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WHAT CONSTITUTES A CHANGE IN BUSINESS IN THE CONTEXT OF SECTION 382(a) OF THE INTERNAL REVENUE CODE

Herbert Odell*

I. An Applicable Situation

Assume that the “Handy Glove Corporation” was engaged in making women’s gloves. In 1948, “Handy” incurred a $250,000 dollar net operating loss. In January of 1949, the outstanding stock of “Handy” was purchased by the “Alright Watch Importers,” a partnership engaged in importing and selling Swiss watches. Immediately subsequent to the purchase, all of the assets of “Handy” were sold and “Alright” transferred all of its assets to the corporate shell, so that the corporation could now engage in the business of importing and selling watches. Although “Handy” had been a failure in the glove business, it was quite successful in the sale of watches. During 1949 it had earned income of $250,000 dollars. In filing its tax return for 1949, “Handy” seeks to carry over the 1948 loss so that it will have no federal income tax liability. The Tax Court on the basis of its original interpretation of pertinent sections of the Internal Revenue Code of 1939 would have permitted the carryover.† To remedy this situation and thereby

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Alprosa Watch Corp., 11 T.C. 240 (1948) exemplifies a factual situation similar to the one presented in the text. The Tax Court held that the loss in this situation could be carried over. Although § 129 (“If (1) any person or persons acquire... directly or indirectly, control of a corporation, or (2) any corporation acquires... directly or indirectly, property of another corporation... and the principal purpose for which such acquisition was made is evasion or avoidance of Federal income or excess profits tax by securing the benefit of a deduction, credit, or other allowance which such person or corporation would not otherwise enjoy, then such deduction, credit or other allowance shall not be allowed.”) was not applicable because of its effective date, the court stated that it would not be applied in the future to similar factual situations (hereinafter referred to as an “Alprosa situation”). “That section would seem to prohibit the use of a deduction, credit, or allowance only by the acquiring person or corporation and not their use by the corporation whose control was acquired.” Alprosa Watch Corp., supra at 245. (Emphasis added.)

The Tax Court adhered to its dicta in Alprosa in a case in which the Commissioner sought to apply § 129 under an unusual factual pattern. The acquiring corporation sustained heavy net operating losses. It purchased the acquired corporation and had all of the operating assets of the acquired corporation liquidated and transferred to itself. It then sought to offset the income earned on these newly acquired assets against its net operating loss carryover. The Commissioner allocated the income earned on these assets to the acquired corporation which was still in existence, although it was only a corporate shell, and attempted to tax it on this income. One of the Commissioner’s arguments in the Tax Court was the applicability of § 129. The Tax Court held this contention invalid on the basis of the “acquired-acquiring” distinction, in that the section was only applicable to the acquiring corporation, which was not before the court. T.V.D. Co., 27 T.C. 879 (1957).
prevent "trafficking in loss corporations," as Congress enacted section 382(a) into the Internal Revenue Code of 1954.

II. SECTION 382(a)

For a "loss corporation" to fall within the confines of section 382(a) and thus lose its net operating loss carryover there must be: (1) a change of ownership; (2) by a purchase or redemption of stock; and (3) the corporation must not continue to "carry on a trade or business substan-

The Tax Court's interpretation of § 129 apparently turned on a grammatical point. Section 129 disallows a deduction, credit, or allowance when "any person . . . acquire[s] . . . control of a corporation . . . [the principal purpose of the acquisition being tax avoidance] by securing the benefit of a deduction, credit, or other allowance which such person . . . would not otherwise enjoy." (Emphasis added.) The dichotomy drawn by the Tax Court seemed to turn on the reference of the word "which." That is, if it referred to "benefit" then the Tax Court's interpretation of the section would be incorrect, but if it referred to "deduction, credit or other allowance" then the Tax Court was right.

The Tax Court subsequently reversed itself on this interpretation of § 129 (Thom- as E. Snyder Sons Co., 34 T.C. 400 (1960), aff'd, 288 F.2d 36 (7th Cir. 1961)) after being overruled several times by the courts of appeals, James Realty Co. v. United States, 280 F.2d 394 (8th Cir. 1960); Commissioner v. British Motor Car Distributors, Ltd., 278 F.2d 392 (9th Cir. 1960); Mill Ridge Coal Co. v. Patterson, 264 F.2d 713 (5th Cir. 1959). The Tax Court adopted the Commissioner's rationale that "so long as the enjoyment of the benefit is in the acquiring person, it does not matter whether the actual deduction which produces the benefit is claimed by the acquiring person or the acquired corporation." Thomas E. Snyder Sons Co., supra at 405.

2. See Comment, 69 Yale L.J. 1201 n.l (1960), which gives some indication as to how "loss corporations" were advertised for sale in leading financial papers.


3. "This special limitation on net operating loss carryovers [§ 382] provides an objective standard governing the availability of a major tax benefit which has been abused through trafficking in corporations with operating loss carryovers, the tax benefits of which are exploited by persons other than those who incurred the loss." H.R. REP. No. 1337, 83d Cong., 2d Sess. 42 (1954).

Professor Bittker indicates that § 382(a) was passed because § 129 (now INT. REV. CODE OF 1954, § 269) was ineffective against trafficking in loss corporations due to the requirement of the section that the government had to prove that tax avoidance was the principal or primary purpose of a transaction before § 129 became applicable. Bittker, Federal Income Taxation of Corporations and Shareholders § 2.42 (student ed. 1959).

4. A "loss corporation" as used throughout this paper is one that is entitled to a loss carryover or carryback under § 172 of the Internal Revenue Code of 1954. At least one article has indicated that § 382(a) might not be applicable to a merger of a "loss corporation" into the profitable corporation that acquired it. Relying on the wording of the section itself, the theory is espoused that the limitation of the section is only applicable when the "loss corporation" is the one trying to offset the carryover against the income of a newly acquired business. Comment, 69 Yale L.J. 1201, 1278 n.372 (1960). Thus, when the carryover is permitted to cross corporate lines under § 381 of the Internal Revenue Code of 1954, the limitation, on the basis of this theory, will not be applicable.

5. Section 382(a)(1)(A).

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This article will be limited to what constitutes a change in business in the context of the proposed regulations relating to this subject matter. However, the other two requirements of section 382(a) will be discussed briefly.

The change in ownership required in section 382(a) is a 50 percentage “point” increase in total fair market value of stock owned by the ten largest stockholders at the end of the taxable year, determined by a comparison between what they owned at the beginning of the immediate taxable year or the beginning of the preceding taxable year with what they own at the end of the present taxable year. Thus, the required 50 “point” increase may occur over a two-year period. It should be noted that in determining the ten largest shareholders the attribution rules of section 382(a) are applicable.

Secondly, there must be a “purchase” or redemption of stock which is the basis of the change in ownership. Generally, for there to be a “purchase” the stock must have been acquired in a sale or a taxable exchange. The corporation may also redeem the stock of the shareholders, disproportionately, so that there is an increase in the percentage of stock owned by the ten largest shareholders. If X corporation has two shareholders, A and B, who each own 50 per cent of the outstanding stock of X, and the corporation redeems all of A’s shares, B has had a 50 percentage point increase in the amount of shares he now owns within the terms of section 382(a).

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7. Section 382(a)(1)(C).
9. A 50 percentage point increase is not the same as a 50% increase. If a stockholder owns 10% of the fair market value of the stock on January 1, 1959, and 20% of the fair market value of the stock on December 31, 1960, his percentage point increase is 10, while he has a 100% increase. Thus, in order to meet the change in ownership requirement, 50% of the proper stock must change ownership through the ten largest stockholders within a two year period. See Proposed Treas. Reg. § 1.382(a)-1(d)(1), 25 Fed. Reg. 13776 (1960).
10. “Stock” means all shares except nonvoting stock which is limited and preferred as to dividends.” Section 382(c).
12. Section 382(a)(3) provides for the application of the attribution rules of § 318 (Int. Rev. Code of 1954), “except that section 318(a)(2)(C) shall be applied without regard to the 50 percent limitation contained therein.”
The third requirement of section 382(a) is that there must be a continuation of substantially the same trade or business as was conducted prior to the change in ownership.16 This requisite will be considered and analyzed in detail in the following sections of this article.

For the limitation of section 382(a) to be applicable, all three of the aforementioned requirements must have occurred. If there is this confluence, the net operating loss carryover of the "loss corporation" will be eliminated in its entirety.17 Apparently, Congress was not concerned with the carryback of a loss as no provision was made for its limitation. It should be noted that section 269,18 which disallows the benefit of a deduction, credit or other allowance if a person or persons19 acquire control20 of a corporation for the principal purpose of evasion or avoidance of federal income tax, may be applicable to a situation which would normally fall within 382(a), but which has failed to meet one of its requisites. Congress has indicated that section 269 is not applicable when section 382 would apply, but the fact that 382(a) does not limit the net operating loss carryover does not affect the adhibition of section 269.21 Thus, in addition to the requirements of section 382(a), section 269 should always be considered. To avoid the disallowance of a net operating loss carryover in a situation similar to the one presented in section I, there must be a business purpose for the transaction,22 for if the ban of section 382(a) is not applicable, the alternative ban of section 269 might be.23 In these transactions section 269 is ubiquitous.24

16. Section 382(a)(1)(C).
17. "If, at the end of a taxable year of a corporation... [the three requirements are met] the net operating loss carryovers, if any, from prior taxable years of such corporation... shall not be included in the net operating loss deduction for such taxable year and subsequent taxable years." INTERNS. REV. CODE OF 1954, § 382(a). See generally, 3 RIA Fed. Tax Coord. ¶ M 7105.
18. INTERNS. REV. CODE OF 1954. [All references to § 269 hereinafter refer to the Internal Revenue Code of 1954.]
20. Control means ownership of sufficient stock to have 50% of the total voting power or at least 50% of the total value of shares of all classes of stock. Section 269(a).
21. "If a limitation in this section [382] applies to a net operating loss carry-over, section 269, relating to acquisitions made to evade or avoid income tax, shall not also be applied to such net operating loss carry-over. However, the fact that a limitation under this section does not apply shall have no effect upon whether section 269 applies." S. REP. NO. 1622, 83d Cong., 2d Sess. 284 (1954).
22. "In light of the current developments, it would now appear that the loss carryover in corporate acquisitions will be barred unless a business purpose other than tax avoidance can be proven." Golding, Recent Developments in Tax Loss Corporate Acquisitions, 39 Taxes 323 (1961). For a recent case, see Urban Redevelopment Corp., 34 T.C. 845 (1960), which dealt with the applicability of §§ 129 and 269, and the requirement of a business purpose in the acquisition of a "loss corporation."
23. See note 1 supra in relation to the Tax Court's new interpretation of the applicability of § 269 in an "Alprosa situation."
24. See note 21 supra. It should be noted that § 269, which was formerly § 129 of the 1939 Code, was strengthened when Congress enacted subsection (c) into its provisions in the 1954 Code. This subsection creates a presumption of a tax avoidance purpose when the price paid upon an acquisition is substantially disproportionate to the sum of the adjusted
III. The Development of a Doctrine

Before considering the proposed regulations relating to a change in business under section 382(a), the development of judicial and Internal Revenue Service doctrine pertinent to these regulations will be considered.

Section 172 of the Internal Revenue Code of 1954 provides for a three year carryback and a five year carryforward of a net operating loss. Section 381 of the Code provides for the succession of the loss carryover to a corporation that acquires a "loss corporation's" assets under certain tax free reorganizations and liquidations. Prior to the adoption of this section in the 1954 Code, there was no specific provision for the retention of this tax attribute. Thus, in cases in which the corporate entity that suffered the net operating loss changed its legal form, or the loss was being offset against a business completely different from the one that sustained it, whose ownership had changed, the question of whether the carryover would be allowed turned on doctrinal rather than statutory considerations. In essence, a common-law theory developed concerning the meaning of the term "the taxpayer" as used in the early provisions relating to net operating loss carryover. For example: section 122(b) of the 1939 Internal Revenue Code provided that "if for any taxable year . . . the taxpayer has a net operating loss, such . . ."
net operating loss shall be a net operating loss carryover for each of the
two succeeding taxable years.” In drafting the 1954 loss carryover provision,
the use of the term “the taxpayer” was carefully avoided.

The first theory that developed judicially as to the allowance of a
loss carryover when the corporation that sustained the loss changed its
form was the “entity” theory. In New Colonial Ice Co. v. Helvering the
Supreme Court disallowed a loss carryover when the assets of the “loss
corporation” were transferred to a newly organized corporation in exchange
for stock. The shareholders of the transferee corporation were substantially
the same as the shareholders of the transferor. The business of the
transferor was continued by the transferee. The transaction was motivated
by a business purpose and was not carried on as a tax avoidance scheme.
Thus, there was a continuity of ownership and business, without tax avoid-
cance motivation, but the Court refused to allow the transferee to apply
the loss against the income subsequently earned by it. There was, there-
fore, an adherence to a stringent formulary entity approach. If the corporate
entity seeking to deduct the loss carryover was not the same entity that had
sustained it, even though there was a continuity of business and ownership,
“the taxpayer” was not the same “taxpayer” which had sustained the loss.

Subsequent to the decision in New Colonial, the courts of appeals
began carving exceptions into the rule. The first basic chip fell when a
carryover was permitted to cross corporate lines when there was a statutory
merger of a parent corporation with its subsidiary. The indentation

32. Section 172(b) of the Internal Revenue Code of 1954 provides: “A net operating
loss for any taxable year . . . shall be . . . a net operating loss carryover to each of the 5
taxable years following the taxable year of such loss.”
34. The transferor corporation had started off poorly and suffered losses. It decided
to reorganize and set itself up on a stronger financial foundation. The transferee corporation
made plans to obtain new financing and made agreements with prior creditors to extend the
due date of existing debts.
35. “[T]he statutes have disclosed a general purpose to confine allowable losses to
the taxpayer sustaining them, i.e., to treat them as personal to him and not transferable to
36. Stanton Brewery, Inc. v. Commissioner, 176 F.2d 573 (2d Cir. 1949). Although
this involved the carryover of an excess profits credit, the result is also applicable to the
carryover of a net operating loss as the terms of the excess profits carryover provision are
couched in the language of “the taxpayer,” raising the same issue as is presented under
questions involving net operating loss carryovers.
became greater when the Ninth Circuit allowed a carryover after a statutory merger between two independent corporations. Later, in Newmarket Mfg. Co. v. United States, the First Circuit was faced with a statutory merger of a parent corporation and its subsidiary. Although the court could have permitted the carryback of the loss across corporate lines on the basis of the merger of the parent into the subsidiary by the “operation of law” merger, it chose to go further. It reasoned that the same business that sustained the loss had had prior profitable years and even though its form had changed, in substance it was the same “taxpayer” which had suffered the loss which was attempting to carry it back against profitable years. If this result could not be achieved, then the purpose of the loss carryback and carryover provisions would be subverted. This reasoning was the foundation for the largest chip in the New Colonial approach.

In F. C. Donovan, Inc. v. United States the First Circuit allowed the carryback of a loss across corporate lines when a subsidiary had merged into its parent, although the merger was not a statutory one (by operation of law). The merger was effectuated by an exchange of the assets of the subsidiary subject to its liabilities, for stock of the subsidiary held by the parent. The subsidiary was then dissolved by a cancellation of the stock it received. The operations of the subsidiary subsequent to the merger produced a loss, and the parent which survived the merger sought to carry back the loss to the income earned prior to the merger. The subsidiary had sufficient income during the years to which the loss was sought to be carried back to offset this loss. The court allowed the carryback rationalizing that had the two corporations not merged, the loss carryback would have been

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The court reasoned that since the merger was by statute, its effect was “by operation of law” and therefore it was not a voluntary transfer as had occurred in New Colonial. For a later case concerning a similar question, except that a carryback was involved and the post-merger corporations had filed consolidated returns prior to the merger, see Koppers Co. v. United States, 134 F. Supp. 290 (Ct. Cl. 1955).

37. E. & J. Gallo Winery v. Commissioner, 227 F.2d 699 (9th Cir. 1955). This case also concerned the carryover of an excess profits credit. However, the doctrine is also applicable to net operating loss carryovers. See note 36 supra.

38. 233 F.2d 493 (1st Cir. 1956).

39. For the purposes of this section carrybacks and carryovers will be considered synonymously in the development of the theory underlying their allowance across corporate lines.

40. The taxpayer in this case presented a favorable factual situation. The transferor corporation had incorporated in one state; subsequently it decided that it would rather be incorporated in another state. It organized a subsidiary in the second state. The transferor then merged, by statute, into the corporation newly organized in the second state. The corporation that survived the merger was substantially equivalent to the transferor corporation that had earned the income in prior years. The surviving corporation and the constituent corporation had these facts in common: (1) the same par value stock; (2) the same number of shares outstanding; (3) the shares were owned by the same parties; (4) the corporations had the same corporate officers; and (5) the same business was conducted by the corporations. Therefore, the court did not find it difficult to declare that the same "taxpayer" was seeking to carry back the loss which had in the past earned the income.


42. Supra note 41, noted in 12 Vand. L. Rev. 1411 (1959).
available to the subsidiary and there was no reason to deny it this privilege because of the tax free reorganization.43 The most compelling reason for allowing the tax attribute of the loss carryback to survive the merger, however, was the continuity of business and ownership of the corporation that had suffered the loss and that had earned the income in prior years.44 Thus, the requirement of a statutory merger as a necessity for the effectuation of a succession to a loss carryover across corporate lines apparently is no longer imposed.

A. Libson Shops

Prior to the adjudication of the Donovan case, the Supreme Court decided Libson Shops, Inc. v. Koehler.45 In this decision the Court departed from the New Colonial entity approach, and disallowed the carryover of a loss after a statutory merger of sixteen operating corporations into a management corporation, all seventeen corporations being owned by substantially the same individuals. Three of the sixteen corporations had suffered net operating losses prior to the merger. After the merger the surviving management corporation sought to carry over the net operating losses against post-merger income. However, the three businesses that had sustained the pre-merger losses were still operating at a deficit. Thus, their losses were sought to be offset against the income of the other businesses. Although the government argued New Colonial, the Court chose to ignore it without overruling it and disallowed the loss on another theory. The taxpayer "is not entitled to a carry-over since the income against which the offset is claimed was not produced by substantially the same businesses which incurred the losses."46 This was an adoption by the Court of the

43. "If we should hold, in the present case, that the effectuation of such a reorganization has resulted in cutting a carry-back privilege which otherwise existed, we would be defeating the essential purposes of the Congress in enacting the provisions for tax-free reorganizations." F. C. Donovan, Inc. v. United States, 261 F.2d 470, 476 (1st Cir. 1958).

44. In this case the subsidiary was wholly owned by the parent. Thus, when the subsidiary merged with the parent, the same stockholders owned the business. The business of the subsidiary was continued after the merger.

45. 353 U.S. 382 (1957).

46. Id. at 390. It should be noted that in this case a consolidated return was not filed prior to the merger. Thus, if there had not been a merger, there would have been no possibility, at least at the time, of using the loss carryover.
government's alternative argument that there must be a continuity of business enterprise for a loss carryover to survive a statutory merger.

The constitution of "continuity of business" is not clear. There appear to be three elements that comprise a continuity of business: (1) corporate entity; (2) assets; and (3) ownership. Libson denied the loss carryover when the entity and assets sustaining the loss were different from the entity and assets to which the loss was to be carried. In the context of these three elements it would appear that the Court relied most heavily on the change in assets and therefore by implication indicated that at least when there is no applicable statutory provision, the most important factor in the determination of whether the carryover will be allowed across corporate lines is the asset requirement.

The Court held that although § 129 was not applicable, this did not per se give rise to the allowance of the carryover. Thus, the Court disallowed the carryover without the benefit of § 129 and without the use of the New Colonial approach, thereby necessitating a new approach to the loss carryover problem.

Libson itself has been subject to various interpretations. See Comment, 69 Yale L.J. 1201, 1216 (1960). In fact, it may be argued that the continuity of business requirement as used in Libson is no more than a modified entity approach. For example: X corporation is a wholly owned subsidiary of Y corporation engaged in the business of making shoes. X merges into Y. X keeps its separate identity although it is no longer in existence (keeps separate books, its assets are separated, etc.). All of X's assets are then sold, and with the funds equipment is purchased, putting it in the business of making belts. X, prior to the merger, had suffered net operating losses and after the merger it has earned enough income in the belt business to offset the losses. On the basis of the Libson rationale it is arguable that there is a continuity of business because X and its profits and losses are still identifiable although it no longer exists. This is a modified entity theory—no longer as stringent as New Colonial, but in essence based on the corporate entity without being concerned with the legal entity. Apparently the Internal Revenue Service has not adopted this view. See Rev. Rul. 59-395, 1959-2 Cum. Bull. 475. See also text accompanying notes 64-65 infra.


In Libson, ownership remained the same after the merger as it was prior to the merger. However, since the businesses (which are an aggregate of assets) that suffered the pre-merger losses were still sustaining losses subsequent to the merger, the carryover if allowed could only have been offset against the income of the other businesses (aggregate of assets). Thus, the taxpayer sought to offset losses from one aggregate of assets against income from an entirely different aggregate of assets. This coupled with the fact that the pre-merger legal entity that suffered the loss was different from the post-merger legal entity that sought to use it, was a sufficient change of continuity of business for the disallowance of the loss carryover. The Court, however, said that it was reserving the question as to whether a change in assets and ownership, an "Alprosa situation," (see note 1 supra) would be a sufficient basis to disallow the carryover. Libson Shops, Inc. v. Koehler, 353 U.S. 382, 390 n.9 (1957).

Under § 382(a), the loss is disallowed when there is a change in ownership and a change in business (see part II of text) and it is submitted that according to the proposed regulations under § 382(a), a change in assets constitutes a change in business (see part IV(B) of the text). Thus, it would appear that if Libson is applicable to cases arising under the 1954 Code, a loss carryover will be disallowed when there is either: (1) a change in assets and entity (Libson); or (2) a change in assets and ownership (§ 382(a)).


50. See note 49 supra. Apparently the Court was of the opinion that the point it was raising in the Libson case as to the requirement of a continuity of business was similar to the requirement of § 382(a) as to the necessity of a continuation of substantially the same trade or business. Libson Shops v. Koehler, 353 U.S. 382, 388 n.7 (1957). The Internal Revenue Service felt that the requirement of Libson as to a continuity of business (in relation to its interpretation of this requirement) was similar to the requirement of a continuation of substantially the same trade or business found in § 382(a). The Service
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The Service has ruled\(^5\) that it will not apply Libson to transactions coming within section 381(a).\(^6\) However, section 382(b)\(^7\) may eliminate the carryover on a pro rata basis or in its entirety,\(^8\) and section 269 is always available when there is a corporate acquisition for tax avoidance purposes.

B. Revenue Ruling 59-395\(^9\)

The Internal Revenue Service promulgated its interpretation of Libson in a 1959 ruling.\(^10\) Although the ruling specifically stated that it was only applicable to the treatment of tax attributes under the 1939 Code after a statutory merger or consolidation,\(^11\) it will be considered in this article for the theory that it established, in its limited context, as to when a loss carryover will be permitted to cross corporate lines.

Basically the ruling provides that:

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\text{in the absence of any evasion or avoidance of tax, premerger or preconsolidation net operating losses and unused excess profits credits of an absorbed constituent may be carried over to the resultant corporation to the extent that such losses and unused excess profits credits offset income of the resultant corporation attributable to assets acquired by it from the absorbed constituent...}
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Thus, the Service interprets Libson as holding the asset requirement of continuity of business to be the most compelling reason for allowing the carryover of a tax attribute across corporate lines.\(^12\)

apparently adopted its interpretation of Libson as promulgated in Rev. Rul. 59-395, in designing the regulations relating to what constitutes a change in business under § 382(a) (see part IV(B) in the text infra).

52. See note 51 supra.
54. INT. REV. CODE OF 1954: “In the case of the acquisition of assets of a corporation by another corporation... in a distribution to such other corporation to which section 332... applies... or... in a transfer to which section 361... applies, but only if the transfer is in connection with a reorganization described in subparagraph (A), (C), (D)... or (F) of section 368(a)(1), the acquiring corporation shall succeed to and take into account... [certain tax attributes itemized in subparagraph (c)].”
55. INT. REV. CODE OF 1954.
56. The subsection (§ 382(b)) provides for a pro rata elimination of the loss, the proration being dependent upon the continuity of ownership between the “loss corporation” and the corporation which has swallowed it.
57. 1959-2 CUM. BULL. 475.
58. Ibid.
59. Thus, the Service left itself open to argue New Colonial in a case in which there was a change in entity, but no change in assets or ownership and the fusion of the two corporations involved was not by statute. This argument failed in the Donovan case, however, which was decided after Libson. Thus, at least one circuit (the First) has indicated that Libson did away with the entity approach.
61. See Reese, Reorganization Transfers and Survival of Tax Attributes, 16 TAX L. REV. 207, 220 (1961), who indicates that the vagueness of the Supreme Court’s decision in the Libson case leaves this interpretation subject to litigation. See note 47 supra.
For there to be continuity of business according to Rev. Rul. 59-395, the aggregate of assets that make up a business prior to a fusion and that have sustained prefusion losses must remain intact postfusion, and earn income so that the losses can be carried over against this income. Thus, the ruling allows losses of an aggregate of assets to be offset against income of the same aggregate of assets notwithstanding a change in the legal identity of the business association to which the assets belong. This theory is based upon the congressional intent that predicated the enactment of the loss carryover and carryback provision into the Code. "Congress primarily was concerned with the fluctuating income of a single business." If this reasoning is held to permeate the Libson decision, then it changes the use of the asset test or at least extends it further than was probably anticipated.

Thus, in determining whether a loss carryover would be allowed to cross corporate lines, the above stated reasoning of the Libson Court might be considered the test per se. (This will be referred to as the "but for" test.) For example: X corporation has a wholly owned subsidiary, Y corporation. Y has sustained net operating losses and is entitled to a carryover. Y merges into X by means of a statutory merger. Assume that X keeps Y's identity separate (separate books, etc.). X takes Y's assets and purchases new assets with them, putting Y in a completely different business. The new business earns income and X seeks to carry over the losses against this income. If the asset test is adhered to there would be a question of tracing. Does the asset test as promulgated in Rev. Rul. 59-395 allow or permit tracing? If it does not, there would be no continuity of business and thus the carryover would not be allowed. However, if the "but for" test of Libson is adopted — Would the tax attribute have been available for use had there been no merger? — then the carryover would have been allowed. If tracing is permitted in determining whether the postfusion assets earning the income are the same as the prefusion assets that sustained the loss, then the two tests (the asset and "but for" tests) would be substantially the same. The nomenclature would make little difference. It should also be noted that the "but for" test may be argued by the taxpayer to force the allowance of tracing under the asset test.

62. The ruling placed the burden on the taxpayer to show how much of the carryover should be allowed by showing which prefusion assets produced the loss and how much postfusion income they produced to be offset against the loss. It would thus appear that the taxpayer has to maintain the separate identities of the businesses in order to sustain his burden, even though he is operating them as one.


65. It may be contended that if there had been no merger the loss carryover would
IV. WHAT CONSTITUTES A CHANGE OF BUSINESS IN THE CONTEXT OF THE PROPOSED REGULATIONS

The structure of this article is to provide a background in which the proposed regulations\(^6\) relating to a change in business under section 382(a) may be discussed. It is hoped that some rationale will be provided for the various specifications in these proposed regulations as to what does or does not constitute a change in business. It should be noted at the outset, as a caveat to the reader, that the Internal Revenue Service might not have been prompted by a demand for logical analysis in promulgating these proposed regulations.

However, it appears that the Internal Revenue Service has adopted its interpretation of the continuity of business requirement\(^7\) enunciated by Libson as the basis for the determination of a change in business under section 382(a).\(^8\) Throughout the proposed regulations, the concept of the asset test as defined in Rev. Rul. 59-395 permeates the provisions.\(^9\) Thus, the proposed regulations are a further definitive of the Service’s interpretation of Libson.

A. The Time Aspect

The first question to be considered is: At what times does a change in business have to occur for it to fall within section 382(a)? The requisite in the Code, according to its terms, is met if the “loss corporation” does not continue to carry on a business substantially the same as that conducted

have been available. If the original subsidiary had changed its business by using its assets to purchase new assets and thus had gone into a new business, an attempt to carry its losses over to income of subsequent years would have been permitted. Why should it be prevented from doing so merely because it merged with its parent? However, the counter argument to this is that the Court in Libson specifically stated that it was not ruling on a question where assets and ownership changed (an “Alprosa situation”). Thus, a fortiori, it was not ruling when assets alone changed. That is, that the loss could be carried over when the same corporate entity with the same corporate ownership changed its business by purchasing new assets. It would seem that if Libson was extended to cover this type of situation, tracing would not be allowed and the “but for” argument would fail. The rationale would be that even if there had been no merger, the loss carryover would be disallowed. However, see Reese, Reorganization Transfers and Survival of Tax Attributes, 16 Tax L. Rev. 207, 220 n.59 (1961): “Presumably neither a change in assets nor ownership alone would affect a loss carryover.”

66. Proposed Treas. Reg. § 1.382(a)-1(h), 25 Fed. Reg. 13775, 13778 (1960). [All citations to these regulations hereinafter will be referred to only by the designation: Proposed Treas. Reg. § (h)(1) or § (h)(2) etc.]
67. See part III(B) of the text supra.
68. Since the meaning of Libson is still vague, some writers think this adoption of it in the proposed regulations will lead to litigation. See Teschner, Proposed 382 Regulations Take Some Doubtful Positions on Loss Carryovers, 14 J. Taxation 130, 133 (1961): Reese, Reorganization Transfers and Survival of Tax Attributes, 16 Tax L. Rev. 207, 220 (1961). Both of these writers have implied that Libson has been adopted in the promulgation of the proposed regulations. “The phrase ‘substantially the same business’ [used in the Libson decision] has been construed to mean the physical assets, similarly as the sense in which the phrase ‘a trade or business’ is used in section 382(a).” Reese, supra.
69. See part III(B) of the text supra.
before any change in the percentage ownership.” The proposed regulations go on to delimit this further by providing that section 382(a) is applicable if the “loss corporation” has not continued to carry on a trade or business substantially the same as that carried on prior to the earliest increase in stock ownership taken into account in determining a change in ownership.70 The regulations adopt a first-in, first-out theory when there has been more than a 50 “point” increase during a two year period. Thus, if A, B, C, and D all purchase stock of the X “loss corporation,” A making his purchase on June 30, 1957 and B, C, and D making their purchases at different times subsequent to A’s purchase, but during the same year, the X corporation must continue to carry on substantially the same business as was conducted immediately prior to June 30, 1957, for it to avoid the limitation of section 382(a). This is true even though A had purchased 10 per cent of the stock; B had purchased 10 per cent; and C and D had each purchased 20 per cent. The earliest 50 “point” change during the two year period is the one taken into account.

The proposed regulations fail to determine what business before the change in ownership must be used as the basis for comparison with the post-change-in-ownership business, i.e., how immediate to the change in ownership must the business be that must be substantially continued after the change?72

They do provide, however, that “a change in trade or business of a corporation made in contemplation of a change in stock ownership will be

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70. Proposed Treas. Reg. § (h)(1). This creates some ambiguity. For example assume the following:

<table>
<thead>
<tr>
<th>Purchase of Stock</th>
<th>Date</th>
</tr>
</thead>
<tbody>
<tr>
<td>A 20%</td>
<td>6/57</td>
</tr>
<tr>
<td>B 20%</td>
<td>6/58</td>
</tr>
<tr>
<td>C 10%</td>
<td>9/58</td>
</tr>
<tr>
<td>D 20%</td>
<td>7/59</td>
</tr>
</tbody>
</table>

It would seem that in this instance the government has the option of determining which changes in ownership are to be taken into account, i.e., A, B, C, or B, C, D. If the change in business occurs between 6/57 and 6/58, the most advantageous changes to take into account would be A, B, C. This would meet the requisite of § 382(a)(1)(C), as the change in business would have occurred after the earliest change in ownership taken into account. Suppose, however, that B, C, D had planned to purchase the corporation to benefit from the loss carryover, but that A was an innocent purchaser who happened to buy the stock on the open market without even considering the loss carryover. Will this affect the determination as to which changes will be taken into account? If § 382(a) is to be mechanical in its application, should this subjective element be considered? One might argue a first-in, first-out theory on the basis of the regulation that has adopted this approach. See text at note 71 infra. Of course, if a tax avoidance motive can be shown as the basis of the acquisition, § 269 may be applicable.

71. See note 9 supra.

72. Professor Bittker believes that § 382(a)(1)(C) is only applicable to a business carried on immediately prior to the change in ownership. Bittker, Federal Income Taxation of Corporations and Shareholders § 2.42, at 62 n.47 (student ed. 1959). The proposed regulations by implication give impetus to this conclusion. Proposed Treas. Reg. § (h)(1) states: “Section 382(a) is applicable if the corporation has not continued to carry on a trade or business substantially the same as that conducted immediately before [the date of the earliest purchase taken into account]...” (Emphasis added.)
treated as if such change in trade or business had occurred after such change in stock ownership."78 This is when the pre-change-in-ownership change in business is made pursuant to a plan. This is an adoption of the rationale of the Supreme Court in Commissioner v. Court Holding Co.74

The proposed regulations also fail to answer the question as to how soon after the change in ownership, the change in business must occur. It would appear by relating all the provisions of section 382(a) that the change may occur at any time within the two year period in which the change in ownership occurs.75 If the change in business is after the two-year period, then the limitation of the section will probably not be applicable.78

B. The Measure of a Change in Business

The holding of stock, securities or similar property and their sale or purchase does not constitute a trade or business unless the activities historically have constituted the primary activities of the firm.77 Thus, the proposed regulations have taken investments out of the trade or business classification of section 382(a) unless the firm was engaged in the investment business.

The general factors to consider in determining whether the corporation has continued substantially the same trade or business are: (1) changes in corporate employees, plant, equipment, product, location and customers; and (2) other items significant in determining whether there is a conti-

74. 324 U.S. 331 (1944). This is actually an application of the Court Holding Co. doctrine analogically. In this case the Supreme Court attributed the sale of an asset to a corporation even though the sale had been completed after the shareholders had received the asset as a liquidating dividend. The Court related the time of the sale back, whereas the regulations relate the time of the change in business forward.
75. Section 382(a)(1)(C) "does not contain a time limit. In conjunction with § 382(a)(1)(A) and (B), however, it seems to mean that if all the stock of a calendar year corporation changes hands on Jan. 1, 1958, the carryover will be entirely lost if the old business is abandoned during 1958, that it will be lost for 1959 and later years if the business is abandoned during 1959, and that it will not be affected (at least not by § 381(a) [sic]) if the business is continued until 1960." BITTKER, op. cit. supra note 72.
76. Ibid.
77. The determination of what constitutes "primary" business apparently creates a litigious area. The use of the term "primary" also arises under § 1221(1) of the Internal Revenue Code of 1954, in relation to whether an asset is a capital asset or inventory. Property is inventory if it is held "primarily for sale to customers in the ordinary course of his trade or business." As to the difficulty of determining whether property meets this definition, see Corn Prods. Ref. Co. v. Commissioner, 350 U.S. 46 (1955).
78. Proposed Treas. Reg. § (h)(4). See in this connection Treas. Reg. §§ 1.355-1(c)(1)-(d) (1955), relating to what constitutes an active trade or business for
nuity of the same business enterprise. These factors are to be evaluated in the general light of the purpose of section 382(a) which is to “disallow net operating loss carryovers where there is a purchase of the stock of a corporation with losses for the purpose of using its loss carryovers to offset gains of a business unrelated to that which produced the losses.”

In considering these elements in relation to the purpose, however, the subjective intent and motive to purchase for the purpose of obtaining tax benefits does not have to be shown. It is only necessary to prove the objective requirements of a change in business and ownership.

If a corporation reactivates a business that was dormant prior to a change in ownership, the corporation has not continued to carry on substantially the same trade or business as was carried on prior to the change in ownership. This is so even though the corporation reactivates the same business previously carried on by the corporation prior to its inactivity. The examples in the proposed regulations indicate that a corporation that becomes inactive because of adverse business conditions, then begins to sell its assets and remains inactive for a period of time (in this case nine months), cannot be purchased and reactivated without being considered as having changed its business. However, if the corporation becomes inactive because of a fire, but during the period of inactivity efforts are made to reactivate it, after a change in ownership and a subsequent reactivation of the same business the corporation will not lose its loss carryover. Apparently, the most important difference between the two situations is the effort to reactivate during the discontinuance caused by the fire, and the attempt to liquidate the business that was dormant due

the purpose of § 355 of the Internal Revenue Code of 1954. A trade or business does not include: “the holding for investment purposes of stock, securities, land or other property, including casual sales thereof (whether or not the proceeds of such sales are reinvested), ... the ownership and operation of land or buildings all or substantially all of which are used and occupied by the owner in the operation of a trade or business, or ... a group of activities which, while a part of a business operated for profit, are not themselves independently producing income even though such activities would produce income with the addition of other activities or with large increases in activities previously incidental or insubstantial.”

Proposed Treas. Reg. § (h) (5).

Ibid. Notice the similarity of thought between this and the Internal Revenue Service’s interpretation of Libson as promulgated in Rev. Rul. 59-395, 1959-2 Cum. Bull. 475, 478. “Since, therefore, in the Libson Shops case, the income of the resultant corporation against which the premerger losses were sought to be offset was not produced by substantially the same businesses which produced the losses, the Court ... [held that the] corporation was not entitled to a carry-over of such losses across the line of the merger.” (Emphasis added.)

Thus, if motive can be shown, the government can then try to bring the transaction within the provisions of § 269, if it will not fall within § 382(a).

Proposed Treas. Reg. § (h) (5).

It will be assumed that the change in ownership meets the requisites of § 382(a).

Proposed Treas. Reg. § (h) (6). This is an adoption of a prior ruling by the Service as to what constitutes carrying on substantially the same trade or business. See Rev. Rul. 58-9, 1958-1 Cum. Bull. 190. This involved a corporation in the insurance business that became dormant for a year because of adverse business conditions. It was purchased by an individual in the insurance business who reactivated it again in the same business.
to adverse business conditions. If the proposed regulations assume that a major portion of the producing assets were sold during the period of inactivity, the loss incurred by the pre-change-in-ownership assets could not be offset against the income of these same assets after the change in ownership. Thus, according to the asset test of Rev. Rul. 59-395, the loss carryover would not be permitted and this could be the basis for the distinction between the allowance under one set of circumstances and the disallowance under the other.

Although the above parallelism between the proposed regulation and the continuity of business test of Libson as interpreted by the Internal Revenue Service is somewhat dubious, because it is predicated on an assumption, the remaining regulations delineating a change in business more clearly expot the Libson doctrine.

A corporation has not continued to carry on substantially the same trade or business if it discontinues more than a minor portion of its business subsequent to the change in ownership. The use of the term "minor" is somewhat misleading as its determination turns on the continuity of business requirement of Libson as defined by Rev. Rul. 59-395. Thus, a substantial portion of the business may be discontinued and yet it may not constitute a "minor" portion within the terms of the proposed regulation.

The test for ascertainment of a "minor" portion of the business is: "whether the discontinuance of the activities has the effect of utilizing loss carryovers to offset gains of a business unrelated to that which produced the losses." Thus, X corporation operates three businesses: A making up 50 per cent of the business, B making up 30 per cent of the business, and C making up 20 per cent of the business. Business C has sustained

85. Teschner has expressed a belief that the distinction made between the fire loss and the inactivity due to adverse business conditions is tenuous. Teschner, Proposed 382 Regulations Take Some Doubtful Positions on Loss Carryovers, 14 J. Taxation 130 (1961). However, it was his opinion that the distinction was based on the cause of the inactivity rather than on whether the corporation sought to continue its activity. Seemingly, if a business went inactive because of adverse business conditions, but during the period of inactivity an attempt was made to reactivate the corporation and there was no selling of assets, a reactivation after a change in ownership would not constitute a change in business. 86. It would seem to be an elastic logic that could fit the above mentioned examples into the context of the asset test of Rev. Rul. 59-395, unless the proposed regulation assumes that a major portion of the producing assets were sold during the period of inactivity. If this is a proper assumption, then the loss incurred by the pre-change-in-ownership assets could not be offset against the income of these same assets subsequent to the change in ownership, and therefore, the carryover would not be permitted. If this is what was meant by Proposed Reg. § (h) (6), then its theory would fit the Internal Revenue Service's interpretation of Libson's continuity of business requirement. However, if this is what was meant it was not very clearly indicated. See Bookwalter v. Hutchens Metal Prods. Inc., 281 F.2d 174 (8th Cir. 1960) in which the Libson rationale was applied to disallow a loss carryover involving a merger with an inactive corporation.

88. See part III(B) of the text supra.
net operating losses. If business C is discontinued after a change in ownership, the X corporation has lost its net operating loss carryover because it has not continued to carry on substantially the same trade or business. However, if business A sustained the net operating losses, discontinuance of business C after a change in ownership will not constitute a change in business. It should be noted that the proposed regulation in the example states: "the capital released by the discontinuance of business C is used to revitalize business A . . . ." This apparently is an outright adoption of Libson in that it requires the assets that sustained the losses prior to the change in ownership to be the same assets earning the income against which the loss is to be offset.

Although this rationale is sound in the sense that it is an application of a theory espoused by the Supreme Court, the government may have difficulty in convincing the courts that Congress intended the outright adoption of a Libson theory in its enactment of subsection C of section 382(a)(1).

If the "loss corporation" continues to carry on the same trade or business activities undiminished after a change in ownership, the addition of a new trade or business does not constitute a failure to carry on substantially the same trade or business. At this point, the proposed regulations become "sticky" in holding that there is no change in business even though the addition of the new business makes it possible to carry over the loss. That is, had it not been for the income of the new business, there would be nothing against which the loss carryover could be applied. This apparently is a departure from the Internal Revenue Service's interpretation of Libson. The pre-change-in-ownership assets that suffered the loss are not the post-change-in-ownership assets earning the income against which the loss may be applied. It would seem that the government was compelled to adopt this provision both by the words of the section itself — if the loss "corporation has not continued to carry on a trade or business"
— and by an interpretation of an expression of congressional intent which stated that "if the corporation continued to carry on substantially the same trade or business, the limitation [of section 382(a)] would not be applicable even though the corporation also added a new trade or business." The unfortunate aspect is that this creates a conflict, at least in theory, among the proposed regulations themselves, and therefore creates some doubt as to whether they will all be upheld, or, if not all, which ones. The regulations do express the caveat that the unwary should beware of section 269, as it might be applicable in a situation of this nature. Thus, it appears that the Service was backed into a corner and had to take cognizance of "the handwriting on the wall" in its approach to this situation. This does create a cloud on the outright adoption of Libson in other areas of the proposed regulations.

If there is a change of location of a major portion of a corporation's business and the business is substantially altered, this will constitute a change in business within the purview of section 382(a). The examples relative to this principle indicate that a change in location accompanied by a change in the major assets of the business would be a discontinuance of substantially the same trade or business. Thus, when a manufacturing firm moves to another state, and is required, because of the move, to dispose of its plant and a majority of its equipment, and has to hire new employees as well, it has changed its business. This is true even though it continues to sell the same product to the same customers. Likewise, if a corporation in the retail liquor business moves to another town in the same state, requiring it to obtain a new liquor license and new customers, it has changed its business even though it transfers most of its inventory and half of its ten employees. In both of these cases, the major assets of the firm were changed in the process of relocation. Thus, if there is a substantial change in the major assets of the "loss corporation," there is not the continuity of business required by Rev. Rul. 59-395.

Conversely, if the major assets of the firm are kept intact, even though there is a change in location, the business will not be considered as having changed substantially. Thus, if a department store relocates from the center of a city to the suburbs and continues to sell the same product to

96. See text accompanying notes 87-93 supra.
97. Proposed Treas. Reg. § (h) (9).
98. It should be noted in this respect that if this is a proper interpretation of the proposed regulations and the differentiating factor is held to be the loss of the major assets of the firm, the examples, by implication, deny the right to trace the pre-change-in-ownership assets to post-change-in-ownership assets if these assets are used to purchase new assets after the change in ownership. The examples do not take cognizance of the possibility of using the proceeds from the sale of the pre-change-in-ownership assets to buy the post-change-in-ownership assets. Thus, the "but for" test seems to be excluded by the regulations. See text accompanying notes 63-65 supra.
the same customers through the same employees even though it had to dispose of its building and equipment, it has continued substantially the same business.

The most important thread running through the example is the type of asset retained. An asset, apparently, is a major one if it is basic to the type of business involved, e.g., plant and equipment in the case of a manufacturing firm, a liquor franchise and good-will (with customers) in the case of a retail liquor dealer, and inventory and good-will (with customers) in the case of a department store.

Similarly, there is a change in the trade or business “if the corporation is primarily engaged in the rendition of services by a particular individual or individuals and, after the increase in ownership, the corporation is primarily engaged in the rendition of services by different individuals.” 99 The individuals are the most important and basic assets of the firm and if they change, the trade or business has not been substantially continued.

Thus, if a corporation is in the real estate business, most of the business being done by broker A and there is a change in ownership with broker B taking over A’s position, there has been a change in business.

However, if a corporation is operating a beauty salon with ten operators whose skill is responsible for attracting customers, and A, the supervisor who is also the beauty expert, is replaced by B after a change in ownership, there is no change in business within the terms of section 382(a).

Thus, it would appear that in determining whether the trade or business has been substantially continued, the essential factor is the type of asset retained. If a substantial portion of the major assets of the pre-change-in-ownership business which sustained the loss are retained after the change in ownership, there is no change in business. This rationale threading through the regulations is an adoption of and in accord with the interpretation of Libson in Rev. Rul. 59-395. 100

CONCLUSION

The proposed regulations apply the change of business concept in two distinct situations. One involves a factual pattern in which a corporation

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100. Although the proposed regulations do not state that the pre-change-in-ownership assets that incurred the loss must be retained and earn the income after the change in ownership against which the loss is to be offset, this is implied throughout their provisions. When a corporation is engaged in only one business, if the assets of the business do not earn income, there will be no reason to carry over the loss after a change in ownership as there will be no income against which to apply the loss. However, if the corporation is engaged in several businesses, then the business earning the loss must be continued and earn income against which the loss may be offset. See text accompanying notes 87-93 supra.
is engaged in several businesses, while the other involves a situation in which a corporation is engaged in only one type of business. In the former the test of Libson as interpreted by Rev. Rul. 59-395 is applied when there is a discontinuance of one of the businesses to ascertain whether this constitutes the substantial change in business contemplated by section 382(a); and in the latter the test is applied to determine whether an alteration in the only business in which the corporation is involved will constitute the requisite change.