Among the inequities inherent in our system of progressive taxation are those which arise from the annual basis of taxation. Congress has attempted to remedy the resulting inequities by allowing the taxpayer to "set off its lean years against its lush years" through the use of the net operating loss deduction, carrying forward and back in time the deficit of the loss years so as to reduce the taxable income in profitable years. Through this mechanism Congress has attempted "to strike something like an average taxable income computed over a period longer than one year." This process of averaging, first written into the law in 1918, is desirable for various reasons: it places taxpayers with fluctuating incomes (those that in some years sustain a loss) in roughly the same position as those with stable incomes; it encourages investment in new business, since losses which may occur in early years can be offset against later profits; it encourages investment in businesses with greater risk of loss, which may be economically desirable; less obviously, it is said to ameliorate the highs and lows of business cycles, for carryovers may result in refunds during recessions and thus encourage expenditures in such periods.

From these reasons, the intent of Congress in providing for carryovers appears to be that this relief should only be available to the person who actually suffered the economic loss. Yet, since this relief apparently followed the taxpaying unit (i.e., the corporation), both individual and

5 The Revenue Act of 1918, ch. 18, § 204(b), 40 Stat. 1061, permitted net losses to be carried back one year and forward one year.
7 Ibid.
8 Treasury Department & Joint Comm. on Internal Revenue Taxation, Business Loss Offsets, reprinted in Hearings Before the House Committee on Ways and Means on Revenue Revisions, 80th Cong., 1st Sess., pt. 5, at 3784 (1947).
9 Ibid.
corporate taxpayers who had not originally incurred a loss attempted to obtain the benefits of the carryover privileges.\textsuperscript{11} These attempts arise in two general areas, the "multiple" and the "single" corporation situations.\textsuperscript{12} Although there are situations in which these categories overlap, this comment is organized on the basis of the "multiple" and "single" categorization since it is the one employed by the Internal Revenue Code of 1954.\textsuperscript{13} The "multiple" corporation situation arises when, through some type of reorganization or merger, a profitable corporation attempts to take advantage of the past misadventures of a corporation with a history of losses in order to reduce its tax liability, or when a loss corporation merges with a profitable corporation in order to take advantage of its losses. In the "single" corporation situation an individual or a corporation simply obtains control of a "going" or a "shell" corporation with a history of losses,\textsuperscript{14} puts into that corporation profitable assets and attempts to offset the losses prior to the change in ownership of the corporation against profits earned subsequent to the change of ownership.\textsuperscript{15}

Since the 1954 Code sets down specific rules to govern the allowance of carryovers, the impact of the Supreme Court decision in \textit{Libson Shops, Inc. v. Koehler}\textsuperscript{16} is most immediate in cases arising under the 1939 Code; there are, however, general principles to be drawn from this case which are also applicable under the 1954 Code. Thus an inquiry into the meaning of the \textit{Libson Shops} doctrine is warranted, although most of the controversies arising under the 1939 Code have already been decided.

\section{I. THE "MULTIPLE CORPORATION" CASES}

The first attempt at trafficking in net operating losses to reach the Supreme Court was \textit{Woolford Realty Co. v. Rose}.\textsuperscript{17} The case involved

\begin{itemize}
  \item \textsuperscript{11} It has been argued that "the tax law need not be concerned whether the interests which suffered the loss recoup by selling it or recoup by going forward themselves." Tarleau, \textit{Difficulties Faced by Taxpayer Trying to Take Tax Advantage of a Loss Carryover}, 4 J. Taxation 91, 94 (1956). Cf. Arent, \textit{Current Developments Affecting Loss Corporations}, 35 Taxes 956 (1957); Smith, \textit{Federal Tax Reform} 224-25 (1961). But quite clearly this is precisely what concerned Congress.
  \item \textsuperscript{12} There is also a third situation—the divisive reorganization (spin-offs, split-offs and split-ups)—but this area has not been the subject of much litigation on the carryover question.
  \item \textsuperscript{13} \textit{Int. Rev. Code} of 1954, § 381(a) relates to "multiple corporations," whereas § 382(a) relates to the "single corporation" situation.
  \item \textsuperscript{14} A "going" corporation is one containing operating assets, whereas a "shell" corporation is generally no more than a corporate charter.
  \item \textsuperscript{15} For a detailed discussion of the various situations in which this problem might arise, see Note, 69 \textit{Yale L.J.} 1201, 1268-90 (1960).
  \item \textsuperscript{17} 286 U.S. 319 (1932).
\end{itemize}
a consolidated return, but arose before the consolidated return regulations had any provisions disallowing a carryover of losses from one affiliate during a separate return year to the profits of another affiliate earned during the year in which a consolidated return was filed. In denying the carryover in precisely such a situation, the Court expressed its disapproval of allowing tax benefits to be obtained by juggling: "To such an attempt the reaction of an impartial mind is little short of instinctive that the deduction is unreasonable and cannot have been intended by the framers of the statute."18

Instead of maintaining this straightforward attitude of looking to the purposes behind the carryover provisions, just two years later, in *New Colonial Ice Co. v. Helvering*,19 the Court tied itself to an inflexible conceptual test. *New Colonial* involved a formal change of corporate entity pursuant to a reorganization. All of the assets and the business of the older corporation were taken over by the taxpayer, which was specifically organized for that purpose by the shareholders of the older corporation. The successor corporation was basically the same as its predecessor, but the Supreme Court refused to allow the successor corporation to deduct the pre-reorganization losses of the predecessor on the ground that the two corporations were not the "same taxpayer." Clearly, if the two corporations in *New Colonial* were to be considered as separate taxpayers, only when the corporate entity remained unchanged would the "same taxpayer" be involved for purposes of the carryover deduction.

The "corporate entity" concept was rigorously applied by the courts20 until *Stanton Brewery, Inc. v. Commissioner*,21 which involved the merger of a wholly-owned subsidiary into its parent holding company. Although the emerged corporation could not be regarded as the same corporate entity as the subsidiary, the Second Circuit held that the "evident statutory purpose" required the allowance of a carryover from the subsidiary to the emerged corporation since "essentially a continuing enterprise" was involved.22 The court seemed to reason that since the corporation

18 Id. at 330.
20 See, e.g., Standard Paving Co. v. Commissioner, 190 F.2d 330 (10th Cir. 1951); Weber Flour Mills Co. v. Commissioner, 82 F.2d 764 (10th Cir. 1936); Pennsylvania Co. v. Commissioner, 75 F.2d 719 (3d Cir. 1935); Shreveport Producing & Refining Co. v. Commissioner, 71 F.2d 972 (5th Cir. 1934); Brandon Corp. v. Commissioner, 71 F.2d 762 (4th Cir. 1934).
21 176 F.2d 573 (2d Cir. 1949), reversing, 11 T.C. 310 (1948). This case involved an excess profits tax credit, but for the purposes of this comment it is not necessary to draw a distinction between the carryover of excess profits tax credits and the carryover of net operating losses.
22 176 F.2d at 577. It should be noted that before the merger the subsidiary was not
resulting from a statutory merger is required to assume the obligations of its components, it should also be accorded the privileges of its components.23 New Colonial was mentioned by the court, but was not explicitly distinguished.24

The Court of Claims exhibited a somewhat different style of reasoning in Koppers Co. v. United States.25 The taxpayer was the product of a merger of a parent and subsidiary which had filed consolidated returns prior to the merger. In allowing the carryback of an excess profits tax credit to reduce the consolidated excess profits tax of the pre-merger corporations, the court emphasized not that the merger was statutory, but that the taxpayer continued in the same business with substantially the same ownership, and that absent the merger the predecessor corporations would have enjoyed the tax privileges in question.

In Newmarket Mfg. Co. v. United States,26 a carryback was allowed in a case where the taxpayer merely changed its state of incorporation from Massachusetts to Delaware through the mechanism of a statutory merger with a newly formed Delaware corporation. Once again there was a changed corporate entity, but New Colonial was distinguished on the ground that it did not involve a statutory merger. In discussing the purpose of the loss carryover provisions of the statute, the court rejected the artificial entity concept, since "income-taxwise, there is no more reason why the Congress should choose to attach crucial significance to a quite wholly owned—one hundred shares of the subsidiary were not owned by the parent. These shares were purchased by the parent immediately prior to the merger.

23 This reasoning stemmed from Helvering v. Metropolitan Edison Co., 306 U.S. 522 (1939), where the Supreme Court held that a corporation surviving a statutory or a de facto merger could deduct the unamortized discount on bonds issued by a pre-existing subsidiary.

24 Learned Hand, J., dissented: "A statute so intricate and detailed as this leaves little latitude for interpretation. Moreover, I do not think that it is more consistent with any declared purpose that I can find, to extend the privilege of a 'carry-over' to the taxpayer at bar. . . . [P]rivileges, closely akin in purpose to this, are ordinarily lost by transfers by one corporation to another; and the form of the transfer cannot be important. We have no warrant for supposing that Congress in general regards such credits as parts of a 'universitas juris' passing, with the chattels, choses in action and the rest, like goodwill or trade-marks." 176 F.2d at 578. Cf. E. & J. Gallo Winery v. Commissioner, 227 F.2d 699 (9th Cir. 1955), reversing, 12 CCH Tax Ct. Mem. 414 (1953), where two operating companies, apparently totally unrelated in ownership, rather than a parent and subsidiary, were merged. The court, relying on Stanton Brewery, allowed the surviving corporation to use the unused excess profits tax credit of the merged corporation and held that state law controlled as to whether a statutory merger had taken place.


mere change of corporate domicile than it would to a change of an individual taxpayer's domicile from Massachusetts to Delaware."^{27}

At this point confusion reigned.\textsuperscript{28} New Colonial and its progeny seemed to dictate that if the carryover privilege is to be allowed the corporate taxpayer, there must be no change in the corporate entity.\textsuperscript{29} Stanton Brewery could be interpreted to mean that any corporation resulting from a statutory merger was entitled to the tax attributes of its predecessors. And Koppers and Newmarket suggested a "substance over form" rule—whether "but for" the change in corporate organization the carryover would have been available.

Congress attempted to set up clear rules in the 1954 Code, but only the Supreme Court could resolve the confusion for cases arising in prior years. The opportunity arose in \textit{Libson Shops, Inc. v. Koehler}.\textsuperscript{30} The issue was whether, under the 1939 Code,\textsuperscript{31} a corporation resulting from the merger of seventeen corporations may carry over the pre-merger net operating losses of three of the predecessor corporations to its post-merger income.

The taxpayer was incorporated in order to provide management services for sixteen corporations selling women's clothing in retail shops. The sixteen sales corporations and the management corporation were owned, directly or indirectly, by the same individuals in the same proportions, but were operated independently of each other and filed separate income tax returns. After a statutory merger of the seventeen corporations, with its corporate purposes expanded and the par value of its stock revised, the taxpayer conducted the entire business as a single enterprise. In the period prior to the merger three of the retail shops showed net operating losses; in the period following the merger, the same three shops continued to sustain losses.

In the Supreme Court the taxpayer relied on Stanton Brewery to argue that "a carryover is allowable in a statutory merger"\textsuperscript{32} and argued further that the statute, construed in light of its purpose, entitled the

\textsuperscript{27} Id. at 497.
\textsuperscript{29} In this comment the characterization "entity concept" or "entity theory" is meant to refer to the doctrine of New Colonial—that a carryover is only allowed if the gain and loss corporation possess the same corporate charter and identity. The Stanton result is considered an exception to this concept. This clarification is necessary since some courts and commentators include within the "entity concept" both the New Colonial decision and the Stanton exception, reasoning that the same entity continues in existence after a statutory merger.
\textsuperscript{31} INT. REV. CODE OF 1939, ch. 247, §§ 211(a), (b), 53 Stat. 867.
taxpayer to the carryover because "tax-wise, it stands in the same position as each of the merged corporations."\textsuperscript{33} The Government argued from \textit{New Colonial} that since the taxpayer was a different taxable entity, it was not entitled to the carryover. Alternatively, the Government relied on \textit{Stanton Brewery}, \textit{Koppers} and \textit{Newmarket} to argue that the carryover privilege could not be accorded unless there was "continuity of the business enterprise."\textsuperscript{34} The Government argued that this factor was lacking since not only the three loss corporations, but all sixteen operating corporations, were merged. The point seized upon by the Court, perhaps as the decisive one, was however that since the three loss stores continued to operate at a loss after the merger, the taxpayer was claiming a tax benefit to which it would not have been entitled in the absence of a merger.

The Court did not encounter any difficulty in denying the carryover:

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.\textsuperscript{35}

\textsuperscript{33} Id. at 10.

\textsuperscript{34} Brief for Respondent, p. 5, Libson Shops, Inc. v. Koehler, 353 U.S. 382 (1957).

\textsuperscript{35} 353 U.S. at 386-87 (footnotes omitted). This is the most crucial language in the opinion. It has been quoted, in part, in approximately one-third of the cases citing \textit{Libson Shops}. In Cuddihy, \textit{Methods of Utilizing Loss Carryovers: Safe, Doubtful and Forbidden}, 8 J. TAXATION 72 (1958), it is argued that the Court lacked authority for the statement made in the last sentence since the only authority relied upon was a report of the House Committee on Ways and Means on the Revenue Act of 1939, ch. 247, 53 Stat. 862, 867-68, at H.R. REP. No. 855, 76th Cong., 1st Sess. 9 (1939), where it was stated that the purpose of the carryover was that "a business with alternating profit and loss [not be] required to pay higher tax over a period of years than a business with stable profits, although the average income of the two firms is equal." The Court emphasized the word "business," inferring from that word a congressional intent that the carryover privilege be applied only to the "fluctuating income of a single business." The criticism is that the Court should have found support in the legislation passed by the Congress rather than in its committee pronouncements. It would seem, on the contrary, that the committee report is valid support for a rather obvious proposition, that Congress did not intend to create a market for corporations with net operating losses.
Under the doctrine of "continuity of business enterprise," all the cases relied on by the taxpayer could be reconciled. Stanton, the Second Circuit had said, involved "essentially a continuing enterprise." In Newmarket the change of entity was but a means of changing domicile. In both cases the deductions would have been allowed without the merger, whereas in Libson Shops neither the loss nor the profitable constituent corporations could have availed themselves of the benefit of the carryover had there been no merger. And Koppers, because the constituent corporations were affiliated for tax purposes before the merger, would seem to have involved the same taxable enterprise both before and after the merger.

The Court failed to discuss New Colonial; in fact, the Libson Shops opinion failed to enunciate at all what were the ingredients of "continuity of business enterprise." The commentators were uncertain as to whether Libson Shops was setting up a new criterion or refining an old one, whether continuity of business enterprise was to be the sole criterion as to the allowability of a carryover or whether a statutory merger was still to be required. The Commissioner interpreted the decision to require a statutory merger.

The Commissioner's test for "continuity of business enterprise" was an asset test. He ruled that losses and unused excess profits tax credits could be carried over to "offset income of the resultant corporation attributable to the assets acquired by it from the absorbed constituent." He also ruled that losses and credits of the resultant corporation attributable to the assets acquired from the absorbed corporation could be carried back to offset pre-fusion income of the absorbed corporation. As to situations where the constituents filed consolidated returns before the statutory merger, the Commissioner ruled that continuity would be found to the extent that "the resultant corporation conducts the same businesses as previously operated by the constituent corporations."

36 Stanton Brewery, Inc. v. Commissioner, 176 F.2d 573, 577 (2d Cir. 1949).
37 The failure of the Court to discuss New Colonial is regrettable. Whatever the "continuity of business enterprise" test is, it certainly is not the "entity" test of New Colonial. The Court should have either distinguished the case or overruled it. Cf. Llewellyn, The Common Law Tradition 256 (1960).
40 Rev. Rul. 59-395, 1959-2 Cum. Bull. 475. The Commissioner placed great emphasis on the fact that all of the cases cited by the Supreme Court in Libson Shops in defining "continuity" were cases that involved statutory mergers.
42 Ibid.
43 Ibid. All three of these seem to be simple "but for" tests, supplemented by the requirement that the merger be statutory. The Commissioner failed to distinguish
The first cases to reach a court of appeals after *Libson Shops* involved statutory mergers, so the court did not have to decide whether a statutory merger was a prerequisite to the allowance of a carryover. That question was presented, however, in *F.C. Donovan, Inc. v. United States*, a case involving a tax-free reorganization. The taxpayer was organized to deal in leather goods and its wholly owned subsidiary to deal in plastics. Prior to the merger at the end of 1946, in which the taxpayer was the emerging corporation, both corporations were profitable. In 1947 the plastics division sustained a loss; in 1948 only the leather division sustained a loss. The Commissioner allowed the 1947 plastics losses to be carried back to the 1945 and 1946 income of the leather corporation, but refused to allow the carryback of the remaining plastics division loss to the pre-merger income of the plastics subsidiary, on the theory that losses could only be carried back to the income of the same corporate entity. The taxpayer argued that the plastics losses should have been carried back to the pre-merger plastics income, so that the leather division losses could be offset against prior income of the leather corporation, and the court agreed. Looking not to the continuity of assets, between the "asset" test and the "conducting the same business" test. Perhaps these tests cannot be distinguished. But see text accompanying note 54 infra. For other interpretations of the meaning of "continuity of business enterprise," see Levine & Petta, supra note 38; Note, 69 Yale L.J. 1201, 1227 (1960). Cf. Treas. Reg. § 1.382(a)-1(h) (1962).

44 Old Nat'l Bank v. Commissioner, 256 F.2d 639 (7th Cir. 1958), reversing in part 28 T.C. 1075 (1957); Patten Fine Papers, Inc. v. Commissioner, 249 F.2d 776 (7th Cir. 1957). The Old Nat'l Bank case and Dumont-Airplane & Marine Instruments, Inc., 28 T.C. 1308 (1957), were the first cases to be decided by the Tax Court after *Libson Shops*. In both cases *Libson Shops* and *New Colonial* were cited by the Tax Court and the carryovers were denied. In the former, the Tax Court held that the income against which the offset was claimed "was not produced substantially by the same business which had the excess profits credit." 28 T.C. at 1078. In the latter, a carryback of an unused excess profits credit was denied, seemingly because the amalgamation was by tax-free reorganization rather than by statutory merger. The Tax Court relied on both *New Colonial* and *Libson Shops* to reach this result. See 28 T.C. at 1315-16.

In the Patten Fine Papers case, *Libson Shops* was first applied to a situation involving a capital loss carryover and a merger between two related personal holding companies. The carryover was denied since the merged corporation had ceased to do business, and "when it was dissolved, there was no continuity of its business." 249 F.2d at 780. The Seventh Circuit, however, felt a necessity to go further, stating that a statutory merger was necessary to "continuity." Ibid. This case also involved an attempt by the taxpayer to carry over a capital loss from a year when separate returns were filed, to capital gain in a year when consolidated returns were filed. This situation is governed by Treas. Reg. 104, § 23-31(d)(10) (1944), issued pursuant to § 141 of the 1939 Code. For a discussion of the applicability of the *Libson Shops* principle to this situation, see Phinney v. Houston Oil Field Material Co., 252 F.2d 357 (5th Cir. 1958).

45 261 F.2d 470 (1st Cir. 1958). Whether a tax-free reorganization under § 112 of the 1939 Code exists is determined by tax law, whereas whether a merger is statutory is determined by state law.
but to the fact that the loss was incurred and the income was earned by the same business, the court stressed that but for the merger the carry-back would have been allowed. The "corporate entity" theory of New Colonial was rejected, and "continuity of enterprise" was found even though the case involved a tax-free reorganization and not a statutory merger.

In Bookwalter v. Hutchens Metal Prod., Inc., for the first time since Libson Shops, a carryover was denied in a situation involving a statutory merger. Two "closely related" and economically integrated corporations, having substantially the same shareholders, officers and directors, were merged to form the taxpayer. The court considered these factors to be immaterial and denied the carryover. That different assets were involved did not appear to influence the court as much as the fact that the losses were incurred by a different business than that which produced the income subsequent to the merger. The court found that absent the merger the deduction would not have been obtained.

Foremost Dairies, Inc. v. Tomlinson construed Libson Shops to require continuity of assets. After a merger in which the owners of the loss corporation received only twenty-seven per cent of the stock of the emerged corporation, the taxpayer attempted to carry over its pre-merger losses to its post-merger income. Neither the fact that the loss corporation was the survivor of the merger, nor the legal formalities followed in effectuating the merger, was considered material by the court, which said, however, that it took into consideration the change in ownership of the corporation. Even so, the carryover was allowed to the extent that the assets of the pre-merger loss corporation contributed to the post-merger profits:

46 The court distinguished New Colonial on the ground that it arose under the Revenue Act of 1921, which did not provide for tax-free reorganizations. "If we should hold, in the present case, that the effectuation of such a reorganization has resulted in cutting out a carry-back privilege which otherwise existed, we would be defeating the essential purposes of the Congress in enacting the provisions for tax-free reorganizations." 261 F.2d at 476.


48 281 F.2d 174 (8th Cir. 1960).

49 Cf. Irving-Kolmar Corp., 35 T.C. 712 (1961), where, although there was "continuity of ownership" but no statutory merger, the carryover was denied because the predecessor loss corporation was engaged in a different business than the profitable successor corporation.

50 63-2 U.S. Tax Cas. 89568 (M.D. Fla. 1963).
[T]he continuity of business enterprise theory in *Libson Shops* means that where a loss corporation and a gain corporation are merged, pre-merger losses may be offset against post-merger gains only to the extent that the business which was previously operating at a loss is now operating at a profit. Furthermore, the business referred to in the sentence above does not mean the formal legal entity but rather the bundle of assets which previously constituted the pre-merger business unit.\(^5\)

In *Julius Garfinckel & Co. v. Commissioner*,\(^6\) once again the loss corporation survived the merger,\(^7\) and once again the deduction was allowed only to the extent that the assets and business which had incurred the losses produced a profit. That both corporations were in the same line of business was not deemed material by the court.

The one recurring theme in the cases following *Libson Shops* is whether absent the merger the corporation incurring the loss would have obtained the carryover. The Supreme Court's statement that the carryover is to be allowed to the extent that the income against which the offset is claimed is "produced by substantially the same businesses which incurred the losses"\(^8\) has been interpreted by some courts to mean a "continuity of assets" and by others to mean a "continuity of business." But it is doubtful that a strict asset test was meant since such a test would allow carryovers only when the specific assets which incurred the loss produce the income, thus discouraging new investment and expansion. The continuity of business test would allow a carryover without requiring that uneconomic assets be maintained in operation.

The entity concept of *New Colonial* has been buried, and the statutory merger requirement has been abandoned. Whether the gain or loss corporation survives is immaterial; and, although some courts consider "continuity of ownership" to be a relevant factor, it has never been held to be necessary to the allowance of a carryover.\(^9\) In *Newmarket*...

\(^{5}\) *Id.* at 89589.

\(^{6}\) 335 F.2d 744 (2d Cir. 1964), *cert. denied*, 85 Sup. Ct. 651 (1965).

\(^{7}\) In both these cases the loss corporation was the one to survive the merger and the court in each held that fact to be immaterial. Levine & Petta, *supra* note 38, suggested that *Libson Shops* would have been decided differently had the profitable corporations merged into the loss corporations. These cases, at least, would seem to repudiate that suggestion.


\(^{9}\) See also Fawick Corp., 23 CCH Tax Ct. Mem. 194 (1964) (carryover allowed on basis of asset test although there was a 51.2% change in the ownership of the surviving corporation). *But see* Federal Cement Tile Co., 40 T.C. 1028 (1963), *aff'd*, 338 F.2d 691 (7th Cir. 1964), where the Tax Court stated that since in *Libson Shops* there was no
and Donovan continuity of ownership was said to be important; whereas in Hutchens the fact of continuity of ownership was deemed immaterial. In Garfinckel there was some change in ownership but no change in control and the carryover was denied; whereas in Foremost the carryover was allowed although there was a seventy-three per cent change in ownership. In the final analysis, the decisive question is: would the deduction have been available to the loss corporation absent the amalgamation? The answer depends on whether or not the income from which the loss is to be deducted was produced by the assets (whether or not improved) which incurred the loss.

II. The “Single Corporation” Cases

The law dealing with the “single corporation” situation developed differently. Before Libson Shops, the entity concept was most strictly applied in this area. An exemplary case is Alprosa Watch Corp., where the Tax Court allowed a carryover, even though a complete change in ownership occurred and the business changed from manufacturing gloves to manufacturing watches, because the taxable entity remained unchanged. Then, only section 129 of the 1939 Code restricted tax-free trading in net operating loss carryovers. The test in that section turned upon whether tax avoidance or evasion motivated the taxpayer’s acquisition of a corporation with beneficial tax attributes. This subjective test was a flimsy barrier against tax avoidance schemes.

The logical inference from the Libson Shops decision was that the entity concept would also be abandoned in the single corporation area. The Supreme Court, however, had refused to pass on situations where “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.”

Mill Ridge Coal Co. v. Patterson was the first case to raise the question of whether Libson Shops’ reasoning applied to the single corporation area. There, after incurring losses in the coal business, the taxpayer cor-

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58 The difficulty with this section was that in order to activate it the principal purpose of the acquisition had to be tax avoidance or evasion. It is not overly difficult to find business motives for such transactions.
60 264 F.2d 713 (5th Cir.), cert. denied, 361 U.S. 816 (1959).
poration disposed of its assets and remained inactive for more than a year; ownership changed completely, the corporation entered the oil business and the taxpayer sought to carry over the coal business losses to income from the oil business. The district court, relying on Libson Shops, denied the carryover because "the income against which the offset was claimed was not produced by substantially the same business which incurred the loss." The court of appeals agreed with the district court as to the applicability of Libson Shops, but preferred to rely on section 129 of the 1939 Code—the obvious principal purpose of the acquisition was the avoidance of taxes—and the general applicability of the Libson Shops reasoning remained unsettled.

After the Mill Ridge case there was disagreement as to whether the same result would have been reached had there been a change in business but no change in ownership. Kolker Bros., Inc., a case involving a forty-six per cent change of ownership, where the business was changed from a retail grocery and liquor store to an enterprise selling food to hotels and restaurants, raised this question. But the Tax Court avoided it and allowed the carryover, holding that both the income and the losses resulted from the same business, the retail sale of food, although different types of customers were involved. Mill Ridge was not distinguished, nor was the change of ownership mentioned. The decision would have been consistent with the analysis in this comment had the holding been that a change in the ownership of a non-controlling interest in the taxpayer, although coupled with a change in business, was insufficient grounds for denying a carryover.

That Libson Shops applied to the single corporation situation and that a change in ownership accompanied by a change in business together could be sufficient to negate a finding of "continuity of business enterprise" was made clear by the Tax Court's decision in J.G. Dudley

62 The first case to reach the Tax Court after this ground-breaking district court decision was British Motor Car Distrib., Ltd., 31 T.C. 437 (1958), rev'd, 278 F.2d 392 (9th Cir. 1960). In this case there was a change in control, a change in business and tax avoidance motives. The Tax Court refused to follow the reasoning of the district court in Mill Ridge and distinguished Libson Shops on the facts. The reversal was on the ground that § 129 applied.
63 Levine & Petta, Libson Shops Applied to the Single Corporate Taxpayer, 36 TAXES 562 (1958) (the result is dependent on the change in ownership); American Bar Ass'n Tax Recommendations (H.R. 10591), 6 CCH 1960 STAND. FED. TAX REP. ¶ 6347 (result dependent on change in business); Speiller, Acquisition by Loss Corporation of Profitable Businesses, 40 TAXES 22 (1962) (result dependent on change in ownership).
64 85 T.C. 299 (1960).
65 Id. at 305.
The case involved a thirteen month period of corporate inactivity, an almost complete change in ownership and a change in business from the manufacture of hosiery to plumbing. Relying upon Libson Shops and Mill Ridge for the "continuity of business enterprise" standard, the court denied the carryover of losses from the hosiery business to the plumbing business. Although the taxpayer's prolonged inactivity indicated strong tax avoidance motives, they were deemed immaterial. But the question remained, with how large a change in ownership would a carryover still be permissible?

The Commissioner apparently took the position in litigation that if there was a change in the taxpayer's business, Libson Shops should be applied, even if there was no change or only a small change in the ownership of the taxpayer. Collins v. United States illustrates this, for the losses that were denied carryover treatment there arose after the change in ownership, but prior to the change in business. Eighty per cent of the stock of Priscilla, a manufacturer of worsted yarns with a history of net operating losses, was purchased by Collins, a wholesaler of wool and mohair. From the acquisition date to the end of Collins' fiscal year, Priscilla sustained further operating losses and losses from the sale of equipment. Then Priscilla began operations as a wool and mohair wholesaler, later changing its name to Collins Wool Corp. The question was whether the losses from the post-acquisition manufacture of worsted yarns could be carried over to income derived from the wholesale business. The district court denied the carryover on the basis of section 129 of the 1939 Code, emphasizing that Libson Shops would also have precluded the carryover. The court of appeals, however, affirmed solely on the basis of the tax avoidance purpose of the acquisition.

Judge Aldridge in dissent, however, disputed the district court's treatment of Libson Shops:

In Kolker Bros., Inc., 35 T.C. 299 (1960), see text accompanying note 64 supra, the change in ownership was of only 46%. The court allowed the carryover, but avoided holding that a 46% change in ownership was insufficient to deny the carryover, focusing instead on the slightness of the change in business. Yet it would seem that it was really the lack of sufficient change in ownership which was determinative. This is demonstrated by Commissioner v. Virginia Metal Prods., Inc., 290 F.2d 675 (3d Cir.), cert. denied, 368 U.S. 889 (1961), where the change in business was also slight (from manufacture of aluminum storm doors to manufacture of steel partitions), but where there was a 100% change in ownership. The carryover was denied on the ground that there was a change in business. When this case is compared on its facts to Kolker, the critical question would seem to relate to the percentage of the change of ownership.

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67 36 T.C. 1122 (1961), aff'd, 298 F.2d 750 (4th Cir. 1962).
68 36 T.C. at 1127.
69 In Kolker Bros., Inc., 35 T.C. 299 (1960), see text accompanying note 64 supra, the change in ownership was of only 46%. The court allowed the carryover, but avoided holding that a 46% change in ownership was insufficient to deny the carryover, focusing instead on the slightness of the change in business. Yet it would seem that it was really the lack of sufficient change in ownership which was determinative. This is demonstrated by Commissioner v. Virginia Metal Prods., Inc., 290 F.2d 675 (3d Cir.), cert. denied, 368 U.S. 889 (1961), where the change in business was also slight (from manufacture of aluminum storm doors to manufacture of steel partitions), but where there was a 100% change in ownership. The carryover was denied on the ground that there was a change in business. When this case is compared on its facts to Kolker, the critical question would seem to relate to the percentage of the change of ownership.
The . . . lower court cases [subsequent to Libson Shops] which have been decided against taxpayers involved a change of ownership of the company along with the change in business. It would be one thing to prevent trading in tax losses by preventing a new party from acquiring a built in tax loss for a new business, but something else to say that a taxpayer who has himself incurred a bona fide loss must lose the deduction if he changes the nature of his business.\textsuperscript{72}

\textit{Huyler's v. Commissioner,}\textsuperscript{73} however, further buttressed the Commissioner's position that a small change in ownership should suffice to deny the carryover if accompanied by a change in business. The case involved a taxpayer, engaged in the restaurant business, that was reorganized in December 1952 under Chapter X of the Bankruptcy Act. In March 1953 the taxpayer acquired the assets of an aluminum manufacturing corporation; these assets produced income from the date of their acquisition and in the meantime the restaurant operations were being discontinued. In 1954 there was a forty-eight per cent change in ownership—twenty-four per cent in May and an additional twenty-four per cent in August. One of the issues involved in the case was whether the taxpayer could carry over post-reorganization losses incurred in the restaurant business during the fiscal year ending June 30, 1953 to income from the aluminum business in the fiscal year ending June 30, 1954.

The Seventh Circuit denied the carryover, employing the rather strained argument that since the pre-reorganization losses of fiscal year 1953 could not be carried over to post-reorganization income, the post-reorganization losses of fiscal year 1953 could not be carried over to fiscal year 1954, because that would be a fragmenting of fiscal year 1953 contrary to the concept of the annual accounting principle as expressed in \textit{Burnet v. Sanford \\& Brooks Co.}\textsuperscript{74} Awkward as it is, the argument could have been sufficient; instead, the court relied on a revenue ruling to state further that under an expanded view of \textit{Libson Shops} the deduction would have been denied anyway, since the twenty-four per cent change in ownership in May 1954 was more than minor.\textsuperscript{75}

The unlikely result of this decision is that income cannot be set off

\textsuperscript{72} 303 F.2d at 149 n.3.

\textsuperscript{73} 327 F.2d 767 (7th Cir. 1964), \textit{affirming}, 38 T.C. 773 (1962).

\textsuperscript{74} 282 U.S. 359 (1931). \textit{Huyler's} seems quite clearly contrary to the policy behind the Bankruptcy Act, which is presumably to afford a business the opportunity to start anew, without being burdened by its past liabilities. Yet, had the corporation in this case just been incorporated in December 1952, it would undoubtedly have been entitled to the carryover.

against a loss when both are incurred within a period when no change of ownership has occurred (in this case between December 1952 and May 1954), if at the end of the period there is a change of ownership which does not coincide with the end of the fiscal year. Had the decision held that losses from fiscal year 1953 could not be set off against income made after the change in ownership in 1954, the decision would have been more plausible. But even then, the decision seems unwarranted in that the change of ownership considered too great by the court was a change of only twenty-four per cent. As to why a twenty-four per cent change in ownership should be sufficient reason for denying the carryover, the court gave no explanation.

Thus, under this last interpretation of Libson Shops, it would appear that under the 1939 Code, if there is a change in the business of the corporation accompanied by a more than minor change in the ownership of the corporation, a carryover of pre-change losses to post-change income will not be allowed. Although the question has not arisen in this area, it would seem that when after a more than minor change in ownership the new owners add a new line to the business, the continuity of business test could be applied to allow a carryover to the extent that the post-change income is produced by the business which incurred the pre-change loss. Although there is dictum to the contrary,76 it seems quite clear that when there is no change in business, the carryover will be allowed under Libson Shops. Finally, although the reasoning in Huyler's and Kolker Bros. create some doubt, where there has been no change in ownership but a change in business, the carryover is allowed.

This has been the manner in which the courts have handled the problems created by the loss carryover provisions. In determining whether or not the lines and distinctions have been drawn in accordance with congressional policy, it is important to note that it was quite clearly not the intention of Congress to provide for an open market in net operating loss carryovers.77 "Thus," in the words of one commentator, "where the corporate existence is not continuous in a manner similar to the continued existence of an individual, the carryover may be denied."78

III. A Reappraisal

In his classic study on tax reform, Professor Henry Simons has observed:

77 This was evidenced by INT. REV. CODE OF 1939, § 129, 58 Stat. 47 (now INT. REV. CODE OF 1954, § 269), passed soon after the carryover provisions were enacted.
78 Cornfield, Net Operating Loss Deductions and the Continuity of the Enterprise, 40 TAXES 1019, 1020 (1962).
The real mess in tax law on reorganizations largely concerns the corporation tax. There are no very good answers to the questions and problems with which this mess seeks to deal. All corporation tax procedure is infested with or rested upon the fiction, elsewhere often useful, that corporations may properly be treated as or like natural persons. The fiction becomes obviously silly when these "persons" are merged, affiliated, or suddenly reincarnated in new adult forms, and the whole foundation or rationale of procedure (which was really never there at all) seems suddenly to drop away. One can't contrive reasonable rules or even plausible expedients in such cases. To ask what corporation income-tax procedure should do here, is to open up an awful question which delusions have concealed, namely: What is the corporation tax up to anyway? . . . Such questions totally demoralize discussion. . . . There can be no good answers to detailed problems within a bad or anomalous tax. 79

The answers can, however, be responsive to the questions raised by the inherent problems of a system that taxes the corporation. The problems created by the utilization of an artificial concept of the corporate entity were recognized by the courts and Congress, by the former in deciding cases under the 1939 Code, and by the latter in framing the provisions of the 1954 Code. But the basic questions were not answered adequately: (1) Following a change in the ownership of a loss corporation should the corporation retain its tax attributes as to the availability of loss carryovers? (2) Following a change in corporate form through merger or other method of amalgamation should the emerging corporation retain the right to a loss carryover deduction that would have been available to one of the merged corporations had there been no amalgamation? 80

Before these two questions are examined, it should be noted that where there is neither a change in the ownership nor a change in the form of the corporation, but there is either a change in the business or the corporation adds a new business to the old, the loss carryover should be allowed. There is no reason why shareholders who sustain a loss and then are wise enough to liquidate an uneconomic enterprise and embark on a different field of endeavor through the same corporation should not be equally entitled to offset the earlier loss as are those who stay with an unprofitable corporation through the lean years into the good without changing the corporation's activities. 81 The same should be true where a

79 SIMONS, FEDERAL TAX REFORM 90 (1950).
80 Whether or not the loss corporation survives the merger is immaterial for purposes of the loss deduction. See Julius Garfinckel & Co. v. Commissioner, 335 F.2d 744 (2d Cir. 1964); Foremost Dairies, Inc. v. Tomlinson, 63-2 U.S. Tax Cas. 89586 (M.D. Fla. 1963).
loss arises from a new venture within the same “entity”; to deny a carryback to the profits of the old venture would discourage investment. An individual doing business as a sole proprietor or as a member of a partnership would, depending on the situation, be entitled to carry his losses either back or forward, regardless of any change in his business. When there has been no change in the ownership or in the form of a corporate taxpayer, neither a carryback nor a carryover deduction should be denied under the *Libson Shops* doctrine.

While the above problem has not generally been the subject of controversy, the questions relating to the allowance of loss carryovers after change in ownership or after corporate amalgamation have. These problems can be analyzed through the following situations:

(1) *When there is a significant change in the ownership of a single corporation with a history of losses.* Although the carryover and carryback provisions were intended to permit a rough averaging of income and losses by the corporate taxpayer, Congress did not intend to subsidize a corporate or individual taxpayer who loses money over the long run. This would occur if the law permitted shareholders to sell a loss corporation at a premium attributable to its history of losses.

When a sole proprietorship is sold it does not retain any of the tax attributes of the former owner; the former owner retains the right to any loss deduction and consequently no premium is attached to the sale of a losing business. The sale of a corporate business, however, may involve a subsidy or windfall if the fictional taxable entity is presumed to have continuity of existence and is therefore presumed to be entitled to the carryover. Thus, under the 1939 Code prior to *Mill Ridge*, as in *Alprosa Watch*, the loss deduction was retained by the corporate entity despite a complete change in ownership. *Libson Shops*, however, became the basis for an imprecise doctrine, whereby upon a change in ownership and a change in “business,” the deduction might be denied.

The change in business in such a situation has been given undue significance by the courts. The purchaser of a sole proprietorship will not receive the tax benefit of the prior owner’s losses, regardless of the nature of his business. The corporate form gives no additional signifi-

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83 *Mill Ridge Coal Co. v. Patterson*, 264 F.2d 713 (5th Cir.), cert. denied, 361 U.S. 816 (1959); see text accompanying note 60 supra.
84 *Alprosa Watch Corp.*, 11 T.C. 240 (1948); see text accompanying note 56 supra.
cance to continuation of the old business. Libson Shops does not require this emphasis upon the change in business, for its holding as to the “continuity of business enterprise” is only binding in multiple corporation cases—its relevance to the single corporation cases lies only in its contribution to the erosion of the strict corporate entity theory of loss carryovers.

Under this analysis, in the “single corporation” area, Congress and the courts should have rejected any factors other than change in ownership. If there is a “significant” change in the ownership of a corporation, regardless of any change in business, the fiction of the corporate entity should be ignored and the carryover or carryback deduction denied. To do otherwise would be to treat individuals engaged in the corporate form of business differently from those engaged in individual and partnership forms—a distinction unwarranted by the difference in form of business. The seller of a partnership or sole proprietorship can only obtain the benefit of a carryover of losses incurred in that business if he earns sufficient income within the next five years to offset the loss. But, allowing a carryover to a corporation that has “significantly” changed in ownership would benefit the selling shareholders immediately, regardless of their future income. The benefit would be the premium paid for their stock which is attributable to the value to the new shareholders of the carryover privilege.

In determining what constitutes a “significant” change in ownership, it is important to note that corporate ownership is normally subject to some change over time. Any criterion would of necessity be arbitrary, but one possibility might be a fifty per cent rule. After such a change

86 Jackson Oldsmobile, Inc. v. United States, 65-1 U.S. Tax Cas. 94541, 94545 (M.D. Ga. 1964): “Although Libson Shops is not a binding precedent when the legal entity of the taxpayer is unchanged as in the case at bar... the Libson Shops rationale has been applied to disallow a carryover where a single corporate taxpayer discontinued the business to which a loss was attributable and undertook a new and profitable business.”

87 This was not done in Int. Rev. Code of 1954, § 382(a); but see § 269(a)(1).


89 See, e.g., the interesting parallel in Calvin v. United States, 65-1 U.S. Tax Cas. 94538 (D. Colo. 1964), where Libson Shops reasoning was utilized to deny the carryover of losses sustained by wife in business prior to marriage to post marriage income in a joint return.

90 The argument might be made that to deny to the selling shareholders upon a “significant” change in corporate ownership the same carryover privilege that is available to the seller of an unincorporated business is to discriminate against individuals engaged in the corporate form of business. This is, however, a fallacious argument, since the individual shareholders never had any right to the loss carryover privilege which belongs to the corporation.

91 Int. Rev. Code of 1954, § 382(a) adopts this figure. On the other hand, American Law Institute, Federal Income Estate and Gift Tax Project 349 (1958), recom-
in ownership, more new individuals than old would benefit from the
carryover of any net operating loss deductions. Due to the nature of the
corporation and the ease with which shares can be exchanged, it would
be desirable to temper this criterion by a proviso (as in section 382(a) of
the 1954 Code) that the change occur within a period of twenty-four
months, among ten or fewer shareholders.

To avoid the harshness of complete denial of the carryover upon a
fifty per cent change in the ownership of a corporation, after such a
change has occurred only that proportion of the carryover equal to the
percentage of change in ownership might be denied. A fifty per cent
sliding scale rule, however, would not relieve the pressure to arrange that
the change of ownership be less than fifty per cent, nor would it avoid the
difficulty of determining whether the requisite change in fact occurred;
the rule would but reduce the deduction that would be denied under
the flat fifty per cent rule. The same objections may be levelled at any
rule based on a sliding scale. With either a sliding scale or a flat change
of ownership rule there is a substantial deduction lost once the "signifi-
cant" change in ownership occurs.

(2) When the form or "entity" of the loss corporation changes through
some form of amalgamation with one or more other corporations.

(a) In the Newmarket situation where there is a formal, but not a
substantive, change in the identity of the corporation, the carryover
should be allowed. This type of case involves a merger with a second
corporation newly organized by the first corporation's shareholders;
the ownership and business of the corporation remain the same, only
the name or place of incorporation change. Congress did not consider
such changes significant in drafting the 1954 Code. An individual would
not be denied a carryover due to a change in his place of business or in
his business name. The policy of Congress to allow a taxpayer to set off


92 The argument is that it would be unfair to deny the entire carryover because it
would injure the interests of old shareholders retaining their equity in the corporation.
Perhaps this is a disadvantage that must be accepted if the corporate form of business
is chosen. Such a sliding scale rule would not entirely cure this defect because the
deduction allowed under the rule would benefit new and old shareholders alike. Any
mechanism that would attempt to allocate loss carryovers to the remaining old share-
holders without benefiting the new shareholders would probably be too complicated
and unwieldy for practical application.

93 Newmarket Mfg. Co. v. United States, 233 F.2d 493 (1st Cir. 1956), cert. denied,
353 U.S. 983 (1957); see text accompanying note 26 supra. See also New Colonial Ice

“its lean years against its lush years” militates against denying the carryover in this situation.

(b) When, as in Libson Shops, the ownership of the merging corporations is identical (brother-sister or parent-subsidiary), the loss deduction should be permitted if the same “business activity” which incurred the loss also produced the income against which the loss is to be offset. No policy would be furthered by denying a loss deduction merely because an individual chose to consolidate his separately incorporated businesses. Yet corporate owners should not obtain the tax benefits of both single and multiple incorporation—for example, the surtax exemptions of the latter and the carryover advantages of the former.

The “but for” test, implied in Libson Shops, is the only feasible solution, because it eliminates any possible carryover or carryback incentive to the merger. To the Commissioner this has meant a “continuity of assets” test: whether the same assets which incurred the loss also produced the income.

But since such a test is not necessarily desirable and accounting problems are encountered in its application, most cases have refined it to a “business activity” test. Libson Shops spoke of “continuity of business enterprise,” the 1954 Code and the Supreme Court speak of substantially the same business, but none of these formulations is very clear. The nature of the problem probably precludes a precise test, but in most cases the type of business activity, geographical boundaries, units of production (such as stores or banks), or even groups of assets will serve as guidelines.

(c) When a loss corporation merges with one or more corporations, and the ownership of the emerging corporation differs in some degree from the ownership of the merged loss corporation, both the fifty per cent change of ownership and the “but for” tests are appropriate. Because this variant involves the merger of organizations owned, at least partially,

95 Cf. Humacid Co., CCH Tax Ct. Rep. Dec. 26927, at 2692 (42 T.C. 894) (1964): “Obviously ‘continuity of business enterprise’ means something different from identity or similarity in economic endeavors. It seems to us that what the Supreme Court had in mind in Libson Shops, Inc., was something more in the nature of an economic concept prohibiting separate business units from combining so that profits from one separate enterprise might be offset against the losses of another.”


97 See text following note 54 supra.


100 Treas. Reg. § 1.382(a)-1(b) (1952) attempts to define the test by means of examples. This attempt also falls short of achieving a clear definition of the test. Cf. discussion of “substantially the same business” in H. F. Ramsey Co., Inc., CCH Tax Ct. Rep. Dec. 27220 (43 T.C. No. 42) (1965).

101 See, e.g., Julius Garfinckel & Co. v. Commissioner, 335 F.2d 744 (2d Cir. 1964), cert. denied, 85 Sup. Ct. 651 (1965); Foremost Dairies, Inc. v. Tomlinson, 63-2 U.S. Tax Cas. 89587 (M.D. Fla. 1965).
by different interests, a change in ownership occurs; considerations based upon the situation where an individual or group of individuals had the opportunity to choose between the single and multiple corporate structure are not determinative. Allowing the carryover or carryback deduction when the former owners of the loss corporation obtain less than fifty per cent of the market value of the stock of the emerging corporation would permit the rules governing the change of ownership of a single corporation to be avoided by resort to merger.\footnote{102} When the former owners of the loss corporation own more than fifty per cent of the emerged corporation, the “but for” test must be applied to prevent the rules regulating the merger of corporations with complete identity of ownership from being avoided by the sale of a small share in one of the merging corporations to an outsider.

IV. Libson Shops and the 1954 Code

Congress passed sections 381 and 382 of the 1954 Code to eliminate the chaos that existed in this area. Section 381, applicable to the “multiple corporation” situation, eliminated the formal “entity” distinction of New Colonial. As a result, the predecessor corporation’s loss can be carried over to the resulting corporation when the acquisition of the predecessor’s assets is via (1) a tax free liquidation of a subsidiary,\footnote{103} (2) a statutory merger,\footnote{104} (3) a tax free reorganization involving the transfer of substantially all of the assets of one corporation to another,\footnote{105} or (4) a “mere change in identity, form, or place of organization, however affected.”\footnote{106}

Section 382(a) governs the “single corporation” situation and denies a corporation the benefit of a loss carryover if within two taxable years (1) any one or more of the ten largest stockholders, (2) own fifty per cent more of the outstanding stock than such person or persons did at the start of such period, (3) due to purchase, indirect purchase or a reduction in the outstanding stock, and if the corporation “has not continued to carry on a trade or business substantially the same as that conducted before any change in the percentage ownership of the fair market value of such stock.”\footnote{107}

\footnote{102} Even if the 50% rule were not adopted, the merger would have to be with an established corporation in order that the carryover be allowed. A corporation formed specifically for the purpose of merging with the loss corporation would have to contend with both § 269 of the 1954 Code and the doctrine of Gregory v. Helvering, 293 U.S. 465 (1935).

\footnote{103} INT. REV. CODE OF 1954, §§ 381(a)(1), 382, 334(b)(2), 381(c)(1).

\footnote{104} INT. REV. CODE OF 1954, §§ 381, 354(b)(1), 368(a)(1)(A).

\footnote{105} INT. REV. CODE OF 1954, §§ 368(a)(1)(C), 368(a)(1)(D).

\footnote{106} INT. REV. CODE OF 1954, § 368(a)(1)(F).

\footnote{107} INT. REV. CODE OF 1954, § 382(a). For a detailed analysis of these sections, see Winton, Loss Corporations and Carry-overs, 34 Taxes 549 (1956); cf. Lee, Mills...
Section 382(b) was enacted to limit the trading in loss carryovers allowed by section 381(a). By this subsection, if following the reorganization the shareholders of the loss corporation do not own (as a result of their ownership of the loss corporation) at least twenty per cent of the fair market value of the outstanding stock of the resulting corporation, the loss carryover will be proportionally reduced to the ratio of such interest to twenty per cent.

In addition, section 269 preserves the subjective test of section 129 of the 1939 Code. A taxpayer is denied the beneficial tax attributes of an acquired corporation when the principal purpose of the acquisition was tax avoidance or evasion “by securing the benefit of a deduction, credit, or other allowance which” the taxpayer would not otherwise enjoy. This section applies whether the benefit of the acquisition is obtained by the acquired or the acquiring corporation.

These statutory rules make feasible trading in loss carryovers by methods which the case law would have made economically undesirable. Section 381 does not mention the divisive reorganization; also, the effect of the specific language of section 382(a) could be avoided by a carefully drafted agreement. The only bar to unhindered trafficking in these situations is the subjective test of section 269.

All mergers taking place prior to June 22, 1954 will clearly be subjected to the test of Libson Shops, as presumably will all cases involving...
divisive reorganizations which are not specifically covered by the loss carryover provisions of the Code.\textsuperscript{114} The controversial question has been whether the reasoning of \textit{Libson Shops} restricts the possibilities of trading in carryovers inherent in the 1954 Code provisions.

Commentators have argued that the changes made in the 1954 Code have rejected the entire case law interpreting the 1939 Code carryover provisions.\textsuperscript{115} The formal argument is made that by eliminating the word "taxpayer" from section 172(b)(1)(B) of the 1954 Code, Congress changed the meaning of the carryover provision interpreted in \textit{Libson Shops} (section 122(b)(2)(3) of the 1939 Code), which contained the word "taxpayer."\textsuperscript{116} There seems to be no reason to believe that Congress, in omitting the word "taxpayer," intended to effectuate a substantive change in the meaning or purpose of the carryover provisions.\textsuperscript{117} Indeed, it has been convincingly demonstrated that the change was made solely to eliminate confusion in reorganization and liquidation cases as to who the "taxpayer" was.\textsuperscript{118}

The more substantial argument is that superimposing \textit{Libson Shops} on sections 381 and 382 would return the law of carryovers to its prior chaotic state, and thus frustrate the congressional purpose of eliminating the confusion that prompted enactment of these sections.\textsuperscript{119} But the argument fails to note an essential difference between the sections. In section 381(a) Congress spoke positively—if certain requirements are met, the carryover will be allowed. Thus \textit{Libson Shops} is not to be applied to be determined by the 1954 Code. The computations to be made in determining the amount of any net operating loss carryover to any taxable year are to be made under the law of that taxable year. See Allied Central Stores, Inc., 23 CCH Tax Ct. Mem. 248 (1964), aff'd, 339 F.2d 503 (2d Cir. 1964); Euclid-Tennessee, Inc., 41 T.C. 752 (1964); Irving-Kolmar Corp., 35 T.C. 712 (1961); Herbert J. Kent, 35 T.C. 30 (1960); Treas. Reg. \S 1.172-1(c) (1956), as amended, T.D. 6486, 1960-2 Cum. Bull. 78; Montgomery, \textit{Federal Taxes} 5-45 (37th ed. 1958).


\textsuperscript{117} See H.R. RE. No. 1337, 89d Cong., 2d Sess. A56 (1954); see also Arthur T. Beckett, 41 T.C. 386 (1965).

\textsuperscript{118} See Speiller, \textit{Acquisition by Loss Corporation of Profitable Business}, 40 Taxes 22 (1962).

\textsuperscript{119} See Sinrich, \textit{supra} note 115.
to cases governed by this section,\textsuperscript{120} because Congress left no room for judicial improvisation. But in section 382(a), the single corporation area, Congress spoke in the negative—when certain facts are present the carryover is denied. Leeway is left for the application of judicial prohibitions, and the \textit{Libson Shops} principle retains some vitality. Thus, the Commissioner is justified in ruling that “there is more than a minor change in stock ownership of a loss corporation which acquires a new business, the Service may continue to contest the deductibility of the carryover of the corporation’s prior losses against income of the new business enterprise.”\textsuperscript{121} If the Commissioner’s interpretation as to the applicability of \textit{Libson Shops} to section 382(a) of the 1954 Code is sustained, the result is not necessarily a return to chaos; for if \textit{Libson Shops} were only applied to deny a carryover in situations within the spirit, but not within the exacting language, of section 382(a), the certainty and clarity desired by Congress would remain unimpaired.\textsuperscript{122}

Application of the reasoning of \textit{Libson Shops} to section 382(a) would be an important contribution to the tax law of carryovers. \textit{Libson Shops} can be the basis for an omnibus doctrine in the area of carryovers, comparable to the “business purpose” requirement of \textit{Gregory v. Helvering}.\textsuperscript{123} In 1963, in \textit{Arthur T. Beckett},\textsuperscript{124} the Tax Court began to implement this doctrine. In \textit{Beckett}, a loss corporation engaged in the hardware business entered an agreement with two partners who dealt in real estate. By the agreement, the corporation established a real estate department which was financed by the two partners who received in return preferred stock of the taxpayer of approximately two-thirds of the value

\begin{itemize}
  \item \textsuperscript{120} Rev. Rul. 58-603, 1958-2 CUM. BULL. 147; Rev. Rul. 59-395, 1959-2 CUM. BULL. 475.
  \item \textsuperscript{121} Rev. Rul. 63-40, 1963-1 CUM. BULL. 46. What constitutes the requisite “minor” change is a matter of dispute.
  \item \textsuperscript{122} The possibility that such fact situations could arise was recognized even before the Supreme Court’s decision in \textit{Libson Shops}; see Brody, \textit{Net Operating Loss Deduction}, 34 TAXES 325 (1956).
  \item \textsuperscript{123} 293 U.S. 465 (1935).
  \item \textsuperscript{124} 41 T.C. 386 (1963). Prior to \textit{Beckett}, a few cases implied that \textit{Libson Shops} applied to § 382(a) situations. In Goodwyn Crockery Co., 37 T.C. 355 (1961), aff’d, 315 F.2d 110 (6th Cir. 1963), the Tax Court allowed a carryover under § 382(a) holding that there was not a substantial change in trade or business. The court did not decide whether \textit{Libson Shops} was applicable. See Davis, \textit{Developments in the Federal Taxation of Corporations}, 45 CHICAGO B. RECORD 231 (1964). In Wallace Corp., 23 CCH Tax Ct. Mem. 39 (1964), the Tax Court implied that \textit{Libson Shops} was applicable under the 1954 Code, since the same criteria were necessary to determine whether “substantially the same business was carried on, under both section 382(a) and \textit{Libson Shops}.” Finally, in Frederick Steel Co., 42 T.C. 13 (1963), § 382(a) was held not to apply (§ 394 provides that § 382(a) is applicable only to acquisitions made subsequent to June 22, 1954). The Tax Court, however, was unsure as to whether § 122 of the 1939 Code or § 172 of the 1954 Code applied; nevertheless, it applied \textit{Libson Shops} to deny the carryover.
\end{itemize}
of the common stock. The agreement restricted the common shareholders' powers, although technically no change in control occurred. The hardware business was discontinued and the real estate business was operated at a profit. A carryover of pre-change losses in the hardware business to post-change income in the real estate business was denied although the court was able to utilize neither section 382(a) nor section 269 of the 1954 Code to this end since the requisite change of ownership was absent. The Tax Court agreed with the Commissioner that

the combination of the potentially profitable business with the loss business was skillfully arranged in this manner in order that there would be no acquisition of control of a corporation . . . within the meaning of section 269. . . . However, there appears to us to be no reason why the method [of acquisition] . . . should control the issue of whether under the decision in the Libson Shops, Inc. case, the . . . losses sustained by the hardware business of Maxwell Hardware may properly be used to reduce the taxable income from the real estate subdivision.

In Beckett a technical reading of section 382(a) would have required allowance of the carryover. But the income against which the offset was claimed was "not produced by substantially the same business which incurred the losses"; thus, the congressional purpose of allowing a taxpayer to "set off its lean years against its lush years" was not served. It is in such situations that the policy of Libson Shops should be followed to deny a deduction. The need for the development of such an overriding doctrine was most aptly expressed by the Tax Court in Beckett:

Petitioner's theory that only in cases which fall directly within the provisions of section 382 or section 269 would the net operating loss carryover be denied to a taxpayer, would invite the well advised and technically skillful to "traffic" in net operating loss carryovers. Since the provisions of sections 382 and 269 as to ownership changes are precise and definite, all that would be necessary would be to create a relationship such as that provided for in the instant case which brings in new capital, new stockholders, and a new business without falling precisely within any statutory proscription. We cannot credit to Congress the issuance of an invitation to indulge in a practice which the stated purpose of the enactment is to control, the "trafficking" in net operating loss carryovers.\textsuperscript{127}

\textsuperscript{125} 41 T.C. at 413-14.

\textsuperscript{126} Id. at 414. This determination by the court was based on both the change in business and the change in ownership.

\textsuperscript{127} Id. at 418. Cf. Fidelity Baltimore Nat'l Bank v. United States, 328 F.2d 953 (4th Cir. 1964); Joseph C. Gallagher, 39 T.C. 144 (1962) (Pierce, J., dissenting).