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A businessman's concept of applying a $1 million loss of a corporation against the profits of his existing operations to greatly reduce Federal income taxes soon will be as generally outmoded as the "old" mathematics to today's schoolchildren. The Treasury has made a concentrated effort to limit this type of tax advantage and to stop so-called "traffic" in loss corporations. It has received substantial support in the courts.

Such operations have been so successful that a buyer should carefully consider whether anything at all should be paid to a seller for an operating loss carryover. An everyday illustration of the effectiveness of Treasury measures is the virtual disappearance of loss corporation advertisements from the Wall Street Journal.

Although many court cases and many articles have been concerned with the acquisition of one corporation by another formerly unrelated corporation, much remains to be said about operating loss carryover of single corporate taxpayers and affiliated corporations. A summary of tax laws involved follows.

Section 381 of the 1954 Internal Revenue Code provides that a net operating loss carryover is one of the items to be utilized by the acquiring corporation in certain nontaxable corporate acquisitions. Section 382 calls for special limitations on net operating loss carryovers, and the regulations on this section (issued in 1963) expand the theory and give numerous examples where a change in business coupled with a change in ownership will prevent the use of the loss carryover.

These two sections present a formidable defense for any taxpayer to penetrate. Once this barrier is hurdled, the taxpayer is often confronted by the linebackers, Section 269. This powerful section permits the Treasury to disallow, among other things, a net operating loss carryover, if a taxpayer acquired control of a corporation or property and the principal purpose was evasion or avoidance of Federal income taxes.

If the taxpayer manages to break into the clear and leave these restrictive sections behind, he will probably come face to face with the judicial safety man, "The Libson Shops Theory." This theory, developed from a Supreme Court decision in 1957,(1) has been interpreted in different ways by different courts.

One interpretation presents the argument that only the same "taxpayer" that incurred the loss may enjoy the benefits of future carryover. Another interpretation, which is often more inclusive, states that losses incurred in one "business" cannot be carried forward to offset the profits of another business. The Libson Shops Theory goes much further than Sections 382 or 269 previously mentioned. Even though the Treasury has announced it will not rely on Libson Shops in the case of mergers and consolidations under Section 381(a),(2) there is little reason to believe the courts will abandon the opportunity to use and interpret the theory in 1954 Code cases.

SINGLE CORPORATE TAXPAYERS

The net operating loss carryover of a single corporation will clearly be disallowed if a change in ownership is coupled with a change in business as defined in Section 382. This situation is covered by law, but the unknown area concerns the addition or discontinuation of corporate activity when there has been little or no change in ownership.

The Internal Revenue Service issued a public ruling in 1963 which, at first glance, appears to clarify the problem.(3) It states that the IRS will not rely on the Libson Shops rationale or on Section 269 to disallow the loss carryovers of single corporate taxpayers solely because the losses are attributable to a discontinued corporate activity. Further, these carryovers will not be disallowed if a new profitable business is acquired through the purchase of assets or the purchase of stock if the company is immediately liquidated.

A closer analysis of this ruling indicates that any concessions by the IRS are greatly restricted by the suggestion that the carryover may be disallowed if:(4)

1. There is more than a minor change in ownership of the loss corporation prior to or subsequent to the period in which losses are incurred.
2. The price of the assets purchased exceeds the fair market value or is payable over a long period of time.
3. The assets are acquired from a corporation which is directly or indirectly related to the loss corporation.
4. In the case of stock acquisitions, the acquired corporation is not immediately liquidated.(5)

This ruling is not referring to a net operating loss carryover of an acquired company but rather a net operating loss carryover that exists in a company that is discontinuing an activity or acquiring a new business. It does not discuss the problem of a dormant corporation, but it is probable that a loss carryover would be challenged where a company has ceased operations and, after a period of time, acquires a new business.

It is important to analyze case law to interpret the meaning of the Libson Shops Theory as it pertains to single corporate taxpayers. One interpretation presented is that the Supreme Court in "Libson" was willing to allow the loss carryover if the user of the carryover was the same taxpayer incurring the losses. Obviously, if "taxpayer" is the key word, the losses of a single corporate taxpayer could not be disallowed if there was little or no change in ownership. The interpretation that losses incurred in one business cannot be used to offset profits from another business, even if the same taxpayer is involved, can give entirely different results.

Unfortunately, there are cases which support both of the above interpretations. Revenue Ruling 63–40 may give assurance to some taxpayers for transactions already consummated while others will find the ruling of little help because of the narrow path the IRS has used for its application. The ruling is of great importance for taxpayers in planning for future transactions and can be used as a yardstick for application to the facts and circumstances of a single corporate taxpayer.

PARENT-SUBSIDIARY RELATIONSHIP

When a subsidiary is liquidated into its parent, the parent's corporate entity continues unchanged and any loss carryover of the parent can be used against future operations. When a parent acquires the assets of a subsidiary in a tax-free liquidation and the subsidiary has a net operating loss carryover, the Internal Revenue Code provides that such carryovers can usually be used against the post-liquidation profits of the surviving parent company.(6) There are two common situations in which the net operating loss carryover will not be allowed in the liquidation of a controlled subsidiary.

The first situation exists when a company is liquidated within two years after a purchasing company acquires 80 per cent control.(7) This is known as the "buying stock to get assets" route and, under this theory, the basis of the stock becomes the basis of the assets, usually giving a stepped-up basis to the assets. No net operating loss carryover is allowed since the whole transaction is, in effect, treated as a purchase of assets.

The second situation arises when an insolvent subsidiary is liquidated. The regulations provide that the recipient corporation must receive at least partial payment for its stock ownership to qualify as a liquidation under Section 332.(8) A study of the assets to be transferred may reveal that they have enough value to remove the insolvent condition of the subsidiary and thus fulfill the partial payment requirement.

Many times the parent corporation will have advanced a considerable amount of money to the subsidiary on open account. Indeed, these advances often approximate the net operating loss carryover of the subsidiary corporation. The conversion of this debt to capital in sufficient amount to restore solvency of the subsidiary is a suggested solution. This approach has apparently not yet been litigated.

Assuming the subsidiary is insolvent upon liquidation, the transaction becomes taxable. If the parent can meet certain tests of ownership and the subsidiary certain tests of operation, the parent will have an ordinary loss on its investment in the stock of the insolvent subsidiary.(9) This may be more advantageous than receiving the net operating loss carryover from the subsidiary.

CHOOSING SURVIVOR CORPORATION

Once a decision has been made to combine parent and subsidiary, one of the next questions to consider is which of the corporations will be the survivor. An alternative would be the creation of a new taxable entity in a tax consolidation. One of the biggest disadvantages in creating a new entity is when post-consolidation losses occur and the company is unable to carryback these losses to the pre-consolidation entities.

Prior to the 1954 Code, the utilization of losses generally dictated that the loss corporation be the survivor but the provision for carryover of tax attributes to acquiring corporations has given new flexibility.

Occasionally, it will be desirable for the subsidiary corporation to become the survivor and a "downstream merger" is consummated. These mergers can usually be arranged to comply with the tax-free reorganization provisions of the Code if the parent and subsidiary have had this relationship for some time.

A problem develops when a corporation acquires control of a subsidiary, and wishes to merge into one company, but does not want an upstream merger because the subsidiary wants to preserve the high-tax basis of its assets. It is understood the IRS will not issue a ruling on this type of downstream merger where it occurs a short time after the purchase of the controlling interest.(10)

A special provision of the 1954 Code limits the use of an operating loss carryover when the stockholders of a loss corporation acquire less than 20 per cent ownership of the corporation which is acquiring the loss carryover. For every per cent of ownership less than 20, five per cent of the carryover loss will be disallowed.(11)

Considering this restrictive provision, the theory has been advanced that a loss carryover could be jeopardized in a merger of parent and a less than 80 per cent owned subsidiary if one company is much smaller in size. For example, if the subsidiary has net assets worth only one per cent of the net assets of the parent and the two corporations are merged, it would seem that the parent will obtain only five per cent of the subsidiary's net operating loss carryover.[12]

Although this theory may be overly pessimistic, it is not beyond the realm of possibility and can be used to underline an important conclusion: In comparing a merger, liquidation, or other form of reorganization involving parent and subsidiary, it is safe to conclude that the liquidation of the subsidiary into the parent is highly preferred if the main purpose is to conserve an operating loss carryover. However, the section 382 limitation does not apply to a section 332 liquidation. In the case of subsidiaries owned 80 per cent or more by the parent, it would not make any difference if the transaction were consummated as a statutory merger or a section 368(a) (1) (6) reorganization.

CONSOLIDATED RETURNS

Assuming a parent-subsidiary relationship with 80 per cent control, an affiliated group is usually eligible to file consolidated returns.[13] A consolidated return can be used to offset the profits of one company against the losses of an affiliated company in a consolidated return year. The filing of a consolidated return after a loss has been established in a separate return year has limited value since the offsetting of pre-consolidation losses against profits of other members of the consolidated group is restricted. A recent change in the regulations relating to consolidated returns allows the offsetting of pre-consolidation losses against the consolidated income for the first time in 1964 if the losses occurred during the period 1959 to 1963 and if the corporations were affiliated (80 per cent parent and subsidiary relationship) during this time.[14] This is an advantage of limited duration since only losses originating from 1959 through 1963 are covered. Affiliated companies filing separately in 1964 and later will not benefit. A qualifying liquidation or merger gives this offsetting advantage without restriction and allows both the pre-merger and post-merger losses to be offset against post-merger profits.

On the other hand, the filing of a consolidated return does not eliminate the carryback of net operating losses during the consolidated return year to pre-consolidation years.[15] This advantage is lost to the disappearing corporation when a liquidation or merger is consummated.

BROTHER-SISTER CORPORATIONS

If two corporations are controlled by the same taxpayer, what are the chances of utilizing the net operating loss carryover by the merger of one corporation into the other?

Assuming there has been no recent change in ownership and that the net operating losses have arisen since the purchase or formation of the loss corporation, the loss carryover should not be disallowed under Section 382 or 269 of the 1954 Internal Revenue Code.

In one case, however, the IRS has taken the position that a "C" type reorganization did not qualify as a tax free reorganization for lack of business purpose and has denied the loss carryovers and also the after-merger losses of such corporation. The IRS alleged that the only reason for the merger was the utilization of the loss carryovers against the income of the continuing corporation.

Further assuming that all this has happened under the 1954 Code, it would appear the taxpayer has no problem since the Treasury has stated that the Libson Shops Theory will not be applied to a merger or any other transaction under Section 381(a) of the 1954 Code.[16] But there is certainly no assurance that the courts will not apply the Libson Shops Theory to 1954 Code cases.

In Julius Garfinckel, we have an example of the Libson Shops Theory being applied to brother-sister corporations under the 1939 Internal Revenue Code.[17] Corporation A and Corporation B both operated clothing stores and were controlled by Corporation C. A, the profit corporation, was merged into B, the loss corporation, and the loss carryover of B was not allowed against the combined merger operations. The court said, "The consolidated corporation was not 'the taxpayer' which sustained the pre-merger losses. There is a lack of business continuity when the controller of the merger has one constituent doing a separate business contribute its loss and another doing a separate business of the same type contribute its earnings." The court in this case used a hybrid interpretation of the Libson Shops Theory, throwing in both the "taxpayer" and the "continuity of business" theories.

If the facts are not this favorable and some of the losses have occurred prior to the acquisition of one of the companies, Section 269 will probably apply unless the taxpayer can demonstrate a good business purpose for the acquisition. In this situation, not only the losses carried over but also any subsequent losses may be disallowed under Section 269. The courts have found this section to apply to post-acquisition losses as well as pre-acquisition losses if the principal purpose of the acquisition was the evasion or avoidance of tax.[18]

The Brick Milling Company case is a good example of just how far the courts will extend themselves to apply flexible Section 269.[19] In this case, individual stockholders of both A and B Corporations donated their stock in A Corporation to B Corporation. Corporation A was liquidated into B Corporation and the carryover losses of A Corporation were then deducted on the B Corporation return. The court held that Corporation B acquired control of Corporation A at the time of the donation of stock and completely ignored the indirect ownership prior to that time. Although stating that it might be regarded as giving harsh results, the court said that Section 269 applies to the acquisition of control of one corporation by another corporation even if they are both owned by the same taxpayer.[20]

What would the line of reasoning of the courts have been if Corporation A had merged into Corporation B with an exchange of stock so that Corporation B did not have control of A? This method should avoid the technical application of Section 269.

OWNERSHIP OF BROTHER-SISTER CORPORATION BY PARENT CORPORATION

If we assume that the Libson Shops Theory will continue to be interpreted variously under the 1954 Code, will the applications change if the brother-sister corporations are owned by a corporation rather than an individual?

The theory has been advanced that "Libson" is properly applied to corporations having similar stockholders, but is not applicable to a parent-subsidiary relationship where such group is eligible to file a consolidated return.[21] The reasoning advanced here is that a parent-subsidiary relationship is all one economic pool while brother-sister ownership provides for separate pools. With brother-sister ownership, the stockholders may pay themselves a dividend from one corporation or they could liquidate and pay a capital gains tax without the problems of dividend taxation.

Proceeding with this theory, stockholders who may receive these benefits should not be allowed to retroactively change the form of their investments through a merger and offset the loss of what they intended as a separate "pot" against profits arising from another separate "pot." Conversely, since a parent-subsidiary organization does not have the advantages of brother-sister corporations and is actually a single corporate enterprise, the loss carryovers should be allowed when one or more of the companies in a "single corporate enterprise" is merged or liquidated.

Although this theory seems to have considerable merit, there is no indication that any such distinction has been or will be made by the courts in applying "Libson."

The utilization of operating loss carryovers in affiliated corporations has never been a simple and clear-cut matter and probably never will be. It appears that Congress attempted to clarify the area by the enactment of Sections 381 and 382 but unfortunately, this seems to have supplemented the Libson Shops Theory and Section 269. Instead of exclusive reliance upon these specific sections of law, the courts now have a choice between these sections and various interpretations of the Libson Shops Theory.

A strong business reason for merger or consolidation is probably the best assurance that a net operating loss carryover will be allowed. Unfortunately, the saving of income taxes through utilization of the carryover is not a strong business reason for this purpose.

Although the overall outlook for loss companies is not bright, there are still legitimate situations where a loss carryover may be utilized. The real problem is to recognize these situations and develop an awareness of the methods which are most likely to succeed.

(1) Libson Shops, Inc. vs. Koehler, 353 U. S. 382 (1957).

(2) Rev. Ruling 58–603, 1958–2 CB 147.

(3) Rev. Ruling 63–40, 1963–1 CB 46.

(4) William M. Speiller, The Journal of Taxation, May 1963.

(5) Rev. Ruling 63–40 states where a company negotiated for the purchase of assets, but could only consummate the transaction through a purchase of stock, an immediate liquidation under 334(b)(2) will be treated the same as a purchase of assets.

(6) IRC Sec. 381(a)(1).

(7) IRC Sec. 334(b)(2).

(8) Reg. Sec. 1.332.2(b).

(9) IRC Sec. 165(g)(3).

(10) Wilson C. Piper, New York University Sixteenth Annual Institute on Federal Taxation (1958).

(11) IRC Sec. 382(b).

(12) B. J. Adelson, Western Reserve Law Review, March 1963. This article develops in detail the theory presented here in summary form.

(13) IRC Sec. 1504 (a) and (b).

(14) Reg. Sec. 1.1502–31(b)(3).

(15) Reg. Sec. 1.1502–31(b)(6). The carryback to a separate return year will be the percentage of the consolidated loss that the loss of the company bears to the combined loss of the loss companies.

(16) Rev. Ruling 58–603, 1958–2 CB 147.

(17) Julius Garfinckel & Co. Incorporated, 40 T.C. August 20, 1963.

(18) Zanesville Investment Co., 38 T.C. 406 (1962).

(19) Brick Milling Company, T.C. Memo 1963–305.

(20) Ibid. — The court states that Congress did not exempt corporations with common shareholders from Section 269(a)(1) as it did in Section 269(a)(2).

(21) Don V. Harris, Jr., New York University Twenty-First Annual Institute on Federal Taxation (1963). This theory was unsuccessfully argued by the above author in Norden-Ketay Corporation, T.C. Memo 1962–248.