ARTICLE: A Case For Neutrality in the Design and Implementation of the Merger and Acquisition Statutes: The Post-Acquisition Net Operating Loss Carryback Limitations

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SUMMARY: ... The taxation of corporate business combinations unquestionably ranks among the most complex and inextricable areas of contemporary federal income tax law. ... But what happens where, for the carryback year in question, the group members were filing separate returns? Clearly, if S[3] was formed as a subsidiary of P, the 1988 consolidated loss will be carried back to P's (and only to P's) SRY income. ... These regulations reflect a concern that an acquisition of assets could be effected through the use of a newly formed or a long affiliated subsidiary member, and that the acquired business could then produce post-acquisition losses, which, under the current regulations, can be carried back as part of the consolidated loss carryback to offset pre-acquisition consolidated income. ... Where the consolidated return regulations are applicable, they generally restrict the deduction of built-in losses to the income of the corporation which ultimately recognizes them (i.e., the acquired corporation itself in a stock acquisition, and the acquiring corporation in an asset acquisition). ... The Type F Reorganization as a Function of "Absolute Shareholder Continuity" ...

TEXT:

[**85**] INTRODUCTION

The taxation of corporate business combinations unquestionably ranks among the most complex and inextricable areas of contemporary federal income tax law. Students and practitioners alike are invariably compelled to wonder whether the drafters of these rules and regulations might not have received some great measure of their inspiration from the design of the mythical Labyrinth, constructed to house the Minotaur. Indeed, history attests to the experiences of numerous taxpayers who have likewise discovered that a similar beast lurks in this tax maze, and that the design of the maze, though elaborate, frequently proves incapable of containing it.

Notwithstanding the intricacy which characterizes the merger and acquisition tax statutes, the abundance of administrative and judicial interpretations, illustrations, and refinements, and the veritable flood of ink which has poured forth from the pens of commentators, this body of law is, and has always been, replete with imperfection. n1 One frequent criticism is that radically different tax consequences often flow from alternative acquisition structures which, notwithstanding their technical distinctions, impart equivalent or near-equivalent economic effect to the participants. n2 To date, this persistent and pronounced flaw in the statutory design has inexplicably failed to inspire remedial action on the part of Congress, and has been greatly exacerbated by the Treasury, the Service, and the courts through their uneven application of the often-recited tenet that substance should prevail over form in prescribing tax consequences.

n1 Randolph Paul, the noted tax attorney and educator, once observed in connection with the reorganization provisions: "There is something wrong with provisions which remain so obscure, in spite of
filigree detail in the statute and the regulations, that hardly any prediction as to their meaning can be made without the feeling that it is little better than a dignified guess.” Paul, Studies in Federal Taxation 164 (1940).


The general lack of neutrality in the taxation of economically equivalent or near-equivalent corporate acquisition transactions n3 is perhaps nowhere more apparent than in the inconsistencies which characterize the limitations imposed on a corporation's right to carry its post-acquisition net operating losses back to recover taxes paid on the pre-acquisition taxable incomes of the acquiring corporation, the acquired corporation, and, where either or both of the amalgamating corporations are or were members of an "affiliated group," n4 the taxable incomes of their respective affiliates. As subsequent illustrations amply demonstrate, not only does the impact of these restrictions vary substantially from one acquisition scenario to another, it varies primarily as a function of the mechanical form, rather than the economic substance, of the transaction. Since so many of these rules tend to run counter to one's intuition, and since both the principals and their tax advisors often lack the clairvoyance enabling them to foresee the post-acquisition losses that ultimately materialize, victims of this technical quagmire are not infrequent. n5

n3 "Neutrality," or more specifically "functional neutrality," is defined in note 429 and discussed throughout the text accompanying notes 429-500.

n4 IRC § 1504, discussed in the text accompanying notes 127-9.


Purpose and Scope

The purpose of this article is twofold. First, it is intended to fill one of the few remaining voids in the literature addressing technical issues related to the taxation of mergers and acquisitions. It examines, in depth, [**87] the rules and regulations which govern the carryback of post-acquisition losses to pre-acquisition tax years, and illustrates their application to each of several acquisition scenarios. n6 It stresses the importance of anticipating these limitations in evaluating alternative approaches to structuring the transaction, and of recognizing the potential value n7 of the pre-acquisition taxable income histories of the respective corporations as one of the many factors to be considered in negotiating the ultimate sale price or stock exchange ratios. The technical discussion of these limitations also includes an analysis of the controversial holdings of the Second and Ninth Circuit Courts of Appeal in Aetna Casualty & Surety and Bercy Industries, holdings which may provide a basis for reviving the refund potential of pre-acquisition income which was technically eliminated by the statute at the moment the acquisition was consummated. Finally, since the restrictions of § 381(b)(3) and the consolidated return regulations are inapplicable where the "acquisition" qualifies as a "mere change in the identity, form or place of one corporation, however effected," the circumstances under which a transaction will so qualify are also addressed.
The subject of this article, the limitations imposed on the carryback of post-acquisition losses to pre-acquisition income, must be distinguished from the asymmetrical limitations applicable to the converse process, the carryforward of pre-acquisition losses to offset post-acquisition income. These latter rules are briefly summarized in the text accompanying notes 144-228, 239-53, 275-81.

The value of carrying losses back rather than forward has been measurably enhanced as a result of the Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085 (hereinafter referred to as the 1986 Act). First, at least for the short term, a $100,000 loss carried forward to a tax year beginning on or after July 1, 1987 will produce a maximum tax saving of $34,000, whereas a carryback of the same loss to pre-1987 taxable income could generate a refund of up to $46,000. Although the tax benefit associated with investment tax credit carryforwards was reduced to reflect changes in the tax rates, the statute does not similarly reduce benefits of net operating loss carrybacks which straddle the effective dates of the corporate rate reductions. Second, the new limitations imposed on the "built-in" losses of an acquired corporation may not be as severe when such losses are carried back as when they are carried forward. See the discussion in the text accompanying notes 250-3. Third, in the wake of the repeal of the so-called General Utilities doctrine (summarized in note 10), the acquisition methods which are most likely to preserve the pre-acquisition refund potential of the acquired corporation (i.e., certain nontaxable acquisitions, and stock purchases which are not followed by § 338 elections) can be expected to become more popular than they were prior to 1987. Finally, the post-acquisition net operating loss carryback limitations discussed and illustrated in this article will generally apply to both regular tax net operating losses and alternative minimum tax net operating losses.

The second, and perhaps most important, part of this article is much broader in its scope than the foregoing technical analysis. There, the author focuses on one of the fundamental and congenital defects in the legislative design of the merger and acquisition tax statutes: the failure of policy makers to design the statute so as to render it neutral as between equivalent or near-equivalent transactional forms. In this context, the exhaustive technical discussion of post-acquisition loss carrybacks serves [*88] to illustrate the nature of this defect, the importance of addressing it, and the alternative means by which it may be removed to prepare the way to a more effective and credible system of taxing mergers and acquisitions. The author concludes by summarizing his thoughts as to the means by which the current system could be made to be more congruent with generally accepted tenets of taxation and with the economic realities attending corporate acquisitions.

Summary of Acquisition Techniques n8

As to the manner in which the rules and regulations summarized in this section apply to acquisitions involving S corporations, see Bolling & Englebrecht, Tax Planning Opportunities and Pitfalls on the Reorganization of an S Corporation, 64 Taxes 596 (1986).

"Acquisitions" Involving Unrelated Corporations

There exists a seemingly infinite number of diverse factors which can bring about the decision to buy or to sell a corporate business enterprise. The purchasing corporation might, for instance, be motivated to acquire another business in order to expand or diversify its product lines more quickly, or at a lower cost, than would be possible through internal growth. Alternatively, the acquisition might be undertaken in order to obtain needed managerial talent; to improve technological skills or research and development capabilities; to acquire patent rights which cannot be developed internally; to enable the purchaser to gain access to new geographical markets where existing resources might otherwise prevent or delay entry; to effect operating economies; or to increase borrowing capacity.

Frequently cited reasons for selling a business, on the other hand, include the need to obtain otherwise unavailable financing, or the desire, on the part of the owners, to acquire liquid assets (e.g., marketable securities of the purchaser) in order to facilitate estate planning or to solve an existing estate tax problem. Many sales are undertaken in order to avoid serious losses or bankruptcy where the ability of the seller's company to survive on its own is questionable, or to benefit from the expertise of the acquiring
corporation's management, particularly where the acquired corporation lacks an effective second-line management capable of taking over for the company's retiring owner-managers.

Once the decisions to buy and to sell a particular corporate business have been made, the actual mechanics of the transaction must be negotiated between the parties. Although the specific circumstances attending each sale and purchase of a corporate business are unique, the fundamental approaches are relatively few in number. To effect the acquisition, the acquiring corporation may, either directly or through a newly created or previously existing subsidiary, acquire either the assets or the stock of the targeted corporation. It may effect the acquisition using cash, notes, its own stock, stock of its parent corporation, or some combination of these, as consideration.

Characteristically, where cash or notes are used as consideration, the effect of the transaction is to divorce the seller's prospective economic fortunes from those of the disposed business enterprise. The tax law recognizes the fundamental economic significance of this event by mandating the seller's contemporaneous recognition of gain or loss.

Although notes, bonds, and escrow arrangements may tie the seller to the purchaser's economic fortunes for a limited period following the sale, the statute and the courts generally look only to the nature and extent of continuity of proprietary economic interests in distinguishing between taxable and nontaxable exchanges. See, for example, the "solely for voting stock" requirements of § 368(a)(1)(B) and (C), and § 368(a)(2)(E). In Le Tulle v. Scofield, 308 U.S. 415 (1940), the Court rejected the notion that the value of the acquiring corporation's long-term debt received by the acquired corporation's shareholders in exchange for their stock was relevant in testing the sufficiency of their continuing interest.

The Tax Reform Act of 1986 also amended § 453 so as to prohibit taxpayers from deferring gain on installment sales of publicly traded stock or securities, IRC § 453(j)(2)(A) (should be (k)(2)(A)). The so-called "proportionate disallowance" rules of § 453C, which limited the amount of the gain that could be deferred by taxpayers upon the sale of certain assets, were repealed by the Revenue Act of 1987, Pub. L. No. 100-203 (hereinafter the 1987 Act).

However, if the consideration used by the purchasing corporation is instead either its own stock, or, where the acquiring corporation is itself a controlled subsidiary, its parent's stock, then the transaction may qualify as a nontaxable "reorganization" under § 368(a) if it otherwise conforms precisely to one of the statutorily defined nontaxable acquisition alternatives and to judicial interpretations of the legislative intent which originally inspired and presently sustains these exceptional provisions. In general, an acquisition meeting these criteria is viewed as merely an intermediate step in an ongoing business or financial venture, rather than as the termination of one such activity followed by the initiation of another. In keeping with this premise, the statute generally exempts the shareholders of the acquired corporation from the contemporaneous recognition of the gains and losses realized as a result of the exchange. Instead, such gains or losses are deferred by means of statutorily mandated basis adjustments that have been carefully designed so as to preserve the fundamental purpose of the reorganization provisions: that is, to align tax recognition with events which more conclusively alter the shareholder's relationship with the original corporate enterprise.
subject to a host of refinements and limitations, mandate the preservation of the acquired corporation's "personal" tax characteristics, either in the original corporate shell, in the case of a stock acquisition, or in that of the acquiring corporation following an asset acquisition. n16

n11 Very briefly, the transaction must be undertaken for business purpose; the shareholders of the acquired corporation must, as a group, end up with a continuing proprietary interest in the acquiring corporation (or its parent); and the business enterprise of the acquired corporation must be continued under judicial standards now incorporated in the regulations. Reg. § 1.368-1.

n12 IRC § 354(a)(1). But where the taxpayers receive money or other property (boot) in addition to permitted consideration, § 356(a) requires that any realized gain be recognized pro tanto.

Under the new corporate alternative minimum tax, most C corporations, for tax years beginning in 1987, 1988, and 1989, are required to increase their alternative minimum taxable income by 50% of the excess of (1) their adjusted net book income over (2) their alternative minimum taxable income (determined without regard to this adjustment or the alternative minimum tax net operating loss deduction). IRC § 56(c)(1), (f). If, for book purposes, a corporate shareholder is required to recognize the gain resulting from the exchange of stock pursuant to a nontaxable reorganization, as will usually be the case, up to one-half of that gain may, notwithstanding § 354(a)(1), be taxable under § 55. Temp. Reg. § 1.56-1T(b)(2)(iii), (b)(6) Ex. 1.

n13 IRC § 358.

n14 This objective is frequently compromised where the stock received in the nontaxable exchange is held until death. Under § 1014(a), the stock's fair market value on the date of death (or alternate valuation date under § 2032) replaces the decedent's predeath adjusted basis, and any deferred gain or loss simply vanishes.

n15 IRC § 361. But unless the acquisition also meets the rigorous standards set forth in Accounting Principles Board Opinion No. 16 for the use of the "pooling-of-interests" method of accounting, then, for purposes of computing corporate alternative minimum taxable income, the book income adjustment required by § 56(c)(1),(f) may render up to one-half of the gain taxable under § 55. Temp. Reg. § 1.56-1T(b)(2)(iii), (b)(6) Exs. 1 & 2. See note 12.

Under the pooling-of-interests method of accounting for business combinations, the financial accounting treatment of the amalgamating corporations roughly corresponds to their tax treatment in a nontaxable acquisition: the acquired corporation recognizes no gain or loss on its income statement, and the book value of its assets carries over intact to the balance sheet of the acquiring corporation. This is usually the accounting method of choice in that it keeps book values, and consequently future depreciation and amortization expenses, low, and future earnings correspondingly high. Additionally, under the pooling-of-interests method, the pre-combination financial statements of the amalgamating enterprises are retroactively restated by combining their respective balance sheets and income statements. This procedure, of course, has no tax law counterpart that would either require or, where one of the amalgamating corporations has pre-acquisition net operating losses, permit, the filing of an amended return for a pre-acquisition tax year to reflect the combined amounts. See the text accompanying notes 256-7.

Some of the more substantial requirements under Accounting Principles Board Opinion No. 16 for use of the pooling-of-interests method are:

1. The acquiring corporation must use its own voting common stock to acquire at least 90% of the voting common stock of the target corporation or at least 90% of the target's assets;

2. Contingent stock consideration is generally not permitted;

3. There cannot be a plan to dispose of any significant portion of the assets of the combining corporations within two years;
4. The combination must be completed within one year after the date the plan is adopted;

5. The distribution of the acquiring corporation's stock to the participating shareholders of the acquired corporation must generally be pro rata; and

6. The acquired corporation usually must not have been a subsidiary of the acquiring corporation for the two years prior to initiation of the plan.

If the acquisition fails to qualify for the pooling-of-interests method, it must be accounted for by the purchase method. In an asset acquisition, for example, this will mean that the acquired corporation must recognize gain as a result of the sale, and that the acquiring corporation must record all of the acquired assets, including goodwill, at their fair market values.

n16 IRC §§ 381, 382, 383, 384, 269.

n17 Such attributes include the acquired corporation's asset bases, its net operating loss carryovers, and its earnings and profits history. See IRC §§ 362(b), 381(c)(1)-(26).

State and federal tax consequences do not always coincide. For an overview of important state tax considerations see Milefsky, State Tax Aspects of Corporate Mergers and Acquisitions, 18 Tax Adviser 236 (1987).

Acquisition of Assets for Cash

The acquiring corporation may purchase the target corporation's assets for cash and/or notes. If the target corporation thereafter continues its existence, either by actively conducting another business or by serving as a private investment company for its shareholders, then it will usually be required to recognize the entire amount of the gain or loss it realized as a result of the sale. n18 When the sale proceeds are ultimately distributed as dividends, n19 or as liquidation n20 or redemption n21 proceeds, additional income, gain or loss will then be recognized at the shareholder level. Likewise, if the selling corporation is liquidated soon after the sale, then, unless the transaction falls within the purview of one of the transitional rules relating to the repeal of pre-1986 Act § 337, the sale will be fully taxable at the corporate level, n22 while the liquidation itself will generally cause the shareholder receiving the liquidation proceeds to recognize any realized gain or loss. n23 In either event, the purchasing corporation will usually recognize no gain or loss, and its basis in the acquired assets will be its cost. n24

n18 IRC §§ 61(a)(3), 165(a), 1001(a)-(c).

n19 IRC § 301.

n20 See note 23.

n21 IRC §§ 302, 303, 304, 306.

n22 IRC §§ 1001(c). The distribution of any retained assets will likewise usually be taxable to the liquidating corporation under § 336. But see § 337 for an important exception where the liquidating corporation is an 80% controlled subsidiary of another corporation to which it distributes noncash properties.

n23 IRC § 331. But see § 332 for an important exception where the shareholder receiving the liquidation proceeds is a corporation owning stock representing 80% control of the liquidating subsidiary at the time of the transaction.

n24 IRC § 1012.

Acquisition of Stock for Cash
Another method of acquiring a corporate business involves the acquiring corporation's purchase of the target corporation's stock, again using cash or notes as consideration. The shareholders of the acquired corporation will generally recognize, immediately, all of the gain or loss that each realizes on the sale. n25 The purchasing corporation's basis in the acquired stock will be its cost. n26

n25 An exception to this immediate recognition rule could apply, however, where notes of the acquiring corporation are received under conditions which enable the shareholder to qualify for the installment method of reporting any resultant gain under § 453. See, however, § 453(j)(2)(A) (which denies installment method reporting where the stock that was sold is publicly-traded on an established securities market) and § 453(f)(4) (which treat the receipt of demand notes and of readily tradable bonds and notes as the equivalent of cash payments).

If the shareholder selling the stock is the target corporation's parent, then § 336(e) authorizes the Treasury to promulgate regulations that will permit the seller to treat the transaction as a taxable sale of assets, rather than as a taxable sale of stock. The § 336(e) election is only available if, at the time of the sale, the selling corporation holds stock representing 80% control (as defined in § 1504(a)(2)) of the subsidiary, and if the seller disposes of its entire interest therein. Unlike § 338 (see the text accompanying notes 27-9, 140-1, and notes 152 and 176), § 336(e) does not require that the purchaser be another corporation, and does not require that a single purchaser (or a single group of affiliated purchasers) acquire 80% or greater control of the disposed subsidiary. And unlike a § 338(h)(10) election (see note 152), § 336(e) does not require an election by the buyer.

The statute only addresses some of the tax consequences that result to the seller from its § 336(e) election, and does not address any of the tax consequences that the election will have on the buyer. Although a § 336(e) election will undoubtedly have ramifications as to whether the pre-disposition income of the disposed subsidiary will be available to absorb post-disposition loss carrybacks (as well as which corporations' losses may be so carried), these ramifications will not be explicitly addressed in this article. The regulations required, by statute, to animate § 336(e) have not, at this time, been issued in either proposed, temporary, or finalized form. Whatever the outcome, however, the transactional pattern which a § 336(e) election will, under the regulations, be deemed to emulate will likely be one that is discussed and illustrated in these pages. See also the text accompanying notes 142-3.

n26 IRC § 1012.

The tax consequences to the acquired corporation itself will depend upon whether a timely § 338 election is made (or deemed made) by the acquiring corporation. n27 Very generally, this election, available only if a corporation has purchased stock representing 80% control of the target corporation within a 12-month period, will cause the stock purchase and sale to be recast as an asset purchase and sale. Under this fiction, the target corporation is treated as if it had sold all of its assets as of the close of the acquisition date for an amount equal to their fair market values. With the abandonment of General Utilities and its statutory manifestations, the acquired corporation will generally be required to recognize all of the gain or loss deemed to have been realized on the hypothetical sale. n28 Further, its assets are deemed to have been "purchased" by a newly formed subsidiary of the acquiring corporation, and the assets so acquired by that corporation will take a basis equal to the deemed purchase price. n29

n27 Since § 336(e) addresses only the tax consequences of the seller, it is not clear as to whether a § 336(e) election by the seller to treat the sale of stock as a sale of assets will necessarily result in the buyer being treated as having purchased the assets. See note 25.

n28 IRC § 338(a)(1). Except in the case of a § 338(h)(10) election, if the old target corporation was a subsidiary member of an affiliated group filing consolidated returns, it will generally report this gain or loss on its "final" separate return, not on the consolidated return of either its new or former group. IRC § 338(a), (h)(9). For additional details, see note 176.
The deemed purchase price is generally equal to the actual purchase price of the stock (adjusted for the liabilities of the target corporation and for other relevant items) where the acquiring corporation purchases 100% of the target corporation's stock within 12 months. IRC § 338(b). For a glimpse of the complexities involved in allocating the deemed purchase price among the target corporation's assets, see Temp. Reg. §§ 1.338(b)-1T, -2T, and -3T.

Repeal of the statutory provisions implementing the General Utilities decision (see note 10) generally renders § 338 elections, where otherwise available, far less attractive than they were under pre-1986 tax law. Now, except to the extent mitigated by the net operating loss carryforwards, investment tax credit carryforwards, post-1986 alternative minimum tax credit carryforwards, etc., of the target corporation (or, under a § 338(h)(10) election, the consolidated net operating loss, etc., of its former group) the price of a stepped-up basis is a contemporaneous tax on the entire amount of the acquired corporation's net appreciation. And since § 338 recasts the acquisition as a fully taxable asset sale and purchase, the generally shorter recovery periods otherwise applicable with respect to the acquired corporation's pre-1987 depreciable assets, especially to its depreciable real property, are lost.

If § 338 is not applicable, the acquired corporation generally recognizes no gain or loss, and its asset bases will usually be unaffected by the change in ownership. However, the post-acquisition utilization of its favorable tax attribute carryforwards may be adversely affected.

But see Canaveral Int'l Corp. v. Commissioner, 61 T.C. 520 (1974), where the court invoked § 269 to reduce the acquired corporation's basis in its only asset to its fair market value. The court based its holding on a finding that the method of acquisition (that is, the purchase of the stock of a corporation with a high-basis, low-value asset, rather than a direct purchase of the asset) was laced with tax avoidance purpose. This decision is discussed briefly in the text accompanying note 305.

See also note 25 and the text accompanying notes 142-3, regarding the possible impact of the seller's § 336(e) election on the bases of the disposed subsidiary's assets.

See discussion in text accompanying notes 239-53.

Acquisition of Assets for Stock

Where the purchasing corporation uses its own stock, or the stock of its parent, to acquire the assets of the targeted corporation, it is possible that the transaction will qualify as a "reorganization" under one of several components of the statutory definition. If "substantially all" of the assets of the selling corporation are acquired by the purchasing corporation in exchange "solely" for its own voting stock (or for the voting stock of its parent), then the transaction may qualify as a Type C reorganization.

The assets can also be acquired by means of a statutory merger or consolidation, in which case the transaction will qualify as a Type A reorganization if the judicial requirements applicable to all nontaxable acquisitive reorganizations are satisfied. Although additional conditions are imposed, the statute likewise permits the use of the stock of the acquiring corporation's parent as consideration.

Given the fact that, except in the case of a reverse triangular Type A reorganization under § 368(a)(2)(E), the statute does not expressly impose any conditions as to the type of consideration that can be used in a Type A reorganization, the continuity of proprietary interest requirement is of special importance. See note 444.

In a "triangular" Type A reorganization, the transaction may take one of two forms. Section 368(a)(2)(D) permits the acquisition of the target corporation's assets by the acquiring corporation in exchange for stock of the acquiring corporation's parent. Section 368(a)(2)(E) sanctions the reverse process wherein the acquiring corporation merges into the target corporation, which then becomes a controlled subsidiary of the acquiring corporation's parent.
If the stock-for-asset exchange fails to meet the requirements prescribed for either the Type A or the Type C reorganization (or their respective "triangular" variations), the consequences to the parties will be essentially the same as they would have been had the acquisition been for cash or notes. n35

n35 If the acquiring corporation acquires property in exchange for its own stock, whether newly issued or treasury stock, it generally does not recognize any gain or loss regardless of whether or not the acquisition is a reorganization within the meaning of § 368. IRC § 1032. But the acquiring corporation's basis in the property so acquired very much depends upon whether the acquisition qualifies as a reorganization. A reorganization usually gives the transferee a basis equal to the transferor's basis plus any gain recognized by the transferor on account of the transfer. IRC § 362(b). But if the acquisition fails to qualify as a reorganization, the transferee's basis in the property it receives in exchange for its stock is its cost, which is usually the acquired property's fair market value. IRC § 1012.

Acquisition of Stock for Stock

Finally, if the purchasing corporation uses solely its own voting stock (or that of its parent corporation) to acquire a controlling n36 interest in another corporation, the exchange will be nontaxable if it satisfies the statutory and judicial requirements of a Type B reorganization. n37 If it does not meet these requirements, the resulting tax consequences will be similar to those previously discussed for a transaction involving the purchase of stock for cash.

n36 Section 368(c) defines control for this purpose as ownership of stock representing at least 80% of the total combined voting power of all classes of stock entitled to vote and at least 80% of the total number of each class of nonvoting stock outstanding. Rev. Rul. 59-259, 1959-2 C.B. 115.

n37 IRC § 368(a)(1)(B). See notes 11 and 38.

"Acquisitions" Involving Related Corporations

Frequently, an "acquisition" will be undertaken for the purpose of either perfecting or restructuring an existing affiliation. In some instances, the transaction evokes the same statutory rules described above for acquisitions between unrelated corporations. In other instances, however, the nature and extent of the pre-acquisition affiliation of the participants is recognized as the basis upon which meaningful distinctions are to be made as to the tax consequences of the transaction, generally, and to the carryback of post-acquisition losses, in particular.

Perfecting Control of a Subsidiary

With few exceptions, neither the means by which a corporation may perfect its control of an existing subsidiary nor the tax consequences resulting therefrom differ substantially from those outlined above for stock acquisitions involving unrelated corporations. If the parent corporation's voting stock is used either to increase its degree of control to 80% or more, or to upgrade an existing 80% or greater control, the acquisition can qualify as a Type B reorganization. n38 If the additional stock is purchased for cash, the transaction will usually be fully taxable to the selling shareholders, and § 338, which requires the acquisition of stock representing 80% or greater control within a 12-month period, will generally be unavailable to the parent corporation. Whether stock or cash is used, a corporation which increases its control of another to above 80% will usually qualify (or, where the acquiring corporation is already a member of an electing affiliated group, be required) to commence filing consolidated returns with that corporation. n39

n38 Section 368(a)(1)(B) requires only (1) that voting stock be the sole consideration, and (2) that statutory control exist immediately after the exchange.

n39 IRC §§ 1501-1504, discussed in the text accompanying notes 127-238.
Amalgamating Brother/Sister Corporations

When two or more commonly controlled corporations are combined into a single corporate shell, the transaction invariably qualifies as a nontaxable Type D reorganization. n40 Alternatively, if the objective of the shareholders of such corporations is to convert the brother/sister relationship [*96] into that of a parent/subsidiary, perhaps to obtain the benefits of filing consolidated returns, this goal can usually be achieved tax free, either by contributing the stock of one corporation to the other as a nontaxable contribution to its capital, or by exchanging such stock for additional stock of the acquiring corporation in a § 351 exchange. n41


n41 Section 351 requires that the transferor shareholders, as a group, have 80% control of the transferee corporation (§ 368(c)) immediately after the exchange. See note 36. Section 304(b)(3)(A) may require the shareholders to treat any boot they receive in the transaction as a dividend distribution under §§ 304(a)(1) and 301(a), rather than as proceeds from the exchange of a capital asset under § 351(b)(1).

Amalgamating Parent/Subsidiary Corporations

Under § 332, the liquidation of an 80% or greater controlled subsidiary is usually a nontaxable event insofar as the parent corporation is concerned. Unless the liquidation is part of a transaction with respect to which § 338 is applicable, the liquidating subsidiary likewise recognizes no gain or loss on the transaction. n42 Further, its asset bases and other tax attributes generally carry over to the parent. n43 If control of the liquidating subsidiary was acquired by purchase within a 12-month period and a § 338 election is in effect, the ultimate tax consequences will be much the same as those that would have resulted from a direct purchase of assets.

n42 If the liquidating subsidiary distributes property to a minority shareholder, it will be taxed as if the distribution had been a nonliquidating redemption. Accordingly, gain, but not loss, would be recognized to the distributing corporation. IRC § 336(a), (d)(3).

n43 IRC §§ 334(b), 381.

The reverse of the above-described process entails the merger of the parent corporation "downstream" into its subsidiary. The Service now regards this transaction as one to which the reorganization rules, rather than the liquidation rules, are applicable. n44

n44 Rev. Rul. 78-47, 1978-1 C.B. 113. Additionally, under Reg. § 1.1502-75(d)(2)(ii), a downstream merger of the common parent corporation of an affiliated group into one of its subsidiaries usually will not result in the deemed dissolution of the group.

Special Abbreviations and Definitions

In the interest of clarity, the following abbreviations and phrases will generally be used throughout the remainder of this article:

-- A is the "acquiring" corporation, i.e., the corporation which is acquiring the stock or the assets of another corporation.

-- T is the "target" corporation, the stock or assets of which are being acquired by A.

-- "Loss" refers to the amount of a corporation's
(1) Regular tax net operating loss, n45

n45 IRC § 172(c).

(2) Alternative minimum tax net operating loss, n46 or

n46 IRC § 56(a)(4), (d). Any limitations of the statute and consolidated return regulations which are explicitly applicable to carrybacks of post-acquisition regular tax net operating losses likewise apply, with equal force and effect, to post-acquisition alternative minimum tax net operating losses. Staff of the Joint Comm. on Tax'n, General Explanation of the Tax Reform Act of 1986, at 468-70 (1987).

See note 52, first two paragraphs, for a summary of the special rules and limitations on the carryback of alternative minimum tax net operating loss carrybacks.

(3) Capital loss n47

n47 IRC § 1212(a). See note 52, fifth paragraph, for general limitations that are imposed on capital loss carrybacks.

that can be carried over from the year it was recognized to another year -- net, however, of any amount of such loss attributable to a "built-in loss" (below) that is subject to special limitations.

-- "Income" refers to -- depending on the type of loss being carried over -- the amount of a corporation's

(1) Regular taxable income,

(2) Alternative minimum taxable income, or

(3) Capital gain,

that is available to absorb the loss carryover.

-- "Built-in loss" is a loss (or a deduction) that has accrued economically as of the date of the acquisition, but that has not been recognized, for tax purposes, as of that date. This term will generally be used to refer only to built-in losses that are subject to special limitations under § 382 n48 and Reg. § 1.1502-15. n49

n48 See discussion in the text accompanying notes 250-3.

n49 See discussion in the text accompanying notes 213-28.

-- "Pre-acquisition income (or loss)" is the income (or loss) that was recognized in a taxable year ending on or before the date of the acquisition. n50

n50 Except in the case of any gain or loss that is reported on a "final" separate return of a consolidated target subsidiary following a deemed sale of its assets under § 338, any gain or loss resulting from a § 338 election is "pre-acquisition income (or loss)." Temp. Reg. § 1.338-1T(f)(2)(iv). The tax consequences associated with the exception noted here are discussed separately in note 176.

-- "Post-acquisition income (or loss)" is income (or loss) that has been recognized in a taxable year ending after an acquisition.

In the section of this article which deals with the application of the consolidated return regulations, the above phrases will be modified further to distinguish between the "consolidated" income (or loss) of a consolidated [**98] group, and the income (or loss) that is attributable to (or apportioned to) its respective members.
CURRENT LIMITATIONS ON POST-ACQUISITION LOSS CARRYBACKS

To mitigate distortions and inequities which would otherwise result from the annual accounting period approach to the measurement of taxable income, \( n_51 \) the tax law allows a carryover of certain excess losses and credits to tax years in which the taxpayer's income is sufficient to absorb them. Sections 172, 56(a)(4), and 56(d), for example, generally permit regular tax and alternative minimum tax net operating losses to be carried back three years and forward fifteen years. \( n_52 \)

\( n_51 \) IRC § 441(a). See *Burnet v. Sanford & Brooks Co.*, 282 U.S. 359 (1931), which illustrates the type of problems that result from a strict periodic approach to the measurement of taxable income.

\( n_52 \) Although there are substantial differences in the statutory formulae which prescribe the manner in which the regular tax net operating loss and the alternative minimum tax net operating loss for a given post-1986 tax year are to be derived, the carryback and carryforward periods are identical. See note 46. Of course, since the corporate alternative minimum tax was a creation of the Tax Reform Act of 1986, a post-1986 alternative minimum tax net operating loss cannot be, as such, carried back to reduce a pre-1987 add-on minimum tax liability. According to the Staff of the Joint Committee on Taxation's General Explanation of the Tax Reform Act of 1986, at 469 (1987), however, if *an NOL arises in a taxable year beginning after December 31, 1986, and is carried to another taxable year, the NOL must be reduced by the corporation's taxable income for any taxable year beginning before 1987 to which the NOL was carried back under the regular tax system, notwithstanding that the alternative minimum tax was not applicable in those years." There is no provision in the statute requiring this adjustment.

In any given carryover tax year, the alternative minimum tax net operating loss deduction cannot exceed 90% of alternative minimum taxable income for such year. IRC § 56(d)(1)(A). No such limitation applies to carryovers of regular tax net operating losses. Additionally, an alternative minimum tax net operating loss must be used to offset any available alternative minimum taxable income in a carryback or carryforward year regardless of whether the taxpayer has any alternative minimum tax liability for the carryover year. S. Rep. No. 313, 99th Cong., 2d Sess. 538 (1986). Alternative minimum tax net operating losses that are not allowed in a particular taxable year because they exceed 90% of alternative minimum taxable income for that year may be carried over to other taxable years, in accordance with the rules of § 172(b).

It is important to note that, under some circumstances, net operating losses can be carried back much further than the standard 3 years. The statute allows commercial banks to carry back bad debt net operating losses 10 years (but forward only 5 years) where such losses are sustained in tax years beginning after December 31, 1986 and before January 1, 1994. IRC § 172(b)(1)(L) (should be (K)), (1). Product liability losses can be carried back 10 years, unless the taxpayer elects to relinquish this right and to instead carry them back only 3 years, or, as with net operating losses generally, not at all. IRC § 172(b)(1)(D), (j)(3). Certain deferred statutory and tort liability losses may likewise be carried back 10 years (but not, unless they otherwise qualify under the usual 3 year carryback rule, to tax years beginning before January 1, 1984). IRC § 172(b)(1)(J), (k). An extended carryback period is also available for certain losses attributable to the decommissioning of a nuclear powerplant. IRC § 172(k)(2). And finally, for certain tax years beginning before January 1, 1987, 10 carryback periods were permitted for the net operating losses of certain financial institutions (IRC § 172(b)(1)(F)), Banks of Cooperatives (IRC § 172(b)(1)(G)), certain losses of the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation (IRC § 172(b)(1)(H)), and -- for tax years beginning before January 1, 1986 -- the net operating losses of thrift institutions (IRC § 172(b)(1)(M) (should be (L))).

Some net operating losses, such as those resulting from a foreign expropriation and those of a real estate investment trust, cannot be carried back at all. IRC § 172(b)(1)(D), (E). Further, § 172(b)(3)(C) provides an election under which a taxpayer may relinquish the entire carryback period with respect to a given year's net operating loss. This election does not, however, extend the carryforward period. Nor is this option always available for state income tax purposes. An election under § 172(b)(3)(C) to relinquish the

In addition to net operating losses, corporations can generally carry net capital losses back 3 years and forward 5 years. However, a net capital loss can be carried back only to the extent that (1) it is not attributable to a foreign expropriation capital loss, and (2) the carryback does not result in the creation of a net operating loss or increase an existing net operating loss for the year to which it is carried. IRC § 1212(a)(1)(A); Reg. § 1.1212-1(a)(3)(i)(a). Unused general business credits can be carried back 3 years and forward up to 15 years (IRC § 39), while excess foreign tax credits may only be carried back 2 and forward 5 years (IRC § 904(c)).

Two new creations of the 1986 Act, the net passive activity losses of closely held and personal service corporations (IRC § 469), and the alternative minimum tax credit (IRC § 53) cannot be carried back at all, but both can be carried forward indefinitely.

[*99] Where net operating losses are sustained soon after a corporate business combination, a determination must be made as to whether and to what extent the pre-acquisition incomes of T, A, and, where either corporation is or was a member of an affiliated group, their respective affiliates are available to absorb such losses and to thereby generate refunds of pre-acquisition taxes. n53 The limitations imposed by § 381(b)(3) and the consolidated return regulations are particularly important where the post-acquisition losses are substantial, the participants' pre-acquisition incomes which fall within the prescribed carryback period are of a commensurate magnitude, and the prognosis for near-term utilization in a carryforward year is uncertain. The extent to which the participants' respective pre-acquisition incomes will be accessible to post-acquisition losses will vary as a function of (1) the technical means by which the acquisition is effected, (2) the purchaser's motive for the acquisition, and (3) whether either or both of the transacting corporations are, were, or will be members of affiliated groups n54 filing consolidated returns, n55 and, if so, (4) whether either was the common parent of its pre-acquisition group. The consolidated return regulations contain special rules pertaining to "reverse acquisitions" and "built-in losses" that make additional distinctions meaningful in the context of post-acquisition loss carrybacks.

n53 The limitations on the carryback of post-acquisition losses also apply to excess general business credits and foreign tax credits which are earned after a corporate business combination.

n54 This term is defined in § 1504(a) and is summarized in the text accompanying notes 127-29.

n55 The consolidated return regulations apply only to those affiliated groups with respect to which an election to file a consolidated return is, or, for the year in question, was, in effect.

[*100] The necessity, or at least the desirability, of preserving the refund potential of the pre-acquisition incomes of A, T, and, where applicable, their respective affiliates, is frequently overlooked in evaluating the available alternatives. Within the framework of other legal and tax-related constraints, A should attempt to structure the acquisition so as to preserve as much of the pre-acquisition refund potential of the amalgamating corporations as possible in the event that post-acquisition losses subsequently materialize. Where T has substantial pre-acquisition income, the parties representing it or its shareholders should likewise insist that the tax benefit of any refund be shared according to some mutually acceptable formula which takes into account the certain and immediate value of a post-acquisition loss that can be carried back, as compared with the risk and diminished present value of a loss that can only be carried forward. n56

n56 If the parties intend the acquisition to qualify as a nontaxable reorganization, special caution must be exercised regarding any contingent consideration specified in the agreement. In a Type B, Type C, or reverse triangular Type A reorganization, the consideration should be payable in additional voting stock: both to avoid running afoul of the "solely for voting stock" requirements of those respective provisions (IRC § 368(a)(1)(B), (C); (a)(2)(B), (E)), and to comply with the advance ruling standards of Section 3.06 of Rev. Proc. 77-37, 1977-2 C.B. 568. The choice of the form of additional consideration is less critical, but nevertheless important, in a Type A reorganization (or in a forward triangular Type A reorganization) where too much non-equity consideration could result in violation of the continuity of interest requirement.
and thereby retroactively disqualify the transaction. For an excellent and comprehensive discussion of the various ramifications of using contingent consideration in corporate business combinations, see C. Fleming, Jr., Tax Aspects of Buying and Selling Corporate Businesses ch. 14 (1987).

Acquisitions To Which The Consolidated Return Regulations Are Inapplicable

n57 That is, where neither A nor T belonged to an affiliated group which filed consolidated returns at any time during the relevant post-acquisition loss carryback period, and such corporations are not parties to a consolidated return in any subsequent year from which a carryback of post-acquisition losses to a member's pre-acquisition income is attempted.

Asset Acquisitions

Nontaxable Transactions

When the assets and businesses of two or more corporations are merged, consolidated, or otherwise combined into a single corporate entity, questions arise as to whether and to what extent the tax attributes of the respective corporations should be preserved in the surviving corporation. Where the amalgamation is itself the product of a fully taxable sale or exchange, there is clearly no basis upon which to justify a departure from the general rule that such attributes are personal to the taxpayer and thus nontransferable. In a nontaxable asset acquisition, however, this approach would conflict with the statutory conceptualization of such transactions as merely one of many phases in the life cycle of a continuing enterprise. Subject to a number of general and specific limitations and conditions designed to prevent abuse or to preclude administrative complexities perceived as insurmountable, n58 § 381(a) provides for the preservation of T's tax attributes by requiring that they follow its assets to A in acquisitions which qualify as Type A, Type C, nondivisive Type D, Type F, or nondivisive Type G reorganizations. n59

n58 IRC §§ 381, 382, 383, 384, 269.

n59 This provision also applies to the liquidation of an 80% or greater controlled subsidiary under § 332. IRC § 381(a)(1). Section 381 is not, however, applicable to divisive Type D or Type G reorganizations under § 355. In these transactions, earnings and profits are nevertheless allocated between the distributor and distributee corporations under the authority of § 312(h).

Section 381(c) contains an inclusive list of the predecessor corporation's tax attributes that carry over to the successor corporation. Some of the more important are: net operating loss, capital loss, investment tax credit, and alternative minimum tax credit carryforwards; accounting and inventory valuation methods; and the earnings and profits account balance.

Absent from the list of preserved attributes is T's pre-acquisition taxable income history. Section 318(b)(3) provides that, except in the case of a Type F reorganization: "The corporation acquiring property [in one of the above-described transactions] shall not be entitled to carry back a net operating loss or a net capital loss for a taxable year ending after the date of distribution or transfer to a taxable year of the distributor or transferor corporation." n60

n60 This same limitation applies to carrybacks of post-acquisition credits. Reg. §§ 1.381(c)(23)-1(b), 1.381(c)(24)-1, 1.381(c)(26)-1.

Only in a Type F reorganization, a "mere change in the identity, form, or place of one corporation, however effected," will this prohibition not apply. IRC §§ 381(b), 368(a)(1)(F). Recent legislation, which limited the Type F reorganization to transactions involving but one operating corporation, largely stripped this exception of its usefulness. The circumstances under which a transaction will qualify as a Type F reorganization under current law is the subject of an extensive analysis in a later section of this article. See the text accompanying notes 308-425.
Under § 381(b)(3), T's pre-acquisition income cannot be offset by any losses that are sustained by A following the acquisition, unless the acquisition qualifies as a Type F reorganization. n61 This prohibition applies even where the losses can be irrefutably identified with the operations of the acquired business.

n61 Where the transaction qualifies both as a Type F reorganization and as either a Type A, Type C, or Type D reorganization, it will be treated as a Type F reorganization in applying the operating rules of § 381(b). Reg. § 1.381(b)-1(a)(2). The Type F reorganization also prevails where the transaction simultaneously qualifies as a § 332/334(b) liquidation. Eastern Color Printing Co. v. Commissioner, 63 T.C. 27 (1974). But in Gordon v. Commissioner, 424 F.2d 378 (2d Cir. 1970), and in Columbia Gas, Inc. v. United States, 366 F.2d 991 (Ct. Cl. 1966), the courts rejected taxpayer attempts to circumvent the exacting requirements of § 355 through the alternative application of the Type F reorganization to corporate divisions.

[*102] Although the prohibition against carrybacks to T's pre-acquisition income is unyielding, nothing in the statutory scheme expressly prevents any post-acquisition losses attributable to the business or assets acquired from T from being carried back to offset pre-acquisition income generated by A's original business. n62 The propriety of permitting one business's pre- or post-acquisition losses to cross over to offset the income of other businesses residing in the same corporate shell, has, however, attracted the attention of the courts. In Libson Shops, Inc. v. Koehler, n63 the Supreme Court added an altogether unexpected dimension to the pre-1954 judicially formulated carryover rules. The Libson Shops case involved the statutory merger of 16 brother-sister corporations, each of which owned and operated a single retail store, into another corporation controlled by the same shareholders. Before the merger, all 17 corporations had been owned by the same shareholders in identical proportions. Following the merger, the surviving corporation attempted to use the net operating loss carryforwards of three of the corporations to offset its aggregate post-merger income. Since the same three stores which had sustained the pre-merger loss continued to produce operating losses after the merger, their carryforwards, if allowed, would offset income attributable to the businesses formerly conducted by the other amalgamating corporations. The issue before the Court was whether the loss carryforwards were to be limited only by the successor corporation's aggregate income, or whether their deductibility was contingent upon and confined to the post-merger income produced by the same businesses which had sustained the pre-merger losses.

n62 Nor do the regulations under § 381 imply any such limitation. See, however, discussion of § 269 and the possible implications of Hall Paving Co. v. United States, 471 F.2d 261 (5th Cir. 1973), in the text accompanying notes 290-300.

n63 353 U.S. 382 (1957). Although this case was decided in 1957, the transaction under review took place prior to enactment of the 1954 Code.

The Court held that the net operating loss carryforward deduction was intended to mitigate the annual accounting period rule as it pertained to the income and losses of a single business. The Court thus denied the taxpayer's carryforward on the ground that the post-acquisition income against which the deduction was sought had not been produced by the same businesses that had sustained the pre-acquisition losses. n64 Commentators have suggested that the decision may have been motivated by more pragmatic considerations: "[T]he Libson Shops decision seemed concerned with the possibility of a tax 'windfall' if the carryovers had [\*103] been allowed as deductions: Absent the merger, operating losses of the three loss corporations could not have been offset against profits of the other corporations since consolidated returns had not been filed prior to the merger." n65

n64 In subsequent years, this tracing requirement was to produce great confusion, uncertainty, and controversy in an area theretofor thought to have been relatively settled. Congress had in the intervening years enacted §§ 381 and 382 to deal specifically with the carryover of pre-acquisition tax attributes. Unfortunately, these rules neither sanctioned nor repudiated the tracing requirement of Libson Shops. Consequently, the issues and vagaries to which the decision gave rise did not instantly become moot as might have been hoped.
In Estate of Stauffer v. Commissioner, the Libson Shops tracing rule was expressly extended to the converse scenario, that is, the carryback of post-acquisition losses. There, under pre-TEFRA law, the Ninth Circuit held that amalgamations of commonly owned operating corporations could, at least under some circumstances, qualify as Type F reorganizations, and that, while a carryback of post-acquisition losses to T's pre-acquisition tax years was thus not limited by § 381(b)(3), such carrybacks would be restricted, under Libson Shops, to the pre-acquisition income of the business subsequently producing the carryback losses. Although this case involved a Type F reorganization, the rationale employed by the court to justify its invocation of the Libson Shops tracing rule raised the spectre of the universal application of that rule to post-acquisition loss carrybacks following all types of asset acquisitions.

n66 48 T.C. 277 (1967), rev'd, 403 F.2d 611 (9th Cir. 1968). See also Rev. Rul. 75-561, 1975-2 C.B. 129 (made obsolete by TEFRA revisions to § 368(a)(1)(F) (see note 60)).

n67 The Type F reorganization is now restricted to transactions involving only one operating corporation. See note 60.

n6 The rationale employed by the court to justify its invocation of the Libson Shops tracing rule raised the spectre of the universal application of that rule to post-acquisition loss carrybacks following all types of asset acquisitions. n68

Whatever the merits of these two holdings, the issue was recently and definitively rendered moot. In the committee reports accompanying the revision of § 382 in the 1986 Act, Congress expressly rejected the Libson Shops doctrine. n69


Note, however, that § 382, where applicable, now limits the amount of a corporation's loss carryforwards that can be used in any given year to the amount of income which, under a mandatory statutory formula, the net assets of the loss corporation are deemed capable of having produced. The statute does not, however, inquire as to the actual source of the income against which such limited losses are utilized. Section 382 is discussed in the text accompanying notes 239-53.

The following examples serve to illustrate the application of § 381(b)(3), and the manner in which its ultimate impact varies as a function of the mechanical form chosen by the parties to effect the acquisition.

n70 None of the transactions described in the following examples qualifies as a Type F reorganization, in that both of the amalgamating corporations actively conduct a business.

**[*104]** Example 1

A and T are unrelated, calendar year C corporations. Neither is a member of an affiliated group, and each actively conducts a business. On December 31, 1987, T, the smaller corporation in terms of its net value, merged into A in a transaction that qualified as a nontaxable Type A (or Type C) reorganization. The acquisition was undertaken for business purposes, and thus did not have as its principal purpose the evasion or avoidance of income taxes within the meaning of § 269. After the merger, the business of each was maintained as a separate division in A. In the three tax years preceding the acquisition (1985-1987), A and T reported total taxable income of $700,000 and $200,000, respectively. Due to unanticipated business reversals in the first post-acquisition tax year, these same pre-acquisition businesses of A and T sustained 1988 net operating losses of $700,000 and $200,000, respectively. No portion of these amounts was attributable to built-in losses.
That is, they have no common shareholders.

Had no merger occurred, both T and A could have utilized their respective 1988 net operating losses fully against 1985-1987 taxable income. n72 Due to the intervening merger, however, § 381(b)(3) comes into play, and, in all but a Type F reorganization, requires a less favorable outcome. The 1988 losses may be carried back to A's pre-acquisition income, but may not be used to offset any amount of T's pre-acquisition income. Thus, instead of carrying back the full $900,000 net operating loss with tax benefit, A may carry back only $700,000. The $200,000 balance may be carried forward for up to 15 years. A must wait until a future year to obtain any economic benefit from the loss, n73 and will lose all such benefit should it fail to generate sufficient income during the carryover period (or, assuming the worst, prior to a less distant liquidation and dissolution).

n72 IRC § 172(a), (b).

n73 It is worth noting that A's carryforward is not "indexed" to reflect changes in the purchasing power of the dollar. Assuming continued inflation, the economic value of the eventual tax saving diminishes with each passing year.

Example 2

Assume the facts of Example 1, except that the combination of the two businesses is instead effected by having A merge into T in a nontaxable Type D reorganization. n74 Under this revised circumstance, the $700,000 pre-merger taxable income of A, now the "transferor corporation," is inaccessible under § 381(b)(3), and only $200,000 of the post-acquisition loss may be utilized. n75

n74 A's shareholders end up with 50% or greater control of T as required by §§ 368(a)(1)(D), 354(b)(1), 368(a)(2)(H) and 304(c).

n75 Unlike either § 382 (which limits the utilization of pre-acquisition loss carryovers that survive the transaction, discussed in the text accompanying notes 239-53) and Reg. § 1.1502-75(d)(3) (the "reverse acquisition" rules of the consolidated return regulations, discussed in the text accompanying notes 198-203), neither § 381(b) nor the regulations thereunder inquire as to the true identity of the acquiring and acquired corporations. Thus, if T has the greater amount of pre-acquisition income, and if A anticipates substantial post-acquisition losses (or merely recognizes that possibility), the parties might structure the transaction as a merger of A into T in order to preserve the greatest amount of pre-acquisition refund potential. This can usually be accomplished without compromising the other tax, legal, and economic objectives of the parties. The Service, however, has taken the position that if either the acquiring corporation or the acquired corporation is the common parent of a consolidated group, then the consolidated return rules, among them the reverse acquisition rules, control. LTR 8527001 (March 20, 1985), discussed and illustrated in the text accompanying note 204-10. Other potential problems with this technique are discussed in the text accompanying notes 301-7.

Example 3

Assume the facts of Example 1, except that T and A combined by means of a statutory consolidation rather than by merger. Now both are transferor corporations and, notwithstanding the functional equivalence of the consolidation transaction with the merger alternatives described in Examples 1 and 2, no amount of the 1988 loss can be carried back.

Example 4

Assume the same facts as presented in Example 1, where T merged into A, except that A has 1985-1988 taxable income of $900,000, while T has none. Now, both the $700,000 post-acquisition loss generated by A's original business and the $200,000 loss sustained by the business formerly conducted by T may be carried back to generate a refund of pre-acquisition taxes paid by A.
Section 381(b)(3) makes no distinction between amalgamations of theretofore unrelated corporate business enterprises, and those which involve related corporations and are undertaken either to perfect this relationship by increasing the level of common control, or to merely alter the legal form of affiliation. The operation of § 381(b)(3) is unaffected by the degree of continued equity participation by those who were T’s shareholders [*106] at the time the taxes on the pre-acquisition income were paid. n76 Indeed, § 381(b)(3) denies carrybacks of post-acquisition losses to T’s pre-acquisition income even where amalgamating corporations were owned in the same proportions by the same shareholders and there is a consequent identity as to those who ultimately bore the detriment of the original tax liability and those who stand to benefit from its return. n77

n76 Where the amalgamated corporations were both members of the same consolidated group for the consolidated return year to which the post-acquisition loss is to be carried, the consolidated return regulations operate in such a way as to preclude the harsh results that § 381(b)(3) usually gives rise to.

n77 TEFRA modified the statutory definition of the Type F reorganization so as to limit its application to transactions involving but one operating corporation. In written and oral testimony before the Subcommittee on Select Revenue Measures of the House Ways and Means Committee, the author argued that this decision was seriously flawed in that it grossly misinterpreted legislative history and failed to consider, or even recognize a responsibility to consider, the critically important equity and policy issues which the Stauffer line of cases (see note 317) had brought to light. See Carryover of Net Operating Losses and Other Tax Attributes of Corporations: Hearings Before the Subcomm. on Select Revenue Measures of the House of Rep. Comm. on Ways and Means, 99th Cong., 1st Sess. 63-109 (1985).

Example 5

Assume the facts of Examples 1 through 4, except that all of the stock of both T and A is owned by the same noncorporate shareholder. Since, after 1986, this transaction no longer qualifies as a Type F reorganization, n78 § 381(b)(3) would apply in the same manner, and with the same effect, as in each of these preceding scenarios.

n78 See the text following notes 316-18. This transaction would qualify as a nontaxable, nondisruptive Type D reorganization under §§ 368(a)(1)(D) and 354(b).

Example 6

Assume the same facts as in Examples 1 and 4, except that T has been A’s 80% or greater controlled subsidiary throughout the relevant carryback period and that the merger is actually a liquidation of T in a transaction that qualifies under §§ 332/334(b). Assume further, that A and T had not filed consolidated returns for 1985-1987. Under this revised scenario, § 381(b)(3) would produce the same results as in these two previous examples: The pre-acquisition refund capacity of T, even as to the post-acquisition losses attributable to the same business that was conducted by T prior to the liquidation, would forever vanish as a result of the restructuring of the legal form of A’s interest in the business of the late T. n79 Nor would the [*107] result set forth in Example 2 be altered where A merged downstream into its controlled subsidiary, T. n80

n79 Under circumstances in which, unlike those in Examples 1 and 4, the parent corporation is merely a holding company, the transaction may qualify as a Type F reorganization, in which case the post-acquisition losses sustained by the former parent could be carried back against its own pre-acquisition income as well as that of its former subsidiary. IRC § 381(b). See Eastern Color Printing Co. v. Commissioner, 63 T.C. 27 (1974).

n80 See also Reg. § 1.1502-79(a)(1). If, instead of opting to repose in the same corporate entity, A and T had merely elected to begin filing consolidated returns for 1988 and thereafter, Reg. §§ 1.1502-79(a)(1) and 1.1502-21(b) would have permitted the 1988 consolidated net operating loss attributable to T to be carried back to offset the pre-acquisition income reported in its 1985-1987 separate return years.
Taxable Transactions

In an asset acquisition that fails to qualify under one of the nontaxable reorganization (or liquidation) transactions listed in § 381(a), T's pre-acquisition tax history remains with T (or disappears when T liquidates and dissolves). Post-acquisition losses attributable to the business acquired from T cannot be carried back to offset T's pre-acquisition income, but they may be carried back against the pre-acquisition income of A. Thus, although the transactions described in Examples 1 through 4 involve nontaxable asset acquisitions, tax consequences identical to those described in each of those four scenarios would likewise have resulted even if the respective transactions had been fully taxable. But since T would not necessarily go out of existence as a result of the transaction, any post-acquisition losses generated by a retained business -- or by a business subsequently acquired by T with the sale proceeds -- could be carried back to generate a refund by offsetting the taxable income reported on T's pre-sale tax returns. n81

n81 A refund of the pre-disposition taxes paid by the continuing corporate entity is possible even if that corporation has since witnessed a substantial, or even complete, change in its ownership prior to the time it sustains post-disposition losses. Absent a dominant tax avoidance motive for the purchase of T's stock, § 269, discussed in the text accompanying notes 275-307, would not apply. Nor would the limitations imposed under § 382 be applicable, at least not insofar as losses actually accruing, in an economic sense, after the acquisition. The possible implications of § 382 in attempted carrybacks of pre-ownership change, built-in losses that are recognized in post-ownership change tax years are discussed in notes 254-74.

Stock Acquisitions

Nontaxable Transactions

The post-acquisition losses of A and T that are recognized following a Type B reorganization can be carried back to their respective pre-acquisition incomes, but cannot, where such incomes are insufficient to absorb these losses, be utilized to offset each other's pre-acquisition incomes. These rules also apply where, in a transaction involving corporations under common control, a brother corporation acquires a sister corporation's stock from its shareholders, either as a contribution to its capital or in a § 351 exchange.

Taxable Transactions

Where A acquires stock representing 80% control n82 of T in a taxable transaction, the extent to which the pre-acquisition income of A or T can be offset by the carryback of their respective post-acquisition losses will depend upon whether a § 338 election was made (or deemed made), and upon whether the corporations file a consolidated return for the year in which the losses are recognized. As noted previously, a § 338 election generally treats A as having purchased all of T's assets in a taxable transaction, and as then having transferred them to a newly-organized subsidiary. Since T is considered a new entity for almost all purposes relating to federal income taxation, n83 its pre-acquisition tax history vanishes as of the transaction date. Consequently, any post-acquisition losses sustained by T's business cannot be carried back to the pre-acquisition income recognized by that business. n84 Nor, absent an election to file a consolidated return, can such losses be carried back to A's pre-acquisition income. n85 If, however, the subsidiary is liquidated into A under § 332 before the losses are incurred, then the post-acquisition losses of T's business may be carried back to A's pre-acquisition income. n86

n82 As defined under § 1504(a)(2), reproduced at note 129.

n83 IRC § 338(a). For the purposes of subpart F (procedure and administration), New T is treated as a continuation of Old T.

n84 Any losses resulting from the deemed sale of T's assets are pre-acquisition losses, and can be carried back under the normal rules to offset its own pre-acquisition income. See notes 50 and 176.
If a consolidated return is filed, the so-called "offspring" rule of Reg. § 1.1502-79(a)(2) should be applicable. The effect of this rule would be to permit the post-acquisition losses attributable to T to be carried back to the pre-acquisition consolidated income of the group (where the carryback year was a consolidated return year), or to the pre-acquisition separate return income of A (where the carryback year was a separate return year as to A). LTR 8742006 (July 1, 1987). These rules are discussed and illustrated in the text accompanying notes 153-62.

Where A acquires all or any portion of T's stock in a taxable purchase with respect to which § 338 is not applicable, the rules and limitations discussed above in connection with nontaxable stock acquisitions apply here with equal force and effect.

Example 7

Assume the facts of Example 1, except that on December 31, 1987, instead of acquiring the assets of T, A acquires all of the stock of T either (1) in a nontaxable Type B reorganization or

[*109] (2) from its own shareholders in a nontaxable contribution to A's capital or in a nontaxable § 351 exchange. Assume, again, that the consolidated return rules are inapplicable.

In marked contrast to the tax consequences resulting from the asset acquisition alternative described in Example 1, T and A may each utilize their respective 1988 net operating losses fully against 1985-1988 taxable income. Further, assuming that no § 338 election is made (or deemed made) by A within the prescribed time period, and that T is not liquidated into A following the stock purchase, this result would obtain even if A had purchased the stock of T for cash in a fully taxable acquisition.

Thus, in a fully taxable stock acquisition, a refund of T's pre-acquisition taxes is allowed even if none of the shareholders who ultimately suffered the detriment of those taxes is any longer in a position to benefit from the refund, n87 and notwithstanding the fact that the economic benefit thereof will instead inure to shareholders whose economic position was in no way diminished by the payment of the original taxes. n88 Yet, in a nontaxable asset acquisition, no such refund is permitted notwithstanding that those who suffered the original taxes -- that is, T's shareholders -- continue to hold a proprietary interest in the business now producing the losses.

n87 By virtue of the fact that they do not own any stock in A at the time T's post-acquisition losses are carried back.

n88 This outcome would not obtain where the sale contract contained a contingent agreement which would require that a portion of the tax refunds be paid to T's former shareholders, or where the stock sale price was otherwise adjusted to reflect the anticipated value of the refunds. See discussion in the text accompanying note 56.

Example 8

Assume the same facts as those presented in Example 4, except that A acquires all of T's stock in a nontaxable Type B reorganization. Assume, again, that the consolidated return rules are inapplicable.

Under these circumstances, A's $700,000 net operating loss may be carried back to generate a refund of the taxes it paid on its own pre-acquisition income. However, unlike the tax consequences resulting from the analogous merger scenario described Example 4, the 1988 net operating loss of T, now a wholly-owned subsidiary, rather than a division, of A, cannot be carried back to offset the remaining $200,000 of A's pre-acquisition income.

[*110] Triangular Asset Acquisitions
Nontaxable Transactions

The reorganization provisions expressly provide for nontaxable acquisitions that are effected through the use of a controlled subsidiary which, in turn, uses its parent corporation's stock, rather than its own, as consideration. By its terms, § 381(b)(3) applies equally to all nontaxable asset acquisitions, whether they are accomplished directly or through a controlled subsidiary.

n89 The subparagraphs setting forth the requirements for the Type B and Type C reorganization contain parenthetical references to the use of the stock of the acquiring corporation's parent. IRC § 368(a)(1)(B), (C). Triangular Type A reorganizations are permitted but are subject to additional requirements under § 368(a)(2)(D). Section 368(a)(2)(E) permits the reverse of the usual subsidiary acquisition process, that is, the controlled subsidiary is merged into the target corporation.

n90 IRC § 381(a).

Example 9

Assume the facts of Example 1, except that in addition, S[a] is a wholly-owned subsidiary of A. On December 31, 1987, S[a], using voting stock of A, acquires the assets of T in a nontaxable triangular Type A or Type C reorganization. The consolidated return rules are inapplicable.

If S[a] had no operating assets of its own, the effect of this transaction is virtually indistinguishable from A's acquisition of a subsidiary in a Type B reorganization. Nevertheless, the transaction is technically an acquisition of assets by S[a], and, except where either (1) the transaction can be held to qualify not only as a Type A or Type C reorganization, but also as a Type F reorganization, or (2) § 381(b)(3) is held inapplicable on the theory that Congress did not intend such a result, S[a] cannot carry back the losses produced by the acquired business to T's pre-acquisition income.

n91 See Example 8, following note 88.

n92 In Aetna Casualty & Sur. Co. v. United States, 568 F.2d 811 (2d Cir. 1976), and Bercy Indust., Inc. v. Commissioner, 640 F.2d 1058 (9th Cir. 1981), the respective appellate courts held that § 381(b)(3) was not intended to apply where, in a forward triangular Type A reorganization, the acquiring subsidiary was a shell corporation having no substantial assets of its own. These decisions are discussed in the text accompanying notes 91-126.

n93 Such losses, however, would generally offset the pre-acquisition income, if any, of S[a].

If, in a reverse triangular merger under § 368(a)(2)(E), S[a] had merged into T, then T could carry its post-acquisition losses back to obtain a refund of taxes it paid on its own pre-acquisition income. In neither the forward nor the reverse acquisition, however, could T's excess losses be carried back to A's pre-acquisition income.

Judicial Reinterpretation of Section 381(b)(3)

Whether or not the legal identity of a particular corporate party to a reorganization will survive an acquisition is frequently a matter of little or no consequence in terms of the ultimate economic effect of the transaction. Nevertheless, this transactional attribute may, as Example 9 illustrates, be decisive as to the resulting tax consequences. If, in that example, the legal identity of T had survived the acquisition (that is, T had been maintained as a wholly-owned subsidiary of A), T would have been permitted to carry its 1988 loss back to offset its pre-acquisition income. If, on the other hand, T contemporaneously merged (or was subsequently liquidated) into S[a], § 381(b)(3) would, absent qualification as a Type F reorganization, intervene to preclude such a carryback. This statutory mandate result is in no way compromised by the fact that the economic effect of the latter alternative, ignoring tax consequences, is virtually indistinguishable from that of the former. In both instances, the same business concern, with the same
assets and the same liabilities, is conducted in corporate form under the ultimate control of the same parties (that is, the shareholders of A).

On facts similar to those presented in the forward triangular merger illustrated in Example 9, the Second Circuit, in Aetna Casualty, and the Ninth Circuit, in Bercy Industries, permitted the respective taxpayers to carry back the post-merger net operating losses of the transferee corporation (S[a]) to offset the premerger taxable income of the transferor corporation (T). In Aetna Casualty, the court rested its ultimate holding primarily on the ground that, notwithstanding a substantial contemporaneous shift in proprietary interests, the merger of the operating transferor corporation into the shell transferee corporation constituted a Type F reorganization. n94 Later, in denying the government's request for rehearing, the court offered an alternate rationale: Irrespective of whether the transaction constituted a Type F reorganization, Congress did not intend § 381(b)(3) to apply where there were no problems in tracing the postfusion losses of the acquired business to its pre-fusion tax returns. In Bercy Industries, the Ninth Circuit went even further by relying exclusively upon this latter rationale to reach the same result in a similar transaction that involved a much greater shift in proprietary interests.

n94 568 F.2d at 819-21. The possible impact of shifts in proprietary interests on a transaction's status as a Type F reorganization is discussed in the text accompanying notes 308-425.

[*112] In each case, the court appears to have been decisively influenced by the fact that the transaction actually consummated was the economic equivalent of alternatives under which net operating loss carrybacks would uncontestably have been allowed. n95

n95 Not all courts have been so influenced. See the discussion of Spinoza, Inc. v. United States, 375 F. Supp. 439 (S.D. Tex. 1974), in the text accompanying notes 399-413, where, under facts similar to those in Bercy Industries and Aetna Casualty, the court confined the taxpayer to the legal form chosen to consummate the acquisition, and, accordingly, applied § 381(b)(3) to the taxpayer's detriment.

Aetna Casualty

Aetna Casualty & Surety Co. v. United States n96 involved a forward triangular merger of a profitable operating corporation into a 100%-owned shell subsidiary corporation. Aetna Life Insurance Co. (Aetna Life) owned 61.61% of Aetna Casualty and Surety Co. (Old Aetna), a corporation actively engaged in the sale of liability, fire, theft, property damage, and surety insurance. As a result of changes made in 1959 in the manner in which life insurance companies were taxed, Aetna Life sought to reduce its federal income taxes by placing its Old Aetna stock directly in the hands of its shareholders. n97 To make this divestiture nontaxable, n98 Aetna Life devised and consummated the following plan.

n96 568 F.2d 811 (2d Cir. 1976), rev'g 403 F. Supp. 498 (D. Conn. 1975).

n97 Under the 1959 legislation, the amount of taxes payable by life insurance companies was made to depend, in part, upon their asset base: the greater the value of a company's assets, the greater its taxes. One of Aetna Life's assets was the 61.61% stock interest it owned in Old Aetna.

n98 Under § 802(b)(3), a direct distribution of the Old Aetna stock to its shareholders would have triggered taxable income to Aetna Life. Section 815(f)(3)(B), as then constituted, avoided this result by treating certain stock distributions covered by the reorganization provisions as not constituting a "distribution" to shareholders.

Aetna Life organized Farmington Valley Insurance Co. (Farmington Valley) as a wholly-owned subsidiary. To this corporation, Aetna Life transferred 13,300,000 shares of its own stock. Pursuant to a plan of reorganization, Old Aetna then merged into Farmington Valley whereupon its shareholders received the Aetna Life stock as consideration for their respective interests in Old Aetna. Aetna Life, by virtue of its 61.61% ownership of Old Aetna, received 61.61% of this stock which it promptly retired. The remaining 38.39% of the Aetna Life stock was distributed to the Old Aetna minority shareholders. Farmington Valley immediately changed its name to Aetna Casualty and Surety Co. (New Aetna) and continued, without
interruption or modification, the business formerly conducted by Old Aetna, the transferor corporation. Aetna Life subsequently distributed all of its New Aetna stock to a trust for the benefit of all of its shareholders. Evidence of a proportional beneficial interest in the trust was attached to each Aetna Life share so that the Aetna Life stock and the proportional interest in the trust holding the New Aetna stock would be indivisible. An advance letter ruling was obtained from the Service to the effect that the transaction constituted a Type C reorganization.

In the period immediately following the merger, New Aetna incurred sizable net operating losses which it sought to carry back to offset the pre-merger taxable income of Old Aetna and thereby recover over $4 million dollars of the taxes (plus interest) previously paid by Old Aetna. To sustain its claim to the carryback, New Aetna advanced several alternative arguments: (1) The transaction was not a reorganization at all, but rather a redemption of minority shareholders; (2) the transaction constituted a Type B reorganization; (3) the transaction constituted a Type F reorganization; and (4) Congress did not intend the restrictions of § 381(b)(3) to apply to the combination of an operating corporation with a mere shell corporation, regardless of the tax label placed on the transaction.

n99 Recall that § 381(b) does not grant exemption from the carryback prohibition of § 381(b)(3) in Type C reorganizations.

If the taxpayer succeeded under either of the first two arguments, the carryback would be allowed under the general rules of § 172, which control where there is no change in the taxpaying entity. Under the last two arguments, the carryback would be allowed under § 381(a) and (c) inasmuch as § 381(b)(3), an exception to the general rule allowing carryovers in acquisitive reorganizations, would be disabled.

The taxpayer fared poorly at the trial level: The District Court rejected each argument and disallowed the carryback. It first distinguished and criticized the Tax Court's holding in Casco Products Corp., n100 where a reincorporation undertaken for the sole purpose (and having the sole effect) of squeezing out minority shareholders was held not to constitute a reorganization at all, but merely a redemption by the same continuing corporation. Here, on the other hand, since a reorganization had in fact taken place, the consequences flowing from it must, according to the court, be determined in the light of that reality.

n100 49 T.C. 32 (1967), discussed in the text accompanying notes 414-21.

The trial court likewise held for the government on the Type B and Type F reorganization issues. The transaction was not a Type B reorganization because Old Aetna lost its unique legal identity by virtue of its merger into Farmington Valley. And, under the still viable standards set forth by the Supreme Court in Helvering v. Southwest Consolidated Corporation, n101 the court deemed the 38.39% shift in proprietary interests that resulted from the exchange of Old Aetna stock by its minority shareholders for stock of Aetna Life far too great to warrant classifying the transaction as a Type F reorganization. In refusing to test continuity by segregating the "redemption" from the "reincorporation" on the theory that the two were "functionally unrelated," the court expressly declined to follow the lead of either the Fifth Circuit in Reef Corp. v. Commissioner, n102 or the Service in Revenue Ruling 61-156. n103 The trial court not only disagreed with the basic philosophy behind the "functionally unrelated" approach, but held further that, even if viable, that approach should be limited to cases involving tax avoidance motivated reincorporation schemes. The court observed:

n101 315 U.S. 194 (1942), discussed in the text accompanying notes 334-45.

n102 368 F.2d 125 (5th Cir. 1966), discussed in the text accompanying notes 376-91.


Perhaps the key to understanding both Reef and Revenue Ruling 61-156 is to realize that they were both efforts to frustrate the "liquidation-reincorporation" stratagems with which the court and the IRS were faced. Such tax avoidance plans subvert the tax laws and have created serious problems; courts and the IRS have been willing to hang decisions rejecting such stratagems in an acrobatic fashion upon any
sections of the Code that seem convenient . . . . The attempt to reconcile positions taken by the Commissioner or the Tax Court where tax consequences of a different kind were at stake is unrewarding and the precedent value of those cases here is slight . . . .

In the case at bar, there is no tax avoidance scheme to be rejected . . . . Thus I decline to apply the step-transaction logic of Reef and Revenue Ruling 61-156 to the distinguishable problem presented here . . . .


To paraphrase, different standards of construction are to be applied depending upon whose ox is being gored. n105

But see Estate of Stauffer v. Commissioner, 403 F.2d 611 (9th Cir. 1968) (court held that the same definitive standards apply regardless of the issue under review).

Since the transaction did constitute a "reorganization," but did not constitute either a Type B or a Type F reorganization, § 381(b)(3) disallowed the carryback sought by the taxpayer.

On appeal, the Second Circuit agreed with the district court that a "reorganization," and not merely a "redemption," had taken place, and that the contrary Tax Court holding in Casco Products, where the facts were very similar, was erroneous. But it then reversed the lower court, holding that the transaction qualified as a Type F reorganization and that § 381(b)(3) therefore did not preclude the carryback. The appellate court's perception of the legislative intent behind the allowance of carrybacks, generally, and of carrybacks following reorganizations, in particular, [*115] seems to have provided the foundation for its interpretation of the Type F reorganization:

We believe that where the issue is whether a corporation is entitled to a carryback after a corporate reorganization, Section 368(a)(1)(F) should be construed with particular sensitivity to the purposes of Section 381(b). The interplay between subsections (F) and (A)-(E) gains its principal significance under the Code through the application of § 381(b). Since New Aetna was merely a corporate shell with no business of its own, none of the accounting problems which motivated § 381(b)(3) is present here. Indeed, since New Aetna had no pre-reorganization tax history of its own, application here of the carryback prohibition contained in § 381(b)(3) would prevent New Aetna from obtaining any carryback of its current losses, even though § 381(b)(3) does not prevent acquiring corporations in other types of reorganizations from carrying back losses to their own pre-reorganization tax years. We do not believe that the mere fact that a redemption has occurred should lead to so Draconian a result, particularly since Section 172 manifests a legislative policy in favor of carrybacks which ordinarily would not be affected by a simple redemption. n106

n106 568 F.2d at 822.

The court, as an initial matter, held that the redemption of the Old Aetna minority shareholders could be separated from the acquisition as "functionally unrelated" to the reincorporation. It held further that even if the redemption and the reincorporation were viewed as components of the same integrated transaction, since a "redemption is not a characteristic of a reorganization," n107 the transaction must nevertheless be evaluated net of the effect of the redemption.

n107 Id. at 822 (citing with approval Reef Corp. v. Commissioner, 368 F.2d 125 (5th Cir. 1966)). The Reef case is discussed further in the text accompanying notes 376-91.

Absent the shift in the proprietary interests of the minority shareholders of Old Aetna, there would be no basis for contending that the merger of Old Aetna into a shell corporation, which had no business or assets of its own, did not qualify as a Section 368(a)(1)(F) reorganization . . . . We know of no authority for the proposition that the merger of one corporation into a mere corporate shell does not constitute a Section 368(a)(1)(F) reorganization. n108
Although this statement implies that changes in proprietary ownership, regardless of direction or magnitude, are of no consequence in assessing qualification as a Type F reorganization where one of the two corporations is a mere shell corporation, it is clear from statements made later in the opinion that the court recognized that some ownership changes could give rise to contrary results:

Here, unlike Southwest Consolidated, there was merely a shift in the proprietary interest of the minority shareholders of Old Aetna. The transaction here involved cannot be described accurately as a "sale" of one corporation's assets to another corporation. We agree with the Fifth Circuit that the instant reorganization might begin to look more like a "sale" -- or at least might look less like a Section 368(a)(1)(F) reorganization and a redemption -- "if the change in proprietary interests were to new persons and less than 50% of the former stockholders' interest in the old corporation remained in the new corporation." n109

Having allowed the carryback on these grounds, the court expressed no opinion as to whether the transaction also might have constituted a Type B reorganization.

The Second Circuit's most significant, and controversial, holding in this case was expressed, not in the original opinion itself, but in the denial of the government's request for rehearing:

We are concerned here with a reorganization in which a corporation is merged into a corporate shell with no prior business or tax history of its own. Since this reorganization presents none of the accounting or allocation problems that might arise in reorganizations involving two corporations each with a prior business and tax history, we concluded that Congress did not intend the loss carryback to be unavailable. In our view, it makes no difference whether effectuating Congressional intent in the circumstances of this reorganization is achieved by construing Section 368(a)(1)(F) somewhat broadly to include the reorganization of Old and New Aetna, or by construing Section 381(b)(3) somewhat narrowly so as to be inapplicable to this particular reorganization. Either way, a loss carryback favored by the policies of the Code, see Sections 172 and 832(c)(10), and not presenting the problems with which the prohibition of

The apparent flaw in the court's suggestion that § 381(b)(3) be construed narrowly is that the express, unambiguous language of the statute, to whatever degree it may or may not succeed in manifesting legislative intent, leaves little, if any, room for judicial construction. If the transaction is described in § 381(a), and if it constitutes a Type F reorganization, a carryback is allowed; and if it does not so qualify, the carryback is denied. It is that simple. In the opinion of the author, the Second Circuit's belated alternate holding, notwithstanding the indisputable equity of its result, is not merely judicial interpretation, but is instead an outright judicial veto of an unambiguous statutory provision. The propriety of this holding is discussed further in connection with the Ninth Circuit's decision in Bercy Industries where, on more extreme facts, the court relied solely upon its interpretation of legislative intent behind § 381(b)(3) in granting the taxpayer's claim to a net operating loss carryback.

Bercy Industries, Inc.

Bercy Industries, Inc. v. Commissioner n111 involved facts very similar to those of Aetna Casualty, except that (1) the parent corporation of the acquiring shell corporation had no pre-acquisition ownership interest in the target corporation (and thus was not simply redeeming a minority interest), and (2) the former shareholders of the target corporation ended up owning only 4.4% of the stock of the parent corporation.
In Bercy Industries, Beverly Enterprises (Enterprises) owned all of the stock of Beverly Manor (Manor), an inactive shell corporation with no assets (other than voting common stock of Enterprises, its parent) and no operating history of its own. Enterprises sought to acquire Bercy Industries, Inc. (Old Bercy), an unrelated corporation, as a wholly-owned operating subsidiary, by means of a forward triangular merger into Manor. Pursuant to a plan of reorganization, Manor exchanged all of the Enterprises voting common stock held by it for all of the outstanding stock of Old Bercy. As a result of this exchange, the shareholders of Old Bercy terminated their entire direct interest in Old Bercy and acquired an aggregate voting interest in Enterprises of 4.4%. Immediately after the merger, Manor changed its name to Bercy Industries, Inc. (New Bercy) and, without change or interruption, conducted the same business as that formerly conducted by Old Bercy. New Bercy unexpectedly incurred sizable net operating losses in the year following the merger and sought to carry them back to the premerger tax returns of Old Bercy on the ground that either (1) the transaction qualified as a Type B reorganization, or (2) congressional intent supporting the enactment of § 381(b)(3) rendered that provision inapplicable under the present facts.

The Tax Court ruled that the transaction did not constitute a Type B reorganization inasmuch as the target corporation, Old Bercy, ended up in a different corporate shell, Manor. The court further implicitly rejected the Second Circuit's alternative holding in Aetna Casualty: "There the court was able to root its argument on a finding that an (F) reorganization had taken place . . . . We have no such lifeline here and we cannot apply that approach in a statutory vacuum." Without analysis or discussion, the Tax Court held that the shift from a 100% direct proprietary interest to a 4.4% indirect proprietary interest was far too great to warrant invoking § 368(a)(1)(F).

The Ninth Circuit reversed in favor of the taxpayer and allowed the carryback. It did so not by fitting the transaction into the Type B or Type F reorganization molds, but by concluding that Congress never intended § 381(b)(3) to apply where the nature of the reorganization did not give rise to complex accounting problems in allocating post-merger losses back to the premerger income of the business which incurred those losses:

[T]he legislative history shows that Congress was concerned with a complex accounting problem -- deciding how a post-reorganization loss should be allocated between the acquiring corporation and the transferor corporations, and, therefore, how much of the loss should be carried back to offset each entity's income in the preceding three tax years . . . . The Senate Finance Committee reported: "Some limitation upon carrybacks in reorganizations and mergers is justifiable on the ground that it is too complex in some cases to determine to which of several component corporations the loss of the surviving corporation is attributable . . . . [I]n two important areas . . . the problem of allocating the loss is not involved, and it is suggested that in such cases, at least, there should be no limit on carrybacks . . . ." This language strongly suggests that when a reorganization generates no complex problems of post-reorganization loss allocation, Congress intended that the surviving corporate taxpayer be able to carry back such losses without limitation.

While the court's assessment of the legislative intent behind the enactment of § 381(b)(3) is most convincing, the enacted statute explicitly denies loss carrybacks where the corporate acquisition is other than by means of the Type B or Type F reorganization. Good or bad, right or wrong, the Code does not mitigate this troublesome and potentially inequitable precondition by expressly establishing, or even hinting at, an exception for situations where no "complex allocation problems" arise. While it is well established that the reports of the congressional committees may be of great usefulness to the courts in determining legislative intent where the statutory language is ambiguous, they do not take the place of the enacted statute, and are of no value where the law is articulated clearly and unequivocally.

n111 70 T.C. 29 (1978), rev'd, 640 F.2d 1058 (9th Cir. 1981).

n112 70 T.C. at 39-40.

n113 640 F.2d at 1060-61 (quoting Hearings on H.R. 8300 before the Senate Finance Comm., 83d Cong., 2d Sess. 404 (1954)).

n114 However
sympathetic the taxpayer's plight in Bercy Industries, the remedy, if there was to be a remedy, should only have come as a result of congressional reconsideration. In the author's opinion, the court exceeded its judicial prerogative in granting the carryback. The decision, moreover, raises extraordinarily difficult questions as to just when and to what extent carrybacks might be allowed by the courts in reorganizations which involve more than one operating corporation, or where the shift in ownership is, to a greater or lesser extent, the result of a taxable exchange. n115


n115 But see In re N.B.H. Land Co., 78-1 USTC P9358 (D. Colo. 1978) (decided before the Ninth Circuit rendered its decision in Bercy Industries). In that case, the transactional pattern was the same as that in Bercy Industries with two differences: (1) the target corporation was acquired by an unaffiliated shell corporation, rather than by a shell subsidiary of an operating parent corporation, and (2) instead of using its stock to acquire the stock of the target corporation in a nontaxable reorganization, the acquiring corporation used cash, with the result that the transaction was fully taxable to the target corporation's shareholders. (A few days after the stock purchase, the target corporation was liquidated into the shell parent corporation under §§ 332 and 334(b)(2)).

The District Court refused to segregate the taxable purchase transaction from the upstream merger and to label the latter a Type F reorganization. Under Southwest Consolidated, the 100% shift in proprietary interest to outsiders precluded the application of this reorganizational form for any purpose under the tax statute. This court did not consider whether the legislative intent behind § 381(b)(3) might mandate a more favorable result to the taxpayer. Nor was the court influenced by the fact that the carryback would not have been precluded under the economically equivalent route of having the parent merge downstream into the subsidiary. See also Cannonsburg Skiing Corp. v. Commissioner, 51 T.C.M. 844 (1986).

Although the acquisition in Bercy Industries was a nontaxable reorganization exchange (and the court noted, in passing, that there was some continuity of interest on the part of the Old Bercy shareholders) the reasoning of the Ninth Circuit in granting the carryback strongly suggests that it would have done so even if the acquisition had been fully taxable, as it was in N.B.H. Land Company.

In addition to holding that exemption from § 381(b)(3) could be obtained under circumstances not set forth in the statute, the court held that post-acquisition loss carrybacks should be allowed without regard to whether or to what extent the ownership of the corporation had changed between the time the pre-acquisition income was earned and the time the post-acquisition losses were sustained. n116 In so holding, it recognized two incongruent theories upon which Congress constructed the statutory carryover provisions:

n116 Except for the possible disallowance of built-in losses under § 382 (see the text accompanying notes 254-74), and for the possible application of § 269 (see the text accompanying notes 275-307), a 100% cash purchase of stock without any change in the corporate entity or in the nature of the business enterprise, for example, does not preclude the carryback of post-acquisition losses.

The Commissioner makes much of the fact that because of the reorganization, the benefit of the loss carryback will accrue to a different set of shareholders than the one that owned Bercy at the time it earned the income to be offset. We fail to see why this should prevent a carryback. Sections 381 and 382 are grounded on two competing theories: (1) A loss carryback ought to be available only when the shareholders who were the "beneficial sufferers" of such loss retain an interest in its use, as the Commissioner argues; and (2) a loss carryover ought to be available only for use against profits from business activities which gave rise to the loss . . . . These two theories conflict in large degree, so that any particular subsection of 381 or 382 may favor one theory over the other. As our discussion of congressional intent indicates, . . . this was the case with Section 381(b)(3); theory (2), rather than theory (1) clearly animates subsection (b)(3). n117

n117 640 F.2d at 1062 n.7.
The court seemed especially impressed by the fact that shifts in proprietary interests, regardless of their magnitude, generally have no effect on the corporation's right to the carryback where the acquisition is by means of a reverse, instead of a forward, triangular merger. n118

n118 "Finally, the Commissioner himself concedes that a loss carryback would have been permitted had Bercy reorganized pursuant to a reverse triangular merger, yet such a reorganization would have resulted in the same change in shareholder ownership which the Commissioner now argues should prevent the carryback." Id.

Although the court's opinion rested upon its perception of the legislative intent behind § 381(b)(3), some of the language used in the opinion indicates that the court may have considered the transaction a Type F reorganization, at least for the purpose of applying that provision where a net operating loss carryback was at issue:

[The Commissioner] further argues that the reorganization transformed Old Bercy economically by shifting control of that corporation from its own shareholders to those of Beverly Enterprises . . . . [W]e are not persuaded that [such] a material [*121] change in identity resulted from the reorganization here at issue. The reorganization involved only one set of operating assets, one set of books, and one tax history. New Bercy is operating the same commercial business that Old Bercy operated. n119

n119 Id. (emphasis added).

Although the precedents established by Aetna Casualty and Bercy Industries certainly carry the potential for major change in the circumstances under which the limitations of § 381(b)(3) will be applied, subsequent legislative developments may have limited their significance. First, while the wording of both opinions seems broad enough to encompass mergers of multiple operating corporations, whether or not commonly owned, so long as "complex allocation problems" do not exist, the 1982 statutory change restricting the Type F reorganization to reincorporations involving but one operating corporation will probably prevent these precedents from extending too far beyond the basic fact patterns in these cases, both of which involved only one operating corporation. n120

n120 Even before the Type F reorganization was redefined in 1982, the Tax Court, traditionally hostile to virtually all attempts at circumventing § 381(b)(3), found this distinction easy to make. Berger Mach. Prod., Inc. v. Commissioner, 68 T.C. 358 (1977), involved the statutory consolidation of four commonly owned (but not identically owned) corporations, and the issue, again, was whether § 381(b)(3) applied to preclude a carryback of post-acquisition losses to the pre-acquisition income of the consolidating corporations. The Tax Court, noting that the appellate court in Aetna Casualty had indicated that its opinion was "strictly limited" to the facts under review, refused to apply that precedent where the transaction involved amalgamations of multiple operating corporations. 68 T.C. at 365. Berger, however, was decided prior to the Ninth Circuit's less equivocal decision in Bercy Industries.

But even where only one operating corporation is involved and the facts otherwise closely parallel those in Aetna Casualty and Bercy Industries, the fundamental change in orientation and philosophy that distinguishes § 382 of the Internal Revenue Code of 1986 n121 from its predecessor may have an impact on the precedential value of these decisions. If future courts attempt to divine the essence of § 381(b)(3), which was unchanged by the 1986 Act, from the legislative intent supporting the redesign of § 382, they will observe that the two competing theories identified by the appellate court in Bercy Industries persist under the new law as well: Neither theory was abandoned in favor of the other. n122 The new rules continue to employ both concepts, but in significantly different ways.

n121 These rules are summarized in the text accompanying notes 239-53.

n122 See the text accompanying note 117.

In determining whether the carryover limitations of § 382 will come into play, the new rules now focus almost exclusively on ownership changes and the time frame within which they take place. Under prior
law, this threshold was defined as a function of ownership change and transactional form and business continuity. For example, in a stock purchase acquisition under prior law, the magnitude of the ownership change mattered not at all, so long as the business of the acquired corporation was continued for at least two years thereafter. n123 The 1986 Act change could be viewed as supporting the notion that the Ninth Circuit's first theory (shareholder continuity, not business continuity, is the touchstone for carryovers) has now become the dominant force behind the allowance of carryovers generally, and that § 381(b)(3) should be applied in this light.

n123 Section 382(a), before amendment in 1986, applied where both the ownership of the stock of a loss corporation and the nature of its business operations changed radically over a short period. More specifically, this section provided that the net operating loss carryforwards of a corporation would be completely and permanently eliminated if:

1. The ownership of the corporation's stock (measured by value rather than by voting power) of its ten largest shareholders (attribution rules applied in making this determination) increased by more than 50 percentage points since the beginning of either the present tax year or the preceding tax year;

2. Such increase was the result of "purchases" of stock from "unrelated" parties, or from a decrease in the number of shares outstanding (via redemptions); and

3. Within two years of such change in ownership, the business theretofore conducted by the corporation was discontinued.

On the other hand, a comparison of the magnitude and design of the old and new limitations on loss carryforwards, once evoked, seems to lend support to the Ninth Circuit's second theory (a loss carryover ought to be available only for use against profits from business activities which gave rise to the loss). Under the new rules, survival of pre-acquisition loss carryforwards depends on whether the business of the loss corporation continues for a specified period following the ownership change. If it does, the amount of the loss carryforward that can be deducted in a given year is limited to a hypothetical amount of income that the business of the loss corporation is deemed to have been capable of producing in that year. In contrast, the grief inflicted by the business end of old § 382(b), for example, varied as an exclusive, and inverse, function of shareholder continuity. n124

n124 Section 382(b), before amendment in 1986, permanently reduced the amount of net operating loss carryforward in certain nontaxable asset acquisitions (Type A, Type C, non-divisive Type D and G, and Type F reorganizations), wherein the shareholders of the loss corporation wound up owning an insufficient amount of the surviving corporation's stock. If, after the reorganization, the shareholders of the loss corporation owned less than 20% of the stock (measured by value) of the surviving corporation, the net operating loss carryforward was permanently reduced by 5% for each percentage point by which the stock ownership of the loss corporation shareholders fell short of the 20% threshold. In marked contrast to old § 382(a), it made no difference whether the business of the loss corporation was continued by the surviving corporation. Consequently, § 382(b) reduced net operating loss carryforwards solely on the basis of stock ownership.

It was quite easy, at least for the well-informed, to avoid any reduction in the net operating loss carryforwards of an acquired corporation even where the post-transaction interests of the former shareholders of such corporation in the acquiring corporation fell below 20%. First, old § 382(a) and old § 382(b) were both expressly made inapplicable to acquisitions structured as Type B reorganizations. Second, in a triangular or reverse triangular asset acquisition, § 382(b)(6) applied the 20% test by comparing the value of the parent corporation stock held by the shareholders of the loss corporation to the value of the outstanding stock of the acquiring subsidiary. It was thus possible for a whale to swallow a minnow without any reduction in the minnow's loss carryforwards, so long as the acquisition either took the form of a Type B reorganization, or was effected through the use of a controlled subsidiary.

[*123] Although the recent overhaul of § 382 may indeed compel future courts to reexamine Aetna Casualty and Bercy Industries in that light, one significant feature of the law has not changed. Section
381(b)(3) still does not in any way impede the carryback of post-acquisition losses sustained by a business following a stock acquisition or a reverse triangular Type A merger of an inactive subsidiary into an operating target corporation. But, as in the past, the near-equivalent alternative of the forward triangular Type A merger of the active target corporation into a shell subsidiary incurs its unmitigated wrath. This blatant lack of "functional neutrality" n125 in the legislative design, and the inequities to which it gives rise, undoubtedly influenced the Second and Ninth Circuits, and there is every reason to expect that courts may continue to look askance at future attempts by the government to rigidly enforce these asymmetrical statutory standards. n126

n125 This term is defined in note 429 and discussed in the text accompanying notes 429-500.

n126 See, however, note 483 for insight as to the Supreme Court's view on the propriety of equating economically equivalent or near-equivalent transactions where the statute is unambiguous.

Acquisitions to Which the Consolidated Return Regulations Are Applicable

Section 1502 allows the "members" of an "affiliated group" to join in the filing of a single, consolidated federal income tax return, in lieu of the usual requirement that each corporation file its own separate return. An "affiliated group" exists only where the relationship between two or more "includible corporations" n127 meets or exceeds the intercorporate affiliation [*124] thresholds established by § 1504(a). More specifically, the statute requires that the "common parent corporation" must directly own stock representing "control" n128 of at least one other includible corporation. This accomplished, the membership of the resulting affiliated group will include not only the common parent and the subsidiaries that it directly controls, but any other includible corporation which is itself controlled, individually or collectively, by one or more of the group's other members. n129

n127 Under § 1504(b), only domestic corporations (and certain wholly-owned Canadian and Mexican corporations that are, at the election of the owning member, treated as domestic corporations (IRC § 1504(d))) qualify for membership in an affiliated group. Additionally, certain specially-taxed corporations are generally excluded from membership. Among these are tax-exempt corporations (IRC § 501), life insurance companies (IRC § 801), electing possessions corporations (IRC § 936), regulated investment companies and real estate investment trusts that are taxable under Subchapter M (IRC §§ 851-860), a former DISC corporation with accumulated DISC income or undistributed previously taxed income (IRC § 992(a)(1)), and Foreign Sales Corporations (which, by definition, are foreign corporations (IRC § 922)).

n128 "Control," for this purpose, means 80% or more of the total combined voting power of all classes of voting stock and 80% or more of the value of all outstanding stock, excluding only nonvoting, nonparticipating, nonconvertible preferred stock. IRC § 1504(a)(2), (4) (reproduced in note 129).

n129 IRC § 1504(a)(1), (2), and (4) read as follows:

(a) AFFILIATED GROUP DEFINED. -- For purposes of this subtitle --

(1) IN GENERAL. -- The term 'affiliated group' means --
(A) One or more chains of includible corporations connected through stock ownership with a common parent corporation which is an includible corporation, but only if --

(B) (i) the common parent owns directly stock meeting the requirements of paragraph (2) in at least one of the other includible corporations, and

(ii) stock meeting the requirements of paragraph (2) in each of the includible corporations (except the common parent) is owned directly by one or more of the other includible corporations.

(2) 80-PERCENT VOTING AND VALUE TEST. -- The ownership of stock of any corporation meets the requirements of this paragraph if it --

(a) possesses at least 80 percent of the total voting power of the stock of such corporation, and

(B) has a value equal to at least 80% of the total value of the stock of such corporation.

(4) STOCK NOT TO INCLUDE CERTAIN PREFERRED STOCK. -- For purposes of this subsection, the term 'stock' does not include any stock which --

(A) is not entitled to vote,

(B) is limited and preferred as to dividends and does not participate in corporate growth to any significant extent,

(C) has redemption and liquidation rights which do not exceed the issue price of such stock (except for a reasonable redemption or liquidation premium), and

(D) is not convertible into another class of stock.

Once a valid election to file a consolidated return is made by an affiliated group (hereinafter a consolidated group), every member of the group must participate. n130 The principal effect of the election is that the subsidiary members of the group are characterized as mere extensions, or [*125] divisions, of the common parent corporation. n131 This fundamental approach is subject to several exceptions which, in large measure, are designed to deal with problems that would otherwise result where the affiliated group has not, or will not, always file consolidated returns, or [*126] where the composition of the group changes over time. n132

n130 Reg. § 1.1502-75(a), (b), (e); see also Rev. Rul. 56-559, 1956-2 C.B. 595.

To be effective, the election to file the group's first consolidated return must itself be filed on or before the due date (including extensions) for the filing of the common parent corporation's return, and each corporation that has been a member of the affiliated group at any time during the first consolidated return tax year must consent. Reg. § 1.1502-75(a)(1).

Once made, the election to file a consolidated return has continuing effect. Under Reg. § 1.1502-75(a)(2) and (d), a group which filed (or was required to file) a consolidated return for the immediately preceding taxable year is required to continue filing a consolidated return for the current taxable year, unless either the group itself has terminated, or the common parent has made a valid election to discontinue filing a consolidated return.

Except in the case of a "reverse acquisition" (defined and discussed in the text accompanying notes 198-203), an affiliated group is considered as remaining in existence as long as (1) the common parent corporation remains the common parent corporation of the group, and (2) it has at least one subsidiary corporation at all times throughout its taxable year. This second requirement is satisfied regardless of
whether or not the subsidiary in question was a member of the group in a prior year, and regardless of whether or not one or more corporations have ceased to be subsidiaries at any time since the group was originally formed. Reg. § 1.1502-75(d)(1). Further, a mere change in the identity, form, or place of organization of the common parent corporation under § 368(a)(1)(F) will not trigger a termination of the group. The successor corporation will simply inherit the "common parent" status of its predecessor. Reg. § 1.1502-75(d)(2)(i). Nor will the liquidation and dissolution of the common parent corporation cause the consolidated group to terminate if (1) substantially all of its assets are transferred "downstream" to other members of the group, and (2) there remains one or more chains of includible corporations connected through stock ownership with a common parent corporation that (a) qualifies as an "includible" corporation and (b) was a member of the group prior to the date on which the former common parent corporation ceased to exist. Reg. § 1.1502-75(d)(2)(ii).

An election to discontinue filing a consolidated return requires the consent of the Commissioner. Where amendments to the Code or regulations might have a substantial adverse effect on the filing of consolidated returns, relative to members filing separate returns, the Commissioner, at his discretion, may grant blanket permission to all consolidated groups or to one or more classes of consolidated groups. Otherwise, the common parent corporation of a particular group may apply to the Commissioner to terminate the filing of a consolidated return. Approval is subject to the Commissioner's finding of "good cause" (e.g., the net effect of all amendments to the Code and/or regulations would otherwise have a substantial adverse effect on the group's tax liability computed on a consolidated basis when compared with that which would otherwise result from the filing of separate returns by its members, etc.). Reg. § 1.1502-75(c).

n131 This general view of a group of corporations filing a consolidated return is not entirely accurate. The consolidated return regulations actually employ a combination of "single entity" and "separate entity" concepts in the derivation of consolidated taxable income:

The consolidated return regulations represent a blending of two views of the nature of an affiliated group of corporations. One view is that an affiliated group is an aggregation of distinct corporations, each of which should be treated as a separate taxpayer for federal income tax purposes. Under this view, a parent corporation is simply treated as an unrelated investor in each of its subsidiaries. The other view is that the affiliated group is itself a single taxable entity, and that each member corporation is simply a component part of a greater whole. Under this latter view, transactions between members generally do not give rise to tax consequences, and a parent corporation is treated as owning directly the assets of its subsidiaries.


Of importance to the topic of this article are the consolidated return regulations which address the technical and policy issues that are triggered either by the acquisition of a new member by one or more existing members of a consolidated group, or by the disposition of one of the consolidated group's existing members. Although these special rules were designed primarily to prevent the acquisition of a corporation with existing net operating loss carryforwards (or other favorable tax attribute carryforwards n133) in order to utilize them against income produced by other members of the group, many of these limitations also impact the ability of the respective corporations to carryback post-acquisition losses to pre-acquisition incomes. Only the latter rules are discussed here, n134 and the discussion of these rules will generally be confined to their impact on post-acquisition loss carrybacks.

n133 Note, however, that neither the "separate return limitation year" nor the "consolidated return change in ownership" rules are applicable to carryforwards of excess charitable contributions. Reg. § 1.1502-24.

n134 While the "consolidated return change in ownership" regulations are, for example, often decisive in determining the extent to which loss carryforwards of a member can be utilized within the group, these rules have no applicability to loss carrybacks from a consolidated return year to a separate return year. This
is true even where the current losses are "built-in" losses which the loss corporation or its group wishes to carry back.

Summary of the Issues

One of the principal advantages of an election to file a consolidated federal income tax return is that the net operating losses of one member can generally be used contemporaneously to offset the taxable income of another member. For any given taxable year, the consolidated taxable income (or consolidated net operating loss) of a consolidated group is determined by first computing the separate taxable incomes (or the separate net operating losses) of each member under the procedures set forth in Reg. § 1.1502-12, and by then combining and further adjusting these amounts in the manner prescribed by Reg. § 1.1502-11.

Where, in a given taxable year, the consolidated group sustains a consolidated loss, that loss can generally be carried back or forward to offset consolidated income in essentially the same manner that an unaffiliated corporation would carry its loss over to offset its own income. Unless the composition of the group has changed (or, under the regulations, is deemed to have changed) in the intervening years, no special computations are required and no special limitations apply. n135

n135 This statement is subject to two exceptions. The first applies where a § 1504(c)(2) election is in effect. This election allows life insurance companies to be included as members of a consolidated group that also includes nonlife companies. See note 127. Section 1503(c)(2) provides that any loss attributable to a nonlife member that has not been a member of the group for at least five taxable years may not be used to offset any of the income attributable to the subgroup of life members, either in the year the loss is recognized, nor in any other year to which the loss might be carried. Section 1503(c)(1) further limits the amount of any loss attributable to the subgroup of nonlife members that can be used to offset the income of the subgroup of life members. Briefly and very generally, the statute requires that unless an election to relinquish the carryback period is made, the current losses of the nonlife subgroup must be segregated and carried back to the income produced by that subgroup before any amount of such losses may be used to offset any of the current or future income of the life subgroup. If, in the prior year to which the nonlife subgroup loss was carried, a loss of the life subgroup was used to offset the income of the nonlife subgroup, the life subgroup loss will be supplanted by the current year's nonlife subgroup loss carryback, and the life subgroup loss will be recommissioned as a loss carryforward. Reg. § 1.1502-47(a)(2)(ii). Any portion of the loss attributable to the nonlife subgroup that is not absorbed as a carryback can generally be used to offset the income of the life members to the extent of the lesser of (1) 35% of the unabsorbed loss of the nonlife subgroup, or (2) 35% of the income of the life subgroup. This same limitation applies in all future years to which any balance of the nonlife loss may be carried. If, however, an election has been made to relinquish the carryback period with respect to the loss of either the nonlife subgroup or the life subgroup, then the losses of that subgroup cannot offset any of the income of the other subgroup in future years. Reg. § 1.1502-47(m)(3)(viii), (n)(2).

The second exception was enacted as part of the 1986 Act and applies to "dual consolidated losses" (i.e., the losses of domestic corporations that are subject to an income tax of a foreign country, where such tax is based either on worldwide income or on residence). Under § 1503(d)(1), a dual consolidated loss cannot be used to reduce the taxable income of any other member of the consolidated group unless, under the income tax laws of the foreign country, such loss cannot be used to offset the income of any foreign corporation. Section 1503(d) is generally applicable to net operating losses sustained in tax years beginning after 1986.

Finally, note that under the current consolidated return regulations, the consolidated income or loss generally reflects 100% of the separate income or loss of all of the group's members, notwithstanding the fact that less than 100% of the stock of one or more of those members is owned by the common parent or by other members of the group. Recently proposed legislation would have changed this fundamental and traditional approach to taxing consolidated groups. Under these proposed rules, the amount of the separate income or loss of a less-than-100%-owned subsidiary member that could be included in the group's consolidated income would be limited to the percentage of the subsidiary's stock held by the group. The balance of the income or loss would be reported on a separate minority interest return. These unwelcome

[*127] Problems do arise, however, where the group has acquired a new member or a former member has left the group. More specifically, where a corporation that is (or was) a member of a consolidated group recognizes a post-acquisition/disposition loss that it seeks to carry back to offset pre-acquisition/disposition income, its (or its group's) ability to do so is not unbridled. n136 Several distinct scenarios can readily be envisioned:

n136 It is important to note that, with one important exception, the issue of whether and to what extent the post-acquisition/disposition losses attributable to a member can be carried back to offset previously taxed income arises only when the group produces a loss on a consolidated basis. The regulations neither require nor permit a consolidated group to segregate and carry back the loss produced by one or more of its members if the group did not itself sustain a consolidated loss. Reg. § 1.1502-2(a), -11. Segregating an individual member corporation's current year loss from the consolidation computations might have otherwise been desirable where (1) the marginal tax rate applicable to the group (or the loss member) in a prior year was higher than the rate applicable to the portion of its current year's income that the loss will offset, or (2) where, as a hedge against future losses, the group seeks to preserve the refund potential of its current taxable income by utilizing its member's current separate losses against a prior year's income, before the applicable carryback period expires and such income becomes inaccessible. But, again, the regulations render these otherwise sound planning strategies moot.

The one exception to this rule applies where, in the current year, a member recognizes a loss that was economically accrued in a pre-acquisition tax year, and that member's separate income is not sufficient to absorb such loss. The built-in loss limitations of the consolidated return regulations, discussed in the text accompanying notes 214-28, usually prevent the group from using such losses against income attributable to its other members. Instead, recognized built-in losses that the loss member cannot itself use in the year of recognition can usually be carried back, irrespective of whether the group reported income or loss on a consolidated basis, to offset its own pre-acquisition taxable income.

Even where the group, or, in the case of built-in losses, a member of the group, has losses that can be carried back, recall that § 172(b)(3)(C) allows taxpayer's to forego the entire carryback period, and to instead carry such losses forward only. See note 52.

[*128] 1. Post-acquisition losses are recognized by the business of A or T n137 and an attempt is made to carry these losses back to their own or to each other's pre-acquisition incomes.

n137 Or, in an asset acquisition wherein the historic businesses of the two corporations have been integrated into a single business enterprise, the post-acquisition losses are recognized by the Successor business.

2. Post-acquisition losses are recognized by the business of A or T n138 and an attempt is made to carry these losses back to the pre-acquisition income attributable to other members of their own or each other's pre-acquisition groups.

n138 Id.

3. Post-acquisition losses are recognized by a subsidiary of A or T and an attempt is made to carry these losses back to the pre-acquisition income attributable to other members of its own or the other's pre-acquisition groups.

4. Post-acquisition losses are recognized by the selling corporation (or a continuing member of its consolidated group) and an attempt is made to carry these losses back to offset the pre-disposition income attributable to a former subsidiary member of the selling corporation's group.
The issues presented in the first of these four scenarios will generally be resolved by reference to the limitations of § 381(b)(3), discussed and illustrated in the two preceding sections of this article. Unlike § 381(b)(3), however, the "reverse acquisition" rules of the consolidated return regulations test the realities of the labels assigned by the parties to the "acquiring" and the "acquired" corporations. In short, if T's shareholders end up owning more than 50% of the value of A's stock, the regulations reverse these labels and impose the § 381(b)(3) restrictions accordingly.

[*129] Section 381(b)(3) does not address the issues arising in any of the three remaining scenarios. The consolidated return regulations, however, will sometimes impose tracing requirements which are designed to prevent the losses identified with one corporation from offsetting the income of another corporation in a carryback year in which such corporations either were not members of the same consolidated group, or, because of the acquisition, are no longer deemed to have been members of the same group. n139 The "reverse acquisition" rules are also relevant in this context, in that they will determine which pre-acquisition group is to be preserved (and whose members will thus not be subject to the tracing rules).

n139 These tracing rules have no present counterpart in asset acquisitions. See discussion of the legislatively abandoned "business tracing" rule of Libson Shops v. Koehler, 353 U.S. 382 (1957), discussed in the text accompanying notes 62-9, and Example 4, in the text preceding note 76.

It is important to note at the outset of this discussion, that if a § 338 election is made (or deemed made) with respect to T, many of the issues alluded to above and discussed throughout this section will, as they relate to T and its subsidiaries, n140 be rendered moot. n141 Additionally, until regulations are issued under § 336(e), n142 the effect that this election will have on the tax identity of the acquired corporation and on its pre-disposition taxable income history is uncertain. It is not unlikely, however, that a seller that elects to treat a sale of stock as a sale of assets under § 336(e) might be taxed in a manner which closely parallels that resulting to a seller under a § 338(h)(10) election. n143 Further, if, under § 336(e), a stock sale is treated as a sale of assets with respect to the electing seller, then it seems probable, or at least possible, that the election will likewise result in the purchaser(s) of the stock being treated as if it (or they) had instead purchased the assets of the acquired corporation (and had then transferred such assets to a newly formed subsidiary).

n140 Under § 338(f), a § 338 election cannot be made selectively as between the various members of an affiliated group that are acquired by the purchasing corporation within the "consistency period" (i.e., one year before and one year after the acquisition period). Consequently, if a § 338 election is made or, under § 338(e), deemed made with respect to an acquired parent corporation, it is will likewise be deemed to have been made with respect to each of its acquired subsidiaries.

n141 IRC § 338(a). For a brief overview of the effect of a § 338 election, see the text accompanying notes 27-9.

See, however, note 85 for a description of the effect of § 338(a) on the applicability of the "offspring" rule; note 176 for the treatment of a net loss recognized on the final separate return of a disposed subsidiary where a § 338(h)(10) election is not in effect; and the text accompanying notes 211-2 for the possible interaction between § 338 and the "reverse acquisition" rules of Reg. § 1.1502-75(d)(3).

n142 Section 336(e) was summarized in note 25.

n143 See note 152.

[*130] "Separate Return Year"

In General

As noted above, an affiliated group filing a consolidated return is normally allowed to carry a consolidated loss back to offset the consolidated income it reported in one or more prior consolidated return
years (CRY). But where, for a tax year "equivalent" to the consolidated return carryback year in question, one or more of the members contributing to the current consolidated loss either filed a separate return or joined in the filing of a consolidated return with a different affiliated group, then the loss attributable to that member must be segregated from the group's consolidated loss carryback. This apportioned loss can only be carried back to the income reported by (or attributable to) that member in its equivalent carryback tax year. However, under current regulations, a loss sustained in a "separate return year" (SRY) which is not also a "separate return limitation year" (or SRLY), may be carried back or forward to consolidated return years and there used to offset consolidated income. n150

n144 Reg. § 1.1502-21(a), (b)(1).

n145 The "equivalent" year concept is discussed and illustrated in the text accompanying notes 169-72.

n146 Reg. § 1.1502-1(e) refers to these years as "separate return years."

n147 The portion of a consolidated loss that is attributable to a member is determined under the following formula:

\[
\text{Member's separate loss / Sum of the separate losses of all loss members} \times \text{The group's consolidated loss}
\]

Reg. § 1.1502-79(a)(3). The "separate loss" of a member is derived under the rules and procedures set forth in Reg. § 1.1502-12, as further adjusted by Reg. § 1.1502-79(a)(3)(i) through (iv).

See Reg. § 1.1502-79(a)(4) for an illustration of the application of these rules.

n148 Reg. § 1.1502-79(a)(1). Consequently, even if the consolidated group reported substantial consolidated income for the carryback year, if the loss member reported no income on its separate return for the corresponding "equivalent" tax year, then neither it nor the group will obtain any tax benefit in that year from the carryback. Additionally, even if there has been no change in the composition of the group, this rule will nevertheless apply where the group did not file a consolidated return for the year to which the loss is carried. Reg. § 1.1502-79(a)(1)(i).

n149 Defined and discussed in text accompanying notes 173-95.

n150 In this regard the current regulations are more permissive than their predecessors. Under Reg. § 1.1502-31A(b)(3) (in effect for taxable years beginning prior to 1964), loss carryovers from a SRY (irrespective of whether or not such SRY was also a SRLY) to a CRY could only be used against the separate income of the member that sustained the loss.

In each of the following examples (10 through 17), except as otherwise provided, assume that (1) the additional restrictions set forth under § 1503(c) and (d) are not applicable; n151 (2) all corporations depicted are solvent, calendar tax year C corporations; (3) none of the acquisitions described is a "reverse acquisition" within the meaning of Reg. § 1.1502-75(d)(3); (4) an election under § 172(b)(3)(C) to relinquish the carryback period has not been made; and (5) neither § 338 nor § 336(e) is applicable with respect to the acquisition.

n151 See note 135.

Example 10

P[a] is the common parent of an affiliated group which is comprised of P[a] and its wholly-owned subsidiary, S[a]. P[a] and S[a] were both formed on 1/1/85. On the consolidated federal income tax returns for their 1985-1987 calendar tax years, the group reported a total of $1,000,000 of consolidated income. This amount represents the sum of P[a]'s $950,000, and S[a]'s $50,000 separate incomes.
T was formed by an unrelated individual taxpayer on 1/1/85, and it reported total income of $100,000 on its calendar tax year returns for 1985-1987. Late in the afternoon on 12/31/87, all of T's stock was acquired by P[a]. For 1988, the group sustained an overall loss of $900,000. Of this amount, $50,000 was attributable to P[a], $150,000 to S[a], and $700,000 to T.

Since T's 1985-1987 calendar tax years are SRYs, the $700,000 of the group's 1988 loss attributable to T must be segregated from the consolidated loss and apportioned to T. Since T itself had only $100,000 of income in 1985-1987, only that amount of the apportioned loss can be carried back. The $200,000 balance of the group's 1988 loss is not apportioned between P[a] and S[a], but is, instead, carried back on a consolidated basis to the consolidated income reported by the P[a]/S[a] group in 1985-1987. None of the $600,000 unused balance of T's apportioned loss can be employed to offset any part of the $800,000 balance of P[a]/S[a]'s 1985-1987 consolidated income. Unless and until T leaves the group (or the group itself disbands or ceases to file a consolidated return), n152 the $600,000 unused balance of its 1988 loss will instead be carried forward to 1989 and future years as a consolidated loss.

n152 Upon the happening of any of these events, and except in the case of a stock disposition to which § 338(h)(10) (or possibly, § 336(e)) is applicable, any amount of the $600,000 1988 consolidated loss carryforward which has not already been used by the group would usually be re-apportioned to T for its own separate use in subsequent years. Reg. § 1.1502-79(a)(1). Note, however, that if a member leaves the group at some time during a CRY, any consolidated loss carryforward from a prior year must first be carried to the group's consolidated income for that entire CRY. (But neither the current losses of the departing member, nor the consolidated loss carryforwards attributable to it, may be used by the group to offset any gain that the group recognizes as a result of the member's disposition. Reg. § 1.1502-11(b).)

Only if and to the extent that any such loss remains unabsorbed will it be apportioned to the former member for its separate use in its first and subsequent separate return years. Reg. § 1.1502-79(a)(1)(ii). But see Reg. § 1.1502-76(b)(5)(ii), which allows a member that leaves the group within the first 30 days of the CRY to elect to "be considered as not having been a member of the group during such year," and to thereby avoid having its losses being used to absorb the post-departure income of the group.

In the case of a stock purchase/sale with respect to which an election under § 338(h)(10) (or, possibly, § 336(e)) is made, the transaction is treated as if T had liquidated into its parent under § 332, and had then sold T's assets. Consequently, the seller is allowed to use both T's losses and losses attributable to other members of the seller's consolidated group to offset the gain recognized on the disposition of T's assets. Furthermore, any of T's unused current losses and unused loss carryforwards from prior years remain with the seller's group. See Temp. Reg. § 1.338(h)(10)-1T. The § 338(h)(10) election is made jointly by the purchaser and the selling group on Form 8023 (simultaneously with the § 338 election itself). The election is unavailable if T is the common parent of an acquired group.

The "Offspring" Rule

Where a loss member was not in existence in a year to which a consolidated loss can be carried, the loss attributable to it cannot be carried back to that year at all (either as a component of the group's consolidated loss or, obviously, as a separate loss), unless (1) the loss member became a member of the group immediately upon its formation, n153 and, if and when recently proposed regulations are finalized, (2) the majority of its noncash assets were not acquired in a nontaxable asset acquisition. n154 If the requirements for this exception are satisfied, then the loss attributable to such corporation need not be segregated from the consolidated loss, and can thus be carried back "to the equivalent consolidated return year of the group (or, if such equivalent year is a separate return year, then to such separate return year) . . . ." n155

n153 In a related context, the courts have held that a corporation's existence begins when its charter is issued, rather than at a later date when it might first acquire assets and initiate the conduct of a business. See Braswell Motor Freight Lines, Inc. v. United States, 72-2 USSTC P 9675, 30 AFTR2d 72-5608 (N.D. Tex. 1972), aff'd per curiam, 477 F.2d 594 (5th Cir. 1973) (interpreting the requirement of Reg. § 1.1502-31A(b)(3)(ii)(b) that unless a member corporation was a member of the affiliated group on each day of its taxable year, the year is considered a SRLY (defined in the text accompanying notes 173-95)). See also Jim Burch & Assocs., Inc. v. Commissioner, 76 T.C. 202 (1981).
n154 Prop. Reg. § 1.1502-79(a)(2), discussed in text accompanying notes 180-95. This final requirement will not become effective unless and until the proposed regulations are finalized. Prop. Reg. § 1.1502-79(a)(4)(viii).


Example 11

Assume the same facts as in Example 10, except that instead of purchasing the stock of T, P[a] formed T on January 1, 1988 (and, consequently, that T had no income for 1985-1987).

[*133] Since T was a member of the group immediately after its organization, the 1988 consolidated loss is not apportioned. The entire amount ($900,000) will instead be carried back as a consolidated loss and deducted against 1985-1987 consolidated income. n156

n156 Note that if the group had initiated the filing of a consolidated return in 1988 and had filed separate returns for 1985-1987, both P[a]'s and S[a]'s respective 1985-1987 tax years would have been SRYs. Consequently, only $50,000 of the $150,000 loss attributable to S[a] could be carried back to offset the $50,000 of income reported on its 1985-1987 separate returns. The combined amount of the losses attributable to P[a] and T ($750,000) would be available to offset P[a]'s 1985-1987 separate return income ($950,000), but none of the S[a]'s remaining $100,000 loss could be so used. That balance would instead have to be carried forward, and, assuming S[a] is still a member of the consolidated group in the carryforward year (see note 152), would be carried forward as a consolidated loss.

If consolidated returns have not been filed for any year (1985-1988), then each corporation's loss would be treated as a SRY loss and could be carried back to offset only that corporation's own prior year income. Thus, P[a] would be able to use all of its separate return loss ($50,000) to reduce its 1985-1987 income to $900,000. S[a] could use $50,000 of its loss to eliminate its 1985-1987 income, but would have to carry the $100,000 balance forward to 1989 and later years. T, having no prior year income of its own available to absorb any portion of the loss, would have to carry its entire $700,000 loss forward. If P[a], S[a], and T were to initiate the filing of a consolidated return beginning with their 1989 tax year, the combined $800,000 carryforward ($100,000 (S[a]'s carryforward from 1988) + $700,000 (T's carryforward from 1988)) would be treated as a consolidated loss carryforward, and could thus be used to offset consolidated income.

Example 12

P[a] is the common parent of an affiliated group which is comprised of P[a] and its wholly-owned subsidiary, S[a]. P[a] and S[a] were both formed on January 1, 1985. On their consolidated federal income tax returns for their 1985-1987 calendar tax years, the group reported a total of $1,000,000 of consolidated income. This amount represents the sum of P[a]'s $950,000, and S[a]'s $50,000 separate incomes.

On December 31, 1987, S[a] acquired the assets of unrelated corporation T in a forward triangular Type A reorganization under § 368(a)(2)(D). T had been formed in 1985, and on its 1985-1987 calendar year tax returns, it had reported a total of $500,000 of income.

For its 1988 calendar year tax year, the group reported a consolidated loss of $1,500,000. Of this amount, $1,300,000 was attributable to S[a] ($400,000 of which can be traced to the division that conducts S[a]'s historic business, and $900,000 to the division conducting the business acquired from the late T).

Unless Prop. Reg. 1.1502-79(a)(4) were to apply to this transaction, n157 [*134] the 1985-1987 tax years of S[a] are not, in either fact or administrative fiction, SRYs. Consequently, the entire amount of the P[a]/S[a] group's 1985-1987 consolidated income can be offset with the 1988 consolidated loss. n158
1985-1987 income of T. n159 $500,000 of the 1988 consolidated loss must therefore be carried forward to
1989 and later years.

n157 See discussion of Prop. Reg. § 1.1502-79(a)(4), in the text accompanying notes 180-95. See
Example 16, in the text accompanying notes 188-9, for the effect these proposed rules would have on the
facts presented in this scenario.

n158 One potential threat to this result was eliminated in 1986 with the legislative repudiation of the
Libson Shops rule, discussed in the text accompanying notes 62-9.

n159 See Example 1, in the text accompanying notes 71-3.

If the carryback year is a CRY or if the newly-formed member is owned by the common parent
corporation, there is no problem identifying the income to which the loss attributable to the new member
will be carried back. However, where the carryback of the new member's loss is (1) to a year for which a
consolidated return was not filed by the group, and (2) the new member's stock is owned by a subsidiary
member of the group or by two or more group members, then it is not clear, under current regulations, to
which member's SRY the new member's loss is to be carried.

Example 13

Assume that P and its two wholly-owned subsidiaries, S[1] and S[2], were formed in 1980, that they are all
calendar year taxpayers, and that in each of the taxable years following their formation, all three members
have reported income. Assume further that S[3] is organized by the group in 1988, and that in that year the
group files a consolidated return on which it reports a consolidated loss, the entire amount of which is
attributable to S[3].

If consolidated returns have been filed by the group throughout the carryback period, then the 1988
consolidated loss will be carried back to offset consolidated income. But what happens where, for the
carryback year in question, the group members were filing separate returns? Clearly, if S[3] was formed as
a subsidiary of P, the 1988 consolidated loss will be carried back to P's (and only to P's) SRY income. But
what if, instead, S[1] and S[2] (together, perhaps, with an unrelated party) had formed the new member?
More specifically, assume that S[3] was formed in 1988 by S[1], S[2], and unrelated individual, I.
Throughout 1988, 60% of the stock of S[3] was held by S[1], 25% by S[2], and 15% by I. Given
these additional facts, to which member or member's SRY should S[3]'s 1988 loss be carried back?

As originally proposed, the current regulations would have required that S[3]'s loss be carried back to the
SRY income of P, the common parent corporation. n160 But this allocation rule was dropped prior to
finalization, and the current regulations do not address the issue at all. n161

n160 Current Reg. § 1.1502-79(a)(2), as originally proposed.

n161 In fact, this approach seems never to have been applied by either the Service or the courts. See Rev.
Commissioner, 85 T.C. 1005 (1985), each of which generally follows the philosophy espoused in the
current proposed regulations, discussed in the next paragraph of the text: i.e., the new member's loss should
be carried back to the SRYs of its immediate parent(s).

Under new proposed regulations, however, the new member's loss would generally be allocated among
the group members owning its stock, with each member being allocated a percentage equal to the lesser of
(1) the relative FMV of the group's combined ownership of the new member's stock which was held by the
owning member immediately after the new member's organization, or (2) the relative FMV of the group's
combined ownership of the new member's stock held by the owning member as of the last day of the CRY
in which the new member sustained its loss. n162 Under this rule, S[1] would be entitled to 60%/85% (or
71%) of S[3]'s 1988 loss as a carryback to its SRY income. S[2] would be entitled to the 29% balance
(25%/85%).
If the relative stock ownership of two or more owning members in the new member has changed between the date of the new member's formation and the last day of the year in which the new member sustained the loss, the formula described above might result in something less than 100% of the new member's loss being allocated. In this event, the new proposed regulations allocate this residual amount to the common parent corporation, unless the common parent can demonstrate to the satisfaction of the Commissioner that it would be more appropriate for that amount to be carried back to an equivalent SRY of a different member. Assume, for example, that after the formation of S[3], but before the end of the group's 1988 calendar tax year, S[1] purchased all of the S[3] stock held by I (15%). Under the allocation formula set forth in the proposed regulations, S[1] would be entitled to 71% (i.e., the lesser of (1) 60%/85% or (2) 85%/100%) of S[3]'s 1988 loss. S[2] would be allocated 25% (i.e., the lesser of (1) 25%/85% or (2) 25%/100%). The 4% unallocated balance of S[3]'s loss would go to P, the common parent, unless P otherwise demonstrated, to the Commissioner's satisfaction, a more appropriate allocation.

Finally, if a portion of a group's consolidated loss is attributable to a common parent that was not in existence in a tax year to which the loss could otherwise be carried, Prop. Reg. § 1.1502-79(a)(2)(iii) provides for the common parent to allocate such loss to one or more of the other members of the group. The allocation would, again, be subject to the Commissioner's approval.

Certain Loss Carrybacks of Commercial Bank Members

A commercial bank n163 that sustains a loss in any taxable year beginning after December 31, 1986 and before January 1, 1994, must determine the portion of such loss that is attributable to the deductions that it claims for bad debts. n164 Under § 172(b)(1)(L) (should be (K)), the bad debt losses of a commercial bank can be carried back 10 years, but they can be carried forward only 5 years.

n163 As defined in § 585(a)(2).

n164 Under § 172(1)(1), the portion of the total loss which is attributable to bad debt deduction is the incremental amount by which the bank's actual loss exceeds the loss that it would have had without its deduction for bad debts.

Where a consolidated group is comprised of both bank and nonbank members, circumstances may sometimes trigger an inquiry as to whether and to what extent the usual operation of the consolidated return principles and limitations might require further modification in order to confine the extended carryback privilege (and the detriment associated with the contracted carryforward period) to its intended scope. Although the current regulations are silent, both the proposed regulations and a number of administrative rulings provide important insights. n165

n165 Although the carryback issue is essentially the same, note that both the proposed regulations and the administrative rulings referred to in the next two paragraphs of the text deal with § 172(b)(1)(F) of the Internal Revenue Code of 1954, which did not restrict a financial institution's 10-year carryback privilege to its bad debt losses. The current rule of § 172(b)(1)(L) (should be (K)) was enacted as part of the 1986 Act.

Under Prop. Reg. § 1.1502-21(b)(2)(ii), only the portion of a consolidated loss that is apportioned to one or more bank members n166 (and which is attributable to such member or member's bad debt deductions) will qualify for the 10-year carryback. However, the proposed regulations [*137] do not restrict the utilization of that loss either to the consolidated income attributable to the bank member that subsequently sustained the bad debt loss, or to the combined income attributable to all qualified bank members. Instead, the full amount of the consolidated income reported by the group in the CRY to which the loss is carried would be available to absorb the bank member's apportioned bad debt loss. n167
As always, this apportionment must be made in accordance with the procedures set forth under Reg. § 1.1502-79(a)(3) (summarized in note 147). G.C.M. 39375 (March 21, 1985) and LTR 8527004 (March 19, 1985) (as supplemented by LTR 8613001 (December 12, 1985)). Stated differently, the group may not increase the amount of a bank member's bad debt loss by either (1) identifying the separate losses of its nonbank members as those which first offset the separate incomes of the group's profitable members, or (2) where the group reports consolidated income for the year in question, carrying back the bank member's bad debt losses in lieu of deducting them against the current income of other members of the consolidated group. Except in the case of certain built-in losses, discussed in the text accompanying notes 214-28, there is simply no mechanism in the statute or regulations that would permit any member of a consolidated group to carry its separate loss over to another year where the group does not itself have a consolidated loss. See note 136.

See also LTR 8511003 (October 22, 1984), which applied the principles discussed in this paragraph to the consolidated loss apportioned to the common parent corporation (a financial institution qualifying for the 10-year carryback under pre-1986 Act law).

Conversely, where all or a portion of a consolidated loss is attributable to a nonbank member, the mere fact that the group includes one or more bank members will not result in an extension of the carryback period for such loss beyond the usual three years. Neither the group's consolidated income in the tenth through the fourth preceding taxable years, nor the portion of such income allocable to the bank members is available to absorb the nonbank member's apportioned loss. Rev. Rul. 84-136, 1984-2 C.B. 193, G.C.M. 39375 (March 21, 1985), LTR 7932006 (April 19, 1979), and LTR 8527004 (March 19, 1985) (as supplemented by LTR 8613001 (Dec. 12, 1985)).

Separate Return Years To Which Carryback Is Allowed

The SRY limitations described in the preceding paragraphs are applicable only where a loss member's SRY is "equivalent" to the CRY to which the consolidated loss could otherwise be carried. Under the proposed regulations, SRY/CRY "equivalency" does not always result in the matching of parallel time spans. Instead, a SRY will be equivalent to a CRY if it bears the same "numerical relationship" to the CRY in question. Prop. Reg. § 1.1502-79(a)(1)(ii).

Short tax years caused by entering or leaving a consolidated group count as full years in determining the carryback and carryforward periods. Valley Paperback Mfrs., Inc. v. Commissioner, 34 TCM (CCH) 1359 (1975). But under proposed regulations, a short tax year that results from a nontaxable asset acquisition of one existing member of a consolidated group by another member of the same group would not be counted as a full year for carryback/carryforward purposes unless the transaction constituted a reverse acquisition under Reg. § 1.1502-75(d)(3). Prop. Reg. § 1.1502-21(b)(4).

Example 14

P[a] and S[a] are calendar year taxpayers that have filed consolidated returns since 1982. At the close of business on December 16, 1986, P[a] acquired all of the stock of T. Prior to its acquisition, T had been an October 31 fiscal year taxpayer. For the group's 1988 calendar year, it has a consolidated loss, a portion of which is attributable to T.

On these facts, T's short tax year covering the period November 1, 1986 to December 16, 1986 is equivalent to P[a]/S[a] consolidated return year ending December 31, 1985: for T and for P[a]/S[a], respectively, these years constitute the third tax year preceding the loss year. Since that year is a SRY for T, the loss attributable to T in 1988 must be segregated from the consolidated loss carryback and can only
be used to offset T's income for the short period ending December 16, 1986. Since T's second preceding "equivalent consolidated return year" (December 17, 1986 to December 31, 1986) is not a SRY, any of its 1988 apportioned loss that was not absorbed on the December 16, 1986, return loses its status as a SRY loss and is reunited with the consolidated loss carryback. Consequently, the remaining 1988 loss can be utilized against the full amount of the consolidated income reported by the group on its 1986 calendar year return, even though part of the group's income relates to a period preceding the acquisition of T.

Because T was joining an existing consolidated group, it was required to close its last separate return tax year at the time of its acquisition, to adopt the tax year of the common parent corporation, and to participate in the consolidated return from the acquisition date forward. Reg. § 1.1502-76. Since the transaction here took place during the last half of the day, December 16, 1986, rather than December 15, 1986, will be considered the last day of T's short taxable year. LTR 7904002 (Dec. 16, 1977). See LTR 7914004 (Dec. 13, 1978) wherein a 10 a.m. closing resulted in the closing date being regarded as the first day of the acquired corporation's first CRY. See also Rev. Rul. 80-169, 1980-1 C.B. 188.

Note, however, that an important election is available to a corporation when it joins (or leaves) a consolidated group within the first 30 days of its tax year. Reg. § 1.1502-76(b)(5). In this example, if T had become a member of the group on November 24, 1986, it could have elected to forego the usual required closing of its tax year, and to instead close its year on December 31, 1986. If it had so elected, then T's SRY ending October 31, 1986 would have been equivalent to the group's 1985 CRY. All of T's income for the period November 1, 1986 to December 31, 1986 would be included in the group's 1986 consolidated income, and that short period would not be considered a SRY.

Thus, if T has little or no pre-acquisition income of its own for the carryback period, but P[a] and S[a] do, the short period that results from scheduling a closing other than on a common year-end would prove beneficial.

Separate Return Limitation Years"

In General

To complement the SRY rules and to thereby complete the task of preventing the carryover losses of one corporate entity from offsetting the income of another in a year in which the two were unaffiliated, the regulations created the separate return limitation year (SRLY) rules. In contrast to the SRY limitations, which set forth the circumstances under which a group's consolidated loss must be apportioned to one or more of its current members, the SRLY rules, where applicable, restrict the amount of a consolidated group's income that may be offset by the subsequent (or prior) loss carryovers of a former member. Only the portion of that group's income which is attributable to absorb that member's SRLY loss carryover.

In contrast to the proportional allocation formula used to determine the amount of an individual loss member's attributable share of a consolidated loss (note 147), the amount of income available to absorb a member's SRLY loss carryover is computed under an "incremental" formula. In short, a member's SRLY loss carryover can only offset consolidated income to the extent of the excess of (1) the group's actual consolidated income (computed without regard to its consolidated loss deduction) over (2) the group's consolidated income computed without regard to either its consolidated loss or the income and deductions of the SRLY member. Reg. § 1.1502-21(c).

Note that this limitation is based on income of the member corporation, it is not limited to the income of the business subsequently producing the loss. (See discussion of Libson Shops in the text accompanying notes 62-9.) Consequently, if one of a loss member's businesses has been disposed of prior to the loss year but after the year to which the loss is being carried back, income attributable to the disposed business is just as available to absorb the carryback as is the income produced by the business which currently generates the loss.
In the context of carryforwards of favorable tax attributes, which are also subject to these limitations, the effect of the SRLY limitations can sometimes be reduced or eliminated either by transferring a profitable business to the member which has the SRLY losses, or, conversely, by liquidating or merging that member into a profitable member. (In this latter event, the transferor corporation's SRLY losses would not, of course, lose their character as such. Reg. § 1.1502-1(f)(1). The SRLY limitation would, however, be computed by reference to the income of the profitable transferee corporation.) Section 382, however, will usually be applicable, and if it is, the pre-acquisition loss carryforwards will be subject to not only the SRLY limitations, but also to the § 382 "annual limitation," which is computed by referencing the acquired corporation's historic asset pool. These rules are outlined in text accompanying notes 177-85. Additional caveats for either technique include §§ 269 and 482, and a host of judicial doctrines (e.g., business purpose, step-transaction, and assignment of income).

A "separate return limitation year" is any SRY of a member (or of a predecessor of such member n175) except where (1) the corporation is the common parent for the consolidated return year to which the tax attribute in question is being carried, or (2) the corporation was a member of the affiliated group for each day of such year, or (3) the corporation is a predecessor of any member if such predecessor was a member of the affiliated group for each day of such year. n176 In the context of loss carrybacks, [*140] exception (1) is significant where the former common parent has disposed of all of its subsidiaries and seeks to carry its own post-disposition loss back to the pre-disposition consolidated income of its former group. This exception will also permit a former common parent whose stock n177 has since been acquired by another group to carry its attributable portion of the new group's consolidated loss back to the pre-acquisition consolidated income of its former group. n178 The other two exceptions will become relevant where a consolidated group has made a valid election to cease filing a consolidated return, and later sustain SRY losses which they wish to carry back to the consolidated income of a prior CRY.

n175 A "predecessor" is a transferor or distributor of assets to the current member corporation in a transaction to which § 381(a) applies. Reg. § 1.1502-1(f)(1).

n176 Reg. § 1.1502-1(e), (f). Unless T is the common parent of a consolidated group or unless a § 338(h)(10) election is made (see note 152), the gain or loss recognized on a deemed sale under § 338(a) is not taken into account in determining the consolidated income or loss of the selling corporation's group. IRC § 338(h)(9). Instead, if T was a member of a consolidated group as of the date of the sale, it is treated as having terminated its affiliation with that group immediately prior to the deemed sale. T is required to file a "final" separate return that includes only the gain or loss resulting from the deemed sale, together with its share of the selling group's loss and credit carryforwards from prior tax years. If, however, two or more members of the selling corporation's consolidated group were acquired by the same purchaser on the same acquisition date, a "combined deemed sale return" may be filed by all such target corporations. IRC § 338(h)(15); Temp. Reg. § 1.338-4T(k)(6). The gain or loss recognized as a result of this deemed sale is not includible in determining the consolidated income or loss of A's consolidated group. IRC § 338(h)(9); Temp. Reg. § 1.338-1T(f)(1).

The carryback of losses from T's final separate return is subject to essentially the same limitations that are imposed on loss carrybacks from any other "separate return limitation year." Neither the Code nor the regulations, however, indicate whether a loss carryback from a combined deemed sale return will be treated strictly as the SRLY losses of the individual parties to the combined return (as they normally would be where a subgroup leaves the group), or whether such losses will be treated as SRLY losses with respect to the combined amount of consolidated income attributable to that subgroup in the carryback CRY. The regulations do state, however, that any loss carryforwards of a target that were not subject to SRLY restrictions while it was a member of the selling group may be applied without limitation to the gains recognized by the other target corporations included in the combined return. Temp. Reg. § 1.338-4T(k)(6) (Answer 2). Any tax attribute carryforwards attributable to the old target that cannot be used on its final return disappear when the old target then "liquidates."

n177 If the common parent was acquired in a nontaxable asset acquisition, then the carryback will be denied under § 381(b)(3).
n178 Assume, for example, that P[t]/S[t] has substantial pre-acquisition consolidated income, all of which
is attributable to S[t]. P[a], the common parent of another consolidated group, acquires all of the stock of
P[t] in a transaction to which § 338 is not applicable. In the year following the acquisition, the group
sustains a consolidated loss, all of which is attributable to P[t].

Since P[t] was the common parent of the P[t]/S[t] group in the CRY to which the loss is being carried, the
loss year is not a SRLY with respect to P[t]. (It would, of course, be a SRLY with respect to S[t] had that
corporation any post-acquisition losses of its own to carry back.) Therefore, P[t] can use its loss to offset
the pre-acquisition consolidated income of its former group, notwithstanding the fact that all of such
income is attributable to S[t].

Example 15

Assume the same facts as those presented in Example 10, except that (1) T was formed by P[t] on January
1, 1985, (2) for their 1985-1987 calendar tax year, P[t] and T filed consolidated returns on which they
reported total consolidated income of $600,000 ($100,000 of which was attributable to T), and that (3) P[t]
sold all of the stock in T to P[a] at the close of business on December 31, 1987.

[*141] As in Example 10, T's 1985-1987 taxable years are, from the vantage point of the P[a]/S[a]/T
group, SRYs, and the portion of the group's loss attributable to T must be apportioned to it and carried back
separately under the SRY rules discussed previously. This achieved, a determination must now be made as
to how much of the income reported on the P[t]/S[t] group's 1985-1987 consolidated income tax returns is
available to absorb the $700,000 1988 loss apportioned to T. From the reference point of the P[t]/T group
in 1985-1987, the year from which the loss is being carried, 1988, is a SRLU. Consequently, only the
portion of the P[t]/T group's 1985-1987 consolidated income that is attributable to T ($100,000) can be
offset with the 1988 loss. n179

n179 As noted in the text accompanying notes 229-30, the refund generated by $100,000 loss carryback
will be paid to P[t], as the common parent of the 1985-1987 P[t]/S[t] group, not to T, itself, or to P[a], its
present common parent.

NOL Carrybacks Following An Asset Acquisition By A Subsidiary Member: The Proposed Regulations

The Treasury Department has issued proposed regulations under which the consolidated losses
attributable to certain subsidiary members would have to be apportioned to them and, if carried back to
certain prior CRYs, treated as SRLY losses. n180 These regulations reflect a concern that an acquisition of
assets could be effected through the use of a newly formed or a long affiliated subsidiary member, and that
the acquired business could then produce post-acquisition losses, which, under the current regulations, can
be carried back as part of the consolidated loss carryback to offset pre-acquisition consolidated income. To
summarize these proposed rules: n181

n180 Prop. Reg. § 1.1502-79(a)(4). These proposed regulations would not maintain this SRLY fiction
wher the group is carrying its consolidated loss forward.

n181 These regulations would become effective only for taxable years for which the due date (without
extensions) for filing a group's return is after the filing date of the Treasury Decision adopting the

If --

1. A subsidiary which contributes to a current year's consolidated loss either

(a) Acquired the assets of a nonmember corporation in a nontaxable transaction described in § 381(a), or
A nonmember would include a transferor corporation which had not been a member of the group at any
time during the 36 months preceding the acquisition. Prop. Reg. § 1.1502-79(a)(4)(iii).

(b) Within 36 months after the transferor/distributor member joined the group, acquired all or a part of the assets [*142] of that member in a transaction in which the acquiring member's basis in the acquired member's assets is determined by reference to the basis the acquired member had in such assets prior to its becoming a member, n183 and

n183 The transferee member's basis in the assets it purchases from a recently acquired member in a "deferred intercompany transaction" (defined in Reg. § 1.1502-13(a)(2)) is considered to have been "determined by reference to" the transferor-distributor's basis for this purpose. Prop. Reg. § 1.1502-79(a)(4)(iv)(B).

2. Fifty percent or more of the value of all of that subsidiary's noncash assets were acquired within any 12-month period from one or more corporations in either or both of the above-described manners, n184 and

n184 In making this determination, the value of intangible assets, such as goodwill, going concern value, or patents, is to be taken into account, while "distortions" created by distributions, loans, or contributions to capital are to be disregarded. Prop. Reg. § 1.1502-79(a)(4)(v)(D) and (C).

3. The consolidated loss for any taxable year ending after the acquisition date is to be carried back to a CRY ending on or before that date, then

the entire amount of any consolidated loss that is attributable to that subsidiary must be apportioned to it and treated as a loss carryback from a SRLY. n185 Where these requirements are satisfied, the loss apportioned to the transferee subsidiary, even to the extent that such loss could otherwise be identified with its own historic assets, could only be carried back to offset the pre-acquisition consolidated income apportioned to it under the usual SRLY apportionment rules. n186 Under the proposed regulations, it could not offset other components of consolidated income for the pre-acquisition taxable year, nor, under § 381(b)(3), can any portion of the loss be carried back to the pre-acquisition income of the acquired corporation. n187

n185 Once these conditions have been satisfied, the detrimental effect of the operational rules of the proposed regulations could not be retroactively avoided by subsequent events. Prop. Reg. § 1.1502-79(a)(4)(vi)(B).

Note that the regulations already restrict the use of the acquired corporation's built-in losses which economically accrued in a SRLY. Reg. § 1.1502-1(f)(1), -15(a)(1), (a)(2)(ii). Consequently, where the losses at issue are built-in losses, the proposed regulations add nothing to the limitations already present in the regulations. See discussion of built-in losses in the text accompanying notes 214-28.


n187 Even where the transferor-distributor corporation was a member of the group for some time prior to the acquisition of its assets by another subsidiary, the combined effect of the proposed regulations and § 381(b)(3) would be to deny any carryback of its successor's losses even as to the transferor's own post-affiliation contribution to the group's consolidated income.

[*143] Example 16

Assume the same facts as in Example 12, except that the non-cash assets acquired from T make up 50% or more of S[a]'s total noncash assets immediately after the acquisition, and that Prop. Reg. § 1.1502-79(a)(4)(i), once finalized, would therefore apply to this transaction.

Under the fiction created by these rules, the 1988 tax year of S[a] would be a SRLY. Consequently, the entire $1,300,000 of the 1988 consolidated loss, not just the $900,000 portion of that amount which is
attributable to T's business, would have to be apportioned to S[a] and treated as a SRLY loss. Since only $50,000 of the P[a]/S[a] group's 1985-1987 consolidated income is attributable to S[a], only that amount would be available to absorb S[a]'s SRLY loss. Further, § 381(b)(3) again precludes any portion of that loss from being carried to the 1985-1987 income of T. n188

188 See Example 1, in the text accompanying notes 71-3.

Thus, of the group's $1,500,000 aggregate 1988 loss, only $250,000 of that amount ($200,000 as a consolidated loss plus $50,000 of the $1,300,000 apportioned to S[a]) could actually be used in 1985-1987, notwithstanding the fact that the three corporations produced a combined $1,500,000 income in that year. The $1,250,000 balance of the 1988 loss would be carried forward to 1989 and later years as a consolidated loss. n189

n189 See also Examples 4 and 5 of Prop. Reg. § 1.1502-79(a)(5).

Several shortcomings and inconsistencies in these absurd rules are readily apparent. First, and most significantly, the "abuse" at which these overtly punitive regulations are directed is not the potential carryforward of known, pre-acquisition losses suffered in the past by others who may now be only remotely tied to the enterprise which actually obtains their benefit. Instead, they are directed at the carryback of legitimate post-acquisition losses the economic detriment of which was, in effect, borne by the consolidated group. n190 Once again, the Treasury has failed to recognize that meaningful distinctions exist as to the fundamental [*144] nature of these two issues, and in doing so it has unwittingly allowed its legitimate concerns regarding the former to color its attitude toward the latter and to thereby unnecessarily compromise the uncontestable virtue of the policy supporting the annual accounting period mitigation provisions of § 172. n192

n190 The current regulations already impose SRLY restrictions on the utilization of built-in losses which economically accrued in a SRLY. Reg. § 1.1502-1(f)(1), -15(a)(1), (a)(2)(ii). Consequently, the only losses and deductions that remain to be dealt with by these proposed regulations are losses and deductions that have both accrued and been recognized during the period following the acquired corporation's admission to the group.

n191 See, e.g., Stauffer v. Commissioner, 403 F.2d 611 (9th Cir. 1968); Associated Mach. v. Commissioner, 403 F.2d 622 (9th Cir. 1968); Home Constr. Corp. v. United States, 439 F.2d 1165 (5th Cir. 1971); Aetna Casualty & Surety Co. v. United States, 568 F.2d 811 (2d Cir. 1976); Bercy Indust., Inc. v. Commissioner, 640 F.2d 1058 (9th Cir., 1981). See also discussion in the text accompanying notes 498-9.

n192 This criticism extends to other aspects of the carryback rules, and is discussed at greater length in the text accompanying notes 70-126, and 484-99.

Note also that, while combating the perceived evil of permitting post-acquisition losses to be carried back on a consolidated basis, the proposed regulations make no attempt to ameliorate the possible injustice resulting from the acquired corporation's loss of its own pre-acquisition income history, as otherwise provided under § 381(b)(3). For evidence as to the Treasury's perception of the sufficiency of its authority, under § 1502, to override § 381(b)(3) and § 172, where it is so inclined, see discussion of Reg. § 1.1502-75(d)(3)(v)(b) and LTR 8527001 (March 20, 1985) in the text accompanying notes 204-10.

Secondly, to insure against this perceived "abuse," the proposed regulations, which are to be applied on an "all or none" basis, sacrifice the subsidiary member's right to carryback, on a consolidated basis, the losses identified with (or apportioned to) its own historic business or assets.

Third, note that the adverse limitations of the proposed regulations do not extend to the post-acquisition loss carrybacks where the subsidiary member acquired the nonmember's assets in a taxable acquisition. If the objective is to prevent the losses of an acquired business from offsetting income that such business did not produce, why should the tax status of the acquisition itself be a deciding factor? n193 The result is, of
course, counter-intuitive: the detriment of these proposed rules is reserved for transactions traditionally favored and encouraged through deliberate legislative action, while transactions which fail to possess these requisite qualities are exempt.

n193 Similarly, given this objective, why do the proposed regulations not prohibit all carrybacks of post-acquisition losses attributable to the acquired business or assets in that all of the pre-acquisition income relates to the subsidiary member's historic business or assets?

Finally, on those rare occasions where the acquiring group actually anticipates post-acquisition losses of the acquired business, the transaction could be structured so as to circumvent these proposed limitations by simply casting the common parent corporation as the acquiring corporation, n194 or by making sure that at the time of the acquisition the subsidiary selected to effect the acquisition is endowed with enough of its own assets that it avoids the "all or none" 50% threshold, or with enough of its own pre-acquisition income so as to render the limitations of these rules moot. n195

n194 However, in a "reverse acquisition," discussed in the text accompanying notes 198-203, the "acquiring" corporation's pre-acquisition separate income (IRC § 381(b)(3)) and consolidated income (Reg. § 1.1502-1(g), -79) becomes inaccessible to any post-acquisition losses, whether attributable to its own business or that formerly conducted by the "acquired" corporation. But the "acquired" corporation's pre-acquisition income (or, if the acquired corporation is the common parent of another group, its group's pre-acquisition consolidated income) remains accessible.

n195 Possible caveats for these otherwise sound strategies include, again, §§ 269 and 482, and the judicial doctrines of business purpose, step-transaction, and assignment of income.

For other thoughts as to the shortcomings of these proposed regulations see H. Lerner, R. Antes, R. Rosen, & B. Finkelstein, Federal Income Taxation of Corporations Filing Consolidated Returns ch. 10, n.24.3 and 26.1.

Additional Rules Designed to Preserve the Integrity of the SRY/SRLY Limitations

Effect of the Acquisition on a Pre-Acquisition Affiliation

If the acquired corporation owns a controlling interest in one or more subsidiaries (or chains of subsidiaries), then, except in the case of a "reverse acquisition," the acquisition of that group (or "subgroup," as the case may be) by another corporation will, for the purposes of applying the SRY and SRLY limitations, dissolve that group's pre-acquisition affiliation bonds. n196 That is to say, for the purpose of applying the limitations on post-acquisition loss carrybacks, all of the pre-acquisition tax years of the corporations in the acquired group will become SRY's from the perspective of the acquiring consolidated group, and, except with respect to the group that was formerly the common parent of the acquired consolidated group, n197 will become SRLY's from the perspective of the selling consolidated group. It is immaterial that the acquired affiliated group members are still affiliated inter se (albeit as members of a different group), or that, but for this retroactive deemed-dissolution of the group, they would have qualified to use their respective post-acquisition SRY-limitation loss carrybacks against their consolidated pre-acquisition incomes.

n196 Reg. § 1.1502-1(f),-21(c).


Reverse Acquisitions

In General

The regulations anticipate the ease with which the SRY and the SRLY limitations discussed above could be avoided by merely reversing the formal roles played by the acquiring corporation and a target
corporation. If, for any of several possible reasons, the parties seek to avoid the application of these limitations to the target corporation and the subsidiary members of its group, then, absent the "reverse acquisition" rules, the transaction could simply be structured so that the acquiring corporation is actually acquired by the target corporation. If the acquiring corporation is larger than the target, as is the usual case, then the target corporation, now recast as the "acquiring" corporation, would have to use so much of its own stock as consideration that the shareholders of the "acquired" corporation would wind up with majority control (or at least with a majority of the value of the target's outstanding stock).

Several consolidated return benefits are contingent upon the continuity of the group's common parent corporation and its status as such. When the identity of the common parent as such changes (e.g., where a small group is acquired by a larger group, or a nonmember becomes the common parent), that event will trigger the application of several sets of rules which are generally applicable to members entering and leaving a group, rules which are invariably adverse to the taxpayer. (Changes in the identity of the common parent as a result of either a "downstream" merger into one of its subsidiaries or a Type F reorganization will not, however, result in the termination of the group's identity, and will thus not bring these rules into play. Reg. § 1502-75(d)(2)(i), (ii), discussed in note 130.)

The technical "acquiring" corporation's group is apparently deemed terminated for all purposes under the consolidated return regulations. Reg. § 1.1502-1(f)(3),-75(d)(3)(i).

To prevent the SRLY limitations from being circumvented in this manner, the consolidated return regulations require that where an acquisition qualifies as a "reverse acquisition," any group of which the nominal acquiring corporation was a common parent is deemed to terminate as of the date of the acquisition, while any group of which the nominal acquired corporation was a common parent is treated as remaining in existence. Under Reg. § 1.1502-75(d)(3)(i), a "reverse acquisition" occurs when a corporation (hereinafter the "first corporation") or any member of a group of which the first corporation is the common parent, acquires either

1. Stock of another corporation (hereinafter the "second corporation"), and as a result the second corporation becomes (or, but for the application of the reverse acquisition rules, would become) a member of a group of which the first corporation is the common parent, or

2. Substantially all of the assets of the second corporation,

in exchange (in whole or in part) for the stock of the first corporation, and the stockholders (immediately after the acquisition) of the second corporation, as a result of owning stock of the second corporation, own (immediately after the acquisition) more than 50% of the fair market value of the outstanding stock of the first corporation.

In applying the 50% test, all stock must presumably be counted, whether the stock is common or preferred, voting or nonvoting. Contingent stock ultimately issued in connection with the acquisition will likewise probably be counted in applying this test. Clearly, where the contingent stock is of a value sufficient to cast doubt upon the ultimate outcome, the possible impact of the retroactive application of the "reverse acquisition" rules should be anticipated and, if necessary and possible, circumvented through the use of an alternative transaction structure or of cash or other nonstock consideration in lieu of equity.

In a "reverse triangular" Type A reorganization, wherein the "acquired" corporation becomes a subsidiary of the common parent of the "acquiring" corporation's group, the common parent of the group is considered to be the "first" corporation, while the "acquired" corporation is considered the "second" corporation in applying these tests. Prop. Reg. § 1.1502-75(d)(4).

A reverse acquisition does not occur where, in concurrent acquisitions, the greater-than-50% test is satisfied only by reference to the combined amount of the first corporation's stock held by the shareholders of two or more second corporations. Rev. Rul. 73-303, 1973-2 C.B. 315.
Finally, a special election is sometimes available that would permit a first corporation to treat its acquisition of a second, related, corporation as a reverse acquisition. To qualify, the first corporation (and/or other members of its group) must have owned at least 25% of the "acquired" corporation's stock continuously for the five years preceding the acquisition. See Reg. § 1.1502-75(d)(3)(ii), (iii) for details.

[*147] If these requirements are satisfied, the transaction will qualify as a "reverse acquisition" regardless of whether or not the transaction also happens to qualify as a nontaxable reorganization. Also covered by the definition, and the resulting limitations, are transactions involving (1) the acquisition of a single corporation by a group, (2) the acquisition of a group by a single corporation, and, presumably, (3) stock acquisitions in which neither corporation was a member of a group prior to the acquisition. n200 As with all of the consolidated return regulations, however, they do not come into play unless an election to file a consolidated return is in effect for the year of the acquisition or an earlier or subsequent year to which the SRY and/or SRLY rules would otherwise apply.


The carryback of post-acquisition losses are affected by the characterization of the acquisition as a "reverse acquisition" in that all of the usual limitations imposed on an acquired corporation and its group are instead imposed on the nominal acquiring corporation (i.e., the "first corporation") and its group. Similarly, the nominal acquired corporation (i.e., the "second corporation") and its group are spared from these consequences, in that this group is deemed continuing. Consequently, the pre-acquisition tax years of each of the corporations that were members of the first corporation's affiliated group now become SRY's and, except with respect to the first corporation itself, n201 are subject to the SRLY limitations. n202 A reverse acquisition will also convert any economically [*148] accrued, but unrecognized losses of the first corporation and its former group into "built-in" losses, while simultaneously preventing those of the second corporation and its group from being so classified. n203 And if the second corporation is the common parent of a consolidated group, then, depending on the transaction date and the respective tax years of the participants, the members of the first corporation's group may be required to close their tax years and adopt that of the second corporation.

n201 Reg. § 1.1502-1(f)(2)(i). But see Reg. § 1.1502-1(f)(3), which states categorically that "all of the taxable years of the first corporation and of each of its subsidiaries ending on or before the date of the acquisition shall be treated as separate return limitation years, . . . ." Given the purpose and the usual effect of the reverse acquisition rules, it seems clear that this statement references the pre-acquisition tax years of the members of the first corporation's group from the perspective of the continuing group (i.e., any loss carryforwards or built-in losses of the first corporation's group would be SRLY losses and SRLY built-in losses as they are carried over or recognized in post-acquisition CRYs). It undoubtedly should not be read as overriding the usual rule that from the perspective of an acquired group in a pre-acquisition CRY to which a post-acquisition loss is carried, the post-acquisition SRYs of the common parent are not SRLYs. See the text accompanying notes 177-8.

n202 If the transaction described in Example 10 had been a reverse acquisition, and if the new group had elected to file a consolidated return for 1988 and thereafter, then $50,000 and $150,000 of the $900,000 1988 consolidated loss would have to be apportioned to P[a] and S[a], respectively, and carried back to their respective 1985-1987 SRYs. There, S[a]'s apportioned loss would be a SRLY loss, and could therefore offset only the $50,000 of the P[a]/S[a] group's 1985-1987 consolidated income apportioned to it. Since P[a] was the common parent of the consolidated group throughout 1985-1987, 1988 is not a SRLY with respect to P[a] for carry back purposes. This fact is of no consequence here, since the consolidated income attributable to P[a] ($950,000) is sufficient to absorb the entire amount of the 1988 consolidated loss apportioned to it ($50,000).

Only $100,000 of the $700,000 consolidated loss carryback can be used in 1985-1987 (it will offset the entire amount of T's 1985-1987 income). The $600,000 balance, together with the $100,000 unused balance of S[a]'s apportioned loss, will be reunited and carried forward to 1989 and subsequent years on a consolidated basis.
The Consolidated Return Regulations Versus Sections 381(b)(3) and 172

As noted previously, where the transaction is an asset acquisition not involving members of consolidated groups, § 381(b)(3) accepts the formal designation of the "acquiring" and the "acquired" corporations without any attempt to distill economic reality. Reg. § 1.1502-75(d)(3)(v)(b), however, requires that the ordinary application of § 381, and therefore § 381(b)(3), be reversed as between the nominal acquired and the nominal acquiring corporations. n204

If a consolidated return is filed for the first taxable year ending after a reverse acquisition, then (b) If the acquisition is a transaction described in Section 381(a)(2), then for the purposes of Section 381 --

(1) All taxable years ending on or before the date of acquisition, of the first corporation and each corporation which, immediately before the acquisition, is a member of the group of which the first corporation is the common parent, shall be treated as taxable years of the transferor corporation, and

(2) The second corporation shall not close its taxable year merely because of such acquisition, and all taxable years ending on or before the date of acquisition, of the second corporation and each corporation which, immediately before the acquisition, is a member of any group of which the second corporation is the common parent, shall be treated as taxable years of the acquiring corporation.

This regulation was applied, to the taxpayer's benefit, in a recent private letter ruling. n205 In that ruling, X was the common parent of a consolidated group which included one subsidiary, Q. Y was not a member of an affiliated group. In a nontaxable Type A reorganization, X and Y consolidated into Z, with X's shareholders receiving 60.8% of the stock of Z, and the shareholders of Y receiving the balance. Shortly after the consolidation, Z sustained a loss which it sought to carry back to offset the pre-consolidation income of X.

n205 LTR 8527001 (March 20, 1985). See also LTR 8514047 (undated).

Under § 381(b)(3), the carryback would have been denied, as both X and Y would be regarded as "transferor" corporations. n206 However, the ruling held that the reverse acquisition rules were applicable, with Z designated as the "first" corporation, and X the "second" corporation. The role of X was thus recast as that of the "transferee" corporation, to which § 381(b)(3) is not applicable. n207

n206 See Example 3, in the text following note 75.

n207 Query: What would happen if, shortly after the consolidation, the stock of Q was sold to an unrelated party for cash? Since the sale of the parent corporation's only subsidiary dissolves the consolidated group, the consolidated return regulations are no longer applicable. If Z then sustains a loss, can that loss still be carried back to the pre-amalgamation income of X? See Lerner, Antes, Rosen, and Finkelstein, note 132, at § 10.02(5) n.30, where, without elaboration, the authors suggest that the manner in which § 381(b)(3) is initially applied should probably control for all subsequent years, even the SRYs of the surviving corporation.

While this story has a happy ending for the taxpayer, one can readily envision circumstances wherein the effect of the position taken in this ruling could prove detrimental. If, for example, X had instead statutorily merged into Y (with its former shareholders receiving 60.8% of Y's stock), and that Y sought to carry the post-merger losses back to its own pre-merger income, then a consistent application the Service's position n208 would preclude the carryback (Y would be recast as the "transferor" corporation under § 381(b)(3)), notwithstanding that the carryback is explicitly permitted under § 172. Note that this results in a consolidated return rule n209 being applied not only at the expense of an express statutory provision, but being so applied in a context that has nothing to do with consolidated returns: Y is merely seeking to carry

n203 Built-in losses are defined and discussed in the text accompanying notes 214-28.
back its own losses to its own separate pre-acquisition income, not to any pre-acquisition consolidated income. n210

n208 "Since a consolidated return was filed . . . for the first taxable year ending after the date of the reverse acquisition, the practical effect of Section 1.1502-75(d)(3)(v)(b) . . . reverses the ordinary application of Section 381(b)(3)." LTR 8527001 (March 20, 1985).

n209 Note that since X is deemed to be the acquiring corporation, X, Q, and Y have no choice but to continue the election to file consolidated returns, and cannot therefore avoid the application of the consolidated return regulations as applied by the aforementioned private letter ruling. (This assumes, of course, that Y has not applied for and received permission to discontinue the election under Reg. § 1.1502-75(c), the conditions of which were summarized in note 130.)

n210 Because the effect of the application of the reverse acquisition rules of the regulations in this context produces a result contrary to that which would otherwise obtain from the application of an express provision of the statute, a taxpayer adversely affected by this interpretation might challenge the validity of the regulation itself, or its application to these particular circumstances. Although the consolidated return regulations, of which the reverse acquisition rules are a part, are "legislative regulations," (IRC § 1502) they are not per se invulnerable. The courts have, on occasion, found regulations to be inconsistent with statutory provisions or unreasonable, and therefore invalid. See, e.g., Kanawa Gas & Utils. Co. v. Commissioner, 214 F.2d 685 (5th Cir. 1954).) Similarly, where the Commissioner's application of otherwise sound regulations has been shown to be unreasonable, the courts have sometimes interceded on behalf of the taxpayer. E.g., Joseph Weidenhoff, Inc. v. Commissioner, 32 T.C. 1222 (1959); Commissioner v. General Mach. Corp., 95 F.2d 759 (6th Cir. 1938).

[*150] Section 338 and the Reverse Acquisition Rules

Another potential conflict between the statute and the regulations exists where a § 338 election is made (or deemed made) with respect to an acquisition which also satisfies the requirements for a reverse acquisition. Assume, for example, that P[a], the common parent of a consolidated group, purchases all of the stock of T, the common parent of another consolidated group, using cash and its own stock as consideration. n211 As a result of the transaction, the shareholders of T end up with more than 50% of P[a]'s outstanding stock.

n211 Since the cash "boot" used as consideration would prevent the transaction from qualifying as a nontaxable transaction under § 368(a)(1)(B) ("Type B" reorganization), the "purchase" requirement of § 338(h)(3) would be satisfied.

If the express language of § 338 overrides the reverse acquisition rules, then whether a § 338 election is to be made (or, under § 338(e) and (f), is to be "deemed" to have been made) will be determined by reference to the actions of P[a], and the operational rules of § 338 will be applied to T and its affiliates. Conversely, if the reverse acquisition rules take precedence, as they apparently do in applying § 381, then T might be considered the "purchasing corporation," P[a] the "target corporation," and § 338 applied on that basis. It has also been suggested that both the reverse acquisition rules and the § 338 operational rules might apply concurrently. n212

n212 Lerner, Antes, Rosen, and Finkelstein, note 132, at 17-28 to 17-30. Note, however, that the authors of this treatise conclude that the acquisition of T by P[a] would not be a reverse acquisition if P[a] were to make a § 338 election.

The manner in which these two sets of rules might interface is not addressed in § 338 (or in the committee reports accompanying its enactment), or in the consolidated return regulations. Nor has the issue yet been addressed in the published rulings of the Service or in the decision of any court.

Built-in Losses and Deductions
The timing of the recognition of a gain or a loss for tax purposes frequently does not parallel that of the economic events and circumstances giving rise to it. For example, the diminution of the economic value of a business or investment asset, absent more, does not usually produce an immediate tax benefit to its owner. Instead, a taxpayer must usually wait until the asset is later sold or exchanged (and the loss is thereby "sustained" n213), or until the excess of its basis over its value is recovered [*151] under the applicable capital recovery provisions. Similarly, when a cash method taxpayer incurs an obligation relating to a business expense, any resulting deduction is generally deferred to the year of payment.

n213 IRC § 165(a).

Where a corporation has economically accrued deductions and losses n214 prior to its acquisition by another, but has not yet recognized them for tax purposes as of the transaction date, the law earmarks these built-in losses for special treatment. n215 If the motive for the acquisition is sufficiently laced with the desire to obtain the benefit of the target corporation's prior misfortunes, then § 269 may operate to forever preclude their recognition. n216 Even if the built-in losses of the acquired corporation survive the rigors of the subjective standards of § 269, their utility may be otherwise limited. As will be discussed in a later section of this article, n217 where the requisite change in the ownership of a corporation occurs, § 382 imposes new limitations on the carryforward of both existing losses and, under some circumstances, built-in losses. Although it is clear that the § 382 limitations are intended to apply in addition to the limitations set forth in the consolidated return regulations, n218 the extent to which they are to be applied to carrybacks of built-in losses is uncertain. n219

n214 A deduction or loss is considered to have accrued with respect to an asset only if and to the extent that the asset's adjusted basis exceeds its fair market value as of the date of the acquisition.

n215 In a stock purchase with respect to which a § 338 election is made or deemed made, the potential for built-in losses ceases with the hypothetical sale of the acquired corporation's assets, the results of which are reported on its final pre-acquisition tax return.

Nor does the problem of built-in losses present itself where the assets of the target corporation were acquired in a taxable purchase transaction.

n216 This important topic is discussed under a separate heading in the text accompanying notes 275-307.

n217 See discussion in the text accompanying notes 239-74.


n219 See the text accompanying notes 254-74.

Where the consolidated return regulations are applicable, they generally restrict the deduction of built-in losses to the income of the corporation which ultimately recognizes them (i.e., the acquired corporation itself in a stock acquisition, and the acquiring corporation in an asset acquisition n220). n221 Such losses cannot be used to offset the income of any of the group's other members in the year of recognition, even though that [*152] year is a CRY. n222 If the built-in deductions and losses of a member that are recognized in a CRY exceed that member's income, the excess will be treated as a SRLY loss, to be carried back or forward to offset that member's past or future year's separate income, regardless of whether or not the group sustains a loss on a consolidated basis for the year the built-in loss is recognized. n223 This limitation applies even if, in a nontaxable asset acquisition, the acquiring corporation was the common parent. n224

n220 Reg. § 1.1502-15(a)(2)(ii). As is generally true for the SRLY limitations applicable to losses, any built-in loss limitation would usually be based on the entire income of the successor member corporation. Section 381(b)(3) would, of course, prevent any carryback to the pre-acquisition income of a predecessor (i.e., "transferor") corporation following a nontaxable asset acquisition described in § 381(a).
n221 Built-in losses carried to post-acquisition years may be subject to the additional limitations of § 382, which, with important exceptions, subject net built-in losses to the same annual "percentage of net assets" limitation as is imposed on the losses carryforwards from pre-acquisition tax years. See the text accompanying notes 250-3.

n222 Reg. § 1.1502-15. Losses and deductions incurred in rehabilitating the acquired corporation are not considered built-in losses, and are thus not subject to these adverse limitations. Reg. § 1.1502-15(a)(2)(i). The regulations do not elaborate upon the meaning of "rehabilitation" deductions and losses. But in G.C.M. 38864 (May 24, 1982), only deductions and losses economically accrued in post-affiliation years were held to qualify.


n224 For example, P[a] and S[a] have filed consolidated returns for several years. In 1987, P[a], the common parent, acquires all of the assets of T in a nontaxable Type C or Type A reorganization. At the time of the acquisition, T has built-in losses which are subject to the limitations set forth in Reg. § 1.1502-15, but which are not eliminated or otherwise restricted by either § 382 or § 269. If these losses are recognized in 1988, they may be carried back by P[a] to offset its separate pre-acquisition income, but if that amount proves insufficient, it may not be used against the group's other consolidated income for such year. Although the common parent of the group for the CRY to which a loss is carried will usually be exempt from the SRLY rule, this is not always the case. Reg. §§ 1.1502-1(f)(1) and -15(a)(2)(ii) make it clear that where SRLY losses or SRLY built-in losses are acquired from a "predecessor" corporation in a nontaxable transaction, the common parent is itself subject to these limitations.

n225 Since none of the carryback periods specified in § 172(b) exceeds 10 years, see note 52, this exception is of no help where the built-in losses are being carried back.

n226 The basis and the fair market value of marketable securities will be considered in applying this test if immediately before the acquisition:

1. The fair market value of the security is less that 95% of its adjusted basis, or
2. The acquired corporation had held the security for at least 24 months, or
3. The security is stock in a corporation at least 50% of whose value is owned by the acquired corporation.


n227 Reg. § 1.1502-15(a)(4). Stated differently, the aggregate fair market value of the assets must be at least 87% of their aggregate basis.

Where an affiliated group of corporations is acquired, the regulations are silent as to the level of aggregation at which this test is to be applied. If one or more of the corporations in the acquired group have substantial built-in losses, but the group, as a whole, does not, will the members with the substantial
built-in losses be subject to these limitations? The Service has resolved to apply this de minimus test on a member-by-member basis. LTR 8125088 (March 26, 1981); LTR 8202022 (Sept. 30, 1981). It has justified this position on the grounds that the built-in loss rules are merely extensions of the SRLY limitations, and that if such losses had actually been recognized in the pre-acquisition year in which they accrued, the SRLY limitations would have applied. The lack of symmetry in this reasoning is apparent when one takes a moment to reflect that if the built-in gains of the group had likewise all been recognized in the pre-acquisition year, there would have been no SRLY losses to worry about. It has also been suggested that this interpretation is not in accord with the original intent of the regulations, which was to prevent trafficking in corporations with built-in losses. J. Crestol, K. Hennessey, and A. Rua, The Consolidated Return: Principles, Practice, Planning 5-70 (1980).

n228 See discussion in the text accompanying notes 250-3.

Special Considerations in Planning the Acquisition of a Subsidiary Member of Another Affiliated Group

Where, for the carryback year in question, the acquired corporation was a subsidiary member of another consolidated group, then any refund resulting from the carryback of its post-disposition will be paid to the common parent of the member's former affiliated group. n229 Although the payment of the refund to the common parent will discharge the government's liability to the group and its individual members, these regulations have no effect on any obligation that the parent may have to turn all or any portion of the refund over to other members of the group. n230 Nevertheless, in negotiating the acquisition of the stock of a corporation which is a subsidiary member of a consolidated group, the purchaser should recognize the importance of expressly including provisions in the agreement which will make it possible for the acquired corporation to obtain the tax benefit of its own post-acquisition losses, should they materialize. These provisions should include agreements which:

n229 Reg. § 1.1502-78(b)(1). This is true regardless of whether the corporation which actually sustained the loss applied for the refund under § 6411 (tentative carryback adjustment), or whether the common parent corporation of the acquired corporation's former consolidated group, as the sole agent for the group, applied for the refund.

n230 See Bob Richards Chrysler-Plymouth Corp. v. Commissioner, 473 F.2d 262 (9th Cir. 1973); Jump v. Manchester Life & Casualty Management Corp., 579 F.2d 449 (8th Cir. 1978), aff'g 438 F. Supp. 185 (E.D. Mo., 1977). In both of these cases, the common parent was required to remit to a subsidiary the portion of the refund that resulted from the subsidiary's use of its own loss against its own income.

1. Require the former common parent corporation of the acquired corporation to prepare and file claims for refund;

2. Require the former common parent corporation to transfer all, or some prenegotiated portion, of the resulting refund to its former subsidiary; n231

n231 Such a reimbursement, to the extent it does not exceed the disposed member's allocable share of consolidated tax liability for the CRY to which its loss was carried, will likely be treated in the same manner as if the tax refund had been paid directly to the former subsidiary.

3. Require the former common parent corporation to supply information required for its former subsidiary to file a claim for a tentative carryback adjustment. n232


If the necessity of such an agreement was overlooked at the time of the original negotiations and if the seller will not concede the necessary retroactive modifications, the common parent can, of course, relinquish the entire carryback period with respect to a given year's loss, as provided under § 172(b)(3)(C). n233 However, this election cannot be made selectively. Either all of the losses subject to the SRY
limitations and the residual consolidated loss are carried back or none of them are. Consequently, failure to anticipate and provide for the carryback of the post-acquisition losses of the acquired corporation can have the unexpected effect of denying the acquiring group the certain and contemporaneous benefit that would otherwise result from carrying back consolidated losses which are not subject to the SRY limitations: that is, the refund that would otherwise result from carrying back the SRY-limitation losses (and which might otherwise be lost to, or refused by, the former common parent) might be of sufficient magnitude to compel the group to carry all losses forward to offset income it hopes to generate in future years.

See, however, Reg. § 1.1502-47(h)(2)(iii), which permits a group electing § 1504(c)(2) (see note 135) to make this election independently with respect to the losses of its nonlife subgroup and those of its life subgroup.

Note, however, that if the acquired corporation's former affiliated group had a consolidated loss for the carryback year in question, the acquired member is neither required nor permitted to carryback its post-acquisition SRY-limitation loss to that year even if individually it had positive income for that year. Rev. Rul. 66-91, 1966-1 C.B. 54.

Note further that in the years since the disposition, the former affiliated group of the acquired corporation may have carried its own post-disposition losses back to obliterate all of its consolidated income for the carryback years which would otherwise still have been open to the acquired corporation's SRY-limitation losses. If this is discovered to be the case, the acquiring affiliated group can now safely carry its own consolidated losses back without forfeiting any of the potential tax benefit of the SRY-limitation losses.

[*155] If an agreement along the lines recommended above is sought by the purchaser, the parties representing the seller may insist that the tax benefit of any refund be shared according to some mutually acceptable formula which takes into account the certain and immediate value of a post-acquisition loss that can be carried back, as compared with the risk and diminished present value of a loss which can only be carried forward. They will, of course, also want to insist on assurances that any refund remitted to the former subsidiary will be paid back in the event of adverse audit adjustments affecting either the amount of the loss initially carried back or the amount of income originally thought to be available to generate the refund. The seller may also wish to consider whether it will want the refund restored to it in the event that it later finds its own post-disposition losses could have otherwise been carried back to generate a refund of taxes attributable to the disposed subsidiary's income.

n236 Reg. § 1.1502-78(b)(2) holds each member of the consolidated group severally liable for the deficiency and for any interest and penalties assessed thereon.
The election to forego the carryback period cannot be made or revoked on an amended return. As to which corporation has first access to the pre-disposition separate income of the former affiliate, see the "absorption" rules set forth in Reg. § 1.1502-21(b)(3).

Application of the Consolidated Return Regulations to the Carry Back of Post- Acquisition Losses

It would be impractical, if not impossible, to attempt to illustrate the application of the rules discussed above and in preceding sections of this article to each of the hundreds of conceivable fact patterns which might produce unique or quasi-unique results. The following example, which applies these rules to several variations of a fairly typical acquisition scenario, should, however, prove useful.

Example 17

P[a] is the common parent of an affiliated group which is comprised of P[a] and its wholly-owned subsidiary, S[a]. P[a] and S[a] have been filing consolidated returns since 1981.

P[t], on the other hand, is the common parent of an affiliated group which includes S[t], its wholly-owned subsidiary, and SS[t], the wholly-owned subsidiary of S[t]. P[t], S[t], and SS[t] have been filing consolidated returns since 1982.

Each of the five corporations actively conducts a business, each is a calendar year taxpayer, and each has contributed substantial separate income to the consolidated income of their respective groups for each of the years in the remaining loss carryback period. The two common parent corporations have no shareholders in common, either directly or indirectly. Finally, assume that the continuing group (or the new group, as the case may be) files a consolidated return for each year following the acquisition. The tables which follow illustrate the effect of the limitations discussed in this and previous sections of this article upon the carry back of post-acquisition losses in each of the 350 individual scenarios derived from the above facts. "Y" is used to indicate "Yes" and "N" to indicate "No." Alphabetical footnote explanations follow the five tables.

n238 The solutions set forth in these tables assume that none of the additional limitations that might sometimes be imposed under §§ 382 and 269 are applicable. These provisions are discussed in the text accompanying notes 239-307.

<table>
<thead>
<tr>
<th>TABLE I</th>
</tr>
</thead>
<tbody>
<tr>
<td>P[a] acquires all of the assets of P[t]</td>
</tr>
<tr>
<td>In a nontaxable Type A, Type C, or nondivisive Type D Reorganization</td>
</tr>
<tr>
<td>Additional Facts: Can the post- acquisition consolidated . . . Be carried back to offset the pre- acquisition consolidated income</td>
</tr>
</tbody>
</table>
| Reverse Acquisition? loss nl attributable to . . . attributable to . . . P[a]? S[a]?
| P[t]?
| No n2 |
| N b |
| N c |
| N b |
| N g |
\begin{itemize}
\item \textbf{Yes n3} P[a]'s business \hfill N h b \hfill N c
\item P[t]'s business \hfill N h b \hfill N c
\item S[t] \hfill N g \hfill Y g
\item S[a] \hfill N g \hfill Y g
\item SS[t] \hfill Y a \hfill Y a
\end{itemize}

\begin{itemize}
\item \textbf{Yes n3} P[a]'s business \hfill Y d a /N e \hfill Y d
\item S[a] \hfill N f
\item P[t]'s business \hfill Y a
\item S[t] \hfill Y a
\item SS[t] \hfill Y a
\end{itemize}

\[\text{Additional Facts: Can the post-}
\text{acquisition consolidated reverse loss n1 attributable to . . . Be carried back to offset the pre-acquisition consolidated income?}\]

\begin{itemize}
\item \textbf{Yes n3} P[a]'s business \hfill Y d a /N e \hfill Y d
\item S[a] \hfill N f
\item P[t]'s business \hfill Y a
\item S[t] \hfill Y a
\item SS[t] \hfill Y a
\end{itemize}

\text{n1 Or, where appropriate, the built-in losses of a member, irrespective of whether the group has a consolidated loss.}

\text{n2 The P[a]/S[a] group is the continuing group. The P[t]/S[t]/SS[t] group is discontinued.}

\text{n3 The P[t]/S[t]/SS[t] group is the continuing group. The P[a]/S[a] group is discontinued. [*158]}
<table>
<thead>
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<th>Additional Facts:</th>
<th>Can the post-</th>
<th>... Be carried back to offset acquisition consolidated attributable to ...</th>
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<td>Section 338 loss</td>
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<td>Applicable? to ...</td>
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<td>S[a]?</td>
</tr>
<tr>
<td>SS[t]? Yes</td>
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</tr>
<tr>
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</tr>
<tr>
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<td>Y d</td>
</tr>
<tr>
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<tr>
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<td>SS[t]</td>
<td>Y n</td>
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<tr>
<td>N k</td>
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<td>N c</td>
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</tr>
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<td>N g</td>
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<td>N f</td>
</tr>
<tr>
<td>Y g</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

n1 Or, where appropriate, the built-in losses of a member, irrespective of whether the group has a consolidated loss.

n4 Under Section 338(e)(1), P[a]'s taxable purchase of P[t]'s assets (referred to as as a "tainted asset acquisition") will usually cause a Section 338 election to be deemed to have been made with respect to S[t] and SS[t].

n5 Assume, for example, that P[a] made a "protective carryover election" under Temp. Reg. Section 1.338-4T(f)(6). This election permits a purchasing corporation that does not make an express Section 338 election to instead make a "protective carryover election" which will prevent a deemed Section 338 election in the event of a "tainted asset acquisition." The effect of a protective carryover election (and of an "affirmative action carryover election") is to limit the purchasing corporation's basis in the assets acquired in the tainted asset acquisition to the basis they had in the hands of the transferor corporation immediately before the acquisition. [*159]
**Facts:**
Pa acquires the stock of Pt
Can the post acquisition consolidated offset the pre-acquisition consolidated loss attributable income

<table>
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<tr>
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<th>S[a]?</th>
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<td>Y a</td>
</tr>
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<td>Y a</td>
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<tr>
<td>N c</td>
<td></td>
<td>P[t]</td>
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<td>N f</td>
</tr>
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<td>Y v</td>
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<td>S[t]</td>
<td>N f</td>
<td>N f</td>
</tr>
<tr>
<td>N g</td>
<td></td>
<td>SS[t]</td>
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<td>N f</td>
</tr>
<tr>
<td>N g</td>
<td>Yes n3</td>
<td>P[a]</td>
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<td>Y v</td>
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<tr>
<td>N f</td>
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<td>S[a]</td>
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<td>Y g</td>
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<td>Y n</td>
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<td>? p r s</td>
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### consolidated
### acquisition
### consolidated
### acquisition
### acquisition
### consolidated
### acquisition
### consolidated
### acquisition

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<th>N2 attributable to ...</th>
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<td>S[a]</td>
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<td>N f</td>
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<td>S[t]</td>
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<td>Y a</td>
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<td>SS[t]</td>
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<td>Y a</td>
</tr>
<tr>
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<td>Yes</td>
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</tr>
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<tr>
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<td>Yes</td>
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</tr>
<tr>
<td>? p q t</td>
<td>S[a]</td>
<td>? p q t</td>
<td>? p q t</td>
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<td>? p q t</td>
<td>P[t]</td>
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<td>? p q t</td>
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<tr>
<td>? p q t</td>
<td>S[t]</td>
<td>? p q t</td>
<td>? p q t</td>
</tr>
<tr>
<td>? p q t</td>
<td>SS[t]</td>
<td>? p q t</td>
<td>? p q t</td>
</tr>
</tbody>
</table>

---

n1 Or, where appropriate, the built-in losses of a member, irrespective of whether the group has a consolidated loss.
n2 The P[a]/S[a] group is the continuing group. The P[t]/S[t]/SS[t] group is discontinued.

n3 The P[t]/S[t]/SS[t] group is the continuing group. The P[a]/S[a] group is discontinued.  [*160]

<table>
<thead>
<tr>
<th>Additional Facts:</th>
<th>Can the post-</th>
<th>. . . Be carried back offset the pre-</th>
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</thead>
<tbody>
<tr>
<td>Reverse Aquisi-</td>
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<td>acquisition</td>
</tr>
<tr>
<td>tion?</td>
<td>loss n1 attribut-</td>
<td>income attributable to . . .</td>
</tr>
<tr>
<td>80% Control of P[a]?</td>
<td>able to . . .</td>
<td>attributable to . . .</td>
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<td>P[a]'s business</td>
<td>Y a</td>
</tr>
<tr>
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<td>---</td>
</tr>
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<td>Y d a</td>
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</tr>
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<td>P[a]'s business</td>
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<td>N c Y d a</td>
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<td>S[a]</td>
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Facts:  

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<th>Post-acquisition</th>
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<td>Reverse</td>
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<td>es 80% Cont-</td>
<td>attributable</td>
<td>income</td>
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<td>loss n1</td>
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Acquisition

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<tr>
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<td>N c</td>
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<td>Y u</td>
</tr>
<tr>
<td>Y u z</td>
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<td>SS[t] N g</td>
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n1 Or, where appropriate, the built-in losses of a member, irrespective of whether the group has a consolidated loss.

n2 The P[a]/S[a] group is the continuing group. The P[t]/S[t]/SS[t] group is discontinued.

n3 The P[t]/S[t]/SS[t] group is the continuing group. The P[a]/S[a] group is discontinued.

n6 Both P[a]/S[a] group and the P[t]/S[t]/SS[t] group are discontinued. [*161]

TABLE V

P[a] acquires the stock of S[t]  
In a nontaxable Type B reorganization  
Additional Can the post- Be carried back to offset the
**Facts:**

<table>
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<th>Reverse Acquisi-</th>
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<th>Pre-acquisition consolidated income attributable to . . .</th>
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<td></td>
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<td>g</td>
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n1 Or, where appropriate, the built-in losses of a member, irrespective of whether the group has a consolidated loss.

n2 The P[a]/S[a] group is the continuing group. The P[t]/S[t]/SS[t] group is discontinued.

n3 The P[t]/S[t]/SS[t] group is the continuing group. The P[a]/S[a] group is discontinued.

n6 Both P[a]/S[a] group and the P[t]/S[t]/SS[t] group are discontinued.

a The consolidated loss attributable to this corporation will not be apportioned to it since this corporation was a member of the continuing consolidated group in the carryback year. Instead, this corporation's separate loss will be part of the group's consolidated loss carryback, and, as such, it can be carried back to offset the continuing group's pre-acquisition consolidated income. § 1.1502-21(a), (b)(1) (and, in the case of a reverse acquisition, Reg. §§ 1.1502-75(d)(3)(i), -1(f)(3)). See Example 10, in the text accompanying note u52 (or, in the case of a reverse acquisition, note 202).
b Section 381(b)(3) prohibits carry back of the loss attributable to this business to the pre-acquisition income of the transferor corporation. See Example 1, in the text accompanying notes 71-3.

c The consolidated loss attributable to this corporation (or business) is part of the group's consolidated loss carryback. Reg. § 1.1502-21(a), (b)(1). As such, it can only be carried back to offset the pre-acquisition consolidated income of the continuing group.

d The consolidated loss attributable to the acquired corporation's business is now part of the acquiring corporation's separate loss. Since the Libson Shops tracing rule has been legislatively abandoned, and since Prop. Reg. 1.1502-79(a)(4) will not, if and when finalized, apply to either the post-acquisition losses of a common parent, or post-acquisition losses of a subsidiary member following its purchase of assets in a transaction that is not a "carryover basis acquisition," then the loss attributable to the acquired corporation's business will, with one or two possible exceptions (see notes e and w), be treated in the same manner as a loss sustained by the acquiring corporation's historic business. See Example 4, in the text preceding note 76.

e To the extent that the loss sustained by the acquired corporation's business is attributable to the recognition of a built-in loss, that loss would be considered a SRLY loss, even if it is recognized by the common parent corporation (which is generally exempt from the SRLY limitations under Reg. § 1.1502-1(f)(2)(ii)). Reg. § 1.1502-15(a)(1), (a)(2)(ii), -1(f)(1). Consequently, it can only be carried back to offset the pre-acquisition income of the acquiring corporation itself. It cannot offset any of the pre-acquisition consolidated income that is attributable to the other members of the continuing group. Reg. § 1.1502-21(c).

f The consolidated loss attributable to this corporation must be apportioned to it under the SRY rules. It cannot be carried back as part of the group's consolidated loss carryback to offset any of the pre-acquisition consolidated income of the continuing group. Reg. § 1.1502-79(a). See Example 10, in the text accompanying note 152 (or, in the case of a reverse acquisition, note 202).

g The consolidated loss attributable to this corporation must be apportioned to it under the SRY limitation rules. Reg. § 1.1502-79(a). Additionally, from the perspective of the discontinued group's pre-CRY, the consolidated loss apportioned to this corporation under the SRY rules is a SRLY (Reg. § 1.1502-1(e), (f)), and, as such, may offset only the portion of discontinued group's pre-acquisition consolidated income which was attributable to this loss corporation in the carryback year. Reg. § 1.1502-21(c). See Example 15, in the text accompanying note 179.

h Under Reg. § 1.1502-75(d)(3)(v)(b), the reverse acquisition rules of the consolidated return regulations reverse the usual application of Section 381: The nominal acquiring corporation is treated as the "transferor" corporation for the purposes of Section 381(b). See LTR 8527001 (March 20, 1985), discussed in text accompanying notes 204-10.

i Since there is no continuing group in this scenario, the consolidated loss of the new group must be apportioned to each of its subsidiary members under the SRY rules. The loss attributable to this corporation may not be carried back to offset the pre-acquisition income of the members of the other discontinued group. Reg. § 1.1502-79(a).

j The carryback is disallowed under the general principle that a loss sustained by one tax-payer may not, in the absence of an express statutory provision to the contrary, be deducted by another.

k Under the fiction created by Section 338(a), the acquired corporation (in a stock acquisition) and its subsidiaries are treated as new corporations that came into existence at the time of the acquisition. As such, they simply have no pre-acquisition existence, nor do they have any pre-acquisition income against which a post-acquisition loss might otherwise be carried.

l Not Applicable. P[t] is not, and has never been, affiliated with P[a] or S[a].
n Under the fiction created by Section 338(a), the subsidiaries of the acquired corporation are treated as new corporations that came into existence at the time of the acquisition. Since they are treated as (1) not having been in existence in the year to which this loss is to be carried, and (2) to have become members of the continuing group immediately upon their organization, and (3) if and when Prop. Reg. § 1.1502-79(a)(4) is finalized, they have not acquired their assets in a carryover basis acquisition, then the consolidated losses attributable to these subsidiaries will not be apportioned to them. Reg. § 1.1502-79(a)(2). Instead, each corporation's separate loss will be part of the group's consolidated loss carryback, and, as such, can be carried back to offset the continuing group's pre-acquisition consolidated income. See Example 11, in the text accompanying note 156, and note 85.

o Under the fiction created by Section 338(a), the subsidiaries of the acquired corporation are treated as new corporations that came into existence at the time of the acquisition. Since these new corporations have never been affiliated with P[t], the carryback is disallowed under the general principle that a loss sustained by one taxpayer may not, in the absence of an express statutory provision to the contrary, be deducted by another.

p If a Section 338 election renders the reverse acquisition rules inapplicable (see note 212), then this outcome would be the same as that indicated previously in this table for Section 338 transactions which do not meet the definitional requirements of a reverse acquisition.

q If a correct interpretation of the application of the reverse acquisition rules would require that P[t] be recast as the "purchasing" corporation under Section 338(d)(1), and P[a] the "target corporation" under Section 338(d)(2), then this outcome would be "Yes." See also note a, and, where the losses are those attributable to P[a] or S[a], note n.

r If a correct interpretation of the application of the reverse acquisition rules would require that P[t] be recast as the "purchasing" corporation under Section 338(d)(1), and P[a] the "target corporation" under Section 338(d)(2), then this outcome would be "No." See also note k.

s If a correct interpretation of the application of the reverse acquisition rules and Section 338 is that Section 338 applies to P[t] and its subsidiaries, and that the reverse acquisition rules apply to P[a], this outcome would be "Yes." See also notes g (S[a]'s losses) and v (P[a]'s losses).

t If a correct interpretation of the application of the reverse acquisition rules and Section 338 is that Section 338 applies to P[t] and its subsidiaries, and that the reverse acquisition rules apply to P[a], this outcome would be "No."

u This loss can be carried back to the pre-disposition income of the P[t]/S[t]/SS[t] group under the "lonely parent" exception of Reg. §§ 1.1502-1(f)(2)(i), -21(a), (b)(1).

v The consolidated loss attributable to this corporation must be apportioned to it under the SRY limitation rules. Reg. § 1.1502-79(a). However, since this loss corporation was the common parent of the discontinued group for the year to which the loss is to be carried, the SRLY restrictions are inapplicable. Reg. § 1.1502-1(f)(2). See the example in note 178, and, in the case of a reverse acquisition, notes 201-2.

w This income would not be available to absorb this loss, however, if the requirements set forth in Prop. Reg. 1.1502-79(a)(4), if and when finalized, have been satisfied. See text accompanying notes 180-95.

x The post-disposition losses of P[t] may have already been carried back to reduce the pre-disposition consolidated income attributable to its former members. Reg. § 1.1502-21(a), (b)(1).

y The resulting refund will be paid to P[t], not to P[a] or to S[t] (or SS[t]). Reg. § 1.1502-78(b). See the text accompanying notes 229-37.
The postdisposition SRLY loss carrybacks of S[t] (or SS[t]) may have already been used to reduce the predisposition consolidated income attributable to S[t] (or SS[t]).

[*163] Section 382 and the Carryback of Built-In Losses

Overview of Section 382

The Tax Reform Act of 1986 fundamentally altered the mechanical rules that restrict the utilization of the loss (and credit) carryforwards of a corporation that experiences sudden and dramatic changes in the identity of its shareholders in the interval separating the recognition (or, in some cases, the economic accrual) of such losses, and the recognition of the income that these losses could otherwise offset. Briefly, if a corporation with loss carryforwards, credit carryforwards, or substantial net unrealized built-in losses (the "loss corporation") (1) experiences either (a) an "owner shift involving a 5-percent shareholder," n239 or (b) an "equity structure shift," n240 and (2) if such transaction (or the cumulative effect of two or more such transactions occurring within the "testing period") n241 results in a more than 50 percentage point increase in the value of the stock held by all of the corporation's "5-percent shareholders," n242 then the transaction constitutes an "ownership change." Once an ownership change has occurred, § 382 imposes an "annual limitation" on the amount of postchange income that such prechange losses (and credits) can offset. n243 Subject to important exceptions and modifications, this annual limitation is derived by multiplying the aggregate fair market value of all outstanding equity interests n244 in the loss corporation immediately prior to the ownership change, n245 by the highest of the "long-term tax-exempt rates" in effect for any month in the three-month period ending with the calendar month in which the ownership change occurs. n246 If the amount of the corporation's income in any post-change year proves to be less than the amount of the annual limitation, any unused limitation can be carried forward (but not carried back) to increase the annual limitation of a later tax year. n247

n239 IRC § 382(g)(1), (2). An "owner shift" is any change in stock ownership other than one resulting from a gift or bequest, from certain divorce/separation-related transfers, from certain acquisitions made by employee stock ownership plans, or from mere fluctuations in the relative values of different classes of stock. IRC § 382(g)(1), (1)(3)(B)-(D). An owner shift can occur, for example, when one shareholder purchases stock from other shareholders, when a corporation issues new stock (or treasury stock) in exchange for cash, property, or services, when it redeems outstanding stock or makes a nonprorata stock dividend distribution, or when it converts its debt into stock. Corporate divisions may also result in an ownership shift.

Under a new rule enacted as part of the 1987 Act, the treatment of the corporation's stock as worthless may also be treated as an owner shift. Revenue Act of 1987, Pub. L. No. 100-203, § 10225(a). New § 382(g)(4)(D) provides that if any stock owned by a "5-percent shareholder" is treated by that shareholder as worthless during that shareholder's tax year, and if such stock is held by that shareholder as of the close of such taxable year, then, in determining whether or not an "ownership change" has occurred, such stock will be treated as if it had been acquired by a new shareholder on the first day of the first succeeding taxable year. A "50-percent shareholder" is any shareholder that owned 50% or more in value of the corporation's outstanding stock at any time during the three-year period ending on the last day of the taxable year in which the stock is treated as worthless. This rule applies to stock treated as worthless in tax years beginning after December 31, 1987. It is designed to reverse the precedent established by Textron v. United States, 561 F.2d 1023 (1st Cir. 1977), which held that the net operating losses of an unconsolidated subsidiary could be carried forward to offset its future income notwithstanding the fact that the parent corporation had deducted the subsidiary's stock as worthless.

Only owner shifts which affect the proportionate interest of one or more of the corporation's "5-percent shareholders" carry the potential of triggering § 382. A "5-percent shareholder" is any person who directly or indirectly owns 5% or more in value the corporation's outstanding stock at any time during the "testing period." IRC § 382(k)(7). In making this determination, and in determining whether a shareholder is a "50-percent shareholder" for the purpose of new § 382(g)(4)(D):
1. The value of any "pure" preferred stock is excluded from both the numerator and the denominator. "Pure" preferred stock is used throughout this section of the article to mean nonvoting, nonparticipating, nonconvertable preferred stock, but only if any redemption or liquidation premium is not excessive under the circumstances. IRC §§ 382(k)(6)(A), 1504(a)(4).

2. The constructive ownership rules of § 318 (as substantially modified by § 382(1)(3)(A)) apply. Additionally, all stock owned by shareholders who are not 5% shareholders is aggregated and treated as if owned by one 5% shareholder. IRC § 382(g)(4)(A).

n240 IRC § 382(g)(1). An "equity structure shift" includes both (1) nontaxable reorganizations under § 368(a)(other than "divisive" Type D and G reorganizations, and Type F reorganizations), and (2) certain taxable reorganization-type transactions, public offerings, and similar transactions. IRC § 382(g)(3).

n241 The "testing period" is generally the three-year period ending on the date of the owner shift or equity structure shift in question. However, this period cannot begin before the later of:

1. The day after the day on which a prior ownership change triggered application of § 382;

2. Except in the case of a corporation with a "net unrealized built-in loss" (defined in the text accompanying notes 250-3), the first day of the first taxable year from which the corporation has either a loss or credit carryforward (as distinguished from a loss or credit carryover that was carried back); or


IRC § 382(i).

n242 In determining whether or not the requisite 50 percentage point change in ownership has occurred, note that:

1. "Pure" preferred stock is not taken into account (IRC § 382(k)(6)(A));

2. Changes in proportionate ownership resulting from gifts, bequests, certain divorce/separation-related transfers, certain acquisitions made by employee stock ownership plans, or from mere fluctuations in the relative values of different classes of stock are not taken into account (IRC § 382(1)(3)(B)-(D)); and

3. In addition to stock owned outright, a shareholder is deemed to own stock attributed under a substantially modified application of § 318 (IRC § 382(1)(3)(A)).

n243 Special, generally favorable, rules may apply where the loss corporation is under the jurisdiction of a court in a "title 11 or similar case," or where, prior to 1989, the corporation is a troubled financial institution. See IRC § 382(1)(5).

n244 Including, for this purpose, the value of any outstanding "pure" preferred stock. IRC § 382(e)(1).

n245 This rule is subject to three exceptions. First, if a redemption occurs in connection with an ownership change, the value of the corporation is determined after taking the redemption into account. IRC § 382(e)(2).

Second, § 382(1)(1) generally requires that the amount of any cash and value of any property received by the corporation as a contribution to its capital be ignored if it was contributed either within two years of the date of the ownership change, or for the principal purpose of reducing the impact of § 382.

Finally, except in the case of certain investment entities, if more than one-third of the value of the corporation's total assets are nonbusiness assets, the value which would otherwise be used to compute the
annual limitation must be reduced by the value of such assets (net of their proportionate share of the corporation's liabilities). IRC § 382(1)(4).

n246 IRC § 382(f). One of the stated objectives of new § 382 was to confine the net operating loss carryover rules to their "intended function": to provide an averaging mechanism that mitigates the distortions otherwise resulting from the annual accounting period definition of income. Consequently, if the statute were to permit the loss carryforwards of an acquired corporation to be utilized against unrelated income, no legitimate averaging function would be performed:

Permitting the carryover of all losses following an acquisition, as is permitted under the 1954 Code if the loss business is continued following a purchase, provides an improper matching of income and loss. Income generated under different corporate owners from capital over and above the capital used in the loss business, is related to a pre-acquisition loss only in the formal sense that it is housed in the same corporate entity. Furthermore, the ability to use acquired losses against such unrelated income creates a tax bias in favor of acquisitions.


In keeping with this objective, the formula set forth in the text was, in essence, conceived as a surrogate measure of the amount of income the acquired corporation would have had available to absorb its net operating loss carryforwards had it simply sold its assets for cash, and used the cash proceeds first to pay its liabilities and then to invest in securities yielding the equivalent of whatever the applicable "long-term tax exempt rate" happens to be at the time of the requisite change in ownership.

n247 IRC § 382(b)(2). Under some circumstances, the annual limitation may, for a given year, be increased through recognition of built-in gains. If the loss corporation had a "net unrealized built-in gain" immediately prior to the ownership change, the annual limitation for a taxable year that includes any part of the five-year period beginning on the date of the ownership change (hereinafter the "recognition period") will be increased by the amount of any built-in gains recognized as a result of a taxable disposition taking place within that five-year period. The loss corporation is treated as having a net unrealized built-in gain only if, immediately prior to the ownership change, the aggregate adjusted basis of its noncash assets (exclusive of certain marketable securities and "cash items") is less than 75% of their aggregate fair market value. IRC § 382(h)(3)(B). (If the event that triggered the ownership change was a redemption of stock, then this test is applied after taking into account the redemption distribution.)

In any given recognition period taxable year, the annual limitation cannot be increased through recognition of built-in gains by more than the excess of the net unrealized built-in gain over the sum of all built-in gains recognized in prior post-change tax years. IRC § 382(h)(1)(A)(ii).

Note further that § 382(h)(1)(C) allows a corporation to utilize its pre-change losses to offset any gain resulting from the application of § 338.

A more Draconian rule applies where, within the two-year period following the ownership change, the loss corporation's historic business is discontinued and no significant portion of its historic business assets are used in the conduct of a business. n248 Here, prechange loss carryforwards are not merely limited, they are eliminated -- permanently and irrevocably. n249

n248 IRC § 382(c). The committee reports accompanying § 382(c) state that this "continuity of business enterprise" test is intended to be the same as that set forth in Reg. § 1.368-1(d). S. Rep. No. 313, 99th Cong., 2d Sess. 234 (1986).

n249 IRC § 382(c)(1). Even if the business continuity requirement is not satisfied, prechange losses are nevertheless allowed to offset (1) recognized built-in gains of a loss corporation that has a "net unrealized built-in gain," and (2) gain recognized by reason of § 338 election. IRC § 382(c)(2).
In contrast to its predecessor, revised § 382 may also limit the post-change utilization of losses that already had accrued, in an economic sense, prior to the ownership change, but which had not yet been recognized for tax purposes. n250 More specifically, if, at the time of the ownership change, the excess of the loss corporation's adjusted basis in all of its assets (other than cash, "cash items," and certain marketable securities) n251 exceeds the total fair market value of such assets by more than 25%, then the corporation is considered to have a "net unrealized built-in [*167] loss," and the annual § 382 limitation will apply to the combined amount of the corporation's pre-change recognized loss carryforwards (and credit carryforwards) and any built-in losses recognized within the five-year period beginning on the date of the ownership change. n252 Any portion of the built-in losses that are recognized in a given year but are disallowed under § 382 by virtue of the annual limitation must be carried forward to subsequent taxable years, where they will likewise be subject to the annual limitation. n253

n250 The concept of built-in loss was elaborated upon more fully in the text accompanying notes 214-28. Note, however, that the § 382 rules apply and operate differently from the consolidated return regulations in many fundamental and important respects. Further, the committee reports make it reasonably clear that these two sets of rules are not mutually exclusive: In appropriate circumstances, they may be applied simultaneously to restrict the utilization of the same built-in loss. S. Rep. No. 313, 99th Cong., 2d Sess. 233, 247 (1986).

n251 That is, marketable securities having a value that does not differ substantially from their adjusted bases. IRC § 382(h)(3)(B)(ii)(II).

n252 IRC § 382(h)(1)(B). Section 382(h)(3)(B) sets a corporation's net unrealized built-in loss at zero if the actual amount does not exceed the 25% threshold.

Recognition of built-in losses in excess of the amount of the corporation's net unrealized built-in loss are not subject to § 382. IRC § 382(h)(1)(B)(ii). On the other hand, the more substantial the net built-in loss, the greater the risk that such loss will be disallowed entirely under § 269 (discussed in the text accompanying notes 198-230).

The 1987 Act added capital recovery to the list of events which trigger the recognition of built-in losses. Under this new rule, the portion of a given asset's depreciation, amortization, or depletion deduction which is attributable to the excess of its adjusted basis over its fair market value (both amounts determined immediately prior to the ownership change) will be treated as a recognized built-in loss. Section 382(h)(2)(B) (as amended by § 10225(b) of the Revenue Act of 1987 and generally applicable only where the ownership change occurs after December 15, 1987). Accounting for this component of an affected corporation's capital recovery deductions is likely to be difficult under the best of circumstances. Given the exponential relationship that seems to exist between complexity and compounding tiers of limiting provisions (for example, the uniform capitalization rules, LIFO accounting procedures, and the corporate alternative minimum tax rules), the task may well be rendered impossible for some.

Significantly, the 1987 Act does not provide a symmetrical rule that would allow a corporation to contemporaneously offset the annual recovery of built-in losses with the additional amount of depreciation, amortization, or depletion that it would have been entitled to claim had the basis of an appreciated asset equalled its fair market value as of the change date. (Nor, in the case of a corporation with a net unrealized built-in gain, are such additional capital recovery amounts permitted to increase the amount of its annual limitation.) As noted previously, however, § 382(h)(1)(B)(ii) limits the aggregate amount of recognized built-in losses that are subject to the annual limitation to the amount of the corporation's net unrealized built-in loss.

n253 IRC § 382(h)(4). For a more complete examination of net operating loss carryforwards under § 382, see Wooten, Section 382 After the Tax Reform Act of 1986, 64 Taxes 874 (1986); Silverman & Keyes, New Limitations on NOL Carryovers Following the Tax Reform Act, 66 J. Tax'n 194 (1987). Both articles were published before the 1987 Act, which, as noted in this discussion, added §§ 382(g)(4)(D), (h)(2)(B) (last sentence), 384 (see note 256).
Carryback of Built-In Losses

At initial glance, § 382 does not appear to have any potential applicability where the issue is whether and to what extent post-change losses can be carried back to offset pre-change income. First, the statute unambiguously restricts the scope of § 382 to only two categories of losses: (1) those recognized prior to an ownership change, and (2) unrealized built-in losses that have accrued as of that date. It does not apply to losses that accrue (and are ultimately recognized) after an ownership change. Nor is the carryback of such losses restricted under § 382 by the less direct mechanism of limiting the amount of pre-change taxable income that is available for such losses to offset. Although § 383 lists other tax attributes that are subject to the constraints of § 382, the corporation's prechange refund capacity is not among them. n255

Section 383 subjects additional pre-change tax attribute carryforwards, such as capital losses, unused general business credits, unused alternative minimum tax credits, and foreign tax credits, to essentially the same standards and limitations as those imposed on net operating loss carryforwards under § 382. The annual limitation establishes the maximum amount of postchange taxable income that the combined amount of these prechange tax attributes can offset in a given year.

Conceptually, carrying back postchange losses to prechange taxable income is more or less equivalent to carrying forward the refund capacity attributable to the taxes paid by the corporation in each of the pre-change tax years falling within what remains, as of the date of the ownership change, of the applicable carryback period. American Law Institute, Federal Income Tax Project: Subchapter C: Proposals of the American Law Institute On Corporate Acquisitions and Dispositions and Reporter's Study on Corporate Distributions 286-87 (1982). Arguably, this refund capacity is like other potentially valuable tax credit carryforwards and should be treated no differently. In marked contrast to loss and other credit carryforwards, however, the economic benefit of a corporation's prechange refund capacity can be realized only if the corporation recognizes postchange net operating losses and thereby suffers commensurate economic detriment. At least for the present, this issue is moot: neither § 382 itself, nor its companion, § 383, applies to this tax attribute. Indeed, as noted in the text accompanying notes 57-93, § 381(b)(3) expressly rejects the notion that the corporation's refund capacity be treated like other tax attribute carryovers.

Furthermore, recall that the statute and regulations unequivocally forbid the use of one corporation's pre-acquisition recognized loss carryforwards to offset the pre-acquisition income of another corporation. n256 How § 382 might otherwise apply to limit the utilization of this type of loss "carryback" is therefore moot.

IRC § 381(c)(1)(A), and the consolidated return regulations discussed in the text accompanying notes 144-62 and 173-95.

Most recently, Congress' concern that the losses of one corporation might, in some way, ultimately be used to reduce the taxable income of another, unrelated corporation prompted enactment of § 384, effective, generally, for acquisitions taking place after December 15, 1987. Subject to several exceptions and refinements, new § 384 generally prevents an acquiring corporation with pre-acquisition loss carryforwards or a net unrealized built-in loss from using those losses to offset the recognized built-in gains of (or, following a nontaxable asset acquisition, attributable to) an acquired corporation that had a net unrealized built-in gain as of the date of acquisition. This limitation applies only if the acquired corporation has a net unrealized built-in gain (as that term is defined in § 382), but it applies whether or not either corporation has experienced an ownership change.

Compare this tax treatment with that required under the financial reporting standards applicable to stock and asset acquisitions accounted for under the "pooling-of-interests" method. There, comparative income statements for pre-acquisition years are retroactively restated on the basis of the combined income statements of the acquired and acquiring corporations. Accounting Principles Board Opinion No. 16, the principal requirements of which are summarized in note 15.
Consequently, the only circumstances in which § 382 might influence the utilization of a postchange loss carryback is where the loss at issue is a built-in loss. Even in this limited context, § 382’s governance is by no means absolute. Section § 382 expressly disqualifies itself from any application to (1) the built-in losses of a corporation that does not have a net unrealized built-in loss, n258 (2) any built-in losses recognized following the termination of the five-year recognition period, n259 and (3) any built-in losses recognized in excess of the "net unrealized built-in loss." n260 The carryback (or, for that matter, the carryforward) of recognized built-in losses in any of these situations is generally subject to the same rules that apply to losses that are both accrued and recognized after an ownership change. n261

n258 IRC § 382(h)(3)(B).

n259 IRC § 382(h)(2)(B), (h)(7)(A).

n260 IRC § 382(h)(1)(B)(ii).

n261 Notwithstanding that their treatment falls outside the scope of § 382, recognized built-in losses may nevertheless be subject to adverse restrictions under § 269, or, unlike postchange accrued and recognized losses, the built-in loss rules of the consolidated return regulations.

Even where § 382 does apply to a recognized built-in loss, § 382(h)(4) requires that any portion thereof which is "disallowed for any postchange year" must be carried forward to a subsequent tax year and may not be carried back to an earlier one. By its terms, this rule does not apply to all built-in losses that cannot be deducted in the post-change year in which they are recognized, it applies only to those that cannot be used due to the intervention of § 382, namely, those in excess of any annual limitation remaining for the year of recognition after other prechange loss carryforwards have been deducted. If all or a portion of a recognized § 382 built-in loss cannot be used in the year of recognition due only to an insufficiency of taxable income, the statute does not expressly preclude such loss from being carried back. And it is only in this limited circumstance that § 382 will, or might, ever have any application to loss carrybacks. n262

n262 For the remainder of this section of this article, all references to "loss" and "built-in loss" are to the portion of a built-in loss recognized in a given taxable year that is neither used in that year to reduce taxable income nor required to be carried forward under § 382(h)(4)(A), and which does not otherwise fall within the purview of one of the exemptions outlined in the text accompanying notes 258-61.

If the carryback is to a prior postchange tax year, § 382 unquestionably limits its utilization in that year to the excess of the annual limitation over the amount of taxable income that would have already been offset with prechange losses (and credits). n263 If, on the other hand, the corporation seeks to carry the loss back to offset its prechange taxable income, § 382 does not expressly forbid this.

n263 IRC § 382(a), (h)(1)(B)(1). Assume, for example, that X Corporation experiences an ownership change on December 31, 1987, when individual B sells his 60% interest in the corporation to individual C. As of that date, X had a net unrealized built-in loss of $2,000,000, and the § 382 limitation was determined to be $500,000/year. X has a prechange net operating loss carryforward of $100,000. In its 1988 and 1989 calendar tax years, X recognized built-in losses of $30,000 and $650,000, respectively, and reported $700,000 and $100,000 of taxable income (before consideration of either the prechange loss carryforward or the recognized built-in loss).

Of the $650,000 built-in loss recognized in 1989, $100,000 is used to reduce 1989 taxable income to $0, and $150,000 ($650,000 - $500,000 (annual limitation)) must be carried forward under § 382(b)(4)(A). Since, as noted in the text, nothing in § 382 expressly overrides the usual carryback rules of § 172(b)(2), it would appear that X must (absent an election under § 172(b)(3)(C)), carry the $400,000 back to 1988, against the income of which it could deduct $370,000 ($500,000 (annual limitation) less $130,000 (sum of losses subject to § 382 that were used in 1988)). The $30,000 balance (plus the $150,000 amount "disallowed" under § 382) would be carried forward to 1990 and future years.

[*170] Consider the following scenerio:
On December 31, 1987, X Corporation experiences an ownership change when individual B sells his 60% interest in the corporation to individual C. As of that date, it had a "net unrealized built-in loss" of $2,000,000, and the § 382 limitation was determined to be $500,000 per year. The corporation has no loss or credit carryforwards which might otherwise carry over to 1988 or subsequent tax years. For its 1988 calendar tax year, X recognizes built-in losses totalling $650,000, and it has $100,000 of taxable income (before consideration of its recognized built-in losses).

Because X has a net unrealized built-in loss as of the date of the ownership change, § 382 will apply, unless future regulations otherwise provide. n264 Of the $650,000 recognized built-in loss, $100,000 reduces 1988 taxable income (to $0), and $150,000 ($650,000 - $500,000) must be carried forward under § 382(h)(4)(A).

n264 IRC § 382(k)(1) (second sentence).

But what of the remaining $400,000 ($500,000 annual limit, less $100,000 built-in loss used in 1988)? Section 382 does not expressly deny X the usual privilege of carrying this loss back to offset its own prechange taxable income. n265 Although § 382(h)(1)(B)(i) states that such recognized built-in losses "shall be subject to limitation under this section in the same manner as if such loss were a pre-change loss," § 382(a) only applies to "the amount of the taxable income . . . for any post-change year which may be offset by pre-change losses . . . [emphasis added]." Indeed, absent an election under § 172(b)(3)(C) to relinquish the entire carryback period, § 172(b)(2) would seem to require that the $400,000 loss be carried back to the earliest permitted taxable year.

n265 Nor, under these circumstances, would § 381(b)(3) or the consolidated return regulations operate to preclude the carryback.

One could argue, then, that because § 382 does not specifically prevent the carryback of built-in losses to prechange taxable income, this process should not be prevented or impeded. And indeed, some aspects of the legislative purpose animating § 382 support this proposition, particularly [*171] where the ownership change which evoked § 382 leaves the loss corporation entity (and its own pre-acquisition refund capacity) intact.

Arguments Favoring Carryback of Built-in Losses

Although the refund of prechange taxes resulting from the carryback of recognized built-in losses admittedly would inure largely, or even wholly, to the ultimate benefit of shareholders who suffered neither the detriment of the original payment of the taxes now being refunded, nor the economic loss resulting from the decline in the value which gave rise to the built-in loss, this result does not necessarily conflict with the philosophy of § 382, as presently constituted. The limitations imposed by § 382 on prechange tax attribute carryforwards (once the requisite ownership shift has evoked those limitations) are not themselves a function of shareholder continuity, as they were under prior law. Section 382 makes no attempt, however artificial such an attempt might have otherwise been (or, under prior law, was), to restrict the ultimate incidence of the benefit resulting from tax attribute carryovers to the shareholders that originally bore, indirectly, the related economic detriment. Even where there is a 100% change in ownership, tax attribute carryovers are not denied, but rather are subject to the identical limitations imposed in the wake of much less drastic ownership changes. Assuming requisite business continuity, these limitations are a function of the amount of income that the historic asset pool of the affected corporation, unadulterated by any subsequent actions of its new owners to increase the size of that pool, is deemed to have been capable of producing in postchange tax years under the paradigm manifest in the annual limitation formula.

If the carryback of built-in losses to pre-change taxable income is to be allowed, the issue becomes what limitations, if any, might or should be imposed? In this context, there is no apparent need for a surrogate measure of taxable income, as there seems to be in the case of prechange loss carryforwards: Reference to the actual results of operations in those years would seem to be in keeping with the spirit of § 382. Consequently, if the shift in ownership which brings § 382 into play is a taxable or nontaxable stock
transaction, as in the above illustration, then allowing the loss corporation to carry back the recognized built-in loss to its own prechange income would seem to be congruent with the intended function of § 382: to confine the utilization of loss carryovers to the income produced by the historic asset pool of the corporate enterprise that sustained them. n266 Indeed, if the built-in losses had been recognized [*172] prior to the ownership change, this is precisely the amount of income that would have been available for them to offset.

n266 See note 246. This observation would also apply (1) to the shift in ownership resulting from a forward triangular A reorganization that is to be treated, in essence, as a stock acquisition for the purpose of denying the application of § 381(b)(3), as in Aetna Casualty and Bercy Industries, discussed at notes 91-126; and (2) to asset acquisitions wherein the built-in losses of the acquiring corporation are subject to § 382 (that is, where the shareholders of the "acquired" corporation end up with greater than 50% control of the "acquiring" corporation), but only if § 381(b)(3) is applicable to the "acquired" corporation (that is, the "reverse acquisition" rules of the consolidated return regulations, discussed in the text accompanying notes 198-203, do not alter the normal application of § 381(b)(3)).

If this approach is correct where the ownership change is triggered by a stock ownership change, then in a nontaxable asset acquisition in which § 382 applies to T (rather than A), it would likewise seem appropriate to limit the amount of A's pre-acquisition income which can be offset with T's built-in losses to the amount of taxable income that was actually reported by T during the corresponding period. n267

n267 Assume, for example, that A had taxable income for 1986-1988 totalling $10 million. During the same period, unrelated T Corporation reported taxable income of $325,000. On December 31, 1988, A acquires the assets of T in a nontaxable Type A reorganization in which the shareholders of T receive stock in A representing only 5% of the value of A's outstanding stock. Assume further that, as of the acquisition date, T has built-in losses in an amount which exceeds the de minimis threshold of § 382(h)(3)(B), and that the annual limitation under § 382 is computed to be $500,000. Finally, assume that A recognizes $650,000 of the built-in loss in 1989, and that it has $100,000 of taxable income in that year before consideration of the built-in loss.

Under § 382, only $100,000 of the loss could be utilized in computing taxable income in 1989, and the $150,000 of built-in loss recognized in excess of the annual limitation must be carried forward under § 382(h)(4)(A). If A seeks to carry back the $400,000 balance, that carryback may offset only A's own pre-acquisition income (§ 381(b)(3) would, of course, preclude the carryback of this loss to any of T's pre-acquisition income), and, under the proposition set forth in the text, the carryback would be allowed to offset only $325,000 of that income, the amount of taxable income reported by T during the corresponding carryback period. The remaining $75,000 would be carried forward subject to the annual limitation rules of § 382.

Whatever the theoretical or practical deficiencies of § 382, the approaches suggested for dealing with carrybacks of built-in losses have the virtue of being congruent with that provision's underlying theme and with the manner in which that theme is manifest in the statutory design. Alternatively, if one were to insist on mathematical symmetry between carrybacks and carryforwards, a less congruent, but not necessarily unreasonable, approach would be to permit the carryback of recognized built-in losses to pre-change income, as before, but then to limit utilization of these losses to an annual amount computed in a manner similar n268 or identical to the annual limitation expressly applicable to carryforwards. The principal shortcoming of this approach should be readily apparent: the [*173] need for an artificial, surrogate measure of the income that T's historic asset pool was capable of producing is simply unnecessary since the pre-change income was recognized prior to either the opportunity or the inducement, on the part of the new owners, to create tax-advantaged distortions.

n268 For example, the limitation might be computed by reference to the long-term tax-exempt rate and the corporation's value for the prechange year to which the loss is being carried. The resulting amount would then, perhaps, be reduced by any losses previously carried over to that year. Recognizing the implementational drawbacks of this approach, it nevertheless has the virtue of being reasonably consistent
with the carryforward limitations, while simultaneously fine tuning the statutory formula to account for the fundamental differences between carrybacks and carryforwards.

Arguments Opposing Carryback of Built-in Losses

Notwithstanding the internal consistency of these extrapolations, their implementation could yield counter-intuitive results. If one compares the present value and the certainty of a current refund of pre-change taxes with the deferred and uncertain value of future tax savings, a corporation could actually obtain greater benefit from the carryback of built-in losses than it might if the carryforward of such losses were unhindered. It is by no means inconceivable that the carryback of built-in losses to prechange income might be denied entirely on either of two theories. n269 First, if the ownership change that triggered § 382 was a nontaxable acquisition of the loss corporation's assets, it could be argued that pre-acquisition built-in losses are the equivalent of pre-acquisition net operating losses (which could not have been "carried back" to offset A's pre-acquisition income by virtue of § 381(c)(1)(A)). n270 Second, to allow a loss carryback in this scenario might be viewed as compromising the fundamental purpose of revised § 382 (and of § 384, its recently enacted companion provision): n271 to preserve the averaging function of the carryover provisions of § 172 by forbidding the utilization of an acquired corporation's pre-acquisition losses against unrelated income. n272

n269 In this regard, note that § 382(m) (and § 384(e)) grants the Treasury Department unusually broad authority to promulgate regulations that may prove necessary to prevent abuse and to carry out legislative intent where the statute itself proves inadequate.

n270 See notes 256-7. This is precisely how the committee reports characterize built-in losses: "The committee concluded that built-in losses should be subject to special limitations because they are economically equivalent to pre-acquisition NOL carryforwards." S. Rep. No. 313, 99th Cong., 2d Sess. 235 (1986).

Built-in losses were treated differently from other loss carryforwards (that is, the 25% de minimis rule of § 382(h)(3)(B)), because of administrative considerations relating to the expense and difficulty of obtaining the necessary valuations. This leaves one with a strong impression that, where built-in losses in fact exceed the 25% threshold, they should be treated in all respects as would net operating loss carryforwards from pre-acquisition tax years. (Of course, if such losses had actually been recognized prior to the acquisition, they could have been utilized to reduce the T's own taxable income in the year of acquisition. Since these "net operating loss equivalents" are not actually recognized until after the acquisition has been consummated, § 381(b)(3) precludes retroactive amelioration.)

n271 See note 256.

n272 See note 246. Again, § 381(b)(3), which would prevent T from carrying these losses back to its own pre-acquisition income, itself violates this stated objective. As noted in several places in this article, this lack of internal consistency is but one of § 381(b)(3)'s deficiencies.

[*174] Alternatively, the carryback might be denied on the ground that to permit the carryback of losses economically borne by the the prechange shareholders to produce a refund of taxes which were likewise indirectly paid by the prechange shareholders is simply too much of too many good things insofar as the postchange shareholders are concerned. n273 This argument would find particularly strong support where the pre-change shareholders of the corporation that accrued the built-in losses end up with little or no continuing proprietary interest in that corporation or in its parent or successor corporation. While there is, no doubt, considerable merit to factoring shareholder continuity into the carryover and carryback limitation equations, as noted earlier, n274 the recent and substantial revisions to § 382 reject this approach.

n273 "This limitation on earnings' approach is intended to permit the survival of NOL carryforwards after an acquisition, while limiting the ability to utilize the carryforwards against another taxpayer's income." S. Rep. No. 313, 99th Cong, 2d Sess. 232 (1986)(emphasis added).
n274 See also the author's recommendations in the text accompanying notes 448-99 regarding the manner in which the post-acquisition loss carryback rules might be improved.

Intent as a Factor in Determining the Availability of Pre-Acquisition Taxable Income

In addition to the numerous objective standards and limitations discussed and illustrated in the preceding pages, a taxpayer's motive for an acquisition may, in appropriate circumstances, evoke additional statutory or judicial impediments to the carryback of post-acquisition losses. If the acquisition was motivated principally to secure the benefit of T's built-in losses or the refund potential of T's pre-acquisition income (to which A or A's consolidated group would not otherwise have been entitled), § 269 may intervene to deny the carryback. Even without the requisite degree of tax-avoidance purpose, if the transaction nevertheless was insufficiently inspired by business purpose, the courts may resort to the ever-present business purpose doctrine n275 to render taxable an otherwise nontaxable asset acquisition, and to thereby eliminate any potential carryback of T's built-in losses. n276 Or, insofar as losses are both accrued and recognized after the acquisition, the courts may apply the so-called spreckles rule n277 to deny the corporations the right to compute current income on a consolidated basis. n278

n275 The various facets of the business purpose requirement of nontaxable reorganizations have been dealt with extensively in the literature. Other than to observe its potential role in the carryback of post-acquisition losses, no attempt is made here to rehash this familiar doctrine.

n276 IRC § 1012 (applied in lieu of § 362(b)).

n277 J. D. & A. B. Spreckles Co. v. Commissioner, 41 B.T.A. 370 (1940). There, the Board held that, in addition to the statutory requirements for obtaining the privilege of filing consolidated returns, the affiliation must have been established for a business purpose.

n278 In the context of post-acquisition loss carrybacks, the SRY, SRLY, and built-in loss rules of the consolidated return regulations explicitly accomplish what otherwise might have been left to the courts. The potential, though remote, threat posed by Spreckles is that post-acquisition losses not otherwise limited by § 269 or the consolidated return regulations may be confined to the acquired member on the ground that an inadequate business purpose for the acquisition denies the corporations the right of affiliation for consolidated return purposes. Although the Spreckles doctrine has not been expressly repudiated, it has been largely supplanted by the Treasury (through the objective standards of the consolidated return regulations) and the courts' exclusive reliance on § 269.

Generally, under § 269, if (1) a corporation acquires assets in a non-taxable transaction, or a taxpayer, in either a fully taxable purchase or a nontaxable stock-for-stock exchange, acquires enough stock to obtain 50% control of a corporation, and if (2) such acquisition has as its primary purpose the evasion or avoidance of federal income taxes n279 by securing the benefit of a deduction, credit, or other allowance which the purchaser would not otherwise enjoy, then the deduction, credit, or other allowance is disallowed. n280 Where the facts and circumstances have compelled a finding that the forbidden subjective state of mind was present, the usual effect of § 269 has been to eliminate all or a portion of T's loss or tax credit carryforwards or its built-in losses. n281 Although the courts have yet to deal with the application of § 269 in the context of post-acquisition loss carrybacks, the scope of § 269 is clearly broad enough, n282 and the precedents established by some courts indicate several areas of potential vulnerability:

n279 Section 269 becomes operative "only if the evasion or avoidance purpose outranks, or exceeds in importance, any other one purpose." S. Rep. No. 627, 78th Cong., 1st Sess. 59 (1943).

n280 Section 269 applies regardless of whether or not the transaction falls within the purview of § 381(a). Furthermore, § 269 can be used by the Service to eliminate entirely a carryover which would otherwise have been reduced or limited by § 382, § 383, § 384, or the consolidated return regulations. S. Rep. No. 313, 99th Cong., 2d Sess. 247 (1986), and, as regards § 384, H. Rep. No. 391, 100th Cong., 1st Sess., 1093-4 (1987).
n281 The literature contains several excellent works exploring the various facets of § 269 where the issue is the survival of pre-acquisition losses, credits, and excess asset bases to obtain post-acquisition tax benefits. See, e.g., Watts, Acquisitions Made to Avoid Taxes: Section 269, 34 Tax L. Rev. 539 (1979).

n282 Section 269 can be applied to eliminate the tax benefit of "a deduction, credit, or other allowance," including, presumably, the refund potential of T's pre-acquisition income.

1. T has substantial built-in losses, and A, in a nontaxable asset acquisition, seeks to exploit them by carrying them back to offset its own pre-acquisition income. n283

n283 See the text accompanying notes 254-74 for an assessment of the possibility that § 382 might itself deny any carryback of post-acquisition built-in losses to pre-acquisition taxable income, irrespective of the taxpayer's motive.

2. T has substantial built-in losses, and it also has substantial pre-acquisition income of its own, against which these losses can otherwise be carried back to generate a refund.

[*176] 3. T sustains post-acquisition losses which were anticipated n284 at the time of the acquisition, and either A (in a nontaxable asset acquisition) or T (in a stock acquisition) has sufficient pre-acquisition income to benefit substantially from the carryback of these losses.

n284 Recall that under no circumstances are T's pre-acquisition losses ever permitted to be carried back to offset the corresponding vintage pre-acquisition taxable income of A. See the text accompanying notes 256-7. Consequently, this is not an issue with which § 269 must deal.

4. The form chosen to accomplish the acquisition n285 is motivated principally by a desire to preserve the pre-acquisition income histories of one or both of the transacting corporations the event that in post-acquisition losses materialize.

n285 E.g., stock rather than asset acquisition; merger of A into T rather than T into A (or consolidation of T and A into a newly formed corporation).

Built-In Losses

It is clear, from both the statutory language n286 and from the decided cases, n287 that § 269 applies to built-in losses in essentially the same way that it applies to existing pre-acquisition loss carryforwards. Consequently, if the principal purpose of the acquisition is to obtain the benefit of the built-in losses, § 269 prevents their being deducted in any year --past, present, or future. This is true regardless of whether T's built-in loss is recognized by A following a nontaxable asset acquisition (where A could otherwise have carried such loss back to offset its pre-acquisition income), or whether the built-in loss was recognized by T itself following a stock acquisition (where T could otherwise have carried it back to generate a refund of its own pre-acquisition taxes). n289

n286 See note 282.

n287 E.g., R. P. Collins & Co. v. United States, 303 F.2d 142 (1st Cir. 1962); Canaveral Int'l Corp., 61 T.C. 520 (1974).

n288 See also American Pipe & Steel Corp. v. Commissioner, 25 T.C. 351 (1955), aff'd, 243 F.2d 125 (9th Cir. 1957); Elko Realty Co. v. Commissioner, 29 T.C. 1012 (1958), aff'd, 260 F.2d 949 (3d Cir. 1958), where the courts disallowed built-in losses not only on the ground that the acquisition was made for the proscribed purpose under the predecessor of § 269, but also by denying the acquiring corporations the benefit of filing consolidated returns with the acquired subsidiaries. This latter holding was based on J. D. & A. B. Speckles Co. v. Commissioner, 41 B.T.A. 370 (1940). See note 277 and the related text.
Unless the refund is paid to and retained by a former common parent of T (see text accompanying notes 229-32), the refund would, of course, inure to the ultimate economic benefit of A, now the parent of the acquired subsidiary.

**Anticipated Post-Acquisition Losses**

Frequently, one corporation acquires another with the expectation that the acquired business will operate at a loss, not indefinitely, but at least for some period of time following the acquisition. Where the desire to utilize these projected operating losses against the income of other businesses conducted by A (following a nontaxable asset acquisition) or members of the acquiring consolidated group (following a stock or asset acquisition) has been sufficiently intense, the courts have on several occasions been willing to mobilize § 269 to defend the revenue.

Section 269 is expressly limited to asset acquisitions in which T's basis carries over to A. In a taxable asset acquisition, A's basis in the purchased assets is its cost, and § 269 is inapplicable. Interestingly, where the issue is the effect of tax-avoidance motive on the deductibility of projected operating losses (rather than built-in losses), a buyer who pays cash in a taxable asset acquisition of a business expected to produce post-acquisition losses runs no risk that the losses will be disallowed under § 269.

Section 269 applies regardless of whether the stock which gives A 50% or greater control is acquired in a taxable purchase or in a nontaxable Type B reorganization. One likely exception (because it is generally viewed as a taxable acquisition of assets) is a stock acquisition to which a § 338 election (or, possibly, a § 336(e) election (see note 25 and the text accompanying notes 142-3)) is applicable. See § 269(b) which supports this conclusion.

In Zanesville Investment Co. v. Commissioner, for example, a holding company which owned a successful newspaper corporation acquired, from its sole shareholder, a controlling interest in an unsuccessful mining corporation. Thereafter, a consolidated return for the three affiliated corporations was filed, and the income of the newspaper corporation was offset first by the loss produced by the mining corporation's operations, and then by the loss recognized upon the ultimate sale, in bankruptcy, of that corporation's assets. At the time of the acquisition, the mining corporation was in the process of modernizing its operations in the hope of turning the business around. The Commissioner disallowed both the operating loss and the loss sustained as a result of the sale of the assets in bankruptcy. The taxpayer's improper motive was divined from the long history of unprofitable operations and the taxpayer's expectation that such losses would continue, at least for a time, after the acquisition.

The Tax Court held for the Commissioner on the ground that, assuming a principal tax-avoidance purpose, § 269 was sufficiently broad to embrace anticipated losses, even where, unlike built-in losses, the projected losses were both accrued and sustained after the transaction. The court also held that, if the prohibited purpose exists as to the operating losses, the transaction is thereby tainted, and all of the acquired corporation's losses, even unanticipated bankruptcy losses, must be disallowed.

On review, the Sixth Circuit reversed as to both the anticipated operating losses and the unanticipated bankruptcy losses, reasoning that "[t]he overall purpose of Section 269 was to prevent distortion of a taxpayer's income resulting from the utilization of someone else's loss or a built-in but unrealized loss . . . ."

And this view was sustained in Herculite Protective Fabrics Corp. v. Commissioner, where, after observing that § 269 makes no explicit references to losses sustained after an acquisition, the Third Circuit held that "[t]he disallowance of . . . losses caused by the operation of the business after the acquisition constitutes a penalty which should not be imposed in the absence of a clear legislative mandate."

Significantly, the court did not inquire as to whether sufficient business purpose existed to invoke the Spreckles doctrine (see note 277), which could have denied the affiliated group's right to
compute income on a consolidated basis. This omission, whether or not intended, is of little consequence in the context of post-acquisition loss carrybacks in that the application of Spreckles would produce results more or less equivalent to the SRY limitations of the regulations, which apply irrespective of the taxpayer's intent. If, however, § 338 applied to the acquisition, the anticipated post-acquisition losses of "new" T could, but for the possible application of § 269 or Spreckles, be carried back to the pre-acquisition income of the consolidated group under the "offspring rule" (see note 85).

n294 387 F.2d 475 (3d Cir. 1968). This case addressed the issue of anticipated, but unaccrued, losses in the context of an asset acquisition which involved the merger of a profitable brother corporation into a sister corporation acquired eight months earlier by the common shareholder. The Commissioner unsuccessfully sought to deny the sister corporation's post-acquisition losses accrued and recognized during the 8-month interval between the acquisition of its stock by the common shareholder and the date of the merger.

n295 Id. at 476.

But in the Fifth Circuit's decision in Hall Paving Co. v. United States, n296 the majority held that the legislative intent which resulted in the enactment of § 269 was to "enable the Internal Revenue Service to disallow not only current and past losses but prospective and anticipated losses also." n297 This position parallels that of the First, n298 Second, n299 and Seventh n300 Circuits.


n297 471 F.2d at 263. Significantly, on appeal, the government conceded the district court's finding that § 269 subsumed the Spreckles doctrine.

n298 R. P. Collins & Co. v. United States, 303 F.2d 142 (1st Cir. 1962).


n300 Luke v. Commissioner, 351 F.2d 568 (7th Cir. 1965).

And the controversy continues.

Structuring the Transaction to Preserve Carryback Potential

Assuming that the taxpayer's principal purpose for acquiring another corporation is not tax avoidance, will § 269 nevertheless apply where the choice of the method by which the acquisition is effected is principally motivated by the desire to preserve the pre-acquisition income histories of one or all of the corporations involved in the transaction, so that, in the event of post-acquisition losses, the acquiring corporation might obtain the economic benefit of a tax refund to which it would not otherwise have been entitled? For example, A decides to acquire T in order to further A's business objectives. Both corporations have reported substantial taxable earnings within the three years preceding the date of the proposed acquisition, and new losses resulting from current expansion plans, [*179] of which the acquisition is a part, either are anticipated or are at least a recognized possibility. Consequently, for no reason other than to avoid losing the potential benefit of a post-acquisition loss carryback to the pre-acquisition incomes of the respective corporations, A acquires the stock, rather than the assets, of T.

Could the Service successfully invoke § 269 to deny T's subsequent claim for a refund of its pre-acquisition taxes on the ground that the choice of the method of acquisition was dominated by an improper purpose? Alternatively, assume that A had relatively little pre-acquisition income, but that T's pre-acquisition income was substantial. Primarily for the purposes of (1) preserving the refund potential of T's pre-acquisition income history in the event of post-acquisition losses produced by T's business, and (2) making that income accessible to any post-acquisition losses sustained by A's business, the transaction is structured as a nontaxable asset acquisition with T cast as the "acquiring" corporation (but with A's former
shareholders winding up with the controlling interest). Could § 269 prevent carryback of any post-acquisition losses produced by A's business? Could any post-acquisition loss carrybacks attributable to T's business be denied, and, in that event, would the losses attributable to A's business then be allowed to offset A's limited amount of pre-acquisition income?

Even assuming the correctness of LTR 8527001 (March 20, 1985), discussed in the text accompanying notes 204-10, the reverse acquisition rules of the consolidated return regulations would not apply here because neither corporation is a member of a consolidated group, and they do not become such as a result of the asset acquisition.

Initially, it would seem that § 269 could not be applied to a transaction in which a business would have been acquired irrespective of its pre-acquisition earnings history. Indeed, neither the courts nor the Service has addressed this issue in the context of post-acquisition loss carrybacks. But in several cases, the purpose behind the method chosen for effecting a business-motivated acquisition was held determinative under § 269 as to the survival of other tax benefits.

In Industrial Suppliers, Inc. v. Commissioner, for example, A, for business purposes, decided to purchase the assets of T, a loss corporation. In order to preserve T's loss carryforward, however, A bought T's stock, rather than its assets. After the transaction, T continued its historic business. Conceding a business motive for the acquisition itself, the Tax Court nevertheless disallowed the loss carryforward on the ground that the method employed to effect the acquisition was chosen primarily for tax avoidance purposes. This conclusion appears to have been influenced by two additional factors. First, under the circumstances, a direct purchase of the assets would have been a relatively simple transaction compared to the stock acquisition. Second, and probably more important, the taxpayer arranged for the diversion to T of other income, unrelated to the operation of T's business, presumably in order to accelerate utilization of the loss carryforwards.

Consequently, in spite of the ownership change, T's losses were not eliminated under the mechanical standards set forth in pre-1987 § 382(a).

See also Scroll, Inc. v. Commissioner, 447 F.2d 612 (5th Cir. 1971), aff'd 28 TCM (CCH) 768 (1969), where, under similar facts, the post-acquisition shuffling of income seems to have decisively influenced the court to the taxpayer's detriment. Significantly, however, the court did not completely disallow the loss. Instead, it applied a SRLY-type standard to confine use of the loss to the income produced by the historic business of the acquired loss corporation.

The facts in Canaveral International Corp. v. Commissioner differed from those in Industrial Suppliers in that T was not actively conducting a business at the time the acquisition was effected. It owned only one asset: a high-basis, low-value yacht. For business purposes, A arranged to purchase the yacht, but upon the discovery of T's high basis, A's sole shareholder negotiated for the purchase of the stock, rather than the direct purchase of the yacht itself. Once again the Tax Court held that a principal tax avoidance motive for the method selected to effect the acquisition was fatal to a transaction which was otherwise dominated by a business purpose.

In Canaveral, the Tax Court expressly recognized that § 269 is not automatically invoked just because one method of effecting an acquisition produces tax advantages that are not obtainable with alternative methods. The facts of D'Arcy-MacManus & Masius, Inc. v. Commissioner gave the court an opportunity to identify the distinctions which might be meaningful. There, presumably in order to obtain a more immediate use of T's loss carryforwards, A abandoned the Type B reorganization originally planned, in favor of a direct asset acquisition structured as a nontaxable Type C reorganization. Under this latter alternative, T's loss carryforward would be available to offset the expected post-acquisition income of A's business, while under the former alternative, the SRLY rules would have restricted the loss to income.
eventually earned by T's business. In holding for the taxpayer, the court seems to have been persuaded by the fact that here, the tax consequences of the competing alternatives, both of them nontaxable reorganizations in which tax attributes normally survive the transaction, were not so drastic as in the other cases, where the distinction between a stock purchase and an asset purchase was an all-or-nothing proposition. n307 The taxpayer's case seems to have been measurably strengthened by the recognition that, as [*181] with all nontaxable forms of acquisition, the ultimate parties suffering the economic detriment of the losses -- T's shareholders -- remain, to a greater or lesser extent, in a position to share in the tax benefit those losses will subsequently produce. The court also noted that the facts in D'Arcy-MacManus did not reveal the type of unnatural, contrived transaction involved in Canaveral, where the taxpayer simply wanted to acquire a single asset rather than a complex going concern.

n306 63 T.C. 440 (1975).

n307 See also Yonker Brothers, Inc. v. United States, 318 F. Supp. 202 (S.D. Iowa 1970), where, notwithstanding facts evidencing sophisticated planning undertaken to preserve T's net operating loss, the court held § 269 inapplicable. As in D'Arcy-MacManus, so much of A's equity was to be used to effect the acquisition, that the choice was essentially between alternative nontaxable reorganization forms.

Effect of a Contemporaneous Shift in Proprietary Interests on an Otherwise Valid Type F Reorganization

Generally, a reorganization transaction described in any one of the seven subparagraphs of § 368(a)(1) will be accorded the same tax treatment as one which falls within the purview of any other. But in several important instances, the Code and regulations are more generous with the Type F reorganization. For example, only asset acquisitions which qualify as Type F reorganizations are exempt from the strictures of § 381(b)(3). n308 Similarly, in a Type F reorganization involving the common parent corporation of an affiliated group filing consolidated returns, § 1.1502-75(d)(2)(i) of the regulations preserves the identity of that group by treating the old and the new corporation as the same entity. n309

n308 Type F reorganizations also are exempt from the requirement of § 381(b)(1) that the transferor corporation's tax year close as of the transaction date. Where a non-Type F reorganization is consummated other than on the last day of T's tax year, a short tax year results. Regardless of the actual number of days or months comprising the short period, it is counted as a full year in determining how much time remains before existing loss and credit carryforwards will expire.

n309 Given the function of the reverse acquisition rules, discussed in the text accompanying notes 198-203, in establishing the true identity of the continuing group, this rule has little, if any, practical effect. If the identity of the common parent's shareholders changes so much that as a result of the transaction so that it is not considered a Type F reorganization, then, assuming the shareholders of the original common parent end up owning at least 50% of the stock of the new common parent, the reverse acquisition rules of Reg. § 1.1502-75(d)(3) will nevertheless treat the old affiliated group as continuing uninterrupted.

For other areas in which the treatment of a Type F reorganization differs from that of other reorganization forms, see IRC § 1244(d)(2) (which preserves the characterization of "Section 1244 stock" only in Type E (recapitalization); Type F reorganizations); Role v. Commissioner, 70 T.C. 341 (1978); Rev. Rul. 64-250, 1964-2 C.B. 333 (the Type F reorganization is one of the reorganization forms which will not terminate an S Corporation election); Rev. Rul. 61-156, 1961-2 C.B. 62 (taxation of boot distributions incident to a Type F (and Type E) reorganization is governed by § 301, not § 356); Reg. § 1.243-4(a)(5) (relating to the definition of "qualified dividends"); § 1103(b)(3) (relating to the qualification of a successor corporation as a "qualified bank holding corporation"); Rev. Rul. 79-289, 1979-2 C.B. 145 (liabilities in excess of basis are not taxable under § 357(c) in Type F reorganizations).

Under Proposed § 365(e) of the Subchapter C Revision Bill of 1985, neither a recapitalization, nor "a mere change in the identity, form, or place of organization of 1 corporation, however effected" would qualify for the proposed § 365(b) election to be treated as a "cost basis acquisition."
The Type F reorganization is defined as "a mere change in the identity, form, or place of one corporation, however effected." This reorganizational form has been held to include: the change of a corporation's name; reincorporation of a single corporation's business under a new corporate charter (in the same state or in a different state where the identity of the shareholders was unchanged; a transfer of all assets of a corporation to a newly formed trust taxable as a corporation, where there was no change in beneficial ownership; the change of a federal savings and loan association to a state savings and loan association; and the upstream merger of a single operating corporation into its holding company parent corporation.

n311 Ahles Realty Corp. v. Commissioner, 71 F.2d 150 (2d Cir. 1934).
n312 George Whittell & Co. v. Commissioner, 34 B.T.A. 1070 (1936).
n313 Rev. Rul. 67-376, 1967-2 C.B. 142. The Service privately ruled that the converse process, i.e., the reincorporation of an unincorporated business trust, taxable as a corporation, into a corporation, qualifies as a Type F reorganization. LTR 7938053 (June 20, 1979).
n314 Rev. Rul. 80-105, 1980-1 C.B. 78. See also LTR 8549026 (April 5, 1985) in which the Service held that a change from a mutual to a stock savings and loan association qualified as a Type F reorganization.

To the naked eye, it would appear axiomatic that the Type F reorganization encompasses only the simplest and most trivial of corporate changes. Despite its apparent insignificance, the Type F reorganization has, in recent times, inspired a plethora of litigation and commentary. The focus of this controversy has been the identification of legal and economic factors which distinguish "mere" changes in identity, form, or place of organization, from those that are too substantial to bear that label. Before enactment of TEFRA in 1982, taxpayers had argued that, at least under some circumstances, the amalgamation of two or more commonly owned operating corporations into a single corporate entity constituted the "mere" change contemplated by the statute. Several courts and, ultimately, the Service, agreed. In 1982, however, Congress overruled these interpretations by inserting the phrase "of one corporation" into the statutory definition.

n316 But for an in-depth analysis of the legislative intent behind the original enactment of the Type F reorganization, see Hearings on Carryover of Net Operating Losses and Other Tax Attributes of Corporations before the Subcomm. on Select Revenue Measures of the House Comm. on Ways and Means, 99th Cong., 1st Sess., 71-77 (May 22, 1985), where the author concludes that this reorganizational form may have been conceived as encompassing transactions much more complex than the contemporary meaning ascribed to the words used in the definition would seem to indicate.

n317 Stauffer v. Commissioner, 403 F.2d 611 (9th Cir. 1968), rev'd 48 T.C. 277 (1967); Associated Mach., Inc. v. Commissioner, 403 F.2d 622 (9th Cir. 1968), rev'd 48 T.C. 318 (1967); Home Constr. Corp. of Am. v. United States, 439 F.2d 1165 (5th Cir. 1971); Performance Sys., Inc. v. United States, 382 F. Supp. 525 (M.D. Tenn. 1973), aff'd per curiam, 501 F.2d 1338 (6th Cir. 1974); Movielab, Inc. v. United States, 494 F.2d 693 (Ct. Cl. 1974).


Another issue relates to the relevance of contemporaneous changes both in the identity of the shareholders of a corporation which is itself undergoing a change in identity, form, or place of organization, and in their relative proprietary interests. Assume, for example, that: (1) the shareholders of a profitable manufacturing concern organized under Texas law decide to reincorporate that business under Delaware
law; and (2) in the first full year ending after the reincorporation, the Delaware corporation suffers a substantial net operating loss which it proposes to carry back to generate a refund of taxes paid by its Texas predecessor. If the reincorporation was accomplished without any shift in the proprietary interests of the original shareholders, the transaction would qualify as a Type F reorganization, and the carryback would be permitted. But if one or more of the shareholders used the occasion of the reincorporation to reduce or terminate their interest in the corporation, or if the reincorporation was part of a plan of expansion which resulted in the infusion of equity capital from outsiders, would the resultant shift in proprietary interests adversely impact the status of the reincorporation as a Type F reorganization and thus preclude the carryback?

The question is by no means a new one. The Service and the courts have on several occasions been called upon to determine the degree of proprietary continuity required of the Type F reorganization. Regrettably, these efforts have failed to distill a coherent set of criteria for isolating "mere" changes from all others. Indeed, four irreconcilable approaches have emerged. In Helvering v. Southwest Consolidated Corp., n319 the Supreme Court stated categorically that a transaction which shifted the ownership of the proprietary interest in a corporation was "hardly a mere change in identity, form, or place of organization."

n320 The Service adopted a similar posture in Revenue Ruling 66-284, n321 which, by implication, restricts Type F reorganizations to transactions in which only de minimis changes in the identity of the equityholders and their relative proprietary interests take place.

n319 315 U.S. 194 (1942).

n320 The Court was construing § 112(g)(1)(E) of the Revenue Act of 1934, a predecessor to § 368(a)(1)(F).

n321 1966-2 C.B. 115. This ruling involved the reincorporation of a publicly-held corporation from one state to another. The transaction was undertaken for valid business purposes. Shareholders owning less than 1% of the transferor corporation's stock voted against the reincorporation and subsequently elected to have their shares appraised and redeemed as provided by state law. The transferor corporation's business was continued without change or interruption. See also Rev. Rul. 78-441, 1978-2 C.B. 152.

Where, as in the instant case, a plan of merger is designed to effect a change in the corporation's place of organization, the Internal Revenue Service considers the failure of dissenting shareholders owning a total of less than one percent of the outstanding shares to participate in the plan of merger to be such a diminimus [sic] change in the corporation's shareholders and its assets as not to disqualify the merger as a reorganization under section 368(a)(1)(F) . . . .

See also Rev. Rul. 74-36, 1974-1 C.B. 85 (payment of cash in lieu of fractional shares permitted in a Type F reorganization), which likewise implies a near-absolute shareholder continuity requirement.

At about the same time that Rev. Rul. 66-284 was issued, the Service successfully argued that the elimination of 48% of the transferor corporation's shareholders had no impact on the transaction's qualification as a Type F reorganization. See Reef Corp. v. Commissioner, 368 F.2d 125 (5th Cir. 1966), discussed in the text accompanying notes 376-91.

n322 In an admittedly different context, namely, the exceptions to the general rule of § 47(a) that a premature disposition of investment credit property triggers recapture of any unearned credit, the regulations interpreting the phrase "mere change in the form of conducting the trade or business" (IRC § 47(b)) require only that the transferor of the property retain a "substantial" interest in the transferee. Reg. § 1.47-3(f)(1)(ii)(c), (2). In Example 1 of Reg. § 1.47-3(f)(6), the conversion of a 100% interest in a sole proprietorship into a 45% interest in a transferee-corporation was held to a "mere change" under § 47(b), in that the magnitude of the change in ownership was insufficient to justify recapture under § 47(a).

The Service's position in this ruling is fundamentally inconsistent with the position it had adopted five years earlier in Revenue Ruling 61-156. n323 There, the Service found a Type F reorganization notwithstanding the fact that a 55% shift in the corporation's proprietary interests to outsiders had occurred.
as part of the plan of reincorporation. This conclusion derived from two independent lines of reasoning. First, as with other reorganizational forms, shareholder continuity need only be definite and substantial, not absolute. The 45% shareholder continuity presented by the facts was deemed sufficient for this purpose.


Second, the Service also reasoned that the injection of new shareholders was a "functionally unrelated" transaction, to be severed from the "mere" reincorporation and taxed independently. Under this approach, the degree of shareholder continuity arguably was 100%. The Fifth Circuit later adopted this approach in Reef Corp. v. Commissioner n324 to support its conclusion that a contemporaneous, but "functionally unrelated," 48% shift in proprietary interest did not preclude the reincorporation itself from qualifying as a Type F reorganization. The court also held that strict ownership continuity was not in any event a condition precedent to a Type F reorganization, and that Southwest Consolidated did not control resolution of this issue under the 1954 Code.

n324 368 F.2d 125 (5th Cir. 1966).

The waters were muddied further by Casco Products Corp. v. Commissioner, n325 in which the Tax Court disregarded entirely the reincorporation component of a transaction in which shareholders who owned 9% of the corporation's stock were squeezed out. Instead, and without the assistance of the reorganization provisions, the Tax Court treated the transaction as a redemption of minority shareholders by a single continuing corporation.

n325 49 T.C. 32 (1967).

In addition to these four alternative rationales, two courts simply avoided the definitional issue and instead focused on the operational provisions and the objectives they were designed to achieve. As noted earlier, the Second and Ninth Circuits, in Aetna Casualty & Surety Co. v. United States n326 and Bercy Industries Inc. v. Commissioner, n327 reinterpreted legislative intent to hold that Congress, in enacting § 381(b)(3), did not intend its limitations to apply where no tracing problems would result, regardless of whether the transaction under review qualified as a Type F reorganization. It is arguable that these two decisions also stand for another proposition: that in order to determine how best to protect the intent of the statute from its letter, the courts, at least under some circumstances, should reference economically equivalent alternatives to the transaction actually consummated and block any discrepancies in the respective outcomes that cannot be traced to legislative purpose. n328

n326 568 F.2d 811 (2d Cir. 1976), rev'g 403 F. Supp. 498 (D. Conn. 1975).

n327 640 F.2d 1058 (9th Cir. 1981), rev'g 70 T.C. 29 (1978).

n328 See, however, the Supreme Court's reiteration of the "established tax principle that a transaction is to be given its tax effect in accord with what actually occurred and not in accord with what might have occurred . . . ." Commissioner v. National Alfalfa Dehydrating & Milling Co., 417 U.S. 134, 148-49 (1974), quoted more extensively at note 483.

Historical Perspective: Use of the Type F Reorganization to Combat Reincorporations

Although in recent years it has been the taxpayer who has argued for a liberal reading of § 368(a)(1)(F), it was, ironically, the Commissioner who first sought to expand the scope of the Type F reorganization in an effort to preserve the integrity of the corporate liquidation provisions. The numerous tax benefits which, before 1987, were legislatively reserved for parties to a corporate liquidation, inspired a variety of schemes through which shareholders frequently sought to obtain liquidation treatment for themselves and their corporations without having to actually liquidate the business enterprise as a going concern, or remand it to noncorporate form. The chronic failure on the part of Congress to deal directly with these tax avoidance schemes -- schemes which are collectively referred to as "liquidation/reincorporation" transactions, or simply as "reincorporation" transactions n329 -- forced the Service to develop and employ
guerilla warfare tactics in order to prevent the abuses, which would otherwise result, from reaching epidemic proportions.

n329 In common tax parlance, the term "reincorporation" refers to a series of steps through which the business assets and working capital of an existing corporation are ultimately relocated in and employed by one or more other corporations, newly created or previously existing, which are owned primarily or exclusively by a group consisting of most or all of the transferor corporation's shareholders. The plan invariably called for the complete or partial liquidation of the transferor corporation, and the favorable tax consequences which, until recently, attended the liquidation was the reward usually sought by the shareholders for their efforts. These included: (1) conversion of ordinary income into capital gain (IRC § 331 v. IRC § 301); (2) a step-up in the basis of distributed appreciated properties at the price of a single capital gains tax at the shareholder level (IRC §§ 336 (pre-1986 version), 331, 334(a)); (3) tax-free sales of assets by the liquidating corporation (IRC § 337 (pre-1986 version)); and (4) elimination of the liquidating corporation's earnings and profits account.

If the "liquidation" was successfully dissociated from the reincorporation, the parties stood to profit from any one or more of these tax benefits, all of which were denied continuing corporations and their shareholders. Yet these benefits were obtained without the drastic results which invariably attend a bona fide liquidation: without the dissolution of the business as a continuing enterprise; without the forfeiture of the benefits unique to the corporate form of organization; and without the termination of the economic interest of the respective shareholders in the business through sale or redemption of their stock.

One such tactic was to mobilize the Type F reorganization. Revenue Ruling 61-156, n330 through which this action was announced, signaled an end to the relative anonymity which had characterized the Type F reorganization throughout its first forty years of statutory existence. Although certain fundamental changes wrought by the 1986 Act have combined to effectively neutralize the reincorporation stratagem, n331 the numerous pre-1987 antireincorporation administrative rulings and judicial precedents which probed the definitional limits of the Type F reorganization carry uncertain implications for corporations that now seek to avoid the adverse impact of § 381(b)(3) or the consolidated return regulations n332 on the ground that the transaction which triggered the issue was a Type F reorganization.


n331 The Tax Reform Act of 1986 virtually eliminated the potential tax advantages of liquidation-reincorporation transactions by (1) purging the statute of the broad corporate-level nonrecognition rules formerly applicable to sales, exchanges, and in-kind distributions by a liquidating corporation under §§ 336 and 337 of the 1954 Code, (2) eliminating most of the significance of the distinction between capital gains and ordinary income, and (3) extending the cost recovery periods under § 168. But see Segal & Konselman, Liquidation-Reincorporation: Issues and Planning in the Battle Over Recharacterization, 18 Tax Adviser 337 (1987), in which the authors suggest that, at least under some circumstances, the liquidation-reincorporation transaction remains an attractive potential source of tax benefits.

n332 Or to obtain the benefit of other special provisions which are applicable only if the transaction qualifies as a Type F reorganization, discussed in the text accompanying notes 308-9.

Many of the decisions and rulings discussed in the following pages interpret § 368(a)(1)(F) in the context of the reincorporation transaction, wherein the Service advocated a liberal construction in order to "protect the revenues" from actual or perceived abuses. Where the issue is the carryback of post-acquisition losses to pre-acquisition income, it will be the taxpayer that seeks to benefit from these interpretations. Although the reincorporation precedents provide valuable insight as to the possible effect of shifts in proprietary interests on the Type F reorganization, one [*187] must be acutely conscious of the fact that the Service and some courts have expressly or impliedly conformed different constructions of the same statutory language, depending upon which of the litigants, the government or the taxpayer, stands to benefit. n333

n333 See, e.g., Moffatt v. Commissioner, 363 F.2d 262, 262 n.1 (9th Cir. 1966) (suggesting that a "different standard of construction" applies depending on whether the taxpayer wishes to avoid or to
qualify for a reorganization). See also the decision of the lower court in *Aetna Casualty & Sur. Co. v. United States*, 403 F. Supp. 498, 512 (D. Conn. 1975), rev'd, 568 F.2d 811 (2d Cir. 1976), in which the court stated:

Perhaps the key to understanding both Reef and *Rev. Rul. 61-156* is to realize that they were both efforts to frustrate the "liquidation-reincorporation" stratagems with which the court and the IRS were faced. Such tax avoidance plans subvert the tax laws and have created serious problems; courts and the IRS have been willing to hang decisions rejecting such stratagems in an acrobatic fashion upon any sections of the Code that seem convenient. . . . The attempt to reconcile positions taken by the Commissioner or the Tax Court where the consequences of a different kind were at stake is unrewarding, and the precedent value of those cases here is slight. (Emphasis added.)

Decisions in which the courts held for consistent statutory construction include *Wilson v. Commissioner*, 46 T.C. 334 (1966), and *Stauffer v. Commissioner*, 403 F.2d 611, 619 (9th Cir. 1968), where the government's prerogative in maintaining inconsistent positions is positively asserted by the Commissioner, and firmly rejected by the court.

See also Zelenak, Should Courts Require the Internal Revenue Service to be Consistent?, 38 Tax L. Rev. 411 (1985).

The Type F Reorganization as a Function of "Absolute Shareholder Continuity"

No pre-1954 decision has had a greater or more lasting impact upon subsequent interpretation of the Type F reorganization than the Supreme Court's opinion in *Helvering v. Southwest Consolidated Corp.* n334 This case involved a bankruptcy reorganization in which the assets of the bankrupt corporation were transferred to a new corporation formed for that purpose. The new corporation issued 49,286 shares of its common stock and 2,760 Class A warrants (of which 1,760 were ultimately exercised) to the creditors of the old corporation. The preferred and common stockholders of the old corporation received 18,445 Class B warrants. Only 4,623 of these warrants were ever exercised. n335 Thus, by the time all was said and done, only about 8.3% of the total outstanding stock of the new corporation was held by former shareholders of the old corporation. n336

n334 315 U.S. 194 (1942), revg 119 F.2d 561 (5th Cir. 1941), which had affirmed an unreported memorandum opinion of the Board of Tax Appeals.

n335 Both Class A and Class B warrants entitled their holder to acquire one additional share of common stock.

n336 Even this level of ownership continuity was not automatic under the plan of reorganization since additional cash investment was required by the warrant holders to secure the common stock. Thus the old shareholders could have ended up owning as little as 0% or as much as 27% of the new corporation.

[*188] The Court rejected the taxpayer's claim to nontaxable reorganization treatment under the Revenue Act of 1934. It was not a Type C reorganization n337 because the assets of the bankrupt corporation were not acquired by the new corporation in exchange solely for its voting stock. n338 It was not a Type D reorganization n339 because the transferor or its stockholders were not in control of the new corporation immediately after the exchange. n340 It was not a recapitalization because the transaction involved more than one corporation. And it was not a Type F reorganization because: "[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' within the meaning of [IRC § 368(a)(1)(F)]." n341

n337 Section 112(g)(1)(B) of the Revenue Act of 1934.

n338 The old corporation's assets were acquired with voting stock, stock warrants (held not to qualify as voting stock), and cash.
n339 Section 112(g)(1)(C) of the Revenue Act of 1934.

n340 The Supreme Court did not accept the view expressed in *Helvering v. Cement Investors, Inc.*, 122 F.2d 380 (10th Cir. 1941), aff'd, 316 U.S. 527 (1942), that the bondholders of the insolvent predecessor corporation could be regarded as "stockholders" (because they had acquired an equitable interest in the property of the insolvent corporation and were empowered to supplant the shareholders within the meaning of § 112(g)(1)(C) of the 1934 Act). *315 U.S. at 202. Helvering v. Alabama Asphaltic Limestone Co.*, 315 U.S. 179 (1942), was distinguished. *315 U.S. at 198-200.

n341 *Id. at 201.*

This statement appears to leave little room for interpretation: to paraphrase, any shift in proprietary interests, either through the injection of new shareholders, the elimination of old shareholders, or the realignment of the interests of the old shareholders inter se, cannot be a "mere" change and therefore precludes a Type F reorganization. n342 But the shift in proprietary interests that evoked such an unequivocal maxim was so drastic that the rule necessarily invites speculation as to whether the Court would have arrived at a different conclusion had there been a 97% or 80% or even 50% continuity of proprietary interest between the old and the new corporations. Was the Court reacting to the extremely lopsided facts before it in this specific case, or was it deliberately undertaking the task of charting, with infallible precision, theretofore uncharted waters?

n342 But see *Reef Corp. v. Commissioner*, 368 F.2d 125 (5th Cir. 1966), discussed in the text accompanying notes 376-91, where the appellate court distinguished a shift in proprietary interests resulting from the injection of new shareholders, as in Southwest Consolidated, from the shift under its review, which instead resulted from the elimination of old shareholders.

The opinion itself sheds no light upon the resolution of this question. The Court engaged in no analysis and cited no support. Its holding was simple, unelaborated, and conclusory. Indeed, the only words in the opinion which even remotely relate to the Type F reorganization issue are those used in articulating the rule itself, a fact which would seem to [*189*] undermine any contention that the rule should be regarded as a mandate for all reincorporations involving shifts in proprietary interests. n343

n343 Nor is there any evidence that the taxpayer even asserted qualification as a Type F reorganization. Neither the Board of Tax Appeals nor the Fifth Circuit raised the issue. They both apparently considered the Type F reorganization definition so irrelevant to the facts presented that it was not even included in an edited version of the reorganization statutes which was reproduced, for reference, in the text of their respective decisions.

Unfortunately, none of the many courts that have addressed the shift-in-proprietary-interest issue since Southwest Consolidated has inquired into questions presented here. n344 Yet, as discussed below, this case has been cited repeatedly as authority for denying Type F reorganization status to reincorporations which involved shifts in proprietary interests. n345

n344 Several post-1954 decisions did not follow Southwest Consolidated. These courts, however, relied upon changes made to the reorganization statutes in 1954 in rendering the Supreme Court's rule inapplicable to post-1954 transactions. They did not rely upon any assessment of its pre-1954 validity. See, e.g., *Reef Corp. v. Commissioner*, 368 F.2d 125 (5th Cir. 1966), discussed in the text accompanying notes 376-91. But see *Gordon v. Commissioner*, 424 F.2d 378, 384 (2d Cir. 1970), cert. denied, 400 U.S. 848 (1970), where the Second Circuit in dictum questioned whether complete identity of proprietary interest is an "indispensable condition to the invocation of Section 368(a)(1)(F)." The court, however, engaged in no analysis of the issue, and cited no authority which might support this assertion.

n345 Two of these subsequent decisions preceded enactment of the Internal Revenue Code of 1954. *Stollberg Hardware Co.*, 46 B.T.A. 788 (1942), also involved a bankruptcy reorganization. There, 98% of the preferred stock of the new corporation, 44% of its common stock, and 100% of its management stock was issued to parties who had not been shareholders of the old corporation. In *Cushman Motor Works v.*
Commissioner, 130 F.2d 977 (8th Cir. 1942), aff’g 44 B.T.A. 1288 (1941), the court of appeals also concluded that the transaction could not have been a Type F reorganization since there had been a shift in proprietary interests as between the old dissolved corporation and its successor. Unfortunately, neither the nature nor the extent of this shift was disclosed in or can be derived from the published records of the two tribunals which decided this case. The only clue to be found is an observation by the Board that "over 80% of those who held stock in [the old corporation] became shareholders of [the new corporation]." 44 B.T.A. at 1298.

Post-1954 decisions following Southwest Consolidated include Gallagher v. Commissioner, 39 T.C. 144 (1962); Berghash v Commissioner, 43 T.C. 743 (1965), aff'd, 361 F.2d 257 (2d Cir. 1966); Estate of Lammerts v. Commissioner, 54 T.C. 420 (1970), remanded on other grounds, 456 F.2d 681 (2d Cir. 1972); and the dissenting opinion of Judge Bell in Reef v. Commissioner, 368 F.2d at 138-39.

Revenue Ruling 61-156

In Revenue Ruling 61-156, n346 the Service launched the Type F reorganization in its campaign against actual and perceived abuses emanating from reincorporations involving substantial shifts in shareholder identity. n347

n346 1961-2 C.B. 62; see also Rev. Proc. 86-16, 1986-1 C.B. 546, 549 (setting forth the criteria and information required for advance letter rulings addressing tax consequences associated with the liquidation of a corporation and directing the reader to the still viable standards set forth in this aged ruling).

n347 The reason for the enlistment of the Type F reorganization for duty on this front was suggested by Richard C. Pugh:

Encouraged, perhaps, by the broad language of the [Type] F definition, especially the "change in identity" or "form" phrases, and by the absence of too heavy an encrustation of judicial gloss, the Commissioner may have felt it was not too late for the courts to breathe life into the [Type] F reorganization as a means of denying the tax advantages sought through a liquidation-reincorporation.


[*190] In Revenue Ruling 61-156, X Corporation, within 12 months following its adoption of a plan of complete liquidation, sold substantially all of its assets to Y Corporation, newly formed by X's management. In consideration for these assets, X received Y stock (representing 45% of all Y stock ultimately issued and 11% of the total consideration received by X), long-term notes (28% of total consideration), and cash (61% of total consideration). Y obtained the cash through first mortgage borrowing on the acquired assets. Immediately after the purchase, Y sold its remaining voting stock -- 55% of the total amount outstanding after the transaction -- to the public through underwriters. X was then completely liquidated and the proceeds from the sale were placed into the pockets of its shareholders. The business conducted by X was continued without interruption by Y.

The Service held this transaction to be "in substance" both a Type E and a Type F reorganization. This conclusion was based upon what may be viewed as two separate theories. The first of these asserts that the introduction of the new shareholders was a separate, unrelated transaction, which must therefore be ignored. The ruling categorically states that the dominant purpose of the transaction was the "[withdrawal of] corporate earnings while continuing the equity interest in substantial part in a business enterprise conducted in corporate form." n348 Since this dominant purpose could have been achieved without the issuance of stock to the public shareholders (that is, the "transaction was not fruitless without it . . . [or] dependent on it"), n349 the introduction of new shareholders was held to have been functionally unrelated to the true nature of the transaction. By ignoring the existence of the new shareholders, [*191] the old shareholders were deemed to possess a 100% continuing interest in the new corporation.
Id. This language appears to derive from such cases as *American Bantam Car Co. v. Commissioner*, 11 T.C. 397, 406-07 (1948), aff'd per curiam, 177 F.2d 513 (3d Cir. 1949), and *Manhattan Bldg. Car Co. v. Commissioner*, 27 T.C. 1032, 1042 (1957). See Goldman, Revised "Reincorporation Doctrine" Upsets Planners; Rev. Rul. 61-156 Analyzed, 17 J. Tax'n 150 (1962). In these cases, however, the courts were grappling with the issue of whether two transactions could properly be combined, rather than the issue presented by the converse process described in Revenue Ruling 61-156. But in *Bazley v. United States*, 331 U.S. 737 (1947), the Supreme Court bisected what was, in form, a unitary transaction in order to find dividend income disguised as an otherwise nontaxable distribution incident to a Type E reorganization. Whether Bazley extends to the immediate fact pattern is debatable. Compare, e.g., Wood, A Proposed Treatment of Reincorporation Transactions, 25 Tax L. Rev. 288 (1970), with the Goldman article referenced earlier in this note.

Revenue Ruling 61-156 then offers what appears to have been intended as a supplemental explanation, but which is more appropriately regarded as an entirely separate alternative rationale:

The fact that the shareholders of the "selling" corporation own only 45 percent of the stock of the "purchasing" corporation because of the public stock offering does not dispose of the reorganization question. A surrender of voting control, or ownership of less than 50 percent of the stock of a newly-formed corporation, does not in itself mark a discontinuity of interest . . . . It is necessary only that the shareholders continue to have a definite and substantial equity interest in the assets of the acquiring corporation. n350

Having justified its characterization of the transaction as a Type E or a Type F reorganization, the ruling concluded that the withdrawal of the cash and notes from corporate solution was taxable as a dividend, not under § 356(a) (which had theretofore been understood as having absolute dominion over the consequences of boot distributions in reorganizations), but rather under § 301, the ordinary dividend rules. n351

Under § 356(a)(1), any gain realized by a shareholder of the acquired corporation who receives nonqualified consideration is recognized to the extent of the amount of cash and the fair market value of any other boot property so received. Where the receipt of boot has the "effect of the distribution of a dividend," the taxpayer's recognized gain must be treated as such to the extent of his or her ratable share of post-1913 accumulated earnings and profits. IRC § 356(a)(2).

Several important differences distinguish the "boot dividend" rules of § 356(a)(2) from the rules ordinarily applicable to cash or property distributions under § 301. First, under § 356, dividend income, if it is to be recognized at all, is limited to the gain, if any, that the recipient realized on the exchange. Second, only the recipient's ratable share of earnings and profits are taken into account under § 356(a)(2), whereas no such limitation constrains ordinary dividends under §§ 301 and 316. Third, § 356(a)(2) refers only to accumulated earnings and profits, while § 316 prescribes dividend treatment where either current or accumulated earnings and profits exist at the time of the distribution.

Revenue Ruling 61-156 concludes by revoking Revenue Ruling 56-541 n352 which, notwithstanding the acknowledged presence of a dominant [*192*] business purpose for the transaction under review in that ruling, is described as involving "similar circumstances."

n352 1956-2 C.B. 189. Rev. Rul. 56-541 was the Service's first ruling on the subject of reincorporations under the Internal Revenue Code of 1954. It described the sale of a baseball club by T to A, 45% of which was contemporaneously acquired by shareholders who had owned 80% of T's stock. A's majority shareholders permitted T's shareholders to acquire their interests because they believed that participation of T's shareholders in the new corporation was essential to the perpetuation of community interest in the club, and because they needed to retain certain of those individuals who had managerial know-how in baseball operations. Shortly after the sale, T liquidated, distributing all of the cash and debentures received in the
sale to its shareholders. On these facts, the Service held the intercorporate sale to qualify for nonrecognition of gain or loss under old § 337, and the liquidation of T to qualify as an "exchange" under § 331.

Since the degree of continuity on the part of the T shareholders fell far short of the 80% control then required for a Type D reorganization under § 368(c), and since there then existed no authority which would have even remotely indicated a contrary result, this holding is hardly surprising. Indeed, one wonders what prompted the Service to address what to all outward appearances was an unambiguous complete liquidation of a corporation. Unfortunately, the ruling engaged in no analysis and cited no authority in arriving at its conclusions. Nor was any express mention made of the theory or theories upon which a contrary result might have rested. Consequently, all that could be derived with certainty from Rev. Rul. 56-541 was that, while it was in effect, the Service would not challenge a "reincorporation" where there was no more than a 45% continuity of shareholder interests -- at least where this continuity was bolstered by business purpose.

Both the holding and the supporting rationale of Revenue Ruling 61-156 have been roundly criticized in the professional literature on the grounds that they lack internal consistency, and that they misinterpret or ignore relevant statutory law, legislative history, and judicial precedent. n353 The Service's conclusions might have been more defensible if, instead of forcing the transaction into the reorganization mold, it had argued that the lack of business purpose for the switch in corporate entities, coupled with the continuity of the underlying business in corporate form, justified invocation of the "substance over form" doctrine to produce, in substance, one continuing corporation. The shareholders of the "selling" corporation would have thus been deemed to have either (1) redeemed 55% of their stock, which was subsequently reissued to the public, (2) sold their stock directly to the public through the underwriters, or (3) caused the "selling" corporation to authorize and issue stock representing 55% control of the corporation. If the transaction were restructured along the lines of either alternative (1) or (2), and assuming that the distribution of cash and notes was pro rata, n354 the shareholders undoubtedly would have been entitled to exchange treatment under Section 302. n355 Under assumption (3), however, notwithstanding that the [*193] difference between it and (1) or (2) is primarily one of form, the continuing shareholders probably would be charged with dividend income under § 301.

n353 Rev. Rul 61-156 is discussed at length in Nicholson, Recent Developments in the Reincorporation Area, 19 Tax L. Rev. 133 (1964); Goldman, note 349, at 148-52; Wood, note 349, at 287-89. Many of the observations made in these articles are incorporated in the following text.

n354 The ruling is silent as to how the property distributed to the shareholders was divided among them.

n355 IRC § 302(b)(2). See also Nicholson, note 353, at 133-34 (suggesting that if the purchasing corporation could be ignored as a separate entity, the transaction "would have had the net effect of a redemption").

In Rev. Rul. 75-447, 1975-2 C.B. 113, the Service ruled that, where a redemption is combined with a contemporaneous sale or issuance of stock to unrelated parties, the combined effect of the two transactions should be the basis upon which compliance or noncompliance with the terms of § 302 is determined. See also Zenz v. Quinlivan, 213 F.2d 914 (6th Cir. 1954); B. Bittker & J. Eustice, Federal Taxation of Corporations 9-22 (4th ed. 1979). Under assumption (3), however, the reduction of the ownership from 100% to 45% would be attributable entirely to the issuance of additional stock, and it seems unlikely that the Service would carry the rationale of Zenz this extra distance.

The following analysis is organized around the three of Revenue Ruling 61-156's four key holdings n356 that are relevant to the subject of this article: (1) One component of a transaction, lacking business purpose, may be regarded as functionally unrelated to the other components and thereby segregated from them on the ground that it is, in substance, a separate, unrelated transaction; (2) A Type F reorganization requires neither absolute nor even 50% continuity of proprietary interest so long as such interest is "substantial;" and (3) Section 301, and not § 356, governs the taxation of "boot" distributions in Type F reorganizations.
The fourth revelation was that a Type E reorganizations (that is, a "recapitalization" under § 368(a)(1)(E)) could involve more than one corporation.

"Functionally Unrelated" Transactional Components

Revenue Ruling 61-156 rested in part on the finding that the introduction of new shareholders was functionally unrelated to the dominant purpose of the multi-step transaction and thus could be disregarded in assigning tax consequences. This approach would seem to require, as the first order of business, identification of the transaction's "dominant purpose" in order to determine whether, or to what extent, the transaction must be fragmented in assessing its tax consequences: "The issuance of stock to new investors can be disregarded as being a separate transaction, since even without it the dominant purpose -- to withdraw corporate earnings while continuing the equity interest in substantial part in a business enterprise conducted in corporate form -- was fully achieved." n357

Revenue Ruling 56-541 involved a transaction which, from start to finish, was concededly undertaken primarily for business purposes, one which under the separate transaction analysis quoted above would appear to be the antithesis of the transaction described in Revenue Ruling 61-156. n359

It would seem that if every step in the transaction were integral to a dominant business purpose, there would be no support for segregating one component of the transaction from another. Why, then, does Revenue Ruling 61-156 revoke Revenue Ruling 56-541 on the ground that the situation there was similar? Revenue Ruling 56-541 implied that business purpose, whether present or absent, is of no consequence where corporate earnings are withdrawn without contemporaneously abandoning the corporate form or substantially reducing the distributee shareholders' proprietary interest in the corporation. If this is, in fact, the message of Revenue Ruling 61-156, then the dominant effect of the transaction, not its dominant purpose, is controlling. n360

Although the concept of dominant purpose is presented as the cornerstone of this analysis, nowhere does the ruling expressly identify the factors that were (or should be) weighed in making this determination, or what factors might have led to conclusions more favorable to the taxpayer. Indeed, given the revocation of Revenue Ruling 56-541, the ruling implies that business purpose, whether present or absent, is of no consequence where corporate earnings are withdrawn without contemporaneously abandoning the corporate form or substantially reducing the distributee shareholders' proprietary interest in the corporation. If this is, in fact, the message of Revenue Ruling 61-156, then the dominant effect of the transaction, not its dominant purpose, is controlling. n360

In this connection, it must be observed that the withdrawal of corporate earnings at capital gain rates is not, and has never been, regarded by Congress or the courts as per se evil. Both have recognized the propriety of awarding capital gain treatment where, even in the presence of this objective, the transaction results in a substantive reduction or other modification of the taxpayer's economic interests in the enterprise. Revenue Ruling 61-156, however, fails to explain how, even in the presence of a dominant purpose to withdraw earnings, the prearranged dilution of the original owners' interests from 100% to 45% can be regarded as having economic substance insufficient to warrant exchange treatment. Since the stock was sold to the public through underwriters, there can be no question about the reality of this dilution:
The transaction was shaped so as to make it essentially "a device whereby it has been attempted to withdraw corporate earnings at capital gains rates by distributing all the assets of a corporation in complete liquidation and promptly reincorporating" them. See Conference Report No. 2543, 83rd Cong., to accompany H.R. 8300 [1954 Code], page 41 . . . . It was not intended by Congress that such a device should obtain the benefits of [pre-1987] Section 337 and avoid dividend taxation. In substance, there was no reality to the "sale" of corporate assets or to the "liquidation" of the selling corporation, since each [*195] was only a formal step in a reorganization of the existing corporation. The entire transaction was consummated pursuant to a plan of reorganization which readjusted interests in property continuing in modified corporate form. Sections 1.368-1(b) and 1.368-2(g) of the regulations. n361

n361 1961-2 C.B. 62, 63-64.

A number of comments regarding the quoted statement are in order. First, the legislative history that this passage refers to accompanied a provision that was proposed in 1954, but never enacted. n362 Moreover, congressional committee reports, even when they accompany bills which ultimately become law, only explain the law, they do not make the law. Though often helpful in interpreting ambiguous statutory language, the reports cannot themselves be relied upon, nor should they be cited, as independent authoritative pronouncements.

n362 The reference in this quotation was to the conference committee reports which accompanied a provision expressly designed to deal squarely with the reincorporation problem. Proposed § 357 would have come into play whenever more than 50% of the operating assets received upon a complete or partial liquidation were, within five years, transferred in a nontaxable § 351 exchange to one or more corporations controlled by the same shareholders. Statutory control was, for this purpose, achieved whenever 50% or more of the stock of the transferee corporation was owned by individuals who had been shareholders of the liquidated corporation. Proposed § 357 was, however, deleted in its entirely by the Senate Finance Committee and never became law.

Propriety aside, even if congressional intent regarding the line demarcating reincorporations from true liquidations could properly be gleaned from the aborted 1954 effort to inject such legislation into the statute, what does this effort imply for the transactions set forth in Revenue Rulings 56-541 and 61-156? Proposed § 357 would have required a 50% minimum ownership continuity. n363 In each of these two rulings, shareholder continuity was 45%. This should have given the shareholders a comfortable 5% margin of safety. Furthermore, proposed § 357 would have, in any event, exempted taxpayers whose hearts were sufficiently pure, notwithstanding compliance with its mechanical formulae. n364 The transaction in Revenue Ruling 56-541, laced as it was with business purpose, would appear to have been precisely what the House of Representatives contemplated in establishing this exemption. If the Service's position in this ruling can be attributed to the inspirational language of the quoted conference committee report, and it appears that it can, why then does this ruling fail to acknowledge the terms of the proposed statute [*196] and the manner in which it would have applied to the fact pattern under review?

n363 See note 362.

n364 Proposed § 357(a)(2)(b) reads as follows:

TRANSACTIONS NOT IN AVOIDANCE OF TAX. -- Subsection (a) shall not be applicable in any case in which it is established by the taxpayer that such transactions did not have as one of their principal purposes the avoidance of tax on corporate distributions of property under section 301.

Ironically, the ruling cites sections 1.368-1(b) and -2(g) of the regulations. Between the two, the business purpose prerequisite for reorganization status is adamantly and unequivocally repeated no less than three times. The transaction in the ruling was held to have been a reorganization precisely because it lacked business purpose. n365
n365 But see Lewis v. commissioner, 176 F.2d 646 (1st Cir. 1949), aff’g 10 T.C. 1080 (1948); Survaunt v. Commissioner, 162 F.2d 753 (8th Cir. 1947), aff’g in part and rev’g in part 5 T.C. 665 (1945) (where the absence of business purpose did not deter either court from holding that a statutory reorganization had, to the taxpayers' detriment, taken place).

Assuming the legitimacy of the separate (or functionally unrelated) transaction approach and, perhaps more importantly, its applicability to the facts, the ruling does not explain why the transaction cannot be viewed as a Type D reorganization. If the issuance of 55% of the stock to outsiders can be carved away from the intercorporate sale of assets and the selling corporation's liquidation, and treated as an unrelated event, this leaves the shareholders of the liquidated corporation with 100% control of the transferee corporation, more than enough to justify the invocation of § 368(a)(1)(D). Yet the ruling is silent as to the applicability of the Service's traditional reincorporation ally. It relies instead upon untested and highly questionable applications of the Type E and Type F reorganizations.

**The Type F Reorganization As A Function Of "Substantial Shareholder Continuity"**

The next phase of the Service's analysis of the transaction is expressed in the following terms:

The newly formed "purchasing" corporation was utilized to effect, in substance, a recapitalization and a change in identity, form, or place of organization of the "selling" corporation and, at the same time, to withdraw accumulated earnings from the corporate enterprise for the benefit of the shareholders, while they nevertheless continued a substantial equity interest in the enterprise. . . .

The fact that the shareholders of the "selling" corporation own only 45% of the stock of the "purchasing" corporation because of the public stock offering does not dispose of the reorganization question. A surrender of voting control, or ownership of less than 50% of the stock of a newly-formed corporation, does not in itself mark a discontinuity of interest. In *John A. Nelson Co. v. Helvering*, 296 U.S. 374 . . . (1936), the

[*197] Supreme Court of the United States held that there was a "reorganization" even though the shareholders of the acquired corporation received less than half of the stock of the acquiring corporation and received only nonvoting preferred stock therein. It is necessary only that the shareholders continue to have a definite and substantial equity interest in the assets of the acquiring corporation. n366


If, under the ruling's separate transaction theory, the old shareholders are deemed to have 100% continuity, why did the Service argue a case for "substantial" continuity? n367 Indeed, here it describes the old shareholders as having only a 45% continuity. If the transaction is to be analyzed in the context of 45% continuity, this substantial continuity requirement fails miserably in the light of legislative history, related statutory provisions, and established case law.

n367 What makes this ruling even more difficult to follow is that this "substantial continuity" approach is not presented as an alternative to the "separate transaction" approach, but appears somehow to have been intended as one of its integral components.

First, the Nelson case cited in the ruling expresses the Supreme Court's interpretation of the continuity of interest requirement as it pertains to Type A reorganizations, not Type E or Type F reorganizations. Conspicuously missing is any reference to Helvering v. Southwest Consolidated Corp., n368 and its statements that shifts in proprietary interests are fatal to Type F reorganization status. n369 While the author has argued that this statement, when read in the context of the entire case and contemporary statutory law, should not be taken at face value, it nevertheless imparts the message that shifts in ownership, if they are to be permitted at all, should probably be somewhat less drastic than 55%. n370

n368 315 U.S. 194 (1942), discussed in the text accompanying notes 334-45.
n369 Id. at 202-03.

n370 Of course, under the separate transaction analysis the continuity of proprietary interests would be 100% and there would be no question as to the applicability of the Type F reorganization. At this point in the ruling, however, the Service is stating that § 368(a)(1)(F) requires only "substantial continuity."

Finally, in the Service's attempt to quantify economic realities for the purpose of distinguishing true liquidations from reorganizations, why were the redemption thresholds of § 302(b)(2) and § 304 not consulted? Generally speaking, § 302(b)(2) grants exchange treatment to shareholders who, after redeeming part of their stock, own directly or indirectly less than 50% of the stock outstanding after the redemption, and less than 80% of the proportion of stock they had owned before the redemption. Section 304 finds an economically meaningful relationship between two corporations only where common ownership is at least 50%. Admittedly, neither of these two provisions has direct authority over reorganization [*198] transactions. They do, however, govern transactions which are closely related to -- and in some cases though not here, indistinguishable from -- reorganizations. They also shed light on congressional intent as to the magnitude of ownership changes that should be regarded "substantial" enough to be likened unto third-party exchanges. n371 Applying these standards to the transaction described in the ruling, the radical shift in ownership interest from the old shareholders to the outsiders would seem to justify exchange treatment to the old shareholders.

n371 Indeed, for some time now, the courts, and even the Service itself, have looked to the standards under §§ 302, 304, and 346 to assess the character of boot generated gain in reorganization transactions, notwithstanding that the statute does not expressly tie § 356(a)(2) to any of these other sections. E.g., Wright v. United States, 482 F.2d 600 (8th Cir. 1973); Hawkinson v. Commissioner, 235 F.2d 747 (2d Cir. 1956); Idaho Power Co. v. United States, 161 F. Supp. 807 (Ct. Cl. 1958); Rev. Rul. 74-515, 1974-2 C.B. 118.

"Ordinary" Versus "Boot" Dividend Rules

Having held the transaction to be a reorganization, the ruling concluded with a listing of the tax consequences resulting from that determination. X's bases in its assets carried over to Y under § 362(b), and, at the shareholder level, the exchange of X stock for Y stock was nontaxable under § 354. Neither of these conclusions is surprising. Assuming the correctness of the Service's assertion that the transaction was indeed a reorganization, the statute expressly mandates these results.

The statute also requires that the amount and character of gain occasioned by the receipt of boot in a reorganization be governed by § 356. The Service, however, citing the Bazley decision n372 and the "reincorporation" regulations n373 as support, applied the less favorable rules of § 301. Reference to Part I of Subchapter C (although not necessarily to § 301) might have been warranted had the Service concluded either that a bona fide liquidation had not, in substance, taken place -- that is, that the separate entity of Y should be ignored as a mere continuation of X -- or that there had been no change in the identity of the owners of the enterprise. But the ruling, as noted earlier, does not advance this argument: it acknowledges that two bona fide corporations participated in an exchange transaction. Regarding the ruling's reliance on Bazley to override the explicit terms of § 356, one commentator observed: "[I]t is doubtful that the principles stated [in Bazley] were intended to apply to more than the extreme situations where, due to the virtual identity of shareholder and corporation, the choice of forms for effecting distributions can be made exclusively with a view toward minimization of taxes." n374

n372 Bazley v. United States, 331 U.S. 737 (1947), briefly discussed in note 349.

n373 Reg. §§ 1.301-1(1), 1.331-1(c).

Even assuming that application of § 356 was inappropriate to this particular transaction, why must the distribution necessarily fall within the domain of § 301 rather than § 302? The interests of the continuing shareholders as a group fell from 100% ownership to only 45% ownership. Assuming that the stock and the boot received by the old corporation were each distributed pro rata to its shareholders, the standards set forth in § 302(b)(2) would seem to clearly mandate exchange treatment. In the light of these facts, and in the absence of an explanation as to why the benefits of § 302(a) were to be withheld from the old shareholders, one must conclude that the Service considered the distributions to be per se evils, taxable to the maximum extent. In the author's opinion, nothing in the history of the reincorporation transaction, in terms of either the extent of the problem or the government's success in dealing with it, in any way warrants such an adversarial posture.

The ruling does not disclose the manner in which the stock and boot were allocated among the shareholders. The assumption that each shareholder received the same mix of boot and Y stock is perhaps indicated by the ruling's unqualified holding that the distributions are to be taxed under § 301. Had some of the X shareholders received only boot, the distribution of that portion of the boot would surely have produced capital gain to the recipient.

However deficient the arguments set forth by the Service in justifying reorganization status and the nonapplicability of § 356 may have been, the guiding force behind them was the apparent desire to distill the substance of the transactions from their form. It seems less than sporting that this devotion to substance should have been so selectively applied to the taxpayers' detriment.

Reef Corp.

After several initial losses, the Service's "functionally unrelated"/Type F approach of Revenue Ruling 61-156 was accepted by the Fifth Circuit in Reef Corp. v. Commissioner. The complicated facts of this case, reduced to essentials, follows.


Reef Fields, a June 30 fiscal year, accrual method Texas corporation, was owned by two groups of shareholders: the Butler group and the Favrot group. The Butlers held 52% of Reef Fields' outstanding stock and actually operated the company. The Favrots, inactive investors who took no part in the management or operation of the firm, owned the remaining 48% stock interest.

In 1958, the Butlers decided to buy out the Favrots, and to this end, a plan was adopted whereby a new corporation, Reef Corporation (New Reef), was formed by the Butlers under Delaware law. Immediately following its formation, New Reef, also a June 30 fiscal year, accrual method taxpayer, acquired the assets and assumed the liabilities of Reef Fields, as planned. New Reef issued its own notes as consideration in the exchange. Upon completion of this sale to New Reef, Reef Fields was completely liquidated. The Favrot group shareholders received cash and the notes of New Reef, while the Butler group shareholders received only notes for their interest in Reef Fields. The business which had been operated by Reef Fields was continued by New Reef, without interruption, under the same management and with the same employees, although it was now owned entirely by the Butlers. In December of 1958, however, prior to consummation of the transaction, an oral agreement had been made with some of the employees of Reef Fields under which they would be permitted to subscribe to 1,680 shares of New Reef (4.2% of its outstanding stock). None of these individuals previously had held stock in Reef Fields. The stock was actually issued, pursuant to this agreement, shortly after the transfer of the business to New Reef.
Neither the Tax Court nor the Court of Appeals found any substance to the role played by a straw intermediary, and the following rendition of the facts ignores his part in the scheme.

Not only was the court faced with the issue of how the intercorporate sale and the liquidating distributions should be taxed, it also faced an important procedural question arising from a deficiency notice which had been mailed to New Reef. The outcome of this question turned squarely on whether the transaction constituted not just a reorganization under § 368(a)(1), but more specifically, whether it fell within the narrow definitions of the Type E or Type F reorganizations. In this regard, Reef may be contrasted with Gallagher, Pridemark, Berghash, Book Production Industries, and Davant. In those cases, the Commissioner sought to apply the operational rules attendant to all reorganization transactions, regardless of the specific type involved. The Commissioner's choice of the Type F reorganization as its champion had derived from a belief that the courts might somehow give it a scope broader than that of what at the time appeared to be an emasculated post-1954 Type D reorganization.

The damage to the Type D reorganization as an antireincorporation device subsequently proved to be much less severe than thought when these early cases were decided. E.g., cases cited in notes 380-81. The retention of large amounts of cash, Reef Fields had not transferred "substantially all" of its assets to New Reef as required by § 354(b)(1)(A). Citing Morgan and Armour, the court disposed of this first argument by noting that no distribution of New Reef stock by Reef Fields was required since, as part of the overall plan, the Butlers had in fact acquired all of the New Reef stock and held it at the time of the intercorporate exchange. The court relied on Moffatt and again on Armour, to find that the term "substantially all" was intended to refer to operating assets, not necessarily total assets. As the only asset withheld from the exchange with New Reef was cash which had been borrowed for the purpose of effecting the buyout of the Favrot group, this requirement was deemed satisfied.

The court refused, however, to affirm the Commissioner's assertion that the transaction also constituted a Type E and a Type F reorganization. Regarding the former, the court, citing Helvering v. Southwest Consolidated Corp., n382 rejected the notion that a recapitalization could involve more than one corporation. As to the latter, the shift in proprietary interest resulting from the Favrot group's elimination was held to be too great to constitute the "mere" change contemplated by the statute. In so holding, the court refused to permit the transaction to be broken into two sets of separate, unrelated components: a complete redemption of the Favrot group, and a Type E and Type F reorganization by the Butler group. In refusing to fragment the transaction, the court stated:

Respondent . . . states that the transaction can be viewed as a redemption of stock of the Favrot group, and thereafter a continuation of the business operations of Reef Fields under the name of Reef Corporation with exactly the same stock ownership, thus constituting a mere change in name and place of incorporation of the corporation. The difficulty with respondent's position is that the shift in proprietary interest was inherently a part of the overall plan whereby the stockholders of Reef Fields who became stockholders of Reef continued to have the equitable ownership of the business and the stockholders who received cash and notes for their stock in Reef Fields ceased to have an equitable ownership in the business.

On appeal, the Fifth Circuit affirmed the Tax Court's characterization of the transaction as a Type D reorganization, but reversed it on the Type F reorganization issue. At the Commissioner's urging, the court broke the transaction into two functionally discrete components.
Whether the government actually argued this position here, as it had in other cases, is not disclosed in the opinion. Not only did the court base its holding on the substantial continuity argument of Rev. Rul. 61-156, but its analysis of the scope of the Type F reorganization makes clear that it viewed this organizational form as more, not less, restrictive than the Type D reorganization.

Distilled to their pure substance, two distinct and unrelated events transpired. First, the holders of 48 percent of the stock in Reef Fields had their stockholdings completely redeemed. Second, new Reef was formed and the assets of Reef Fields was transferred to new Reef.

Much confusion flows from the fact that the corporate reorganization took place simultaneously with the stock redemption. But taking the Code as a standard, these two elements were functionally unrelated. Reef Fields could have completely redeemed the stock of 48 percent of its shareholders without changing the state of its incorporation. A complete redemption is not a characteristic of a reorganization. Congress clearly indicated this when it defined reorganization in section 368. Congress did not have redemption of stock as a primary purpose of any of the forms of a reorganization. That subject came under consideration when it undertook to enact specific legislation on complete and partial redemptions, section 302.

To effectuate the intention of Congress manifested in the Code, we must separate this transaction into its two distinctly separate functional parts. The test of whether events should be viewed separately or together as part of a single plan is not temporal but is functional. Applying this test to the instant case, it is clear that the redemption and the change of corporate vehicles must be viewed as separate and distinct occurrences.

The Butler group was thus deemed to have absolute continuity of proprietary interests.

In support of its conclusions, the court made several observations. It noted that in 1954 Congress enacted legislation designed specifically to eliminate the confusion which attended redemptions under the 1939 [*203] Code. Given the explicit intent of Congress that all redemptions be taxed under § 302, the court was unwilling to permit the mere fact that a reincorporation occurred simultaneously with the complete termination of the Favrot group's proprietary interest to interfere with this mandate. Thus, "[s]ince the reorganization and the redemption are functionally unrelated in this case, the redemption should be tested by the standard Congress has laid down in section 302."

The court next focused upon the Tax Court's reliance on Helvering v. Southwest Consolidated Corp. for its holding that a shift in proprietary interest precludes a Type F reorganization. In addition to distinguishing that case as involving a shift in proprietary interest resulting from the introduction of new shareholders, rather than from an elimination of old shareholders, the majority noted that the enactment of § 381(b) in 1954 had rendered that decision obsolete insofar as the attributes it had identified as distinguishing Type F reorganizations:

In section 381 Congress made a rational distinction between reorganizations that constitute a mere change in form and those that integrate two previously separate and independent enterprises. Thus for the first time, in 1954 it became important to determine whether a reorganization was considered a (D) type or an (F) type reorganization.
At this point the consistency of the opinion breaks down. Although the court cited congressional intent supporting the exclusion of the Type F reorganization from § 381(b) as rendering the Type F reorganization narrower in scope than the Type D reorganization, it simultaneously cited the same legislative intent as a ground for neutralizing the Supreme Court's strict prohibition against shifts in proprietary interest. While its ultimate holding was based squarely on the proposition that the redemption could be separated from the reincorporation, the court nevertheless gratuitously speculated that a Type F reorganization might be found even where there was a shift in proprietary interest to outsiders which was (under the pre-TEFRA 80% control requirement) too great to support a Type D reorganization.

The Tax Court's position might have more force if the change in proprietary interests were to new persons and less than 50% of the former stockholders' interest in the old corporation remained in the new corporation. Then the change begins to look like a sale of the assets to a new and legally separate entity [*204] followed by a bona fide liquidation . . . . But just how much of a complete redemption would be required to avoid the impact of section 381? Would 1% be enough? Sufficient continuity of interest has been found where 67% or 69% of the old corporation's stockholders control the new corporation . . . . Changes of less than 50%, as we have here, or for that matter any change not sufficient to prevent the finding of a reorganization should not be sufficient to prevent the operation of Section 381. The corporate enterprise went on as before, no new blood was injected and all that took place was a redemption followed by a change in name. n390

n390 Id. at 137 (emphasis added).

The last statement ignores the fact that 4.2% of the New Reef stock was owned by new shareholders, the former employees of Reef Fields. Judging from the text of the quoted statement and the court's rejection of Southwest Consolidated, it appears that the court simply viewed this 4.2% shift in ownership as too small to affect the analysis.

If the Favrot group's redemption was to be completely disregarded in assessing the nature of the reincorporation under the functionally unrelated approach, why does the court imply, in its reference to "changes of less than 50%," that it might have arrived at a different conclusion had that group owned 50% or more of the Reef Fields stock? Under the functionally unrelated approach, if the business operations continue without change or interruption, and if no new shareholders are brought into the picture, it should make no difference whether the business is continued by 99%, 51%, or 5% of the original shareholders.

While the court clearly distinguishes between the impact of shifts in ownership resulting from elimination of shareholders and those characterized by infusion of new shareholders -- the latter being more inimical to Type F reorganization status -- the implied magnitude of the infusion sufficient to disqualify a transaction as a Type F reorganization changes materially as one progresses through the quotation. At the beginning, the court states that it would take a more than 50% shift to outsiders; then it refers to "any change not sufficient to prevent the finding of a reorganization." The latter may point to the 80% statutory control requirement of the Type B reorganization and thus may suggest that (1) it would take a shift of more than 20% to outsiders for the court to reject Type F reorganization status, and (2) anything less would fall within the tolerances of that reorganizational form. The court did not speculate whether it might, under some circumstances, be willing to disregard the injection of new shareholders, as opposed to the disappearance of old [*205] shareholders, as functionally unrelated to the dominant purpose of a transaction, as did the Service in Revenue Ruling 61-156.

Although the court did believe that "stricter rules" were applicable to the Type F reorganization than to the Type D reorganization, these stricter rules apparently had nothing to do with the requirements regarding the continuity of proprietary interest. Rather, the court held that a higher degree of business continuity was necessary for the Type F reorganization than for the Type D reorganization. Thus,
Only those reorganizations which reflect a substantial change in the corporate operation should be viewed as solely (D) reorganizations qualifying for the more liberal rule. Where there is no substantial change in the corporate operation, (F) should be applied since it invokes the stricter rules. n391

n391 Id. at 136 (emphasis in original).

One may accept the argument that § 381 does indeed evidence congressional intent that the Type F reorganization be more narrowly construed than the other reorganization provisions. It is difficult, however, to see how this intent can at once be viewed as tightening the reins insofar as the business continuity requirement is concerned, while relaxing them as to ownership continuity.

Whatever the shortcomings of this aspect of its decision, the court's basic premise, that a unified transaction may sometimes be broken down to its functional components and taxed accordingly, is fundamentally sound and has important ramifications which extend far beyond the bounds of § 368(a)(1)(F).

Post-Reef Applications of the Functionally Unrelated Test in Ascertaining the Corporate Identity

Dunlap & Associates

In Dunlap & Associates v. Commissioner, n392 the Tax Court implicitly adopted a variant of the Fifth Circuit's "functionally unrelated" approach in finding, to the taxpayer's detriment, a Type F reorganization. Dunlap and Associates (New York) was a corporation actively conducting a business. It owned more than 50%, but less than 80%, of two subsidiary corporations engaged in related businesses. Early in 1961, New York decided to raise additional capital through a public offering of its stock. The group of underwriters formed to effect the offering insisted that New York raise its interest in the two subsidiaries to at least 80% so that consolidated federal income tax returns might be filed. To overcome technical legal problems in connection with the offering, it was further determined that it was necessary for New York to reincorporate its business in another corporate entity. To satisfy these prerequisites, New York devised and consummated the following plan. New York formed a new corporation under Delaware law, also named Dunlap and Associates, Inc. (Delaware). Shortly thereafter, New York merged into its Delaware subsidiary pursuant to state merger law. Delaware contemporaneously issued stock -- representing 4.6% of all of its pre-offering outstanding stock -- to the minority shareholders of the two subsidiaries in exchange for all of their stock. Of the 7,740 shares issued to these minority shareholders, only 380 shares (4.9%) were issued to persons who were not also shareholders of the now reincorporated New York corporation. n393

n392 47 T.C. 542 (1967).

n393 Nothing in the opinion indicates that the subsidiary stock was otherwise held pro rata by the New York shareholders.

At issue was whether New York was entitled to file a return for the short year ending on the date of the transaction, and, on that return, to claim a surtax exemption. n394 The Commissioner argued that § 381(b)(1), which requires such returns, was inapplicable because the reincorporation qualified as a Type F reorganization. This position was premised upon the Commissioner's view of the transaction as having two functionally unrelated components: a mere reincorporation of New York into Delaware (Type F) and the acquisition of the minority interests for voting stock (Type B). It was only by reconstructing the transaction in this manner that the Commissioner was able to ignore the shift of proprietary interests which, under Helvering v. Southwest Consolidated Corp., n396 was fatal to a Type F reorganization finding.
n394 The effect would have been to allow two surtax exemptions for the corporation in the same year: one to New York, the other to Delaware. Section 443 does not require annualization of income or proration of exemption unless the short tax year is the result of a change in the taxpayer's tax year.

n395 The issue of whether a Type F reorganization can encompass transactions which involve a shift in proprietary interests was not addressed or decided by the court.

n396 315 U.S. 194 (1942), discussed in the text accompanying notes 334-45.

The Tax Court acknowledged that both the reincorporation and the acquisition of the minority interests were contemplated from the beginning and that they were necessary to a public offering. In holding for the Commissioner, however, the court determined that these facts did not, standing alone, establish that all such actions were parts of a single transaction constituting but one reorganization or one plan of reorganization. It arrived at this conclusion by way of the "mutual interdependence" test of American Bantam Car Co.: "Were the steps so interdependent that the legal relations created by one transaction would have been fruitless without a completion of the series?" n397 The court did not consider the reincorporation and the acquisition of the minority interests to be mutually interdependent, even though both were contemplated within the same "general plan:"

n397 47 T.C. at 550-51, citing American Bantam Car Co. v. Commissioner, 11 T.C. 397, 405 (1948), aff'd, 177 F.2d 513 (3d Cir. 1949) (per curiam).

Although it was planned from the beginning that the petitioner would make offers to obtain the minority interests of the subsidiaries, there was no assurance, at the time of the merger, that such minority interests would accept the offers. Nor was there any provision in the merger agreements that the transfer of the New York corporation's assets to the petitioner would be undone if the minority stockholders were not responsive to the offers. n398

n398 47 T.C. at 551.

The Tax Court's finding that the components of the transaction were not mutually interdependent seems to ignore the fact that, without successful consummation of both steps, the purpose for which the two were together undertaken would have been entirely defeated. The court's formalistic view of the transaction also fails to recognize that the willingness of the minority shareholders to swap their stock for the Delaware stock was, in all likelihood, a foregone conclusion. First, 95% of them were also shareholders in New York. Second, all of the minority shareholders did, in fact, participate in the exchange. Third, the stock-for-stock swap occurred contemporaneously with the reincorporation, not weeks or months after it. These facts strongly imply that tacit approval had been obtained from the minority shareholders before the reincorporation, and that, had the 80% control objective appeared to have been unattainable, New York still would have had time to scrub the reincorporation.

Spinoza, Inc.

In Spinoza, Inc. v. United States, n399 NHA, Inc. (NHA) formed Spinoza of Delaware (Delaware) with a transfer of its own stock representing 37.7% of the shares outstanding. Delaware then exchanged all of the NHA stock that it had received upon its incorporation for all of the outstanding stock of Spinoza of Texas (Texas), which was then merged into Delaware pursuant to applicable state merger laws. Following the transaction, a major change occurred. Before its dissolution, Texas had engaged in both the engineering and the construction businesses. NHA, however, took away Spinoza's engineering division, set it up as a separate division, and within two months dropped this line of business entirely.


The taxpayers originally treated the transaction as a Type B reorganization followed by a Type A reorganization. Texas closed its taxable year as of the date of the transaction, and Delaware, without securing the Commissioner's permission, adopted a calendar tax year; Texas had been a June 30 fiscal year
taxpayer. These actions are consistent with the Type B-Type A characterization of the transaction. In a Type F reorganization, however, the tax year of the transferor corporation would not have closed on the date of the merger, nor could the transferee corporation change its tax year without the Commissioner's consent. Texas likewise adopted the percentage of completion method of accounting for its long-term contracts in computing income for its final taxable year. A switch from the completed contract method to the percentage of completion method would not have been required to prevent a material distortion of income had the transaction been a Type F reorganization.

Consent of the Commissioner is now automatic where a subsidiary changes to the tax year of its parent in order to enable it to file a consolidated return with the parent. Reg. § 1.442-1(c).

In the first tax year following the merger, Delaware incurred a substantial net operating loss, which it sought to carry back to the premerger tax years of Texas on the theory that the merger of Texas into Delaware constituted a Type F reorganization for purposes of § 381(b). This theory rested on the assumption that the transaction could have been structured as a Type B-Type F reorganization: NHA, Inc. could have first exchanged its stock for the stock held by the shareholders of Texas. As sole shareholder, it could then have reincorporated Texas under Delaware law.

Even as originally structured, if the stock-for-stock exchange could be segregated from the merger as a separate transaction and if the business continuity requirement could be found satisfied (or nonapplicable), the merger of Texas into its holding company parent would qualify as a Type F reorganization. Movielab Inc. v. United States, 494 F.2d 693 (Ct. Cl. 1974) (merger of subsidiary into parent under § 332 also qualified as a Type F reorganization for purposes of § 381; the case, decided under the earlier version of § 381(a)(1)(F), actually involved two operating corporations); Performance Sys. v. United States, 382 F. Supp. 525 (M.D. Tenn. 1973), aff'd, 501 F.2d 1338 (6th Cir. 1974) (per curiam); Eastern Color Printing Co. v. Commissioner, 63 T.C. 27 (1974) (merger into preexisting holding company).

The district court rejected this theory, and with it the taxpayer's claim to the net operating loss carryback, for two reasons. First, the parties were held bound by the form which they adopted to achieve their initial objectives:

The simple answer to this argument is that a "B-F" reorganization was not the form chosen by the parties to the transaction. Plaintiff's argument is essentially directed at having this Court reform their transaction to gain them a tax advantage that they may have enjoyed had they structured the reorganization in another matter. While the Court, in scrutinizing a given transaction for tax purposes, may ignore sham and not "exalt artifice over reality," nevertheless, the parties to a transaction are bound by what they did. They cannot ignore the tax consequences of the form in which they chose to do business because at a later date they found that form to be disadvantageous. While the taxing authorities have freedom to attack the form of a transaction when it constitutes an artifice, the taxpayer cannot change direction willy-nilly to avoid unfavorable tax consequences it did not originally anticipate.

It is worth noting that the taxpayer obtained no special tax benefits at the time of the transaction by structuring it as a Type B-Type A, rather than a Type B-Type F, exchange. The court's position would have been more credible had the taxpayer deliberately adopted the former approach to gain special tax benefits not available under the alternative approach.

The court's second objection to allowance of the net operating loss carryback stemmed from its unwillingness to break the transaction into two separate components:

[Even if the taxpayer had] structured the reorganization as a "B-F" reorganization, this Court would not examine each segment of the reorganization separately. Rather, it would look at the complete transaction without separating it into various steps and ignoring one step while considering only the other. Thus, this Court [even if the transaction had been structured as a "B-F" reorganization] would not ignore the transfer
of stock between Spinoza of Texas and NHA, Inc., and concentrate only upon the reincorporation of Spinoza of Texas under Delaware law. Rather, this Court would, in that case, examine the entire transaction whereby the stock ownership of Spinoza of Texas was transferred entirely to NHA, Inc.

Recall, however, that in Dunlap Associates, the Tax Court went to great lengths to segregate the components of a single plan of reorganization designed to achieve a single objective: the public offering of the taxpayer's stock. Insofar as the separate transaction issue is concerned, only one substantive difference separates the facts in Dunlap from those in Spinoza: While in both cases the transactions were carried out contemporaneously, in the former, the Type F reorganization preceded the Type B reorganization, whereas in the latter, this order was reversed. Because this distinction, in the author's view, is purely a matter of form (in Spinoza, precisely the same nontax results could have been achieved had Texas first been reincorporated as a Delaware corporation by its own shareholders), the opposite holdings of the two cases, to the extent they derive from this distinction, are difficult to justify.

Having established the basis upon which to evaluate the transaction, the court looked to the Fifth Circuit's decisions in Davant v. Commissioner, Reef Corp. v. Commissioner, and Home Construction Corp. of America v. United States for guidance and, from these decisions, distilled three prerequisites to a Type F reorganization: (1) identity of shareholders and their proprietary interest, (2) unimpaired continuity of the essential business enterprise, and (3) a new form which is the alter ego of the old. The court concluded that none of these requirements had been satisfied. Continuity of business enterprise was lacking due to the termination of the engineering portion of Texas' business. Nor could Delaware be considered the alter ego of Texas.

The court correctly noted that the reorganization transformed the 100% direct interest of the original Texas shareholders into a 37.7% indirect interest. What it failed to note, however, was that in Casco Products, all of the former shareholders of the loss corporation had been bought out for cash: 91% by tender offer and 9% by redemption. Notwithstanding

As for the shift in proprietary interests requirement, the court correctly noted that the reorganization transformed the 100% direct interest of the original Texas shareholders into a 37.7% indirect interest. What it failed to note, however, was that in Casco Products, all of the former shareholders of the loss corporation had been bought out for cash: 91% by tender offer and 9% by redemption.
the 100% shift in ownership, the Tax Court permitted post-transaction losses to be carried back to offset the income of tax years in which the new shareholder had no interest whatever in the corporation. Why, as to the shift in proprietary interest issue, should the opposite result obtain here where there is at least a substantial ownership continuity? Furthermore, had the transaction involved only the stock-for-stock swap, there would have been no question as to allowance of the net operating loss carryback. n412 Why should the addition of a mere reincorporation to the recipe alter this result?


n412 Section 381 does not apply to Type B reorganizations, and § 172 contains no restrictions which would have prevented a carryback had the acquired corporation been maintained as a separate legal entity. Neither the shift in proprietary interests, nor the break in business continuity, nor the fact that the corporation would have thereby become a subsidiary of a publicly-traded corporation would have prevented the carryback. See discussion in the text accompanying notes 82-93.

Finally, the court was also influenced by the parties' accounting for the transaction in a manner consistent with a Type B-Type A reorganization: this "[s]trongly suggests that the parties . . . intended . . . a B-A reorganization rather than an F reorganization." n413 This conclusion fails to account either for the prevailing uncertainty regarding the reach of the Type F reorganization, or that, beyond a determination that the transactions were reorganizations under § 368(a), there existed no need for greater precision at the time the transaction was consummated. Consequently, the taxpayer, in all likelihood, simply erred or took the least controversial approach in its original treatment of the transaction.

n413 375 F. Supp. at 445.

The ''Nontransaction Approach'' of Casco Products Corporation

The Tax court offered yet another approach to dealing with shifts in proprietary interests in Casco Products Corporation v. Commissioner. n414 In 1960, Standard Kollsman Industries, Inc. (SKI) offered, by public tender, to purchase all of the outstanding stock of Casco Products Corporation (Old Casco), a Connecticut corporation. It succeeded in acquiring only 91% of the stock. The remaining 9% was owned by shareholders opposed to the takeover. For the sole purpose of providing a legal technique which would enable SKI to become the sole shareholder of Old Casco, SKI formed SKO, a 100% owned Connecticut subsidiary corporation. It succeeded in acquiring only 91% of the stock. The remaining 9% was owned by shareholders opposed to the takeover. For the sole purpose of providing a legal technique which would enable SKI to become the sole shareholder of Old Casco, SKI formed SKO, a 100% owned Connecticut subsidiary corporation, into which, by virtue of its greater-than-2/3 voting power, it caused Old Casco to merge. SKO was immediately renamed Casco Products Corporation (New Casco). SKO conducted no business prior to the merger other than to incorporate and to agree to the merger. New Casco continued without change the business formerly conducted by Old Casco. New Casco subsequently sought to carry back a post-acquisition loss to the pre-acquisition income of Old Casco. Because § 381(b)(3) would otherwise preclude the carryback, New Casco argued that: (1) no reorganization actually took place because Old Casco and New Casco were the same legal identity and the disposition of the 9% minority was, in substance, by way of redemption; and (2) even if a reorganization had occurred, it qualified as a Type F reorganization and the carryback was allowed by virtue of the exemption under § 381(b).

n414 49 T.C. 32 (1967).

The Commissioner -- who just one year earlier successfully argued that the 48% shift in Reef did not preclude a Type F reorganization -- countered that the 9% shift which had occurred in Casco, under strikingly similar circumstances, was too great to be tolerated under § 368(a)(1)(F). Here, as elsewhere in this troublesome area, the standards of construction deemed applicable by the Commissioner seemed to derive more from an assessment as to whose ox was being gored than from any responsible effort to distill legislative intent.

The Tax Court side-stepped the Type F reorganization issue completely, noting that "[b]oth parties invite us to engage in an interpretive exercise as to the scope of section 368(a)(1)(F) . . . . We decline the invitation to attempt to navigate these treacherous shoals." n415 The court instead agreed with the
taxpayer's first argument that the reincorporation was entirely lacking in substance and that the transaction should be viewed merely as the redemption of a minority interest by a single, continuing corporation:

n415 Id. at 36.

There is no question, and indeed, respondent so concedes, that if Old Casco had redeemed the shares of the minority shareholders and had continued in business the loss carryback would have clearly been available. As we see it, the circumstances herein should not produce a different result. To hold otherwise would be to exalt form over substance and to accord an unjustifiable vitality to the merger format which was admittedly adopted only as a "legal technique." . . .

[T]axwise, New Casco was merely a meaningless detour along the highway of redemption of the minority interests in Old Casco. The merger itself, although in form a reorganization, had as its sole purpose the accomplishment of the redemption. . . . Under these circumstances, the merger was a reorganization in form only and should consequently be ignored as such. n416

n416 Id. at 36-37.

Standing alone, this logic is sound. Where, as here, there is no change in identity, form, or place of organization, it seems proper to disregard the transaction as purely formal and having no operational tax significance. n417 Put another way, the court appears to have held that the changes brought about by the reincorporation were so insubstantial that the transaction did not even merit invocation of any statutory nonrecognition provision. n418 Yet in Estate of Stauffer n419 and Associated Machine n420 the same Tax Court strongly implied that any change of substance would preclude a Type F reorganization. Indeed, the court's concluding remarks in Casco suggest that, notwithstanding its view of the reincorporation as totally void of substance, the transaction might nevertheless fail to qualify as a Type F reorganization:

n417 See also Paymer v. Commissioner, 150 F.2d 334 (2d Cir. 1945) where, in a different context, the court refused to recognize the separate existence of the corporation for tax purposes on the ground that the purported corporate entity lacked any and all substance.

n418 See Weiss v. Stearn, 265 U.S. 242 (1924); Eisner v. Macomber, 252 U.S. 189 (1920). Note that if the transaction in Casco had presented a question of gain recognition, the court's reasoning would indicate that nonrecognition would have followed from a lack of realization rather than from qualification under § 368(a)(1).

n419 Estate of Stauffer v. Commissioner, 48 T.C. 277 (1967), rev'd, 403 F.2d 611 (9th Cir. 1968).

n420 Associated Mach., v. Commissioner, 48 T.C. 318 (1967), rev'd, 403 F.2d 622 (9th Cir. 1968).

In view of our holding, we do not reach the question whether, if there had been a reorganization which did not qualify under section 368(a)(1)(F), petitioner would nevertheless have been entitled to carry back that portion of the 1961 loss allocated to the period prior to the effective date of the merger. n421

n421 49 T.C. at 37.

Had the court rejected application of the Type F reorganization, while sustaining the taxpayer on the ground that the reincorporation lacked substance, its holding would have seriously conflicted with the purpose and history of the reorganization provisions.

[*214] Summary: The Impact of Ownership Changes on the Identity of a Corporation

The inconsistency that distinguishes the foregoing collection of cases and rulings derives both from the metaphysical nature of the issue --"what is a corporation?" -- and from the unwillingness, or perhaps the inability, of the courts and the Service to recognize the issue as such. Since the inception of the corporate form, legal philosophers have disagreed as to the fundamental nature of the corporation. Is it an entity
wholly independent of the identity of its shareholders, or does its legal status and identity derive from
them? In the former event, what attributes establish a corporation's identity and determine whether or not
that identity has changed? Is a corporation's legal status, under local law, relevant? And if it is, is the
perpetuation of this legal status conclusive in establishing the unimpaired continuity of its tax identity?
Conversely, does a change in legal status conclusively mandate a like change in tax identity? How do
depth changes in a corporation's rights and privileges under local law impact the corporate identity? Are changes
in the nature and the scope of its business or nonbusiness activities determinative? Or is the appropriate
reference point the nature or identity of the assets that it uses to carry on those activities? Is the corporate
identity a composite of some or all of these attributes? In all events, how much of what kind or kinds of
changes are to be tolerated before the old corporate identity is lost and a new corporate identity takes its
place?

If, on the other hand, the corporate identity is a function of shareholder identity, how does a change in
shareholder identity resulting from introduction of new shareholders vis-a-vis the elimination of old
shareholders vis-a-vis the reallocation of voting power, or participation, et cetera, inter se impact the
corporate identity? And again, how much of what kind of shareholder level change is necessary?

Even the most cursory review of the statute, the administrative rulings, and the decided cases reveals that
each of these factors, and their countless combinations and permutations, have been considered relevant
where, in diverse contexts, a corporation's tax identity has been explicitly or implicitly at issue. The
preceding discussion and analysis provides only a fleeting glimpse of the difficulty encountered to date in
attempts to distill the essence of the corporate tax identity. n422

n422 See Cleary, The Corporate Entity in Tax Cases, 1 Tax L. Rev. 3 (1945), for an interesting survey of
the early decisions that grappled with this issue.

Given the inherently elusive quality of the fundamental issue and its resolution, it is perhaps less than
surprising that these decisions and rulings have failed to produce an unambiguous, operational definition of
the Type F reorganization. The difficulty has been further compounded by the fact that, but for the possible
application of § 382, a shift in the proprietary [*215] interests in a corporation, whether as a result of the
introduction of new shareholders or the elimination of old shareholders, does not of itself bring about a
change in the corporation's tax attributes. Why then should such changes, whether or not functionally
related, bring about a different result merely because the corporation is itself undergoing relatively
insignificant changes contemporaneously?

In the author's opinion, they should not. One path out of the present quagmire would simply abandon this
hopelessly esoteric notion of corporate "identity" by eliminating or otherwise modifying the operational
rules that treat the Type F reorganization differently from other reorganizational forms. n423 The merits of
this approach are discussed later in this article. Alternatively, the definition of the Type F reorganization
could be modified to adopt the quasi-aggregate approach of § 382, n424 whereby the identity of the
corporation would be maintained until a stipulated percentage point change in ownership occurred within a
specified time period. n425 This pragmatic, if not conceptually pure, approach has the virtues of certainty,
relative simplicity, and a greater degree of consistency with the approach applied in limiting other tax
attribute carryovers.

n423 These operational rules are identified in the text accompanying notes 308-9.

n424 The operational rules of § 382 were summarized in the text accompanying notes 239-53.

n425 This approach also has a close counterpart in the statute governing the taxation of partnerships.
Under § 708(b)(1)(B), a partnership is deemed terminated whenever 50% or more of the total interest in
partnership capital and profits is sold or exchanged within a 12-month period. Each partner is thereupon
deemed to have received his or her share of partnership assets as a liquidating distribution, and to have then
recontributed such assets to a new partnership.
The approach adopted under § 382 is, of course, much less drastic. While limitations are imposed on the utilization of favorable tax attributes following a substantial change in the ownership of the corporation, § 382 does not mandate the imposition of the tax consequences that would ordinarily result from the corporation's actual liquidation (and subsequent reincorporation).

FRAMEWORK FOR STATUTORY REFORM

One seemingly self-evident, but nonetheless critical, prerequisite to any conscientious attempt to identify and ameliorate deficiencies in the income tax system is the explicit recognition of the qualitative attributes which provide the framework for distinguishing "good" tax law from "bad" tax law. Yet, inexplicably, these attributes have never really been adequately identified, defined, or prioritized. Nevertheless, there seems to be a consensus that the federal income tax laws should be "equitable," their application "predictable," and that they be capable of (efficient and effective administration. The legitimacy of employing the tax laws as a means of influencing social and economic behavior in ways which contribute to the fulfillment of nonrevenue-generation objectives is generally, but by no means universally or unconditionally, accepted. And finally, few would contest the notion that the tax law should in all events be designed carefully so as not to inadvertently influence economic and social decisions in a manner which is detrimental to the best interests of the nation.


For a more contemporary view as to the function of our income tax system see Eustice, Tax Complexity and the Tax Practitioner, Cal. CPA Q 10, 11 (Sept. 1976):

Most people generally agree (although not necessarily on the respective weight to be given) to five goals a tax system should strive to accomplish: (1) it should, primarily, raise revenue, (2) it should be fair (there is some disagreement as to what is "fair," but at least it is a popular label), (3) it should be neutral, in that it does not distort the economy or the efforts of its citizens, (4) it should be efficient, in that it raises the necessary revenue at a reasonable administrative cost, and (5) it should be simple (in other words, it should be knowable by both the taxers and the taxed, again at a reasonable cost).

n427 The concept of "equity," as it pertains to taxation, is multifaceted. "Horizontal equity," for example, requires that taxpayers of comparable economic circumstance bear correspondingly comparable tax burdens. The complementary, and generally accepted, notion of "vertical equity" suggests not only that taxpayers of dissimilar economic circumstance bear dissimilar relative tax burdens, but also that this relationship be direct, rather than inverse.

Because "economic circumstance" is a function of several complex and interrelated variables, such as income, wealth, family size, health, and education, one obvious impediment to the attainment of the ideal is the difficulty, perhaps impossibility, of capturing and quantifying this elusive and somewhat abstract phenomenon in a manner that renders it susceptible to unambiguous ordinal ranking. Even then, the mathematical function manifesting the "optimum" (i.e., "most equitable") relationship between such measures and different magnitudes of tax burden could not, of course, be derived from, or proven by reference to, the physical laws which sustain order in our universe. The numerous and diverse features of the income tax law which, collectively, have in fact given us some measure, albeit unquantifiable, of "vertical equity," have instead been distilled from a wide range of complex, subjective, and ever-changing value structures and political philosophies by the obscure processes which inevitably culminate in political compromise.

Finally, the equity canon would also seem to require that every effort be made to design and administer the law so as to minimize the potential injustices which might otherwise be inflicted upon unwary taxpayers as a result of technical requirements and distinctions that are unduly harsh, or which simply serve no legitimate policy objective, and are therefore arbitrary and, frequently, counter-intuitive. This facet of tax "equity" is closely related to the "functional neutrality" criterion, which is defined, discussed, and
illustrated in the pages that follow. In marked contrast to the "horizontal" and "vertical" facets of equity, the pursuit of this ideal is constrained less by factors over which the policymaker has little or no control, than by lack of willingness and insight.

n428 "Predictibility" has both static and dynamic dimensions. In the former sense, the term refers to what might be labelled the "ambiguity coefficient" of a particular provision or grouping of related provisions: To what extent is the legislative design, supplemented perhaps by administrative pronouncement, capable of prescribing unique, unambiguous, predictable outcomes for the transactional patterns that fall within its purported scope? At one extreme, § 443 (short period returns), which provides definitive mechanical rules and formulae to cover virtually every conceivable circumstance, might be considered to have an unusually low ambiguity coefficient, while that of the provisions governing corporate acquisitions would be considered by most to be abnormally, and undesirably, high. See note 1 and accompanying text. Clearly, the maximum achievable level of predictability will vary from one area of the law to another, and can generally be expected to do so as a function of such things as the number of variations and permutations which comprise the universe of covered transactions, the extent to which mathematical formulae and objective criteria can be substituted for elusive "fact and circumstance" criteria without unduly compromising legislative purpose, whether or not taxpayer motive and intent is to be a distinguishing factor, and so forth. It should be noted also that the pursuit of greater predictibility must frequently be tempered by an awareness of the additional complexity which omniscience invariably begets.

Predictability over time is likewise generally recognized as a desirable attribute of a tax system. In this regard, attention focuses not only on the frequency, scope, and magnitude of change, but also on the transitional mechanisms selected for its implementation. To many, perhaps most, observers, the recent history of the U.S. income tax system has evidenced considerable legislative indecision, and, all too frequently, an incongruent, but nonetheless impassioned, urgency regarding the implementation thereof. Not only have businessmen, investors, and other taxpayers had to deal with near-exponential rates of change in the tax law throughout the past two decades, they have also had to contend with an increasing propensity on the part of legislators to implement these changes "retroactively." A change in the tax law can be considered "retroactive" if, as a result of the change, taxpayers either suffer unanticipated losses or reap unanticipated gains as a result of irrevocable prechange commitments of resources (or binding executory commitments of future resources). These economic gains and losses may result from --

1. Changes in the tax liabilities attributable to income or loss economically "accrued" in the past but not yet recognized for tax purposes as of the effective date of the change,

2. Tax induced changes in the market value of assets owned by the taxpayer,

3. Tax induced changes in the magnitude of the economic burden of the taxpayer's outstanding liabilities, or

4. Retroactive changes which simply confiscate wealth legally earned, where the change is not the result of a legitimate need to correct actual or perceived ambiguities, and where it does not constitute the exercise of discretion or the resolution of contingencies expressed or implied in the relevant statutes.

It is submitted that the current rules and regulations governing the carryback of post-acquisition net operating losses to pre-acquisition taxable incomes, taken as a whole, fail to conform to these standards. In the opinion of the author, their most significant collective shortcoming is that they have created artificial distinctions between functionally-equivalent transactional forms, and have permitted these distinctions to control important tax consequences, frequently in ways which unnecessarily compromise the unassailable virtue of the equitable concept supporting the carryover provisions of § 172.

It is further submitted that the inconsistencies and ambiguities which have become so apparent in the foregoing technical discussion are by no means confined to post-acquisition loss carrybacks. Rather, these undesirable attributes are pervasive throughout the entire body of law governing the taxation of mergers and acquisitions. In the author's view, this commonality stems from the same congenital defect: the failure
of policy makers to design the statute so as to render it neutral as between equivalent or near-equivalent transactional forms.

In this section the author elaborates upon the meaning and importance of the concept of "functional neutrality," and suggests approaches which could be expected to lead to more equitable and administratable rules for taxing mergers and acquisitions, in general, and post-acquisition loss carrybacks, in particular.

The "Functional Neutrality" Criterion

"Functional neutrality," as that term is used here, calls for impartiality in the tax recognition and treatment of acquisitions which are functional equivalents of one another. Implicit in this criterion is the necessity of first identifying the legal and economic attributes which distinguish one acquisition or form of acquisition from another, and then isolating those differences which, for one policy reason or another, ought likewise to distinguish such transactions in the assessment of the income tax.

n429 The concept of tax "neutrality" is by no means a new one. Professor Groves, perhaps one of the first commentators to explicitly isolate and define this concept, and to distinguish it from "equity," described neutrality in the following terms:

Neutralit... calls for impartiality of treatment. The partiality that we are concerned with may arise from: (1) unequal treatment of essentially similar taxpayers; or (2) the same treatment of essentially different taxpayers. Discrimination may be deliberate or inept. Its curse is removed when it is supported by adequate public purpose and ample prospect for achieving that purpose.

The term "neutrality" as thus defined differs from "equity" . . ., which include(s) an interest in economic equality as well as in impartiality. Thus taxes are said to be equitable when they make for a more even distribution of economic reward. Neutrality has to do less with the standards applied to the over-all distribution of the tax load and more with the even application of those standards once they are chosen. There is no inference of conflict between the two canons. The thought is not that taxes should be neutral rather than equitable; they should be both. Or perhaps more accurately: taxes should be equitable and they should deviate from neutrality only for adequate public purpose.

Groves, Neutrality In Taxation, 1 Nat'l Tax J. 18 (1948).

The complementary, but distinct, notion of "functional neutrality," calls for impartiality at a level different from that implicit in the unqualified term. Once a class of transactions has been designated for partial treatment, the relevant inquiry becomes: Are all transactional variations which achieve the "public purpose" supporting the initial departure from neutrality themselves treated impartially inter se? Conversely, are those transactional structures which fail to evidence the achievement of that purpose denied the benefits (or spared the detriments) of discrimination? Consequently, "functional neutrality" has little, if anything, to do with the formulation of policy, and everything to do with the design of rules intended to implement policy once formulated.

Clearly, as noted later in the text of this section, the motives and purposes which inspired partiality should be of paramount concern in constructing "functionally neutral" operative provisions. Without such a reference point, attempts to distinguish "good" from "bad" will invariably lack the precision which Professor Groves seemed to have had in mind when he qualified the terms under which discrimination could be tolerated. Again: "Its curse is removed when it is supported by adequate public purpose and ample prospect of achieving such purpose." (Emphasis added.)

While the economic effects of acquisitions vary widely, as do the legal consequences attending each of the various acquisition techniques, a critical and comprehensive review of the legislative history of the reorganization provisions reveals that, of such distinctions, only a very select few have been recognized in the formulation or implementation of policy. And the relevance even of these few frequently varies substantially, often for no discernable reason, from one application to another.
Attributes Which Distinguish Corporate Business Combinations

Acquisitions may be distinguished from one another on the basis of the absolute and relative sizes of the amalgamating corporations, the identity of their respective shareholders and the extent to which the ownership of their stock is dispersed, and whether they are actively engaged in the conduct of a trade or business, or, alternatively, derive the bulk of their income from investment activities. Economists and regulatory agencies typically classify mergers as horizontal, vertical, or conglomerate for the purpose of identifying transactions which might be expected to have a substantial impact on industrial concentration and competition. In some acquisitions, one or more of the corporations is financially distressed, while others involve healthy corporations with substantial earnings histories. Motive, that of the seller and/or the buyer, may also serve as a basis for classifying corporate business combinations.

In a "horizontal" merger, the products of the amalgamating enterprises have a high cross-elasticity of demand, i.e., the marketplace views such products as more or less substitutable.

In a "vertical" merger, the product or services of one of the corporations is either sold by or used as a production input by the other.

A conglomerate merger involves corporations that are neither "vertically" nor "horizontally" related. A conglomerate merger results in an enterprise that is diversified as to the geographical or the product markets that it supplies.

Of these distinguishing attributes, only four have generally proven meaningful in separating nontaxable mergers and acquisitions from taxable transactions. First, special rules are available to deal with some of the unique problems attending acquisitions of insolvent or bankrupt corporations. Second, transactions in which the corporations are not engaged in the active conduct of a trade or business may run afoul of either § 368(a)(2)(F), which withholds reorganization status from acquisitions involving certain investment corporations, or the continuity of business enterprise test set forth in Reg. § 1.368-1(d). Third, as noted in previous discussion, the regulations and the courts invariably look to the principals and their motives to determine whether or not they were sufficiently inspired by "business purposes." Finally, special rules sometimes pertain where the amalgamating enterprises have one or more shareholders in common.

The tax law also provides special definitions and rules for the tax treatment of sales or exchanges to effectuate policies of the Federal Communications Commission (IRC § 1071); exchanges in obedience to orders of the Securities and Exchange Commission (IRC §§ 1081-1083); and distributions pursuant to the Bank Holding Company Act (IRC §§ 1101-1103).

Attributes Which Distinguish Alternative Acquisition Structures

Acquisitions can be further distinguished on the basis of the method employed to carry them out. To effect the acquisition, A may, either directly or through a newly created or previously-existing subsidiary, acquire either the assets or the stock of T. It may do so using cash, notes, its own stock, stock of its parent corporation, or some combination of these, as consideration.
n437 See the text accompanying notes 8-44 for an overview of the various taxable and nontaxable acquisition techniques.

One example of an important nontax difference between these alternative acquisition structures relates to the exposure of A to the liabilities, particularly the contingent or unknown liabilities, of T. This exposure is unlimited if the acquisition is structured as a statutory merger or consolidation, while it is limited to A's investment in T in a stock acquisition, n438 and, subject to important exceptions, is nonexistent where the acquisition is otherwise structured as an asset acquisition. n439 Other legal and economic factors that vary from one acquisition structure to another include: (1) preservation or loss of nontransferable franchise rights, contracts, leases, et cetera; (2) mechanical aspects of effecting the transfer; (3) dilutive effect on the equity or voting interests of A's shareholders; (4) shareholder approval and appraisal rights; (5) "purchase" versus "pooling of interests" method of accounting for the transaction in the financial statements; and (6) federal security regulations and state blue sky laws.

n438 Shareholder warranties and contingent and escrow consideration arrangements, however, can be and frequently are used to minimize these risks in both statutory mergers and consolidations and stock acquisitions. Rev. Proc. 77-37, Section 3.06, 1977-2 C.B. 568, sets forth advance ruling criteria for the use of contingent and escrowed stock consideration in nontaxable corporate acquisitions Type A, B, and C reorganizations.

n439 A, in a nonstatutory merger or consolidation, could inherit some or all of T's liabilities due to (1) noncompliance with the applicable state Bulk Sales Act, (2) payment of the purchase price directly to T's shareholders rather than to T itself, or (3) by application of the judicial de facto merger doctrine, as articulated, for example, in Heilbrunn v. Sun Chem. Corp., 150 A.2d 755 (Del. Sup. Ct. 1959).

While major differences do in fact distinguish one method of acquisition from another, a close examination of the legislative record covering the 66 years of the reorganization provisions reveals no instance where any of these factors -- except indirectly, and only to a limited extent, item (3), above -- were expressly or implicitly recognized and consciously and deliberately selected as the basis upon which to apply different standards or to assess different tax burdens. Even insofar as equity/voting power dilution has provided a basis for mandating differing outcomes, neither the statute itself, nor the courts have considered relevant the economic significance of the actual resulting dilution. n440 So long as the required amount and type of "equity" consideration is used to effect the acquisition, it matters not whether the shareholders of T wind up with any meaningful relative interest in A (or its parent) after the smoke clears.

n440 Except in determining whether the transaction qualifies as a "nondivisive" Type D (or Type G) reorganization (IRC §§ 368(a)(1)(D), (G); 354(b)), or in determining whether the § 382 limitations are to be applied, there is nothing to prevent a "minnow from swallowing a whale" tax free.

The lack of functional neutrality in the legislative design is apparent when, for example, one compares the "solely for voting stock" requirement applicable to Type B reorganizations n441 with that applicable to Type C reorganizations, n442 and each of these to the corresponding rule applicable to the reverse triangular Type A reorganization, n443 and all three of these standards with the judicial and administrative interpretations of "continuity of interest" as applicable to the "straight" Type A reorganization. n444 One will search in vain for a reasoned explanation as to why the policy considerations supporting the basic notion of shareholder continuity in the context of corporate amalgamations should manifest themselves so differently from one transactional form to another. Similarly, note the "substantially all" requirement applicable to Type C reorganizations (and the "triangular" versions of the Type A reorganization), and the unexplained omission of any such discriminating criterion for nontaxable "straight" Type A reorganizations or for Type B reorganizations.

n441 IRC § 368(a)(1)(B).

n442 IRC § 368(a)(1)(C), (a)(2)(B). Section 368(a)(1)(C) provides: "in determining whether the exchange is solely for stock the assumption by the acquiring corporation of a liability of the other, or the fact that property acquired is subject to a liability, shall be disregarded."
Section 368(a)(2)(B) further allows consideration other than voting stock in a Type C reorganization where at least 80% of the gross fair market value of T's assets have been acquired for voting stock.

n443 IRC § 368(a)(2)(E)(ii). In a reverse triangular Type A reorganization, the voting stock of the parent corporation must be used to acquire at least 80% control, as defined in § 368(c), of T; but there are no restrictions as to the type of consideration that may be used to acquire any stock in excess of that amount.

n444 For advance ruling purposes, if T's shareholders, as a group, receive equity (voting or otherwise) equal in value to 50% or more of all of the formerly outstanding T stock, continuity of interest generally is deemed satisfied. *Rev. Proc. 77-37*, § 3.02, *1977-2 C.B. 568*. Some courts, including the Supreme Court, have been even more permissive; e.g., *John A. Nelson Co. v. Helvering*, 296 U.S. 374 (1935) (where the court found sufficient continuity of interest although the T shareholders received 62% cash and only 38% nonvoting preferred stock).

A sampling of the many other unexplained and counter-intuitive discrepancies in the legislative design includes:

[*222*] (1) As noted throughout this article, the statutory and administrative rules pertaining to the carryback of post-acquisition losses to pre-acquisition taxable incomes of T, A, and, where applicable, their respective affiliates, exhibit several incongruities;

(2) "Creeping" acquisitions n445 are generally permitted in a Type B reorganization and, to a lesser extent, a Type A reorganization, but are not allowed in either a Type C reorganization n446 or a reverse triangular Type A reorganization; n447

n445 A "creeping acquisition" is generally one in which A already holds an equity interest in T at the time a decision is made to increase its level of ownership in T by acquiring either additional T stock or T's assets.

n446 See *Bausch & Lomb Optical Co. v. Commissioner*, 267 F.2d 75 (2d Cir. 1959), where a portion of the assets received by A was deemed to have been received in exchange for stock it already owned in T, rather than in exchange for its voting stock.

n447 The statute expressly requires that stock constituting at least 80% control must be acquired in the transaction itself. IRC § 368(a)(2)(E)(ii). Consequently, if A already owns more than 20% of T's stock, this requirement cannot be satisfied. But see *Rev. Rul. 72-354, 1972-2 C.B. 216* for a "purge" technique that might sometimes be available to overcome this problem.

(3) Following a stock acquisition, the SRLY rules prevent the utilization of the acquired member's pre-acquisition loss carryforwards by other members of the acquiring group. n448 Yet following a nontaxable asset acquisition, T's pre-acquisition loss carryforwards can generally be used against post-acquisition income produced by A's other businesses. n449

n448 See the text accompanying notes 173-95.

n449 See the text accompanying notes 62-9, where the Libson Shops doctrine was explicitly repudiated in the committee reports accompanying the revisions to § 382 under the 1986 Act.

(4) Direct payment of joint reorganization expenses by A in a Type B reorganization or a Type C reorganization is not viewed as the payment of consideration other than voting stock, whereas the equivalent alternative of paying cash to T for its use in paying such expenses is; n450


(5) The rules governing the treatment of a taxpayer receiving "boot" in an otherwise nontaxable exchange fail to accord with economic realities. Section 356(a)(1) requires that any realized gain be recognized to the full extent of the amount of boot received. Under § 356(c), a realized loss cannot be recognized notwithstanding the receipt of boot by the shareholders. Because these rules do not provide for the recognition of gain or loss as a function of the extent of the shareholder's continuing proprietary interest, a shareholder receiving a relatively small amount of boot may be required to recognize most or all of his or her gain, while a shareholder receiving a substantial amount of boot would be denied any deduction for a realized loss; n451 and

n451 Assume, for example, that shareholder D has a basis in her 100 shares of stock of $450,000, while shareholder E owns 100 shares of stock with a basis of $550,000. In a nontaxable Type A reorganization, D and E exchange their respective shares for $50,000 in cash and $450,000 worth of A stock. Consequently, each has drawn 10% of the current value of their original investment out of corporate solution. The economic realities of this transaction would thus dictate that D and E recognize 10% of their respective gain and loss. Instead, § 356 requires that D recognize 100% of her gain ($50,000), while denying E any deduction for his legitimate and otherwise conclusive loss. Nowhere does the legislative record reveal why the fundamental notion of continuity of interest should be abandoned in favor of these decidedly punitive rules merely because the taxpayer's continuing interest is somewhat less than absolute.

This deficiency in the design of the rules pertaining to the recognition of gain or loss upon the receipt of boot is not limited to § 356. See also, for example, §§ 1031(b), (c); 1034(a). The mandatory treatment of taxpayers receiving boot in these otherwise nontaxable transactions is likewise irreconcilable with the economic realities which they were enacted to acknowledge.

(6) The "80% control" threshold applicable in a Type B and a reverse triangular Type A reorganization is itself an inconsistency in that the distinction it creates between acquisitions that meet or exceed this requirement and those that do not is not grounded in economic or legal realities. n452 Under local law, for example, ownership of stock possessing more than 50% of the outstanding voting power is usually sufficient for the shareholder to control the composition of the board of directors, and consequently the management, of the corporation. But a higher degree of control, usually 2/3, may be necessary under local law for a stockholder to unilaterally approve a merger, a sale of the corporation's business assets, or the corporation's liquidation. Similarly, generally accepted accounting principles usually consider 20% n453 and 50% n454 control thresholds to be relevant in the presentation of financial statements.

n452 Prior to 1934, the predecessor to the Type B reorganization required only that at least a majority of T's voting and nonvoting shares be acquired. Section 202(c)(2) of the Revenue Act of 1921; § 203(h) of the Revenue Acts of 1924, 1926; § 112(i) of the Revenue Act of 1928 and 1932. Without elaboration in the accompanying committee reports, the control requirement was increased to its current level by § 112(g) of the Revenue Act of 1934.

n453 A 20% to 50% level of control usually requires the use of the "equity" method of accounting for an investment in a subsidiary. See Accounting Principles Board Opinion No. 18.

n454 Under GAAP, consolidated financial statements are usually considered appropriate where the parent corporation has greater than 50% of the voting control of the subsidiary.

Because these distinctions serve no apparent policy objective, they create unnecessary traps for taxpayers who either fail to obtain competent professional tax advice, or who, notwithstanding advice of the highest calibre, fail to anticipate subsequent events which render the original decision unsound in terms of its ultimate tax effect. n455 Even where all factors are identified, the law, again for no apparent policy reason, frequently forces the taxpayers to structure the transaction in a manner that does not optimally accord with their economic and financial objectives, n456 or to abandon the proposed acquisition altogether. n457 It is also likely that the resulting high degree of uncertainty associated with extrapolation, n458 coupled with the invariably high tax stakes that attend most corporate acquisitions, has discouraged innovation and adaptation to changing economic and financial environments, n459 and has thus impeded the natural, and generally healthy, evolutionary process.
n455 See, e.g., cases cited at note 5.

n456 For example, assume that the objective of A is simply to acquire all or a part of T's assets. Assume further that T's shareholders are unwilling to proceed unless the transaction can be structured as a tax-free reorganization. If the acquisition cannot be arranged so as to qualify as a Type C reorganization, either because the "solely for voting stock" requirement or the "substantially all" requirement cannot be satisfied, A may be forced to opt for a statutory merger. In so doing, A will be exposing itself to T's contingent and inchoate liabilities. And, since state law generally requires that A's own shareholders approve the merger, it may also incur substantial additional expense or delay in carrying out the acquisition if its stock is widely-held. This additional risk and expense can usually be avoided in a Type C reorganization.

Further, the complexities, ambiguities, and uncertainties which characterize these rules and regulations can also operate to produce windfall gains to one of the transacting parties to commensurate economic detriment of the other. This is because the tax benefits and detriments resulting from the anticipated tax characterization of the transaction are normally factored into the purchase price during the negotiation process. For example, if the assets of a profitable target corporation have appreciated substantially, A will usually benefit from circumventing the reorganization provisions by structuring the transaction so that it is fully taxable. By so doing, it will obtain a higher basis in the acquired assets (§ 1012 v. § 362(b)) and will not inherit the target's pre-acquisition earnings and profits. Consequently, if T's shareholders insist on a nontaxable acquisition to avoid the immediate recognition of their substantial gains, A will usually factor the expected tax detriment of the lower tax basis and the carryover of t's earnings and profits account into their offer. If a transaction, originally thought to be nontaxable, is subsequently determined to have been taxable, then, unless there are contingency provisions in the purchase contract which provide for this possibility, one party stands to benefit to the obvious detriment of the other. Unfortunately, the excruciating complexity that has resulted from the lack of adherence to the functional neutrality criterion has made the risk of retroactive reclassification unnecessarily high: not only because of the difficulty associated with deciphering these rules and, where necessary, interpolating between them, but also because the numerous ultra-technical distinctions make it relatively easy for one of the parties to unilaterally trigger such a reclassification.

n457 For example, where business and legal considerations preclude the use of a statutory merger or consolidation as the means to effect the desired acquisition, a's shareholders may view the dilution of control and equity that would result from compliance with the "solely for voting stock" requirement of the Type B and Type C reorganizations to be so unpalatable that the proposed acquisition is ultimately abandoned. Similarly, if A seeks the legal and economic attributes unique to the Type C reorganization, but finds that T owns a business or substantial assets that A does not wish to purchase (or which T does not wish to sell), the "substantially all" requirement might create an insurmountable impediment to the consummation of the proposed acquisition.

n458 The "logic" manifest in the reorganization provisions is antithetical to that evident in, for example, the algebraic "rule of transitivity," where if it is known that A=B and that B=C, then one may derive that A will in all events equal C.

n459 This brings to mind an old Ashanti proverb: "It is only the fool who tests the depth of a river with both feet."

[*225] This undesirable state of affairs derives largely from a historical failure to adhere to the functional neutrality criterion in both the design and the implementation of the merger and acquisition statutes. While there are several substantial legal and economic attributes which distinguish one acquisition or method of acquisition from another, only those that operate to enhance the fulfillment of the policy objectives supporting the special tax treatment accorded statutory reorganizations, and those that detract therefrom, should be referenced as the basis for assessing differential tax consequence. This is the essence of the problem: the merger and acquisition statutes have been permitted to evolve without the benefit of a coherent and unambiguous statement of the objective or objectives that the technical rules are intended to achieve.
Formulation of an Unambiguous Statement of Purpose: A Prerequisite to the Meaningful Reform of the Merger and Acquisition Statutes

Taxation is, of course, a man-made phenomenon and is thus not grounded in any irrefutable law or laws of nature as are the natural sciences. If there is to be a solid foundation of precepts within which the U.S. federal income tax laws are to be constructed, that foundation must, in the final analysis, derive from congressional deliberation and approval. Unfortunately, Congress has never undertaken such a task. Instead, the present income tax system is to a very large extent the product of our democratic form of government: the cumulative composite of a multitude of debatable judgements and political compromises. n460

n460 Eustice, note 426, at 12.

The foundation upon which the reorganization provisions have been constructed is, if anything, less solid than that of the tax law generally. A close examination of the legislative history of the reorganization provisions fails to reveal a coherent and unambiguous rationale to support the tax preference accorded these transactions. Nevertheless, several "theories," some arising from practical considerations, others resulting from economic or quasi-economic reasoning, have been advanced as justification for the special tax treatment of reorganization transactions. n461 None of these theories, however, presents an entirely accurate and unambiguous description of the philosophy and purposes underlying the reorganization provisions. Since different technical rules would be required to accomplish different objectives, the lack of a clear statement of purpose has inevitably been productive of inconsistency and uncertainty.

n461 In addition to the discussion which follows, see ALI Federal Income Tax Project, Subchapter C: Proposals of the American Law Institute On Corporate Acquisitions and Dispositions and Reporter's study on Corporate Distributions 155-59 (1982).


One line of reasoning, based upon readily apparent practical grounds, is that only the receipt of cash (or its equivalent) should be viewed as income because: (1) the cash concept of income is close to the layman's idea of income, (2) it is an approach that is easily administered, and (3) since the tax must be paid in cash, cash is the best measure of ability pay. n462 Where the taxpayer receives only stock or securities in a reorganization, the argument continues, no tax should therefore be imposed on him. n463

n462 In Eisner v. Macomber, 252 U.S. 189, 213 (1920), the Court advanced several theories for holding that a stock dividend paid by a corporation in its own stock did not constitute income within the meaning of the sixteenth amendment. One of those, though certainly not the most important, was its recognition that a sale of the distributed shares to obtain the cash needed to pay the income tax would reduce the shareholder's voting power and decrease his or her capital interest.

Yet, without selling, the shareholder, unless possessed of other resources, has not the wherewithal to pay an income tax upon the dividend stock. Nothing can more clearly show that to tax a stock dividend is to tax a capital increase, and not income, than this demonstration that in the nature of things it requires conversion of capital in order to pay the tax.

n463 An early advocate of this approach was Robert H. Montgomery: "I do advocate an interpretation of the law which can be applied to actual income and actual gains . . . . [T]hat is, as soon as the realization of income and gains becomes a fact and enough cash or the equivalent of cash is in sight to pay the tax." Montgomery, Reorganization and the Closed Transaction, Federal Income Tax 118, 121 (R. Haig, ed. 1921).

But the general rules of taxation, to which the reorganization provisions are exceptions, tax receipts without regard to whether or not they are in cash. n464 Consequently, this wherewithal-to-pay notion,
though useful, leaves unanswered the question: Why does the law apply this more lenient doctrine to some favored exchanges while denying it to others? n465

n464 See, e.g., Reg. §§ 1.61-1(a), 1.1001-1(a).

n465 Sandberg, The Income Tax Subsidy to Reorganizations, 38 Colum. L. Rev. 98, 100 (1938). Under a "cash flow" or "consumption" based tax system, all forms of savings and invested or reinvested income are excluded from the tax base. Such a system would adhere very closely to the wherewithal-to-pay concept of taxation and would therefore eliminate this inconsistency (and the need for many of the current reorganization provisions) entirely. See Treasury Dept., Blueprints for Basic Tax Reform (1977).

"Strict Continuity of Interest" as a Basis for the Reorganization Provisions

Another theory, which will be referred to here as the "strict" continuity of interest theory, holds that while gain or loss resulting from a reorganization may have technically accrued, the stocks or securities received in the transaction are, in substance, identical or nearly identical to the stocks or securities given up. The ultimate economic outcome of the original investment thus remains conjectural in that the taxpayer has not, [*227] in reality, "... 'cashed in' on a gain, or closed out a losing venture." n466 Consequently, the as yet speculative nature of any technically realized gain or loss should preclude its contemporaneous recognition.

n466 Portland Oil Co. v. Commissioner, 109 F.2d 479, 488 (1st Cir. 1939).

This was the announced purpose underlying the earliest reorganization legislation: "to negative the assertion of tax in the case of certain purely paper transactions" n467 and to thereby provide for transactions which were "merely changes in form but not in substance." n468 Years later the Supreme Court articulated a similar view in Bazley v. Commissioner:


n468 Gregg, Statement of the Changes Made in the Revenue Act of 1921 by the Treasury Draft and the Reasons Therefore, N.Y. Times, Jan. 5, 1924, at 1, col. 2.

Normally, a distribution by a corporation, whatever form it takes, is a definite and rather unambiguous event. It furnishes the proper occasion for the determination and taxation of gain. But there are circumstances where a formal distribution, directly or through the exchange of securities, represents merely a new form of the previous participation in an enterprise, involving no change of substance in the rights or relations of the interested parties, one to another or to the corporate assets. As to these, Congress has said that they are not to be deemed significant occasions for determining taxable gain . . . . These considerations underlie [Section 368] and they should dominate the scope to be given to the various sections all of which converge toward a common purpose. n469

n469 331 U.S. 737, 740-41 (1947) (emphasis added). This case involved a recapitalization of a family corporation. The language quoted is an accurate description of very few corporate reorganizations.

While the strict continuity of interest doctrine may explain why some forms of reorganization (such as the classic Type E or Type F) are not deemed taxable events, n470 it fails to account for the nontaxability of other [*228] forms, notably combinations or divisions of corporations. The corporate-level and shareholder-level changes generally occasioned by these types of transactions, measured by economic and marketplace standards, are unquestionably substantial and not merely formal. n471

n470 Note, however, that even these reorganizational forms might not be -- indeed, prior to express statutory sanction, were not -- always nontaxable on the basis of strict continuity of interest. In Marr v. United States, 268 U.S. 536 (1925), General Motors Company of New Jersey (New Jersey) formed a new corporation, General Motors of Delaware (Delaware). In exchange for all of its common and preferred stock, Delaware received all of the assets and assumed all of the liabilities of New Jersey. New Jersey, in
the process of liquidation and dissolution, then exchanged 5 shares of Delaware common for each share of its own common, and 1 1/3 shares of Delaware preferred for each share of its preferred. The transaction was carried out in 1916, prior to any express statutory provisions dealing with corporate recapitalizations or reincorporations.

In deciding for the government, the Court stressed that Delaware was organized under the laws of a different state: "[The] corporation organized under the laws of Delaware does not have the same rights and powers as [the] one organized under the laws of New Jersey. Because of these inherent differences in rights and powers, both the preferred and the common stock of the old corporation is an essentially different thing from stock of the same general kind in the new." Id. at 541.

Justice Brandeis, who delivered the 5-to-4 majority opinion, also pointed to the differences in other essential characteristics between the New Jersey and the Delaware stock, and to the fact that the transaction had caused a shift in the proprietary interests of the New Jersey shareholders. The Court observed: "But there are also adventitious differences, substantial in character. A 6 per cent non-voting preferred stock is an essentially different thing from a 7 per cent voting preferred stock. A common stock subject to the priority of $20,000,000 preferred and a $1,200,000 annual dividend charge is an essentially different thing from a common stock subject only to $15,000,000 preferred and a $1,050,000 annual dividend charge. The case at bar is not one in which after the distribution the stockholders have the same proportional interest of the same kind in essentially the same corporation." Id. at 541-42.

Thus, the test of the realization of income was not whether a change in the business enterprise itself had occurred, but whether any change in the nature of the shareholder's interests resulted from the transaction. That the same management and the same stockholders conducted the same business with the same assets was not deemed material. Cf. Weis v. Stearn, 265 U.S. 242 (1924).

n471 Dane, The Case for Nonrecognition of Gain in Reorganization Exchanges, 36 Taxes 244 (1958); Hellerstein, Mergers, Taxes and Realism, 71 Harv. L. Rev. 254 (1957); Sandberg, note 465.
"Substantial Continuity of Interest" as a Basis for the Reorganization Provisions

The "substantial" continuity of interest theory, though related, is conceptually distinct from the strict continuity of interest theory described above. At first glance, the only difference between the two appears to be one of degree. But under the strict continuity of interest theory, the function of the reorganization provisions is that of a folderol: they are nothing more than explicit statutory recognition of the implied notion that substance should dominate form in determining whether a transaction produces constitutionally taxable "income." Conversely, under the substantial continuity of interest doctrine, the reorganization statutes become exemptions legislatively bestowed upon transactions which indisputably produce income in a constitutional sense, transactions in which what is received is not identical or even substantially identical in form or in substance to that which is given up:

The purpose of the reorganization provisions . . . is to except from the general rule (of immediate taxation) certain specifically described exchanges incident to such readjustments of corporate structures made in one of the particular ways specified in the Code, as are required by business exigencies and which effect only a readjustment of continuing interest in property [*229] under modified corporate forms. Requisite to a reorganization . . . are a continuity of the business enterprise under modified corporate form, and . . . a continuity of interest therein on the part of those persons who, directly or indirectly, were the owners of the enterprise prior to the reorganization."

n472 Reg. § 1.368-1(b) (emphasis added). See also Cortland Specialty Co. v. Commissioner, 60 F.2d 937, 940 (2d Cir. 1932), where the court stated: "In defining 'reorganization', . . . [§ 368(a)(1)] gives the widest room for all kinds of changes in corporate structure, but does not abandon the primary requisite that there must be . . . some continuity of interest on the part of the transferor corporation or its stockholders in order to secure exemption."
Thus, under the substantial continuity of interest doctrine, the purpose of the reorganization provisions can be viewed as the manifestation of Congressional intent to grant exemption where (1) the taxpayer's investment is still in corporate solution and (2) the taxpayer's interest in the assets and business of the old corporation before the transaction, though significantly modified, is nevertheless "substantial," i.e., "definite and material." n473 after the transaction. n474


n474 It is clear from a reading of even the earliest statutes that Congress had in mind the substantial continuity of interest doctrine (generally referred to simply as the continuity of interest doctrine), rather than their announced purpose of eliminating tax on "purely paper transactions." The courts were the first to articulate this implied purpose of the reorganization statutes. One commentator explained the reorganization exemption in the following terms:

[The] essence of a [statutory reorganization] is a continuance of the proprietary interests in the continuing enterprises under modified corporate form, the transaction being deemed insufficiently closed economically to justify a tax at the time, except in so far as the shareholder gets something in addition to stock or securities in the reorganized company.

Darrell, The Scope of Commissioner v. Bedford's Estate, 24 Taxes 272 (1946) (quoted with approval by the First Circuit in Lewis v. Commissioner, 176 F.2d 646, 648 (1st Cir. 1949)).

Of all the theories advanced as justification for the special tax treatment of corporate reorganizations, this theory seems to be most reflective of Congressional intent. But notwithstanding its strong intuitive appeal, the general notion of substantial continuity of interest lacks the specificity capable of producing consistent operating standards. n475 First, it does not identify the characteristics of an economic interest in A's fortunes which are to be referenced to determine whether any measure of continuity has been conveyed to the holder. In the context of a Type B or a Type C reorganization, for example, all of T's shareholders, even those originally holding nonvoting stock, must exchange their stock for voting stock of A. Yet in a Type A reorganization, nonvoting, nonparticipating preferred stock has been held to impart the requisite continuity to its holder, even where that shareholder originally held a fully-participating, voting interest in T.

n475 For an excellent critical examination of the continuity of interest doctrine and its historical evolution, see Faber, Continuity of Interest and Business Enterprise: Is It Time To Bury Some Sacred Cows?, 34 Tax Law. 239 (1981). For additional thoughts as to the deficiencies of this judicial doctrine and how they might be addressed, see DeCelles & Englebrecht, Safe Harbor Statutes for Solvent Corporate Reorganizations -- A Qualitative Assessment, 61 Taxes 212 (1983); McGaffey & Hunt, Continuity of Shareholder Interest in Acquisitive Corporate Reorganizations, 59 Taxes 659 (1981); Wolfman, note 1.

The general notion of substantial continuity of interest also fails to identify the appropriate reference point for measuring the degree of continuity and testing the sufficiency thereof. To implement legislative intent, should taxable and nontaxable transactions be distinguished on the basis of (1) the degree to which T's former shareholders convert their equity into that of A, or (2) the relative interest in A which T's shareholders wind up with, or (3) some combination of both? Should these standards be applied on an individual, shareholder-by-shareholder basis, or should they be applied by reference to the group of shareholders, with the results binding on all members of that group? What attribute or attributes of equity ownership should be referenced in taking these measurements: the degree of continuing voting power and/or participation in future profitability, or simply the value of A's equity?

Alternatively, or additionally, should "continuity" be tested at the corporate, rather than at the shareholder, level? And if so, what attributes should be referenced as the relevant measure of corporate continuity: continuation of business enterprise, continued use of historic business assets, continuity of legal entity, or all, or a combination, of these?
An even more fundamental issue, which has been raised only recently, is whether continuity of the corporate entity should be separated from the continuing participation of its shareholders, so that these respective components of the transaction are to be evaluated and taxed independently of one another. n476


In the author's opinion, each of these competing perspectives is viable within the context of the general statement of purpose set forth in § 1.368-1(b) of the regulations, and none seems to possess virtue of a relative magnitude sufficient to render the others clearly subordinate. Consequently, if "substantial continuity of interest" is to serve as the touchstone for the identification and isolation of worthy transactions, only an unambiguous statement as to just what the phrase is intended to mean can avoid the inconsistencies and uncertainties that have proliferated in its absence.

Removing Impediments to Business Growth and Expansion as a Basis for the Reorganization Provisions

The reorganization provisions have also been supported on the grounds that, by removing many of the adverse tax effects, they restore a necessary degree of neutrality to the decision processes of those whose economic circumstances either require or might be enhanced by such transactions. n477 This final approach goes beyond mere questions of tax law and tax equity to view mergers and acquisitions as essential to the proper functioning of these activities in the economy. n478 If the sole or principal rationale for awarding tax deferral is to foster mergers and acquisitions by removing tax related impediments, one would expect the technical rules supporting this objective to be much more permissive than those designated to distinguish transactions on the basis of continuity of interest. One would also expect to find some mechanism for distinguishing between amalgamations which are "good" in a societal sense, and those that are not. While a number of tax provisions have been designed to eliminate "unwarranted inducements to mergers," n479 the task of discouraging and preventing mergers, the likely impact of which is considered detrimental to the economy, has been, to date, delegated to the antitrust division of the Department of Justice and to the Federal Trade Commission. n480

n477 Referring to § 202 of the Revenue Act of 1921, the Senate Finance Committee report stated: "The preceding amendments, if adopted, will, by removing a source of grave uncertainty and by eliminating many technical constructions which are economically unsound, . . . permit business to go forward with readjustments required by existing conditions . . . ." S. Rep. No. 275, 67th Cong., 1st Sess. 11-12 (1921).

n478 The desirability of removing obstacles to mergers and acquisitions has long been the subject of considerable controversy. In the legal literature, see Hellerstein, note 401; Cohen, Conglomerate Mergers and Taxation, 55 A.B.A. J. 40 (1957).

The economic literature is, of course, also replete with analyses of the effect of business combinations on industrial concentration and competition. For a sampling of the economic literature on this subject see J. Butters, J. Lintner & W. Cary, Effects of Taxation: Corporate Mergers 241-80, 287-314 (1951); J. Narver, Conglomerate Mergers and Market Competition (1967); P. Steiner, Mergers: Motives, Effects, Policies (1975).


n480 But see § 5881, added by the 1987 Act, which imposes a 50% nondeductible excise tax on gains that corporate raiders realize as a result of any "greenmail" payments they receive.

The American Institute of Certified Public Accountants persuasively argues that the tax law should not be used to regulate merger activity:

[W]here public policy does dictate that the interests of society are best served by preventing, limiting, or retroactively remedying a particular reorganization, the laws, regulations and sanctions employed to accomplish these objectives should arise solely from sources outside the tax law. If these laws, regulations,
and sanctions are properly constructed and adequately enforced, there is simply no reason for the tax law to burden itself with concerns which properly lie far beyond the limits of its responsibility. Indeed, any reorganizations which remain to be dealt with for tax purposes (other than those whose dominant motivation is tax avoidance) would be desirable in a public policy sense and should therefore be facilitated, or at least not hampered, through the operation of "neutral" taxing provisions.


In sum, there does not at present exist a coherent system of unambiguous objectives and fundamental precepts which are capable of producing consistent operating standards. Regrettably, even the laudable, and in another respects, comprehensive, effort of the Staff of the Senate Finance Committee in recommending changes which would overhaul the present statute fails to address this very fundamental problem. In my view, unless and until Congress identifies and prioritizes the specific objectives that the exemption awarded to mergers and acquisitions are intended to achieve, there is simply no basis upon which to definitely evaluate conflicting notions as to how the system might best be improved. Even the most cursory review of the judicial conflicts that this body of law has given rise to reveals that, in the absence of an unambiguous reference point, the essential nature of the opposing arguments of the litigants is uncomfortably analogous to the medieval debate as to how many angels could dance on the head of a pin.


Additionally, it is my view that functional neutrality should be the standard for evaluating both the adequacy of the statutory implementation of tax policy objectives and the validity of subsequent administrative and judicial interpretations. Once the objectives have been unambiguously stated, it is the duty of the legislators and their staffs to identify attributes which either enhance or detract from those objectives. Absent overriding administrative considerations, the statute should be designed so as to affirmatively discriminate between alternative courses of action on the basis of whether they possess or fail to possess such attributes. It should be neutral as to the presence or absence of attributes which neither enhance nor detract from the fundamental objective.

n482 But not all commentators agree. See Jacobs, Reorganizing the Reorganization Provisions, 35 Tax L. Rev. 415, 416 (1980), where the author states:

Clear, simple answers will normally be favored, notwithstanding the recognition that long-held notions of equity or fairness might militate in another direction.

I believe in simplicity . . . . In its cause I am willing:

1. To concede the existence of anomalies;
2. To eschew the temptation to attempt to divine the "right" answer; and
3. To accept the principle that the price one must pay for certainty and predictability of result in tax-free corporate reorganizations is that form must be accorded an all but irrefutable presumption of governance.

Last, and perhaps most important, the temptation to compare and reconcile an endless variety of transactional forms yielding irreconcilable tax results must be resisted. We should not permit our desire to treat substantively similar transactions similarly to become the touchstone of reorganization treatment.

It is not apparent to this observer that the relationship between functional neutrality and simplicity is inherently inverse. One has only to reflect upon the extraordinarily complex mathematical and natural phenomena that have been reduced to a relative few, relatively simple "givens," to query whether it might not indeed be possible to likewise reduce the complexities of the "endless variety of transactional forms" to a relative few attributes identified as relevant to the achievement of legislative purpose. Although this analogy is admittedly not very direct, it should nevertheless be clear from the preceding discussion that the
more focused and unambiguous the stated objectives, the better able we are to discriminate between relevant and extraneous transactional attributes, and to thereby design a system of classification that is more, not less, generic in its orientation.

n483 It is abundantly clear that it is the task of the legislature, and not the courts, to establish the framework within which functionally equivalent transactions can be taxed equivalently: "(The taxpayer's) argument . . . calls upon this Court to take (a step) that we are reluctant and unwilling to take. . . . (I)t would require the rejection of the established tax principle that a transaction is to be given its tax effect in accord with what actually occurred and not in accord with what might have occurred. . . ." Commissioner v. National Alfalfa Dehydrating & Milling Co., 417 U.S. 134, 148-49 (1974).

See also Bausch & Lomb Optical Co. v. Commissioner, 267 F.2d 75, 77-78 (2d Cir. 1959): "The only question for us to decide . . . is whether the necessary requirements have been truly fulfilled. It is for Congress and not for us to say whether some other alleged equivalent set of facts should receive the same tax free status." See also, Spinoza, Inc. v. United States, 375 F. Supp. 439 (D. Tex. 1974), discussed in the text accompanying notes 399-413. But see the effect of the courts' decisions in Aetna and Bercy Industries in the text accompanying notes 91-126.

Clearly, perfection is unattainable. But it is the frequent failure to embark on its quest which has resulted in so much uncertainty and inconsistency, and which has thus contributed so greatly to the erosion of the tax system's credibility.

Post-Acquisition Loss Carrybacks

Preserving the Function of Section 172

Section 172 reflects congressional recognition of the fact that business income often fluctuates widely from year to year, and that some sort of carryover provision is necessary in order to mitigate the inequities which would otherwise result from an annual accounting period definition of taxable income. n484 If one accepts the basic argument as to the equity of net operating loss provisions, it would seem patently inequitable to deny the continuing shareholders of the transferor corporation the benefit, albeit indirect, of the net operating loss carryback. n485 If the business fails [*234] before it is able to use the resulting post-acquisition loss carryforward, then the corporation would, in the final analysis, be taxed on net income which it never really had.

n484 See § 441(a); see also Burnet v. Sanford & Brooks Co., 282 U.S. 359 (1931) (which amply demonstrates the inflexibility of the annual accounting period concept in the absence of express statutory exception). The first net operating loss carryover provision, § 204(b) of the Revenue Act of 1918, was enacted in response to congressional recognition of the "grave injustice" that would inevitably result from strict adherence to the annual accounting approach to measuring taxable income. S. Rep. No. 617, 65th Cong., 3d Sess. 7 (1918).

n485 This inequity is especially apparent where there has been no change in the ownership of the transferor and transferee corporations and precisely the same persons who suffered the ultimate detriment of the tax on pretransaction income now seek the benefits of the carryback. See, for example, cases cited note 317 (where the favorable precedents established by the respective courts were statutorily reversed by TEFRA).

This arbitrary prohibition can be expected to deny carrybacks to deserving corporations just when they need them the most: to generate the cash flow necessary to get the business back on the road to recovery, or, in more extreme circumstances, to stave off financial ruin. In other areas of the tax law, Congress has recognized the desirability of accelerating refunds in circumstances where cash flow needs are great. (See, for example, § 165(i), which allows a carryback of disaster area losses to the year preceding the actual disaster as a means of providing needed funds to affected taxpayers.)
The denial of a net operating loss carryback is especially devastating where the corporation would otherwise qualify for an extended carryback period. See note 52.

In the author's opinion, the proper functioning of § 172 should not be compromised per se merely because of an intervening merger, consolidation, or other acquisition. Ideally, the objective of the post-acquisition loss carryback rules should be to permit the shareholders who suffered the economic detriment of both the pre-acquisition tax payments and a portion of the post-acquisition losses to obtain the full economic benefit of the refund generated by the carryback, while likewise denying any portion of such benefit to others. Although pragmatic constraints imposed by the current corporate income tax system may require that this ideal be compromised in one fashion or another, n486 it should nevertheless remain the standard against which competing alternatives should be tested. n487

n486 The problem, from a policy making standpoint, is that the U.S. corporate legal and tax systems do not provide a convenient mechanism for mandating the disproportionate allocation of economic benefits which inure directly to the corporation. In what would perhaps be a more perfect world, corporations and their shareholders might be taxed more like partnerships, and their partners taxed under current law. Then, the ideal resolution to the post-acquisition loss carryback problem might be automatic. Under a "pure conduit" approach to corporate taxation, the original tax burden would have been personal to the original shareholder, who, as a shareholder of the successor enterprise, is now entitled to a share of the post-acquisition losses: losses which, assuming inadequate current income, could be carried back in his separate capacity under § 172.

For an excellent discussion and analysis of the alternative approaches for integrating the personal and corporate income taxes, see McLure, Integration of the Personal and Corporate Income Taxes: The Missing Element in Recent Tax Reform Proposals, 88 Harv. L. Rev. 532 (1975).


Before identifying alternatives to the present rules governing post-acquisition loss carrybacks, one additional shortcoming of the system must be recognized.

Elimination of Artificial Distinctions Between Alternative Transactional Forms

In terms of their adherence to the functional neutrality criterion, the rules and regulations collectively governing the carryback of post-acquisition losses can be criticized on two grounds. First, although the nature and extent of required shareholder "continuity" varies substantially from one statutory manifestation to another, the ultimate impact of the transaction on shareholder continuity is preeminent in distinguishing acquisitions for tax purposes. n488 Yet, as demonstrated on several occasions throughout the preceding technical discussion of the various rules governing post-acquisition loss carrybacks, except in rare and unusual circumstances, the presence or absence of shareholder continuity makes no difference whatsoever. Consequently, on the one extreme, the pre-acquisition incomes of two corporations, owned at all times by the same shareholders in the same proportions, forever vanish when business concerns compel their statutory consolidation. Yet, at the other end of the spectrum, if A acquires T by purchasing all of T's stock for cash, resulting in a 100% change in T's ownership, the law permits A, and indirectly its shareholders, to benefit from the restoration of taxes actually borne, in the ultimate sense, by T's shareholders. n489

n488 The other dominant themes of the reorganization provisions are "business purpose" and "continuity of business enterprise."

n489 As noted previously, § 382 may prevent or limit carrybacks of built-in losses recognized in post-acquisition tax years. See the text accompanying notes 254-74.

Second, where distinctions are made as the basis for applying different rules, it is clear that such distinctions are not relied upon consistently and that they have little to do with any of the fundamental
themes forwarded to explain the acquisition rules. Indeed, an exhaustive search of legislative history has failed to produce any explicit or intuitive reasoning which might explain why, from a policy standpoint, the rules vary as they do: they seem to have been formulated without any coherent notion as to why they might be necessary in the first place.

For example, tax consequences aside, it usually makes absolutely no legal or economic difference which of the two or more corporations in a statutory merger is selected as the surviving corporation. Nevertheless, as the law presently stands, if the corporate entity chosen to be the transferor corporation happens to be the one with the substantial pre-acquisition taxable income, then, in the event of substantial post-acquisition losses, the surviving corporation, and indirectly all of its shareholders -- even the late transferor corporation's continuing shareholders -- will be denied access to the refund potential that the prior taxable recognition of such income would have otherwise made possible. n490 If the parties instead choose the legal and economic equivalent of statutory consolidation, then none of the pretransaction taxable income of any of the transferor corporations will be available to generate a refund from a post-transaction net operating loss carryback. n491 Further, if the corporations were commonly owned and the objective of the transaction was simply to [*236] report the incomes, gains, losses, deductions, and credits of the two corporations on a single tax return, this could have been accomplished taxfree by simply transferring the stock of the corporations to a newly organized holding company and filing a consolidated return. This alternative to a merger or consolidation would not, however, preclude the carryback of the corporations' respective post-acquisition losses to their own pre-acquisition tax returns. n492

n490 See Example 1, in the text accompanying notes 71-3, and Example 2, in the text accompanying notes 74-5.

n491 See Example 3, in the text following note 75.

n492 Such carrybacks would, however, be subject to the SRY and/or SRLY rules set forth in the consolidated return regulations. See discussion in the text accompanying notes 144-228.

A similarly unexplained and counter-intuitive lack of symmetry exists with respect to the requirement that losses, where they may otherwise be carried back, must sometimes, but not always, be traced to the income of the corporation that produced them. Recognizing the substantial support that exists for each of the opposing arguments as to the propriety of a Stauffer/Libson Shops/SRY-type tracing rule, it is by no means apparent that the rule is any more or less meritorious in the context of a stock acquisition that it is in an asset acquisition. n493

n493 See, e.g., B. Bittker & J. Eustice, note 65, at 15-75, where the authors state: "This lack of parallelism between stock acquisitions (followed by the filing of consolidated returns) on the one hand, and asset acquisitions on the other, is difficult to justify as a policy matter, other than the technical reason that the subsidiary is still a separate entity rather than a mere division."

Interestingly, the same committee reports that repudiated Libson Shops expressly approved the continued application of the SRLY limitations. S. Rep. No. 313, 99th Cong. 2d Sess., reprinted in 1986-3 C.B. (vol. 3) at 247.

Framework For Statutory Reform

In my opinion, the objective of the post-acquisition loss carryback rules should be to permit the shareholders who suffered the economic detriment of both the pre-acquisition tax payments and a portion of the post-acquisition losses to obtain the full economic benefit of the refund generated by the carryback, while simultaneously denying any portion of that benefit to the other shareholders. Whatever compromises must be made in the pursuit of this ideal, it is submitted that two factors must be eliminated from consideration in that neither furthers nor retards its attainment. First, the present distinctions between stock acquisitions and asset acquisitions should be eliminated. There is nothing inherent in an asset acquisition that endows it with a potential for the realization of the above-designated objective that is any greater or lesser than the corresponding potential inherent in a stock acquisition. In either event, the two theretofore
unrelated corporations end up under the common control of the same ultimate group of shareholders. And in either event, the U.S. corporate tax system prevents T's continuing shareholders from the direct participation in the corporation's post-acquisition losses, just as it [*237] prevents them from directly participating in any refund the carryback of such losses might produce.

Similarly, in the absence of compelling administrative considerations dictating a contrary result, no distinction should be made between a corporation which conducts several businesses as divisions within a single corporate shell, and one that carries on the same activities through the use of operating subsidiaries. The two should be viewed as economic equivalents of one another. Neither the public policy supporting § 172, nor any of the alternative rationales suggested earlier as providing the basis for the reorganization statues is better served in the presence of such a distinction than in its absence. More specifically, if a Stauffer/Libson Shops/SRY-type tracing rule or the reverse acquisition rule of the consolidated return regulations are determined to be appropriate for one, then they are thus equally appropriate for the other. And vice versa.

Having identified the ideal, the impediments to its attainment, and extrinsic transactional attributes, there remains a broad range of possible solutions. The extent of the continued participation of T's shareholders in A should obviously play the dominant role. Since, as already noted, the U.S. corporate legal and income tax systems create substantial impediments to the special allocation of corporate tax benefits and detriments among shareholders, n494 the choice is between different levels of abstraction. One approach would be to eliminate, as of the transaction date, a portion of T's pre-acquisition refund potential and to do so as an inverse function of (1) the percentage of T's equity that was converted into the equity of A, (2) the percentage of A's outstanding equity that the shareholders of T end up owning after the acquisition, n495 or (3) some combination of both. Alternatively, if the "continuity of interest" on the part of T's shareholders is sufficient to cause the acquisition to be taxfree, there is considerable appeal to leaving its refund potential intact, and to eliminating it entirely if the transaction is fully taxable. Under any of these approaches, some sort of Stauffer/Libson Shops/SRY-type tracing rule n496 might be desirable to preclude the possibility of a windfall tax benefit to the successor corporation.

n494 See note 486.

n495 Although the thresholds and the impact of exceeding the thresholds differed substantially, this was the basic approach taken by § 382(a) (stock purchases, see note 123) and § 382(b) (nontaxable asset acquisitions, see note 124), prior to their revision in 1986, insofar as determining the percentage of the loss corporation's favorable tax attributes that would be forever eliminated as a result of the acquisition.

n496 Where the businesses of the amalgamating corporations are integrated to the point that it is not possible to specifically identify the post-acquisition loss with the respective pre-acquisition business that sustained it, an allocation formula (based on either relative value or relative basis) could be employed to achieve essentially the same result.

Another approach would be to leave the refund potential of T's pre-acquisition taxable income intact, but to instead limit the portion of the [*238] successor corporation's post-acquisition losses that can be carried back to trigger this refund to the percentage of the successor corporation's outstanding stock held by T's continuing shareholders. In this event, a tracing limitation, which might be appropriate elsewhere, would be more difficult to justify.

Whatever form the default rules might take, consideration might be worth giving to the application of more permissive standards where the merger agreement provides a formula for the payment of additional consideration to the loss corporation's continuing shareholders in the event that post-acquisition losses can be used with tax benefit against the target corporation's pre-acquisition taxable income. n497 A contingent purchase/sale price agreement could thus achieve the otherwise unattainable: the allocation of the economic benefit resulting from the loss carryback to the shareholders who sustained the original detriment of the refunded taxes.

n497 The importance of such an agreement under current law is identified in the text preceding note 56.
Administrative Considerations

Prevention of Unintended Tax Avoidance

Many provisions of the federal income tax statutes have been inspired by the need to protect the laws from unintended abuses. Frequently, the concern for the adequacy of antitax avoidance safeguards overrides equity or economic considerations. n498

n498 See, e.g., United States v. Lewis, 340 U.S. 590 (1951), and Burnet v. Sanford & Brooks Co., 282 U.S. 359 (1931), in which the Supreme Court sacrificed equity in order to preserve administrability of the income tax system.

In formulating alternatives to the current post-acquisition loss carryback limitations, it is important to keep in mind that while it may not be uncommon for profitable corporations to seek -- with less than the purest of motives -- acquisitions of corporations with substantial existing net operating loss carryforwards and/or built-in losses, the converse process -- acquiring a profitable corporation in hopes of turning it around to generate large losses -- is highly improbable.

One fact that necessarily colors loss carryback cases is that the issue is not likely to arise in a tax avoidance setting. On the contrary, the facts will typically involve taxpayers victimized by unexpected losses or poor tax planning, if losses had been anticipated, or even recognized as a possibility, it would normally be a simple matter to preserve a carryback on any post-reorganization loss. Thus, in Stauffer the carrybacks could have been preserved without any need for litigation by choosing any one of a number of different formal routes to the end result sought. But no one planning the consolidation had any inkling of the disastrous postmerger losses that were in store. n499

n499 Pugh, note 347, at 460.

Note, however, that this statement was made at a time when Libson Shops, and its application to post-acquisition loss carrybacks by the Stauffer line of decisions, prevented the "crossover" of the post-acquisition losses produced by the business of one of the amalgamating corporations from being carried back to offset the pre-acquisition income produced by the other business. Without a Stauffer/Libson Shops/SRY-type tracing rule disallowing such crossovers, it is conceivable that a corporation anticipating its own future operating losses could find the existing refund potential of a profitable prospective target corporation to be an irresistible enticement.

Simplification

Given both the degree of legal and economic complexity typically associated with the planning and consummation of corporate mergers and acquisitions, and the wide range of technical tax issues which must necessarily be addressed, it is unrealistic to expect that the tax laws governing such transactions might themselves ever be "simple." Nevertheless, in my opinion, the standards outlined above as necessary to insure equity and neutrality are not only administrable, but, given the complexity of the current rules, would actually further the cause of simplicity.

CONCLUSION

Once the decisions to acquire and dispose of a particular corporate business have been made, the actual mechanics of the transaction must be negotiated between the buyer and the seller. Except in those rare circumstances where one or two legal, economic, or tax factors overwhelm all others, no easy criterion exists for identifying the optimal method. Each of the fundamental acquisition techniques and their numerous permutations has advantages and disadvantages which will vary from one party to the next according to the facts known and projected at the time of negotiation. The strengths and weaknesses of the competing alternatives must be carefully weighed and evaluated within the context of the advisor's
assessment of both (1) the client's legal, economic, and tax objectives and preferences, and (2) the flexibility of the invariably conflicting demands of the transacting parties.

[*240] It is submitted that the necessity, or at least the desirability, of preserving the refund potential of the pre-acquisition taxable incomes of A, T, and, where applicable, their respective affiliates, is frequently overlooked in evaluating the available alternatives. n500 Further, the selling parties often fail to recognize the additional, albeit contingent, value of the refund potential of their corporation's predisposition earning history, and they consequently fail to negotiate for additional contingent cash or stock consideration that A might otherwise have been willing to pay for such value.

n500 This assertion derives not only from the author's own observations and from the numerous experiences of taxpayers whose failure to consider this factor resulted in litigation (see notes 5 and 317), but also from the fact that the articles and books which address acquisition planning almost universally fail to apprise the reader of either the existence or potential significance of this factor.

In this article, the author has identified the technical aspects of the relevant statute and regulations and has illustrated their application to representative acquisition scenarios. Several specific planning strategies and caveats have been identified, and many more have undoubtedly become apparent.

A close examination of these rules and regulations has also compelled the author to conclude that they are antithetical to the notion that functionally equivalent transactions should give rise to like tax consequences, and that, in the absence of compelling administrative considerations which might necessitate occasional departures, the functional neutrality criterion ought to serve as the touchstone for constructing and administering the taxation of mergers and acquisitions, in general, and the rules pertaining to post-acquisition loss carrybacks, in particular. In an area where the stakes are often very high, the risk of the loss of substantial tax benefits can serve to quell necessary and deserving transactions, or to bring financial hardship (or even ruin) ex post where the path chosen subsequently proves to have been the wrong one.