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CORPORATE NET OPERATING LOSSES—LIBSON SHOPS AND THE DECREASING AVAILABILITY OF A LOSS CARRYOVER TO THE SINGLE CORPORATION

OLIVER STEVENS SUGHRUE, JR.*

INTRODUCTION

The recent history of the federal judicial and legislative treatment of corporate net operating loss carryovers and carrybacks has indeed been turbulent. Although some form of provision allowing a corporation to average its taxable income over a period of years has generally been a part of our income tax law for many years, the length of the averaging period has only recently been subjected to major change.¹ In addition, the 1954 Internal Revenue Code contained provisions representing the first Congressional attempt to deal specifically with the problem of what changes in corporate "identity" would cause denial of the privilege of averaging.² Previous Revenue Acts had indicated that carryovers were to be allowed only if the corporation seeking the offset was the "same" as the one incurring the loss. But since they typically provided only that a carryover was available to "the taxpayer" sustaining the loss,³ the courts were left with the difficult task of determining whether, despite some change within a corporation, it had nonetheless remained the "same" for the limited purpose of using a loss carryover.

The current turbulence in the carryover area may fairly be deemed the inevitable result of the ill-defined interplay of at least six different principles each of which has been urged as relevant in determining "sameness." First, a corporation which is merely a different legal entity from the corporation sustaining the loss has been denied a carryover even though in all other respects it retained the char-

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¹ The Revenue Act of 1918, ch. 18, § 204(b), 40 Stat. 1061, first allowed averaging to a corporation by providing for both a carryover and a carryback for a one-year period. But the carryback was eliminated three years later by the Revenue Act of 1921, ch. 136, § 204, 42 Stat. 231, and was not restored until 1942. Revenue Act of 1942, ch. 619, § 153, 56 Stat. 847. The most significant change in the length of the averaging period occurred in 1950, when the carryover was extended to five years. Revenue Act of 1950, ch. 944, § 215, 64 Stat. 937. At present, under § 172 of the 1954 Internal Revenue Code, a carryback may extend for three years and a carryover for five.

² Int. Rev. Code of 1954, §§ 381, 382. These sections do not, however, treat all types of corporate readjustments.

³ See, e.g., Int. Rev. Code of 1939, § 122(b), added by ch. 619, § 153, 56 Stat. 900 (1942) ("If for any taxable year . . . *the taxpayer* has a net operating loss . . .") [emphasis added].

acteristics of its predecessor.⁴ Conversely, where a corporation changed its ownership, business operation, name and location, it was allowed a carryover because its entity remained undisturbed.⁵ Secondly, when the ownership of a corporation changes hands, the "sameness" has been considered destroyed on the theory that the new owners ought not to be given the "windfall" benefit of an advantageous tax history with which they were not connected.⁶ Third, where a corporation discontinues a losing activity and seeks to offset income obtained from a different type of business operation, the carryover, for that reason alone, has been considered not merited.⁷ Fourth, the Congressional provisions for certain corporate reorganizations to be effectuated tax-free have been interpreted as frustrated if a carryover is not permitted to survive such reorganizations.⁸ Thus, even though a reorganized corporation may have a new entity, or a different ownership and possibly even a new type of business operation, the carryover will be allowed as consistent with Congressional solicitude for these reorganizations.⁹ Fifth, the attractiveness of a loss carryover as an independently valuable corporate asset and the original validation of its transferability to new ownership provoked the 1943 statutory response that when tax avoidance is shown to be the principal purpose of the acquisition, the carryover will be denied.¹⁰ Accordingly, acquisitions predominantly inspired by tax avoidance purposes will not be effective to allow a carryover, even though by some other test corporate "sameness" is undisturbed. Last, and perhaps most troublesome, carryovers have been denied when "continuity of business enterprise" is considered lacking. This doctrine, the legacy of *Libson Shops v. Koehler*,¹¹ has been inconsistently interpreted by courts seeking to apply it in the context of various corporate readjustments other than the one with which the case

⁴ West Point Marion Coal Co., 19 B.T.A. 945 (1930); Athol Mfg. Co., 22 B.T.A. 105, aff'd, 54 F.2d 230 (1st Cir. 1931). But cf. Newmarket Mfg. Co. v. United States, 233 F.2d 493 (1st Cir. 1956), cert. denied, 353 U.S. 983 (1957), vacating and remanding 130 F. Supp. 706 (D. Mass. 1955).

⁵ Alprosa Watch Corp., 11 T.C. 240 (1948); But cf. Mill Ridge Coal Co. v. Patterson, 264 F.2d 713 (5th Cir.), cert. denied, 361 U.S. 816 (1959), affirming on this point, 1 Am. Fed. Tax R.2d 1627 (N.D. Ala. 1958).

⁶ A. C. Willingham v. United States, 289 F.2d 283 (5th Cir. 1961). See text accompanying notes 136-40 infra.

⁷ While no case has yet denied the carryover in this situation, the Commissioner consistently argues for disallowance. See text accompanying notes 114-21 infra.

⁸ See Newmarket Mfg. Co. v. United States, supra note 4.

⁹ Int. Rev. Code of 1954, §§ 381(a) and 381(c) generally provide for carryovers through § 368(a)(1)(A),(C),(D) and (F) reorganizations, subject to the 20% "continuing interest" requirement of § 382(b)(1)(B).

¹⁰ Int. Rev. Code of 1939, § 129, added by the Revenue Act of 1943, § 128, 58 Stat. 47. Section 129 was the first tax avoidance provision of the revenue laws; until 1943, carryover disallowance rested totally on judicial determination that the "taxpayer" claiming the offset was significantly different from the one incurring the loss.

¹¹ 353 U.S. 382 (1957).

itself dealt, namely, a statutory merger. The inconsistency has been especially apparent in the case of the single corporation which experiences either a change in the type of its business activity and/or in its ownership but retains an undisturbed legal entity.¹² Some courts and commentators maintain that the *Libson* doctrine of "continuity of business enterprise" can have no application to the single corporation.¹³ Others insist that it can, on the premise that the required continuity is destroyed when *both* ownership and business activity change significantly.¹⁴ Still a third suggestion is that either of the two changes is sufficient.¹⁵ This article will examine the meaning of the *Libson* doctrine; it will then consider the merits of suggested extensions into the so-called single corporation area, particularly its possible application when the corporation has changed only its ownership or its type of business under the still relevant 1939 Code as well as the 1954 Code.

It should be noted initially that the turbulence persists despite the new provisions of the 1954 Code. These provisions do not contain a unified carryover policy.¹⁶ Sections 381(a) and 381(c) allow corporations surviving certain tax-free reorganizations to inherit loss carryovers, but the inheritance is reduced to the extent that shareholders in the "loss corporation" fail to retain an interest equal to at least twenty per cent of the fair market value of the stock of the acquiring corporation.¹⁷ Section 382(a) imposes on the purchasers of fifty per cent or more of the stock of such corporation the requirement that they continue "substantially the same" trade or business as was conducted before the stock purchase, in order to use a carryover.¹⁸ This section thus incorporates the requirements of continuity of both ownership and type of business activity. And the tax avoidance provisions, which Congress attempted to strengthen by adding subsection (c) to section 269, continue to pervade many corporate readjustments by disallowing carryovers when the acquisition of the stock or assets of a corporation is proven to be primarily for the

¹² Compare *British Motor Car Distrib., Inc. v. Commissioner*, 31 T.C. 437 (1958), rev'd on other grounds, 278 F.2d 392 (9th Cir. 1960), with *Mill Ridge Coal Co. v. Patterson*, supra note 5.

¹³ See, e.g., the Tax Court opinion in *British Motor Car Distrib., Inc. v. Commissioner*, supra note 12; *Levine and Petta, Libson Shops Applied to the Single Corporate Taxpayer*, 36 *Taxes* 562, 564 (1958). See also 353 U.S. 382, 390 n.9.

¹⁴ See, e.g., *Mill Ridge Coal Co. v. Patterson*, supra note 5; *Virginia Metal Prod., Inc. v. Commissioner*, 290 F.2d 675 (3d Cir. 1961).

¹⁵ See text accompanying notes 114-21 and 136-40 infra.

¹⁶ See *Winton, Loss Carryovers: Courts Grope Toward Judicial Doctrine of Business Continuity*, 11 *J. Taxation* 76 (1959), characterizing the new provisions as "each with a different test, a different underlying policy and different penalties."

¹⁷ This limitation is imposed by Int. Rev. Code of 1954, § 382(b).

¹⁸ Under § 382(a)(1), the "trade or business" need be continued only for two taxable years, counting the year in which the purchase occurred as one. Further, the section applies only to taxable purchases. Int. Rev. Code of 1954, § 382(a)(4).

purpose of avoiding income tax.¹⁹ Thus, the new Code demands that corporate "sameness" be defined in specific situations in terms of one or more of the principles of continuity of ownership, continuity of type of business operation, solicitude towards tax-free reorganizations and the disallowance of benefits sought principally to avoid taxes. But several common corporate readjustments were left uncovered by the new provisions.²⁰ Further, the most controversial carry-over principle, *Libson's* continuity of business enterprise, was unknown to the drafters of the new Code.²¹ The courts, therefore, are still forced to resolve frequent conflicts among the above enumerated six principles in their attempts to administer carryover justice.

LIBSON SHOPS

A. *The Decision*

The *Libson* case presented a conflict between two of these carry-over principles under the 1939 Code. The taxpayer was a corporation into which had merged, pursuant to state statute, sixteen separate corporations. Before the merger, the taxpayer had provided management services for the other sixteen, each of which operated one retail women's apparel store. All seventeen corporations were owned by the same individuals in the same proportions. After the merger, the taxpayer continued to conduct all of the former operations and new shares were exchanged pro rata for the old shares of the apparel store corporations; the merger had therefore caused no disturbance in ownership or business activity. The only relevant change was one of corporate entity—seventeen separate corporations had become one single corporation. The taxpayer sought to carry forward the pre-merger losses of three of its constituents, each of which continued to lose money after the merger, to offset income derived from the profitable operations of the other stores. Under the 1939 Code, this required a determination of whether the post-merger entity was, for carryover purposes, the same "taxpayer" as the three merged constituents.²² The conflict in carryover principles was posed by the juxtaposition of the doctrine of *New Colonial Ice Co. v. Helvering*²³

¹⁹ Section 269 applies only if a stock purchase enables the purchaser to obtain control of a corporation, or if a corporation obtains the property of another corporation, which at the time of the purchase was not controlled by the purchaser or its shareholders, and obtains the transferor's basis for the property.

²⁰ For example, §§ 381 and 382 do not cover taxable asset purchases by a loss corporation, changes of business or ownership within a single corporation not involving tax-free reorganization, nor § 368(a)(1)(B) and (E) reorganizations.

²¹ The *Libson* decision postdated the new Code by three years.

²² Int. Rev. Code of 1939, § 122(b), supra note 3.

²³ 292 U.S. 435 (1934). This case involved a situation in which a corporation with losses set up a subsidiary into which it transferred all its assets in exchange for a portion of the subsidiary's stock which was thereupon distributed to the parent's shareholders in exchange for the old stock. The subsidiary later sought to use the

which stood for the proposition that since the merger had effected a change in the entity of the loss corporations there could be no carry-over, and the rationale of *Stanton Brewery, Inc. v. Commissioner*²⁴ to the effect that a corporation resulting from a statutory merger is to be treated as the same taxable entity as its constituents to whose legal attributes it has succeeded by operation of state law. The Supreme Court, however, did not resolve this conflict but ruled in accordance with the Government's "alternative argument" that "the carry-over privilege is not available unless there is a continuity of business enterprise,"²⁵ and on this basis denied the carryover. The only explicit guide which the Court left to indicate why the merger had destroyed the necessary continuity was its concluding statement that "petitioner is not entitled to a carry-over since the income against which the offset is claimed was not produced by substantially the same businesses which incurred the losses."²⁶ To this statement it appended the now famous footnote 9, in which the Court said:

We do not pass on situations like those presented in *Northway Securities Co. v. Commissioner*, 23 B.T.A. 532; *Alprosa Watch Corp. v. Commissioner*, 11 T.C. 240; *A. B. & Container Corp. v. Commissioner*, 14 T.C. 842; *WAGE, Inc. v. Commissioner*, 19 T.C. 249. In these cases a *single* corporate taxpayer changed the character of its business and the taxable income of one of its enterprises was reduced by the deductions or credits of another.²⁷

parent's losses but the carryover was denied on the basis that "the two corporations were not identical but distinct." *Id.* at 441. *New Colonial* was subsequently relied on to deny a carryover to a successor corporation after a merger. *Franklin v. United States*, 83 F.2d 1010 (3d Cir. 1936). But cf. *Newmarket Mfg. Co. v. United States*, *supra* note 4, distinguishing *New Colonial* as inapplicable to a statutory merger.

²⁴ 176 F.2d 573 (2d Cir. 1949). *Stanton* gave a holding company the unused excess profits credit of an operating subsidiary which disappeared in a statutory merger of the two companies. The court considered *New Colonial's* voluntary transfer of assets as distinguishable from the situation where, by operation of the state merger statute, the "resulting corporation . . . absorbs the rights and privileges, as well as the obligations, of its constituents." *Id.* at 575. The court found there was "essentially a continuing enterprise." *Id.* at 577. This very language was cited with apparent approval by the Supreme Court in *Libson*, which would seem to cloud the meaning of essential continuity, since in both cases there was a state statute producing an "operation of law" merger and there was no break in continuity of either ownership or type of business activity; yet the *Stanton* court allowed the carryover and *Libson* court denied it. A possible reason for the different results is suggested by the fact that in *Libson*, the carryover would have been unavailable if there had been no merger whereas in *Stanton*, "without the merger the [corporation] would have been entitled to the claimed carry-over." *Libson Shops, Inc. v. Koehler*, 229 F.2d 220, 227 (8th Cir. 1956), *aff'd*, 353 U.S. 382 (1957).

²⁵ 353 U.S. at 386.

²⁶ *Id.* at 390.

²⁷ *Id.* at n.9. In each of the cases referred to in the footnote the carryover had been allowed since the entity had been undisturbed. It is interesting to note the sev-

Subsequently, however, many cases have been forced to answer the question of what effect, if any, the *Libson* decision has on the traditional ability of a single corporate entity to carry forward a loss notwithstanding a change in its type of business operation or ownership or both. But since there has been no universal agreement even on what the Supreme Court meant by "continuity of business enterprise," it followed that other courts would disagree on whether the principle applied to the single corporation.²⁸

B. *Continuity of Business Enterprise*

What was "continuity of business enterprise" supposed to mean? At one end of the spectrum of interpretation is the view that *Libson's* "continuity" is a requirement only in the case of a merger or consolidation of two or more distinct corporate entities. This view focuses on the Court's construction of the issue in the case as being whether, notwithstanding the change in entity effected by the merger, there existed sufficient identity between the successor corporation and its loss constituents so as to allow for their treatment as the same "taxpayer."²⁹ According to this interpretation, when the initial change in entity does not occur—as with adjustments effected within a single corporation—the dispute over identity does not arise and the requirement of continuity of business enterprise is therefore irrelevant.³⁰

Two commentators,³¹ viewing the doctrine as inapplicable to the single corporation, have narrowly construed its operation in the merger case. They view the merger as destroying the required continuity when the total business operations of the successor corporation differ from that conducted by each of the merged companies. Because

eral dozen references to footnote 9 which later courts have made. In retrospect, it seems that the language of the footnote, in which the court was simply attempting to exclude certain matters from the scope of its decision, was perhaps the only helpful tool which Mr. Justice Burton's opinion left for the use of practitioners. Certainly the crux of his opinion—the oft-repeated statement that "continuity of business enterprise" had been found lacking—is by its very vagueness inadequate as a tool by which to conduct business planning. Especially is this so since *Libson's* ambiguous language was appearing in a quite unusual context, that posed by merger pursuant to state law.

²⁸ See *supra* note 12.

²⁹ The Court characterized the issue as "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." 353 U.S. at 385. In resolving it, the Court ruled that only to the extent that there was continuity of business enterprise "is the same 'taxpayer' involved." *Id.* at 386.

³⁰ The Court's analysis of legislative history indicates support for this view. While failing to find Congressional intent that merger was to enable the averaging of "the premerger losses of one business with the post-merger income of some other business which had been operated and taxed separately before the merger," it found "Congress primarily was concerned with the fluctuating income of a single business." 353 U.S. at 387. Thus, while a limit on carryovers after mergers might well be consistent with Congressional intent, Congress had revealed no desire to place a similar limit on carryovers to a "single business."

³¹ Levine and Petta, *Libson Shops: A Study in Semantics*, 36 *Taxes* 445 (1958).

“. . . the operation of 16 stores is a different business from the operation of one store . . . there was no business continuity, and as a result the successor was not the same taxpayer.”³² These commentators, therefore, would claim that a carryover could survive only when the merger united one corporation actively engaged in business with a mere corporate shell, in which there existed no meaningful economic activity. This reading appears to be based on the Court’s apparent approval of the results in *Stanton* and *Newmarket Mfg. Co. v. United States*.³³ In both of these cases, there was only one active business operation before and after the merger. As yet, however, no case has adopted this definition of business continuity.³⁴ Its chief defect would seem to stem from its clear implication that had the three *Libson* loss corporations been profitable after the merger the carryover would nevertheless have been denied. But the Supreme Court’s subsequent analysis of *Newmarket* cuts sharply against this suggested result and indicates a second, more plausible meaning of “continuity of business enterprise.”

The Court analyzed *Newmarket* as properly allowing a carry-back because there, “But for the merger, the old corporation itself would have been entitled to a carry-back.”³⁵ *Libson* obviously presented the converse situation: since the three loss stores continued in the red after the merger, they would have had no opportunity to use the carryover in the absence of merger. But because the Court could not construe the carryover provisions to allow a merger to bring about a “windfall” otherwise unobtainable, the carryover was denied. Placing the *Newmarket* rationale alongside the *Libson* result leads to an interpretation of “continuity of business enterprise” as a requirement that the loss entities be traced into the amalgamated entity so that carryovers are used only against profits derived by the very same traceable entity as had incurred the losses. The tracing is necessary only to ensure that the merger act in a completely neutral fashion with respect to carryovers. This view of *Libson*’s real message as demanding neutrality of the merger device squares nicely with the Court’s refusal to pass directly on the *Stanton-New Colonial* conflict.³⁶ Adherence to *New Colonial* would have demanded denial of the

³² Id. at 448.

³³ Supra note 4.

³⁴ *F. C. Donovan, Inc. v. United States*, 261 F.2d 470 (1st Cir. 1958), allowed a carryback although previously separate businesses had been conducted, and *Old National Bank in Evansville v. Commissioner*, 256 F.2d 639 (7th Cir. 1958), allowed a carryover of an unused excess profits credit in the same situation.

³⁵ 353 U.S. at 388. Similarly, the Circuit Court in *Libson* implied that the result in *Stanton* had been reached because the carryover would have been available but for the merger. See supra note 24.

³⁶ Referring to the *Stanton-New Colonial* conflict, the Court stated that “we find it unnecessary to discuss this issue since an alternative argument made by the Government is dispositive of this case.” 353 U.S. at 386.

carryover because of the change in entity effected by the merger. Thus a carryover otherwise available would disappear simply by virtue of the act of merging. *Stanton*, on the other hand, would have allowed merger to become an affirmative carryover tool by automatically entitling the resultant corporation to succeed to the tax attributes of merged constituents. This "windfall" result, an obvious invitation to tax avoidance, was rejected by the Court's construction of the carryover provisions as "not to give a merged taxpayer an advantage over others who have not merged."³⁷ But neither of these suggested results satisfied the Court, because both were inconsistent with its suggested view that merger should act neutrally on loss carryovers.

The foregoing interpretation of "continuity of business" equates "substantially the same business" with the artificially traced post-merger entity. Continuity is maintained only if the loss entity, as traced into the successor corporation, derives from its own business operations profits against which its losses can be offset. If the loss activity is discontinued, or if it is retained but continues to lose money, there can be no carryover because it would have been unavailable to the entity if there had been no merger. But if the assets used in conducting the loss operation are sold and the proceeds used to buy a new kind of business, the offset should be available when the new activity yields the necessary profits. This result follows from the fact that the prevailing law both before and after *Libson* has not disallowed a carryover when a single enterprise merely shifts from one type of business activity to another.³⁸ Therefore, the fact that the traced entity changes the type of its economic endeavor after the merger and seeks to carry forward a loss against profits earned in a new line should not operate to deny the carryover. The continuity which *Libson* demanded was, according to the Court's own words, that of an "enterprise" rather than of a mere "business." Nothing in the opinion suggests that the traced loss corporation must continue in the identical economic activity in order that the resultant corporation be entitled to the use of the carryover. In fact, the approval by the Court of the result in *Koppers Co. v. United States*³⁹ indicates that changes in the type of business within a single corporation are irrelevant in determining "continuity of business enterprise." In *Koppers*, the merged corporations had filed consolidated returns prior to the merger and for this reason were deemed the same "taxable enterprise" both before and after the merger. It was ir-

³⁷ 353 U.S. at 389-90.

³⁸ See, e.g., *Kolker Bros., Inc.*, 35 T.C. No. 38 (Nov. 21, 1960); *Alprosa Watch Corp.*, supra note 5.

³⁹ 133 Ct. Cl. 22, 134 F. Supp. 290 (1955), cert. denied, 353 U.S. 983 (1957). See 353 U.S. 388, n.7.

relevant in *Koppers* whether the individual corporations continued the same line of business after the merger as they conducted before. If merger is to bring into play adverse tax consequences as a result of post-merger changes in economic activity then it is clearly not acting *neutrally* with respect to the availability of carryovers. This is because a single corporation could have used the carryover, notwithstanding a change in its business, had it not merged.

One article⁴⁰ has criticized this "entity-tracing" view of continuity of business enterprise because of its allowance of a carryover from one pre-merger type of business to a new and different post-merger line of activity. This result allegedly treats merger as a "vehicle for free transferability."⁴¹ But because the law has at least heretofore never objected to this much "transferability" to a single corporation which does not merge, the *Libson* message of merger neutrality is being violated when a corporation which merges has thereby lost the carryover it could otherwise have used.

Nonetheless, the Internal Revenue Service has read *Libson* to impose this limitation on changes in the type of business activity following a merger; its reading is thus still a third interpretation of "continuity of business enterprise."⁴² Rev. Rul. 59-395 provides that following a merger or a consolidation, the tax consequences of which are determined under the 1939 Code,⁴³ the operating losses of an absorbed constituent "may be carried over to the resultant corporation to the extent that such losses . . . offset income of the resultant corporation attributable to assets acquired by it from the absorbed constituent and used in continuing the prefusion business of such absorbed constituent."⁴⁴ The latter phrase imposes a substantive limitation on economic activity changes which follow the merger since the resultant corporation by implication cannot use the loss constituent's carryover unless its "prefusion business" is continued after the merger. The phrase ". . . assets acquired . . . and used . . ." suggests that the carryover is applicable not just to profits obtained from continuing the same activity as conducted by the loss corporation but also to those derived by using only the very assets acquired in the merger. This result would handicap businesses with rapid rates of turnover of both capital and current assets and would motivate corporations about to be merged to build up inventory and replace

⁴⁰ Comment, 69 Yale L.J. 1201 (1960).

⁴¹ Id. at 1218.

⁴² Rev. Rul. 59-395, 1959-2 Cum. Bull. 475.

⁴³ Under the 1954 Code the Commissioner will not apply the *Libson* test to § 381 transactions, which include a statutory merger. Rev. Rul. 58-603, 1958-2 Cum. Bull. 147.

⁴⁴ 1959-2 Cum. Bull. 475 at 476. The "asset approach" of the Revenue Ruling is also the interpretation of Sinrich, *Libson Shops—An Argument Against Its Application Under the 1954 Code*, 13 Tax L. Rev. 167 (1958).

capital assets even though pure business considerations would not call for such ill-timed adjustments. Since general carryover policy does not suggest any reason to discriminate against industry with high turnover rates, the ruling may well be interpreted to allow the *replacement* of assets acquired in the merger and a tracing to ensure that the post-merger profits sought to be offset are "attributable to" them. A more serious problem arises from the apparent preclusion of an offset against income earned from assets *added* after the merger to continue the loss operation. If the relevant income must be attributable to assets "acquired . . . from the absorbed constituent," then the post-merger addition of a new plant, for example, even though used exclusively to continue the loss operation, will not produce profits capable of being offset by the old loss. While a limit on changing the type of activity after a merger derives some support from a view that merger should not enable a carryover against a different type of business, there appears to be no justification for placing a similar penalty on a mere change in degree rather than kind. Yet the Ruling suggests that a business which is merely intensified is thereby not "substantially the same."⁴⁵

A further problem associated with the Treasury Department's interpretation of "continuity of business enterprise" arises from the specific requirement of the Ruling that the post-merger income which can be offset must be derived from "continuing the prefusion business." A merger typically involves some changes in the conduct of formerly distinct operations. But any change at all runs the risk that the new corporation may not be considered as conducting the "prefusion business." Thus, inherent in Rev. Rul. 59-395 are difficult problems of deciding when, despite some change, the business operation conducted after the merger is *qualitatively* the same as that conducted before. Similar definitional problems exist under Section 382(a) of the 1954 Code, where, in order for a carryover to be allowed after the purchase of controlling stock in a corporation, the corporation must continue "a trade or business substantially the same as that conducted before."⁴⁶ The Regulations under section 382 indicate that no single formula can be applied to determine "sameness" in this context; instead, numerous factors are made relevant but with no indication as to their respective weights.⁴⁷ It should be noted that the "entity-tracing" approach to continuity of business does possess the obvious virtue of eliminating this problem, since the successor corporation need not continue the same qualitative prefusion business of the loss corporation in order to be given its carryover.

⁴⁵ No case supporting this position has been discovered. *Kolker Bros., Inc.*, supra note 32, suggests the contrary. See text accompanying notes 120-21 infra.

⁴⁶ Int. Rev. Code of 1954, § 382(a)(1)(C).

⁴⁷ Proposed Treas. Reg. § 1.382(a)-1(h)(5), 25 Fed. Reg. 13778 (1960).

C. *Extension to the Single Corporation*

Viewing *Libson* as requiring the continuity of the particular type of activity conducted by the loss corporation enables the extension of the doctrine into the single corporation area—the opposite end of the spectrum of interpretation of “continuity of business enterprise.” Notwithstanding the possible admonition inherent in footnote 9,⁴⁸ many decisions under the 1939 Code have denied carryovers within a single corporate entity.⁴⁹ Most of the cases involve changes in ownership and tax avoidance in addition to the change in profit directed activity, and *Libson* is customarily invoked without any indication of which of the three factors or combination thereof destroys continuity. Typical of these decisions is the case of *Mill Ridge Coal Co. v. Patterson*,⁵⁰ involving a corporation engaged in a losing coal mining operation which sold all of its assets prior to the purchase of its stock by new owners. A profitable oil business was then inserted into the shell and the carryover from the former business was sought to be used against the new profits. The District Court found that the purchase was not for the principal purpose of tax avoidance but decided the case for the Government since it felt itself “bound by the reasoning of the Supreme Court” in *Libson*.⁵¹ The court seems to have considered decisive the qualitative change in the nature of Mill Ridge’s business,⁵² even though no such change occurred in *Libson*, where the retail selling of women’s apparel continued after the merger as before. The Fifth Circuit affirmed but disagreed with the District Court, both on the tax avoidance issue and possibly on the application of *Libson*. With respect to the latter, the Circuit Court’s interpretation of the carryover provisions as primarily directed against “windfall” benefits and “trading” in carryovers implies strongly that the change in business cannot permit the invocation of *Libson* unless preceded by a significant change in ownership.⁵³ But *Libson* itself involved no change in ownership.

Although *Mill Ridge* clearly establishes that the *Libson* rationale can be extended to the single corporate entity, there exists confusion as to exactly how it extends. Any one of the three factors involved in the case—tax avoidance, change in business and change in owner-

⁴⁸ One commentator, Sinrich, *supra* note 44, at 176, has interpreted footnote 9 as being an unequivocal determination that “continuity of business enterprise” can have no application to the single corporation.

⁴⁹ See, e.g., *Virginia Metal Prod., Inc. v. Commissioner*, *supra* note 14; *Mill Ridge Coal Co. v. Patterson*, *supra* note 5; *J. G. Dudley Co.*, 36 T.C. No. 112 (Feb. 28, 1961). But see *British Motor Car Distrib., Inc. v. Commissioner*, *supra* note 12; *Kolker Bros., Inc.*, *supra* note 38.

⁵⁰ *Supra* note 5.

⁵¹ 1 Am. Fed. Tax R.2d at 1629.

⁵² *Id.* at 1629-30.

⁵³ 264 F.2d at 717.

ship—might be looked upon as determinative, and indeed each one has been so viewed.⁵⁴

One recent case has applied *Libson* to the *Mill Ridge* fact situation where there was no evidence of tax avoidance. In *Virginia Metal Products, Inc. v. Commissioner*,⁵⁵ a parent corporation transferred assets from its profitable steel products construction business to a newly bought subsidiary. The subsidiary had incurred a substantial loss carryover in the businesses of aluminum manufacturing and sales of furnace stokers. After the purchase by Virginia Metal, the assets used in these businesses were sold so that only the shell remained when the new assets were transferred to the subsidiary. The Tax Court held that *Libson* was inapplicable per footnote 9 and decided for the taxpayer in accordance with the authority stemming from *Alprosa Watch Corp.*⁵⁶ allowing for a carryover from one type of business to another within a single corporation. The Court of Appeals reversed, claiming that *Libson* was “unmistakably decisive” and that the disallowance of the carryover must follow “a fortiori” from *Libson*.⁵⁷ The court thought that *Libson* “is a stronger case for the taxpayer than the one before us. The shareholders remained the same in these various *Libson* corporations. The same business was carried on after the merger as before. They all continued to sell women’s apparel.”⁵⁸ This very language indicates that the lack of continuity between the three loss corporations and *Libson Shops, Inc.* cannot be explained by the failure to continue the business nor by any change in ownership. The jump from *Libson* to the *Virginia Metal* result would therefore seem to require more of an explanation than is afforded by the use of the term “a fortiori” or of the unhelpful conclusion that “. . . the thrust of that decision easily includes such a

⁵⁴ Levine and Petta, *supra* note 13, at 564, state that “Under *Mill Ridge*, a single taxpayer could not utilize its own loss against profits of a different divisional business even where there is no change of ownership. . . . [T]he basis of the decision in *Mill Ridge* is change of business, not change of ownership.” Comment, 69 Yale L.J. 1201, at 1229, while recognizing the ambiguity of the opinion, suggests the change in ownership to have been decisive. Friedman and Cuddihy, *Multiplying Cases Extend, but Do Not Clarify Libson Rule in Loss Carryovers*, 15 J. Taxation 338, 342 (1961), maintain that “It is to be gravely doubted that the case would have been so decided had there been no tax avoidance. . . .”

⁵⁵ 290 F.2d 675 (3d Cir. 1961).

⁵⁶ 11 T.C. 240 (1948). The Tax Court in *Virginia Metal* used *Alprosa* as authority for its conclusion that

In the instant case, Winfield [the loss subsidiary] is the same corporate entity that sustained the net operating losses in question. It is not seeking to reduce the income of some other corporate entity by reason of such losses. It only seeks to carry forward and apply them against its own income. This is in accord with the statute, the regulations, and with our decisions.

⁵⁷ 33 T.C. 788, at 799 (1960).

⁵⁸ 290 F.2d at 677, 676.

⁵⁸ *Id.* at 677.

case as this.”⁵⁹ Moreover, the court relied on three decisions as authority for its result; two of them involved carryovers from one entity to another and thus did not present the single corporation issue.⁶⁰ The third, *Mill Ridge*, is arguably distinguishable as having found, perhaps determinatively, that the stock purchase was made for the primary purpose of avoiding income taxes.

Mill Ridge and *Virginia Metal* cannot be justified by the view of *Libson* as deciding only that the device of merger should act completely neutrally with respect to carryovers.⁶¹ If the change in entity which occurred as a result of the Libson Shops merger brought into play the question of whether the “identity” of the loss corporations remained in the successor corporation, then no question of “identity” arises when there is no change in entity as in *Mill Ridge* or *Virginia Metal*.⁶² This was the reasoning of the Tax Court in *British Motor Car Distrib., Ltd. v. Commissioner*,⁶³ a case involving the typical change in control of the loss corporation, discontinuation of the loss activity and the injection of a new and profitable business. The Tax Court held *Libson* inapplicable. It could find no justification for disallowing a carryover to offset profits earned from a new type of business within a single corporation.⁶⁴ *British Motor Car* therefore stands opposed to *Mill Ridge* and *Virginia Metal* on substantially equivalent facts.

But even if it is difficult or impossible to justify *Mill Ridge* and *Virginia Metal* as a matter of proper interpretation of *Libson*, Congress has indicated that for cases decided under the 1954 Code, the result in each of these cases will be proper. Both presented a set of facts characteristic of the typical case of “trafficking in loss corporations,” which Congress dealt with specifically in Section 382(a) of the new Code.⁶⁵ This alleged evil occurs—as in *Mill Ridge* and *Virginia Metal*—when a corporation with an available loss carryover is bought by new owners “for the purpose of” utilizing this carry-

⁵⁹ *Ibid.*

⁶⁰ *Bookwalter v. Hutchens Metal Prod., Inc.*, 281 F.2d 174 (8th Cir. 1960) (statutory merger); *Patten Fine Papers, Inc. v. Commissioner*, 249 F.2d 776 (7th Cir. 1957) (parent corporation disallowed carryover of losses incurred by liquidated subsidiary).

⁶¹ See text accompanying notes 35-41 *supra*.

⁶² See Arent, *Current Developments Affecting Loss Corporations*, 35 *Taxes* 956 (1957); Burnstein, *Problems in the Use of Loss Carry-Overs*, 39 *Taxes* 1065 (1961); Levine and Petta, *supra* notes 13 & 31.

⁶³ *Supra* note 12.

⁶⁴ The court's rationale was virtually identical to its reasoning in *Virginia Metal*. See *supra* note 56.

⁶⁵ H.R. Rep. No. 1337, 83d Cong., 2d Sess. 42 (1954) refers to § 382(a) as a “special limitation on net operating loss carryovers [providing] an objective standard governing the availability of a major tax benefit which has been abused through trafficking in corporations with operating loss carryovers. . . .”

over.⁶⁶ Thus when the old activity is not continued and a new and profitable business is injected into the void, the new owners are immediately suspected of originally contemplating using the shell in which it operated solely to derive the carryover benefit. Section 382(a) therefore conclusively presumes the principal motivation to be tax avoidance when these facts unfold. The difficulties of proving subjective intent demanded by section 269 were felt to warrant the addition of the new section to cover this special category of cases where a legitimate business purpose for the undertaking would almost invariably be absent.⁶⁷

But when the facts do *not* present the "trafficking" situation, the application of *Libson* to deny a carryover to a single corporate entity under the 1939 Code cannot derive support from even this "subsequent" legislative development. Nonetheless, the Commissioner has argued that *Libson* is authority for denying a carryover when the only change taking place within a corporation is a change in the type of its business activity⁶⁸ or its ownership.⁶⁹ Because these arguments are still being made under 1954 Code cases, consideration of their merits in this article will be deferred until the framework of the new Code is presented and the issue raised as to the possibility of *Libson's* vitality under the new provisions.

THE 1954 CODE AND *Libson*

A. *The Statutory Pattern*

The relevant carryover provisions of the 1954 Code are Sections 172, 269, 381 and 382. Section 172 provides for the deduction of net operating losses with an allowance for a three year carryback and a five year carryover.⁷⁰ Unlike its predecessor, Section 122 of the 1939 Code, this section does not grant the carryover or carryback to "the taxpayer." One commentator has argued that the omission of this language by itself should preclude any *Libson* application to the single corporation under the new Code.⁷¹ It is true that *Libson* did address itself to a case where, because of a merger, the pre-merger

⁶⁶ The emphasis on this purpose as the target of § 382(a) is revealed in S. Rep. No. 1622, 83d Cong., 2d Sess. 53 (1954):

Your committee has adopted a provision to limit the application of this provision relating to purchase to those areas in which abuse has most often arisen, that is, the purchase of the stock of a corporation with a history of losses *for the purpose of* using its loss carryovers to offset gains of a business unrelated to that which produced the loss. [Emphasis added.]

⁶⁷ *Ibid.*

⁶⁸ *Kolker Bros.*, 35 T.C. No. 38 (Nov. 21, 1960); *Joseph Weidenhoff, Inc.*, 32 T.C. 1222 (1959).

⁶⁹ *A. C. Willingham v. United States*, 289 F.2d 283 (5th Cir. 1961). See text accompanying notes 136-40 *infra*.

⁷⁰ Int. Rev. Code of 1954, § 172(b)(1).

⁷¹ *Sinrich*, *supra* note 44, at 176.

taxpayer's "identity" in the successor had to be ascertained in order to allow the carryover. But *Mill Ridge, Virginia Metal* and other cases have rejected the implication that because the bare entity of a corporation remains undisturbed after a change in its business and/or ownership there arises no dispute as to taxpayer identity and "continuity of business enterprise" should therefore be irrelevant. Thus, while *Libson* itself may have intended no disruption of the traditional free allowance of carryovers within a single corporation, subsequent cases have disagreed. Their doctrine would seem to make immaterial the omission from the new Code of the term "the taxpayer." In addition, the Congress did not omit the term with the *Libson* case in mind, because the case was decided three years after the effective date of the new act. Instead, it appears that the probable reason for the omission of the term was that the "taxpayers" to whom carryovers would not accrue were largely—though not entirely—spelled out specifically in sections 381 and 382.

Section 381(a) provides for the inheritance of certain tax attributes by a corporation acquiring the assets of another corporation in designated tax-free transactions.⁷² Section 381(c) includes net operating loss carryovers among the inheritable items. The section thus adds to non-recognition of gain the succession to carryovers as inducements to the effectuation of these tax-free transactions. But this inducement has its limitations. First, section 382(b) provides generally for a reduction in the carryover when the loss corporation's shareholders end up after the reorganization with less than a twenty per cent stock interest in the acquiring corporation. For every percentage point interest less than twenty per cent, the section reduces the carryover by five per cent. Section 382(b) thus prevents the use of a carryover when its benefits are to be enjoyed entirely by new owners, but it enables most of the enjoyment to accrue to new owners who successfully manage to ensure only a limited retention of interest by old shareholders. Second, the Regulations under section 269 indicate that transactions qualifying under section 381 must still overcome the tax avoidance hurdle for the carryover to be allowed.⁷³ On the other hand, business planners have a significant advantage in planning transactions under section 381, since the Treasury has ruled that the *Libson* doctrine is inapplicable to such transactions.⁷⁴

Section 382(a) provides the focus of Congressional treatment of the single corporation undergoing changes in type of business and

⁷² These qualifying transactions are a § 332 tax-free liquidation of a subsidiary (except where the basis of the assets received is determined by § 334(b)(2)), and § 368(a)(1)(A), (C), (D) and (F) reorganizations, provided that in the (D) reorganization, liquidation of the transferor follows so that only the transferee corporation continues.

⁷³ Treas. Reg. § 1.269-6 (1962).

⁷⁴ Rev. Rul. 58-603, 1958-2 Cum. Bull. 147.

ownership where no tax-free reorganization is involved. The Revenue Ruling which rendered *Libson* inapplicable to Section 381 transactions specifically left open the possibility of a *Libson* extension to section 382(a),⁷⁵ and the Regulations superimpose section 269 onto section 382(a).⁷⁶ This section eliminates a carryover completely when fifty per cent of a corporation's stock is purchased in a taxable transfer and the corporation "has not continued to carry on a trade or business substantially the same as that conducted before"⁷⁷ the change in ownership. Section 382(a) thus provides an entirely different carry-over rationale to the stock purchase case than does section 381 to the tax-free asset purchase. In the latter case there is no requirement that the loss business operation continue and the continuity of interest requirement is only twenty per cent; even then, the carryover is not lost, but only reduced, if something less than twenty per cent results. This discrepancy is undoubtedly a reflection of the difference between the two-fold Congressional purpose of stimulating tax-free readjustments via section 381, while at the same time discouraging "trafficking" in loss corporations—the stated objective of section 382(a).⁷⁸ The new Code thus shows a liberalizing trend of permitting broadened survival of carryovers except in the section 382(a) case felt to involve particular abuse.⁷⁹

The new Regulations under section 382(a) illustrate the difficulties involved in a determination of whether a corporation has, despite some change, nevertheless continued "substantially the same" trade or business.⁸⁰ Treasury Regulation 1.382(a)-1(h)(5) simply states that all the facts and circumstances will be taken into account in the determination. It lists a number of "relevant factors" including changes of plant, equipment, product, customers, employees and location without indicating their relative weight or when a single one could prove determinative. Another regulation allows a loss corporation to *add* a new business after the stock purchase; the losses from the old activity can be offset against profits from the new, provided only that the old business be continued for two taxable years.⁸¹ Allowing such an offset seems inconsistent with the Senate Report indicating that the function of section 382(a) was to disallow carryovers when loss corporation stock is purchased "for the purpose

⁷⁵ *Ibid.*

⁷⁶ Treas. Reg. § 1.269-6 (1962).

⁷⁷ Int. Rev. Code of 1954, § 382(a)(1)(C). This subsection was not present in the original draft of § 382 offered in the House of Representatives. See H.R. Rep. No. 1337, 83d Cong., 2d Sess. 42 (1954).

⁷⁸ See *supra* note 65.

⁷⁹ See Reese, Reorganization Transfers and Survival of Tax Attributes, 16 Tax L. Rev. 207, 223 (1961).

⁸⁰ See Friedman and Cuddihy, Treasury's Concept of Change of Business for Loss Carryover Seen as Too Broad, 15 J. Taxation 278 (1961).

⁸¹ Proposed Treas. Reg. § 1-382(a)-1(h)(8), 25 Fed. Reg. 13779 (1960).

of using its loss carryovers to offset gains of a business *unrelated to* that which produced the losses.⁸² [Emphasis added.] This language suggests no amelioration merely because the loss activity is continued. Furthermore, the "two year continuation" requirement apparently presupposes that when the loss business is even nominally continued for the necessary period, the tax avoidance possibilities must not have been paramount when the stock purchase was contemplated. To allow for an escape from section 382(a) in a case where the conduct of the loss operation is not *bona fide*, but is rather a subterfuge for a standard "trafficking" case, weakens the scope of the section and prevents its application to cases which otherwise present the forbidden characteristics. This is especially significant in view of the fact that the "two year" rule can be satisfied in actual operation by a period of slightly over one year.⁸³

Section 269 completes the statutory framework. Its predecessor, Section 129 of the 1939 Code,⁸⁴ was designed generally to limit those stock or asset purchases which were primarily motivated by the desire to obtain the benefit of tax attributes. In operation, however, section 129 proved to be a "weak" weapon against "abusive" use of loss carryovers.⁸⁵ In contrast, section 269 seems currently a far more effective statutory provision. This improvement is largely the result of the recent rejection of a common construction of section 269(a)(1) which had considerably narrowed its scope. That section disallows a carryover when control of a corporation is acquired for the principal purpose of "evasion or avoidance of federal income tax by securing the benefit of a deduction, credit or other allowance which such [acquiring] person or corporation would not otherwise enjoy."⁸⁶ In the 1948 *Alprosa* decision, the Tax Court interpreted this language to disallow the deduction when taken by the *acquiring* corporation or individuals but not if by the *acquired* corporation.⁸⁷ The cases following *Alprosa* illustrated the particular inability of this section to cope with the typical "trafficking" case, since so long as the loss entity remained to utilize its own carryover, the purchasers were not

⁸² See supra note 66.

⁸³ Surrey & Warren, *Federal Income Taxation* 1599 (1960 ed.). The Treasury has tried to close the "loophole" created by the inapplicability of § 382(a) to the case where the loss activity is continued nominally for the required two years, in Proposed Treas. Reg. 1.269-3(b) (1960). This Regulation allows for a presumption that tax avoidance was the principal purpose of an acquisition of a loss corporation when a different and profitable business is transferred into the loss corporation, *even though* the loss activity is continued.

⁸⁴ §§ 129(a)(1) and (2) were virtually identical to the new §§ 269(a)(1) and (2).

⁸⁵ See S. Rep. No. 1622, 83d Cong., 2d Sess. 53 (1954).

⁸⁶ Additionally, § 269(a)(2) covers certain asset purchases by a corporation, provided that the purchase is not taxable. See Int. Rev. Code of 1954, § 269(a)(2).

⁸⁷ *Alprosa Watch Corp.*, 11 T.C. 240, 245 (1948) (dictum).

considered as themselves obtaining any proscribed benefit.⁸⁸ Recently, this construction has been rejected and the prevailing view at present is that a purchaser secures the "benefit" of a carryover even though the purchased corporation is the taxpayer actually taking the deduction.⁸⁹ The new Regulations under section 269 incorporate the recent interpretation.⁹⁰

Section 269 has been further strengthened by the 1954 addition of subsection (c). This section generally provides for "prima facie evidence" of a principal purpose of tax avoidance whenever the purchase price paid in an acquisition described in subsection (a) is substantially less than the total of the adjusted basis of the property acquired—or of the corporation's assets in the case of a stock purchase—plus the "tax benefits (to the extent not reflected in the adjusted basis of the property) not available to such person or corporation otherwise than as a result of such acquisition."⁹¹ Subsection (c) thus adds, as one method of determining whether the "principal purpose" was tax avoidance, a comparison of the price paid with the property and benefits received. If the discrepancy is not great, then presumably the tax avoidance purpose did not motivate the purchase; on the other hand, if the buyer fails to pay "enough" for what he receives, section 269(c) assumes his primary interest was the carryover rather than the business. Whatever its merits, the new subsection clearly makes available to the Commissioner a stronger anti-tax avoidance section. Finally, the new Regulations, by assuming the prohibited tax avoidance purpose to be present in certain designated transactions, will further assist the Commissioner. In particular, Treasury Regulation Section 1.269-3(b)⁹² incorporates into section 269 the *Mill Ridge* and *Virginia Metal* extension of *Libson*: when a newly bought loss corporation is injected with a business different in type from its old activity, tax avoidance will be the presumed primary purpose of the initial acquisition, even if the loss activity is continued. The combination of sections 382(a) and 269 should indeed go a long way towards achieving the Congressional purpose of stopping "trafficking in corporations with operating loss carryovers."⁹³

⁸⁸ See, e.g., *Mill Ridge Coal Co. v. Patterson*, 1 Am. Fed. Tax R.2d 1627 (N.D. Ala. 1958), rev'd on this point, 264 F.2d 713 (5th Cir.), cert. denied, 361 U.S. 813 (1959); T.V.D. Co., 27 T.C. 879 (1957).

⁸⁹ The first rejection of the *Alprosa* interpretation occurred in *Coastal Oil Storage Co. v. Commissioner*, 242 F.2d 396 (5th Cir. 1957). Following the *Coastal Oil* view were the decisions in *Mill Ridge Coal Co. v. Patterson*, 264 F.2d 713 (5th Cir.), cert. denied, 361 U.S. 813 (1959), reversing on this point, 1 Am. Fed. Tax R.2d 1627 (N.D. Ala. 1958); and *Thomas E. Snyder Sons Co.*, 34 T.C. No. 39 (Jan. 6, 1960), aff'd 288 F.2d 36 (7th Cir. 1961).

⁹⁰ Treas. Reg. § 1.269(3)(a)(2) (1962).

⁹¹ Int. Rev. Code of 1954, § 269(c)(2).

⁹² See supra note 83.

⁹³ H.R. Rep. No. 1337, 83d Cong., 2d Sess. 42 (1954).

These provisions of the new Code reflect a Congressional choice among various policy alternatives that, except in the special reorganization and "trafficking" situations, carryovers within a single corporation should be limited only by the application of section 269. Since section 382(a) was designed to supplement the operation of section 269 by providing objective criteria to allow for a conclusive presumption of tax avoidance in cases felt to involve particular abuse,⁹⁴ it is quite consistent with the underlying rationale that carryovers should not be denied after those economic and ownership readjustments which are not motivated primarily by the existence of a loss carryover.

B. *The Policy Alternatives*

The alternatives to this choice of policy are many. Indeed, the original draft of section 382(a) in the House of Representatives would have eliminated the requirement of continuing the loss operation and thus would have made carryover availability turn solely on the fifty per cent shift in ownership.⁹⁵ The American Law Institute in 1958 also advocated focusing on ownership change alone.⁹⁶ Its report insists that a policy designed to disallow carryovers only in cases where the desire to evade taxes motivates an acquisition "starts from too confined a view of the basic issue."⁹⁷ In the Institute's view, the "basic issue" is more properly the question of whether outsiders in *any* situation should be able to succeed to carryovers. The conclusion it reached was "designed to prevent the unwarranted acquisition of tax benefits by outsiders."⁹⁸ Recognizing that the operation of a continuity of ownership test operates unfairly to the minority interests who retain their investment after the purchase of control by new interests, the report recommended that carryovers be preserved unless sixty-seven per cent of the stock changes hands within a two-year period. The ALI's rationale is that, in general, new owners should not be allowed to benefit from the misfortune of prior owners. When, however, the old shareholders do retain a substantial interest in the loss corporation, averaging ought to be allowed in order to

⁹⁴ See supra note 65. Section 382(a) "in effect, creates an irrebutable presumption of tax avoidance motivation by eliminating the carryovers where the business is not continued." Cohen, Phillips, Surrey, Tarleau & Warren, *The Internal Revenue Code of 1954: Carryovers and the Accumulated Earnings Tax*, 10 *Tax L. Rev.* 277, 286 (1955).

⁹⁵ H. R. Rep. No. 1337, 83d Cong., 2d Sess. 42 (1954). An analysis of the merits of the various policy alternatives is beyond the scope of this article. The textual treatment of several proposals is designed only to illustrate possible alternatives to the 1954 Code approach.

⁹⁶ See American Law Institute, *Income Tax Problems of Corporations and Shareholders, Report of Working Views of a Study by the American Law Institute Staff and American Bar Association Section of Taxation Liaison Committee* (Oct. 31, 1958) 40 [Hereinafter cited as 1958 ALI].

⁹⁷ *Id.* at 44.

⁹⁸ *Id.* at 358.

enable them to recoup their loss. This approach obviously leaves no room for section 382(a)'s test of continuity of loss operation, which is "inconsistent with a policy based on continuity-of-ownership criteria."⁹⁹ Accordingly, the report recommended the elimination of section 382(a)(1)(C).

In 1954, the Institute's policy did not reflect this concern over whether the succession to old carryovers by new owners represented an unjustified windfall. Its draft of that year showed instead a concern for disallowing carryovers only when the purpose of the acquisition was tax avoidance.¹⁰⁰ This proposal would have relied on section 269 alone, but the Congress was unwilling to accept a suggestion that a general anti-tax avoidance section could adequately police the practice of loss corporation "trafficking."

In 1958, the Advisory Group on Subchapter C reported to the Ways and Means Subcommittee on Internal Revenue Taxation a recommendation which combined certain features of both the continuity-of-ownership and tax avoidance policy views.¹⁰¹ Under this proposal carryovers would have been limited following the purchase of controlling stock in a loss corporation.¹⁰² When there was a fifty per cent ownership change, the available carryover would have been limited to one-half of the consideration paid. This limitation, operative only when the minimum shareholder change has occurred, is related to the net worth of the loss corporation and thus is designed to prohibit a carryover after a sham transaction or the purchase of a mere shell.¹⁰³ Section 269 was to be relied on in all cases not involving purchase of loss corporation stock and in those stock purchase cases where the consideration paid was sufficient to preserve the carryover but the purchase was for the purpose of tax avoidance.

Other suggestions for the appropriate carryover policy to be applied to the single corporation include the proposal that carryovers should be allowed irrespective of ownership changes, so long as the

⁹⁹ *Id.* at 349-50.

¹⁰⁰ *Id.* at 46-47.

¹⁰¹ Report of Advisory Group on Subchapter C to Ways and Means Subcommittee on Internal Revenue Taxation (Dec. 10, 1958); See Hearings Before the House Ways and Means Committee on Advisory Group Recommendations on Subchapters C, J, and K of the Internal Revenue Code, 86th Cong., 1st Sess. 473 (1959) [Hereinafter cited as 1959 Hearings].

¹⁰² See 1958 ALI at 343.

¹⁰³ Section 269(c) provides for a presumption of tax avoidance when the consideration paid is "substantially disproportionate to" the adjusted basis of the stock or of the corporation's assets plus the tax benefits not otherwise available. This provision resembles the proposal of the Advisory Group in that the operative factor in both cases is the price the purchaser pays; if he pays "enough" in both cases the carryover is available. If not, § 269(c)'s presumption is operative and if un rebutted the carryover is lost completely. Under the Advisory Group's proposal, however, the carryover is merely reduced to one half of the price paid for the stock.

type of operation generating the losses is continued,¹⁰⁴ and that a "free trade" in carryovers should be permitted with no restrictions whatsoever on their transferability.¹⁰⁵

All of these policy approaches were available in 1954 to the Eighty-Sixth Congress. Its choice was the adoption of sections 381 and 382 and the addition of subsection (c) to 269. This statutory pattern shows that, absent a section 381 reorganization, the general policy adopted was one of allowing carryovers except when an acquisition is for the purpose of tax avoidance, as determined objectively in the "trafficking" case of section 382(a), or subjectively under section 269. Any extension of the *Libson* doctrine to deny carryovers to a single corporation would have to remain consistent with this choice of policy in order to be consistent with the choice of the Congress. And yet at least two threatened extensions of the doctrine—the disallowance of carryovers where only the business activity *or* the corporate ownership has changed¹⁰⁶—fail to pass this test of consistency with the underlying policy.

C. *The Application of the Doctrine*

Libson's "continuity of business enterprise" requirement may have viability in a number of areas under the new Code. The Revenue Service has presently deemed it inapplicable only to transactions covered in section 381(a).¹⁰⁷ But even in section 381 transactions, *Libson's* continuity may come into play indirectly since those transactions must first qualify as a section 368 reorganization. Because Revenue Ruling 58-603 called attention to the requirements of a section 368 reorganization, it appears that a definition of reorganization "continuity" framed in *Libson* terms is being read into section 368. Further, insolvency reorganizations may have to meet *Libson* requirements;¹⁰⁸ the new section 269 Regulations definitely incorporate the *Mill Ridge* fact situation as presumptive of tax avoidance;¹⁰⁹ and *Libson* may come to deny succession to tax attributes other than net operating loss carryovers.¹¹⁰

Perhaps most troublesome is the possible extension of *Libson* to deny a carryover (1) when one of the two basic conditions of section 382(a) has not been violated and where the operation of that

¹⁰⁴ See 1959 Hearings at 894, 913 (statement of George Lent); Surrey and Warren, *supra* note 83, at 1604.

¹⁰⁵ See Tarleau, *Difficulties Faced by a Taxpayer Trying to Take Tax Advantage of a Loss Carryover*, 4 J. Taxation 91 (1956); Cuddihy, 10th Tax Inst., U. of So. Cal. 303, 306 (1958).

¹⁰⁶ See text accompanying notes 112-21 and 136-40 *infra*.

¹⁰⁷ Rev. Rul. 58-603, 1958-2 Cum. Bull. 147.

¹⁰⁸ *A. C. Willingham v. United States*, 289 F.2d 283 (5th Cir. 1961), makes this suggestion. See text accompanying note 139 *infra*.

¹⁰⁹ See note 83 *supra*.

¹¹⁰ Surrey and Warren, *supra* note 83, at 1589.

section would therefore not disallow the carryover, and (2) when a loss corporation in a taxable transaction purchases the assets of a profitable business and seeks to carry forward its old losses against the profits from the new business. These two cases pose the questions of whether a mere change in ownership *or* in type of business operation will suffice to allow for an application of *Libson*. The remainder of this article will be devoted to answering these questions.¹¹¹

Can *Libson* operate under the new Code to deny a carryover when the only change occurring within a corporation is a shift in the type of economic activity it conducts? While the courts have not yet explicitly agreed with the Commissioner, he has continued to argue that the answer should be "yes." The Commissioner's present position was manifested by his recent removal of acquiescence in the decision of *Northway Securities Co. v. Commissioner*.¹¹² The Board of Tax Appeals in this case rejected the Commissioner's argument that change of business alone was enough to disallow the carryover. Since the non-acquiescence is not by its terms restricted to pre-1954 Code cases, it is highly possible that the Commissioner now considers the recent *Libson* extensions to justify reassertion of his *Northern Securities* argument in an appropriate case under the new Code.¹¹³

In *Joseph Weidenhoff, Inc.*,¹¹⁴ the Commissioner again argued, as in *Northern Securities*, that a carryover should be denied when the loss is sought as an offset to profits earned in a different type of business activity. *Weidenhoff* involved a portion of the consolidated net operating losses attributable to the Fostoria Screw Co., a member of an affiliated group, which had sold its assets and discontinued all operations by the time the group sought to use Fostoria's portion of the carryover. The Screw company's business activity was not continued by any other member of the group; thus the losses were sought as an offset against profits earned later from different activity. The Government argued that *Mill Ridge* and *Libson* "require" disallowance because the profits were earned in years when "the business of Fostoria was no longer continued by any member of the affiliated

¹¹¹ When there has been *both* a change in business and more than a fifty per cent change in ownership, § 382(a) and the *Mill Ridge* version of *Libson* would both operate to deny the carryover. In a 1954 Code case involving this fact situation, the Tax Court denied the carryover on the basis of § 269 but added that "strong support for the Commissioner's position on this issue is found in [*Mill Ridge, Virginia Metal and Dudley*]." Frank Spignolo Warehouse Co., 37 T.C. No. 1, at 6 (Oct. 6, 1961). While § 382(a) would clearly seem to pre-empt the application of *Libson* when both changes are present, the result of disallowance of the carryover on the authority of either would accord with what Congress was seeking to do by enacting § 382(a).

¹¹² 23 B.T.A. 532 (1931), acq., X-2 Cum. Bull. 52 (1931), nonacq., 1960-2 Cum. Bull. 8.

¹¹³ See Burnstein, *supra* note 62, at 1075. The *Mill Ridge* decision may be viewed as resting on the business change alone. See *supra* note 54.

¹¹⁴ 32 T.C. 1222 (1959). *Weidenhoff* was decided under the 1939 Code.

group."¹¹⁵ The Tax Court rejected the argument on the grounds that the "taxpayer" was the affiliated group rather than Fostoria; even though the group's composition had changed, its identity as the "taxpayer" had not.¹¹⁶

At least one case under the 1954 Code has impliedly approved the Commissioner's position. In *Frank Spignolo Warehouse Co., Inc.*,¹¹⁷ although both business and ownership had changed, the Tax Court interpreted the *Libson* issue in the following language: "May [a] single corporation offset losses incurred in one business activity against profits earned in a different business activity? [The doctrine of *Libson Shops, Inc. v. Koehler . . .*]" [Emphasis added.]¹¹⁸ Although deciding the case on tax avoidance grounds, the Court specifically noted that this interpretation of *Libson* might well have applied had tax avoidance not proved dispositive.¹¹⁹

In *Kolker Bros., Inc. v. Commissioner*,¹²⁰ the taxpayer, incorporated to conduct a retail grocery business and generally to deal in food and beverages, operated an unprofitable retail grocery and liquor store. It purchased the assets of an insolvent corporation engaged in the business of selling food to hotels, institutions and restaurants. The insolvent activity became profitable and the old business was sold. There was no change in the ownership of the taxpayer. It sought to carry forward the losses from the retail grocery business to offset the profits obtained from the new business, but the Commissioner again argued that *Libson* and *Mill Ridge* controlled, because the income was not produced by "substantially the same business" as had incurred the losses. The Tax Court rejected the Government's argument, holding *Libson* and *Mill Ridge* distinguishable. While the opinion is confusing, the court seems to have held that *Libson* was not applicable, citing footnote 9, because ". . . there was here 'a continuity of business enterprise,' with the same taxpayer by its own operations earning the income and sustaining the losses involved. . . ."¹²¹ Further, the court claimed that even if there were a requirement that a single corporation offset profits only with losses from "substantially the same business," this requirement was in fact met in *Kolker* due to the "substantial" identity of the retail grocery and food supply businesses.

In each of the above cases the Commissioner has argued that losses from one business activity cannot be carried forward to offset

¹¹⁵ Id. at 1237.

¹¹⁶ This conclusion was suggested by the Supreme Court in *Libson* by its approval of the result in *Koppers*. See 353 U.S. at 388 n.7.

¹¹⁷ 37 T.C. No. 1 (Oct. 6, 1961).

¹¹⁸ Id. at 4.

¹¹⁹ See supra note 111.

¹²⁰ 35 T.C. 299 (Nov. 21, 1960), CCH 1960 Tax Ct. Reg. Dec. 3257.

¹²¹ CCH 1960 Tax Ct. Reg. Dec. at 3261.

profits earned from another. His argument seems supportable only by a literal construction of the Supreme Court's language that the income sought to be offset must be obtained from "substantially the same business which produced the loss."¹²² This construction is contrary to the 1954 statutory scheme which nowhere suggests that the carryover is lost merely because the business activity has been changed. While section 382(a) does contain the requirement of continuity of the loss trade or business, the Regulations show that because a different type of business may be added and the losses offset against profits obtained from its operation, the section does not incorporate a thesis that carryovers are unavailable merely because of a change from one type of business to another.¹²³ Moreover, both the Regulations and the Senate Committee Report show that the transaction sought to be outlawed in section 382(a) is the stock purchase made "for the purpose of" using a carryover to offset profits of a business unrelated to that which caused the losses.¹²⁴ Without the preceding change of control, any mere change of business activity does not involve "trafficking" and therefore cannot come within the proscription of section 382(a). To say that *Libson* allows for the superimposition of a "type of business" requirement onto section 382(a) is thus clearly contrary to the statutory pattern.

This inconsistency with the statute is not present in the *Kolker*-type case where a loss corporation buys profitable business assets and seeks a carryforward against the profits from the new enterprise. This fact situation is not covered specifically in the 1954 Code,¹²⁵ but it is submitted that to invoke *Libson* in this case is equally unwarranted as a matter of desirable carryover policy.

The law presently provides that a corporation conducting businesses A and B may in one year offset losses from A against profits from B, and in the following year, a net loss can be carried over to offset that year's profits obtained from the conduct of B. Furthermore, if A is sold at a loss, this loss may be carried over against later profits from B.¹²⁶ These results reflect a policy (a) not to attach a carryover to a particular line of endeavor, and (b) not to require that the loss business remain in operation in order for the offset to be allowed. It would appear to follow that the corporation could use some of the profits from B to buy the assets of business C and later offset C's profits with losses unexpectedly incurred in the conduct of B. But a broad reading of *Mill Ridge* and *Virginia Metal* plus the

¹²² 353 U.S. at 386.

¹²³ Proposed Treas. Reg. § 1-382(2)-1(h)(8), 25 Fed. Reg. 13779 (1960).

¹²⁴ S. Rep. No. 1622, 83d Cong., 2d Sess. 53 (1954); Proposed Treas. Reg. §1-382(2)-1(h)(5), 25 Fed. Reg. 13778 (1960).

¹²⁵ Surrey and Warren, *supra* note 83, at 1600-01.

¹²⁶ See Burnstein, *supra* note 62, at 1076.

Commissioner's argument in *Kolker* claim that this cannot be done; the purchase of C has destroyed the needed "continuity of business enterprise." In view of what may be done short of the purchase and the policy of allowing intra-corporate economic flexibility which underlies this permissible latitude, it is difficult to see why a line should be drawn at the point of the purchase of assets. If the purchase of a new business suggested tax avoidance, then clearly the drawing of the line might be justified.¹²⁷ But when a loss corporation merely seeks to regain its economic health in a new line of business, its choice is not the evasion of tax but rather the evasion of economic death. A loss corporation's desire to try a new line of business activity, while it may have tax benefits, has not traditionally been considered a tax avoidance measure since legitimate business reasons would very often dictate the abandonment of a losing venture and a new start in more promising activity.¹²⁸ But if the new business cannot utilize an old carryover, the law is in effect taxing "on a business-by-business basis rather than on the taxpayer as a whole."¹²⁹ Furthermore, the result is to grant carryovers only to those who correctly anticipate a profitable future for a certain business, a seemingly unjustified basis upon which to rest the equitable privilege of averaging.¹³⁰

Moreover, Revenue Ruling 58-603 provides that *Libson* is not applicable to a section 368(a)(1)(C) reorganization where a loss corporation purchases assets in exchange for its stock; only section 382(b) is brought into play to ensure a required minimum continuity of ownership. Despite the solicitude revealed by the Congress in section 381 and the Treasury Department in its Revenue Ruling, it is hard to justify the discrimination inherent in the result urged by the Commissioner that a taxable purchase of those assets will operate to disallow any subsequent carryover. This result seems particularly unjustified in view of the fact that the purchaser for cash has already paid the price of a tax on the gain; the purchaser for

¹²⁷ Two cases support the proposition that the purchase of "profitable assets" by a loss corporation does not necessarily indicate tax avoidance but rather is in pursuit of a legitimate business purpose. In *Kolker Bros.*, supra note 120, the court held that an asset purchase has a "bona fide business purpose" with no aim of accomplishing indirectly what is forbidden by § 269. CCH 1960 Tax Ct. Reg. Dec. at 3261. In *T.V.D. Co.*, 27 T.C. 879 (1957), the court also found an asset purchase undertaken for the legitimate purpose of enabling a corporation to "remedy [a] deficiency and to place [the taxpayer] in position to realize future earnings." *Id.* at 885.

¹²⁸ Comment, 69 Yale L.J. 1201, 1258 (1960) notes that "Individuals and Single corporations have long been able to retain their carryovers despite conversion from one line of endeavor to another." Despite this, the authors recognize that *Libson* could presage an extension to the case of a loss corporation purchasing "profitable assets." *Id.* at 1269. For examples of many suggestions that such an extension would be unsound, see Krantz, Loss Carryovers in Chapter X Reorganizations, 16 Tax. L. Rev. 359, 400 (1960) and Winton, supra note 16, at 77.

¹²⁹ Arent, supra note 62, at 963.

¹³⁰ See Levine and Petta, supra note 31, at 453.

stock gets the benefit both of non-recognition of gain and of an available carryover.

Since the purchased assets must be of a business qualitatively distinct from the loss activity in order for the carryover to be denied under the Commissioner's view, there exist serious definitional problems which must be resolved in order to determine whether or not the loss and profit activities are "substantially the same." The *Kolker* decision illustrates a court struggling without any guiding criteria to an arbitrary determination that the business of retail grocery selling was "substantially the same" as the subsequent business of supplying meat to institutional buyers.¹³¹ These problems are much the same as those encountered under the section 382(a)(1)(C) requirement of continuity of the loss operation. The Regulations have delineated a number of criteria as bearing on the question of when a given activity is qualitatively not the "same" as a predecessor activity, but the close questions are left unresolved.¹³² These definitional difficulties, together with the economically undesirable results engendered when a corporation, for fear of losing its carryover, fails to institute changes otherwise demanded by the business situation, are avoided when total carryover flexibility among types of endeavor within a single corporation is allowed.

Still further, can an approach which allows carryovers only among businesses "substantially the same" be reconciled with provisions allowing a consolidated group to carry forward the loss suffered in the operation of the discontinued business of one of the members of the group?¹³³ Why should a single corporation with only one line of business activity not enjoy this particular privilege given to taxpayers filing a single consolidated return?

Finally, the commentators agree that an extension of *Libson* to deny a carryover only because it is sought as an offset to a different type of activity conducted by the same corporation produces an undesirable result.¹³⁴ Their concern seems to be that, whereas the *Libson* doctrine as extended in *Mill Ridge* (where both business and ownership changed) may have been necessary to prevent carryovers in tax avoidance-inspired "trafficking" cases, the doctrine may come to envelope traditionally legitimate economic adjustments from one form of activity to another.

The final question remaining for discussion is whether a *Libson* test framed in terms of continuity of ownership alone can be applied

¹³¹ See text following note 121 supra.

¹³² See text accompanying note 81 supra.

¹³³ This carryover flexibility is clearly available to consolidated return taxpayers. *Joseph Weidenhoff, Inc.*, supra note 68.

¹³⁴ See, in addition to authorities cited at notes 126-30 supra, *Sinrich*, supra note 44, at 178.

under the 1954 Code. The suggestion that it might was originally made in the *Mill Ridge* case, where although both the type of business and the ownership had changed, the court's language of "wind-fall" and "trading" in loss carryovers implied that the ownership change may itself have destroyed the required continuity.¹³⁵ The recent decision of *A. C. Willingham v. United States*,¹³⁶ like *Mill Ridge* a 1939 Code case, has materially strengthened the suggestion because it involved no change of business operation. The case concerned the availability of a carryover after a Chapter X bankruptcy reorganization of a corporation engaged in the trucking business. As part of the reorganization plan, all of the corporate stock was purchased by a new owner who pledged five per cent of the gross receipts to his vendor; most of the debts were wiped out, but the trucking business and the entity continued without change. The corporation sought to carry forward a pre-reorganization loss against subsequent profits but the Fifth Circuit held that the carryover was unavailable. The court cited both *Libson* and *Mill Ridge*, holding that the post-reorganization corporation was a "new business enterprise"; the "complete identification" of the sole shareholder with the "new" corporation made it a "completely different corporate person" from the pre-reorganization company.¹³⁷ Though the same business activity was continued it was "by a corporation having entirely new stock ownership and with an entirely new corporate structure."¹³⁸ While the bankruptcy reorganization may have itself destroyed the needed continuity, one commentator has suggested it was more likely "that the decisive fact in the *Willingham* case was that an outsider who had no previous connection with the loss corporation was the sole individual who would benefit from allowance of the loss carryover."¹³⁹ This conclusion is supported by the Government's own version of continuity as having been destroyed only by the ownership change. It argued that the new owner ". . . has so identified himself with the corporate taxpayer . . . and because of his complete domination and management, as to make it in substance, though not in form, a separate taxpayer."¹⁴⁰

The *Willingham* concept of continuity is clearly at odds with the 1954 Code provisions. Under section 382(a), when a corporation undergoes no change in business, a change in ownership alone will not result in the disallowance of a carryover absent the application of section 269. This is because "There is obviously no trafficking in

¹³⁵ See supra note 54.

¹³⁶ 289 F.2d 283 (5th Cir. 1961).

¹³⁷ Id. at 287.

¹³⁸ Id. at 286.

¹³⁹ Krantz, supra note 128, at 414.

¹⁴⁰ 289 F.2d at 286.

loss corporations where the same business continued."¹⁴¹ The stock purchase is not undertaken "for the purpose of" using a carryover against a business unrelated to the loss activity if the loss activity never changes. While the Congress had available the choice of disallowing carryovers simply on the basis of a significant shift in ownership, instead its choice was that a "Change in stock ownership alone should not affect the corporation's tax attributes, except in cases of abuse," as would be indicated by a subsequent change of business activity.¹⁴² "For this reason it is unlikely that the strict holding of the *Willingham* case will be regarded as controlling in cases arising under the 1954 Code."¹⁴³

In short, the only abuse outside the tax-free reorganization area which Congress felt to warrant more than the general sanction provided by section 269 was the special section 382(a) case involving both an ownership and a business change. The extension of *Libson* to require disallowance of a carryover when only one of these changes is present is therefore inconsistent with the statutory scheme. The Code contains no substantive determination that ownership or business change should disallow a carryover except as the two are used together in a situation predominantly without any purpose other than to obtain the use of an existing loss carryover.

CONCLUSION

The *Libson* doctrine of "continuity of business enterprise" should die a quiet death. The reluctance exhibited by the courts to apply *Libson* to 1954 Code cases is understandable in view of the marked difference between the comprehensive new statutory treatment of loss carryovers and the 1939 Code's sole provision capable of preventing abuse of the carryover privilege—a largely inoperative section 129. It was inevitable in the context of the old Code that a doctrine would be developed to supplement section 129. In the merger case, the answer came in *Libson Shops*, where the Court interpreted the carryover provisions "to prevent their use to obtain tax deductions not otherwise available."¹⁴⁴ Despite the difficulties of extending a doctrine which appeared to be applicable only to the merger case, the courts in several cases under the 1939 Code have applied *Libson* to the single corporation on the theory that a similar supplement to section 129 was needed in this area as well. *Mill Ridge* and *Virginia Metal* decided that *Libson* easily encompassed the case where changes in both business activity and ownership revealed "trafficking" in a

¹⁴¹ 1959 Hearings at 774 (Statement of Mr. Hauser).

¹⁴² Cohen, Phillips, Surrey, Tarleau & Warren, *supra* note 94, at 286; see 7 Mertens, *The Law of Federal Income Taxation* 151 (1956 ed.).

¹⁴³ Krantz, *supra* note 128, at 412.

¹⁴⁴ Reese, *supra* note 79, at 220.

loss corporation. The extension of "continuity of business enterprise" to cover this case, while arguably not justified as a matter of strict interpretation of *Libson*, did produce a result consistent with the choice of policy revealed in section 382(a).

But unlike the 1939 Code, section 382(a), a materially-strengthened section 269 and the Regulations under both reflect a carefully considered Congressional determination of what readjustments within the single corporation warrant disallowance of a carryover. The superimposition of a *Libson* test would clearly upset this determination. When both business and ownership have changed, section 382(a) and not *Libson* should govern the availability of a carryover. When only one change is present, denial of a carryover in the name of *Libson* invokes a policy which the Congress might have adopted in 1954 but did not.

In sum, just as the application of *Libson* to tax-free reorganizations has been precluded so as not to frustrate Congressional solicitude for the effectuation of such reorganizations, its application to the single corporation should be prevented in order not to interfere with the decision that only certain specified readjustments should cause disallowance of a carryover.