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Richard Rothberg

Indiana Bar Association

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AN ARGUMENT FOR THE ELIMINATION OF THE "BUSINESS" TEST FROM THE ADMINISTRATION OF THE NET OPERATING LOSS CARRYOVER

RICHARD S. ROTHBERG†

I. INTRODUCTION

Section 172 of the Internal Revenue Code of 1954 provides for a net operating loss carryback against prior income and carryover against future income. One of the most persistent problems in the administration of this section and its predecessors has been caused by the effort to determine the circumstances under which losses remain available for use against future gains despite a change either in the nature of the loss-producing enterprise or in its ownership.

Perhaps because of an unfortunate use of the term "the taxpayer" in the predecessors of section 172, the first cases to consider this problem focused their attention upon the corporate entity. Thus in New Colonial Ice Co. v. Helvering the Supreme Court considered the availability of losses to a corporation which had undergone what would now be a reorganization under section 368(a)(1)(F). Although the court acknowledged that the nature of the enterprise and its ownership remained the same, it denied the carryover because the transaction had extinguished the old corporate entity. Later, on the theory that a merger, as opposed to a contractual reorganization, "drowns" the transferor in its successor, the Court held in Helvering v. Metropolitan Edison Co. that a parent into which a wholly-owned subsidiary had been merged might succeed to the subsidiary's un-amortized bond discount.

Two important developments have made substantial inroads into this basic "entity" approach. The details of these developments will be discussed as they become relevant. The first is the Internal Revenue Code of 1954 which in section 381 specified certain transactions wherein the loss carryover would pass from one corporate entity to another. Congress also set out in section 382(b) some

† Member, Indiana Bar.
2. E.g., Int. Rev. Code of 1939, ch. 1, § 122 (b) (2) (C), 65 Stat. 505 (1951) read in part: "If for any taxable year beginning after December 31, 1947, and before January 1, 1950, the taxpayer has a net operating loss. . . ." (emphasis added).
important limitations upon the loss carryover in cases where the requisite continuity of ownership was not present. In addition, section 382(a) disallows the carryover in certain situations where there has been both a substantial change in ownership and a change in the nature of the enterprise, even though the corporate "entity" has remained unchanged. This provision supplements section 129 of the 1939 Code which was reenacted as section 269 of the 1954 Code—a provision which disallows the carryover if the corporation is acquired for the principal purpose of tax avoidance.

The second important development is *Libson Shops, Inc. v. Koehler* decided after the enactment of the 1954 Code but applying the 1939 Code in which the Court purported to reject the "entity" approach of *New Colonial Ice* and *Metropolitan Edison* and applied instead a "continuity of business enterprise" test to the operation of the carryover provision.

As a result of these developments, the nature of the enterprise which produced the losses and the nature of the enterprise which produced the gains against which these losses would be offset have become important factors governing the availability of the carryover. This article concludes that the possible justifications for this emphasis upon the nature of the businesses involved do not outweigh the substantial problems of definition and consistency with other parts of the Code which have resulted from this "business" test. Therefore, the availability of the carryover should be made to depend entirely upon whether or not the people who owned the loss-producing enterprise also own at least a part of the profitable enterprise which is seeking to use those losses. Two things about this proposal should be noted here. First, the proposal cuts two different ways—a carryover otherwise available would not be lost because the profitable enterprise differs in nature from the losing enterprise and a carryover otherwise lost would not be saved because the enterprise remains the same. Second, the proposal does not solve the very difficult questions about the definition of "ownership." However, it is believed that these questions are all present in existing law; so if this proposal solves no problems at least it does not create any new ones.

II. CHOICES AND ECONOMIC POLICY—A FRAME OF REFERENCE

The tax system could adopt a rule that the carryover will be disallowed if either ownership or "business nature" has changed. It might adopt one test to the exclusion of the other; it might allow the
carryover unless both have changed; or, as is now the case, it might adopt a number of rules, dependent upon the extent of the changes in ownership and business and upon some third variable such as the form of the transaction. Abstract analysis of these choices in their simplest form could never produce a satisfactory answer to a difficult case but it gives a framework for analyzing the policies which might underlie section 172 and for relating these policies to the cases.

The purposes of the loss carryover are undoubtedly best served in a business which has undergone neither a change in the nature of its operations nor a change in ownership. The important question must be whether the aims of the statute would be better served by viewing the carryover as a benefit to the owners of the loss corporation or by viewing it as a part of the loss-producing enterprise itself. A search for the purposes of section 172 has been inconclusive. The best guide to the purposes of the loss carryover is a comment upon its proposed elimination, contained in a House report accompanying passage of the 1939 Code:

... A business with alternating profit and loss is required to pay higher taxes over a period of years than a business with stable profits, although the average income of the two firms is equal. New enterprises and the capital-goods industries are especially subject to wide fluctuations in earnings. It is, therefore, believed that the allowance of a net operating loss carry-over will greatly aid business and stimulate new enterprises.\(^7\)

This statement suggests three separate purposes, one based upon fairness and two upon economic considerations.\(^8\)

One reason for the statute is that it is unfair to tax the unstable or cyclical business upon its gains without allowing for the losses of its bad periods. Otherwise a business subject to cycles more than a year in length will pay a higher tax over that cycle than a business with the same profits earned evenly from year to year. One view of this argument is that the losses of an unstable business are the cost of sustaining that business until the economy again has sufficient need of it to reward it with profits; this view suggests that the carry-over should not be denied on account of a change in ownership but that a change in the nature of the business would remove the justi-

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fication for the carryover. Similarly, if the fluctuations are due to an inherent inability of that kind of business to match expenses with the revenue, then a business test for denial of the carryover would be appropriate. But one can view this argument as meaning that the owners of risky and cyclical enterprises should be treated the same as those who prefer steadier incomes. This latter view suggests that an "ownership" test of denial should be used.

A second purpose of the carryover is to remove one impediment to the undertaking of new enterprises—the tendency for even a successful business to lose money in its formative years. To fulfill this purpose, the carryover is addressed to those who would undertake a new enterprise. But this does not mean an ownership test would best carry out this purpose. The real beneficiaries under this view of the purpose of the carryover are not the owners of the business but the segments of the economy which want it or need it enough to reward it with profits. To best carry out this purpose the carryover should stay with the business until the business prospers or is abandoned and should not go with the original investors who were not patient enough to see it through.

A third purpose of the carryover is to maximize the stabilizing effect of the taxing system upon the economy. To some extent expenditures, especially expenditures for plant and equipment, can be timed independently of the receipt of revenues, which fluctuate greatly from year to year in many businesses. In the absence of a carryover, businessmen would try to match these expenditures against receipts in order to minimize their tax. This matching process would then accentuate the business cycle. The carryover, however, serves a function similar to depreciation in minimizing this effect. Thus the stabilizing purpose would suggest that the carryover should remain with the business through a change in ownership. But there is another possible view. Earnings are an important source of new investment and, to the extent that the carryover evens out the flow of earnings, it will even out the flow of new investment as well. If our concern is a smooth flow of profits to investors we should focus upon them and not upon their businesses. According to this view the carryover should be left with the owner as he shifts to a new enterprise.

Little more can be safely said about the Congressional purpose in creating a net operating loss carryover than that Congress was not specifically concerned with the problems of corporate acquisitions and reorganizations when it originated the carryover. The carryover principle long antedates the first Congressional attempt (in the 1954
Because there is little evidence that Congress intended the adoption of a business test in administering the carryover provision, it should be asked what contribution such a test makes to the legislative purpose and whether or not that contribution is worth the trouble such a test creates.

III. The “Business” Test

A. Justifications

1. Prevention of “trafficking in loss carryovers”

Undoubtedly the most important reason for having limitations upon the availability of loss carryovers is the desire to prevent the use of a defunct company’s loss as a tax avoidance device by some unrelated business. Certainly, in many such cases, the loss will be used to offset gains from a different kind of business and a “business” test might be an effective means of identifying such abuses. But, as will be discussed, the business test is subject to substantial difficulties. In view of these difficulties it is appropriate to ask whether or not such a test is really the most effective approach to the “trafficking” problem. It is not for many reasons.

First, the cases which are easily identifiable as abuses could be reached by an ownership test. The typical case of abuse is that of a corporation with substantial losses which finally quits, sells its assets, and becomes a “shell.” The shareholders then peddle the one remaining asset, the carryover, wherever they can. Such cases invariably involve a change of ownership so an ownership test would be effective against them. Section 269 of the 1954 Code and its predecessor, section 129 of the 1939 Code, have been successful weapons against the most obvious abuses; these sections are operative only if there has been a change in “control” and the nature of the businesses involved is relevant only insofar as it helps determine whether or not tax avoidance was the principal purpose of the transfer. In other such cases the

9. Section 129 of the 1939 Code, the predecessor of section 269 of the 1954 Code, has been applied to this area, but section 269 is of more general application.


11. E.g., J.G. Dudley Co. v. Commissioner, 298 F.2d 750 (4th Cir. 1962); Brown Dynalube Co. v. Commissioner, 297 F.2d 915 (4th Cir. 1962); Commissioner v. British Motor Car Distrib., 278 F.2d 392 (9th Cir. 1960); Mill Ridge Coal Co. v. Patterson, 264 F.2d 713 (5th Cir.), cert. denied, 361 U.S. 816 (1959); American Pipe & Steel Corp. v. Commissioner, 243 F.2d 125 (9th Cir.), cert. denied, 355 U.S. 906 (1957).

12. At one time this tax avoidance section was not fully effective because it was thought not to apply to the corporation itself when a corporation changed hands. Alprose Watch Corp., 11 T.C. 240 (1948). But this rule has been completely repudiated, Mill Ridge Coal Co. v. Patterson, 264 F.2d 713 (5th Cir.), cert. denied, 361 U.S. 816.
carryover has been denied under the *Libson Shops* doctrine despite a finding that the principal purpose was not tax avoidance. While it is true that both section 269 and the *Libson* doctrine have depended to some extent upon a change in business—indeed *Libson* has often depended solely on a change in business, the point here is only that an ownership test is sufficient to prevent the most obvious abuses.

A second important reason that a business test is not the most effective approach is that, in cases where ownership of the loss business and gain business is truly the same, use of the carryover is now thought to be proper no matter how different the two businesses are. In other words, in cases where a business test would most obviously be needed, it is not applied. This, however, has not always been the case. In the *Libson Shops* case, the businesses incurring the losses and earning the profits were owned by the same people in the same proportions. But this aspect of the *Libson* doctrine is no longer followed. The most obvious situation for a denial of a carryover where ownership has not changed would be a situation in which the owners of a loss corporation sold all its assets; purchased, with substantial new capital of their own, the assets of a profitable going business of an entirely different kind; and plugged those assets into the old corporate shell. Section 382(a) would not apply because no stock in the loss corporation had changed hands nor would section 381 or the limitations of section 382(b) be applicable because the loss corporation's entity survives. The Internal Revenue Service has ruled that it will not seek to apply the *Libson* doctrine to such a case. Section 269(a)(1) is not applicable because no one has acquired control of a corporation and section 269(a)(2) is not applicable because the transfer of assets was not in a tax-free form. If instead the corporation

(1959); Commissioner v. British Motor Car Distrib., 278 F.2d 392 (9th Cir. 1960), thereby removing one obstacle to effective use of the ownership test as a weapon against abuse.


14. The use of section 269 and the *Libson* doctrine in conjunction with the "business test" will be analyzed infra.

15. The Sixth Circuit has very recently cast some doubt on this conclusion. In Frederick Steel Co. v. Commissioner, 375 F.2d 351 (6th Cir.), *cert. denied*, 36 U.S.L.W. 3158 (U.S. Oct. 16, 1967), the court reversed the Tax Court and in the process revealed a very substantial loophole in the ownership test established by section 382(a)(1) of the 1954 Code. Of course this demonstrates only that the present ownership test may not be entirely adequate. It does not demonstrate that trafficking cannot be curbed without a business test. Moreover, the Sixth Circuit did not disturb a Tax Court finding that the acquisition was not for the purpose of taking advantage of the loss. It may therefore be questioned whether this is really a "trafficking" case to begin with.

purchased the stock of the profitable corporation and liquidated it, section 269 might be applicable, but the Internal Revenue Service has ruled that, in such a case, it will not contend that the principal purpose is tax avoidance. The conclusion is inescapable that neither the Congress nor the Internal Revenue Service intends that the carryover be denied in such a case; this is a clear indication that the loss carryover is to be administered primarily as a benefit to the owners of the loss-producing enterprise and not as an attribute of the losing enterprise itself. If use of the carryover is to be permitted in this hypothetical case, then use of the proceeds from the asset sale, without the injection of new capital, to purchase a business and use of the proceeds to start a new business would seem a fortiori to be situations in which the carryover should be allowed.  

A third argument against the contention that the business test is needed to combat "loss trafficking" is that the Congress does not seem to think it is necessary. The business test appears in the Code in two places: section 269 (as an indication of motive) and section 382(a). But both these sections contain the prerequisite that ownership change, which indicates that the purpose of the business test is not to locate abuses where the business has changed, but rather to remove from the operation of these sections cases where the business is the same. Whether, as Congress seems to think, the carryover should be allowed in an unchanged business with new owners is an entirely different question, which will be discussed below. Plainly the business test cannot be totally eliminated unless it is decided that the carryover should be denied to an unchanged business with new owners. But whatever view is taken of this latter question, the Congress clearly does not intend that a change in business alone should be used as a ground for attacking the carryover. 

The legislative history of the 1954 Code supports this view. The initial House version of section 382 contained no references to the type of business. Commenting upon its proposal, the House Report said:

This special limitation on net operating loss carryovers provides an objective standard governing the availability of a major tax benefit which has been abused through trafficking in corporations with operating loss carryovers, the tax bene-

17. Id.
18. Northway Sec. Co., 23 B.T.A. 532 (1931), was of the latter type. The carryover in that case was allowed on the ground that the entity had not changed.
19. Section 269 uses the term "control" but defines it to mean ownership of stock.
fits of which are exploited by *persons* other than those who incurred the loss.\(^20\) (emphasis added.)

The Senate added the change of business test now found in section 382(a)(1)(C) and the Senate Report indicates that by so doing it intended to enlarge the availability of the carryover, not to reduce it further.\(^21\)

Finally, the Regulations promulgated under section 382(a)(1)(C) indicate that one of the targets of section 382, at least in the view of the Internal Revenue Service, is a transfer of a corporation within the same industry; this view of section 382 would strongly support the inference that "trafficking" is an entirely personal concept that has nothing to do with the kinds of business involved. One Regulation in particular supports this view.\(^22\) It denies the carryover to a business which is inactive at the time of the stock transfer and is subsequently reactivated in the same line of work. An example, found in the Regulations, is that of a machinery manufacturing firm which suspends its activities, is sold, and then resumes identical operations under its new ownership.\(^23\) It would seem that the Internal Revenue Service is seeking to confine this permissive aspect of the business test within extremely narrow limits. It is therefore necessary to ask what purpose, if any, is served by this permissive use of the business test.

2. Permitting use of the carryover although ownership has changed

The above discussion left open the question of whether or not a business test should be used to permit some use of carryovers where the losing enterprise later makes profits but under different ownership. As has been discussed, there is economic justification for this viewpoint. But in view of Congress' basic commitment to an ownership approach, allowing carryovers in the additional case of an unchanged business under new ownership creates more trouble than it is worth. Fully realizing its undesirability from the taxpayer's point of view, the author concludes that Congress should reconsider this particular act of legislative grace.

First, it may be argued that the carryover offers an incentive to new management to rejuvenate a losing business. Perhaps the best example of the appeal of this argument is *Wallace Corp.*,\(^24\) in which

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\(^{22}\) Treas. Reg. § 1.382(a)-1(h)(6) (1962).

\(^{23}\) Rev. Rul. 58-9, 1958 CUM. BULL. 190 gives a similar example.

the taxpayer was a manufacturer and wholesaler of toothpicks, clothespins, and food trays. Forster, who had a similar business, purchased all the stock of Wallace in the belief, which proved correct, that he could substantially improve its operations and make it a profitable enterprise. The Tax Court found that under section 382(a)(1)(C) the business had not changed and allowed a carryover. This sort of regeneration of a business is certainly desirable economically and if may be that the purchaser derived an incentive to act from the carryover which awaited him if he succeeded. But it is certainly open to question whether or not this is what Congress meant by the “stimulation of new enterprises.” This was not the granting of a carryover to a new business to help it overcome the expected losses of its early years. The losses in the present case were an established fact and there is no reason in fairness or in economics to make them available to the purchaser. Such losses are not available to a businessman starting a new business. The potential for profits should be incentive enough.

The Wallace case also suggests a second difficulty with the rule that the carryover remains available to an unchanged business under new ownership: the rule is potentially inconsistent with the well-established principle that the carryover is available to a new business under the same ownership as the losing business. For example, if Forster had purchased the Wallace Corporation assets for cash, the carryover would have remained with the old owners. The possibility of two carryovers is avoided only because the carryover is treated initially as an attribute of the corporate entity; Forster got the carryover because he bought the stock instead of the assets. If both these principles are allowed to exist simultaneously, then location of the carryover will often be only a matter of form. In such a case the parties could put the carryover where they like and this possibility encourages rather than discourages “trafficking.” Of course this argument tells us only that one or the other of these principles must go; it does not tell us which.

Another difficulty with the business approach to preservation of the carryover is that it makes the carryover available for “bootstrap” acquisitions. For example, in Glover Packing Co. v. United States, the loss corporation was in the meat packing business. Glover, an experienced packer, purchased ten per cent of the stock and discharged ten per cent of the indebtedness. He was given the right to manage the

26. See discussion following note 15 supra.
27. 328 F.2d 342 (Ct. Cl. 1964).
corporation and to nominate the directors. The rest of the stock was placed in escrow to be returned to the corporate treasury gradually as the corporation discharged its remaining indebtedness. The purpose of the arrangement was plainly to use the earnings, sheltered from tax by the carryover, as a means of transferring the business to Glover. The court rightly found that ownership had changed within the meaning of section 382(a) because the escrowed stock had no fair market value. The business was found to have changed, within the meaning of section 382(a)(1)(C) because it had been inactive prior to the transfer. Although the effort failed in this case, this “bootstrap” technique would not be any less available for purchase of an active but losing corporation. In Superior Garment Co.\textsuperscript{28} a similar technique did work. The latter transaction was even more obviously a bootstrap because the note given as part consideration for Superior’s stock was conditioned upon and limited in amount by the tax savings due to the carryover. Of course, to label a transaction as a bootstrap sale is not necessarily to condemn it. There were substantial business reasons for both these transactions. The use of earnings to finance the acquisition of an enterprise so that the enterprise can get back on its feet may be desirable economically. But the application of the “business test” has the result that the otherwise taxable earnings resulting from the energies of new management are diverted from the Government to the old owners of the business, who have in effect given up on the enterprise. It would be surprising if Congress actually intended to be so generous.

Thus far it has been assumed that the question whether or not the business test is satisfied has already been answered. Because application of this test is an extremely complicated process, a great advantage of doing away with it is that all these complex problems would be avoided.

B. Problems

1. Definition

   a. Section 382(a)(1)(C) and its Regulations.

   This section denies the carryover to a corporation which, in a taxable purchase transaction, undergoes a described change in ownership, but only if “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, ...”\textsuperscript{29}

\textsuperscript{28} 24 CCH Tax Ct. Mem. 1571 (1965).
\textsuperscript{29} INT. REV. CODE of 1954, § 382 (a) (1) (C).
The statute seems to require only that “a business” previously conducted by the loss corporation continue, not that the subsequent gains come from the same business which produced the losses. The Regulations\(^3\) make some effort to deal with this ambiguity by their observation that the general objective of section 382(a) is to disallow the carryover where used “to offset gains of a business unrelated to that which produced the losses.”\(^*\) But “unrelated” is an unsatisfactory word here. A business may be substantially different from the loss business and yet be “related.” One question would be whether or not a business is sufficiently “related” if it was owned by those who owned the loss business and sold along with it. The Regulations\(^3\) give two examples which suggest that the carryover will not be available if the losing portion of such a conglomerate enterprise is discontinued. This might suggest that the surviving business is not sufficiently “related.”

But if these Regulations are intended to express a policy that the losses should be available only against gains from the same “business,” it is difficult to explain another Regulation\(^3\) which says that if the old business is continued and a new one is added, the carryover is available against the earnings of the added division.\(^4\) It is not readily apparent why the tax shelter of past losses should be held out as a reward for keeping a losing enterprise going. At any rate, the reasoning behind this Regulation has yielded at least one taxpayer victory.\(^5\)

A principle that has produced substantial difficulty under this section is that the same business has not been “continued” if it is inactive at the time of the change in ownership.\(^6\) The purpose of this Regulation is to prevent “trafficking” within the same industry.\(^7\) The simplest application would be a highly personalized service

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31. This language is apparently borrowed from S. Rep. No. 1622, supra note 21, at 4684.
34. Subject to the test of motive in section 269.
35. Goodwyn Crockery Co. v. Commissioner, 37 T.C. 355 (1961), aff'd, 315 F.2d 110 (6th Cir. 1963). In Euclid-Tennessee, Inc., 41 T.C. 752 (1964), aff'd, 352 F.2d 991 (6th Cir. 1965) the Tax Court distinguished Goodwyn partly on the ground that in the Euclid case the added business was owned by the purchasers of the losing business. Note that this distinction is based on ownership; it must be an effort to prevent the purchase of loss corporations to reduce the taxes of a going business, a policy hardly related to the nature of the businesses and better dealt with by an ownership test.
industry. Another Regulation, however, is probably better suited to such a case; it recognizes that a servicing business is substantially the same as its owner, with whom the service is identified. The carryover should be denied where such a business declines and the shell is sold to another individual rendering the same services. It would seem, however, that an ownership test is a far more direct approach to such a case.

Where the nature of the business is not personal to its owner, but the business is resumed in order to perform precisely the same function it was performing before, application of the “not continued if inactive” principle is more difficult, as Barclay Jewelry Co. shows. The Tax Court allowed the carryover on the ground that the corporation did not become inactive until after the transfer. The First Circuit reversed, saying that the intent to carry on the business, as manifested by actually doing so after acquiring it, is the relevant factor in interpreting this section. This suggests that the purpose of section 382(a)(1)(C) is to allow the carryover to a purchaser in order to induce the purchaser to compensate the seller for the loss. In that way the seller can recoup. The court said that this was the only reason it could see that Congress would want to allow the carryover to a purchaser.

Not only is this supposed purpose, which is nowhere expressed in the legislative history, contrary to the expressed purpose of eliminating “trafficking,” but, if the court’s version of the purpose is correct, section 382(a)(1)(C) actually hinders it.

In order to show that section 382(a)(1)(C) facilitates this purpose the court said:

It seems manifest that a purchaser who abandons the business, and has no plans to continue it, is not the sort of purchaser who could be expected to make any payment to the seller on account of an available tax loss. . . .

This is absurd. The purchaser who buys a business to get the loss carryover is the purchaser least likely to carry on the old business. If Congress wanted to compensate the owner of a losing business by inducing a purchaser to compensate him for the loss, then Congress

42. The opposite result in Fawn Fashions, Inc., 41 T.C. 205 (1963), may be justified on this same ground.
43. 367 F.2d 193 (1st Cir. 1966).
44. Id. at 196.
only hindered that purpose by requiring the purchaser to continue the business.

The Tax Court's criterion, based upon the timing of the inactivity, is a sound approach to some cases. In many cases the inactivity will be due to losses and an effort to find a buyer, in which case the timing of the inactive period would be an accurate indication of "trafficking." But the inactivity may be due to other factors, as the First Circuit in 
Barclay Jewelry recognized. For example, in United States v. Fenix & Scisson, Inc. the loss corporation was a marginal producer of lead and zinc. Because of the expense of reactivating a mine which has been closed down, these marginal producers are often kept in a state of readiness, during periods of low prices, to await a price increase sufficient to make operations profitable. Although in this particular case the court refused to believe that "readiness" was the reason for the inactivity, the case demonstrates that this inactivity standard is at best a crude approach to the "trafficking" problem.

In recent cases the Tax Court has shown great versatility in dealing with inactivity. For example, in H.F. Ramsey Co. the court considered a construction business which was completing outstanding contracts and winding up its affairs; i.e., it was not a mere shell at the time of negotiations for sale; this business was found not to be inactive. And in Clarksdale Rubber Co. the court allowed the carryover to a corporation which suspended its manufacturing, leased its plant, and remained active only in the sense that it continued to deal with its financial problems.

Another source of confusion under section 382(a)(1)(C) is the test expressed in the Regulations that the same business has not been "continued" if the location of a major portion of the activities is changed and, as a result, the business is "substantially altered." In Goodwyn Crockery Co. v. Commissioner, a change in the center of operations was found not to be determinative because the business was still serving the same geographic market. The second and third examples under this Regulation, like Goodwyn, consider merchandising businesses and also rely on the market served by the firms as a test of the importance in the change of location. But the first example concerns a

45. Id. at 195 & n.3.
46. 360 F.2d 260 (10th Cir. 1966), cert. denied, 386 U.S. 1036, rehearing denied, 388 U.S. 924 (1967).
47. 43 T.C. 500 (1965).
48. The carryover in that case was disallowed under section 269.
49. 45 T.C. 234 (1965).
51. 37 T.C. 355 (1961), aff'd, 315 F.2d 110 (6th Cir. 1963).
manufacturer who continues to make the same product for the same customers but with a different plant, equipment, and employees. This example is puzzling. So long as the business is serving the same market in the same way there is no apparent reason for denying the carryover on the ground that the “business” has changed. The justifications for the carryover—fair treatment of fluctuations in profits, minimization of risk, dampening the business cycle—do not suggest any basis for distinguishing between manufacturers and merchandisers or between businesses which own their facilities and businesses which lease their facilities. If the market for the business is nationwide, as will more often be the case with manufacturers than with merchandisers, a market test of location would not affect such a business. But this suggests that a change in location does not substantially alter that business; it does not suggest that a test other than the location of the market served should be applied to manufacturers.

This brief survey of the difficulties so far encountered in the administration of section 382(a)(1)(C) shows that it has caused section 382 to fall considerably short of the legislative purpose of adding certainty to the carryover provisions.52

b. The Libson Shops Doctrine

The business approach to the availability of the loss carryover is not confined to the 1954 Code. The doctrine of Libson Shops v. Koehler53 has been applied to deny the carryover on the ground that a change in business, as well as a change in ownership, might destroy the requisite “continuity of business enterprise.” It is clear that the Libson case depends upon a difference in business because all the corporations involved in the case were owned by the same people in the same proportions throughout the period in question.

One of the problems raised by the Libson line of cases is what importance, if any, these cases have under the 1954 Code; although decided in 1957, Libson applied the 1939 Code. If a case arose in which the business test of Libson would not be met, but section 382 would allow the carryover, it would be necessary to decide whether Libson applies to the 1954 Code. But since the differences between Libson and section 382 are most striking in the ownership area, this problem will be considered later. If the business test of Libson and section 382 are the same, then the courts will no doubt rely on Libson era cases as authority even if Libson is not expressly applicable to cases arising under the 1954 Code.

Since the Libson case and section 382 serve the same basic purpose—limiting the carryover to those applications which Congress intended, it would seem unnecessarily complicated to have two business tests. One is bad enough. The Internal Revenue Service takes this view; it has announced that it will not rely upon Libson under the 1954 Code if there has not been a change in business as defined in section 382 and its Regulations.\(^5\) One Tax Court opinion suggests that the two tests depend upon similar considerations\(^5\) but does not consider any possible differences. In *Clarksdale Rubber Co.*\(^6\) the Tax Court suggests that section 382(a)(1)(C) is more restrictive but it then says that this section is the exclusive test in cases where 382(a)(1)(A)’s ownership test applies. This conclusion, however, would have no meaning unless the court thought there were at least some circumstances in which Libson is more restrictive. In *Euclid-Tennessee, Inc. v. Commissioner*\(^6\) the court suggests that the 1939 Code, as construed by Libson, was more restrictive than the 1954 Code. But no decision has yet been based upon a difference between these tests nor has one suggested a particular in which they might differ. Also, since Libson followed the 1954 Code it could not be argued that Congress intended section 382 to be applied without regard to Libson. It thus appears that the cases decided under Libson’s business test do have value in interpreting section 382(a)(1)(C) even if Libson is not itself applicable.

In the Libson case, sixteen women’s apparel stores and a seventeenth management unit were all separately incorporated; the corporations were owned by the same people in the same proportions. Three of the stores had losses. The corporations were all then merged and the combined enterprise sought to carry these losses against post-merger income of the group. The three losing stores continued to lose. The Supreme Court denied the carryover. Since each store was an easily identifiable economic unit and separate accounting was maintained after the merger, the Court concluded that the losing enterprises were not the same businesses as the profitable enterprises.\(^6\)

It is not always so easy to distinguish the losing enterprise from the profitable enterprise that succeeds it because defining the essence of a business can be very difficult. For example, in *Federal Cement*\(^6\)

\(^{56}\) 45 T.C. 234 (1965).
\(^{57}\) 352 F.2d 991 (6th Cir. 1965).
\(^{58}\) The difficulties raised for cases of this type by consolidated reporting will be discussed below.
Title Co., the loss corporation manufactured cement roofing slabs in the East. Its successor corporation also made cement roofing slabs but did so in the Midwest and without using a patented process which the loss company had used. The Tax Court, relying on the change in process, denied the carryover. The appellate court emphasized the change in location. A change in location which results in serving a new market should be a sufficient change in business to invoke Libson because the only difference among the stores in Libson was that they served different markets. But a change in process of manufacture could be of such varying importance from one business to another that its use and the use of similar changes short of a change in the product itself invite unnecessarily complicated distinctions.

It is tempting to define a business in the Libson sense as a bundle of assets which must work together to earn particular income. This approach works quite well with a chain of stores in separate cities. But it is not at all appropriate for corporations which are closely identified with their owners and acquire new assets with each particular undertaking. Such corporations are especially common in the construction industry. Nor is it an appropriate approach to a corporation which is organized to perform a particular essential function for some other corporation. Furthermore it does not offer any guide for the addition of a complementary new line to a going business. Finally it does not tell whether or not the elimination of substantial liabilities and the injection of new working capital changes the nature of the business.

One difficulty with Libson's business test is that many of the cases which apply it involve a change in ownership as well and the courts cumulate the changes so that it is not clear whether or not the

59. 40 T.C. 1028 (1963), aff'd, 338 F.2d 691 (7th Cir. 1964).
60. Rev. Rul. 59-395, 1959-2 Cum. Bull. 475 takes this approach. This ruling permits use of the carryover only where the income is attributable to assets which were acquired from the loss corporation and used in continuing the prefusion business. This ruling is inapplicable by its own terms to transactions governed by section 381(a) of the 1954 Code.
61. See, e.g., Urban Redevelopment Corp. v. Commissioner, 294 F.2d 328 (4th Cir. 1961). The purchaser of the corporation wanted certain plans which the corporation did not have. If it had, it is questionable which would be the primary asset—the initiative of the owner or the right to develop the plans. Only one had changed.
62. See, e.g., Bookwalter v. Hutchens Metal Prod., 281 F.2d 174 (8th Cir. 1960), in which the taxpayer was organized as a sales outlet for a manufacturer and the court distinguished the sales function from the manufacturing function.
63. Such as the unsuccessful attempt to add an aluminum window and partition line to an existing steel partition business in Virginia Metal Prod., 33 T.C. 788 (1960), rev'd, 290 F.2d 675 (3d Cir.), cert. denied, 368 U.S. 889 (1961).
64. In Willingham v. United States, 289 F.2d 283 (5th Cir. 1961), cert. denied, 368 U.S. 828 (1961), the court thought this change, together with a change in ownership, was enough.
change in business was alone sufficient. Moreover, businesses are of so many different kinds and can change in so many different ways that the effort to describe those changes which are sufficient to produce a "different" business seems doomed to frustration. Since it is far from clear that such a test is needed to fulfill the basic purposes of the loss carryover, this effort to define the "business" test hardly seems worth the trouble.

2. Consistency with Other Parts of the Code

A second major difficulty with the "business" approach to the denial of loss carryovers is that the Code does not generally regard the economic source of gains and losses as significant. The basic approach of the corporate income tax is to tax the corporate entity upon the gains from whatever activities happen to fall under the corporate umbrella. It is not feasible to separate one particular tax attribute such as a net operating loss carryover and administer it on the basis of the character of its source while earnings generally are not separated in that fashion.

The Libson Shops case provides an excellent illustration of this difficulty. The Court treated each of the stores in the Libson group as a separate economic unit serving a separate market and refused to allow the use of losses from one unit to offset gains from another. The Court recognized the possibility that consolidating the returns of these units would accomplish the same thing but overcame this difficulty by arguing that the parties had elected not to do so.

Another case which ably illustrates this difficulty with the Libson business test is Joseph Weidenhoff, Inc. Bowser, Inc. manufactured liquid pumps and meters and owned a number of subsidiaries which manufactured various items. One of the subsidiaries, which made nuts and bolts, incurred losses in 1948 and 1949. Its assets were then sold to interests unconnected with Bowser. Bowser attempted to include these losses in its consolidated returns for 1950 and 1951 and the court allowed the carryover. It pointed out that, since the real sufferer of the loss was Bowser, the Congressional purpose would be served by allowing
AN ARGUMENT FOR

the carryover against Bowser's later income. The difference between the screw company which produced the losses and the pump and meter company which produced the gains is at least as great as the difference between the losing stores and the profitable stores in *Libson*. But any other result in *Weidenhoff* would be hard to support. If consolidation of losses and gains is allowed while the loss business continues and the consolidated enterprise thereby generates a carryover, there is no conceivable reason for wiping away the carryover simply because the bad apple is eliminated. *Libson's* business test thus depends entirely upon the added circumstance that consolidation is not available and the availability of consolidation is a matter of ownership and form, not of the nature of the business conducted.\(^{68}\)

A consolidated group can end all argument about the use of losses from one member to offset gains of another by merging. No one contends that the separate divisions of a single corporation must be accounted for separately. As will be discussed below, sections 381 and 382(b) of the 1954 Code, which govern the availability of a carryover to merged enterprises, make no use of a business test. Such cases as *Irving-Kolnar Corp.*,\(^{69}\) *Frank Ix & Sons Va. Corp.*,\(^{70}\) and the *Libson* case itself, which involve the tax-free combination of different enterprises owned by the same people in the same proportions, are troublesome because of the possibility of consolidated reporting. It is significant that the results in all three cases would in all likelihood have been different had they been decided under 1954 Code.\(^{71}\)

To be sure, the rules governing consolidated returns contain limitations somewhat like the "business enterprise" limitation in the *Libson* case. The consolidation privilege is subject to regulations which, until very recently, provided that the losses of a corporation which filed a separate return were available only against the income

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68. Zanesville Investment Co. v. Commissioner, 335 F.2d 507 (6th Cir. 1964), concludes after examining the legislative history of the consolidation provisions that Congress intended to treat enterprises owned by the same group as one "business." This case, like the Treasury regulations discussed below, distinguishes a pre-affiliation known loss from losses generated after affiliation.  
70. 45 T.C. 533 (1966).  
71. In *Libson* and *Irving-Kolnar* the loss corporations were merged out of existence thus making section 381 expressly applicable. In *Ix* the loss corporation survived but the limitation on the availability of carryovers in section 382(a) of the 1954 Code would definitely not be applicable. In all three cases the carryover would be denied under the 1954 Code only by reason of the "business" branch of the *Libson* doctrine; as is pointed out beginning at text following note 15 supra and preceding note 71 infra, this branch at least of the *Libson* doctrine is practically dead.
of that same corporation after consolidation. This rule has now been liberalized to some extent.\textsuperscript{72} By virtue of the definition of "separate return limitation year,"\textsuperscript{74} the carryover is available to the group if the subsidiary was a member of the group on each day of the loss year.\textsuperscript{75} The requirements for "membership" are in section 1504 and are based upon ownership. In effect, the same limitation is applied to a loss group of corporations and to a loss subsidiary corporation. Thus the continuity required for carryover of losses among enterprises with consolidated returns is entirely a matter of the ownership of the enterprises which have been grouped together for accounting purposes. The nature of the businesses involved has nothing to do with it.\textsuperscript{77} One Regulation\textsuperscript{78} does contain a business test but the purpose of it is only to explain the application of section 382(a) to consolidated groups where the parent undergoes the required change of ownership. The Regulation adds no new requirements.

When enterprises are consolidated for purposes of tax accounting and even more so when they are combined under the same corporate entity, it becomes difficult, if not impossible, to identify income as coming from the formerly losing enterprise. A ruling\textsuperscript{79} attempted to solve this problem under the 1939 Code by shifting to the taxpayer the burden of identifying the income of the losing enterprise. This approach would discourage measures that might otherwise be economically very desirable. For example, it might be desirable to consolidate overhead costs such as office space, but the savings from this would be very difficult to allocate. Similar problems arise for the treatment of labor expense where the two businesses overlap, profits from the gain business which are plowed into the formerly losing business, and income from an expansion of the profitable business with assets from the losing business.\textsuperscript{80}

It has recently been suggested that section 482 might be used as a means of preventing the use of losses from one business to offset

\begin{enumerate}
\item[73.] Treas. Reg. § 1.1502-21 (c) (1966).
\item[74.] Treas. Reg. § 1.1502-1 (f) (1966).
\item[75.] Provided there has been no multiple surtax election under section 1562.
\item[76.] Compare Treas. Reg. § 1.1502-21 (d) (1966) with Treas. Reg. § 1.1502-21 (c) (1966).
\item[78.] Treas. Reg. § 1.1502-21 (c) (1) (1966).
\item[79.] Rev. Rul. 59-395, 1959-2 CUM. BULL. 475.
\item[80.] These problems are raised in Sinrich, Libson Shops—An Argument Against its Application Under the 1954 Code, 13 TAX. L. REV. 167, 174 (1958).
\end{enumerate}
gains from another with which it has been combined. This section is to some extent a limitation on the idea that the tax laws are blind to the nature of operations within the corporate structure. For example, in Commissioner v. Chelsea Prod. Inc. a company which made and sold fans and blowers split into a sales company and a manufacturing company. The Commissioner attempted to reallocate sales company profits to the manufacturing company for purposes of the excess profits tax under the predecessor of section 482. The court said that this section was intended to place accounting on a par with corporations under separate control and dealing at arm's length. These profits were found to be calculated in that manner and a reallocation was denied. In Central Cuba Sugar Co. v. Commissioner the court affirmed a reallocation of expenses to the appropriate fiscal year of a successor corporation in order to match the expenses against related revenues and prevent a loss carryback.

It thus appears that section 482 may be useful to reallocate between fiscal years as well as between corporations within one fiscal year. But there are other substantial difficulties with the application of section 482 in this area. First, it is not clear that section 482 may be applied to reallocate between two divisions of a corporation, which has been filing a single return from year to year. Second, the problem in a loss carryover case would not be that expenses have not been properly matched against revenues or that two organizations have not accounted for their dealings with each other as if they were at arm’s length. The problem would be rather that the losses and profits, which may be correctly calculated in an accounting sense, have come from "unrelated" businesses. The language of section 482 may be broad enough to overcome these difficulties but if section 482 is used in this way, it should be recognized as a significant step beyond the section’s present uses.

IV. THE "OWNERSHIP" TEST

A. Definition under Present Law

Difficult as it is to manage, the business test should not be eliminated unless the system as a whole functions better without it. The problems of the "ownership" test must therefore also be evaluated.

81. Maxwell Hardware Co. v. Commissioner, 343 F.2d 713 (9th Cir. 1965).
82. 197 F.2d 620 (3d Cir. 1952).
83. 198 F.2d 214 (2d Cir.), cert. denied, 344 U.S. 874 (1952).
84. Dillard-Waltermire, Inc. v. Campbell, 255 F.2d 433 (5th Cir. 1958) and Rooney v. United States, 305 F.2d 681 (9th Cir. 1962) are similar examples of the reallocation of expenses to match revenues with which they were obviously related.
These problems are difficult but are seldom if ever made less difficult by the presence of a business test except where a clear-cut change in business has enabled a court to avoid a difficult ownership issue.

1. The 1954 Code

The net operating loss carryover is originally generated as an attribute of some corporation. It remains an attribute of that corporation unless section 381 gives it to some other corporation or unless section 382, section 269, or possibly the Libson Shops doctrine takes it away. For purposes of this paper it is sufficiently accurate to describe the scope of section 381 as covering transfers of assets in one of the tax-free reorganizations described in section 368. Section 381 is based upon a "business" principle in the sense that the carryover goes with the assets if the assets are transferred in a prescribed way. But since the application of section 381 depends entirely on the tests used in applying section 368, section 381 does not require the use of a "business" test in the sense that has been discussed here. In fact, section 381 allows the carryover in many situations where the business test would otherwise deny it. For example, the Libson case itself would come out differently under this section.85

The carryover made available by section 381 is limited by section 382(b).86 This section, unlike section 382(a), contains no references to a change in business. It provides for a reduction in the amount of the carryover if the shareholders of the loss corporation own, by reason of their interest in the loss corporation, less than twenty per cent of the fair market value of the stock of the acquiring corporation after the reorganization. The carryover is reduced by five per cent for each one per cent under twenty per cent which these shareholders received.87 No attempt is made to limit the carryover to gains from the assets of the loss corporation.88 The ownership approach of this limitation is further demonstrated by the exception

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85. One benefit of section 381 is that it preserves the carryover through minor changes in the corporate entity such as the reincorporation in another state, Newmarket Mfg. Co. v. United States, 233 F.2d 493 (1st Cir. 1956), cert. denied, 353 U.S. 983 (1957).

86. Section 381(b)(3) limits the availability of the carryback. The use of losses developed after a transaction to offset previous gains raises somewhat different policy questions from those raised by the acquisition of a known loss history; this article is limited to the latter and will not deal with the treatment of carrybacks.

87. For example, if the interest of the loss corporation shareholders after the reorganization is 15%, the acquiring corporation receives only 75% of the carryover.

88. In Foremost Dairies v. Tomlinson, 238 F. Supp. 258 (M.D. Fla. 1963), aff'd per curiam, 341 F.2d 580 (5th Cir. 1965), decided under the 1939 Code, the court applied Libson to allow a carryover against post-merger profits earned solely by the loss corporation assets. This approach depends upon continued separate accounting and is subject to all the difficulties discussed above in connection with consolidated accounting.
in section 382(b)(3), which makes the reduction inapplicable if both corporations are owned substantially by the same persons in the same proportion. This limitation is a very crude treatment of the continuity of ownership principle; it introduces a factor which has no apparent relation to the policy of the carryover, namely the relative value of the two companies. For example, if the two corporations are under entirely separate ownership prior to the reorganization, as much as eighty per cent of the benefit of the carryover might go to the shareholders of the profitable corporation without any reduction in the carryover. But if the value of the loss corporation is only one tenth that of the combined enterprise and the owners of the profitable corporation owned eighty per cent of the loss corporation prior to the merger, they will nevertheless find their carryover cut in half.

Section 382(b) contains one other notable provision. If Z corporation, a loss corporation, is merged into Y corporation, which is controlled (within the meaning of section 368(c)) by X corporation, and the former shareholders of Z corporation receive X corporation stock, section 382(b)(6) provides that the twenty per cent test is to be applied by comparing Z corporation with Y corporation, not with X corporation. The purpose of this provision is not clear. If X is huge in relation to Z, the interest of the Z shareholders in X might be much smaller than the relative values of Z and Y. But since by hypothesis the benefits of the carryover flow to X by reason of its ownership of Y, the continued interest of the Z shareholders in the carryover should be measured by their interest in X, however small it is. This interest will be the same no matter where within the structure of X corporation Z’s assets are put.

Section 382(a) further limits the availability of a carryover by denying it altogether to a corporation which has undergone a described change in ownership and a change in business as discussed above. The method for determining when a sufficient change in ownership has taken place is set out out in the section and in some elaborate Regula-

89. If A and B each owned 50% of Loss Corp. and Gain Corp. and they are merged in such a way that the Loss Corp. shareholders receive 10% of Gain Corp. stock, the limitation of section 382(b) would be applicable but for this exception, although the 100% continuity of interest obviously makes this an inappropriate case for the limitation. But, as is noted in Comment, *Net Operating Loss Carryovers and Corporate Adjustments: Retaining an Advantageous Tax History Under Libson Shops and Sections 269, 381 and 382*, 69 Yale L.J. 1201, 1256 (1960), the parties could avoid the section 382(b) problem without affecting their rights simply by issuing extra stock to themselves as Loss Corp. shareholders.

90. See Treas. Reg. § 1.382(b)-1(d) (2), example (4) (1962).

91. See Treas. Reg. §§ 1.382(b)-1(g) (1) (1962). Paragraph (1)(g)(2) of this Regulation is equally difficult to understand for the same reason.
tions. Complicated as these provisions are, they are very mechanical by comparison with section 382(a)(1)(C)'s business test and they have not as yet generated any litigation. Greatly simplified, the change is sufficient if the interest of the ten largest shareholders is fifty percentage points higher than it was two years before and if the increase is due to either a purchase of stock or a redemption of stock by the corporation.\(^92\) Section 382(a)(4) defines "purchase" so as to exclude tax-free reorganizations.

The most striking feature of this statutory pattern is the difference in treatment accorded tax-free and taxable transactions. If the business changes hands in a tax-free transaction, the required continuity of ownership is twenty percent; the amount of carryover allowed is reduced gradually at levels of lesser ownership and the nature of the continuing business is irrelevant. If the transaction is taxable, the requisite continuity of ownership is fifty per cent; no carryover is allowed at levels of lesser ownership yet if the continuing business is the same, no continuity of ownership at all is required. There are some changes in corporate entity, such as those described in section 368(a)(1)(F), which have so little economic significance that the policy which makes them tax-free under section 368 should also preserve the carryover. But this cannot explain section 381's reliance on the forms of transaction described in 368(a)(1)(A) and (C). It is not at all clear that the policies which have resulted in non-recognition of gain upon the transfer of assets in exchange for stock should also lead to a more liberal treatment of the carryover if the loss business is changed and a less liberal treatment if the loss business is continued. One possible explanation is that a loss corporation frequently would have potential further losses on the transfer of its assets and the present statutes force the taxpayer to choose between these losses and the carryover because the carryover survives a recognition transaction only when the entity of the loss corporation is preserved. But if this is the statutory purpose it certainly could have been accomplished in a more direct fashion.

Section 269's relationship to these sections is not clear. The Senate Report on section 382 contains this puzzling statement:

If a limitation in this section applies to a net operating loss carryover, section 269, relating to acquisitions made to evade or avoid income tax, shall not also be applied to such net operating loss carryover. However, the fact that a limita-\(^{92}\) Or both. Treas. Reg. § 1.382(a)-1(b)(2)(iv) (1962).
tion under this section does not apply shall have no effect upon whether section 269 applies.93

With respect to the limitation in section 382(a), this statement is meaningless because if section 382(a) applies there is nothing more section 269 can do. But the statement is significant if interpreted to mean that a partial reduction under section 382(b) precludes application of section 269. The Internal Revenue Service has taken a position flatly to the contrary94 but this does not necessarily settle the problem.

2. The Libson Shops Doctrine

Although not involved in the Libson case itself, change of ownership has always been an important part of this doctrine's "continuity of business enterprise" standard. Defining Libson's ownership test is made difficult by the same factor that makes defining the business test difficult—these changes often occur together and the court relies upon their cumulative effect.95 It is very difficult to generalize about the amount of continuity of ownership needed to satisfy Libson. In Julius Garfinckel & Co. v. Commissioner96 Judge Friendly relied partly on an increase in ownership from fifty-eight to ninety-five per cent but the opinion reflects great discomfort over a close case. In Meridan Corp. v. United States97 a decrease from one hundred to fifty-one per cent was sufficient to support an alternative ground for disallowance.98 The Internal Revenue Service has said it would apply Libson if the business changes and the ownership change is more than "minor."99 Little can be said with confidence about the content of this test.100

3. Is Libson Shops still alive?101

Of course the whole question of the content of the Libson Shops doctrine may be moot if Libson is not applicable under the 1954 Code. Part of this question has been foreclosed by revenue rulings

94. Treas. Reg. § 1.269-6, example (2) (1962).
95. See, e.g., Norden-Ketay Corp. v. Commissioner, 319 F.2d 902 (2d Cir. 1963); J.G. Dudley Co. v. Commissioner, 298 F.2d 750 (4th Cir. 1962); Mill Ridge Coal Co. v. Patterson, 264 F.2d 713 (5th Cir. 1959).
96. 335 F.2d 744 (2d Cir. 1964), cert. denied, 379 U.S. 962 (1965).
98. The court relied primarily on the predecessor to section 269.
100. In Humacid Co., 42 T.C. 894 (1964), a 25% owner of the loss corporation had effective control. The same individual owned 100% of the gain corporation. The court said that ownership had changed for Libson purposes but relied primarily on differing economic activities.
which make litigation of the point unlikely. For example, it has been stated that \textit{Libson} will not be relied upon in any transaction described in section 381(a).\textsuperscript{102} The Treasury\textsuperscript{103} has also excluded from \textit{Libson} those cases in which there has been no change in business as described in section 382(a)(1)(C)\textsuperscript{104} or those in which there has been less than a fifty per cent change in the "beneficial ownership of the loss."

The other side of the coin is that the Service will rely on \textit{Libson} where this "beneficial ownership" has changed. This position results from the Service's non-acquiescence in the one case which has directly considered this problem: \textit{Maxwell Hardware Co. v. Commissioner}.\textsuperscript{105} In the \textit{Maxwell} case the assets of a partnership in real estate development were transferred to a real estate "department," set up for this purpose, of an unprofitable hardware corporation. The real estate developers, who had no previous interest in the hardware company, took non-voting preferred stock which was redeemable in kind after six years, for ninety per cent of the real estate department's assets. Control over the common stock was transferred to a voting trustee. The Tax Court opinion\textsuperscript{106} reveals that under the agreement one of the former partners had complete control over the real estate department and the hardware business was discontinued. In effect, the developers got six years' use of the hardware corporation's loss carryovers in exchange for a ten per cent slice of the pie. Neither section 269 nor section 382 could touch this transaction. The court of appeals arguing at some length that \textit{Libson} had no value under the 1954 Code, reversed the Tax Court and allowed the carryovers.

One difficulty with the court's reasoning is that it seems to have approached the problem as if Congress has acted in response to the \textit{Libson} doctrine. The court said:

By enacting the 1954 Code, Congress destroyed the pre-\textit{decisional} value of the rule of decision of \textit{Libson Shops}; that is, that for a loss carryover deduction to be allowed, the income against which the offset was claimed must have been produced by substantially the same business which incurred

\textsuperscript{103} T.I.R. No. 778, P-H 1965 \textit{Fed. Tax Serv.} ¶ 55,096.
\textsuperscript{104} In \textit{Commercial Indus. Corp. v. United States}, 268 F. Supp. 52 (D.N.J. 1967) the court, after an exhaustive review of \textit{Libson} doctrine cases, concludes that \textit{Libson} has never been applied to deny a carryover on the ground of a change in ownership alone.
\textsuperscript{105} 343 F.2d 713 (9th Cir. 1965).
the losses. This is not now the law.  

Of course, Congress could not have been "destroying" anything because Libson was not decided until 1957. The Internal Revenue Service argues that section 382 was only a limited attack on certain abuses specifically brought to the attention of Congress. If section 382 is directed only at what the House Report calls "trafficking," then Libson is very much alive because there was no trafficking at all in the Libson case. But the 1954 Code also added section 381 which, by its modification of the "entity" approach, shows that Congress had broader purposes.

The versatility of the parties in Maxwell shows the importance of flexibility in the administration of ownership criteria. It is very hard to square the result in that case with the policies of section 172; the benefit of the carryover went primarily to new people in a business different from the losing business. The Internal Revenue Service has developed a "beneficial ownership" approach to the problem of a need for added flexibility and Libson provides a convenient authority for doing so.

The need for this kind of flexibility is further illustrated by Jackson Oldsmobile, Inc. v. United States. This case involved a financing plan for General Motors dealerships whereby the dealership is incorporated and GM provides seventy-five per cent of the initial capital. The individual provides the other twenty-five per cent. For its seventy-five per cent, GM takes half in an unsecured long-term loan and the other half in Class A voting stock. The individual takes Class B non-voting stock. The individual is made president of the corporation and gets a salary and bonus. The earnings of the corporation are used

107. 343 F.2d 713, 716 (9th Cir. 1965).  
110. The Sixth Circuit has now joined the Ninth in holding that Libson Shops does not apply under the 1954 Code. Frederick Steel Co. v. Commissioner, 375 F.2d 351 (6th Cir.), cert. denied, 36 U.S.L.W. 3158 (U.S. Oct. 16, 1967). This case also shows that present statutory ownership criteria do not sufficiently protect the loss carryover from what the Supreme Court has characterized as abuse. The opinion in the court of appeals reveals only that there was not a change of ownership such as is described in section 382(a) (1) and so the carryover must be allowed. The Tax Court opinion, 42 T.C. 13 (1964), is much more revealing. The controlling shareholder of the taxpayer corporation purchased his shares when the corporation was virtually a shell. He did not transfer the assets of his profitable steel business to the taxpayer until two years had elapsed since his acquisition of taxpayer's stock. The benefit of the carryover here went to a new individual in a business different from the losing business. The only effect of section 382 was the loss of carryovers for two years. This case raises precisely the same policy issues as Maxwell and should stand or fall with it.  
partly to amortize the note, partly to redeem Class A stock and partly to pay a dividend. The Class B dividends are used to buy Class A stock from GM and convert it to Class B. In this particular case the corporation was founded as John Williams Buick and sold Buicks in Colorado. It incurred losses and then sold its assets and became dormant. Later GM had the charter amended and the name changed and reestablished the corporation, under the same financing plan, as an Oldsmobile dealership in Georgia. At all times GM had at least sixty per cent of the equity and all the votes. The court allowed the carryover. It said that the limitations of sections 382(a) and 269 were inapplicable because ownership had not sufficiently changed; this is literally true. The court also said that the Libson continuity test was met and thereby avoided the issue of its applicability under the 1954 Code.\textsuperscript{112}

This case demonstrates that the beneficiary of the carryover is not necessarily the "owner" in any conventional sense of the term. From one view, GM bore the brunt of the losses of the Colorado dealership and GM got the benefit of the carryover because, in the first few years of the new dealership, most of the earnings were applied to reduce GM's interest. So perhaps Internal Revenue's "beneficial ownership of the carryover" test would favor the taxpayer here. But the dealership was basically Jackson's enterprise—he managed it and, so long as it remained profitable, he would remain in practical control and increase his equity by a prescribed formula. In a very real sense Jackson was the beneficiary of the carryover because each dollar that it added to earnings was applied to increasing his equity. On the same reasoning the real sufferer of the losses was Williams in Colorado, who lost his business and all chance to recoup. It is therefore far from clear that the policies of the carryover would call for its application to Jackson.

This case and Maxwell show that beneficial ownership of the carryover is not necessarily the same as ownership of the common stock.

Before it is concluded that Libson should be retained as a source of flexibility in this area, some consideration should be given to the possibility that section 382 might itself be flexible enough to deal with such cases. The section does not define "ownership" directly but it does provide in section 382(a) (1) (B) (i) that the required ownership could come about by purchase of "... stock of another corporation

\textsuperscript{112} A ruling that Libson is applicable under the 1954 Code would be dictum in a case which allows the carryover. The issue was especially confused here because the time period involved straddled the enactment of the 1954 Code. The court held that the 1954 Code limitations applied because all the relevant events other than the losses occurred after 1954 but it may have thought that the 1939 Code affected the use of pre-1954 losses even if used after 1954. This article does not consider the difficulties raised by the transition to the 1954 Code.
owning stock in such corporation, or an interest in a partnership or trust owning stock in such corporation . . . .” This language does not demand a definition of “own” broader than possession of the legal title to the interests described there but it at least permits a broader interpretation. For example, the contractual power to control a voting trust, such as the one to which the stock was transferred in the Maxwell case, might be considered an “interest” in the trust within the meaning of section 382. But by its very specificity this section limits the power of the courts to stretch the language in order to carry out the legislative purposes supposedly behind the carryover provision. Reliance exclusively on the language of this section would therefore be an open invitation to the ingenuity of the tax bar and the Internal Revenue Service is understandably reluctant to give up Libson’s more generalized approach.

As the law stands now, Libson Shops remains the most authoritative statement of the purposes of the loss carryover provision and it is a narrow view. Because the most recent efforts of Congress in this area antedate this case, Congress cannot be said to have acted specifically with respect to this interpretation. Because the present statutory pattern leaves room for many transactions, such as Maxwell and Jackson Oldsmobile, which seem to be beyond the purposes of the carryover as the Supreme Court has expressed them, Internal Revenue seems to be justified in continuing to use Libson to attack such cases until Congress or the Supreme Court speaks again.

B. Some General Problems

1. Ownership of what?

If, as this paper proposes, the nature of the businesses conducted is made irrelevant to the administration of the carryover, then there must be some other means of identifying just what it is that is “owned.” The approach of the present Code is basically to attach the losses to a corporate entity, so that ownership of the loss carryover is an incident of ownership of the corporation’s common stock. Thus when Congress declared in the 1954 Code that the carryover should survive certain changes in the corporate entity, it was necessary to describe particular forms which the change must take. As has been pointed out, Congress selected the forms described in section 368; this was a convenient way of doing it although the overlap between the policies behind the carryover and the policies behind tax-free exchanges of assets is far from perfect.

The use of the corporate entity as a starting point must remain the Code’s basic approach. With the exception of Subchapter S,
a corporation is generally treated as a taxable entity and the problems of the carryover are hardly limited to corporations small enough to qualify for Subchapter S. In fact, the possession of loss carryovers by large, widely-held corporations is one of the biggest difficulties with an ownership test for administration of the carryover. Where the stock of a corporation is actively traded on a securities exchange, "continuity of ownership" is a meaningful concept only in the sense that, under the terms of a reorganization, ownership of stock in one corporation, a party to the reorganization, entitles the shareholder to ownership of stock in another party. In the case of publicly-held corporations "ownership" of the carryover must be considered as attaching to the stock itself, not to the individual who holds it. This is not inconsistent with the notion of "beneficial" ownership of the carryover because if the stock is actively traded then it is likely that the losses of the company and the value of the carryover will have been reflected in the price of the stock.

One difficulty with the "entity" approach is that, in the simple case of a taxable sale of a closely-held business, the status of the carryover depends upon whether or not the stock is sold, in which case the carryover may go with the stock but definitely will not remain with the former owner, or the assets are sold, in which case the carryover may remain available to the former owner but definitely will not go with the assets. If the business test is eliminated, then the purchaser cannot use the carryover regardless of the form chosen. There would thus be less pressure on the seller to sell the entity and the use of the entity as a means of identifying ownership of the carryover would not interfere with the more basic policy of leaving the loss carryover with the individual who suffered the losses when the corporation is small and closely-held and when that individual can be identified.

2. Beneficial ownership and control

A second general problem with the ownership test is that the right to receive earnings and appreciation in value of the stock is very often not held by the same people who control the policies of the company. By its emphasis on beneficial ownership, the Internal Revenue Service may have indicated that continuity in the right to receive earnings is closer to the purposes of the carryover in a case where the two conflict. The two were not really in conflict in Maxwell because of the right of the real estate partners to bail out after six years. Jackson Oldsmobile is perhaps a better illustration of the

problem because it is not easy to locate either the benefits or the control in that case. To the extent that the carryover is intended to increase fairness in the burden of taxes, its proper focus would seem to be upon those with the right to receive earnings and upon those who suffer by a drop in the price of shares when the corporation loses.

3. Reorganizations in bankruptcy

A related problem is determining whether or not the "continuity of ownership" test is satisfied when the corporation has undergone a reorganization in bankruptcy, as a result of which the old common shareholders have a much reduced interest, if any, and ownership and control have passed to former creditors and preferred shareholders. In such a case ownership has changed hands subsequent to the initial incidence of losses. But it may be argued that equitable ownership passes to the creditors when the corporation becomes insolvent. Thus in Helvering v. Alabama Asphal tic Limestone Co. the Court held that the equitable ownership of the creditors should be dated from the day they "invoke the processes of law." The Court therefore held that the "continuity of interest" test of tax-free reorganization was satisfied.

An effort to use this argument to support a loss carryback failed in Wisconsin Cent. R. R. v. United States. A newly organized corporation took over the assets of a railroad which was in receivership. In the process the unsecured creditors and preferred and common shareholders of the railroad were wiped out. The predecessor corporation had a gain in 1953 and the new corporation sought to carry back its 1954 loss. The court, citing Libson, denied the carryover under the 1939 Code.

This case may be distinguishable from an ordinary carryforward because the loss was suffered subsequent to reorganization and therefore "belonged" unquestionably to the new owners. But this would seem to be a stronger case for continuity than the carryforward. Despite its 1953 profit the railroad was in serious trouble in 1953; it had been in receivership since 1932 and in trusteeship under section 77 of the Bankruptcy Act since 1944. Thus the bondholders had the equitable right to whatever there was in this corporation long before 1953 and the reasoning of the Alabama Asphal tic Limestone case would seem to be applicable. But in the case of a corporation which

114. 315 U.S. 179 (1942).
115. Id. at 184.
116. See also Atlas Oil & Ref. Corp. 36 T.C. 675 (1961).
suffers losses sufficient to bring on insolvency and bankruptcy reorganization and which earns profits after reorganization, it is not nearly so clear that the "owners" in the loss period are the creditors and not the old common shareholders.

Nevertheless the carryover should be allowed in such a case. Such reorganizations are generally forced by circumstances and would seldom if ever be the vehicle for the kind of transaction normally thought of as an abuse of the carryover privilege. Also, it would be extremely narrow and formalistic to argue that the creditors of a corporation are not beneficially interested in the corporation's losses merely because their preferred position might allow them to recoup. Furthermore, disallowing the carryover would work against the plain purpose of bankruptcy reorganizations, which is to help a sick corporation get back on its feet.

The 1954 Code does not deal specifically with this problem perhaps because, in most such cases, the "business" test of section 382(a)(1)(C) would be met. The problem is a serious one if, as this article recommends, that subsection is repealed or if the entity is changed in the process of reorganization. Although section 371 makes most such reorganizations tax-free, these reorganizations are not enumerated in section 381(a), perhaps because section 381 also confers other benefits besides the net operating loss carryover which may not be appropriate in a bankruptcy reorganization.118

4. Transfers of ownership among related taxpayers

Another difficult range of problems is raised when beneficial ownership or control has shifted to an individual or legal entity which is related to the former owner in one of the ways described in section 318. Section 382 specifically considers the problem but its approach is a little confusing. Section 382(a)(2) described the group whose stock is counted to determine whether or not the requisite fifty percentage point change is present; for purposes of selecting the ten members of the group, persons whose stock is attributable to each other under section 382(a)(3) are counted as one. Section 382(a)(3) simply invokes the

118. In Huyler's v. Commissioner, 327 F.2d 767 (7th Cir. 1964), the taxpayer went through a Chapter X reorganization which in effect gave 52% of the stock to former creditors. New investors took the other 48%; the old shareholders took nothing. The court denied the carryover, relying on Libson and finding a "substantial" shift in ownership. The court rejected the argument that the creditors were really the pre-sale owners of the business; it found sufficient shifts for Libson purposes among the other 48%. The court also rejected issues raised by section 382 by saying that meeting section 382 would not be conclusive. Since section 269 is never mentioned, this appears to be an implication that Libson is applicable under the 1954 Code but the court never discussed the point.
The obvious purpose of this pattern is to prevent avoidance of section 382 by transferring stock to a large number of controlled persons or legal entities so that the interest of the largest ten would not total fifty per cent.

What is left unclear is whether or not the operation of the attribution rules under section 382(a)(3) is meant to be confined to the single purpose spelled out in section 382(a)(2)—attribution among persons who have "purchased" stock within the two year period. Section 382(a)(3) is equally subject to the broader interpretation that it attributes to a purchaser all the stock which was owned by a related person before the purchase as well as the stock which has been subsequently purchased by a related person. For example, suppose that a father owned all the stock of a loss corporation and sold the stock to his son in an arm's length transaction. If section 382(a)(3) only attributes among purchasers, then the requisite change of ownership has taken place. But if section 382(a)(3) attributes the father's stock to the son prior to the purchase, then there has been no increase in ownership at all.

So far this issue has not been directly considered, but one recent case which raises similar issues shows that the direction which the Code should take is by no means clear. In Pauline W. Ach, Mrs. Ach owned and ran a profitable dress shop as a sole proprietorship. Her son Roger owned all the stock of an unprofitable corporation in the dairy business. In 1953 the corporation discontinued the dairy business and changed its name and Roger transferred slightly less than a one-half interest to his brother without consideration. The brothers then made Mrs. Ach president, treasurer, and board chairman and she "sold" the dress shop to the corporation for a demand note at book value, without interest. The dress shop continued as usual and the corporation carried prior losses over against its profits. Profits were used to pay off the note to Mrs. Ach and later to pay off old notes of the corporation held by Mr. Ach. The beneficial ownership of the losses was transferred from Roger to his mother but if the attribution principle of section 318 is given a full application in this area, such a transfer within the family is not a break in the continuity of ownership.

The Commissioner successfully attacked this transaction under section 269 which, however, says nothing about attribution among

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119. With one small change not important here.
120. 42 T.C. 114 (1964), aff'd, 358 F.2d 342 (6th Cir. 1966).
related taxpayers. If Congress intends not to permit transfers within the family for the principal purpose of tax avoidance, then section 382(a)(3) should be given the narrow construction that the attribution is only among purchasers. But it is significant here that section 382(a) only applies to stock acquisitions by purchase. Transfers among related taxpayers will often be without consideration and section 382(a) will not reach them. There is no apparent reason for applying section 382(a) to a transfer among the same people solely because consideration is paid but to avoid that result section 382(a)(3) must be given the broader construction. Section 269 would remain a weapon against transfers of this type.

5. *The extent of continuity of ownership to be required*

The task of administering the net operating loss carryover in light of its purposes is not one problem but many. The tests in the Code must deal with a myriad of situations ranging from small closely-held corporations to vast enterprises with thousands of shareholders and with transactions involving many different kinds of change in shareholder interests. It is perhaps too much to expect a single uniform standard to apply equally well to all such situations. There is certainly no single standard under present law, even if the focus is upon ownership tests to the exclusion of tests based upon motive, accounting practice, and nature of the business. Sections 382(a), and 382(b), and 269 each have their own formula. *Libson Shops*, as most recently construed, adds yet another. In some situations, such as the exception to section 382(b) for corporations owned by the same persons in the same proportion, the extent of deviation permitted is very narrow. Yet the amount of continuity required in section 382

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121. In Thomas E. Snyder Sons Co. v. Commissioner, 288 F.2d 36 (7th Cir.), *cert. denied*, 368 U.S. 823 (1961), the court held that the constructive ownership rules of the 1939 Code were not applicable to section 129, the predecessor of section 269.

122. Problems of transfer within the family are also present in *Kolker Bros.*, 35 T.C. 299 (1960). In that case a company controlled by Sidney Kolker acquired at arm's length the assets of a company controlled by his father and successfully carried losses over against profits from the acquired assets. The "ownership" of the loss did not change, so this case may be within the principle of Rev. Rul. 63-40, 1963-1 *Cum. Bull.* 46, see text following note 16 *supra*, although the I.R.S. specifically announced its non-acquiescence in *Kolker Bros.* on the ground that the change in Sidney Kolker's interest was too "substantial." 1963-1 *Cum. Bull.* 5. Neither the court nor the I.R.S. considered the intra-family aspects of the case.

123. Just how narrow is the deviation permitted under this section has been illustrated in *Commonwealth Container Corp.*, 48 T.C.---, No. 47 (June 28, 1967). In this case a 25% shareholder in the acquiring corporation had no interest in the loss corporation and two shareholders who held approximately a 30% interest each in the acquiring corporation held 42% interests in the loss corporation. The corporation resulting from the merger was held not to qualify for the exception in section 382(b)(3).
(b) itself for full use of the carryover is only twenty per cent. Section 382(a) takes an “all or nothing” approach, while section 382(b) reduces the carryover gradually. Since the task of this article has been to convince the reader that the business test should be abolished, the problem of harmonizing all the ownership tests is a separate problem which can be left to another day unless the need to harmonize those tests is made more acute by eliminating the business test. Since the problems of finding continuity of ownership have been present all along, eliminating one source of confusion would not seem to aggravate the other beyond its already nightmarish state.

V. CONCLUSION

Section 382(a)(1)(C) should be repealed and the Libson Shops doctrine should be applied, if at all, to deny carryovers only by reason of a lack of continuity of ownership.

The business test is not eliminated entirely from the administration of net operating loss carryovers by taking these two steps. The nature of the business remains relevant as an indication of the principal purpose of the transaction for purposes of section 269.124

It is tempting to urge that application of section 269 to this area also be discontinued. Since this section also contains an “ownership change” prerequisite, many of the abuses not subject to attack under section 382 are also immune from section 269. Elimination of the business test from section 382 would further narrow the need for section 269. Eliminating section 269's test of motive would substantially increase the simplicity of these provisions, facilitate tax planning, and relieve the courts. If some continuity of ownership is required, abuses of the carryover for tax avoidance purposes would be limited somewhat. But there are substantial differences between the prerequisites of ownership change in sections 382 and 269. For example, one purpose of section 269 is to attack tax avoidance devices involving shifts among related taxpayers. As discussed above125 section 382 may not be concerned with such transfers. It is undesirable to have a subjective standard of motive pervading an area where a great many motives for transactions often act together. Further, tax avoidance is itself a vague and slippery concept. But the carryover is such an obvious target for devices for tax avoidance, as that term is generally understood, that a provision is called for specifically declaring that the carryover is not to be so used. So long as tax avoidance

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124. Detailed consideration of the criteria governing application of section 269 is beyond the scope of this paper.
125. See text accompanying note 119 supra.
remains beyond the intended purposes of section 172, some attention to the nature of the businesses involved is inevitable.