Fall 3-1-1960

Downstream Mergers And The Operating Loss Carry-Over

DOWNSTREAM MERGERS AND THE OPERATING LOSS CARRY-OVER

The enactment of statutes permitting operating profit to be offset against prior operating losses[1] created a new area of contention between corporate taxpayers and the Commissioner of Internal Revenue. The conflict initially arose when a profit-making corporation acquired a loss corporation for the principal purpose[2] of taking "tax advantage" of that loss. For a considerable period of time profit-making taxpayers were successful in utilizing these so-called "upstream mergers."[3] However, when the Treasury Department, fortified with newly-enacted statutes and recent court decisions, began to take a dim view of these mergers, more astute taxpayers conceived a new approach known as the "downstream merger."[4] Under this new approach the loss corporation obtains control[5] of the profit-making corporation. Cases involving the downstream merger are now beginning to reach the appellate courts; the first of these was *Mill Ridge Coal Co. v. Patterson*.[6]

Before considering the downstream merger, it would be advisable to review the law as it developed with reference to upstream mergers. Prior to 1943 and the passage of section 129 of the 1939 Internal Revenue Code, the taxpayer enjoyed almost complete freedom in purchasing another's business losses to offset his own business profits.[7] However, under section 129, the Commissioner can wholly or partially deny any benefit of a deduction to a taxpayer who is (1) a person acquiring control[8] of a corporation, or (2) a corporation acquiring the property of another corporation in a tax-free transaction.[9] Section

[1]Int. Rev. Code of 1939, § 26, 53 Stat. 18 (now Int. Rev. Code of 1954, § 172).

[2]Int. Rev. Code of 1939, § 129, added by ch. 63, 58 Stat. 47 (1944) (now Int. Rev. Code of 1954, § 269).

[3]"Upstream merger" is used in a generic sense and includes acquisitions by purchase, consolidation, or technical merger.

[4]The terms "upstream" and "downstream" merger were developed as shorthand expressions by taxation practitioners.

[5]The word "control" as used in § 269 of the Int. Rev. Code of 1954 was defined as "the ownership of stock possessing at least 50 per cent. of the total combined power of all classes of stock entitled to vote or at least 50 per cent. of the total shares of all classes of stock in the corporation." Int. Rev. Code of 1939, § 129, added by ch. 63, 58 Stat. 47 (1947) (now Int. Rev. Code of 1954, § 269).

[6]264 F.2d 713 (5th Cir. 1959), cert. denied, 361 U.S. 816 (1959).

[7]See, e.g., Moline Property, Inc. v. Commissioner, 319 U.S. 436 (1943), in which a corporation and its single stockholder enjoyed complete individuality for taxation purposes.

[8]See note 5 supra.

[9]For § 129 to be applicable, the acquisition by a person or corporation had to be made after October 8, 1940.

129 only applies, though, when the principal purpose of such an acquisition is to evade or avoid federal income taxes by securing a benefit which the taxpayer would not otherwise have enjoyed.[10] Proof of such a purpose was the primary difficulty confronting the Commissioner under the 1939 Code.[11] In the 1948 case of *Alprosa Watch Corp.*,[12] the Tax Court took much of the sting out of section 129, even though the section was inapplicable.[13] The Tax Court indicated that section 129 did not apply when a corporation is using its *own loss*, regardless of the presence or absence of tax avoidance as a motive. The Commissioner successfully overcame this dictum in 1955 when section 129 was applied for the first time in *American Pipe & Steel Corp. v. Commissioner*.[14] In that case the appellant was not permitted to offset his profits with a loss acquired by the purchase of a real estate corporation owning lots with a book value of $430,000 and a present market value of only $25,000. The Fourth Circuit's decision in *Coastal Oil Storage Co. v. Commissioner*[15] gave even more significant support for the position of the Commissioner, for it was therein held that section 129 applied when a parent corporation created a subsidiary by transfering assets to it. In this decision, the court disallowed a $25,000 surtax exemption for each subsidiary created[16] because the real tax

---

[10]Butler, Purchase and Use of Loss Corporations Under 1954 Internal Revenue Code, 9 U. So. Cal. 1957 Tax Inst. 121, 123.

[11]Commissioner v. Chelsea Products, Inc., 197 F.2d 620 (3d Cir. 1952); J. E. Dilworth Co. v. Henslee, 98 F. Supp. 957 (M.D. Tenn. 1951); WAGE Inc., 19 T.C. 249 (1952) (also failing to consider that the corporations involved were already controlled by the same persons before their merger); Alcorn Wholesale Co., 16 T.C. 75 (1951); Berland, Inc., 16 T.C. 182 (1951); A. B. & Container Corp., 14 T.C. 842 (1950); Commodores Point Terminal Corp., 11 T.C. 411 (1948).

[12]11 T.C. 240 (1948). This case involved the Esspi Glove Corporation, which was in the business of manufacturing and selling gloves. On June 15, 1943, all of the stock of Esspi was purchased by two new stockholders, its name was changed to Alprosa Watch Corporation, its place of business was moved, and the nature of the business was changed to the buying and selling of jewelry. It was held that Alprosa was a single taxable entity after the merger and could apply the operating losses of Esspi to offset its own operating gains, thereby effecting an excess profits tax saving.

[13]The effective date of § 129 was January 1, 1943. Therefore, acquisitions by persons or corporations must affect taxable years after this date in order to make the section applicable. This was not the case in Alprosa.

[14]243 F.2d 125 (9th Cir. 1957), affirming 25 T.C. 351 (1955). This case was decided under the 1939 Code because the transaction took place prior to the effective date of the 1954 Code.

[15]242 F.2d 396 (4th Cir. 1957), reversing 25 T.C. 1304 (1955). For a discussion of this case see 43 Va. L. Rev. 1134 (1957). Accord, Revell, Inc. v. Riddell, 273 F.2d 649 (9th Cir. 1959); Aldon Homes, Inc. 33 T.C. 582 (1959).

[16]The $25,000 surtax exemption was originally provided for by the Revenue Act of 1938, ch. 289, § 13(a)(2), 52 Stat. 447 (now Int. Rev. Code of 1954, § 11(c)).

benefit accrued to the parent as the sole owner of the subsidiary's stock.

The Commissioner's position was further strengthened by the Internal Revenue Code of 1954.[17] While section 269 of the 1954 Code substantially reenacts section 129, it adds a subsection, (c). This new subsection transfers to the taxpayer the burden of proving that his principal purpose in acquiring a loss corporation is not to evade or avoid income taxes when the amount the acquirer pays for such corporation is "substantially disproportionate"[18] to the book value of the assets he acquires.[19] This presumption in favor of the Commissioner is rebuttable, however, by something less than "a clear preponderance of the evidence."[20] Another addition to the 1954 Code, section 381, provides "for the continued use of corporate losses by a successor corporation which results either (1) by reason of the liquidation of a wholly-owned subsidiary corporation,[21] or (2) by reason of a reorganization in the form of a merger or acquisition[22] of assets in exchange for stock."[23] However, this section is subject to the limitations of section 382. Subsection (a) provides that the entire loss carryover is denied the taxpayer if two conditions are present at the end of the taxable year: (1) there has been a substantial change in the ownership[24]

---

[17]The entire 1954 Code can be found in 26 U.S.C. (1958).

[18]"Substantially disproportionate" means substantially less. S. Rep. No. 1622, 83rd Cong., 2d Sess. 228 (1954).

[19]It is probable that Congress did not think that § 269(c) of the 1954 Code would impede the expansion of business, because in this period of inflation market value seldom bears a "substantially proportionate" relation to book value.

[20]S. Rep. No. 1622, 83 Cong., 2d Sess. 228 (1954).

[21]For the purpose of § 381 of the 1954 Code, liquidations of wholly owned subsidiary corporations are defined by § 332 (except for the so-called Kimball-Diamond liquidations which are defined by and subject to the limitations of § 334(b)).

[22]Such acquisitions and mergers are described in clauses A, C, D and F, of § 368(a)(1) of the 1954 Code. But note that mergers under § 368(a)(1)(B), known as Clause B mergers, are not subject to § 382(b) by virtue of § 382(b)(3). The scope of this article does not include a discussion of the various types of mergers, but see 12 J. Taxation 8 (Jan. 1960).

[23]Butler, Purchase and Use of Loss Corporations Under 1954 Internal Revenue Code, 9 U. So. Cal. 1957 Tax Inst. 121, 125. Since the operating loss carryover only applies to the two succeeding taxable years, the acquiring corporate taxpayer should be careful that its taxable year coincides with that of the acquired corporation, lest a short taxable year (the period between the ending of the acquiring and acquired taxpayer's taxable years) be created with a waste of a substantial part of the gain sought. Int. Rev. Code of 1954, § 381(b)(1).

[24]There has been a substantial change in ownership when "as a result of the purchase or redemption of stock, the ten largest stockholders of the corporation own at the end of the taxable year at least 50 percentage points more of its stock than they had owned at the beginning of the taxable year in question or at the beginning of the prior taxable year. . . ." Winton, Loss Corporations and Carry-Overs, 34 Taxes 549 (1956).

"An increase of 50 percentage points does not mean the same as a 50 percent of the corporation, and (2) there has been a substantial change in the nature of the trade or business after such change in control.[25] Subsection (b) of section 382 authorizes the Commissioner, when the stockholders of the acquired corporation have received less than 20 per cent of the stock of the acquiring corporation after the merger, to disallow so much of the loss carryover as is proportionate to the percentage by which the stock given to the stockholders of the acquired corporation is less than the required 20 per cent.[26] In considering section 382 before its passage, the Senate Finance Committee stated:

> "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 limitation under this section does not apply shall have no effect upon whether section 269 applies."[27]

In view of this language, it has been suggested[28] that the taxpayer should voluntarily forego a small portion of the loss carryover by giving the stockholders of the acquired corporation slightly less than the prescribed 20 per cent of the stock of the acquiring corporation,[29] in order to avoid the risk of losing *all* of the loss carryover through the application of section 269.

Thus far the problems considered have involved "upstream mergers," a generic term for situations in which a profitable corporation acquires control of a loss corporation. The question remains as to the

---

increase. A stockholder who owns 4 percent of the fair market value of the outstanding stock and who increases his ownership to 6 percent has had a 50 percent increase in ownership but only a 2 percentage point increase." 12 J. Taxation 9 n.1 (Jan. 1960).

[25]"This prohibition against change of business is generally considered as implying that the loss corporation must be an active business, thereby excluding mere shell corporations." Winton, Loss Corporations and Carry-Overs, 34 Taxes 549, 553 (1956). See American Well & Prospecting Co. v. Commissioner, 232 F.2d 934 (3d Cir. 1956); Rev. Rul. 58-9, 1958-1 Cum. Bull. 190. Penton v. Commissioner, 259 F.2d 536 (6th Cir. 1958), and Hutchens Metal Products, Inc. v. Bookwalter, 174 F. Supp. 338 (W.D. Mo. 1959), which seem to indicate that a reasonable time may elapse after cessation of the business operations of one company and the resumption of them by another company without loss of carryover. Time to negotiate sale of the business would be an example of such a reasonable time.

[26]E.g., if only 19% of the acquiring corporation is given to the previous stockholders of the acquired corporation, only 95% of the loss of the acquired corporation may be carried over. (19/20 x 100%=95%).

[27]S. Rep. No. 1622, 83d Cong., 2d Sess. 228, 284 (1954).

[28]Winton, Loss Corporations and Carry-Overs, 34 Taxes 549, 554 (1956).

[29]But see, Fisher Flouring Mills Co. v. United States, 270 F.2d 27 (9th Cir. 1959), which held that when Congress has amended a statute to cover a loophole, the fact that an addition has been required is proof that the prior statute should be given a different construction.

tax consequences when a loss corporation acquires the assets of a gain corporation, and, in its own name, engages only in the activities of the profit-making business. *Mill Ridge Coal Co. v. Patterson*[30] is a recent case involving such a so-called downstream merger.

In *Mill Ridge,* the taxpayer suffered considerable operating losses in mining and selling coal during the taxable years 1948 through 1953. In December of 1953 the Bunker Oil Company was formed to transport oil pursuant to previously obtained contracts. Subsequently, Bunker Oil purchased all the stock of the Mill Ridge Coal Company, and in Mill Ridge's name proceeded to transport oil under Bunker's contracts. During 1954 the Bunker Oil Company was dissolved. This action, together with a statement by one of the new stockholders that the principal purpose for acquiring Mill Ridge was to obtain the benefit of its earlier losses, showed that Bunker was never more than a shell corporation.[31] The Commissioner, relying on section 129,[32] disallowed the loss carryover. This ruling was sustained by the District Court,[33] which, instead of using section 129, based its decision on *Libson Shops, Inc. v. Koehler,*[34] a case which held that in order for any offset to be allowed, the profit and loss must both result from substantially the same business. The Court of Appeals for the Fifth Circuit affirmed the District Court's decision in *Mill Ridge* on a three-fold basis: (1) that section 129 was applicable, (2) that the construction given to *Libson* was correct, and (3) that the taxpayer's actions ran contrary to the spirit of the law.

In holding that section 129 was applicable and that the taxpayer was "securing the benefit of a deduction, credit, or other allowance which such person or corporation *would not otherwise enjoy,*"[35] the Court of Appeals stretched the wording of section 129, for it was in effect predicting the future of Mill Ridge. The editors of a leading tax periodical, in voicing opposition to this type of prognostication, said that, "at the time of an acquisition, it cannot be stated absolutely that the acquiring corporations 'would not' enjoy the benefit of its

---

[30]264 F.2d 713 (5th Cir. 1959), cert. denied, 361 U.S. 816 (1950).

[31]A shell or dummy corporation is a corporation which exists in name only and carries on no functions as a corporate entity.

[32]The 1939 Code was applied because the transaction had taken place prior to the promulgation of the 1954 Code.

[33]Mill Ridge Coal Co. v. Patterson, CCH 1958 Stand. Fed. Tax Rep. (58-1 U.S. Tax Cas.) ¶ 9489 (N.D. Ala. Mar. 28, 1958).

[34]353 U.S. 382 (1957).

[35]Int. Rev. Code of 1939, § 129, added by ch. 63, 58 Stat. 47 (1944) (now Int. Rev. Code of 1954, § 269).

own loss." At most it can be said that, "it 'might not' enjoy the benefits of its operating loss."[36]

In the *Libson* case,[37] used as a basis for the decision of both the District Court and Court of Appeals in *Mill Ridge,* seventeen separate corporations were merged to take advantage of pre-merger losses sustained by three of the corporations. Mr. Justice Burton, speaking for the majority of the Supreme Court, specifically stated that the court did not pass on situations[38] in which "a *single* corporate taxpayer changed the character of its business and the taxable income of one of its enterprises was reduced by the deductions or credits of another."[39] Since the Mill Ridge Coal Company was a *single* corporate taxpayer, the Court of Appeals in *Mill Ridge* either overlooked the meaning of this Supreme Court statement while recognizing its existence, or decided such a *single* corporate taxpayer would nevertheless have lost in the *Libson* case had the Supreme Court decided the issue.[40] In cases arising after *Libson,* but before *Mill Ridge,* the Tax Court, when squarely faced with the same issue, decided in favor of the taxpayer.[41] One authority has said of *Mill Ridge* that "the real dynamite is in the Fifth Circuit's reliance on *Libson.*[42] While the case involved change of ownership, the logic covers a loss carryover by the *same taxable entity* from its old business to a new business operation. If this is applied under the 1954 Code, it would destroy the *implied* protection given an operating loss carryover (Sec. 382) where *either* the business *or* the ownership of the corporation is unchanged."[43]

As a final basis for its decision in *Mill Ridge,* the Court of Appeals

[36]8 Tax Fortnighter 319 (1959).

[37]353 U.S. 382 (1957).

[38]Id. at 390 n.9. "We do not pass on situations like those presented in Northway Securities v. Commissioner, 23 B.T.A.; Alprosa Watch Corp. v. Commissioner, 11 T.C. 240; A. B. & Container Corp. v. Commissioner, 14 T.C. 842; W A G E, Inc. v. Commissioner, 19 T.C. 249."

[39]353 U.S. at 390. Libson disallowed the carryover of the premerger losses because such losses are only available to the business (taxpayer) sustaining such losses. The court held that the merged corporation was not such a taxpayer.

[40]264 F.2d at 717.

[41]British Motor Car Distrib., Ltd., 31 T.C. 437 (1959); The T.V.D. Co., 27 T.C. 879 (1957). But see Coastal Oil Storage Co. v. Commissioner, 242 F.2d 396 (4th Cir. 1957). See also James Realty Co. v. United States, 176 F. Supp. 306 (D. Minn. 1959).

[42]The Internal Revenue Service expressed its dissatisfaction with the holding of Libson in Rev. Rul. 58-603, 1958-2 Cum. Bull. 147, which stated that the holding in Libson would not be relied on by the Internal Revenue Service under the 1954 Code as to a merger or any other transaction described in § 381(a).

[43]2 Research Institute of America, Tax Coordinator, F-6704 (Recent Developments, Jan. 1960) 22,022. (This page was deleted on February 15, 1960).

stated that " the facts are so clear, the purpose and results of the actions taken are so obviously in conflict with the meaning and intent of the remedial statute [section 129] appellant invokes that... the transaction... is foreign to its spirit and its clearly expressed overall purpose and intent."[44] This sweeping assertion that Mill Ridge violated the spirit of the tax legislation when it acquired Bunker Oil seems to be a matter of conjecture when viewed in light of modern business practices and procedures. Enterprises constantly change the nature of their operations by branching into new fields and withdrawing from others as economic conditions demand, and it cannot be said as a matter of law that this practice is a violation of congressional intent. There was legislative recognition of this fact when Congress, in considering the disallowance of loss carryovers when there is a change in the nature of the business, required a change in *both* the ownership and the nature of the business to deny the loss carryover. One or the other alone is not sufficient under section 382(a) and (b) of the 1954 Internal Revenue Code.

In *Mill Ridge* the court assumed a legislative function by its strained interpretation of the various code sections. Thus a dangerous precedent has been set which may adversely affect one avenue of future expansion of the economy, for businesses must be unduly cautious, lest they be caught unaware by statutes and decisions which tend to thwart any advantage that expansion might hold for them. Congress obviously did not intend to curtail economic expansion in this manner, and the courts should not frustrate this legislative intent unless absolutely necessary, and then only in the narrowest exercise of its judicial powers.

It is submitted that in *Mill Ridge* and other decisions in this area the courts have frustrated legislative intent, so that today the loss carryover will generally be denied the taxpayer both in upstream and downstream mergers. However, by a careful reading of the statutes, a strict adherence to subsequent regulations,[45] and a scrupulous investigation of the case law in the field, the astute taxpayer having a *legitimate* business purpose for his acquisition may avoid the disallowance of his loss carryover. "Truly this is a field requiring careful study and one in which possibly only the brave and the bold can flourish."[46]

Joel E. Kocen

---

[44]264 F.2d at 717.

[45]No regulations construing §§ 269, 381, or 382 of the 1954 Code have been promulgated at this writing.

[46]Winton, Loss Corporations and Carry-Overs, 34 Taxes 549, 575 (1956).