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COMMENTS

(F) Reorganizations and Proposed Alternate Routes for Post-Reorganization Net Operating Loss Carrybacks

Section 368(a)(1)(F)[1] of the Internal Revenue Code (Code) defines the least complex of all corporate reorganizations—commonly known as the (F) reorganization—as "a mere change in identity, form, or place of organization, however effected." Since 1921, when the (F) reorganization first appeared in a Revenue Act,[2] a significant amount of judicial gloss has been appended to this simple definition. To qualify as an (F) reorganization,[3] a reorganization must result in neither a change of shareholders[4] nor a shift in proprietary interest,[5]

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1. INT. REV. CODE OF 1954, § 368(a)(1)(F):
(a) REORGANIZATION.—
(1) IN GENERAL.—. . . the term "reorganization" means—
. . . .
(F) a mere change in identity, form, or place of organization, however effected.

2. The type-(F) reorganization first appeared in § 202(c)(2) of the Rev. Act of 1921. 42 Stat. 230. The wording of the provision was as follows:
SEC. 202. BASIS FOR DETERMINING GAIN OR LOSS
. . . .
(C) For the purpose of this title, on an exchange of property, real, personal, or mixed, for any other such property, no gain or loss shall be recognized unless the property received in exchange has a readily realizable market value, but even if property received in exchange has a readily realizable market value, no gain or loss shall be recognized—
. . . .
(2) when in the reorganization of one or more corporations a person receives stock in place of any stock or securities owned by him, stock or securities in a corporation a party to or resulting from such reorganization. The word "reorganization," as used in this paragraph, includes a merger or consolidation (including the acquisition by one corporation of at least a majority of the voting stock and at least a majority of the total number of all other classes of stock of another corporation, or of substantially all the properties of another corporation), recapitalization, or mere change in identity, form or place of organization of a corporation (however effected) or . . . .

See also R. PAUL, STUDIES IN FEDERAL TAXATION 3-116 (3d ed. 1940), which contains a survey of the corporate tax provisions of all the revenue acts enacted from 1921 to 1939 along with the related legislative history.

3. This discussion assumes a reorganization more complex than the simple change of name.

4. *See, e.g.*, Davant v. Commissioner, 366 F.2d 874 (5th Cir. 1966), *cert. denied*, 386 U.S. 1022 (1967); Pridemark, Inc., 42 T.C. 510 (1964), *rev'd on other grounds*, 345 F.2d 35 (4th Cir. 1965); Rev. Rul. 58-422, 1958-2 CUM. BULL. 145; *cf.* Rev. Rul. 66-284, 1966-2 CUM. BULL. 115, on *de minimus* changes in ownership. *See also* Freling, *The "Boot-Strap" Purchase: Sections 302, 334, and 337; Reorganizations and Reincorporations*, N.Y.U. 24TH INST. ON FED. TAX 1229, 1259-60 (1966); Lane, *The Reincorporation Game: Have the Ground Rules Really Changed?*, 77 HARV. L. REV. 1218, 1235-36 (1964).

5. For cases decided under either the 1939 Code or earlier revenue acts, *see* Helvering v. Southwest Consol. Corp., 315 U.S. 194, 202-03 (1942) ("and a transaction which shifts the ownership of the proprietary interest in a corporation is hardly, 'a mere change in identity, form, or place of organization . . .' ."); *accord*, Cushman Motor Works v. Commissioner, 130 F.2d 977 (8th Cir. 1942), *cert. denied*, 318 U.S. 756 (1943); Stollberg Hardware Co., 46 B.T.A. 788 (1942) (a significant shift in proprietary interest);

and there must be a continuation of the business in the pre-organization fields of activity,[6] using essentially the same operating assets as before.[7] In two recent decisions, the Tax Court has imposed a new and significant requirement for qualification as an (F) reorganization.[8]

The first of the recent cases, *Estate of Stauffer*,[9] involved the consolidation,[10] for valid business reasons, of three brother-sister corporations, *A*, a California corporation, *B*, an Illinois corporation, and

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cf. Ahles Realty Corp. v. Commissioner, 71 F.2d 150 (2d Cir. 1934), *cert. denied*, 293 U.S. 611 (1934).

For cases decided under the 1954 Code, *see* Davant v. Commissioner, 366 F.2d 874 (5th Cir. 1966), *cert. denied*, 386 U.S. 1022 (1967); Joseph C. Gallagher, 39 T.C. 144 (1962). *But see* Reef Corp. v. Commissioner, 368 F.2d 125 (5th Cir. 1966), *cert. denied*, 386 U.S. 1018 (1967) (stating that Southwest Consol., *supra*, involved the 1939 Code and is not applicable to revised 1954 Code); Rev. Rul. 61-156, 1961-2 CUM. BULL. 62 (When corporation *A* sold all assets to corporation *B* and then corporation *B* issued 55% of its stock to the stockholders of corporation *A* with the other 45% being sold to the public a mere recapitalization with an (F) reorganization occurred.). This ruling appears to have been rejected by *Gallagher*.

There appears to be a *de minimus* doctrine at work in this area. *See* Rev. Rul. 66-284, 1966-2 CUM. BULL. 115, which in amplifying Rev. Rul. 58-422, 1958-2 CUM. BULL. 145, stated:

> Where . . . a plan of merger is designed only to effect a change in the corporation's place of organization, the Internal Revenue Service considers the failure of dissenting shareholders owning a total less than 1 percent of the outstanding shares to participate in the plan of merger to be such a de minimus change in the corporations' shareholders and its assets as not to disqualify the merger as a reorganization under section 368(a)(1)(F) of the Code . . . .

Cf. Casco Prods. Corp., 49 T.C. —, No. 5 (Oct. 29, 1967).

A shift in proprietary interest may not disqualify a transaction from being classed as an (F) reorganization. The "step transaction" doctrine might be invoked to separate the shift in proprietary interest from the "mere change in identity, form, or place of organization." *See* Davant v. Commissioner, *supra*. Also, the shift in proprietary interest could be classified as an (E) reorganization, with the other events being classified as an (F) reorganization. *Cf.* Schwartz, *Reincorporations Under the 1954 Code*, 15 U. FLA. L. REV. 159, 181 (1962).

6. *See, e.g.*, Pridemark, Inc. v. Commissioner, 345 F.2d 35 (4th Cir. 1965), *rev'g in part* 42 T.C. 510 (1964); Ahles Realty Corp. v. Commissioner, 71 F.2d 150 (2d Cir. 1934), *cert. denied*, 293 U.S. 611 (1934); *cf.* Reef Corp. v. Commissioner, 368 F.2d 125 (5th Cir. 1966), *cert. denied*, 386 U.S. 1018 (1967); Pridemark, Inc., 42 T.C. 510 (1964); *rev'd in part*, 345 F.2d 35 (4th Cir. 1965). *See also* Recent Development, *Treatment Denied Liquidation-Reincorporation Transaction*, 28 OHIO ST. L.J. 325, 333-34 (1967).

7. *See* Pridemark, Inc. v. Commissioner, 345 F.2d 35 (4th Cir. 1965), *rev'g in part* 42 T.C. 510 (1964). *See also* Freling, *supra* note 4, at 1250-66; Recent Development, *supra* note 6, at 333-34. A distribution of liquid assets may not disqualify a reorganization from achieving (F) status. *Cf.* Freling, *supra* note 4, at 1259-60.

8. There were intimations of this requirement in the dicta of earlier cases. *See, e.g.*, Pridemark, Inc. v. Commissioner, 345 F.2d 35 (4th Cir. 1965), *rev'g in part* 42 T.C. 510 (1964); Hyman H. Bergbush, 43 T.C. 743 (1965). *See also* B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS 503-07 (2d ed. 1966).

9. 48 T.C. 277 (1967).

10. In 1959 the corporations involved in *Estate of Stauffer* requested an Internal Revenue Service (IRS) ruling as to whether the consolidation qualified under § 368(a)(1)(A). The IRS had ruled that the proposed consolidation would qualify as an (A) reorganization. 48 T.C. 277 (1967).

C, a New York corporation, into a newly-formed New Mexico corporation, *D*. *A*, *B*, *C*, and *D* were owned by the same sole shareholder. Prior to the consolidation *A*, *B*, and *C* conducted separate, but very related, businesses in different sections of the United States.[11] After the consolidation in 1959, business difficulties[12] prevented the relocation of the businesses, and *D*, until it was finally liquidated in 1961, continued to carry on the operations of *A*, *B*, and *C* in their pre-fusion locations,[13] using the pre-fusion personnel. *D* suffered a net operating loss for the tax year ending January 31, 1961, and desired to carry the loss back to pre-fusion tax years of *A*, *B*, and *C*.

A similar factual situation was presented to the Tax Court in *Associated Machine*.[14] This case involved two California brother-sister corporations, *E* and *F*, conducting separate but similar businesses.[15] In 1960, *E* merged into *F*, and the resulting *F'*[16] continued to carry on the businesses formerly conducted separately by *E* and *F*. The stock of *E*, *F*, and *F'* was held by one stockholder. *F'* suffered a net operating loss in 1962 and sought to carry back the loss to the pre-merger years of *E*.[17]

In both cases, the resulting corporations, *D* and *F'*, argued that an (F) reorganization had occurred and that as a result section 381(b)[18] authorized the attempted carrybacks. The Tax Court, agree-

11. *A* had manufactured and promoted the sale of oscillating units designed to provide passive and resistive exercise for use in a program of weight control in the Southwest; *B*, although doing some manufacturing, had been responsible primarily for the promotion of sales of reducing units in the Midwest; *C* had been confined to promotional activity in the Eastern United States.

12. In general the difficulties centered around certain unfavorable publicity regarding the effectiveness of mechanical reducing units. In September 1954 the Secretary of Health, Education, and Welfare, in a news conference, attacked the manufacturers of mechanical reducing devices on the ground that they were wholly ineffective to accomplish the results claimed. *Consumer's Research*, in its September 1959 issue, and *Readers Digest*, in its December 1959 issue, also gave unfavorable publicity to the mechanical reducing device. The final blow came in March 1960 when the Federal Trade Commission began proceedings to force Stauffer to cease and desist from the use of certain advertising. The result of all this unfavorable publicity was a drastic decline in sales. 48 T.C. 277 (1967).

13. *D* continued to operate out of the same offices which the California corporation, *A*, had used. Before the consolidation, the operations of *A*, *B*, and *C* had been guided from the offices of *A*.

14. 48 T.C. 318 (1967).

15. *E*'s general machine shop business consisted of fabricating metal parts for use in the manufacture of aircraft, missiles, and computers. *F*'s business involved the sheet metal fabrication of cabinets for companies which built computers and other related items.

16. Throughout this Comment, the resulting corporation which emerged from the combination of *E* and *F* will be referred to as *F'*.

17. *F'* could carry back the post-merger loss to the pre-merger income of *F*. *See* notes 86-90 *infra* and accompanying text. The reason *F'* did not attempt to carry the post-reorganization loss of *F'* back to *F* is due to the fact that *F* was a losing corporation and had no significant earnings and profits to which the loss could have been applied.

18. INT. REV. CODE OF 1954, § 381:

. . . .

(b) OPERATING RULES.—Except in the case of an acquisition in connection with a

ing with the Internal Revenue Service (IRS), held that an (F) reorganization must be contained, from start to finish, within a single corporate shell and that it cannot involve the combination of two or more corporations each of which conducted a separate business prior to the union. In imposing this new requirement, the Tax Court overruled,[19] disregarded,[20] and distinguished[21] all contrary precedent.

A dissection of *Estate of Stauffer* and *Associated Machine* reveals two major issues which are separable but which dovetail in the two principal cases. The first is whether the single-corporation requirement is properly an essential feature of an (F) reorganization. The further issue is whether, as a matter of federal tax policy, a corporation resulting from a combination of brother-sister corporations should be allowed to carry back a post-reorganization net operating loss to the pre-reorganization income years of its component corporation, regardless of whether the combination satisfies the definition of an (F) reorganization. Each issue requires separate yet somewhat interrelated treatment.

I. Defining the Definition

In an analysis of the scope of section 368(a)(1)(F), it is important to understand its origins, functions, and interrelations and interactions with the other corporate tax sections of the Code. (F) originated in section 202(c)(2) of the Internal Revenue Act of 1921[22] as a definitional subsection contained within a more general operative section.[23] As the complexity of the revenue laws increased, (F) was di-

reorganization in subparagraph (F) of section 368(a)(1)—

. . . .

(3) The corporation acquiring property in a distribution or transfer described in subsection (a) shall not be entitled to carry back a net operating loss for a taxable year ending after the date of distribution or transfer to a taxable year of the distributor transferor corporation.

19. Pridemark, Inc., 42 T.C. 510 (1964), *rev'd in part*, 345 F.2d 35 (4th Cir. 1965).

20. Reef Corp. v. Commissioner, 368 F.2d 125 (5th Cir. 1966), *cert. denied*, 386 U.S. 1018 (1967); Davant v. Commissioner, 366 F.2d 874 (5th Cir. 1966), *cert. denied*, 386 U.S. 1012 (1967).

21. Rev. Rul. 58-422, 1958-2 Cum. Bull. 145.

22. The 1921 Act, as passed by the House of Representatives, was a series of amendments to the 1918 Internal Revenue Act; but Dr. Adams, Economic Advisor of the Treasury Department, suggested to the Senate committee holding hearing on the proposed bill that an entirely new and reworded Act be promulgated. *See Hearings on H.R. 8245 Before the Senate Comm. on Finance*, 67th Cong., 1st Sess. 4 (1921). As a result the 1918 Act was repealed and re-enacted with the recommended changes.

No similar provision had existed in the prior revenue acts before the enactment of § 202(c)(2) of the Revenue Act of 1921, *as amended*, Int. Rev. Code of 1954, § 368(a)(1)(F). *See* House Comm. on Ways & Means, Comparison of the Revenue Acts of 1918 and 1921, 67th Cong., 4th Sess. 6-7 (1923). After 1921, the wording of § 202(c)(2) remained substantially the same throughout the legislative process. A few shifts in wording occurred but were unexplained in the reports concerning the bill. *Compare* H.R. Rep. No. 8245, 67th Cong., 1st Sess. (1921) (as introduced by Mr. Fordney), *with* S. Rep. No. 272, 67th Cong., 1st Sess. 12 (1921) (as amended and passed by the Senate).

23. *See* note 2 *supra*.

vorced from the operative provision and was set up in the 1954 Code as part of a separate definitional section.[24] As is the case with the other reorganization definitions, the scope of (F) is to a large extent determined not by the mere wording of its definition but by the substance and policies of operative sections of the Code, which refer to or incorporate (F) by either a specific or a general reference to the reorganization definitional section.

A. *Pre-1954 History of (F)*

The pre-1954 legislative history of (F) offers some literal support for the proposition that an (F) reorganization must be confined to changes within a single corporate shell. The original wording of (F) was a "mere change in identity, form, or place of organization of *a* corporation (however effectuated) . . . ."[25] This subsection was revised in 1924 and appeared as section 202(h)(1)(D) of the 1924 Revenue Act.[26] As a result of the revision, the words "of a corporation" were dropped.[27] The Treasury report,[28] which was incorporated into all the House and Senate reports without further elaboration,[29] stated that "section 202(h)(1) with the exception of minor changes in phraseology is the same as section 202(c)(2) of the existing law."[30] Accordingly, it may be presumed that the deletion is itself insignificant. Yet, even though (F) originally referred technically to the reorganization "of *a* corporation,"[31] due to the lack of illustrative legislative history,[32] it might be argued that (F) could be interpreted to apply to the reorganization of two or more corporations.[33]

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24. *See* note 1 *supra.*

25. Rev. Act of 1921, § 202(c)(2), 42 Stat. 230 (emphasis added); *see* text quoted in note 2 *supra.*

26. The wording of the Rev. Act of 1924, § 203(h)(1), 43 Stat. 257, *as amended*, INT. REV. CODE OF 1954, § 368(a) was as follows:

(h) As used in this section and sections 201 and 204—

(1) the term reorganization means (A) a merger or consolidation (including the acquisition by one corporation of at least a majority of the voting stock and at least a majority of the total number shares of all other classes of stock of another corporation, or substantially all the properties of another corporation), or (B) a transfer by a corporation of all or part of its assets to another corporation if immediately after the transfer the transferor or its stockholders or both are in control of a corporation to which the assets are transferred, or (C) a recapitalization, or (D) a mere change in identity, form, or place of organization, however effected.

27. *See* note 26 *supra.*

28. STATEMENT OF THE CHANGES MADE IN THE REVENUE ACT OF 1921 BY TREASURY DRAFT AND REASONS THEREFOR (1924).

29. *See, e.g.,* H.R. REP. No. 179, 68th Cong., 1st Sess. 13 (1924).

30. STATEMENT OF THE CHANGES MADE IN THE REVENUE ACT OF 1921 BY TREASURY DRAFT AND REASONS THEREFOR 12 (1924).

31. Rev. Act of 1921, § 202(c)(2), 42 Stat. 230 (emphasis added); *see* note 2 *supra.*

32. *See* notes 22 & 30 *supra* and accompanying text. The Treasury Regulations are of little help. The IRS left the ball where it lay, and in the regulations governing (F) simply said:

Where in connection with an internal adjustment of the affairs *of a corporation*, either by recapitalization or a change in identity, form, or domicile (however effected) a person receives in place of stock or securities . . . .

Like the legislative history, the cases involving (F) reorganizations offer only minimal guidance in evaluating the propriety of the single-corporation requirement imposed by the Tax Court in the principal cases. The pre-1954 cases dealing with (F) reorganizations involved either the determination of the proper basis of assets received by a transferee corporation in a reorganization or the question whether the change that occurred should be classified as a "complete" liquidation or a reorganization.[34] The IRS argued for a broad inter-

Treas. Reg. 62, art. 1566(b) (1922) (emphasis added) (which, except for a minor change in 1936 [*see* Treas. Reg. 94, art. 1129 (1936)], remained essentially the regulation governing (F) until late 1961). *See also* Treas. Reg. 65, art. 1577 (1924); Treas. Reg. 69, art. 1577 (1926); Treas. Reg. 74-75, art. 577 (1932); Treas. Reg. 118, § 39-112(g)-3(f) (1953).

33. Authority for this position can perhaps be found in the rather broad interpretation of the wording of other reorganization provisions, of which the treatment of (D) reorganizations is the best example. The courts have tended to apply the (D) reorganization definition to transactions which do not fall within the literal language of § 368(a)(1)(D) but which do fall within the policy objectives of Congress in enacting the provision. For a general discussion of (D) reorganizations, *see* B. BITTAKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS 533-38 (2d ed. 1966).

34. The issues and problems involved in the early cases dealing with (F) are best illustrated by an example. Suppose, for valid business reasons, two corporations sell their operating assets to a third corporation, all three corporations being owned by the same general group of stockholders. The two transferor corporations liquidate, distributing to their shareholders in exchange for their stock all money and property remaining after the sale. Two fundamental questions immediately arise: What is the basis of the assets in the hands of the transferee corporation? Should the distribution to the shareholders be taxed at capital gains rates or at ordinary income rates? The determination of the transferee's proper basis in this general setting evoked the first IRS use of (F) reorganizations; the bailout or liquidation cases evolved a little later, spanning pre- and post-1954 Code years.

In attacking the above situation as a reorganization the vigilant IRS attorneys argued that where the stockholders were essentially the same, and the business continued using the same assets as before the "sale," the result was "a mere change in identity, form, or place of organization." Since this was a reorganization rather than a sale, the argument continued, the basis of the assets in the hands of the transferee corporation was required to be the same as the basis in the hands in the hands of the old corporation. *See* INT. REV. CODE OF 1954, § 362(b). Also the IRS argued that since there was a reorganization, any distribution to the shareholders of the transferor corporations was either "boot" or an outright distribution of earnings and profits in the form of a dividend. *See* INT. REV. CODE OF 1954, §§ 316(a), 356(a). On the other hand, the taxpayers asserted that the transferee corporation had "purchased" the assets and that the basis of the assets in the hands of the transferee corporation was either the cost or the fair market value at the time the new corporation acquired the assets. *See* INT. REV. CODE OF 1954, § 1012. Additionally, the shareholders argued that the property they received in exchange for their stock was received in a "complete liquidation," and to the extent that the value of the property exceeded the stockholder's basis in his stock, the gain was to be taxed at capital gains rates. *See* INT. REV. CODE OF 1954, § 331. At the same time, it should be noted that according to the shareholder's theory the defunct corporation may claim nonrecognition of gain on the sale of assets within twelve months of complete liquidation. *See* INT. REV. CODE OF 1954, § 337. But an avenue of tax avoidance with respect to sale of depreciable property was partially closed by two 1963 additions to the 1954 Code. *See* INT. REV. CODE OF 1954, §§ 1245, 1250. Therefore, this aspect of the hypothetical will not be discussed in any detail.

Arguably, if the new corporation is using the same assets as the old corporation(s)

pretation[35] of (F) in these cases, and the courts, in the main, accepted the IRS's characterization of (F) with some significant qualifica-

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in the same line of business with the same stockholders controlling the new corporation in the same proportions as they controlled the old, the only significant changes are that, according to the shareholders' characterization, the earnings and profits of the old corporation have been distributed at capital gains rates instead of ordinary income rates and the basis of the assets has been increased, allowing additional depreciation deductions. *See* INT. REV. CODE OF 1954, §§ 331, 1012. If this type of transaction were condoned, then any time a corporation accumulated a large amount of earnings and profits, it would fabricate valid business reasons to "sell" its operating assets and distribute its remaining liquid assets. There would be no disruption of business because the same stockholders, officers, and employees would be in control of and operating the "new" corporation. The transaction would result in the perversion of §§ 167, 301, 316, and 337 and the avoidance by the taxpayers of the impact of the progressive rate structure.

Several pre-1954 cases have dealt with the issue of what basis a transferee corporation should take. Ahles Realty Corp. v. Commissioner, 71 F.2d 150 (2d Cir. 1934), *cert. denied,* 293 U.S. 611 (1934), involved the transfer of the assets and stock of a sole stockholder corporation to a new corporation owned by the same stockholder in exchange for the stock of the new corporation. The issue was whether the basis of the assets was cost to the old corporation or their fair market value at the time of transfer. The court held that an (F) reorganization had occurred and that the basis was the basis in the hands of the old corporation. Another case presenting a similar situation was Cushman Motor Works v. Commissioner, 130 F.2d 977 (8th Cir. 1942), *cert. denied,* 318 U.S. 756 (1943). This case involved a dissolved corporation whose assets were purchased at a sheriff's sale by the sole stockholder and then placed in a new corporate shell. Here the court held that the transaction was not an (F) reorganization since a dissolved corporation cannot be a party to a reorganization. This decision resulted in the new corporation's taking a lower basis rather than the old corporation's higher basis. *See also* Helvering v. Southwest Consol. Corp., 315 U.S. 194 (1942); Stollberg Hardware Co., 46 B.T.A. 788 (1942). Both were cases where the original corporation had run into financial difficulties and the creditors, in partially taking over the control of the corporation, had the assets transferred to a newly formed corporation in which the old stockholders were given varied or reduced interests. Held: a shift in proprietary interests precludes (F) reorganization.

A number of other pre-1954 cases involved the question whether a transaction should be classified as a "complete" liquidation or as a reorganization. George Whittell Co., 34 B.T.A. 1071 (1936), is the earliest reported case involving this liquidation issue. In this case the stock and assets of a California corporation were transferred to a newly-formed Nevada corporation in order to avoid the California franchise tax. Both corporations had the same officers, records, number of shares, etc., with only the name changing. The question raised was whether the new corporation had received the assets in liquidation or reorganization. The court alternatively held that an (F) reorganization [then Rev. Act of 1928, § 112(i)(1)(D), 45 Stat. 818] had occurred. In Estate of James F. Suter, 29 T.C. 244 (1957) (a case arising under the 1939 Code), three individuals bought the stock of the sole stockholder—he would not sell only the assets—in order to acquire a corporation that they needed to maintain their business as jobbers. Then, in order to avoid any contingent liabilities of the old corporation, the individuals had the corporation distribute the assets which were then transferred to a new corporation in which each held an equal interest. The court held this was not an (F) reorganization because of the shift in proprietary interest.

For post-1954 cases involving the issue of whether a transaction should be classified as a "complete" liquidation or a reorganization, *see, e.g.,* Reef Corp. v. Commissioner, 368 F.2d 125 (5th Cir. 1966), *cert. denied,* 386 U.S. 1018 (1967) (*see* note 41 *infra*); Davant v. Commissioner, 366 F.2d 874 (5th Cir. 1966), *cert. denied,* 386 U.S. 1012 (1967) (*see* note 40 *infra*); Pridemark, Inc., 42 T.C. 510 (1964), *rev'd in part,* 345 F.2d 35 (4th Cir. 1965) (*see* note 39 *infra*). *See also* Hyman H. Berghash, 43 T.C. 743 (1965).

35. *See* note 34 *supra.*

tions.[36] Although the multiple-corporation issue was not specifically presented to the courts during the pre-1954 period,[37] it is reasonable to assume that had the question arisen at that time, the courts, in light of the prevailing tax problems,[38] would not have confined (F) to changes within a single corporation. This assumption is bolstered by the 1964 *Pridemark, Inc.*[39] decision and the 1966 *Davant v. Commissioner*[40] and *Reef Corp. v. Commissioner*[41] decisions. These three

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36. The qualification which did most damage to the position of the IRS was the one requiring that there be no shift in proprietary interest. *See* note 5 *supra*. This limitation does not mean that the IRS's reorganization theory could not be substantiated by means of one of the other reorganization definitions. *See* note 70 *infra* and accompanying text. But this requirement did hurt the IRS in one major class of basis cases, the cases in which creditors had taken control of a financially embarrassed corporation through a switch of corporate vehicles. *See, e.g.*, Helvering v. Southwest Consol. Corp., 315 U.S. 194 (1942) (*see* note 34 *supra*). On the other hand, it was fairly essential to the IRS attack in the liquidation cases (*see* note 34 *supra*) that the interest of the stockholders be maintained at relatively the same level. If the stockholders' interest shifted, they could argue any distributed property was received in a "complete" or "partial" liquidation and taxable at capital gains rates and not ordinary income rates. See INT. REV. CODE OF 1954, § 331. It was the other requirements of identity of assets (*see* note 7 *supra*) and continuity of business (*see* note 6 *supra*) which blunted the IRS attack in some of the liquidation cases. *See* note 34 *supra*.

37. Rather than attack the multiple corporation issue, the IRS appears to have concentrated instead on the expansion of (F) reorganizations to cover the situation where significant shifts in stockholders had occurred, a situation sometimes not covered by the other reorganization provisions. *See* notes 2 & 34 *supra*.

38. *See* note 34 *supra* for a hypothetical which illustrates the tax problems facing the IRS during this time period.

39. 42 T.C. 510 (1964), *rev'd in part*, 345 F.2d 35 (4th Cir. 1965). This case involved a brother corporation, *A*, and a sister corporation, *B*, which sold part of their assets to *X*, a corporation with which the corporation had dealings, and liquidated the rest of their assets and proceeds from the sale. The stock of *A* and *B* had been held by a trust for a group of individuals. Upon liquidation the individuals reassigned the assets and part of the cash to the trust. The trust then in exchange for the cash and assets received stock in a newly created corporation which continued the business of *A* and *B* except for the severed business contracts with *X*. The Tax Court held that an (F) reorganization had taken place and not a complete liquidation as claimed by the stockholder of *A* and *B*. Accordingly the distribution of cash was a dividend and not property received in exchange for stock upon complete liquidation. Upon appeal to the circuit court new facts, indicating a substantial period of business discontinuation coupled with an attempt at other business endeavors, were presented. These facts, the court felt, substantiated the taxpayer's claim for "complete" liquidation treatment.

40. 366 F.2d 874 (5th Cir. 1966), *cert. denied*, 306 U.S. 1012 (1967). This case involved brother-sister corporations, *W* and *Wa*, engaged in related but different businesses and owned by the same groups of stockholders. *W*'s principal business was drying, cleaning, and storing rice while *Wa*'s principal business was renting land, which it owned, upon which the rice was grown. Through a series of transactions, involving a strawman, *W* sold its assets to *Wa* and liquidated. One of the court's alternative holdings was that an (F) reorganization had taken place and therefore the distributions were treated as dividends.

41. 368 F.2d 125 (5th Cir. 1966), *cert. denied*, 386 U.S. 1018 (1967). In this case the assets of a corporation owned by two separate groups of stockholders were transferred to a strawman. The strawman sold the assets to a new corporation and received stock and notes in exchange for the assets. The notes were transferred to one group; the stock to the other group. The court held an (F) reorganization had occurred. This conclusion was reached by splitting the reorganization into two parts: (1) the exchange of

later cases, although decided under the 1954 Code, merely present variations on the liquidation-reorganization issue involved in the pre-1954 cases.[42] In all three cases the courts held that an (F) reorganization could encompass the reorganization of more than one corporation into a single corporation.[43] While the broad reading given to (F) by these cases might have been proper within the framework of the pre-1954 Revenue Acts and Code, these courts neglected to consider the impact which such a reading would have on the newly enacted 1954 sections which interact with (F).[44]

B. *The 1954 Code and (F) Reorganizations*

The 1954 Code was a complete revision of the 1939 Code, and, accordingly, a slightly new philosophy was introduced into both the revised and the new sections. Section 368(a)(1)(F), as a definitional subsection, was barely discussed in any of the congressional hearings on the proposed 1954 Code. In fact, the House appears to have considered deletion of the (F) reorganization provision; but, after protest in Senate hearings,[45] (F) was retained as a part of the reorganization definition section.

Some insight into the present characteristics of an (F) reorganization can be gained by examining the legislative history of section 381. Generally, section 381 was designed to permit certain reorganized corporations to inherit some tax attributes of their predecessors.[46] When section 381 was first introduced, the House version contained no reference to (F) and indeed did not allow carrybacks in any transaction covered by section 381.[47] During the Senate hearings on section 381, a plea was made for the inclusion of a carryback provision which would operate when a corporation had merely changed its identity, form, or place of organization.[48] This plea, which even-

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one group's stock for notes and (2) the transfer of the assets to another corporate shell. This holding is arguably wrong.

42. *See* note 34 *supra.*

43. *See* notes 39-41 *supra.*

44. It should be noted that the IRS appears to accept the Tax Court's position in *Estate of Stauffer* and *Associated Machine* by its apparent abdication of their own position and the Tax Court's decision in *Pridemark, Inc. See* Freling, *supra* note 4, at 1258: "The Service position is that not withstanding *Pridemark*, the assets of two or more operating corporations cannot be combined in an (F) reorganization."

45. *See Hearings Before the Senate Finance Comm. on H.R. 8300*, 83d Cong., 2d Sess. 403 (American Bar Association Report on the Internal Revenue Act of 1954), 539-40 (The Association of the Bar of the City of New York—Committee on Taxation) (1954).

46. *See* note 50 *infra.*

47. *See* H.R. REP. No. 1337, 83d Cong., 2d Sess. A135 (1954). In the Senate, March 23 (legislative day March 1), 1954.

48. *See Hearings on H.R. 8300 Before the Senate Comm. on Finance*, 83d Cong., 2d Sess. pt. 3, 1531-70 (Report on H.R. 8300 by Section on Taxation—New York State Bar Association, Albany, N.Y.) (1954).

tually resulted in the appearance of (F) together with a limited carryback provision in section 381(b), was precipitated by the case of a New York corporation. Having operated profitably for years, this corporation reincorporated in New Jersey, changing only its place of organization, and thereafter suffered a financial setback which eliminated its working capital. The corporation was thrown into bankruptcy when the IRS ruled that since the New Jersey corporation was not the same as the New York corporation, the loss could not be carried back to pre-reorganization years. In the Senate hearings, the proponents of a carryback pointed out that had a carryback been available, the New Jersey corporation could have replenished its working capital by means of a tax refund on prior tax years.[49]

As finally enacted, the substantive provisions of section 381[50] refer to (F) twice. Specifically, section 381(b) provides that with respect to (F) reorganizations: (1) under section 381(b)(3), the taxable year of the transferor corporation shall not end on the date of transfer; and (2) under section 381(b)(3), the transferee corporation shall be entitled to carry back a net operating loss for a taxable year ending after the transfer to a taxable year of a transferor corporation. Thus, section 381(b) has two revenue effects. First, by preventing a corporation which has engaged in an (F) reorganization from filing a second return, it cuts off a possible additional surtax exemption.[51] Second, by allowing a corporation engaged in an (F) reorganization to carry back losses incurred after the reorganization to pre-reorganization tax years, it reduces the earnings and profits of those prior years and makes possible a tax refund.[52] If (F) reorganizations were broadly defined, additional surtax exemptions[53] would be disallowed;[54] but, at the same time, more reorganized corporations would

49. *See* note 48 *supra.*

50. Section 381 permits certain reorganized corporations to inherit tax attributes of their predecessors. The reorganizations benefitting from INT. REV. CODE OF 1954, § 381 are:

. . . .

(ii) A statutory merger or consolidation qualifying under section 368(a)(1)(A) to which section 361 applies;
(iii) a reorganization qualifying under section 368(a)(1)(C);
(iv) a reorganization qualifying under section 368(a)(1)(D) if the requirements of section 354(b)(1)(A) and (B) are satisfied; and
(v) a mere change in identity, form, or place of reorganization qualifying under section 368(a)(1)(F)

Treas. Reg. § 1.381(a)-1(b) (1967).

51. The additional surtax exemption would result if *A* and *B* merged into *C*, and it was held not to be an (F) reorganization. Both *A* and *B* could file returns for the year ending at date of transfer, each claiming one exemption. *C*, the resulting corporation, could also take a surtax exemption for its year beginning on the date of the transfer. *See* also note 64 *infra.*

52. *See* INT. REV. CODE OF 1954, §§ 6401-07 & 6411.

53. *See* notes 51 *supra* and 60 *infra.*

54. *See, e.g.,* INT. REV. CODE OF 1954, §§ 269, 482, 1551. Some unwarranted surtax exemptions will be prevented by other Code sections. *See, e.g.,* INT. REV. CODE OF 1954 § 6401-07 & 6411.

be able to take advantage of the carryback provision. On the other hand, if (F) were narrowly defined, the tax revenue loss from the increased number of carrybacks would be prevented; however, a tax revenue loss would result from the filing of closing returns and the consequent gaining of an additional surtax exemption.

Accordingly the IRS might be tempted to argue for a broader definition of (F) in return situations than in carryback cases. However, in fact, careful investigation reveals no such inconsistency. In the return situation, the single relevant case[55] and the relevant revenue rulings[56] deal mainly with the reorganization of parent-subsidiary affiliated groups,[57] filing consolidated returns,[58] into a single corporation organized in another state. The case and rulings appear to hold that such a transaction can qualify as an (F) reorganization.[59] This type of multiple corporation reorganization is distinguishable from the combination of a set of brother-sister corporations into a single corporation. An affiliated group filing a consolidated return is effectively *one* integral tax unit; any intercorporate merger or fusion of the group into a single corporation may be treated as an (F) reor-

55. Dunlap & Associates, Inc., 47 T.C. 542 (1967). This case involved a New York corporation which owned slightly less than 80% of the stock in two subsidiaries, *A* and *B*, but which had sufficient interest to control the subsidiaries. For valid business reasons a new corporation was formed in Delaware and the New York parent corporation merged into the Delaware corporation, with the Delaware corporation simultaneously acquiring the outstanding interest in *A* and *B*. The court held as follows:

> Only the state of organization had been changed. There was thus a mere change in place of organization, and the merger, in addition to qualifying as a reorganization under subparagraph (A) also qualified as a reorganization under section 368(a)(1)(F).

The new corporation filed one return for the tax years of the old New York corporation and its own current tax years. The acquisitions of the minority interests in the two subsidiaries were treated as separate reorganizations by the court.

It should be noted that the original parent subsidiary group could not, under state law and federal tax law, file a consolidation return, but the purpose for the reorganization was to enable the resulting group to file a consolidated return. Thus, presumably, the tax policy of encouraging affiliated groups to file consolidated returns explains the result in the case.

56. Rev. Rul. 57-276, 1957-1 CUM. BULL. 126, held:

> [I]f the transferor corporation was the parent corporation of an affiliated group which filed consolidated returns, the same affiliated group with the acquiring corporation as parent remains in existence for the purpose of filing a consolidated return for the taxable year in which the reorganization occurred.

See Rev. Rul. 58-422, 1958-2 CUM. BULL. 145, *amplifying* Rev. Rul. 57-276, 1957-1 CUM. BULL. 126, dealing with a parent-subsidiary situation in which two wholly owned subsidiaries and the parent merged into a new corporation organized in another state. The new corporation liquidated the subsidiaries. Since all the stockholders were the same both before and after the merger and liquidation, Revenue Ruling 57-276 was applied and (1) the former parent was not required to file a return for that portion of the taxable year before the effective date of the reorganization but (2) the two subsidiaries were required to file returns for the taxable year which ended on the effective date of merger in which their separate corporate existence ended.

57. *See* INT. REV. CODE OF 1954, § 1504(a).

58. *See* INT. REV. CODE OF 1954, § 1501.

59. Even if the parent and subsidiaries filing a consolidated return first merged and then moved into another state, under this approach the reorganization would qualify under § 368(a)(1)(F).

ganization, provided that the other criteria mentioned at the beginning of this comment are satisfied.[60] At the same time, any such combination by brother-sister corporations should not be accorded (F) treatment since they cannot file consolidated returns, and thus are sufficiently separate entities to be regarded as distinct tax units.[61]

The Tax Court's decisions in the carryback cases of *Associated Machine* and *Estate of Stauffer*, imposing the stringent requirement that in order to qualify as an (F) organization all changes must take place within a single corporation, thus appear consistent with the holdings in the return cases. Furthermore, the requirement itself appears justified in light of the legislative history of the 1954 Code relevant to (F). Congress appears to have considered (F) reorganizations as limited to changes in a single corporation,[62] and it is this congressional belief which should shape the characteristic features of an (F) reorganization in the 1954 Code.

C. *(F) Reorganizations Today*

It is submitted that (F) reorganizations should be limited to the mere change in identity, form, or place of organization of a *single* corporation, except when an affiliated group filing a consolidated return engages in either an internal merger or merges into a single

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60. *See* notes 3-7 *supra* and accompanying text.

61. *See* INT. REV. CODE OF 1954, § 1504, which precludes brother-sister corporations from being classified as affiliated groups; thus brother-sister corporations are not able to file consolidated returns. It is arguable that since related taxpayers have the choice of several methods of filing corporate returns, once they have chosen a form which classifies them as being separate units, they should be estopped to deny their separate identities. *See* INT. REV. CODE OF 1954, §§ 11, 1501, 1561, 1562.

62. *See* text accompanying note 48 *supra*. The Tax Court's position is sustained and further evidence of Congress' interpretation is offered in the legislative history of two 1958 additions to the Internal Revenue Code—§§ 1244(d) & 4382(b). The history of both sections seems to show that Congress thought (F) reorganizations were limited changes within a single corporate structure. *See* H.R. REP. No. 2198, 85th Cong., 2d Sess. 9 (1958), *discussing* § 1223(d), which stated: "[I]n determining whether it is a small business corporation, a successor corporation in a section 368(a)(1)(F) reorganization shall be treated as the same corporation as its predecessor." Similar language is contained at 10 & 11 of the Report. *See also* INT. REV. CODE OF 1954, § 4382(b)(1)(D), which provides that the transfer taxes, etc., imposed by §§ 4301, 4311, 4331, and 4361 shall not apply in situations "whereby a mere change in identity, form, or place of organization is effected."

The relevance of § 4382(b)(1)(D) for determining the scope of (F) is questionable in light of the revenue rulings and cases dealing with this section. *See* Rev. Rul. 63-203, 1963-2 CUM. BULL. 580, which stated: "In determining the applicability of this documentary tax stamp exemption, the income tax consequences of a similar transaction of the Code pertaining to corporate reorganizations are not relevant."; *accord*, Columbus Gas, Inc. v. United States, 366 F.2d 991 (Ct. Cl. 1966); Cabot Corp. v. United States, 220 F. Supp. 261 (D. 1963) (This case involved the merger of a Massachusetts corporation and its two wholly-owned subsidiaries into a newly-formed Delaware corporation which continued the business of the old corporation. The IRS had ruled this was a § 368(a)(1)(F) and (A) reorganization but the court held that § 4382(b)(1)(D) did not apply.). *But see* S. REP. No. 2090, 85th Cong., 2d Sess. (1958), indicating the committee felt that the definitions of §§ 4382(b)(1)(D) and 368(a)(1)(F) were coextensive in scope.

newly-created corporation. The above analysis of (F) reorganizations furnishes three basic reasons for this conclusion. First, the liquidation-reorganization cases are not helpful in defining (F)'s present scope, since they failed to examine (F) within the context of the relevant tax landscape of the 1954 Code.[63] Second, a natural interpretation of section 381(b)(1) is that the congressional intent in enacting that subsection was simply to ensure that when a single corporation undergoes merely insignificant changes, it is not allowed an unwarranted additional surtax exemption.[64] Finally, the object of the carryback provision, section 381(b)(3), as viewed by Congress, was to allow a single corporation that undergoes a minor change in corporate structure to offset its post-reorganization financial losses.[65] Clearly, in the latter two provisions, Congress intended (F) to embrace only a very limited type of situation. An expansion of (F) after so long a history[66] of being relegated only to the least significant corporate changes appears ill-advised.

This limiting of (F) to changes within a single corporation only answers the first question posed at the outset of this comment: what is an (F) reorganization? The second question, whether the (F) reorganization should be the only vehicle for net operating loss carrybacks, remains open. It is at this point that the issues raised by *Estate of Stauffer* and *Associated Machine* dovetail, and again diverge, thus requiring a shift of focus.

II. A Proposal: Carry Me Back

A. *Prior Carryback Patterns*

The focus of this section of this Comment will be on the carryback of losses incurred after a reorganization or merger of brother-

63. *See* text accompanying notes 37-44 supra. In some of the cases in which the IRS's broad reading of (F) was accepted, the courts alternatively held that the transactions involved were (D) reorganizations. *See* Davant v. Commissioner, 366 F.2d 874 (5th Cir. 1966), *cert. denied*, 386 U.S. 1012 (1967); *cf.* Reef Corp. v. Commissioner, 368 F.2d 125 (5th Cir. 1966), *cert. denied*, 386 U.S. 1018 (1967).

64. The situation Congress no doubt envisioned was corporation *A* reincorporating in state X, the new corporation in state X being now *A'*. If *A* could file a closing return, it would receive one surtax exemption, and when *A'* filed a return for the year it would get another exemption. The result being that a single corporation has received the equivalent of a $50,000 surtax exemption. By enacting § 381(b)(1), Congress prevented *A'* from filing a closing return and the combined *A-A'* is treated as one taxpayer filing one return and receiving one surtax exemption. Congress was probably not considering the results of reorganization involving more than one corporation. *Cf.* text accompanying note 49 *supra*.

65. *See* text accompanying notes 48 & 49 *supra*.

66. *See, e.g.*, R. Paul, Studies in Federal Taxation (3d ed. 1940). It should also be noted that any reorganization which can qualify as an (F) reorganization also usually qualifies as some other form of reorganization. *See, e.g.*, Reef Corp. v. Commissioner, 368 F.2d 125 (5th Cir. 1966) [indicating that all (F) reorganizations also qualify as (D) reorganizations], *cert. denied*, 386 U.S. 1018 (1967); Davant v. Commissioner, 366 F.2d 874 (5th Cir. 1966) [dicta that type (F) can overlap (A), (C), and (D)], *cert. denied*, 386 U.S. 1012 (1967); Dunlap & Associates, Inc., 47 T.C. 542 (1967) [(A) and (F) can overlap]; *cf.* Cabot Corp. v. United States, 220 F. Supp. 267 (D. Mass. 1963) [IRS ruled reorganization was both (A) and (F)]. *See also, e.g.*, B. Bittker & J. Eustice, Federal Income Taxation of Corporations and Shareholders 537 (2d ed. 1966).

sister corporations resulting in a corporation which continues to engage in the same business that the brother-sister corporations had carried on before the reorganization or merger.

Before the enactment of section 381(b)(3), all carrybacks, including the carryback of post-reorganization losses to pre-reorganization years, were controlled by section 122(b) of the 1939 Code,[67] the predecessor of present section 172.[68] The relevant cases based on the 1939 Code can be separated into two categories: pre-*Libson Shops* and *Libson Shops*.[69] In the pre-*Libson Shops* cases, the lower federal courts took a narrow view of what constituted net operating loss carrybacks. These courts focused their attention on the question of whether the resulting corporation was the same as the pre-fusion corporation, whose prior income was being offset against the loss. The rule which evolved from these cases was that a post-fusion corporation could carry back a net operating loss to pre-fusion years only if the original corporation had undergone nothing more than the simplest corporate changes, such as changing its name, its place of organization, or both.[70] Any more complex change in corporate structure precluded a carryback.[71]

A different perspective to the carryback problem grew out of the Supreme Court's decision in *Libson Shops v. Koehler*[72] in 1957. *Libson Shops* involved the combination of seventeen brother-sister corporations, commonly owned and operated and engaged in the same line of business,[73] into a single corporation, owned by the same stockholders in the same proportions and engaged in the pre-reorganization line of business. After the combination, the resulting corporation

67. *See* INT. REV. CODE OF 1939, § 122(b).

68. *See* INT. REV. CODE OF 1954, § 172.

69. *See* note 73 *infra* and accompanying text.

70. *See* Newmarket Mfg. Co. v. United States, 233 F.2d 493 (1st Cir. 1956), *cert. denied*, 353 U.S. 983 (1957); *cf.* F. C. Donovan v. United States, 261 F.2d 470 (1st Cir. 1958), *vacating and remanding* 159 F. Supp. 1 (D. Mass. 1958).

71. *See* Standard Paving Co. v. Commissioner, 190 F.2d 330 (10th Cir.), *cert. denied*, 342 U.S. 860 (1951). In this case *A*, a dissolved Oklahoma corporation, transferred all its assets to its parent corporation, *B*, in a tax free reorganization in which all the stock of *A* was surrendered and cancelled. *B* received certain contracts from *A* and reported the income earned on the contracts as its own. The court held the income realized was *A*'s and had to be reported as *A*'s. The petitioners argued that if this result were correct, then *B* could carry back any net operating losses to *A*'s income. The court responded by stating at 334:

> It is a basic concept of taxation that the only person who can take a net operating loss deduction is the taxpayer who sustained the loss and therefore a successor corporation is not entitled to deduct the losses of its predecessor even though it had assumed the liabilities of the predecessors . . . [citations omitted]. We think the rule applies conversely, which would prohibit . . . (A) from deducting losses sustained by . . . (B).

See also Eleanor H. Vendig, 22 T.C. 1127 (1954). Here the assets of corporation *A* were transferred to its parent *B*, after which *A* was dissolved. *B* suffered a loss for the succeeding tax year and the requested carryback was denied.

72. 353 U.S. 382 (1957).

73. All the corporations were individual dress shops and after the merger the shops were all managed under a single corporate shell.

attempted to *carry over*[74] pre-merger losses of three of its constituent corporations to the income of the resulting corporation attributable to the assets of other constituent corporations. The Court disallowed the carryover, accepting the government's argument[75] that a prior year's loss can be offset against current income only to the extent that this income is a product of the operation of substantially the same business which produced the loss.[76] In *Libson Shops*, the Supreme Court was apparently attacking the evil of the cross-over carryover— a carryover of losses incurred by *X* business with *A* assets to income earned by *Y* business with *B* assets. If the purpose of the carryover is to allow a business to offset fat years against lean years,[77] then a cross-over carryover would undermine this policy[78] to the extent that it allows losses incurred by one business to be offset against gains attributable to a separate business.

Following the *Libson Shops* decision the IRS took the position

74. Although the case involves carryovers it is directly relevant to the carryback problem.

75. The court ignored the government's alternative argument that separately chartered corporations cannot be the same taxable entity and that therefore a corporation resulting from a statutory merger is not the same as any of its constituents. 353 U.S. at 385-86.

76. In other words, the government was requiring a continuity of business enterprise before a carryover would be permissible.

77. *See* S. REP. No. 1631, 77th Cong., 2d Sess. 51-52 (1942); H.R. REP. No. 855, 76th Cong., 1st Sess. 9-10 (1939). The history of § 122 seems to suggest Congress was only concerned with the fluctuating income of a single business. *See also* note 78 *infra*.

78. It might be argued that the tax policy objective of net operating loss carryovers is not to allow a *business* to offset fat years against lean years, but to allow *stockholders* to mitigate their tax liability by offsetting the gains of one business owned by them with the losses of another of their businesses from an earlier year. If this is in fact the rationale, then it could be additionally argued that as long as the "proper" stockholders receive the benefits of the carryover, the policies behind the carryover allowance are fulfilled, regardless of any changes in the stockholders' business. For example, suppose that two corporations, *A* and *B*, engage in different businesses but are owned by the same stockholders. If *A* incurs an operating loss in one year, and in the next year *A* merges into *B* to form resulting corporation *B'*, it might be argued that *B'* could properly carry over the loss incurred by *A* to the post-merger income of *B'* because the stockholders of *B'* are the same as the stockholders of *A* and will be receiving the benefits of the carryover. If this is a true characterization of the carryover policy, then any arguments based on the adverse effects of "cross-over" carryovers become irrelevant in this context. *See* text accompanying note 95 *infra*.

However, it should be remembered that the stockholders of *A* and *B*, at their option, originally set up *A* and *B* as separate corporate entities and have, until merger, received the benefits of separate existence. Accordingly, it would seem to work no great injustice to require these shareholders to continue to operate, for immediate post-merger carryover purposes, within the framework of separate entities which they themselves originally selected. This could be accomplished by the rule of *Libson Shops*, requiring *B'*, for the purpose of the carryover, to segregate the assets of pre-merger *A* and assets of pre-merger *B* and by allowing *B'* to apply the loss incurred by *A* only to the profits produced by the assets of *A* in the post-merger corporation *B'*. The rule thus precludes cross-over carryovers and treats the businesses as continuing separate entities for carryover purposes.

A similar argument can be made for the treatment of carrybacks and for the disallowance of cross-over carrybacks. *See* text accompanying note 95 *infra*.

that the principles of the case were equally applicable to carrybacks. Treasury Regulation section 39.122-4 stated:

> Accordingly, absent any evasion or avoidance of tax within the . . . provisions of the *1939* Code, with respect to statutory mergers and consolidations the tax treatment which is determined *under such Code,* it is held that . . . the portion of the net operating losses attributable to the assets acquired by the resultant corporation from an absorbed constituent and used in continuing the pre-fusion business of such absorbed constituent may be carried back, to the extent that they offset the pre-fusion income of that absorbed constituent, in determining the tax liabilities to which the resultant corporation has succeeded . . . .[79]

Unfortunately, this concept of segregating the assets to determine which ones have incurred the loss, and of allowing the loss to be carried back only to the pre-fusion income produced by the assets thus segregated, has not been incorporated into the 1954 Code.[80]

B. *Present Carryback Patterns*

In 1954, Congress dealt directly with the post-reorganization carryback problem by enacting a new Code section, section 381(b)(3).[81] The announced purpose of section 381, in general, was to reflect economic realities in the determination of which tax attributes a transferee corporation should inherit from a transferor corporation after a reorganization.[82] Congress did not want this determination to turn merely on the legal forms of reorganization.[83] This congressional intent permeates the whole of section 381 and, no doubt, encompasses the carryback provision.

Unfortunately, section 381(b)(3), as presently worded and applied, does not fully effectuate the expressed congressional intent. This results from the fact that section 381 only governs the resulting corporation's inheritance of the tax attributes of a transferor. If the resulting corporation is a pre-existing corporation, section 381 does not affect the continuation of its pre-reorganization tax attributes.[84] Thus, carrybacks to its own pre-reorganization tax years are still governed by section 172. Illustrative of the disparity between the avowed congressional purpose and the actual workings of the statute

79. Treas. Reg. § 39.122-4, 1959-2 CUM. BULL. 475, at 479 (emphasis added).
80. *Id.* at 480.
81. *See* text accompanying note 50 *supra.*
82. *See* H.R. REP. No. 1337, 83d Cong., 2d Sess. 41 (1954); S. REP. No. 1622, 83d Cong., 2d Sess. 52-53 (1954).
83. *Id.*
84. Illustratively, if *A* merges into *B*, an existing corporation, § 381 only specifies the tax characteristics of *A* that can be carried over to *B*. It does not affect the tax attributes of *B* which continue to be the same as before the merger. *See* INT. REV. CODE OF 1954, § 381(a).

are the regulations[85] explaining the mechanics of post-reorganization carrybacks. According to these regulations,[86] section 381 would have allowed the resulting corporation in *Associated Machine, F'*, to carry back to the pre-fusion years of *F* the net operating loss produced by the combined operations of both *E* and *F* in *F'*. Since the charter of *F* technically remained in existence, the resulting corporation, *F'*, automatically retained all the tax attributes of *F* and, under section 172, could have carried back its *entire* net operating loss to the pre-fusion income of *F*.[87] On the other hand, the resulting corporation in *Estate of Stauffer, D*, could not have carried back the post-consolidation net operating loss to the pre-consolidation incomes of any of its three constituent corporations,[88] because *D* was a "new" corporation and had no tax attributes which spanned pre-consolidation and post-consolidation years.[89] However, in *Estate of Stauffer*, had *A* first simply changed its place of organization from California to New Mexico and its name from *A* to *D*, thus qualifying as an (F) reorganization, and then acquired *B* and *C* a sufficient time later to avoid the "step-transaction" doctrine, the new *D'* could have carried the loss back to the pre-consolidation years of *A*.[90] Clearly, then, the effect of the statute is to de-emphasize economic realities and to favor form of reorganization and administrative ease.

Assuming the policies behind the carryback are similar to those of the carryover,[91] one wonders why the resulting corporations in *Estate of Stauffer* and *Associated Machine* should not be allowed to partake in the offsetting of lean years against fat years.[92] The limited carryback provisions for (F) reorganizations were included in section 381(b)(3) to soften the impact of a denial of a carryback on a financially embarrassed reorganized corporation.[93] Such a denial could have an equally adverse effect in the situations presented by the two principal cases. Therefore, it is proposed that a new vehicle be constructed to allow a limited carryback of losses by a corporation resulting from the combination of commonly controlled brother-sister corporations.

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85. See Treas. Reg. § 1.381(c)1-1(b), examples (1) and (2). The Regulation and examples (1) and (2) were derived from the legislative reports concerning § 381(b). *See* S. REP. No. 1622, 83d Cong., 2d Sess. 275-84 (1954); H.R. REP. No. 1337, 83d Cong., 2d Sess. A135-42 (1954).

86. *See* Treas. Reg. § 1.381(C)(1)-1(b), example (1).

87. *Id.; see* note 17 *supra.*

88. *See id.* example (2).

89. Section 381 does require that a resulting corporation inherit certain tax attributes of a predecessor; however, these attributes are not relevant in the carryback context. *See* INT. REV. CODE OF 1954, § 381(d).

90. *See* text accompanying note 87 *supra.*

91. *See* note 78 *supra* and text accompanying note 77 *supra.*

92. *Id.*

93. *See* text accompanying note 49 *supra.*

C. *Proposed Carryback Patterns*

Congress should revise the current carryback provisions by either enacting a new section or amending the existing sections to allow a corporation resulting from the combination of brother-sister corporations to carry back post-fusion losses to pre-fusion tax years of the component corporations. The proposed carryback would be limited to the situation in which all corporations are controlled by the same set of stockholders, in the same proportions, and in which the resulting corporation is using substantially the same assets as the pre-fusion corporations in the same line of business. This carryback would only be permitted to the extent that the taxpayer can segregate the assets and identify which pre-fusion corporation's assets produced the resulting corporation's net operating loss. The resulting corporation would be permitted to carry back each identifiable part of its loss to the appropriate pre-fusion corporation's tax years.

Under the present law, if the resulting corporation was a pre-existing corporation having losses for the three years immediately prior to the combination, it cannot carry back its net operating loss; however, if the resulting corporation had a profit for those three years, it can carry back its loss to offset such profit, whether or not any part of the loss was attributable to the assets of the pre-existing continuing component of the resulting corporation, and even if part or all of such loss was generated by the assets of a constituent corporation that had been a losing corporation during the pertinent three-year period.

The suggested approach has two distinct advantages. First, it permits a corporation resulting from a combination of brother-sister corporations to carry back and thus removes the arbitrary effect of the present law, which disregards economic realities and disallows the carryback simply because of the form of reorganization and because none of the constituent corporations' charters was carried over to the resulting corporation.[94] Second, this scheme would prevent cross-over carrybacks—the carryback of losses attributable to the assets of one constituent corporation to the pre-fusion years of another constituent corporation. Such cross-over carrybacks can result under the present Code and regulations, which allow the resulting corporation to carry back its entire loss to the extent that its pre-existing continuing component corporation, determined only by the form of the combination, had prior income to sustain the carryback.[95] Admittedly, the administrative ease reflected by the present rules is somewhat sacrificed by the suggested approach; however, it is believed

94. *Cf.* Treas. Reg. § 1.381(C)(1)(b), example (1) and text accompanying notes 92-96 *supra.*

95. *See* text accompanying notes 86-90 *supra.*

that by placing the burden on the taxpayer to segregate, the administrative burdens are lessened.

The above proposal is only designed to meet the problem of post-reorganization carrybacks after a fusion of commonly controlled brother-sister corporations engaged in the same line of business. It is submitted, however, that this is not the only situation in which there is need for a revision of the present carryback provisions. In this connection, it should be noted that the rules of section 381(b)(3) as interpreted by the regulations could serve as a pattern for meeting many of these additional problems, if they were utilized in a more sophisticated manner. For example, consider the regulation dealing with the consolidation of *A*, *B*, and *C* into a newly-formed corporation, *D*.[96] This regulation, denying any carryback, could be applied to complex reorganizations, in which there is a substantial shift in the identity of the shareholders, a significant change in the line of business, and a shuffling of assets so as to produce a resulting corporation that is analytically identical to a completely new corporation. A new corporation has no tax history; likewise, the resulting corporation in the situation described, being sufficiently akin to a new corporation, has no meaningful tax history and consequently should not be able to carry back any loss incurred after its creation to any of the tax years of its constituents. Thus, the current regulation, which precludes the carryback, is entirely proper if it is limited to these complex reorganizations.

On the other hand, the regulation dealing with the merger of *E* and *F* into *F'*,[97] which permits a limited carryback, could be applied to less complex reorganizations, such as those which involve only minor shifts in stockholders or line of business, and which are analytically similar to the acquisition of new assets to be used in the acquiring corporation's pre-acquisition business. When an existing corporation simply adds assets to a continuing business, it still can carry back losses produced by the combined assets to income produced by the business before the acquisition. In fact, to allow this carryback is entirely consistent with the general tax policy of encouraging business expansion. The result should not be different where the acquiring company embraces an entire sister business, controlled primarily by the same stockholders, where the effect is essentially the same as simply acquiring stray assets.

All of these suggestions have complex ramifications and require a further development of details. Nevertheless, if the objective is to reflect economic realities, the goal sought would appear to justify the increased difficulties.

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96. *See* Treas. Reg. § 1.381(C)(1)(b), example (2).
97. *See id.*, example (1).