss was incurred; or part of this loss may be recovered by sale of the stock if carryovers are permitted to survive a transfer. More

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82. Note how § 382(a)(2) prevents that statute from affecting diversely owned corporations. *See also* Commercial Indus. Corp. v. United States, 19 Am. Fed. Tax. R.2d 1669 (D.N.J. 1967).

83. *See* ALI, INCOME TAX PROBLEMS OF CORPORATIONS AND SHAREHOLDERS 341-48 (1958).

important, emphasis on the corporation's shareholders overlooks the impact of a net operating loss on the managers, creditors, and employees of a corporation.<sup>84</sup> These groups, who all benefit by survival of a carryover, establish a corporate business entity independent of the shareholder-owners, who may or may not play a significant role in managing the enterprise. Can it fairly be said that only the shareholders are entitled to the benefits of income averaging through the loss carryover? Though the question is not free from doubt, the author believes that carryovers should not be eliminated by a change in corporate ownership alone.<sup>85</sup>

#### D. TERMINATION OF BUSINESS AND CHANGE IN OWNERSHIP

If the loss corporation's losing enterprise is terminated and a controlling block of its stock sold, there is no averaging principle that requires carryovers to survive. This is the most common form of "trafficking in loss corporations." Transfer in such cases, regardless of whether the corporation is kept alive by the transferee through an infusion of new assets, is in substance identical to a sale of the loss carryover as an asset. Such sales are not allowed to individuals nor to corporations: that the issue is beclouded because stock is sold rather than the carryover itself should not change the result.<sup>86</sup>

The basic principle outlined above is that change of business or ownership alone should not affect carryovers but termination of business with change of ownership should. At this point, the carryover transferability problem is reduced to analyzing possible variants and to formulating workable rules. Unfortunately, flexibility in modern corporate law makes these variants innumerable. Perhaps most difficult from a theoretical standpoint is the transaction joining two operating businesses and its converse, a divisive reorganization.<sup>87</sup> If a loss corpora-

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84. Note Judge Magruder's phrasing in *Newmarket Mfg. Co. v. United States*, 233 F.2d 493, 497 (1st Cir. 1956), *cert. denied*, 353 U.S. 983 (1957).

85. This conclusion was also reached by the Advisory Group on Subchapter C. See *Advisory Group Hearings* 568.

86. A purchase of stock was treated as a purchase of assets for basis purposes when the acquired corporation was liquidated immediately subsequent to the stock purchase in *Kimbell-Diamond Milling Co. v. Commissioner*, 187 F.2d 718 (5th Cir. 1951). Compare § 334 (b) (2). The *Kimbell-Diamond* doctrine seems applicable here.

87. It has been argued that carryovers should not survive corporate combinations because tax laws should not encourage large accumulations of corporate wealth and power. See Lanning, *Tax Erosion and the "Bootstrap Sale" of a Business*, 108 U. PA. L. REV. 943, 951



tion acquires a profitable business through its own capital or that of its existing shareholders, the above analysis indicates that, *a fortiori*, loss carryovers should survive. But often a merger involves some change in the loss corporation's ownership; it may also involve the combining of two enterprises under completely new owners.<sup>88</sup> Rigid application of the corporate business entity<sup>89</sup> theory dictates a survival of the carryover because the enterprise that incurred the loss has survived in merely an expanded form. However, change of ownership has created some carryover transferability not available to individuals while change of business, depending on the extent, may be tantamount to termination of the original corporate business entity. Thus, carryovers should not survive all mergers. It does not seem possible to draft a rule that will do justice to all principles in all cases. The answer appears to turn on an assessment of relative "dangers." Since taxpayers are free to manipulate transactions as they wish, the danger of permitting carryovers to survive mergers that are in substance a change of ownership and a termination of the loss corporation's business seems greater than the danger of disallowing carryovers improperly. It is both appropriate and workable, therefore, to limit carryovers any time ownership *and* business are substantially altered by a transaction; at that point neither entity which is arguably entitled to averaging benefits—ownership and business—has survived to claim those benefits.<sup>90</sup>

Given such a principle in the merger situation, the question must be faced: when a sufficiently substantial alteration of a loss corporation occurs through merger, should carryovers be eliminated entirely or should they survive (a) to the extent

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(1960). However, since not all mergers are undesirable, an indiscriminating revenue statute is an inappropriate vehicle for accomplishing an anti-bigness aim. See E. J. Brown, *An Approach to Subchapter C*, 3 TAX REVISION COMPENDIUM 1619, 1622 (House Comm. on Ways and Means 1959).

88. A similar problem exists when a loss corporation receives new capital in exchange for additional common stock in what may or may not be a § 351 tax free transaction.

89. Corporate business entity as used here does not refer to the formalistic *New Colonial* approach that stressed the technical "being" of each chartered corporation; rather, a corporation is viewed as an economic and taxpaying entity, regardless of its personage, at the time a loss is incurred.

90. Deferred for the moment are questions of what should constitute a "substantial" change of business or ownership. See Part V *infra*. However, the above analysis seems clearly applicable to tax free as well as taxable mergers. Therefore, whichever test is better, the difference in approach in §§ 382(a) and (b) does not make sense.

that former owners retain an interest, or (b) to the extent that assets of the loss corporation comprise a portion of the resultant enterprise, or (c) to the extent that both ownership and business continue? Interpreters of *Libson Shops* have assumed that the Supreme Court laid down an assets tracing test after corporate amalgamations.<sup>91</sup> Though commentators have criticized this approach on the ground that the resultant corporation is a unified business venture and a tracing of any one constituent is impractical,<sup>92</sup> it might be administratively sensible to allow a portion of prior carryovers based on the percentage of the resultant's net assets originally derived from the loss constituent,<sup>93</sup> or to base partial survival on relative ownership interests in the resultant.

However, it is suggested that such a partial allowance is improper. The purpose of averaging through carryovers does not depend upon the type or amount of assets existing when a loss was incurred. Allowance of carryovers after an alteration of a corporate taxpayer depends upon sufficient continuity in the taxpaying entity, whether the continuity be ownership or business. When that continuity by definition is lacking, there seems no reason to allow any part of a carryover to survive. So long as the rules devised are predictable enough so that those entitled to averaging benefits can preserve them if they so wish, a partial disallowance rule—which would surely be complex—seems unnecessary.<sup>94</sup> On the other hand, when substantial ownership continuity exists, existence of new “equity” interests should not justify partial disallowance given the comparable freedom of individuals and corporations to expand business as-

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91. See Rev. Rul. 59-395, 1959-2 CUM. BULL. 475, 478; cases cited note 48 *supra*.

92. See, e.g., *Julius Garfinckel & Co. v. Commissioner*, 335 F.2d 744 (2d Cir. 1964) (Friendly, J.), *cert. denied*, 379 U.S. 962 (1965); Arent, *Current Developments Affecting Loss Corporations*, 35 TAXES 956, 963 (1957).

93. See Brown, *supra* note 87, at 1628-30 (allocate by net asset basis); Note, *Corporate Reorganization and Continuity of Earnings History: Some Tax Aspects*, 65 HARV. L. REV. 648, 659 (1952) (allocate according to “assets”). See also Buffington, *Carry-Overs in Reorganizations: Corporate or Tax Entity Approach*, 32 TAXES 575, 580-83 (1954), which lists alternative methods of allocation.

94. It has been suggested that complete elimination is inequitable to minority shareholders. See *Advisory Group Hearings* 570. Even if true, it is hard to see why this group has a particularly strong claim to averaging benefits. In this respect, the analogy to individuals must be imperfect, and disagreement, to say nothing of arbitrariness, may be unavoidable.

sets through loans, gifts, and other influxes of capital without affecting carryovers.

Whether carryovers should survive a divisive reorganization is a somewhat different question. Although ownership and business of each resultant will presumably differ from that of the predecessor, most of the original owners will probably retain the same total financial interest. As ownership of the total losing enterprise is not changed by such a divisive reorganization, it seems analogous to an individual's disposing of one of two operations, and carryovers should survive. But while the divisive reorganization is not an abuse of the averaging concept, it does complicate matters because each resultant is owned by at least some of the original owners. To insure that each group of loss corporation shareholders in fact receives a proportionate benefit from the carryover, allocation of the carryover now seems unavoidable. Earnings and profits have been allocated after such reorganizations,<sup>95</sup> so the task should not prove insurmountable. Unlike earnings and profits, however, the loss carryover is a beneficial tax attribute, and the allocation rules would surely have to be different.<sup>96</sup>

#### E. CONCLUSION

The above analysis as a whole would seem to provide a sound

95. See, e.g., *Estate of Howard H. McClintic*, 47 B.T.A. 188 (1942). The conclusion that allocation is appropriate only in the divisive reorganization situation was reached, after analysis based upon tax free reorganization provisions, in *Buffington*, *supra* note 93, at 582.

96. Since it is ownership continuity which warrants carryover survival in this situation, the aim should be an allocation method which distributes the carryover so that each shareholder retains the benefit of an equitable proportion. Two allocation formulas come to mind:

$$\frac{\text{Carryover allocated to a resultant}}{\text{Total pre-reorganization carryover}} = \frac{\text{Investment in resultant by loss corporation owners}}{\text{Investment in loss corporation before division}}$$

or

$$\frac{\text{Carryover allocated}}{\text{Total carryover}} = \frac{\text{Net fair market value of assets received by resultant}}{\text{Net fair market value of loss corporation assets before division}}$$

Neither formula allows for shareholders eliminated during the division, but that seems unavoidable; hopefully, knowledge that the carryovers will survive would increase the amount they realize upon elimination. Whatever the allocation formula, if any resultant underwent, either pursuant or subsequent to a divisive reorganization, change of business (which is nearly always present) and substantial infusion of new owners, its portion of the carryovers should be eliminated as in other situations.

and consistent theoretical framework in which to solve problems of corporate loss carryover transferability. But an acid test remains—application of these principles to actual problems. For this purpose, a number of situations troublesome under present law have been selected for further analysis. With each, the “correct” theoretical solution will be sought, but within the framework of the 1954 Code, both to illustrate problems under that statute and to suggest ways in which it can be interpreted to provide the most consistent approach possible to the loss carryover transferability issue.

#### IV. SPECIFIC PROBLEMS UNDER THE 1954 CODE

##### A. SINGLE CORPORATION TRANSACTIONS

Section 381 of the 1954 Code covers a number of situations in which a single loss corporation alters its structure in such a way that loss carryovers have been “transferred.” Section 381 links carryover inheritance to tax free transactions. Although survival of other tax attributes is often made to depend upon whether a transaction is tax free, this factor seems irrelevant to loss carryover transferability. Survival of corporate carryovers should depend upon business or ownership continuity; these can be altered as greatly in a tax free transfer as in some that are taxable.<sup>97</sup> Nevertheless, section 381 often produces a theoretically desirable result. The clearest example is that of a section 368(a)(1)(F) reorganization, a “mere change in identity, form, or place of organization, however effected.”<sup>98</sup> Since continuity of ownership and business remain, section 381 properly overrules cases harshly disallowing carryovers on authority of *New Colonial*.<sup>99</sup>

Section 381 omits reference to the section 368(a)(1)(E) or recapitalization reorganization, presumably for the same unex-

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97. See *Advisory Group Hearings* 838 (Statement of Bernard Wolfman). Certain tax attributes, such as the basis of assets acquired in a (C) reorganization, must survive if tax deferral rather than tax reduction is to result. Others, such as earnings and profits after an (F) reorganization, should survive if the tax balance sheet is to balance. Neither argument for linking survival to tax free status is pertinent to loss carryovers.

98. In Rev. Rul. 57-276, 1957 CUM. BULL. 126, the Treasury announced that, for purposes of § 381, an (F) reorganization that also fits the definition of other § 368 reorganization provisions will be treated as an (F) reorganization. This is significant for questions of carrybacks and tax year determinations. Compare *Estate of Stauffer*, 48 T.C. 277 (1967).

99. See, e.g., *Weber Flour Mills Co. v. Commissioner*, 82 F.2d 764 (10th Cir. 1936).

pressed reason that insolvency reorganizations were omitted.<sup>100</sup> This is unfortunate. While a recapitalization often involves a significant change of equity ownership, the business entity usually remains unchanged. If the foregoing theoretical analysis is sound, carryovers should survive.<sup>101</sup> In the *New Colonial* era, carryovers often survived a recapitalization simply because the corporate entity survived. A recent case under the 1939 Code casts doubt on this doctrine,<sup>102</sup> and omission of (E) reorganizations from section 381 may prompt courts to decide that Congress intended a different result than with (F) reorganizations. Hopefully, however, carryovers will be permitted to survive.

Section 381(a) (1) permits the loss carryforwards<sup>103</sup> of an eighty per cent controlled subsidiary to survive a section 332 tax free liquidation of the subsidiary, except when the basis of assets received is determined under section 334(b) (2). The intent of this provision is sound. Although there is normally a change of business upon a "merger" through liquidation, liquidation of a controlled subsidiary involves no more than a minor change of ownership and carryovers of the subsidiary should not be affected. Section 334(b) (2), on the other hand, involves a liquidation within two years of acquisition of a subsidiary's stock. In this situation, assuming the subsidiary is a loss corporation,<sup>104</sup> there has been within a short period of time a change of ownership and business, and carryovers should be eliminated.

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100. See pp. 607-10 *infra*. The reason for this omission is puzzling. Since carryovers had been allowed after some insolvency recapitalizations, see, e.g., *In re Kepp Elec. & Mfg. Co.*, 98 F. Supp. 51 (D. Minn. 1951), Congress might have thought recapitalization, which involves no change of corporate entity, did not require explicit conferral of carryover survival. See Germain, *Carryovers in Corporate Acquisitions*, 15 *Tax L. Rev.* 35, 40 (1959). Compare Rev. Rul. 54-482, 1954-2 *CUM. BULL.* 148, allowing carryovers after (E) reorganizations under the 1939 Code. On the other hand, omitting (E) reorganizations may be related to the traditional harsh view of carryovers after insolvency reorganizations illustrated by *New Colonial*.

A more likely explanation, assuming no oversight, is that § 381 requires survival of certain tax attributes, such as earnings and profits, that should not survive all recapitalizations; thus, Congress chose to leave carryovers to fend for themselves under prior law.

101. See text accompanying notes 82-85 *supra*.

102. *Willingham v. United States*, 289 F.2d 283 (5th Cir.), *cert. denied*, 368 U.S. 828 (1961).

103. For a discussion of 1954 Code rules as to carrybacks, see pp. 610-12 *infra*.

104. Section 381(a) (1) deals only with cases where the liquidated company possessed the loss carryover. If the profit corporation is liquidated into the loss corporation, other rules apply (in this case, §§ 382 (a) and 269).

While section 381(a)(1) essentially adopts the change-of-ownership and change-of-business standards for carryover survival, it unfortunately contains errors of omission. For instance, a liquidation that fails to comply with the technical requirements of section 332,<sup>105</sup> but involves essentially liquidation of a long-controlled loss corporation subsidiary, should not result in elimination of carryovers; regardless of the tax consequences of the liquidation, continuity of loss corporation ownership exists. Conversely, a liquidation which avoids the technicalities of section 334(b)(2), a fairly easy thing to do, should nevertheless result in elimination of loss carryovers, whether or not section 332 is applicable, if it involves in substance changes of ownership and business within a short period of time.

To summarize, the substance of each liquidation should be assessed in terms of basic loss carryover principles regardless of what other tax rules attend the liquidation. Since section 381 treats many liquidations of loss corporations appropriately and obviously does not explicitly cover all of them, enlightened judicial interpretation could achieve sound results in most cases. This belief, to be repeated throughout the discussion in this Part, stems mainly from a conviction that the many gaps in sections 381 and 382 compel a conclusion that Congress anticipated survival of some flexible "common law" as to loss carryover transferability. By eliminating the statutory reference to "the taxpayer" and by stating its preference for realistic economic analysis, Congress should be deemed to have rejected the common law of the *New Colonial* period. The most rational substitute is not the congressionally unpredicted and economically questionable doctrine of *Libson Shops*, but rather rules which decide cases not expressly governed by sections 381 and 382 in a manner consistent with the purposes behind those provisions.<sup>106</sup>

Section 382(a), applicable when a change of ownership of a loss corporation occurs by "purchase" (defined as an acquisition of stock in which basis is determined by the purchaser's cost),<sup>107</sup> eliminates carryovers entirely if ownership has changed

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105. Distribution in complete cancellation of stock must occur within a taxable year or within three years if the plan of liquidation calls for a series of redemptions. Section 332(b).

106. It should be noted that the unfortunate § 382(b) standard is not applicable to liquidations covered by § 381(a)(1). Therefore, it is peculiarly logical in this situation to apply the more general change of ownership plus change of business standard, proposed in Part III and codified to a limited extent in § 382(a), to liquidations of loss corporations not specifically covered by § 381.

107. Section 382(a)(4).

significantly (determined by an elaborate objective test) and if there has been a "substantial" change in business. If the conclusions of Part III are accepted, the standards set forth in this provision are basically sound.

Section 382(a) litigation has usually involved the elusive change-of-business requirement, which Treasury Regulations and congressional history have both attempted to define. It was suggested in Part III that continuity of the business entity should prevent elimination of carryovers after a substantial change in ownership of a loss corporation. However, given a substantial change of ownership, the danger or abuse of the corporate loss carryover is real, while the ability to control events lies with the taxpayer. Under these circumstances, the standard apparently envisioned by the Supreme Court in *Libson Shops* seems appropriate: has the business as constituted when losses were incurred been significantly altered? Reasonable leeway must be permitted so that new owners may rehabilitate a failing enterprise. Thus, a change in location, the Senate committee report notwithstanding,<sup>108</sup> should often be permissible. But any significant change in character of the business, including addition of a major new trade or business now permitted by the Regulations,<sup>109</sup> should result in elimination of carryovers.<sup>110</sup>

Between them, sections 381 and 382 cover many types of

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108. S. REP. No. 1622, 83d Cong., 2d Sess. 284-86 (1954).

109. Treas. Reg. § 1.382(a)-1(h) (8) (1962).

110. Existing case law interpreting § 382(a) (1) (C) seems generally sound. In *Wallace Corp.*, 33 P-H Tax Ct. Mem. 43 (1964), the new owners moved offices, switched personnel, streamlined production, and bought new machinery. All these activities are consistent with rehabilitation of the losing business, and carryovers were permitted. In *Koppers Co. v. United States*, 229 F. Supp. 159 (W.D. Pa. 1964), carryovers were allowed when new owners continued the losing business but purchased raw materials from a new source, one that they controlled. This, too, does not affect business continuity. However, when a losing business was recontinued after a long termination, or when only a minor portion of the original enterprise survived transfer and addition of a new venture, carryovers were properly disallowed. See *Euclid-Tennessee, Inc.*, 41 T.C. 752 (1964), *aff'd*, 352 F.2d 991 (6th Cir. 1965); *Fawn Fashions, Inc.*, 41 T.C. 205 (1963). Compare *Clarksdale Rubber Co.*, 45 T.C. 234 (1965). A hard case was *Goodwyn Crockery Co.*, 37 T.C. 355 (1961), *aff'd*, 315 F.2d 110 (6th Cir. 1963), where the losing business was wholesaling durable household goods. New owners were dry goods wholesalers, and they had petitioner buy a dry goods company and also expand into retailing. However, the old venture, revitalized, was continued. The question should perhaps turn on how much capital was supplied by the new owners to make these changes, *i.e.*, whether in substance a merger was effected. Carryovers were allowed on the ground that only a new trade was added. This test seems inadequate but the case itself is close.

single corporation alterations. However, a number of situations fall outside these specific provisions. Blatant examples of such omissions are section 351 tax free transfers to a controlled corporation (or any exchange of an individual's assets for stock),<sup>111</sup> and situations such as *Maxwell Hardware*, *Jackson Oldsmobile*, and *Glover Packing*, which arguably avoid technical change of ownership requirements in section 382(a).<sup>112</sup> It is not clear what principles Congress intended the courts to apply in such situations. The problem is complicated because judicial rules under the 1939 Code changed radically after 1954, primarily due to *Libson Shops*.

*Libson Shops* involved a merger situation now covered under section 381; the Supreme Court there reached a result in conflict with congressional rules formulated in sections 381 and 382 (b). Therefore, the Treasury and commentators seem correct in refusing to apply the *Libson Shops* change-of-business approach to section 381 transfers. Likewise, *Libson Shops* is not in harmony with section 382(a), and courts should not alter that section by adding a *Libson Shops* gloss to transactions that it covers. It might be argued that, since Congress in 1954 was faced with the absolute rule of *New Colonial*, carryovers should be eliminated in cases not within the ambit of sections 381 and 382. But this seems absurd in the case of single corporation alterations: *New Colonial* never had such broad application.<sup>113</sup> On the other hand, the court of appeals in *Maxwell Hardware* indicated that all carryovers should survive unless barred by section 269 or section 382. But this view ignores the framework of judicial resistance to carryover transferability within which Congress operated in 1954, and the obvious omissions and anomalies in the 1954 Code provisions. In substance, the 1954 Code altered specific prior doctrines (overruling *New Colonial*, *Stanton Brewery*, and *Alprosa*), though of course in fairly broad language. Too many situations were ignored to permit a conclusion that this was a comprehensive specific statute. The answer, as one might suspect and as the Commissioner appears to suggest in

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111. Cf. *Joseph E. Seagram & Sons, Inc.*, 46 T.C. 698 (1966). It is assumed that a corporation may always purchase new assets for cash without affecting its carryovers.

112. The *Glover Packing* decision, see text accompanying notes 55-56 *supra*, which foiled a flagrant attempt to circumvent § 382(a), seems clearly correct. An expansive reading of § 382(a)(1) is preferable to the approach in *Maxwell Hardware*, where the Tax Court and the court of appeals rather passively abandoned that provision and the congressional purpose it manifests.

113. See, e.g., *Northway Sec. Co.*, 23 B.T.A. 532 (1931).



a recent ruling,<sup>114</sup> seems somewhere in between: Congress must have anticipated some "common law" (or common sense) of loss carryover transferability to govern situations not covered by statute.

However, as the Commissioner recognizes, it does not necessarily follow that *Libson Shops* is the proper common law approach for the 1954 Code. Congressional principles in the 1954 Code should be the basis of this common law; *Libson Shops*, for many reasons, simply bears no relation to 1954 statutory principles. The most far-reaching expression of congressional purpose in the 1954 Code seems to be the change-of-business-change-of-ownership definition of trafficking in loss corporations found in section 382(a). It is contended that this test should be applied to all single corporation cases outside specific coverage of sections 269, 381, and 382. As to this aspect of the loss carryover problem, this approach agrees with the present position of the Internal Revenue Service.

Having suggested a general approach to single corporation cases, a moment should be spent on the facts of *Maxwell Hardware*<sup>115</sup> and *Jackson Oldsmobile*.<sup>116</sup> It is true that there was no change of equity ownership in either case and that therefore section 382(a) was apparently inapplicable.<sup>117</sup> In addition, there was no acquisition of control within the meaning of section 269 and no section 381 tax free transaction. Thus, the broad question in each case was whether the court could properly go beyond the confines of these provisions and seek a more general congressional intent from the structure and language of sections 172, 381, and 382. This is never an easy question; if anything it is harder than usual in the taxation realm. But with this problem, we can know with fair certainty that Congress desired that at least section 382(a) be all-inclusive. Given the general preoccupation with economic realities in 1954, this seems reason enough to apply the standard of that section to cases within its identifiable scope of application.

Framed in this manner, the *Maxwell Hardware* decision was wrong. The owners of the hardware business had no control and little share in the profits of the real estate venture. They in fact gained no more than technical and temporary ownership

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114. T.I.R. No. 773 (Oct. 13, 1965).

115. 343 F.2d 713 (9th Cir. 1965).

116. 237 F. Supp. 779 (M.D. Ga. 1964), *aff'd*, 371 F.2d 808 (5th Cir. 1967).

117. *But see* note 56 *supra*.

of the profit enterprise. It does not even seem necessary to measure their relative share of the resultant to conclude that a carryover of hardware losses to real estate income involved a substantial change in ownership continuity. The change in business was obvious; carryovers should not have survived.

Even conceding some judicial leeway to broaden the scope of section 382(a), *Jackson Oldsmobile* was a difficult case. A change of business did occur, but equity ownership remained the same. The question is whether change of management combined with a change in *potential* ownership if the new business proves profitable constitutes a sufficient change in the taxpaying entity. This is a perplexing question of fact inadequately analyzed by a district judge whose abstract discussion of applicable legal principles was in many ways laudable. On the one hand, GM assumed ownership of the corporation mainly to insure recovery of its loan to the dealer (and to gain an outlet for its cars). Because GM's return was limited, greatest benefit from the carryovers flowed to the new Georgia owner; GM profited by allowance only in that its loan was repaid faster (unless the Georgia dealership proved profitable for only a short period). On the other hand, GM made the principal capital investment and was, for business reasons, legal owner during the period in question. Probably this is not a case where equity ownership should have been ignored; thus, carryovers were properly allowed.

The foregoing discussion has intentionally omitted significant reference to section 269. The author feels that a taxpayer's state of mind should be irrelevant to all tax questions except, of course, those of fraud and criminal conduct. Provisions like section 269 seem essentially admissions that Congress and the courts cannot be relied upon to enact and to interpret an effective revenue law.<sup>118</sup> Furthermore, section 269 should not disallow

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118. See Cohen, *Tax Avoidance Purpose as a Statutory Test in Tax Legislation*, TUL. 9th ANN. TAX INST. 229 (1960). The Commissioner's victories under § 129 and § 269 almost invariably have involved change of ownership and change of business. Only *Huddle, Inc.*, 20 CCH Tax Ct. Mem. 745 (1961), arguably did not involve a change of business. However, emphasizing taxpayer intent has led to some strained analysis in cases in which carryovers would obviously be disallowed under a change-of-ownership-change-of-business test. See *H.F. Ramsey Co.*, 43 T.C. No. 42 (1965); *Jeremiah J. O'Donnell, Jr.*, 33 P-H Tax Ct. Mem. 232 (1964). And a rule under which only the ignorant prevail seems patently absurd. An interesting case is *Brick Milling Co.*, 32 P-H Tax Ct. Mem. 1824 (1963), where the Tax Court held that donation of the stock of a loss corporation to another controlled corporation falls under the "acquisition of control" test in § 269(a)(1). Under a comprehensive

carryovers when a loss corporation purchases a new business partially to utilize its own existing carryovers,<sup>119</sup> not because the purpose is only in part tax oriented, but because the averaging concept is not violated.<sup>120</sup>

## B. UNIFYING TRANSACTIONS

A major change accomplished by Congress in section 381 was replacement of the *New Colonial-Stanton Brewery* uncertainties and formalisms with an economic test of carryforward transferability after tax free unifying reorganizations. Although present statutory doctrines are certainly an improvement over prior case law, the economic test established by section 382(b) is undesirable.<sup>121</sup> To illustrate, consider the following hypothetical situations: (1) Individual A owns one hundred per cent of the stock of loss corporation (L) and sixty per cent of profit corporation (P), while individual B owns the remaining forty per cent of P. L's assets have been sold to pay debts, and A now wishes to merge P and L so as to utilize L's loss carryover. B is willing to gain the carryover benefit, but he will block the merger unless he can retain a forty per cent interest in the resultant. If a statutory merger (section 368(a)(1)(A) reorganization) takes place according to B's wishes, section 382(b) will disallow L's entire carryover (whether P or L is technically the acquiring corporation) because A will not then own any stock in the resultant "as the result of [A's] owning stock" in L "immediately before the reorganization."<sup>122</sup>

(2) The facts are the same as above except that B owns forty per cent of L as well as forty per cent of P. Now if P and L undergo a statutory merger, all of L's carryover will survive because of the exception in section 382(b)(3) for cases where

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change of ownership test, carryovers should survive: in effect, though not in fact, shareholders of the loss corporation have fed in a large amount of new capital. Perhaps the taxpayer should lose for structuring his transaction so badly, but the Tax Court's use of § 269 in this case seems indefensible. (Note: the case also involved redemption of an independently owned one-half interest in the loss corporation, a potential ground for disallowance under a comprehensive change of ownership test.)

119. That this is a common business practice is apparent. See, e.g., Little, *Why Companies Sell Out*, *FORTUNE*, Feb., 1956, at 117, 118; Murphy, *Sonnabend's Sackful*, *FORTUNE*, Sept., 1958, at 133.

120. See note 77 *supra*.

121. The author has not analyzed the specific mechanical restrictions placed on carryovers in § 381(c)(1).

122. Compare *Commonwealth Container Corp.*, 48 T.C. 483 (1967), discussed p. 583 *supra*.

“the transferor corporation and the acquiring corporation are owned substantially by the same persons in the same proportion.”

(3) Now assume that *A* owns one hundred per cent of *L* and *B* owns one hundred per cent of *P*. After statutory merger, *A* owns twenty per cent and *B* owns eighty per cent of the resultant (which is comprised of *P*'s assets and *L*'s carryover). Section 382(b) has been satisfied; the entire carryover will be allowed unless the Commissioner can successfully attack the transaction under section 269.<sup>123</sup>

The preceding theoretical discussion should have made clear that the above hypothetical situations pose difficult problems, but the author submits that section 382(b) does not supply rational answers. Hypothetical (2) involves no change of ownership; the question is whether business owners should be able to realign their taxpaying entities so as to reap averaging benefits which they *would have had* had they structured the businesses properly in the first place. *Libson Shops* and its progeny<sup>124</sup> thought disallowance proper, but the author agrees with the 1954 Congress that carryovers should survive.

Hypothetical (1) adds a forty per cent change of ownership to the problem raised by (2). The argument for disallowance is clearly far stronger, but the “as the result of” test in section 382(b) fails to focus upon the extent of the total ownership change in the loss corporation. Hence, section 382(b) must produce anomalous results, at least if one agrees that total ownership change is the relevant criterion. If hypothetical (1) were governed by the standards of section 382(a)(1), then *L*'s carryovers would have survived because the ownership change was only forty per cent. There has been no justification put forth for the historically unexplained<sup>125</sup> addition of a different standard in section 382(b) to control tax free transactions.

Section 382(b) errs on the side of leniency in hypothetical (3). Here is a clear attempt by *A* to sell his carryover to *B*. That *A* retains twenty per cent ownership interest “as the result

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123. There is a difference of opinion as to whether § 269 can be applied to transactions within the objective standards of §§ 381 and 382(b). See note 40 *supra*. Compare *Brick Milling Co.*, 32 P-H Tax Ct. Mem. 1824 (1963).

124. See *Frank Ix & Sons Virginia Corp. v. Commissioner*, 375 F.2d 867 (3d Cir.), cert. denied, 36 U.S.L.W. 3158 (Oct. 17, 1967).

125. The Senate in 1954 added § 382(b). Its committee report gave no reason for this change. S. REP. No. 1622, 83d Cong., 2d Sess. 53 (1954).

of" a tax free sale should not affect whether the carryover survives. Of course, the more stock A owns in the resultant, the stronger his argument for carryover survival. At some point, A will acquire enough ownership in the resultant to provide sufficient "continuity" of ownership. But twenty per cent continuity seems far too low to justify survival; hence section 382(b) has again produced an irrational variation from the fifty per cent change of ownership standard of section 382(a).

Turning to more specific problems, some commentators have criticized the omission of (B) reorganizations from the ambit of section 381.<sup>126</sup> However, the (B) reorganization by itself is merely a change of ownership. Under the author's approach, carryovers should survive unless: (a) original owners of the loss corporation retain a small enough interest in whatever entity results so that in effect there has been a substantial change of ownership, *and* either (b) the loss corporation is merged into another through liquidation subsequent to such (B) reorganization, or (c) sufficient new assets are promptly fed into the loss corporation to comprise a substantial change of business. It is doubtful that either transaction would survive unscathed under the 1954 Code.<sup>127</sup>

Another error on the side of leniency in section 382(b) permits carryovers to survive if the original loss corporation owners receive a twenty per cent interest in the resultant through voting preferred stock, essentially a fixed obligation argued one commentator.<sup>128</sup> As in other areas of federal tax law, allowance may or may not be proper in a particular case. The core of this problem lies, in the author's opinion, in trying to enact specific objective rules defining change of ownership in terms of formal rights attending a class of stock rather than in terms of economic interests the security represents. Because section 382(b) is less flexible than corporate law, undesirable reliance on section 269 may be necessary to curb abuses.

### C. DIVISIVE REORGANIZATIONS

Congress intentionally<sup>129</sup> omitted divisive, section 368(a)(1)

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126. See Lanning, *Tax Erosion and the "Bootstrap Sale" of a Business*—II, 108 U. PA. L. REV. 943, 960-61 (1960).

127. The Regulations treat the former situation as a (C) reorganization, see Treas. Reg. § 1.381(a)-1(b)(2); cf. Rev. Rul. 57-53, 1957-1 CUM. BULL. 291, and the Commissioner would no doubt have a carryover-limiting answer for the latter.

128. See ALL INCOME TAX PROBLEMS OF CORPORATIONS AND SHAREHOLDERS 341-48 (1958).

129. S. REP. NO. 1622, 83d Cong., 2d Sess. 52 (1954).

(D) reorganizations from section 381, leaving such transactions to fend for themselves under prior law with perhaps a presumption of nonsurvival because of pointed statutory omission.<sup>130</sup> It may be that Congress wanted no part of any rule requiring allocation of this beneficial tax attribute: the Supreme Court intimated in *Commissioner v. Phipps*<sup>131</sup> that earnings and profits are allocated only to preserve revenue-producing dividend characterization. Another reason for omitting divisives from section 381 may be that some section 381 attributes are not suited to allocation.

Although there is apparently only one reported case involving divisive reorganizations under prior statutes,<sup>132</sup> that loss carryovers should, in theory, survive some divisive reorganizations has already been noted. In addition, the tracing implications of *Libson Shops*, which can certainly be *relevant* to cases not covered by the 1954 provisions, are some further authority for adoption of an allocation formula. While it is not irrational to conclude that all divisive reorganizations involve sufficient change in continuity of a loss corporation to warrant carryover elimination, Congress has not clearly taken such a stand. In terms of general principles derivable from 1954 Code provisions, an allocation doctrine, to be judicially developed along lines tentatively set forth in Part III, seems the preferable solution.

#### D. INSOLVENCY REORGANIZATIONS

A large number of cases, including *New Colonial*, have dealt with the question of loss carryover survival after an insolvency reorganization. There are two basic methods of accomplishing such a reorganization: recapitalization of the insolvent corporation, or merger of the insolvent into a newly created corporation having a different capital structure. Either method may be accomplished by court order pursuant to Chapter X of the Bankruptcy Act.<sup>133</sup> Under the *New Colonial* doctrine, carryovers would not survive if the latter method was adopted but would if there were a mere recapitalization.<sup>134</sup> Even after *Stanton*

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130. The status of earnings and profits after a divisive reorganization is governed elsewhere in the Code. See Treas. Reg. § 1.312-10(c) (1967). As to other § 381 attributes, prior law should be controlling. See B. BITTKER, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS* 38 (1959).

131. 336 U.S. 410, 416-19 (1949). Compare § 312(i); Treas. Reg. § 1.312-10(c) (1960).

132. *Central Nat'l Bank*, 29 B.T.A. 530 (1933).

133. 11 U.S.C. §§ 501-676 (1950). See especially § 616(10).

134. See Mandell, *How Chapter X Reorganizations Affect the Net*

*Brewery*, insolvency mergers fared poorly because they generally did not fulfill requirements of a statutory merger under state law.<sup>135</sup> Two major criticisms can be levelled at these decisions. First, hinging carryover survival on the form of an insolvency reorganization seems absurd. The bankruptcy laws authorize alternative modes of reorganization to simplify prior law and to provide flexibility.<sup>136</sup> Substantively, there is little inherent difference whether the old corporation survives a bankruptcy proceeding. By treating only recapitalizations favorably, the tax laws discourage desired flexibility.<sup>137</sup> Second, a general rule eliminating carryovers is unfortunate. An insolvency reorganization is basically a reshuffling of ownership. But even that change may be more imaginary than real. Creditors of an insolvent corporation, who often inherit ownership, already have, at the time of reorganization, at least an inchoate equitable interest in the corporation's assets. And if it cannot be said that they have an equity interest in the corporation prior to reorganization, at least the economic interest of the stockholders has been greatly reduced by insolvency. Furthermore, creditors who must assume post-reorganization ownership are persons who suffered the economic detriment of prior losses. Finally, if one gives validity to the "help dying business" arguments of groups such as the AFL-CIO, carryovers should certainly survive an insolvency reorganization.

Congress omitted reference to insolvency reorganizations in section 381 of the 1954 Code. Section 381(a)(2) provides for the survival of carryovers in some reorganizations "to which section 361 [relating to nonrecognition of gain or loss to corporations] applies." Insolvency reorganizations are specifically governed by sections 371-374.<sup>138</sup> Section 371 sets forth operating rules in many ways similar to section 361; since some insol-

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*Operating Loss Deduction*, 28 TAXES 1059 (1950); Rev. Rul. 54-482, 1954-2 CUM. BULL. 148.

135. Compare *Wabash R.R. v. United States*, 164 F. Supp. 226 (Ct. Cl. 1958), with *Wisconsin Cent. R.R. v. United States*, 296 F.2d 750 (Ct. Cl. 1961), *cert. denied*, 369 U.S. 885 (1962).

136. See Krantz, *Loss Carryovers in Chapter X Reorganizations*, 16 TAX L. REV. 359, 363 (1961).

137. Carryovers are not, of course, the only tax considerations relevant in planning an insolvency reorganization. Whether gain or loss will be recognized, whether discharge of indebtedness will be considered income to the corporation, and whether assets will receive a carryover basis may, in some cases, be of paramount concern. *Id.* at 409.

138. Sections 373 and 374 pertain to railroad reorganizations; a specific statute, 61 Stat. 324 (1947), permits carryovers after such transactions.

veny reorganizations could meet requirements of sections 368 and 361 if section 371 were not controlling, some commentators have speculated whether the similarity of sections 361 and 371 would justify application of section 381 to all section 371 insolvency reorganizations; or whether at least those insolvency reorganizations which could satisfy section 361 should be deemed to fall within section 381.<sup>139</sup>

Certainly, any court would be hardpressed to answer either question affirmatively.<sup>140</sup> And problems would arise if section 381 were applicable to insolvencies. First, the successor to an insolvency reorganization would then inherit tax attributes other than loss carryovers. A deficit in earnings and profits, for example, would survive, and it has been strongly argued that, because the capital account is restructured in an insolvency reorganization, such a deficit should be reduced or eliminated.<sup>141</sup> Second, if section 381 applies, section 382(b) must be satisfied; since shareholders of the insolvent are often replaced by bondholders, the requisite twenty per cent continuity of ownership will be lacking unless, under section 382(b)(3), bondholders are interpreted as "owning" the insolvent prior to reorganization. One commentator concluded that because of these difficulties sections 381 and 382 cannot produce appropriate results and that congressional relief is needed.<sup>142</sup>

While a specific statute might be best, it need not be the only answer. As with divisive and (E) reorganizations, omission from section 381 should not preclude a judicial decision that purposes of section 172 are best served by allowing carryovers to survive insolvency reorganizations.<sup>143</sup> This decision is difficult to reach because prior law disallowed carryovers except in some cases of recapitalization and because tax free alterations should arguably be governed solely by sections 381 and 382(b). However, the outlook for imaginative judicial treatment permitting carryovers may be brighter here than in the case of divisive reorganizations: there is no unfavorable legislative history as to insolvency reorganizations; prior law permitted carryovers to

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139. See Krantz, *supra* note 136, at 363-67.

140. Not all insolvency reorganizations would qualify under § 368. See *Helvering v. Southwest Consol. Corp.*, 315 U.S. 194 (1942).

141. See Krantz, *supra* note 136, at 407-10.

142. *Id.* at 409. The Advisory Group on Subchapter C did not take a firm stand as to insolvency reorganizations, merely recommending that consideration be given "as a policy matter" to extending § 381. See *Advisory Group Hearings* 565.

143. Here, too, however, ownership and business may be changed so drastically in a particular transaction that carryovers should not survive.



survive insolvency recapitalizations arguably beyond the scope of section 381 and it would be anomalous to continue artificial distinctions;<sup>144</sup> and equities more strongly support carryover survival after an insolvency reorganization.

A particularly harsh approach to insolvency reorganizations was adopted by the Fifth Circuit in *Willingham v. United States*,<sup>145</sup> a recent decision involving the 1939 Code. The carryover issue arose as a defense to criminal prosecution for attempted tax evasion. That fact may have induced the court to adopt a strict view of carryovers; it held that carryovers do not survive an insolvency recapitalization when debt is wiped out, capital altered, and new ownership substituted because these changes destroy "continuity of business enterprise" within the meaning of *Libson Shops*. The court refused to follow the taxpayer's argument, based on *New Colonial*, that the corporate identity remained unchanged, relying instead on a factually distinguishable case.<sup>146</sup> *Willingham* has been criticized;<sup>147</sup> also it did not involve 1954 Code years and was peculiar in that a person who joined the corporation during reorganization was the only one who stood to benefit by a decision that carryovers survived. For these reasons, it should not control future cases. But its import, particularly its suggestion that a corporation which has had its debts wiped out in a bankruptcy reorganization is not deserving of an averaging benefit through loss carryovers, bodes ill for future cases of insolvency reorganizations unless the current statute is altered.

#### E. CARRYBACKS

The carryback has had a checkered history. In early years, no carrybacks were allowed, and the immediate congressional purpose for re-enactment in 1942 was merely to create a substitute for a postwar adjustments reserve deduction.<sup>148</sup> Although carrybacks have remained in the law as an averaging device, a

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144. They were "arguably beyond" because § 381 is limited by the § 382(b) continuity requirement and recapitalization may leave no shareholder continuity. Section 382(a) governs changes of ownership by purchase and is normally inapplicable to insolvency reorganizations. See Krantz, *supra* note 136, at 392-95.

145. 289 F.2d 283 (5th Cir.), *cert. denied*, 368 U.S. 828 (1961).

146. *Mill Ridge Coal Co. v. Patterson*, 264 F.2d 713 (5th Cir. 1959) (alternative holding). Change of business and ownership were distinct in *Mill Ridge*.

147. See Krantz, *supra* note 136, at 410-14.

148. See S. REP. No. 1631, 77th Cong., 2d Sess. 51-52 (1942).

net operating loss still may not be carried back as many years as it may be carried forward.

Cases involving carrybacks have been relatively rare. Although courts have not considered carrybacks to be analytically different from carryforwards, Congress in the 1954 Code specifically disallowed carrybacks in all section 381 situations except the (F) reorganization.<sup>149</sup> Section 382 (a), too, confusingly discusses only loss carryforwards, leaving the courts with perhaps an impression that carrybacks are treated differently after all alterations except the (F) reorganization.

A possible rationale, at least in the merger situation, for this unexplained congressional position is a desire not to reopen prior tax years of dissolved corporations. However, if allowance of loss carryovers should turn only on the question of continuity of the taxpaying entity, rules as to carrybacks should more closely parallel those as to carryforwards. When one corporation purchases another, the resultant should be able to carry back a postacquisition net operating loss only against income of the acquiring corporation because there is no ownership or business continuity between the resultant and acquired corporations. The question is more difficult in the case of unifying reorganizations because some continuity exists between the resultant and each constituent. It seems appropriate to allow a carryback in full to offset premerger income of any constituent as to which there is sufficient ownership and business continuity to justify survival of any premerger losses that constituent might have had. No carryback should be allowed to the income of any other constituent. Such a rule would avoid the problem of allocating any postmerger losses.

In the case of divisive reorganizations, the question is whether postdivision losses of one resultant may be carried back to offset the entire income of years prior to the division. Since, in most cases, only an allocated portion of a carryforward should be allowed to postdivision income of any one resultant,<sup>150</sup> this is a difficult question. In theory, predivision income should be allocated just as predivision losses are. Though allocation should be avoided where possible and though the simpler answer would be to allow any resultant its entire carryback, fairness to all owners of the predivision enterprise requires allocation as to carrybacks as well as to carryforwards.<sup>151</sup>

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149. Section 381(b)(3).

150. See text accompanying notes 95-96 *supra*.

151. Suppose AB Corporation earns \$100,000 in year 1. It splits up

In addition to the above difficulties in formulating technical rules for carryback survival, present congressional treatment of carrybacks prompts the largely unexplored question whether carrybacks are less important to the averaging principle than carryforwards. A goal of averaging is to stimulate new ventures by permitting early lean years to offset later lush years; the carryback is irrelevant to this purpose. Furthermore, it seems less important to the economy that a dissolving business be allowed a carryback than that an infant business be allowed a carryforward. For a going business, however, carrybacks are a logical part of averaging, and Congress was certainly wise to permit carrybacks to survive an (F) reorganization. The merger situation is more difficult. Perhaps Congress silently concluded that the resultant corporation needs only the same averaging benefits that a new company receives—but this theory proves too much because then all carryovers would have been eliminated. All things considered, it seems that any policy difference between carryforwards and carrybacks is not significant enough to justify different treatment, assuming that the administration of carrybacks after changes in corporate entity is not prohibitively difficult. Nevertheless, congressional intent to restrict the carryback is clear, and the need to circumvent any anomaly in section 381(b)(3) is not as great as the need to allow carryforwards in situations such as the insolvency reorganization. Since, in addition, the carryback question arises less frequently, the author would be tempted, as judge, to follow the implication of section 381(b)(3) in most cases, though as advocate he would be less passive.<sup>152</sup>

#### F. CONSOLIDATED RETURNS

One of the most complex and interesting aspects of the loss carryover problem involves the status of a loss carryover when a corporation joins or leaves an affiliated group filing consolidated tax returns. Early Supreme Court decisions established that carryovers from a separate returns period to a consolidated returns year are limited to taxable income of the corporation

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into A Corporation and B Corporation, each of its two shareholders taking full ownership of one-half the business. In year 2, A loses \$100,000 and B breaks even. In year 3, B loses \$50,000 and A breaks even. B should not be deprived of utilizing his losses because they occurred later.

152. A divided Tax Court equitably allowed a carryback to survive in the very recent case of Casco Prods. Corp., 49 T.C. No. 5 (Oct. 24, 1967), but only by treating a merger as a stock redemption.

that originally incurred the loss.<sup>153</sup> The recently revamped consolidated returns regulations largely adopt this approach. The taxable income of each affiliate is computed without benefit of a section 172 deduction;<sup>154</sup> a consolidated net operating loss deduction is then computed for the group that may reduce consolidated taxable income. This deduction includes carryovers from other consolidated returns years whether or not the group has changed members.<sup>155</sup> However, when a loss affiliate leaves the group, its share of any consolidated carryover is available to that corporation in its subsequent separate returns and not to the group.<sup>156</sup> Conversely, when a corporation having carryovers from prior separate returns years joins the group, these carryovers are included in any year's consolidated net operating loss deduction only to the extent that the loss affiliate has income for that year.<sup>157</sup> Likewise, if any member of an affiliated group acquires carryovers of a nonaffiliate in a section 381 transaction, those carryovers are limited to subsequent income of the acquirer.<sup>158</sup>

The courts have followed the prior regulations, sometimes rather blindly, in a number of cases.<sup>159</sup> In addition, general principles of loss carryover transferability have influenced consolidated returns cases. Carryovers have properly been retained by affiliated groups after a constituent loss corporation sold its assets (either within or outside the group), whether the transferor was

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153. See *Planters Cotton Oil Co. v. Hopkins*, 286 U.S. 332 (1932); *Woolford Realty Co. v. Rose*, 286 U.S. 319 (1932).

154. Treas. Reg. §§ 1.1502-12(h); 1.1502-31A(b)(1)(ii) (1966). The statutory provisions creating the privilege to file consolidated returns, §§ 1501-05, leave the loss carryover problem for resolution by regulations. The new regulations apply only to years beginning after December 31, 1965, so the old regulations, renumbered, are still in effect.

155. Treas. Reg. §§ 1.1502-21(b)(1); 1.1502-78; 1.1502-31A(a)(3), (a)(4), (d)(1) (1966).

156. Treas. Reg. §§ 1.1502-79; 1.1502-31A(d)(1) (1966).

157. Treas. Reg. §§ 1.1502-1(f)(1); 1.1502-21(c); 1.1502-31A(b)(3) (1966). However, for tax years beginning after December 31, 1963, this limitation does not apply if the new affiliate could have filed a consolidated return with the group in the loss year, and if no multiple surtax exemption was claimed for that year. This recent liberalization is clearly sound.

158. Treas. Reg. §§ 1.1502-1(f); 1.1502-21(c); 1.1502-31A(b)(21) (1966).

159. See, e.g., *Phinney v. Houston Oil Field Material Co.*, 252 F.2d 357 (5th Cir. 1958); *Midland Management Co.*, 38 T.C. 211 (1962); *Seaboard Commercial Corp.*, 28 T.C. 1034 (1957); *American Trans-Ocean Navigation Corp.*, 13 CCH Tax Ct. Mem. 839 (1954), *aff'd*, 229 F.2d 97 (2d Cir. 1956); *Trinco Indus., Inc.*, 22 T.C. 959 (1954).

dissolved<sup>160</sup> or remained in the group as a shell,<sup>161</sup> because in effect such a sale produces only a reduction in a taxpayer's business. An unsound decision was *A. R. Ruppert Plumbing & Heating Company*,<sup>162</sup> where a loss corporation created a subsidiary, transferred assets to it, and filed consolidated returns. The Tax Court held that prior losses could be used only to the extent that the parent had consolidated returns period income, basing its opinion on a technical application of the regulations plus the *New Colonial* corporate entity theory. This result is correct if the subsidiary files separate returns but not in the consolidated returns context.

Section 269 has also been applied to consolidated returns situations. In *R. P. Collins & Company*,<sup>163</sup> the court found that two companies consolidated for the purpose of utilizing pre-acquisition carryovers, potential capital losses, and postacquisition losses. All three were disallowed although a persuasive dissent argued that postaffiliation operating losses, because they involved cash loss to the new owners, could never have been the purpose of an acquisition and should be allowed to reduce consolidated income.<sup>164</sup> On authority of *Collins*, the Commissioner has attacked consolidations of commonly owned profit and loss corporations in which the intent was to offset the profit corporation's income with postaffiliation losses. Although the government lost one case on the facts,<sup>165</sup> this attack was nearly successful in *Zanesville Investment Company*.<sup>166</sup> The Sixth Circuit reversed a decision for the Commissioner, concluding that no legislative plan prohibits offsetting income of one controlled corporation with losses of another. This is a correct result in theory, and it illustrates a problem with section 269. Since the intent of consolidated returns is to permit averaging of a control

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160. See *Northern R.R. v. United States*, 222 F. Supp. 134 (D. Mass. 1963), *aff'd*, 334 F.2d 936 (1st Cir. 1964).

161. See *Joseph Weidenhoff*, 32 T.C. 1222 (1959).

162. 39 T.C. 284 (1962).

163. 193 F. Supp. 602 (D. Mass. 1961), *aff'd*, 303 F.2d 142 (1st Cir. 1962).

164. Unfortunately, the reasoning of *Collins* as to postacquisition losses has appeared in nonconsolidated returns cases. Disallowance of such losses is perhaps justified when they were "economically realized before the merger," as the judge found in *Meridan Corp. v. United States*, 253 F. Supp. 636 (S.D.N.Y. 1966). But § 269 was simply used punitively in *Luke v. Commissioner*, 351 F.2d 568 (7th Cir. 1965), where postmerger operating losses of the loss corporation's business were denied the new owners.

165. *Naeter Bros. Publishing Co.*, 42 T.C. No. 1 (1964).

166. 38 T.C. 406 (1962), *rev'd*, 335 F.2d 507 (6th Cir. 1964).

group's profitable and losing enterprises, offset should not be denied because the group consolidated with the intent of averaging. Though section 269 literally applies, it should not, and the courts are forced into a "this is a tax purpose which Congress approves as opposed to those that section 269 condemns" sort of reasoning.

In theory, consolidated returns add a new wrinkle to the loss carryover problem. The business entity and the taxpaying entity are the affiliated group yet each constituent retains a corporate identity facilitating ease of departure. Because separate taxable incomes must be computed anyway, a tracing test after acquisition of a loss subsidiary is more workable than in a merger situation. Furthermore, although tracing was rejected as analytically unsound in the merger situation,<sup>167</sup> and although the group is logically a single tax entity for most purposes, retention of the acquired business in a single corporation is arguably a sufficient continuity to justify survival of a carryover if it is restricted to future income of that loss corporation.<sup>168</sup> The chief avoidance danger is that large numbers of tax free inter-company transactions might enable a group to shift consolidated income to whatever member has preaffiliation loss carryovers.<sup>169</sup>

If the regulations are appropriate when a loss corporation is acquired and placed in an affiliated group, they, like the analogous *Libson Shops* doctrine, are too harsh in other situations. If a loss corporation acquires a subsidiary and consolidates, it is like any other expansion of a losing enterprise by the same owners; carryovers should survive. Likewise, consolidation itself is analogous to a change of business.<sup>170</sup> Therefore, losses incurred in separate returns years should be permitted to carry over to consolidated returns years so long as there has been no intervening change of ownership<sup>171</sup> in the loss corpora-

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167. See pp. 594-96 *supra*.

168. Admittedly, lines are getting somewhat arbitrary here. Assuming change of ownership, change of business through merger causes complete elimination of carryovers but change of business through affiliation permits partial survival. In part, this may be a rejection of an entity theory of the affiliated group. Primarily, it is limited recognition of the corporate entity plus adoption of tracing only in its administratively easiest form—when separate income of the affiliate must be computed for other reasons.

169. See Note, *The Affiliated Group as a Tax Entity: A Proposed Revision of the Consolidated Returns Regulations*, 78 Harv. L. Rev. 1415, 1421 (1965).

170. Cf. *Libson Shops, Inc. v. Koehler*, 353 U.S. 382 (1957).

171. Change of ownership should be measured under standards normally applied to loss carryover issues, not by the rules governing eligibility to file a consolidated return. See also note 157 *supra*.

tion.<sup>172</sup> With each case, the test should be the same as in the nonconsolidated context; adjustments must of course be made to recognize economic and tax implications of consolidated returns. Though adequate and workable, the present regulations are inappropriate in some situations and should be amended.

## V. ALTERNATIVES FOR STATUTORY REFORM

Although one purpose of Part IV was to demonstrate that the 1954 Code, if coherently interpreted, can in large part provide a workable approach to loss carryover transferability, nearly all commentators agree that statutory reform is needed. The proposals, both specific and abstract, have been prolific; they differ greatly, often reflecting underlying differences in attitude toward the loss carryover. In this Part, some of the creditable suggestions will be criticized in light of the author's conclusions in Part III. In conclusion, an attempt will be made to transform the theory of Part III into statute.

### A. EXISTING PROPOSALS

A number of writers have suggested that loss carryovers should survive any tax free reorganization, presumably section 368 and section 371 reorganizations under the 1954 Code.<sup>173</sup> A basic theme of this Article has been that the question of when a loss entity has so changed that carryovers should be eliminated does not depend upon whether an alteration was tax free. "Continuity of interest" is basic to a section 368 reorganization, but the continuity that will satisfy an essentially tax-deferring provision is not necessarily the same as that which should justify survival of a tax reducing attribute like the loss carryover. Furthermore, survival of loss carryovers does not seem necessary to accomplish other purposes behind the tax-deferring reorganization provisions.<sup>174</sup> Although carryovers should survive most tax free reorganizations, the standards should not be equated.

The American Law Institute has suggested a test based solely on two-thirds change of ownership of a loss corporation, arguing that any change-of-business test is anomalous because the business of a loss corporation is always changed after acquisition

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172. The regulations seem correct in allocating to a loss corporation that leaves an affiliated group its share of an existing consolidated net operating loss carryforward.

173. See, e.g., Dane, *Net Operating Loss Carry-Overs and Unused Excess Profits Credits in Tax Free Reorganizations*, 28 TAXES 336 (1950).

174. But see *id.*

in an attempt to rehabilitate.<sup>175</sup> As was mentioned earlier, a test based on a significant and identifiable change of ownership (such as two-thirds) is plausible. However, such a test ignores the independent corporate business entity.<sup>176</sup> Furthermore, a change-of-business test is logical when combined with a change-of-ownership requirement: though a losing business requires rehabilitation, if that "rehabilitation" is radical and is not attempted by those who incurred the loss, then reasons for averaging disappear. Finally, a two-thirds change of ownership test would leave much room for abuse and admittedly would require reliance on section 269. For this reason alone,<sup>177</sup> the ALI proposal is an imperfect solution.

Another suggestion, based on the proponent's considerable reluctance to allow any carryover transferability, would eliminate carryovers whenever at least two of three factors are changed—ownership, business, and corporate entity.<sup>178</sup> Corporate entity, in the author's opinion, is irrelevant except, to a limited extent, in the consolidated returns context to any test based upon economic realities and the purposes behind income averaging. Consequently, this proposal would deny carryovers unnecessarily when the corporate entity changes along with business entity (as in the *Libson Shops* merger) or with ownership (as in section 371 insolvency reorganizations). Hence, this test, too, is unsatisfactory.

A number of proposals have urged adoption of a tracing test that would allow a certain percentage of carryovers to survive both unifying and divisive reorganizations. The most practical, if not the most theoretically satisfying, suggestions base the allowable percentage upon the net basis of assets contributed by the loss corporation to the new entity.<sup>179</sup> Although there is much logic to such a scheme, the author agrees with Chairman Wilbur Mills of the House Ways and Means Committee<sup>180</sup> that (with

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175. See ALI, *INCOME TAX PROBLEMS OF CORPORATIONS AND SHAREHOLDERS* 341-48 (1958).

176. This is the criticism of the ALI proposal put forth by the Advisory Group on Subchapter C. See *Advisory Group Hearings* 568.

177. See pp. 603-04 *supra*.

178. See Lanning, *supra* note 126.

179. See E. J. Brown, *An Approach to Subchapter C*, 3 *TAX REVISION COMPENDIUM* 1619, 1629 (House Comm. on Ways and Means 1959). In Note, *Corporate Reorganization and Continuity of Earnings History: Some Tax Aspects*, 65 *HARV. L. REV.* 648, 657 (1952), whether value or basis of assets is to govern allocation is not explained.

180. See *Advisory Group Hearings* 630 (discussion of Advisory Group recommendations).



the exception of divisive reorganizations and consolidated returns situations) carryovers should either be allowed or eliminated in full.<sup>181</sup>

One of the most intriguing proposals is that of the Advisory Group to the House Ways and Means Committee on Subchapter C of the Internal Revenue Code of 1954. While retaining, unfortunately, current section 381, this proposal revises section 382 to disallow carryovers after a fifty per cent change in ownership to the extent that they exceed fifty per cent of the net worth of the loss corporation when transferred.<sup>182</sup> The Group recognized that this is an arbitrary test but could find no satisfactory alternative. The proposal is based on a notion that sham transactions are the principal evil to be combatted; consequently, if a loss corporation is sold as a going concern, it is likely that carryovers should not be eliminated. The specific test is designed to ensure that a large carryover will only accompany transfer of substantial operating assets. Despite its desirable tendency to simplify somewhat existing statutory structure and to rectify certain anomalies, this approach contains a number of problems. First, commentators have feared that emphasis on a loss corporation's net worth would encourage premature sales of declining businesses.<sup>183</sup> Second, the test is admittedly arbitrary, failing to deal directly with some factors, such as business continuity, relevant to corporate loss carryover transferability. This should be avoided if possible. Third, the test is complex. The change of ownership provision has proven difficult to draft. In addition, carryovers would hinge on a loss corporation's net worth, a figure not readily available; accounting manipulation and litigation would probably result.<sup>184</sup> Finally, the Group's proposal places heavy reliance on section 269 because its standard can be easily avoided.<sup>185</sup>

#### B. STATUTORY REFORM—A NEW APPROACH

a. The following subsection is hereby added to section 172 of the Internal Revenue Code of 1954:

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181. See pp. 594-96 *supra*.

182. See *Advisory Group Hearings* 454-55.

183. See ALI, *supra* note 175, at 345.

184. This is a problem not present under a tracing test that looks to net basis of assets at the time of merger. See Brown, *supra* note 179, at 1629.

185. For example, the loss corporation's assets can be sold prior to transfer and the cash used to bolster net worth. Disposal immediately subsequent to sale would be another abuse.

“(l) *Limitations on Carrybacks and Carryovers Applicable to Corporations.*—

(1) *In General.*—Notwithstanding section 269, a net operating loss deduction allowed under this section to a corporation shall exist as a net operating loss carryback and carryover (to be applied according to the rules of subsections (b) to (j) inclusive) unless the corporation that sustained the net operating loss (or any successor corporation or corporations) —

(A) undergoes a substantial change in ownership, as defined in paragraph (2) of this subsection, within a one year period; and

(B) does not continue, for the subsequent two year period, to carry on a trade or business substantially the same as that conducted before the substantial change in ownership.

(2) *Substantial Change in Ownership Defined.*—For purposes of paragraph (1), substantial change of ownership means—

(A) an acquisition or series of acquisitions (including acquisitions in which gain or loss is not recognized), which together transfer 50 per cent equity interest in the corporation to persons who did not own, directly or indirectly, the equity interest transferred to them; or

(B) a reorganization, combination, or division involving the corporation in which persons previously possessing an equity interest in the corporation receive less than a 50 percent equity interest in the corporation or corporations resulting from the reorganization, combination, or division; or

(C) a redemption or series of redemptions which effect transfer of a 50 per cent equity interest in the corporation; or

(D) liquidation of the corporation, unless, immediately prior to liquidation, a greater than 50 per cent equity interest in the corporation is held by another corporation.

Equity interest shall be broadly construed to include stock or securities entitling the holder to traditional benefits of corporate ownership, principally, but not exclusively, a share in the corporation's profits.

(3) *Allocation of Carryovers After Corporate Divisions.*

—In any case in which a corporation divides into two or more resulting corporations, loss carryovers existing prior to the division shall be allocated, according to the fair market value of assets received from the dividing corporation, among the resulting corporations 50 per cent of the equity interest of which are directly owned by shareholders of the dividing corporation, according to regulations prescribed by the Secretary or his delegate.

(4) *Power of Secretary or His Delegate to Allow Carryback or Carryover.*—In any case to which paragraphs (1) to (3) apply, the Secretary or his delegate is authorized to allow, in whole or in part, a loss carryback or carryover if he determines that such allowance would further the purposes of this section.

(5) *Effective date.*—[Date of enactment]”

- b. Section 381(c)(1) of the Internal Revenue Code of 1954 is repealed.
- c. Section 382 of the Internal Revenue Code of 1954 is repealed.

C. COMMENTS

The principles developed in Part III are essential to consideration of the draft, since disagreement over specifics may in fact stem from more basic disagreements in principle. In addition, certain purposes and the intended operation of this draft need further clarification.

In general, separate treatment of tax free transactions has been eliminated by repeal of sections 381(c)(1)<sup>186</sup> and 382(b), and section 269 has been made inapplicable. The basic operative provision is derived from present section 382(a). However, the amendment has been placed in section 172 so that rules as to carryover transferability are not isolated from net operating loss provisions.

If one standard is successfully to replace the pluralistic approach of current law, it must set down guidelines for all cases and not leave openings for unintended taxpayer avoidance. An example of statutory simplicity, section 382(a)(1)(C), has

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186. Whether analysis would prove other subparts of § 381(c) unnecessary is beyond the scope of this Article. Some of the attributes there enumerated seem closely related to the question of whether a transfer is tax free, while others, particularly the capital loss carryover, are analogous to the problem discussed here.

been substantially retained for the change-of-business test. However, the author intends a more rigid test of change-of-business than the current regulations and some cases under section 382 (a) adopt.<sup>187</sup> Legislative history and regulations setting forth the stricter approach will be necessary. Comprehensiveness also requires a liberal interpretation of the parenthetical "or any successor corporation or corporations" in paragraph (1). If a corporation sustained a loss in year one, underwent an (F) reorganization in year two, and had an unrelated substantial change in ownership and business in year three, this parenthetical would be critical to the amendment's applicability.

Given the adoption of a rigid change-of-business test, the change-of-ownership test is most critical to the goal of comprehensiveness.<sup>188</sup> It is also difficult to draft since all transactions, whether or not they are tax free and whether or not the loss corporation technically survives, must be encompassed. Principle loopholes in sections 382(a)(1)(A) and (B) stem from their specificity. As *Maxwell Hardware* and *Jackson Oldsmobile* illustrate, "ownership" of a corporation can be represented in a multitude of ways. Thus, paragraph (1)(A) of this proposal turns upon change of "equity interest," a concept only loosely defined in paragraph (2). This is intended to be the type of security classification scheme suggested for all of Subchapter C by Professor Ernest J. Brown.<sup>189</sup> This draft would need accompanying legislative history and regulations, and a better formulation may be possible. An unlimited right to share in the profits of a corporation is most often indicative of an equity interest (compare *Maxwell Hardware*); in addition, it identifies in most cases those persons who have suffered the economic detriment of a net operating loss. Thus, this factor is specifically mentioned. Other factors might be relevant in determining whether a given security represents an equity interest in a corporation, for example, a right to participate in management of the business (note *Jackson Oldsmobile* and *Glover Packing*) or the financial status of the enterprise (e.g., fixed income bondholders may have a substantial equity interest in an insolvent corporation being managed by a creditors' committee).

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187. See text accompanying notes 108-10 *supra*.

188. Since the *Libson Shops* definition of change of business is adopted, it would be almost impossible for a loss corporation purchaser to avoid this standard if he lacks a bona fide purpose to continue the loss corporation business. But no such strict judicial gloss exists for a change-of-ownership requirement.

189. See Brown, *supra* note 179.

Likewise, "50 percent equity interest" is undefined. In most cases, fair market value of equity interest securities outstanding would be an appropriate test. However, market value of a security may stem from characteristics other than those making it an equity security. Furthermore, a voting trust arrangement such as that in *Glover Packing* might make fair market value irrelevant to computation of equity interest. It is believed that courts can handle the equity interest issues intelligently if the statute and regulations make clear in general terms what the draftsmen intended. Leaving definitions vague should encourage courts to discern statutory purpose and may deter taxpayers from attempting to abuse the statutory scheme.<sup>100</sup> Admittedly, the judiciary often demonstrates a lack of sophistication in tax matters. However, what constitutes a substantial change of ownership seems the type of issue which must be answered with reference to specific fact situations and which can be left to the judiciary with some confidence.

Another problem was excluding cases in which a large, publicly-held corporation has incidental shiftings in its shareholders that by chance total over fifty per cent.<sup>101</sup> To avoid complexity, the period over which change of ownership must take place was shortened to one year. An intentional change of ownership normally occurs in a short span. In cases of creeping control in which there is no agreed plan of long-term acquisition, it seems tolerable to allow carryover survival.<sup>102</sup> The

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190. This proposal might be criticized on the ground that it does not provide sufficiently predictable guidelines for the tax planner. In most cases, the author envisions little difficulty. It is true that, with unifications, carryover survival will be difficult to predict in close cases until the 50% test has been better defined by the Treasury or the courts. But the goal of deterring attempted abuse and of providing needed flexibility outweighs this disadvantage.

191. It could be argued that the change-of-ownership test should be tightened by hinging it upon change in the effective control of a loss corporation. However, emphasis upon ownership rather than control of operations still seems the appropriate criterion. Change of management of a publicly-held corporation through a less than 50% stock shifting is in theory a way for the owners to revitalize their losing venture (though of course the change may not be voluntary); since the principal economic burden of taxes and losses usually remains with original owners, carryovers should survive.

192. It is recognized that in limiting change of ownership to a one-year period, a possible loophole of significant proportions has been created if many businessmen would structure acquisition of control to avoid this time limitation (e.g., by acquiring 60% of the stock of a corporation in two 30% purchases thirteen months apart). Since a loss carryover survives only five years, the incentive to acquire a 50% interest in this manner might be much less if paragraph (1)(A) set

author considered a specific provision covering cases of contracted long-term acquisition such as *Glover Packing*, but decided that reasonable statutory interpretation would be more effective than a difficult-to-draft statutory reference. In part to compensate for this leniency, the change of business period has been lengthened after the ownership change to catch additional tax oriented acquisitions.<sup>193</sup>

Turning to paragraph (2), the critical words in paragraph (2)(A) are "directly or indirectly." They appear in section 269 but seem largely uninterpreted there. The intent is to recognize that transfers among closely related taxpayers, such as husband and wife or individual and his solely owned corporation, do not in economic terms effect a change in ownership. The question is whether the transferor and transferee are the same person with respect to the right to share in profits and management. The attribution rules of section 318, besides being applicable only to "stock," seem too inflexible for this purpose.<sup>194</sup> Also critical to paragraph (2)(A) is that it be interpreted as covering cases where a majority shareholder sells his interest to a former minority shareholder. It is believed that this situation is covered by the phrase "equity interest transferred to them." The related problem of a redemption to eliminate a majority shareholder or shareholders is covered by paragraph (2)(C). A difficult question is whether such a redemption should always

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forth a two-year limitation. The countervailing question is how many publicly traded corporations have 50% of their stock transferred in a two, as opposed to a one-year period. This would require statistical analysis. One alternative is found in § 382 (a) which requires that the change of ownership involve a limited number of people. But that creates an avoidance opportunity. As another alternative, the incidental transfer problem might be covered specifically in the statute, but this seems exceedingly difficult. Or perhaps the problem would not arise no matter how long a time period was created because the Commissioner could never prove that incidental transfers all occurred between unrelated persons. But that seems an unsatisfactory resolution unless the one-year time limit is intolerable. The author has hesitantly kept the one calendar year requirement, primarily because § 382 (a) has to some extent a similar loophole that has not aroused attention. For example, if an acquirer purchased 30% of loss corporation 15 days before the end of tax year 1 and 30% 15 days after the end of tax year 2, § 382(a) would not apply. Of course, § 382(a) is backed up by § 269 while the author's draft is not. Therefore, further consideration might compel a decision to lengthen the limit to two years and to find another resolution to the heavily traded corporation problem.

193. Certain mechanical problems which do not seem overwhelming, such as when the year period begins and when a change of ownership should be deemed to occur, have not been considered.

194. Cf. *Pauline W. Ach*, 42 T.C. 114 (1964), *aff'd*, 358 F.2d 342, (6th Cir.), *cert. denied*, 385 U.S. 899 (1966).

result in carryover elimination because the business is thereby contracted. Arguments seem closely balanced as to whether such contraction should by itself constitute a change of business if remaining shareholders do not reinvest compensating capital thus, as to carryovers, eliminating as a practical matter the redemption technique of shifting control.

Paragraph (2) (B) is intended to produce the same result whether a combination or division is taxable and whether or not the loss corporation technically survives. Therefore, no reference was made to Subchapter C definitions of reorganization, though use of that word will of course influence judicial interpretation (desirably, it is hoped, in cases such as the (E) or (F) reorganization).<sup>195</sup>

The purpose of paragraph (2) (D) is, of course, to isolate liquidations in which there is a successor corporation to inherit carryovers. A rule permitting survival whenever a corporation is owned substantially by one *person* was rejected as being far too broad; however, a fifty per cent control test is broader than present section 381(a)(1). It is also critical to paragraph (2) that carryovers be disallowed if the successor to a liquidation acquired the liquidated loss corporation in a transaction falling under (A) or (B), except in cases when the parent is a corporation with no independent operating assets of its own so that no change of business occurs.

Paragraph (3) is admittedly inadequate. The primary purpose of this Article has been to formulate appropriate rules for the survival of loss carryovers after corporate alterations; although Part III points out when, in general, allocation is appropriate,<sup>196</sup> the drafting problems are considerable. The major problem is defining those divisive transactions as to which allocation is appropriate. Only when equity securities of the resulting corporations are distributed to shareholders of the divid-

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195. Under this test, carryovers of both constituents to a merger would survive only if owners of each received 50% ownership in the resultant. Some have argued that this is too harsh—that the 20% test in § 382(b) is appropriate in merger situations. See *Advisory Group Hearings* 838 (Statement of Bernard Wolfman). Assuming that businessmen are carryover conscious, the effect of the author's proposal would probably be to encourage: (1) owners of loss corporations receiving disproportionately large ownership in resultants; or (2) mergers between large loss corporations and smaller profit corporations. Considering both the averaging concept and the economic effects of tax measures, this result does not seem unfortunate. At worst, the 50% test is arbitrary; for reasons more fully discussed in Part III, it seems appropriate.

196. See p. 596 *supra*.

ing corporation should allocation be necessary.<sup>197</sup> There appear to be three drafting approaches to this problem. First, the problem can be left, with guidelines, to the Commissioner. Second, the definitions of divisive reorganizations in sections 355 and 368(a)(1)(D) could be adopted. Third, a more comprehensive specific definition could be attempted. The second alternative is unsatisfactory because it would not cover every situation which raises a carryover allocation problem, primarily because the "control" definition of section 368 is not the same as the change of ownership definition in this amendment. The first alternative has been adopted here for convenience. It is probably most satisfactory, but the author made no attempt to draft a specific but comprehensive alternative. Also, a provision is perhaps needed referring to the converse allocation problem of a carry-back after a divisive reorganization.

Finally, on the theory that this provision is, if anything, too restrictive, paragraph (4) gives the Commissioner a power similar to that in section 269(b) to allow part or all of any carry-over otherwise eliminated by this subsection if he finds that purposes behind the net operating loss deduction would thereby be furthered. Given the Treasury's current attitude toward carryovers, such a provision would surely be little used. But it seems a sensible way to insert additional flexibility into the statute.

Hopefully, this proposal lacks the type of glaring loopholes that have led to constant tinkering with Subchapter C provisions. If so, it is believed that this amendment would present a unified and realistic approach to loss carryover transferability consistent with the purposes behind income averaging.

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197. Cf. *Mansfield v. United States*, 159 F. Supp. 346 (Ct. Cl. 1958).



