An Analysis of Corporate Transactions Involving Net Operating Loss Benefits

A multitude of tax considerations arise when one corporation purchases another. One of the major considerations is the net operating loss carryforward. Corporate planners are often confronted with the problem of whether the net operating losses previously incurred by the purchased corporation may be deducted by the purchasing corporation in future years. Another major consideration is the availability of net operating loss carrybacks in corporate reorganizations. The question raised here is whether the post-merger net operating losses generated by the purchasing corporation may be offset against the pre-merger taxable income of the acquired corporation.

Determining the availability of net operating loss deductions that may exist after corporate purchases and reorganizations is a complex task. However, the problem can be simplified by first examining the general concept of the net operating loss deduction. Based upon this examination, a more detailed analysis can be made of the intricate rules that control the availability of net operating loss deductions in corporate transactions.

The intent of this analysis is to better equip the corporate planner for buying and selling corporations that may have net operating loss deductions. In addition, this discussion includes all of the relevant changes made by the Tax Reform Act of 1976.

I. The General Concept of the Net Operating Loss Deduction

The Internal Revenue Code defines "net operating loss" as the excess of deductions over gross income for any taxable year.[1] A taxpayer may utilize a net operating loss deduction against taxable years and thereby receive a tax refund. In addition, any remaining net operating loss deduction qualifies as a "carryover" or offset against taxable income generated during a five-year period subsequent to the loss year.[2] Congress recognized the inherent unfairness

[1] I.R.C. § 172(c). In computing the net operating loss for a taxable year, no deduction is allowed for such items as another year's net operating loss, personal exemptions, § 1202 deductions, capital losses in excess of capital gains, and nonbusiness deductions of noncorporate taxpayers in excess of gross income. *Id.*

[2] *Id.* § 172(b)(1)(A),(B). The Tax Reform Act of 1976 extends the carryforward period to seven years (nine years for regulated transportation corporations). Also, the new Act allows the taxpayer to elect to forego the carryback treatment of net operating losses and only carry forward the net operating losses. This avoids the difficult computational tasks that would require the reconstruction of income tax returns of prior years. *Id. See also* A. Greenhill & A. Brown, Analysis and Text of the Tax Reform Act of 1976 at 16-17 (1976).

of taxing profitable years while at the same time allowing no benefits for loss years.[3] In the absence of the carryback and carryforward provisions, the taxpayer with relatively stable annual taxable income would have an advantage over the taxpayer with fluctuating taxable income and losses. In high income years the latter would be in a higher tax bracket, while in loss or no taxable income years, such a taxpayer would be without any offsetting tax benefit.

In addition to avoiding the inequity caused by a tax structure that varied with the type of business involved, Congress also intended to provide liquid funds to a once profitable taxpayer currently suffering net operating losses. This is accomplished by allowing the taxpayer who is suffering economic reverses to carry back current net operating losses and to offset them against his prior three years' taxable income. This results in a tax refund, the proceeds of which can be used to bolster the current operation.[4]

Prior to 1954, only section 269 of the Internal Revenue Code regulated acquisitions and reorganizations consummated to evade federal income tax.[5] In order to disallow a net operating loss deduction acquired by a profitable corporation from an unprofitable business, the Commissioner was required to prove that tax avoidance was the "primary purpose" of the acquisition. However, the acquiring corporation could usually demonstrate at least some degree of genuine business interest in the acquired corporation; therefore, the Commissioner rarely met the "primary purpose" proof barrier. The incentive to reduce taxable income by purchasing semi-related businesses with excessive net operating loss deductions was greatly increased.[6]

In 1954, Congress recognized that the existing law was "uncertain in its effects," and "placed a premium on litigation and a

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[3]H.R. REP. NO. 1337, 83d Cong., 2d Sess. 27, *reprinted in* [1954] U.S. CODE CONG. & AD. NEWS 4017, 4052 [hereinafter cited as H.R. REP. NO. 1337] states:

> The longer period for averaging will improve the equity of the tax system as between businesses with fluctuating income and those with comparatively stable incomes, and will be particularly helpful to the riskier types of enterprises which encounter marked variations in profitability. The additional year for the carryback also increases the liquid funds available for a business experiencing economic reverses.
>
> Your committee has also made changes . . . [i]n order to lessen the differences in tax treatment of firms with fluctuating and those with stable incomes.

[4]*Id.*

[5]I.R.C. § 269.

[6]*See, e.g.,* Mill Ridge Coal Co. v. Patterson, 264 F.2d 713 (5th Cir.), *cert. denied,* 361 U.S. 816 (1959). *See also* Gregory v. Helvering, 293 U.S. 465 (1935).

damper on valid business transactions."[7] In response to this problem, Congress promulgated special rules to govern net operating loss carryover and carryback provisions, to achieve the highest degree of objectivity possible and to thereby eliminate the uncertainty of section 269.[8] The 1954 Internal Revenue Code provided the mechanism for Congress to carry out such intent: section 382 specifically dealt with the availability of net operating loss carryovers in corporate purchase transactions. This section sets forth two objective limitations. The acquiring corporation's claim for the purchased net operating loss carryover will be disallowed only if both of the following limitations apply: (1) The acquired corporation's ten largest stockholders own fifty percentage points more of the acquiring corporation's outstanding stock after the acquisition than they had owned prior to the change in ownership (based on total fair market value),[9] and (2) the acquired corporation has not continued to

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[7]H.R. REP. NO. 1337, *supra* note 3, at 41-42. "This provision has proved ineffectual, however, because of the necessity of proving that avoidance was the primary purpose of the transaction. It has also been so uncertain in its effects as to place a premium on litigation and a damper on valid business transactions." *Id. See, e.g.*, Scroll, Inc. v. Comm'r, 447 F.2d 612 (5th Cir. 1971); Younker Bros. v. United States, 318 F. Supp. 202 (S.D. Iowa 1970); D'Arcy-MacManus & Masius, Inc. v. Comm'r, 63 T.C. 440 (1975); Stange Co. v. Comm'r, 36 T.C.M. (CCH) 31 (1977); Key Buick Co. v. Comm'r, 35 T.C.M. (CCH) 1359 (1976).

[8]H.R. REP. NO. 1337, *supra* note 3, at 42.

[9]I.R.C. § 382(a) (1954) (amended 1976). Section 382(a) states the following:

(a) Purchase of a Corporation and Change in Its Trade or Business.—

(1) In general.—If, at the end of a taxable year of a corporation—

(A) any one or more of those persons described in paragraph (2) own a percentage of the total fair market value of the outstanding stock of such corporation which is at least 50 percentage points more than such person or persons owned at—

(i) the beginning of such taxable year, or

(ii) the beginning of the prior taxable year,

(B) the increase in percentage points at the end of such taxable year is attributable to—

(i) a purchase by such person or persons of such stock, the stock of another corporation owning stock in such corporation, or an interest in a partnership or trust owning stock in such corporation, or

(ii) a decrease in the amount of such stock outstanding or the amount of stock outstanding of another corporation owning stock in such corporation, except a decrease resulting from a redemption to pay death taxes to which section 303 applies, and

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

carry on a trade or business substantially the same as that conducted before any change in the percentage ownership of such stock.[10]

As Treasury regulation examples indicate, the fifty percentage point standard is primarily a mechanical and objective test.[11] In contrast, however, the continuity of business test has been a frequent source of litigation. The basic question is whether the acquiring corporation can utilize previously incurred net operation loss carryover benefits of the acquired corporation. This problem commonly arises when the acquired corporation operates a business entirely different from that of the acquiring corporation but is then changed after the purchase.[12]

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(2) Description of person or persons.—The person or persons referred to in paragraph (1) shall be the 10 persons (or such lesser number as there are persons owning the outstanding stock at the end of such taxable year) who own the greatest percentage of the fair market value of such stock at the end of such taxable year; except that, if any other person owns the same percentage of such stock at such time as is owned by one of the 10 persons, such person shall also be included. If any of the persons are so related that such stock owned by one is attributed to the other under the rules specified in paragraph (3), such person shall be considered as only one person solely for the purpose of selecting the 10 persons (more or less) who own the greatest percentage of the fair market value of such outstanding stock.

(3) Attribution of ownership.—Section 318 (relating to constructive ownership of stock) shall apply in determining the ownership of stock, except that sections 318(a)(2)(C) and 318(a)(3)(C) shall be applied without regard to the 50 percent limitation contained therein.

(4) Definition of purchase.—For purposes of this subsection, the term "purchase" means the acquisition of stock, the basis of which is determined solely by reference to its cost to the holder thereof, in a transaction from a person or persons other than the person or persons the ownership of whose stock would be attributed to the holder by application of paragraph (3).

[10] *Id.* § 382(a)(1)(C) (1954) (repealed 1976).

[11] *See* Treas. Reg. § 1.382(a)-1(d)(4), examples (1), (2) (1962).

[12] The Tax Reform Act of 1976 deletes the continuity of business requirement of § 382(a)(1)(C) for purchase transactions. Instead, only the change of ownership rule applies, which was increased to sixty as opposed to fifty percentage points, as under the 1954 version. Furthermore, if this ownership requirement is not met, the net operating loss carryover is not automatically disallowed. For each percentage point over sixty percent, the net operating loss is decreased by three and one-half percent. Above eighty percent, the rate of elimination is one and one-half percent per percentage point change. These provisions become effective after June 30, 1978 for stock purchases, and January 1, 1978 for tax-free reorganizations. I.R.C. § 382(a). *See also* A. Greenhill & A. Brown, Analysis and Text of the Tax Reform Act of 1976 at 16-17 (1976); Myerson, Tax Reform Act of 1976. A Review for Business and Individuals, (1976) (Coopers & Lybrand Newsletter).

II. The Continuity of Business Test

A. The Libson Shops Doctrine

Example 1: On Jan. 15, 1975, *XYZ* Corporation, a metal hanger manufacturer, purchased Cola Corporation, a producer of soft drinks. Since 1972, Cola had experienced annual net operating losses, including the fiscal year that ended January 15, 1975. *XYZ*'s operations were historically profitable, and for the fiscal years ending January 15, 1976 and 1977, it experienced high profits and large taxable income.
Given: The transaction resulted in less than a fifty percentage points change in ownership.
Issue: Can *XYZ* apply Cola's pre-purchase net operating loss deduction as a carryover against its post-merger taxable income?

The Supreme Court in *Libson Shops, Inc. v. Koehler*[13] was presented with the issue of whether a corporation, resulting from the merger of seventeen separately incorporated businesses, could carry over and deduct pre-merger net operating losses, generated by three of the former entities, from the post-merger taxable income attributable to the other merged businesses. In disallowing the net operating loss carryover, the Court ruled that the taxable income against which the offset is claimed must be produced by substantially the same business that incurred the net operating losses.[14]

The narrow rule enunciated in *Libson Shops*, applied to the above example, would require that Cola Corporation, which generated the net operating loss, also generate the offsetting taxable income. Since only *XYZ* Corporation generated taxable income in *Example 1*, under the *Libson Shops* doctrine *XYZ* Corporation could not utilize Cola Corporation's net operating loss carryover incurred prior to the purchase.

Even though *Libson Shops* was decided in 1957, the Supreme Court based its decision on the 1939 Internal Revenue Code rather than the 1954 Code, which included section 382 and its special limitations. As previously mentioned, Congress intended that both the fifty percentage points test and the failure to carry on substantially the same business test apply before determining whether the net operating loss carryover would be disallowed.[15] *Example 1* did not fall within the fifty percentage points test; therefore, disallowance

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

[14] *Id.* at 390.

[15] I.R.C. § 382(a)(1)(A),(C). However, the continuity of business requirement will no longer apply to purchases occurring after June 30, 1978. *See* note 12 *supra*.

of *XYZ's* net operating loss deduction would have been improper. Even if *XYZ* had subsequently changed Cola's operations, disallowance would have been improper since both of section 382's limitations were not applicable.

Maxwell Hardware Co. v. Commissioner[16] emphasized that *Libson Shops* was decided under the 1939 Code, and that "by enacting the 1954 Code, Congress destroyed the precedential value" of the *Libson Shops* ruling that the taxable income against which offset is claimed must be produced by substantially the same business that incurred the net operating loss.[17] *Maxwell* allowed a taxpayer-corporation to carry over a net operating loss deduction incurred by a pre-merger hardware business and to offset such loss carryover against the taxable income generated by the taxpayer's post-merger real estate business. The merger transaction utilized an irrevocable voting trust device, which avoided the application of the fifty percentage points ownership limitation. The court noted, however, that the surviving entity, the real estate business, failed "to carry on substantially the same business or trade" as the hardware operation had conducted before any change in ownership. Nevertheless, only one of the section 382 limitations was met; therefore, the net operating loss carryover could not be disallowed. Similarly, in *Example 1*, *XYZ* may utilize Cola's net operating loss carryover deductions since only one of the section 382 tests applied, as *XYZ's* acquisition did not fall within the fifty percentage points barrier.[18]

Revenue Ruling 63-40 and Technical Information Release 777[19] also severely limit the effect of *Libson Shops*. The doctrine will now apply only when both the ownership and the acquired corporation's business change *after* the maximum two year period specified in section 382(a) has elapsed.[20] Another limited instance in which the *Libson Shops* doctrine will apply occurs when a single corporation discontinues a losing operation, purchases a profitable business, and undergoes a major change in stock ownership.[21]

B. *Continuity of Business Involving Discontinued Operations*

Example 2: *XYZ* Corporation operated three separate busi-

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[16]343 F.2d 713 (9th Cir. 1965).

[17]*Id.* at 716.

[18]Similarly, the only requirement of the Tax Reform Act of 1976—the 60 percentage points test—was not violated by the taxpayer in *Maxwell Hardware*. Therefore, the net operating loss carryover would be allowed. I.R.C. § 382(a).

[19]Rev. Rul. 63-40, 1963-1 C.B. 46; TIR 777, 1965-2 C.B. 53.

[20]Milefsky, Using Acquired Corporate Loss Carryovers, (1976) (Coopers & Lybrand Newsletter).

[21]*Id.*

nesses, *X*, *Y*, and *Z*: *X* processed dry goods, *Y* catered parties, and *Z* manufactured shoes. Each business contributed about twenty percent to *XYZ*'s total output and assets. In 1973, *XYZ* suffered substantial net operating losses, all attributable to *Z*. In January 1974, *ABC* Corporation purchased sixty percent of *XYZ*'s stock, but during the same month, *Z*'s operations were discontinued. *ABC* experienced substantial profits during the calendar year 1974.

Issue: Can *ABC* Corporation carry over the net operating loss attributable to *Z* for the year ending December 1974 even though *Z* was discontinued?

Example 3: In 1974, *P* Corporation, a profitable steel manufacturer, acquired *S* Corporation, a steel fabricator that had experienced net operating losses for many years. During the taxable year 1975, *P* discontinued one-half of *S*'s operations, which comprised twenty-two percent of *P*'s total assets. In 1975, *P* experienced large profits.

Issue: In 1975, can *P* deduct the net operating loss carryover arising from the discontinued activities of *S* corporation?

Treasury Regulation § 1.382(a)-1(b)(7) states that a corporation has not continued to carry on substantially the same business or trade as that conducted prior to an increase in ownership of the purchaser's stock if such corporation discontinues more than a "minor portion" of its business carried on before such increase. The proposed test to determine what constitutes a "minor" portion is to question whether "the discontinuance of the activities has the effect of utilizing loss carryovers to offset gains of a business *unrelated* to that which produced the losses."[22]

In *Coast Quality Construction Corp. v. United States*,[23] a residential real estate developer, after a series of stock transfers and mergers, reorganized his four former wholly-owned subsidiaries. One unprofitable subsidiary that comprised forty-four percent of the taxpayer's total assets was discontinued. The court ruled that in order to satisfy the substantially the same business test of section 382(a)(1)(c), it must be shown that any discontinued activities to which the net operating loss is attributable were related to the ongoing business and did not constitute more than a minor portion of the corporate taxpayer's business prior to the ownership change. The taxpayer was therefore allowed to deduct the net operating loss carryover even though the discontinued segment comprised forty-

[22]Treas. Reg. § 1.382(a)-1(h)(7) (1962) (emphasis added).
[23]463 F.2d 503 (5th Cir. 1972).

four percent of taxpayer's total assets, because all of the business activities were related to real estate development.[24]

Coast Quality demonstrates that percentage is less important than the qualitative relation between the wholly-owned subsidiaries in determining what constitutes a "minor" portion. Discontinuance of a segment of the acquired business does not result in a failure to carry on substantially the same business, provided the net operating loss carryover attributable to the discontinued segment is *not* used to offset the acquiring corporation's taxable income derived from a source wholly unrelated to the discontinued business.[25] In *Coast Quality,* all of the separate subsidiaries operated as real estate developers and employed the same number of people; hence, there were no distinguishing characteristics. They were not separate and unrelated economic units but were, in fact, closely related.

In *Example 3,* the partially discontinued *S* corporation comprised twenty-two percent of *P*'s total assets, which would appear to be only a minor activity since *Coast Quality* held that a forty-four percent segment was still within the "minor" range. However, this quantitative analysis alone is inadequate since it still must be determined whether the net operating loss carryover attributable to *S* offsets the taxable income of *P* that is related to the business that produced the net operating loss. Since both businesses relate to steel production, the discontinuance of only one-half of *S* most likely constituted a "minor portion." Therefore, *P* probably continued to carry on substantially the same business as it did at the time of the increase in ownership.

Even though the discontinued *Z* segment in *Example 2* included a lower percentage of total assets than the abandoned business in *Example 3,* it still fails to qualify as a "minor portion" of *XYZ*'s total operations. *Z* was not related to the ongoing business; it was a separate and distinct type of business and therefore failed to constitute a "minor portion." Since it was established that *Z* was a separate business, allowance of the net operating loss carryover deduction would have resulted in offsetting taxable income and net operating losses of wholly unrelated businesses (*Z* produced shoes, *Y* catered parties, and *X* processed dry goods). In comparison, the businesses in *Example 3* were not separate, for both were related to steel production.

Treasury Regulation § 1.382a-1(h)(5) requires that all facts and circumstances of a particular case be examined in determining whether a corporation has continued to carry on substantially the

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[24]*Id.* at 512.

[25]Treas. Reg. § 1.382(a)-1(h)(7) (1962).

same business. The analysis should particularly examine changes in corporate employees, plants, equipment, production, and location. Therefore, in both *Example 2* and *3*, these additional facts should be examined in order to accurately ascertain the degree of relation between the business segments.

The objective of net operating loss carryovers is to smooth out fluctuations that extend beyond the accounting periods of a business due to the tax accounting rules, rather than offset the taxable income of a business with another *unrelated* business' net operating loss carryover.[26] "In short, Congress did not want the net operating loss to be applicable if it was incurred by a different business."[27] The Senate explicitly provided that a discontinuance of any portion, except one which is "minor," would result in a failure to carry on substantially the same business.[28]

In *Glen Raven Mills, Inc. v. Commissioner*,[29] the principal operation of the acquired subsidiary, hosiery manufacturing, was entirely discontinued. Subsequent to the change in ownership the purchasing parent corporation implemented the production of flat fabric cloth in the newly-acquired subsidiary's plant. The court examined the factors set forth in Treasury Regulation § 1.382a-1(h)(5)[30] and concluded that from the viewpoint of a person in the knitting business, production of hosiery and flat fabric cloth are quite similar. The purchasing corporation was therefore allowed to carry over the previous incurred net operating loss deductions of the acquired subsidiary even though the latter's product line, which had incurred the loss, was completely discontinued. The court noted that even though the acquired subsidiary experienced a significant change in customers, the Commissioner had failed to prove how this altered or substantially changed the acquired corporation's business.[31]

The dissenting opinion in *Glen Raven* cited *Coast Quality* to support the proposition that the "substantially same business requirement of section 382(a) only permitted a minor or insubstantial change in the acquired corporation."[32] Therefore, a complete change

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[26]Coast Quality Constr. Co. v. United States, 463 F.2d 503, 509 (5th Cir. 1972) (citing Commissioner v. Barclay Jewelry, Inc., 367 F.2d 193, 196 (1st Cir. 1966)).

[27]*Id.*

[28]S. Rep. No. 1622, 83d Cong., 2d Sess. 285, *reprinted in* [1954] U.S. Code Cong. & Ad. News 4924.

[29]59 T.C. 1 (1972).

[30]For example, the following factors are listed therein: changes in the acquiring corporation's employees, plant, equipment, production, location, and customers.

[31]I.R.C. § 382(a)(1)(C).

[32]59 T.C. at 18-21 (dissenting opinion) (citing Coast Quality Constr. Co. v. United States, 463 F.2d 503 (5th Cir. 1972)).

in product line and customers was outside this narrowly defined range. Furthermore, Congress did not contemplate the "unlimited or extensive changes" necessary to eliminate unprofitable operations when it required that the acquired business remain substantially the same.[33]

The four concurring judges in *Glen Raven* presented the most liberal interpretation of the substantially same business requirement of section 382(a):

> Congress intended for us to strike a balance between two oft-conflicting goals; one, the curtailment of trafficking in loss corporations and, two, the avoidance of any dampening effects on valid business transactions. Here the majority has found no "trafficking." I would also emphasize the potential "dampening effects." Because of the high degree of competition and the need for product diversification in the textile business, the key to success seems to be flexibility. The rather narrow, restrictive view expressed in the dissenting opinion would tie the hands of businessmen in this and similar businesses for as much as 2 years. That, in my judgment, would make section 382(a) the instrument of uneven justice.[34]

Glen Raven can be distinguished from *Example 2* and *3*, for in the latter situations, the discontinuance related to an entire business segment and not merely to a product line. *Glen Raven*, however, remains an important guide for those parent corporations desiring to change product lines of a subsidiary while still claiming the subsidiary's net operating loss carryover.

Finally, close attention must be directed to the type of industry involved in the particular transaction. For example, if the taxpayer in *Glen Raven* had been in a less competitive and less diversified product industry, perhaps a different construction of a "substantial change" in business would have been applied.[35]

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[33]*Id.* at 19 (Simpson, Raum and Quealy, JJ., dissenting opinion).

[34]*Id.* at 17 (Dawson, Drennen, Sterrett, and Goffe, JJ., concurring opinion). Section 382 requires the change of business to occur within a two year period of the change in ownership; therefore, an acquiring corporation could arguably avoid a disallowance in § 382 by purchasing a loss corporation, then waiting two years before changing the business. However, application of § 269 might disallow any deduction if the transaction's principal purpose is tax avoidance. Note that under the Tax Reform Act of 1976, the change of business requirement has been deleted and now the only relevant inquiry is whether there has been a significant change in ownership (a sixty percentage point change). For a discussion, *see* note 12 *supra.*

[35]*See id.* at 17 (Dawson, J., concurring opinion).

C. Continuity of Business Involving Dormant Operations

Example 4: *X* Corporation manufactured luggage. On January 1, 1975, *X* discontinued its operations due to its adverse financial position. On August 1, 1975, *B* Corporation purchased at least fifty percent of *X*'s stock. *X* remained dormant during the interim. On September 1, *B* revived *X*'s operations, changing, in part, the luggage design. In 1976, *B* experienced substantial profits, although the luggage business continued to lose money.
Issue: Can *B* utilize *X*'s previously incurred net operating loss carryovers for the fiscal year ending in January 1976?

In *Six Seam Co. v. United States*,[36] a mining company claimed a net operating loss carryover deduction arising from a formerly owned coal processing company. The processing company had suspended operations with intent to wind up its affairs just prior to the change in ownership. The court applied a treasury regulation[37] which disallows a net operating loss carryover if the acquired corporation is not carrying on an "active" trade or business at the time of the increase in ownership.[38] The problem remained, however, of determining the appropriate degree of activity necessary to sustain the characterization of "active trade or business." The court in *Six Seam* held the proper test to be whether there is an intent to "wind up" the business, or whether the corporation is simply maintaining a "low profile" with intention to resume operations upon a change in economic conditions.[39] Applying this rationale to *Example 4*, it is apparent that in order to avoid disallowance of the net operating loss carryover, *B* corporation must show that *X* corporation's nine month suspension of operations was due solely to economic conditions and not to an intent to wind up the corporate business.

In *Six Seam*, the Commissioner unsuccessfully argued that there had been a "substantial" change in business—from coal processing to coal mining—regardless of the discontinuance issue. Relying on *Frederick Steel Co. v. Commissioner*,[40] the court held that change in ownership and change in business must occur in the same year to warrant disallowance of the net operating loss carryover deduction. The change of business in *Six Seam* occurred in 1963, whereas the

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[36]524 F.2d 347 (6th Cir. 1975).

[37]Treas. Reg. § 1.382(a)-1(h)(6) (1962).

[38]Hence, if this "active" requirement is not met, the taxpayer's acquired corporation will be deemed not to have carried on substantially the same business as carried on prior to the increase in ownership.

[39]524 F.2d at 354.

[40]375 F.2d 351, 354 (6th Cir.), *cert. denied*, 389 U.S. 901 (1967).

change in ownership occurred in 1961; therefore, the substantial business test was not in issue because of this two year time lag. If there had not been a discontinuance, the Commissioner would have been required to allow the taxpayer's net operating loss carryover. Similarly, section 382 requires that the change of ownership be measured either in the prior taxable year or at the beginning of the taxable year in which the deduction is sought,[41] but not within the prior two years, as the Commissioner argued in *Six Seam.*[42]

Arguably, a taxpayer could avoid the application of section 382(a) by acquiring a loss corporation that has a different type of business and by maintaining its operations at a low level for two years.[43] After this period the acquiring corporation could change the loss corporation's business substantially and still utilize the net operating loss carryover. This would have been the situation in *Six Seam* in the absence of the inactive period. However, two major problems are involved in such a scheme: (1) The economic realities of allowing large capital investments to remain idle for a two year period may cost more than the benefits derived from the allowable net operating loss carryovers,[44] and (2) section 269 disallows any tax benefits resulting from an acquisition if tax avoidance was the principal purpose of such scheme.[45]

The underlying rationale of the rule disallowing the net operating loss carryover deductions of a business temporarily suspended prior to a change in ownership has been addressed by many courts.[46] Profits arising from revived operations do not fall within the same accounting period as losses attributable to the pre-revival business. Furthermore, even if customers, employees, product, and location remain the same, there is still a new endeavor. "In effect, [the

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[41]I.R.C. § 382(a)(1)(A)(i),(ii) (1954) (amended 1976).

[42]Note that the Tax Reform Act of 1976, in deleting the continuity of business test and requiring only a continuity of ownership test (sixty percentage points), utilizes a three year period in which stock is purchased or exchanged as opposed to the aforementioned two year limit. *See* note 13 *supra.* Therefore, under the new law, one could possibly avoid the invocation of the sixty percentage points ownership barrier by spreading the purchase agreement over a period greater than three years. However, if the principal purpose of this transaction was tax avoidance, then § 269 would disallow related deductions.

[43]That is, maintain the corporation's operations at a level that would not constitute what Treas. Reg. § 1.382(a)-1(h)(6) (1962) defines as an "inactive" level of operation.

[44]*See* McGaffey, *Utilization of Net Operating Losses,* 51 TAXES 613, 616 (1973). "The relatively short period of a year and a fraction can be justified on the ground that it is unlikely that the operation will be continued this length of time if the tax avoidance is the sole reason for the acquisition." *Id.*

[45]I.R.C. § 269(a).

[46]*See, e.g.,* S.F.H., Inc. v. Comm'r, 444 F.2d 139 (3d Cir. 1971).

business] has taken its losses, given up, had a change of mind, and begun afresh."[47] As previously mentioned, these suspension situations must be distinguished from those cases in which economic conditions alone require a slowdown of operations and there is no intent to wind up corporate affairs.[48]

The court in *Glover Packing Co. v. United States*[49] recognized that even though a business is temporarily suspended prior to a change in ownership, a suspension does not automatically require a failure of the "continuity of business" test set forth in section 382 (a)(1)(c). The original Senate Finance Committee draft of the "continuity of business" test required that the acquired corporation "carry on a trade or business substantially the same as that conducted *immediately* before any change in the percentage ownership."[50] However, the Committee deleted the word "immediately" from the final report;[51] therefore, an apparent tolerable break in the continuity requirement exists, as illustrated by the following Treasury example. If prior to the merger the acquired corporation experiences a devastating fire that halts normal operations for a temporary period preceding the increase in ownership, this, in itself, does not constitute a failure to carry on substantially the same business.[52] In contrast, the taxpayer in *Glover* allowed his meatpacking facilities to remain idle for five years prior to the change in ownership. Therefore, the net operating loss carryover was properly disallowed in accordance with the Treasury's interpretation of section 382(a).[53]

D. Continuity of Business Involving Trading of Securities

> *Example 5:* *X* Corporation, a drug retailer, suffered heavy losses during 1971, 1972, and 1973. In late 1973, *X* discontinued its drug retail business and used the proceeds from liquidation to purchase United States Government Securities. From the trading of these securities, *X* realized taxable income in 1974 and 1975 and applied part of its net operating loss carryover deductions to both years. On January 1, 1976, *Z* Investment Corporation, a brokerage firm, purchased *X* Corporation and continued its business investments.
> *Issue:* Can *Z* Investment Corporation utilize *X*'s net opera-

[47] Coast Quality Constr. Corp. v. United States, 463 F.2d 503, 510 (5th Cir. 1972).
[48] Clarksdale Rubber Co. v. Comm'r, 45 T.C. 234 (1965).
[49] 328 F.2d 342 (Ct. Cl. 1964).
[50] *Id.* at 348 (emphasis added).
[51] *Id.*
[52] Treas. Reg. § 1.382(a)-(h)(6), example 2 (1962).
[53] *See also* United States v. Fenix & Scisson, Inc., 360 F.2d 260 (10th Cir. 1966).

ting loss carryovers against the combined income of *Z* and *X* for the year ending December 31, 1976?

Excel Corp. v. United States[54] reaffirmed *Maxwell Hardware*, which had held that loss-producing businesses need not be continued, nor must the net operating loss carryover offset the taxable income produced by the loss-incurring business as long as the surviving corporation continues to carry on substantially the same business.[55] In *Excel*, the taxpayer, who was in the investment business, purchased a newly-formed investment company that previously had been an unprofitable retail lumber company. Because an investment business was present prior to the change in ownership, the taxpayer argued that the continuity test of section 382(a) had been met and therefore the net operating loss incurred by the old lumber business should have been allowed as a net operating loss carryover deduction. The court, however, relying on Treasury Regulation § 1.382a-1 (h)(4), rejected this argument. This regulation states that the holding, purchase, or sale of stock or securities for investment purposes shall not be considered a trade or business unless such activities have historically constituted the corporation's primary activities. Thus, the taxpayer's claimed investment activities prior to change in ownership were considered nonexistent. The court concluded that retail lumber, as compared to the post-ownership investment activities, constituted a substantial change in business.

Excel applied Treasury Regulation § 1.382a-1(h)(4) even though it was promulgated *after* the occurrence of the controverted activity. The court held that Treasury regulations must be applied, even retroactively, "unless they are unreasonable and plainly inconsistent with the revenue statutes. . . ."[56] Based upon the above conclusions, in *Example 5*, *Z* Investment Corporation would not be able to utilize *X*'s net operating loss.

E. Continuity of Business Test—In Contemplation of an Ownership Change

Example 6: *S* Corporation, a manufacturer of infants' garments, suffered substantial net operating losses in the last five years. *S* is located in a city which has many travel trailer manufacturers. In 1972, *S* decided to terminate its in-

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[54]451 F.2d 80 (8th Cir. 1971).

[55]343 F.2d at 722-23. *See also* notes 16-17 *supra* and accompanying text. However, any discontinuance may only be a "minor" portion of taxpayer's business, as *Examples 2* and *3* have demonstrated.

[56]451 F.2d at 85 (citing Commissioner v. South Texas Lumber Co., 333 U.S. 496, 501 (1948)).

fant clothing line and switch to manufacturing upholstery material for local travel trailer manufacturers. This operation also was unprofitable, so in 1974, *S* sold its operations to Bigline Trailer Manufacturers, Inc., which intended to use *S* as its exclusive upholstery source.
Issue: Can Bigline use the net operating loss deductions incurred by *S* corporation prior to its change in product line?

The Commissioner denies net operating loss carryover deductions only when there is a substantial change in business of the acquired corporation after a change in ownership.[57] Treasury Regulation § 1.382(a)-1(h)(3), however, provides that if a substantial change in business or trade is made by the acquired corporation in contemplation of a change in stock ownership, any resulting net operating loss carryover deductions will be disallowed. The critical issue in *Example 6*, therefore, is whether *S* made the change in product line in contemplation of a purchase by Bigline Trailer. If Bigline Trailer initiated the scheme and the change was merely to avoid the continuity of business requirement of section 382(a), then the net operating loss carryover would not be allowed. Note that if Bigline had acquired *S* prior to any change in business and then switched the product line from infants' clothing to upholstery cloth, such a change would have resulted in a break of the continuity of the loss corporation's business.[58]

F. Continuity of Business Test—Relocation of Facilities

Example 7: Book Corporation manufactured bookends in State *X* and sustained net operating losses in the past three years. In 1970, Volume Corporation purchased eighty percent of Book's outstanding stock. In early 1971, Book moved its operations to State *Z*, 800 miles away. In the process Book sold its plant and fixtures in State *X*, and built a new plant and hired new employees in State *Z*. However, Book still sold to the same customers.
Issue: Can Volume Corporation utilize Book's pre-merger net operating loss carryover against its taxable income for the year ending December 31, 1971?

A loss corporation has not continued to carry on substantially the same trade or business as that conducted before an increase in

[57]I.R.C. § 382(a)(1)(C).

[58]In that instance § 382(a)(1) of the 1954 Code would have been applied to disallow the loss carryover if the fifty percentage points test of § 382(a)(1)(A) was also met. However, the Tax Reform Act of 1976 would render the continuity of business issue irrelevant, and only the ownership test would be in issue. For further discussion, *see* note 12 *supra.*

ownership if the corporation changes the location of a "major portion of its activities, and as a result of such change in location of the business" is substantially altered.[59] The Book Corporation continued to manufacture the same product and retained the same customers. However, as a result of changing the location of its operations, the construction of a new physical plant with the installation of new plant fixtures was required. In addition, new employees were hired. Therefore, a substantial change in the business of the loss corporation occurred. If there was also an increase of fifty percentage points in ownership, the net operating loss carryover would be disallowed.[60] In contrast, if Book Corporation had only relocated to the nearby city and, except for a change in production facilities, retained the same business, there would not have been a substantial change in business.[61]

III. Utilizing Net Operating Loss Carryforwards in Tax-Free Reorganizations

> *Example 8:* On January 1, 1973, by way of a statutory merger under section 368(a)(1)(A),[62] *AB* and *CD* Corporations merged into *ABCD* Corporation. Prior to this merger, *CD* had suffered heavy financial losses for the year ending December 31, 1972, and had available a $50,000 net operating loss carryover. *CD*'s shareholders were given 1500 shares of *ABCD* Corporation, which had a total of 15,000 shares outstanding at $100 par value. In 1973, *ABCD* earned $100,000. *Issue:* Can *ABCD* utilize the net operating loss deduction carryover arising from *CD*'s operations, and if so, to what extent?

In a tax-free reorganization, section 382(b)(1) explicitly requires that the stockholders of the transferor corporation maintain at least a twenty-percent interest in the fair market value of the outstanding shares of the acquiring corporation.[63] So in *Example 8*, since the

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[59]Treas. Reg. § 1.382(a)-1(h)(9) (1962).

[60]I.R.C. § 382(a)(1)(A),(C).

[61]*See* Treas. Reg. § 1.382(a)-1(h)(9), examples (1),(2) (1962).

[62]Commonly termed an "A" type statute merger.

[63]This limitation only applies to "A," "C," "D," or "F" type reorganizations. I.R.C. § 382(b)(1) (1954) (amended 1976). Section 382(b)(1) states the following:

> (b) Change of Ownership as the Result of a Reorganization.—
>
> (1) In general.—If, in the case of a reorganization specified in paragraph (2) of section 381(a), the transferor corporation or the acquiring corporation—
>
> (A) has a net operating loss which is a net operating loss carry-over to the first taxable year of the acquiring corporation ending after the date of transfer, and
>
> (B) the stockholders (immediately before the reorganization) of such cor-

fair market value of the stock held by the transferor shareholders was less than twenty percent of the fair market value of the acquiring corporation's (*ABCD*) outstanding stock,[64] a reduction of the net operating loss carryover is required. *CD* shareholders own 1500 shares, or only 1/10 of the total outstanding shares. The amount of this deduction is determined by multiplying the percentage of the acquired or transferor's shareholders' ownership by 5, and then subtracting this product from 100.[65] Through this procedure, the $50,000 loss carryover in *Example 8* would be reduced by one-half,[66] to $25,000.

If *both* the transferor and the acquiring corporation are substantially owned by the same person and in the same proportion, then the twenty-percent limitation will not apply in a tax-free reorganiza-

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> poration (hereinafter in this subsection referred to as the "loss corporation"), as the result of owning stock of the loss corporation, own (immediately after the reorganization) less than 20 per cent of the fair market value of the outstanding stock of the acquiring corporation,
>
> the total net operating loss carryover from prior taxable years of the loss corporation to the first taxable year of the acquiring corporation ending after the date of transfer shall be reduced by the percentage determined under paragraph (2).

Note that the Tax Reform Act of 1976 extends this limitation to "B" type reorganizations. *Id.*

In addition, I.R.C. § 381(a) states the following:

> (a) General Rule.—In the case of the acquisition of assets of a corporation by another corporation—
>
> (1) in a distribution to such other corporation to which section 332 (relating to liquidations of subsidiaries) applies, except in a case in which the basis of the assets distributed is determined under section 334(b)(2); or
>
> (2) in a transfer to which section 361 (relating to nonrecognition of gain or loss to corporations) applies, but only if the transfer is in connection with a reorganization described in subparagraph (A), (C), (D) (but only if the requirements or subparagraphs (A) and (B) of section 354(b)(1) are met), or (F) of section 368(a)(1),
>
> the acquiring corporation shall succeed to and take into account, as of the close of the day of distribution or transfer, the items described in subsection (c) of the distributor or transferor corporation, subject to the conditions and limitations specified in subsections (b) and (c).

[64] *CD* shareholders own 1500 shares or only 10% of the total outstanding shares.

[65] I.R.C. § 382(b)(2) (1954) (amended 1976). Section 382(a)(2) states the following:

> (2) Reduction of Net Operating Loss Carryover.—The reduction applicable under paragraph (1) shall be the percentage determined by subtracting from 100 percent—
>
> (A) the percent of the fair market value of the outstanding stock of the acquiring corporation owned (immediately after the reorganization) by the stockholders (immediately before the reorganization) of the loss corporation, as the result of owning stock of the loss corporation, multiplied by
>
> (B) five.

[66] 5x10% = 50%; 100% - 50% = 50%.

tion.[67] In *Commonwealth Container Corp. v. Commissioner,*[68] the court allowed the acquiring corporation to deduct only sixty-five percent of the total net operating loss carryover, since prior to the merger there was a shareholder who owned twenty-five percent of the acquiring corporation but had no interest in the transferor corporation.

The Treasury explains that determining if the net operating loss of a corporation involved in a tax-free reorganization will be allowed in full depends on whether the shareholders of the loss corporation have a "substantial continuing interest"[69] in the acquiring corporation. This assures that those who have incurred the net operating loss will benefit to some extent from the related net operating loss carryovers,[70] and coincides with the legislative intent that section 382 should forbid the "trafficking" of net operating losses to parties who are unrelated to the loss corporation.[71]

Note that in *Examples 1* through *6* the transaction involved stock purchases, whereas *Example 7* utilized a tax-free reorganization. In the former instances, both the continuity of ownership and business requirements set forth in section 382(a) are controlling, while in the latter situation, only the "twenty-percent" rule limits the availability of the net operating loss carryovers. Instead of a similar "gradual" reduction, section 382(a) imposes an all or nothing concept in stock purchases. If the continuity requirements are not met, then the entire net operating loss carryover is disallowed.

The Tax Reform Act of 1976[72] removes this disparity by imposing parallel limitations on both purchases and tax-free reorganizations. The new Act establishes a gradual reduction of net operating loss carryovers for both purchases and reorganizations based on ownership requirements only. The continuity of business test for stock purchases has been repealed.[73]

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[67]I.R.C. § 382(b)(6)(A).

[68]393 F.2d 269 (3rd Cir. 1968).

[69]Treas. Reg. § 1.382(b)-1(c)(1) (1962).

[70]*Id.*

[71]H.R. Rep. No. 1337, *supra* note 7, at 22.

[72]Tax Reform Act of 1976, Pub. L. No. 94-455, § 806, 90 Stat. 1520 (approved October 4, 1976).

[73]For purchases under the new law, there is no elimination of net operating losses unless there is an increase in ownership of sixty percentage points. Moreover, net operating losses are eliminated at the rate of three and one-half percent per one percentage point change if the ownership change is from sixty percent to eighty percent. The rate of elimination is one and one-half percent per percentage point change above eighty percent. This rule goes into effect for taxable years of the net operating loss corporation beginning after June 30, 1978.

For tax-free reorganizations, losses are eliminated when the transferor shareholders own less than forty percent—as opposed to twenty percent under prior

IV. The Net Operating Loss Carryback Rule in General

Whether post-merger net operating losses generated by the purchasing corporation can be offset or "carried back" against the pre-merger income of the acquired corporation is another question facing corporate planners. The examples below present common problems in this area.

> *Example 9:* On January 1, 1974, *X* Corporation merged with *Y* Corporation pursuant to a merger agreement executed December 15, 1973. *X* had experienced net operating taxable income in the past three years. For the year ending December 31, 1974, *Y* suffered substantial net operating losses.
>
> *Issue:* May the newly merged corporation, *XY*, carry back the net operating losses generated by *Y* to offset the pre-merger taxable income of *X* and thereby receive a tax refund for the three previous years?

The Internal Revenue Code forbids the acquiring corporation to carry back a net operating loss generated *after* the date of transfer to a pre-merger taxable year of the transferor (acquired) corporation.[74] Therefore, in *Example 9, XY* could not carry back the net operating loss generated by *Y* to offset the pre-merger income of *X*.

In one narrow setting, however, the Code does allow the utilization of net operating loss carryback benefits after a corporate reorganization. The reorganization must be an "F" type, which is usually defined as a "mere change in identity, form, or place of organization."[75] Whether a reorganization qualifies as a "F" type has been a frequent issue in tax court litigation, and the results of such cases have usually caused more confusion than consistency.[76]

law, § 382(b)—of the surviving entity. Elimination of net operating losses occurs at the rate of three and one-half percent for each percentage point below forty percent, and one and one-half percent for each percentage point below twenty percent. This rule becomes effective for plans adopted after January 1, 1978. I.R.C. § 382(a),(b).

[74]I.R.C. § 381(b)(3). *See* discussion in note 2 *supra* concerning the election available to the taxpayer under the Tax Reform Act of 1976 that permits an immediate deduction for a net operating loss carryforward in lieu of the three year net operating loss carryback.

[75]I.R.C. § 368(a)(1)(F). For other discussions, *see* Ranzal, *The F Reorganization: How It Can Be Used to Advantage to Combine Multiple Corporations*, 36 J. of Tax. 168 (1972); *see also* Pugh, *The F Reorganization: Reveille for a Sleeping Giant?* 24 Tax. L. Rev. 437 (1969); Osterberg, *Expansion of the (F) Reorganization*, 27 S.W. L. J. 251,267 (1973).

[76]Congress, in enacting the 1976 Tax Reform Act, did not amend or repeal any net operating loss carryback rules in § 381, but only dealt with the previously discussed net operating loss carryover rules.

In an attempt to solve this problem, Revenue Ruling 75-561 was issued, which states in part:

> (1) Given the combination of two or more commonly owned operating corporations or the merger of two wholly owned subsidiaries, an "F" reorganization will occur so long as (a) there is a complete identity of shareholders and their proprietary interests in the tranferor and acquiring corporations, (b) the acquiring and transferor corporation are in the same business or integrated activity prior to combination, and (c) the business enterprise of the two entities continues unchanged after the combination; and
>
> (2) an acquiring corporation that qualifies as an "F" type and desires to carry back the transferor's post-merger net operating losses to the transferor's pre-merger taxable income under section 381(b)(3) must further show (a) net operating losses are attributable to a separate business or division formerly operated by the transferor corporation, and (b) that the transferor corporation has taxable income in its pre-merger taxable years to offset the net operating loss carryback.[77]

The effect of this Ruling is to present two major barriers to the corporate planner advising on a reorganization that has potential net operating losses: (1) The planner must determine whether the reorganization qualifies as an "F" type; and (2) the planner must decide whether the post-merger net operating losses, if likely to arise, are "attributable" to separate divisions of the transferor corporation. As the examples presented below indicate, Revenue Ruling 75-561 will hereafter provide corporate planners and the courts with objective guidelines to reorganization planning and litigation in most instances.

A. The Net Operating Loss Carryback "Attribution" Rule

> *Example 10:* *A*, *B*, and *C* Corporations are all owned by Golden. A merger agreement is drafted and signed on December 31, 1974; the new entity is *ABC* Corporation. For the year ending December 31, 1975, *ABC* suffered a $100,000 net operating loss: $60,000 was attributable to *A*, and $40,000 to *B*. *C* reported no losses or taxable income.

[77]Rev. Rul. 75-561, 1975-2 C.B. 129.

For the three years prior to the merger, the three divisions had the following taxable incomes:

	A	*B*	*C*
1974	$10,000	0	$50,000
1973	$20,000	0	$50,000
1972	$20,000	$10,000	$50,000

Issue: Assuming Golden's reorganization qualifies as an "F" type, is the entire $100,000 net operating loss available for carryback treatment?

ABC Corporation could carry back only $50,000 of the $60,000 net operating loss attributable to division *A* and only $10,000 of the $40,000 net operating loss attributable to *B*. Even though *C* had pre-merger taxable income available to offset the net operating loss carryback, Revenue Ruling 75-561 requires that such a loss be attributable to the same division that previously generated the taxable income.[78] Hence *C* did not qualify for a net operating loss carryback since it generated *no* net operating losses in 1975.

Unlike the conclusion reached in *Example 9*, the court in *Associated Machine v. Commissioner*[79] allowed the carryback of the post-merger net operating loss generated by the acquiring corporation to offset the transferor's pre-merger taxable income without limitation or "attribution," as required by Revenue Ruling 75-561. The taxpayer in *Associated Machine* owned both corporations prior to merger; one corporation was an engineering firm and the other a machine shop that processed the former's designs. The Commissioner incorrectly interpreted section 381 to allow only the offsetting of the transferor's pre-merger net operating loss against the acquiring corporation's pre-merger taxable income.[80] The court rejected this interpretation, holding that such a "simultaneous" offsetting of taxable income and net operating loss was without "logic or authority."[81] The court noted that Congress intended a sequential application of the net operating loss carryback concept[82] that would allow offsetting of post-merger net operating losses against pre-merger taxable income, but would never allow the offsetting of pre-merger figures alone.

Strangely enough, the same court, on the same day, expressly limited the amount of the available net operating loss carryback in deciding a different case having similar facts. In *Estate of Stauffer*

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[78]*Id.*

[79]403 F.2d 622 (9th Cir. 1968).

[80]*Id.* at 625.

[81]*Id.*

[82]I.R.C. § 172(a).

v. Commissioner,[83] the taxpayer owned three similar retailing operations: one in New York, one in Illinois, and one in California. Pursuant to a merger agreement, these three businesses were to be reorganized in New Mexico. However, the relocation never occurred because all three businesses suffered financial losses caused by a drop in retail consumer demand. The court allowed the net operating loss carryback only to the extent that the post-merger net operating loss was attributable to an entity that had pre-merger taxable income available for offset.[84]

Reconciling the holdings of *Associated Machine* and *Stauffer* is not an easy task. *Associated Machine* may have mistakenly omitted the "attribution" limit mandated in *Stauffer.* Or perhaps the court placed significance on the fact that the businesses in *Associated Machine* were of the "brother-sister" type as opposed to the "parent-subsidiary" relation presented in *Stauffer.* Finally, the court may have felt the necessity of providing the "attribution" limitation for the closely-related California operations in *Associated Machine* was not as great as the necessity of providing the "attribution" limits for the three interstate corporations in *Stauffer,* which operated almost autonomously. In any event, the *Stauffer* rule is controlling in view of the "attribution" clause set forth in Revenue Ruling 75-561.

More recently, in *Home Construction Corp. of America v. United States,*[85] the court held that only such portion of the net operating loss as could be shown to be attributable to each of the former separate entities presently within the new organization could be carried back. In *Home Construction,* there had been a merger of 123 commonly owned corporations into a single legal entity.[86] The court emphasized that the "after-merger taxpayer may not obtain any more favorable treatment than it would have received had the loss occurred under the business' pre-merger form."[87]

In effect, *Home Construction* applied the strict "attribution" limitation, which requires that the post-merger entity generating the net operating loss have pre-merger taxable income available to offset the carryback.[88] In support of this application the court cited

[83]403 F.2d 611 (9th Cir. 1971).

[84]*Id.* at 621-22.

[85]439 F.2d 1165 (5th Cir. 1971).

[86]This constituted an "F" type reorganization in that the only change was in simplification of bookkeeping; it was merely a "matter of form."

[87]439 F.2d at 1172.

[88]This is similar to the requirement that the post merger net operating loss be attributable to a pre-merger entity that had previously generaged income available for offset. Rev. Rul. 75-561, 1975-2 C.B. 129.

the rule of *Libson Shops*: net operating loss carrybacks may only be utilized if the net operating loss of the new corporation can be "reunited for the sake of tax accountability into the same taxable units which existed *before* reorganization."[89] This policy coincides with Revenue Ruling 75-561 in that the newly-reorganized corporation will not be allowed to reap the tax benefits of net operating loss carrybacks unless it can prove that such benefits would have been derived even if reorganization had not occurred. This net operating loss carryback policy is analogous to the accounting principle of proper "matching" of revenue and expenses incurred in the same period[90] in that Revenue Ruling 75-561 allows only a limited "matching" of post-merger income with pre-merger income once the strict "attribution" barrier is overcome.

B. The General Nature of an "F" Type Reorganization

> *Example 11:* *P* Corporation, a manufacturer of baseball gloves, owned *S* Corporation, a profitable subsidiary that processed leather. Pursuant to an agreement dated January 1, 1974, *S* was merged into *P*, but there were no personnel or production changes. For the year ending January 15, 1975, *P* incurred a net operating loss, caused partially by the operation of *S*.
> *Issue:* Can an "F" type reorganization include more than one "active" operating corporation and still constitute only a mere change in identity or form?

In *Movielab, Inc. v. United States*,[91] a parent corporation that processed black and white film merged with its wholly owned subsidiary, a processor of color film. The Commissioner disallowed the post-merger net operating loss carryback to the subsidiary's premerger taxable income. The Commissioner argued that the merger failed as an "F" type reorganization and therefore, section 381 barred any net operating loss carryback.[92] In addition, the Commissioner asserted that because of the restrictive language of an "F" type reorganization, which by definition only includes a "mere change in identity, form, or place of organization,"[93] only reorganizations involving one "active" operating corporation and one "shell," or nonoperating entity, would qualify as an "F" type.[94]

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[89] 439 F.2d at 1172 (citing Libson Shops, Inc. v. Koehler, 353 U.S. 382, 388-90 (1957)).

[90] *See* E. HENDRIKSEN, ACCOUNTING THEORY 183-84 (1970).

[91] 494 F.2d 693 (Ct. Cl. 1974).

[92] *Id.* at 696; I.R.C. § 381(b)(3).

[93] 494 F.2d at 696; I.R.C. § 368(a)(1)(F).

[94] 494 F.2d at 696-97.

The court rejected this one "active" operating corporation argument, noting that in allowing an "F" type reorganization, Congress permitted reorganizations that were only a matter of form as opposed to a matter of substance.[95] Thus, so long as the reorganization was within this definition, the fact that the transaction involved more than one active corporation was irrelevant. Finally, the court held that there must be a complete identity of ownership between the merging entities, and a continuation of the same business without interruption;[96] these are the same elements that Revenue Ruling 75-561 requires.[97] Therefore, in *Example 11,* the merger of the two wholly-owned "active" corporations would not in itself bar a finding that such merger was an "F" type.[98]

Citing *Associated Machine, Stauffer,* and *Home Construction,* the court in *Movielab* reasoned that the basic concept surrounding the "F" type reorganization was that the new corporation is actually the "alter ego" of the former and constitutes a mere change in form.[99] Finally, the court stated that an "F" type reorganization could simultaneously qualify as a second type of reorganization specified by section 368(a)(1).[100]

Performance Systems, Inc. v. United States[101] was decided on the same basis as *Movielab.* The court, in allowing the carryback of the post-merger net operating loss to the transferor's pre-merger taxable income, held that the transaction was a matter of form only; therefore, it fell within the section 381(b) exception for an "F" type reorganization.[102] Furthermore, the district court recognized that a reorganization may qualify under several sub-sections of section 368 and still qualify as an "F" type.[103]

C. A Matter of Form Versus a Matter of Substance

> *Example 12:* Jones owned ten separate Corporations. Each was located in a different city, produced the same product, and had separate management. In order to centralize bookkeeping and to utilize managerial specialization, Jones merged all ten corporations into one corporation called "Jones, Inc.," located in California. In the process, two corporations were

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[95] *Id.* at 697-98.

[96] *Id.* at 699.

[97] Rev. Rul. 75-561, 1975-2 C.B. 129.

[98] However, the attribution test illustrated by *Example 10* still must be met in order to utilize one hundred percent of the net operating loss carryback.

[99] 494 F.2d at 697.

[100] *Id.* at 700.

[101] 382 F. Supp. 525 (M.D. Tenn. 1973), *aff'd,* 501 F.2d 1338 (6th Cir. 1974).

[102] 382 F. Supp. at 533-34.

[103] *Id.* at 533 (acquiesced in Rev. Rul. 57-276, 1957-1 C.B. 126-128).

relocated to the new California headquarters, while the other eight remained in the same locations. The following year Jones, Inc. suffered heavy financial losses and desired to carry back these losses against the pre-merger taxable income of the "attributable"[104] former subsidiaries.

Issue: Is the reorganization still only a matter of form, thereby qualifying as an "F" type reorganization, or is it a matter of substance because of the relocation of two of the subsidiaries?

The basic problem is determining the exact point at which a matter of "form" becomes one of substance in regard to a reorganization of the type represented in *Example 12.* The courts, in addition to examining whether there has been an uninterrupted continuation of business and ownership interest, also examine another key factor: the purpose of the business transaction. In *Movielab*, the court concluded that the purpose of the merger was merely to simplify bookkeeping and administration since all other factors, such as personnel, product, and location, remained the same.[105] In *Home Construction*, the Commissioner argued that a reorganization which alters the number of taxable entities—in this case from 123 to 1—could never qualify as an "F" type reorganization because of the varying tax effect.[106] Therefore, any reorganization which changed the tax results of an entity could not be considered a "mere change in form," but one in substance only.[107] The court rejected this reasoning and held that tax results cannot form even "a partial measure of determining what substance is present in a transaction. . . . [T]he government's position would literally let the tail wag the dog."[108] *Stauffer* adopted the concept enunciated in *Davant v. Commissioner*[109] concerning "F" type reorganizations. *Davant* held that a shift of the operating assets from the transferor corporation to its alter ego, given complete identity of proprietary interests and continuity of business enterprise, results in an "F" type reorganization.[110]

In *Example 12*, the major objectives of Jones, Inc. were to simplify bookkeeping and to attain a higher degree of managerial specialization. These goals appear to be within the permissive limits

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[104]*See* the discussion of the attribution clause of Rev. Rul. 75-561, 1975-2 C.B. 129 at notes 78-91 *supra* and accompanying text.

[105]494 F.2d at 693.

[106]439 F.2d at 1170.

[107]*Id.*

[108]*Id.*

[109]366 F.2d 874 (5th Cir. 1966), *cert. denied*, 386 U.S. 1022 (1967).

[110]*Id.* at 884.

of what constitutes an "F" type reorganization. However, the relocation of two businesses could possibly alter this characterization in favor of it being a matter of substance. In *Stauffer*, the court noted in dictum that if the pre-merger operations had been physically relocated from New York, Illinois, and California, to New Mexico, thus forming a single operation, there would have been "no means by which a loss could be pro-rated among the pre-merger identities."[111] In other words, if there had been a relocation that resulted in the combining of all three formerly separate operations, then the "attribution" test[112] would be impossible to satisfy since the total losses of the combined unit would not be subject to an easy demarcation. The relocation of only two subsidiaries, however, provided they remained segregated, probably would not cause such a problem, since it would still be possible to determine each division's corresponding net operating loss. However, if the ten subsidiaries in *Example 12* were all relocated and integrated at the new headquarters, such division or "attribution" of each division's corresponding net operating loss would be practically impossible.

The rationale underlying an "F" type reorganization is that the transaction involves merely a change in corporate structure and not a break in the continuity of ownership and business of the enterprise. Thus, a tax-free status is achieved via the reorganization. In contrast, a change in ownership, or even a slight shift of the proprietary interests, would not result in a tax-free merger, but rather a "sale"; such a transaction becomes one of substance. In addition, a liquidation of assets would result in taxable income since this also would constitute a matter of substance.[113] The Senate intended that such decisions pertaining to form or substance be based on "economic realities" rather than "artificialities."[114] A close analysis of the entire reorganization is therefore necessary to determine whether there has been more than a mere change in form. A finding that the reorganization is more than a change in form results in a loss of tax-free status in addition to a disallowance of the claimed net operating loss carryback.

Eastern Color Printing v. Commissioner[115] reaffirmed the proposition that a mere change in form, even though involving two active corporations, qualifies as an "F" type reorganization. In *Eastern*

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[111]403 F.2d at 622.

[112]*See* Rev. Rul. 75-561, 1975-2 C.B. 129. *See also* notes 78-91 *supra* and accompanying text.

[113]Estate of Stauffer v. Comm'r, 403 F.2d 611, 617 (9th Cir. 1968).

[114]S. Rep. No. 1622, 83d Cong., 2d Sess. 52, *reprinted in* [1954] U.S. Code Cong. & Ad. News 4683 (1954).

[115]63 T.C. 27 (1974).

a taxpayer merged its wholly owned subsidiary into its parent corporation and thereafter incurred net operating losses. The court allowed the taxpayer to carry back this net operating loss to the pre-merger taxable income of the transferor corporation since, with minor exceptions, there was no change in enterprise assets or personnel. The dissenting judge in *Eastern*, who would have disallowed the net operating loss carryback, construed section 368(a)(1)(f) as not encompassing the merger of two taxable entities.[116]

D. *The Continuity of Interest Requirement in "F" Type Reorganizations*

> *Example 13:* *P* Corporation owned seventy-eight percent of *S* Corporation. In prior years *S* had generated substantial operating profits. *P* bought out the twenty-two percent minority interest in merging *S* into *P*. During the next fiscal year, *S* incurred substantial net operating losses. *P* wishes to carry back these net operating losses against *S*'s prior years' taxable income.
> *Issue:* Can *P* successfully claim that this merger is an "F" type in order to carry back the net operating loss even though there has been a change in ownership of the entity that generated the net operating loss?

As previously mentioned, Revenue Ruling 75-561 requires that in order for a reorganization to qualify as an "F" type there must be a complete identity of shareholder interests between the transferor and the acquiring corporation.[117] Therefore, in *Example 13*, *P* Corporation would not be allowed to carry back *S* Corporation's post-merger net operating loss since the merger resulted in a break of the continuity of ownership. In *Aetna Casualty & Surety Co. v. United States*,[118] the Court of Appeals for the Second Circuit expressly rejected this continuity of ownership requirement set forth in Revenue Ruling 75-561. The court held that the merger of a corporation's sixty-one percent owned subsidiary into the corporation's newly-created and wholly-owned subsidiary nevertheless qualified as an "F" type reorganization even though the thirty-nine percent minority interest was eliminated.[119]

The *Aetna* decision was premised upon *Reef Corporation v. Com-*

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[116] *Id.* at 38 (dissenting opinion).

[117] *See* note 77 *supra* and accompanying text.

[118] [1976] STAND. FED. TAX REP. (CCH) (77-1 U.S. Tax Cas.) ¶ 9120, *rev'g*, 403 F. Supp. 498 (D. Conn. 1975).

[119] *Id.*

missioner.[120] In *Reef* the Commissioner successfully argued that the transaction at issue was not a liquidation-reincorporation, but rather a redemption of a minority interest governed by section 368(a)(1)(f) and section 302. Thus, the change in ownership in *Reef*, by way of the redemption, did not preclude the finding that the transaction qualified as an "F" type reorganization.[121] Similarly, the same principle was applied in *Aetna* in lieu of the strict ownership requirements set forth in Revenue Ruling 75-561.

Aetna limited its holding to situations involving "F" type reorganizations. The court required that the new corporation continue without interruption of the old. In addition, the court required that shareholders of the new corporation hold at least fifty percent of the old entity. Finally, the court stated that new shareholders may not be admitted during the reorganization.[122]

Aetna would permit *P* Corporation of *Example 13* to carry back *S* Corporation's post-merger net operating loss to *S*'s pre-merger taxable income. However, the other requirements set forth in *Aetna* and Revenue Ruling 75-561 must also be followed: (1) The business enterprise of the two entities must continue unchanged after the combination, (2) the merging entities must be in the same integrated activity prior to combination, and (3) the acquiring corporation which desires to carry back the transferor's post-merger net operating losses to the transferor's pre-merger taxable income must show that these net operating losses are attributable to a separate division or business formerly operated by the transferor corporation.

V. Conclusion

As the foregoing analysis reveals, determining the availability of net operating loss benefits that exist after corporate purchases and reorganizations is a complex task. Corporate planners dealing with these transactions should possess a general knowledge of the concepts and underlying legislative intent concerning the net operating loss deduction, a firm understanding of the intricate rules controlling the availability of these tax benefits, and an awareness of the changes made by the Tax Reform Act of 1976.

The controversy surrounding the utilization of net operating losses as carrybacks in corporate reorganizations primarily concerns the "F" type reorganization. The initial problem is determining what constitutes an "F" type reorganization in a given transaction. The

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[120] 368 F.2d 125 (5th Cir. 1966), *cert. denied*, 386 U.S. 1018 (1967).

[121] *Id.* at 138.

[122] [1976] Stand. Fed. Tax Rep. (CCH) (77-1 U.S. Tax Cas.) ¶ 9120, *rev'g* 403 F. Supp. 498 (D. Conn. 1975).

importance of this question is attributable to the rule which permits the carryback of post-merger net operating losses in this one type of reorganization only. In addition, the use of an "F" type reorganization as a planning tool for utilizing net operating loss carrybacks is substantially increased by the decision in *Aetna Casualty & Surety Co. v. Commissioner*,[123] which tolerates a material change in ownership in a corporation yet still permits the "F" type status. The second problem, given an "F" type status, is to determine whether the "attribution" rules set forth by the Commissioner and in recent court decisions have been satisfied.

The problem concerning the availability of net operating loss carryovers in purchase transactions is equally perplexing. The continuity of business doctrine, which was repealed by the Tax Reform Act of 1976, has been the most frequent source of litigation in this area. Since the new Act has delayed effective dates for the abrogation of this doctrine, and the dockets of many courts are severely backlogged, the demise of the continuity of business doctrine is still far down the road. In this regard, corporate planners must still be aware of the intricate rules set forth in the above examples.

As for future tax planning, the Tax Reform Act will only require that the continuity of interest of a transacting corporation be preserved. Not only will this place purchases on an equal footing with reorganizations, but it will also eliminate the bulk of confusion resulting from the continuity of business doctrine.

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[123] *Id.*