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CONTINUITY OF BUSINESS REQUIRED FOR TAX LOSS CARRYOVER

The net operating loss carryover provision of the Internal Revenue Code of 1939, section 122(b)(2)(C),[1] did not expressly deal with the post-reorganization treatment of a pre-reorganization net operating loss. The section provided:

> "If for any taxable year beginning after December 31, 1947, and before January 1, 1950, *the taxpayer* has a net operating loss, such net operating loss shall be a net operating loss carryover for each of the three succeeding taxable years. . . ."[2]

If a net operating loss corporation merged into another corporation, or consolidated with another to form a new corporation, a question arose as to whether the resulting corporation was "the taxpayer," insofar as a loss carryover is concerned.

In *Libson Shops, Inc. v. Koehler*[3] the United States Supreme Court considered this question. Petitioner was incorporated in 1946 to provide management services for businesses engaged in retailing women's apparel. The same ownership interests, in the same proportions, incorporated sixteen other corporations to retail women's apparel. Each of these sixteen corporations operated separately, and filed separate tax returns.[4] In 1949 the sixteen retail corporations were merged into petitioner, and thereafter petitioner, the surviving corporation, carried on both the managerial services and the operation of its own retail stores. Ownership proportions remained unchanged.

Prior to the merger, three of the retail corporations had losses. After the merger the stores formerly operated by these three corporations continued to have losses. Petitioner sought to offset the premerger losses of these three corporations, through the use of a net operating loss carryover deduction, against earnings of the surviving corporation. The Commissioner disallowed the claimed deduction. Petitioner paid the deficiency. A suit for refund was dismissed by the

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[1]Int. Rev. Code of 1939, § 122(b)(2)(C), added by 56 Stat. 847-48 (1942), as amended, 65 Stat. 505 (1951).

[2]Ibid. (Emphasis added.) For years after Dec. 31, 1949, the carryover is for five years. Int. Rev. Code of 1939, § 122(b)(2)(B), 64 Stat. 939 (1950).

[3]353 U.S. 382 (1957). Justice Douglas dissented.

[4]The Court intimates that the deduction would have been allowed had these seventeen corporations elected to file a consolidated return. Id. at 388. See Koppers Co. v. United States, 133 Ct. Cl. 22, 134 F. Supp. 290 (1955). But see Int. Rev. Code of 1939, § 141, 56 Stat. 858 (1942).

district court,[5] the circuit court affirmed,[6] and the Supreme Court granted certiorari.[7]

The Supreme Court rejected the government's contention that "the taxpayer" as used in the 1939 Code requires tracing a corporate entity through a reorganization, but nevertheless denied a refund. The basis for this holding was that "the income against which the offset is claimed was not produced by substantially the same businesses which incurred the losses."[8]

As used in the statute, "the taxpayer," according to the Court, involves "continuity of business enterprise."[9] That is, the business enterprise (as distinguished from the corporate entity that was engaged in the business enterprise) that produced the pre-merger loss must also produce the post-merger income against which the loss carryover is to be offset.

The Court explains its decision in terms of the legislative history of the carryover provision:

> "The requirement of a continuity of business enterprise as applied to this case is in accord with the legislative history of the carry-over and carry-back provisions. Those provisions were enacted to ameliorate the unduly drastic consequences of taxing income strictly on an annual basis. They were designed to permit a taxpayer to set off its lean years against its lush years, and to strike something like an average taxable income computed over a period longer than one year. There is, however, no indication in their legislative history that these provisions were designed to permit the averaging of the pre-merger losses of one business with the post-merger income of some other business which had been operated and taxed separately before the merger. What history there is suggests that Congress primarily was concerned with the fluctuating income of a single business."[10]

In section 172 of the Internal Revenue Code of 1954, Congress brought forward the net operating loss carryover deduction provision of section 122 of the 1939 Code, omitting, however, the words "the taxpayer."[11]

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[5]55-1 CCH U.S.T.C. par. 9458 (E.D. Mo. 1955).

[6]229 F.2d 220 (8th Cir. 1956).

[7]351 U.S. 961 (1956).

[8]353 U.S. at 390.

[9]Id. at 386.

[10]Id. at 386-87.

[11]The five year carryover was retained in the 1954 Code but subject to certain differences in the method of computation of the net operating loss. For the official explanation of these changes refer to: S. Rep. No. 1622, 83d Cong., 2d Sess. (1954); 3 U.S. Code Cong. & Ad. News 4847-50 (1954); Official Explanation of the Internal Revenue Code of 1954 at 24,256 (Prentice-Hall 1954).

In addition, Congress recognized the desirability of dealing specifically with net operating loss carryovers in corporate reorganizations, covering the subject in sections 381 and 382 of the 1954 Code.[12] Section 381, generally speaking, provides that if one corporation acquires the assets of another corporation in a reorganization,[13] the acquiring corporation succeeds to the pre-merger net operating loss carryover of the acquired corporation.[14] Section 382 places a limitation on the

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[12]The provisions of § 269 must always be kept in mind, providing for disallowance of any deductions in a corporate acquisition made principally to evade income taxes.

[13]The reorganizations contemplated are:

A. Liquidation of loss subsidiaries by acquiring corporations. Under § 332 such subsidiaries are defined as those in which the acquiring corporation owned at least 80 per cent of the voting power and 80 per cent of all stock. Such percentage must not have been acquired by purchase within twelve months of liquidation. § 334(b)(2).

B. Statutory mergers and consolidations. § 368(a)(1)(A), expressly included by § 381(a)(2).

C. Exchange of all or part of the voting stock of the acquiring corporation for substantially all the properties of the acquired corporation. § 368(a)(1)(C), expressly included by § 381(a)(2).

D. Transfer of the assets of a corporation if after the transfer the transferee is controlled by the transferor or its stockholders. § 368(a)(1)(D), expressly included by § 381(a)(2); but only if § 354(b)(1)(A), making necessary the transfer of substantially all the assets, and § 354(a)(1)(B), requiring that the distribution of stock, securities, and other properties be in accord with the plan of reorganization, are complied with.

E. A mere change of identity, form, or location. § 368(a)(1)(F), expressly included by § 381(a)(2).

The reorganizations not included are:

A. Divisive reorganizations, such as split-ups and spin-offs. 3 U.S. Code Cong. & Ad. News 4914 (1954); Official Explanation of the Internal Revenue Code of 1954 at 24,052 and 24,317 (Prentice-Hall 1954).

B. Partial liquidations. Ibid.

C. Exchange of stock for stock under § 368(a)(1)(B).

[14]Section 381(a) and (b) sets out the rules under which § 172 carryovers are to be computed in cases of corporate acquisitions. In summary:

A. The taxable year of the acquiring corporation to which they are first carried is the first taxable year ending after the transfer. § 381(c)(1)(A).

B. The taxable year of the transferor corporation ends on the date of transfer. § 381(b)(1).

C. The deduction in the first taxable year is limited to an amount in the same ratio to the taxable income of the acquiring corporation in the taxable year as the number of days in the taxable year after transfer bears to the total number of days in the taxable year. § 381(c)(1)(B).

D. A loss year of the transferor corporation ending on or before a loss year of the acquiring corporation is considered to be a net operating loss for a year prior to such loss year for the acquiring corporation. But if the date of transfer is other than the last day of a taxable year of the acquiring corporation:

availability of the loss carryover in non-reorganization situations, and also places a limitation on the availability, under section 381, to the acquiring corporation in a reorganization situation, of a pre-reorganization loss carryover.

Section 382(a) in substance provides that if 50 per cent of the stock of a corporation is acquired within a two-year period and the corporation is kept alive as a going concern, the loss carryover of section 172 will not be allowed even to the entity which incurred the loss *if* the business is substantially changed.[15]

Section 382(b) of the 1954 Code limits the deductibility of a pre-reorganization net operating loss carryover when there has been a change of ownership as the result of a reorganization. This section covers both the acquisition in a reorganization of the assets of a loss corporation by a corporation with net income, and the acquisition by a loss corporation of the assets of a corporation with income.[16] The section restricts the availability of a net operating loss carryover in the following respect: If after the reorganization the pre-merger owners[17] of the stock of the loss corporation own less than 20 per cent of the

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1. Such taxable year of the transferor corporation shall be considered two taxable "years," one starting the day beginning the taxable year and ending the day of acquisition, the other beginning the day following the date of the acquisition and ending the end of the taxable year. The taxable income should then be proportionately divided between these two "years." § 381(c)(1)(C).

E. The earnings or deficit of earnings of the transferor corporation is deemed to be received on the date of transfer. § 381(c)(2)(A).

F. Such deficit shall be used to offset earnings accumulated after the date of transfer only. § 381(c)(2)(B).

G. Carrybacks are not allowed to pre-transfer years of the transferor corporation. § 381(b)(3).

Section 381(c) then lists other advantages, such as capital gains carryover, which the acquiring corporation may receive, not within the scope of this article.

[15]In order for the prohibition under § 382(a), which is absolute, to apply, the change in ownership through the purchase of stock must be, substantially, such that 50 per cent of the participating interest changes hands within a two-year period [the statutory test is somewhat complicated and is explained by the Senate Finance Committee: 3 U.S. Code Cong. & Ad. News 4923 (1954); Official Explanation of the Internal Revenue Code of 1954 at 24,326 (Prentice-Hall 1954)]. Also the corporation must cease to carry on the old business. Seemingly the carryovers are disallowed only if the old business is discontinued during the two-year period when the change in ownership occurs. Apparently the change in ownership can be effected over a period of more than two years without losing the advantage. For a discussion of these and related problems see Cohn, Acquiring the Loss Corporation: Fact or Fantasy, N.Y.U. 13th Inst. on Fed. Tax 757 (1957).

[16]3 U.S. Code Cong. & Ad. News 4924 (1954); Official Explanation of the Internal Revenue Code of 1954 at 24,327 (Prentice-Hall 1954).

[17]Only those owning voting stock are included. § 382(b)(6).

stock of the surviving (or new) corporation,[18] then the net operating loss carryover available under section 381 is reduced proportionately. For example, if such stockholders emerge owning 18 per cent of the surviving (or new) corporation, the deductible loss carryover will be eighteen-twentieths, or 90 per cent, of the total which would be allowable if they had received 20 per cent or more.[19] The requested deduction in the *Libson* fact situation would not be disallowed by any provision contained in section 382(b).[20]

Subsections 382(a) and 382(b) are not interrelated in the Code and by reading the Code together with the committee reports thereon it seems clear that these two subsections were intended to cover two different situations.[21] Section 382(a) covers only purchases and 382(b) only reorganizations. The tests of ownership are different and one imposes an absolute loss of the carryover while the other diminishes it.

It has been suggested in one of the tax services[22] that, in addition to

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[18]Or of a corporation controlling such surviving corporation. § 382(b)(6).

[19]For further explanation see 3 U.S. Code Cong. & Ad. News 4924-25 (1954); Official Explanation of the Internal Revenue Code of 1954 at 24,327 (Prentice-Hall 1954).

[20]The title of § 382(b) is "Change of Ownership as the Result of a Reorganization." If there has not been a "change of ownership" in the Libson fact situation, the subsection appears to be inapplicable. If there has been a "change of ownership," then the deduction is not disallowed because § 382(b)(3) provides: "The limitation in this subsection shall not apply if the transferor corporation and the acquiring corporation are owned substantially by the same persons in the same proportion."

[21]3 U.S. Code Cong. & Ad. News 4684 (1954); Official Explanation of the Internal Revenue Code of 1954 at 24,052 (Prentice-Hall 1954): "Your committee has adopted a provision to limit the application of this provision relating to purchase to those areas in which abuse has most often arisen, that is, the purchase of stock of a corporation with a history of losses for the purpose of using its loss carryovers to offset gains of a business unrelated to that which produced the losses. Accordingly, your committee has provided that if more than 50 per cent of the stock of a corporation is purchased within a 2-year period and if the corporation thereafter engages in a different type of business, then the loss carryover is eliminated.

"Your committee also limits the allowance of net operating loss carryovers as a result of a tax free reorganization. Your committee considers it appropriate to allow such carryovers in full only when the shareholders of the predecessor corporation have a substantial continuing interest in the successor corporation. Thus, if the shareholders of the old loss corporation have 20 percent of the stock of the new corporation the loss carryover is available to the new corporation without diminution."

The Committee, referring to the purchase provision, said: "An increase in percentage of stock owned resulting from ... a tax-free reorganization ... is not counted in determining whether the 50 percentage point increase has been reached." 3 News, op. cit. supra, at 4923; Official Explanation, op. cit. supra, at 24,326.

[22]5 CCH 1957 Fed. Tax Rep. par. 8695. "However, it is quite possible that the Commissioner will apply the 'same business' test in his regulations under Sec. 381, in effect circumscribing Sec. 381 in somewhat the same manner as the Gregory

the express restrictions of the 1954 Code, the Treasury Department may add another by reading the *Libson* requirement of a "continuity of business enterprise" into the 1954 Code in reorganization situations, while in the Code such a restriction was imposed by the Congress only in a purchase situation.[23] That is, a post-reorganization surviving (or new) corporation may be required to show a continuity of pre-reorganization enterprise in order to deduct a pre-reorganization operating loss, and so be allowed to offset a pre-reorganization loss carryover only against post-reorganization gains of the same business enterprise. Some support for this suggestion is to be found in the language of the Supreme Court used in *Libson*:

> "There is, however, no indication in their legislative history that these provisions were designed to permit the averaging of pre-merger losses of one business with the post-merger income of some other business which had been operated and taxed separately before the merger."[24]

Although this statement was written after the 1954 Code was enacted, obviously the Court was referring only to the 1939 Code. Further on in the opinion the Court did show that it was not unaware of the differences in the 1954 Code.[25]

The suggestion that *Libson* furnishes a rule of construction for the 1954 Code beyond those rules set up by the statute seems unsound for several reasons. In the *Libson* case the Court is interpreting an indefinite term, "the taxpayer," in order to arrive at the result which Congress intended when it made loss carryovers available. In so doing, the Court recognized that all carryovers should not be lost because of a reorganization, where there is a continuing business,[26] and by this decision limits this continuing business concept to require that

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case (Gregory v. Helvering, 293 U.S. 465, 35-1 USTC par. 9043) tightened the reorganization provisions where the letter of the law was complied with but there was not a corporate business purpose.

"All the regulations under Subchapter C were finalized long ago except those under Secs. 381 and 382, which are not even proposed. Is this because the Commissioner was waiting for the *Libson* case? It has made uncertain the status of carryovers after mergers, under present law, and has definitely limited the right to carryovers under the 1939 Code."

[23]See note 21 supra.

[24]353 U.S. at 386-87.

[25]Id. at 388, n. 7.

[26]The Court cites with approval Stanton Brewery, Inc. v. Commissioner, 176 F.2d 573, 577 (2d Cir. 1949), stating: "... the merging corporations there involved carried on 'essentially a *continuing enterprise*, entitled to all ... benefits [of the carry-over provisions] in ameliorating otherwise harsh tax consequences of fluctuating profits or expanding business.' " 353 U.S. at 387.

losses before merger can only be offset against income by the same business after merger. Ordinarily, under the 1939 Code, no prohibition against the carryover is imposed because of a change in ownership of the corporation because of stock purchase.[27]

On the other hand, Congress in the 1954 Code has made express provision for the rules it wishes applied in regard to carryovers. It has provided different standards in purchase and reorganization situations, and has placed primary importance upon the change in ownership in both situations. Congress thus indicates that it regards the acquisition of loss corporations as the abuse to be restricted, rather than a change of business by the present owners of a corporation, regardless of any reorganizational change which might accompany the business change.[28] Congress has also shown clearly that it was aware of the "change in business enterprise" problem, by prohibiting the carryover where a change in ownership is accompanied by a change in business in a *purchase* situation. Such a limitation should not be read into the reorganization provisions, since Congress did not include this limitation specifically.

Thus, under the 1939 Code, Congress did not expressly provide rules in this field; under the 1954 Code, Congress did. In so providing, Congress expressed its dissatisfaction with court-made rules and stated that its purpose was to provide the regulations to be applied in this field.[29] Therefore, courts should not superimpose restrictions not imposed by the Congress.

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[27]This is true unless the new stockholders purchased control for the principal purpose of evading income or excess profit tax. Int. Rev. Code of 1939, § 129, added by 58 Stat. 47 (1944).

[28]See note 21 supra.

[29]In discussing the whole problem of carryovers the Senate Finance Committee stated: "Present practice rests on court-made law which is uncertain and frequently contradictory. Your committee agrees that whether or not the items carryover (sic) should be based upon economic realities rather than upon such artificialities as the legal form of the reorganization....

"The new rules enable the successor corporation to step into the 'tax shoes' of its predecessor corporation without necessarily conforming to artificial legal requirements which now exist under court-made law. Tax results of liquidations or reorganizations are thereby made to depend less upon the form of the transaction than upon the economic integration of two or more separate businesses into a unified business enterprise." 3 U.S. Code Cong. & Ad. News 4683-84 (1954); Official Explanation of the Internal Revenue Code of 1954 at 24,051-52 (Prentice-Hall 1954).