Tightening the Limitations on Carryovers under Section 382(b): F Reorganization and the Tax Reform Act of 1976.

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A corporate reorganization is a readjustment of structure or ownership occurring when one corporation acquires the stock or property of another, or changes its capital structure, name, form, or place of organization. Six different types of corporate reorganizations are defined in the Internal Revenue Code. They are: type A, statutory mergers and consolidations; type B, stock for stock acquisition; type C, acquisition of the assets of one corporation by another; type D, transfer by a corporation of all or a part of its assets to another corporation; type E, recapitalization; and type F, "a mere change in identity, form, or place of organization, however effected." These reorganizations are distinguishable from other corporate restructurings in the Code by the specialized tax treatment afforded to them. Through section 381(b)(3) Congress has disallowed the carryback by an acquiring corporation of a post-acquisition net operating loss to the pre-acquisition years of the transferor corporation. Additionally, special limitations on net operating loss carryovers are

3. Id. § 368(a)(1)(B).
4. Id. § 368(a)(1)(C).
5. Id. § 368(a)(1)(D).
6. Id. § 368(a)(1)(E).
7. Id. § 368(a)(1)(F).
8. Id. § 361(a) provides that: "No gain or loss shall be recognized if a corporation a party to a reorganization exchanges property, in pursuance of the plan of reorganization, solely for stock or securities in another corporation a party to the reorganization." See generally 2 MICHIE'S FEDERAL TAX HANDBOOK 509-10 (39th ed. 1977).
9. I.R.C. § 172(c) (net operating loss generally considered excess of deductions over gross income). Under present law a net operating loss ordinarily can be carried back three years and, if not exhausted, carried forward seven years. Id. § 172(b)(1)(A)(i) and § 172(b)(1)(B). For example, a loss in 1976 is carried back to 1973 where the taxpayer gets a refund equal to the difference in the amount paid in 1973 and the amount which would have been paid had the loss occurred in that year. If the loss from 1976 is not exhausted, it may be applied in the same manner against the 1974 and 1975 income. If the carryback does not absorb the entire loss it can be carried forward seven years (five years under prior law). Id. § 172(b)(1)(A)(i) and § 172(b)(1)(B).
10. I.R.C. § 381(b).

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provided by two separate sets of rules.\textsuperscript{11}

Congress, in the 1954 Code, enacted section 381 in an effort to liberalize the carryover and carryback provisions,\textsuperscript{12} while concomitantly placing a section 382 special limitation on net operating loss carryovers.\textsuperscript{13} Under prior law, when the purpose of acquiring a controlling interest in a corporation was to avoid taxes, the Internal Revenue Service could disallow the benefits of a deduction.\textsuperscript{14} This provision was often ineffective because it required proof that tax avoidance was the primary purpose of the transaction.\textsuperscript{15} The special limitation provided in section 382 was designed to limit the undue tax benefits of this character.\textsuperscript{16}

Section 368(a)(1)(F) defines the term "reorganization" to mean "a mere change in identity, form, or place of organization, however effected."\textsuperscript{17} This is a definitional section which, until 1966, encompassed the least significant of the corporate changes permitted by the statute.\textsuperscript{18} Although having no operational significance of its own, this section becomes important when employed with other provisions of the Code.\textsuperscript{19} Since this F-type reorg-

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\item \textsuperscript{11} I.R.C. § 382(a) is the "purchase" rule which provides specific limitations on net operating loss carryovers where 50% (60% after June 30, 1978) or more of the corporation's stock is purchased in a taxable transaction within a two year period. Section 382(b) is the rule pertaining to tax free reorganizations. I.R.C. § 172(b)(1)(B) provides in part that "a net operating loss . . . ending after December 31, 1975, shall be a net operating loss carryover to each of the 7 taxable years following the taxable year of such loss." Id.
\item \textsuperscript{12} H.R. Rep. No. 1337, 83d Cong., 2d Sess. 41 (1954). The provisions were "based upon economic realities rather than upon such artificialities as the legal form of the reorganization." Id. at 41.
\item \textsuperscript{13} Id. at 42. This statute was introduced to curtail trafficking in corporations with operating loss carryovers. \textit{See generally} H.R. 8300, 83d Cong., 2d Sess., 100 Cong. Rec. 3421 (1954).
\item \textsuperscript{15} Id. at 41.
\item \textsuperscript{16} Id. at 42.
\item \textsuperscript{17} I.R.C. § 368(a)(1)(F); \textit{see} Griswold v. Commissioner, 400 F.2d 427, 432 (5th Cir. 1968) (reorganization involved mere change in identity); Hollman v. United States, 275 F. Supp. 297, 300 (S.D. Ala. 1967) (reorganization involved mere change in form); Dunlap & Assoc. v. Commissioner, 47 T.C. 542, 551 (1967) (only state of incorporation changed).
\item The term "F reorganization" first appeared in section 202(C)(2) of the Revenue Act of 1921 and was defined as a "mere change in identity, form, or place of organization of a corporation, however effected." The words "of a corporation" were deleted from the statute in 1924, and this new version reenacted in the Internal Revenue Code of 1939. Deletion of the section as being unnecessary was proposed in the House version of the Revenue Bill of 1954, but disagreement during the Senate hearings resulted in the retention of the F section as section 368(a)(1)(F). For a detailed history on F reorganization see Comment, \textit{(F) Reorganizations and Proposed Alternate Routes for Post-Reorganization Net Operating Loss Carrybacks}, 66 Mich. L. Rev. 488 (1968).
\item \textsuperscript{19} \textit{See} B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND
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Evolution of a Standard

From its genesis in 1921, and until 1966, the F reorganization was narrowly construed. Under the Internal Revenue Service's earlier view, all changes had to take place within a single corporation in order to qualify as an F reorganization.

In Ahles Realty Corp. v. Commissioner, a 1934 decision, the Second Circuit specifically held an F reorganization had occurred when the only ultimate change was that of the corporate form. The Supreme Court did not construe this section until 1942 when, in Helvering v. Southwest Consolidated Corp., it disqualified an application for F-type reorganization, noting simply that "[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' . . ." The Court did not elaborate on its holding, and subsequent decisions have been far from harmonious in its application.

In 1966, however, the application of the F reorganization was materially

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22. 366 F.2d 874 (5th Cir. 1966), cert. denied, 386 U.S. 1022 (1967).
23. Id. at 884.
26. 71 F.2d 150 (2d Cir.), cert. denied, 293 U.S. 611 (1934).
27. Id. at 151.
29. Id. at 202-03.
expanded to include the merger of multiple corporations. In Davant v. Commissioner, corporation Y dried and stored rice which had been grown on farm land owned by corporation W. Both corporations were owned by four families. The original shareholders wished to transfer the operating assets of Y to W and withdraw a certain amount of Y’s appreciated corporate assets at capital gains rates. Their attorney proposed a plan whereby a third party bought the Y stock, sold the assets to W, liquidated Y, and ultimately made a reasonable profit. The Commissioner argued that the transaction was a corporate reorganization within subsections D or F and not a bona fide sale. It was his contention that “since the entire business of [Y] was transferred over to [W] there was in substance no liquidation of [Y] so that the entire distribution should be viewed as a dividend out of earnings and profits of the two corporations” and therefore taxed as a dividend. The shareholders took the position that it was a sale and that they had properly reported the gain on the sale as capital gain. The Tax Court held that the transfer constituted a section 368(a)(1)(D) reorganization and that the distributions to the stockholders were taxable as dividends to the extent of the current earnings and profits of Y.

A type-D reorganization requires that a corporation transfer all or a part of its assets to another corporation controlled by one or more shareholders of the transferor. The Davant transaction conformed to the requisites of

32. Id. at 874.
34. Id. at 566.
35. Id. at 566.
36. Id. at 569.
37. Id. at 572. Generally, the theory of the tax-free reorganization is that there is no gain or loss recognized on the exchange since the corporation acquires the transferred property with the same basis it had in the hands of the transferor. See generally 2 MICHIE’S FEDERAL TAX HANDBOOK 506 (39th ed. 1977). In Davant v. Commissioner, 366 F.2d 874, 882 (5th Cir. 1966), cert. denied, 386 U.S. 1022 (1967) the shareholders received $700,000 in earnings and profits from W corporation and $200,000 in earnings and profits from Y corporation. These sums were dividends and taxable as ordinary income against the combined earnings and profits of the two corporations. They had no rational connection with the reorganization. The court stated: “We are merely recognizing that two distinct and functionally unrelated types of transactions were carried on simultaneously—one was a dividend and the other a reorganization.” Id. at 888.
38. Id. “Control is defined . . . as the ownership of stock possessing 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 shares of all other classes of stock of the corporation.” [1977] 3 STAND. FED. TAX REP. (CCH) ¶ 2551.015. See Reilly Oil Co. v. Commissioner, 189 F.2d 382, 384 (5th Cir. 1951) (control met where new corporation issued all its stock to holders of 69% of predecessor, and other 31% paid off in cash).
a reorganization since corporation Y transferred its assets to corporation W and the ownership of both corporations was identical.40

The Fifth Circuit also considered the Commissioner's argument that the transaction was an F reorganization.41 During the reorganization, continuity of the stockholders' proprietary interests and continuity of the business enterprise had been maintained.42 With these criteria satisfied, the court reasoned that the change was of corporate form rather than substance, thereby satisfying the F reorganization requirements.43 This was a potentially costly victory for the government because it expanded the F reorganization definition to include multicorporate reorganizations.

Although the Commissioner in Davant had overlooked the net operating loss carryback ramifications of section 368(a)(1)(F), the taxpayers in Estate of Stauffer v. Commissioner44 and Assbciated Machine v. Commissioner45 fully recognized the significance of this provision.46 The question presented in both cases was whether the merger of multiple operating corporations could qualify as an F reorganization. Citing Davant in each case, the Ninth Circuit held for the taxpayers, finding that both transactions qualified as F reorganizations.47 The Internal Revenue Service thereafter rejected these decisions, issuing a revenue ruling based on the legislative history of the F reorganization and the Code mandate against the F-type involving more than one corporation.48 The courts did not find the Revenue Ruling persuasive, however, and in Home Construction Corp.

41. Id. at 884.
42. Id. at 883.
43. Id. at 884.
44. Id. at 884. The Davant court provided: "Whatever the outer limits of section 368(a)(1)(F), it can clearly be applied where the corporate enterprise continues uninterrupted, except for a distribution of some liquid assets or cash." Id. at 884. Continuity of the proprietary interests of the stockholders is maintained, when they receive the same amount of stock of the acquiring corporation that they held in the transferor corporation. For example, if four persons own 25% of each transferor corporation and they each obtain 25% of the acquiring corporation stock, the continuity test is satisfied. See generally Note, Use of Multicorporate F Reorganizations to Carry Back Net Operating Losses, 56 Neb. L. Rev. 173, 186 (1977).
45. 403 F.2d 611 (9th Cir. 1968).
46. 403 F.2d 622 (9th Cir. 1968).
47. In Associated Mach. v. Commissioner, 403 F.2d 622, 624 (9th Cir. 1968) the court accepted the petitioner's reasoning in holding that an F reorganization can involve multiple corporations. Similarly, in Estate of Stauffer v. Commissioner, 403 F.2d 611, 618-21 (9th Cir. 1968) the court found an F reorganization where the taxpayer effected a merger of three corporations, relying on the principle derived in Davant. Id. at 619.
48. Estate of Stauffer v. Commissioner, 403 F.2d 611, 622 (9th Cir. 1968); Associated Mach. v. Commissioner, 403 F.2d 622, 626 (9th Cir. 1968).
of America v. United States\textsuperscript{50} the Fifth Circuit laid down the broadest interpretation of an F reorganization to date. In that case 123 separate corporations, owned by the same individual, merged into a single new corporation. The court found that there had been no change in the identity of the stockholders or their proprietary interests, and that the method of business remained the same.\textsuperscript{51}

The first parent-subsidiary case,\textsuperscript{52} Performance Systems, Inc. v. United States,\textsuperscript{53} provided a new argument for the Internal Revenue Service to disallow the net operating loss carryback. In that case a subsidiary corporation was merged into its parent which attempted to carry back post-merger losses to the pre-merger years of the subsidiary.\textsuperscript{54} The Commissioner argued that the transaction was a liquidation, and that the liquidation provision should prevail.\textsuperscript{55} The court concluded that although an F reorganization also qualified as a section 332 liquidation, this was not justification to exclude the benefits provided to the F reorganization under section 381(b).\textsuperscript{56}

THE F REORGANIZATION TEST

The Davant decision established the criteria for determining when a reorganization qualifies as an F reorganization. The relevant test involves an “identity of shareholders and their proprietary interests, unimpaired continuity of the essential business enterprise and a new form which is the alter ego of the old.”\textsuperscript{57} The Internal Revenue Service in acquiescing to the Davant decision, imposed still more stringent conditions, holding that a corporation seeking to carry back post-merger losses must initially satisfy

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\item \textsuperscript{50} 439 F.2d 1165 (5th Cir. 1971).
\item \textsuperscript{51} Id. at 1172. The court stated in part: “This situation meets the ultimate benchmark by which to gauge an F reorganization—continuity in all matters of business substance.” Id. at 1172.
\item \textsuperscript{52} The earlier cases involved mergers where the corporations were under the common ownership of the same individuals, so-called brother-sister corporations. See generally Note, Use of Multicorporate F Reorganizations to Carry Back Net Operating Losses, 56 Neb. L. Rev. 173, 179 (1977).
\item \textsuperscript{53} 382 F. Supp. 525 (M.D. Tenn. 1973), aff'd, 501 F.2d 1338 (6th Cir. 1974).
\item \textsuperscript{54} Id. at 526.
\item \textsuperscript{55} Id. at 534.
\item \textsuperscript{56} Id. at 527-28; accord, Movielab, Inc. v. United States, 494 F.2d 693, 703 (Ct. Cl. 1974) (fact that transaction technically qualified as liquidation does not preclude relief as F). In Eastern Color Printing Co. v. Commissioner, 63 T.C. 27, 37 (1974) the court held that section 381(b)(3) required only that a reorganization be one described in subparagraph F of section 381(a)(1) despite the fact that the transaction might also qualify as a liquidation.
\item \textsuperscript{57} Home Constr. Corp. of America v. United States, 439 F.2d 1165 (5th Cir. 1971); see Davant v. Commissioner, 366 F.2d 874, 884 (5th Cir. 1966), cert. denied, 386 U.S. 1022 (1967). The Davant court stated: “The term ‘mere change in identity [or] form’ obviously refers to a situation which represents a mere change in form as opposed to a change in substance.” Id. at 884. See generally Estate of Stauffer v. Commissioner, 403 F.2d 611, 619 (9th Cir. 1968); Treas. Reg. § 1.368-1(b) (1976).
three requirements: continuity of business, similarity of business activities, and identity of shareholder interests.3'

The Business Test: Continuity and Similarity

A primary requisite for a successful reorganization is a continuity of the business enterprise under the modified corporate form.5' The courts have not required, in all types of reorganizations, that the post-reorganization corporation carry on the same type of business as that conducted before; although this requirement appears to be more stringent when applied to an F reorganization.6 Revenue Ruling 75-56112 states that both the transferor corporations and acquiring corporation must be engaged in the same or integrated business activities before the merger, and the nature of the new enterprise must continue unchanged after the merger.63 The example given by the Internal Revenue Service apparently recognizes that a literal interpretation will not be given to the regulation.64 The example further illustrates the net operating loss carryback requirements imposed when three corporations are merged into a new corporation. If the newly formed company was a shell formed solely for the reorganization, it clearly would not have assumed any business activity before the merger. This seems to be an implicit recognition by the Internal Revenue Service that the acquir-

59. See Cortland Specialty Co. v. Commissioner, 60 F.2d 937, 940 (2d Cir. 1932), cert. denied, 288 U.S. 599 (1933); Treas. Reg. § 1.368-1(b) (1976).
60. In American Bronze Corp. v. Commissioner, 64 T.C. 1111, 1123 (1975) the court stated: "Nowhere does continuity import a requirement of identity; the continuing business need not be the same as that conducted by the transferor." The requirement for an acquisitive C reorganization is apparently not as strict as that outlined for an F reorganization. See Bentsen v. Phinney, 199 F. Supp. 363, 367 (S.D. Tex. 1961) (old corporation engaged in land development, presently engaged in insurance).
61. See Pridemark, Inc. v. Commissioner, 345 F.2d 35, 42 (4th Cir. 1965). The Pridemark court stated in part: "If its application is limited to cases where the corporate enterprise continues uninterrupted, except perhaps for a distribution of some of its liquid assets." Ahles Realty Corp. v. Commissioner, 71 F.2d 150, 151 (2d Cir.) (enumerated continuance of business as applicable to F reorganizations), cert. denied, 293 U.S. 611 (1934).
63. Id. at 129. The application of the ruling is illustrated by the following example: Corporation X, Corporation Y, and Corporation Z, owned by A, an individual, were merged into a new corporation, XYZ, on December 31, 1972. The transaction qualified as an F reorganization. XYZ had a net operating loss of $70,000 in its taxable year ended December 31, 1973, $50,000 of which is attributed to the former business conducted by X, and $20,000 of which is attributed to the former business of Y. In 1972 X had taxable income of $10,000, $15,000 in 1971, and $20,000 in 1970. In 1972 Y had taxable income of $10,000 and net operating loss in all prior years, and Z had taxable income in all prior years. XYZ was allowed to carry back $45,000 of its net operating loss to the pre-merger years of X and $10,000 of its net operating loss to the pre-merger years of Y. The remaining $15,000 of net operating loss could only be carried forward. Id. at 130.
64. See ruling and material cited note 63 supra.
ing corporation does not have to be engaged in the same business activities or integrated business activities before the combination. 5

Continuity of Interest

Another principal requisite for an F reorganization under the Code is a continuity of interest on the part of those persons who either directly or indirectly owned the enterprise before the reorganization. 6 This requisite has been characterized as a major limitation on transactions seeking to qualify as F reorganizations. 7 The identity of proprietary interest in the transferee and transferor corporations has been identified as the salient trait of an F reorganization; 8 moreover, it is the fundamental concept in reorganization upon which the tax deferral theory is based. 9 This requirement has been used effectively in a number of cases to preclude classification as a F reorganization.10

SHIFT IN PROPRIETARY INTEREST

In Aetna Casualty & Surety Co. v. United States11 the corporate taxpayer, New Aetna, was a subsidiary which was organized by its parent, Aetna Life, for the sole purpose of acquiring one of the parent’s other subsidiaries.12 The taxpayer sought to carry back its post-reorganization net operating losses as deductions against the pre-reorganization income of its predecessor.13 The taxpayer’s initial argument had been that the

68. Associated Mach. v. Commissioner, 403 F.2d 622, 624 (9th Cir. 1968).
69. Cf. Helvering v. Minnesota Tea Co., 296 U.S. 378, 385 (1935) (transfer of substantially all assets plus $426,842.52 cash was reorganization); Nelson Co. v. Helvering, 296 U.S. 374, 376-77 (1935) (reorganization and no taxable gain recognized); Pinellas Ice & Cold Storage Co. v. Commissioner, 287 U.S. 462, 468-69 (1933) (gain must be recognized where no reorganization).
70. See Helvering v. Southwest Consol. Corp., 315 U.S. 194, 199-202 (1942) (significant shift of proprietary interests of shareholders); Hyman H. Berghash, 43 T.C. 743, 754 (1965) (shift from nearly 100% ownership to 50%), aff’d sub nom. Commissioner v. Berghash, 361 F.2d 257 (2d Cir. 1966); Gallagher v. Commissioner, 39 T.C. 144, 161 (1962) (former shareholders acquired only 73% of stock of new corporation, balance subscribed by new investors); Stollberg Hardware Co. v. Commissioner, 46 B.T.A. 788, 789-92 (1942) (former shareholders of bankrupt corporation acquired only approximately 27% of the stock of survivor).
72. Id. at 502, 39 A.F.T.R.2d ¶ 77-400.
transaction was not a "reorganization," but simply a "redemption" of the minority shareholders' interest in Old Aetna.74 Had this been true, the section 381 exclusion of a loss carryback would not apply, and the taxpayer would be entitled to a refund.75 The court disposed of this argument, finding that a fundamental objective of Aetna Life had been to remove certain stock from its asset base in a tax-free transaction.76 Achievement of this objective required that the transaction be a reorganization within section 368(a)(1).77

A second and alternative argument raised by the taxpayer was that the transaction amounted to an F reorganization.78 This type of transaction is expressly excepted from the section 381(b)(3) exclusion from the loss carryback benefits of section 172. During the reorganization, however, 38.39% of the minority shareholders had been ousted.79 Relying on the language of the Supreme Court in Helvering v. Southwest Consolidated Corp.,80 the district court found, therefore, that there had been a substantial change in the proprietary interests of one group of shareholders precluding the transaction from being an F reorganization.81

The Second Circuit reversed on appeal, and distinguished Southwest, noting that in the principal case there was merely a shift in the proprietary interest of the minority shareholders.82 In Southwest the assets of the old corporation had been transferred to the new one, but the original shareholders received only a small interest in the new corporation,83 with the remainder going to the creditors of the insolvent old corporation who, after

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75. Aetna Cas. & Sur. Co. v. United States, 403 F. Supp. 498, 504 (D. Conn. 1975). The court noted that "[t]he exclusion of § 381(b)(3) applies only to a 'corporation acquiring property in a distribution or transfer described in subsection (a)."' Id. at 504 n.11. Section 381(a) describes, in relevant part, only transfers "in connection with a reorganization." Id. at 504 n.11.

76. Id. at 505.

77. Id. at 505 (objective effectuated a more favorable tax position).

78. Id. at 509.

79. Id. at 515.

80. 315 U.S. 194 (1942).


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reorganization owned the majority of the new shares. The Supreme Court had found this shift of proprietary interest "hardly a mere change in identity, form, or place of organization." In Aetna the Second Circuit did not consider when a substantial shift of proprietary interest would preclude classification as an F reorganization, but held that a redemption had occurred which would not preclude the carryback.

DE MINIMIS CHANGE

The F-type reorganization has judicially progressed from reincorporations of a single operating corporation, to reorganizations involving multiple corporations. The Commissioner acquiesced in the courts' decisions, and issued Revenue Ruling 75-561, which imposed three conditions to qualify as an F reorganization. The first requirement is a complete identity of shareholders and their proprietary interests. The second requires that the transferor corporations and the acquiring corporation be engaged in the same business activities or integrated activities before the combination. Finally, this ruling requires that the business enterprise of the transferor corporations and the acquiring corporation continue unchanged after the combination.

The complete identity of shareholders and their proprietary interests requirement is consistent with the principles expressed in Helvering v. Southwest Consolidated Corp. Moreover, a shift in proprietary interests

84. Id. at 197-99.
85. Id. at 203.
87. See, e.g., San Joaquin Fruit & Inv. Co. v. Commissioner, 77 F.2d 723, 724 (9th Cir. 1935) (F found where shareholders of old corporation emerged with only 83% of stock in new), rev'd on other grounds, 297 U.S. 496 (1936); Ahles Realty Corp. v. Commissioner, 71 F.2d 150, 151 (2d Cir.) (sole stockholder of old corporation organized new corporation and transferred all stock and assets of old corporation in exchange for stock and bonds in new), cert. denied, 293 U.S. 611 (1934); George Whittel & Co. v. Commissioner, 34 B.T.A. 1070, 1073 (1936) (plan simply to change state of incorporation).
88. Home Constr. Corp. of America v. United States, 439 F.2d 1165, 1166 (5th Cir. 1971); Associated Mach. v. Commissioner, 403 F.2d 622, 625 (9th Cir. 1968); Estate of Stauffer v. Commissioner, 403 F.2d 611, 620-21 (9th Cir. 1968).
89. 1975-2 C.B. 129. Although satisfaction of these criteria ensures characterization as an F reorganization, two additional requirements must be met before the reorganization will qualify for the carry back provision under section 381(b)(3). First, the acquiring corporation must show that the losses are attributable to a separate business unit or division formerly operated by the transferor corporations. Second, "the transferor corporation must have income in its preacquisition taxable years against which such losses can be offset." Id. at 129.
90. Id. at 129.
91. Id. at 129.
92. Id. at 129.
93. See 315 U.S. 194 (1942). The F reorganization was disallowed where the creditors of the shareholders of the old corporation became the owners of the new corporation. Id. at 198.
of less than one percent is a de minimis change which will not violate the Southwest rule. The courts have failed, however, to specify whether a one percent or more shift in shareholder interest will result in disallowance of F-type characterization.

This problem was before the Tax Court in Casco Products Corp. v. Commissioner, where Standard Kollsman Industries wished to purchase all of the shares of Old Casco. It had succeeded in acquiring ninety-one percent of the outstanding shares, but had difficulties procuring the remaining shares owned by dissident shareholders. To achieve its goal, Standard resorted to a statutory merger to force out the remaining shareholders of Old Casco. It formed New Casco, acquiring 100% of its stock, and then merged with Old Casco. By paying shareholders in cash for their interest in Old Casco, the nine percent minority interest was squeezed out. The Commissioner argued that the nine percent shift in proprietary interest between Old Casco and the new corporation prevented the transaction from being an F reorganization. Declining to navigate "these treacherous shoals," the Tax Court held the transaction to be a redemption rather than a reorganization. Judge Raum, in his dissent, stated that the majority had erred in refusing to consider whether a nine percent shift may be ignored to satisfy the F requirement, concluding that although it was a difficult question, it should not be disregarded.

In Aetna the Second Circuit was given the opportunity to resolve the question which had been before the Tax Court in Casco. The critical elements of Aetna were similar to those in Casco. Aetna Life owned 61.61% of Old Aetna, and had formed a new corporation as a 100% subsidiary to acquire Old Aetna. The minority shareholders exchanged 38.39% of their Old Aetna stock for Aetna Life stock, and were subsequently frozen out during the course of the merger. The Second Circuit distinguished Reef
Corporation v. Commissioner on the grounds that the Aetna merger could not be separated from the redemption under the functionally unrelated steps doctrine. Additionally, the court noted that a redemption was not a characteristic of a reorganization. The shift in proprietary interest was merely that of the minority shareholders, and therefore the transaction resulted in an F reorganization. The court alluded to the Casco case, but failed to answer the question of whether a one percent or more shift in shareholder interest would constitute a de minimis change. Consequently, the taxpayer was again left to navigate without judicial light.

The Functionally Unrelated Steps Doctrine

The Commissioner has used the functionally unrelated steps doctrine as a means of attacking liquidation-reincorporations, and Davant is illustrative of the Commissioner's success in this area. Although the taxpayers in that case attempted to classify their transaction as a liquidation to obtain a favorable tax position, the Commissioner prevailed by contending that a reorganization had taken place. In liquidation-reincorporations, stockholders liquidate the corporation, distribute the liquid assets, and transfer the operating assets to a new company. The new company carries on the same business with the stockholders owning substantially the same proportional interests as in the liquidated corporation. The step doctrine is exemplified by the Fifth Circuit's decision in Reef Corp. v. Commissioner. In Reef forty-eight percent of the shareholders had their stock interests reduced to one percent, and the court illustrated the application of the functionally unrelated steps doctrine. There a corporate reorganization and stock redemption occurred simultaneously, but were considered functionally unrelated when determining if an F reorganization had occurred.


See Davant v. Commissioner, 366 F.2d 874, 879 (5th Cir. 1966), cert. denied, 386 U.S. 1022 (1967).

See Becher v. Commissioner, 221 F.2d 252, 253 (2d Cir. 1955); Lewis v. Commissioner, 176 F.2d 646, 647 (1st Cir. 1949).

Becher v. Commissioner, 221 F.2d 252, 253 (2d Cir. 1955).
The majority effected this redemption by forming a new corporation which was wholly owned by them in a different state and paying the ousted group in cash. The court viewed the corporate reorganization and stock redemption as two functionally unrelated elements and concluded that an F reorganization had taken place because the minority shareholders had their stockholdings completely redeemed before the corporate reorganization occurred, and the business enterprise continued uninterrupted during both transactions. The redemption and reorganization ultimately resulted in the continuance of the business controlled by the majority stockholders, absent the forty-eight percent redeemed minority stockholders. The court, distinguishing Southwest, reasoned that there was not a shift in the ownership of the proprietary interest since the assets had not been sold to new shareholders. The approach adopted by the Reef court does not establish criteria to determine when a substantial shift in the proprietary interests of the shareholders has occurred.

TIGHTENING THE RULES

Section 381 deals with carrybacks and carryovers when a corporate reorganization, as defined by section 368(a)(1), has taken place. Section 382 requires a minimum stock ownership for the loss company’s shareholders, thus providing special limitations on these carryovers. Prior to 1976 when the assets of a loss corporation were merged with another corporation in what qualifies as a tax free reorganization, the loss carryover would survive in full, if, immediately after the reorganization, the shareholders of the loss corporation owned at least twenty percent of the fair market value of the outstanding stock of the acquiring corporation. For each percentage point less than twenty percent, the loss carryover was reduced.

112. Id. at 134.
113. Id. at 134.
114. Id. at 134, 136. The court stated in part: “Only those reorganizations which reflect a substantial change in the corporate operation should be viewed as solely (D) reorganizations qualifying for the more liberal rules. Where there is no substantial change in the corporate operation, (F) should be applied. . . .” Id. at 136.
115. Id. at 134.
116. Id. at 138. In Southwest the creditors became the shareholders of the new corporation; this shift was sufficient to prevent a reorganization. Helvering v. Southwest Consol. Corp., 315 U.S. 194, 202-03 (1942).
118. I.R.C. § 381.
119. See Int. Rev. Code of 1954, ch. 1, § 382(b), 68A Stat. 130 (now I.R.C. § 382(b)) (minimum stock ownership 20%).
by five percent. Therefore, if the loss company shareholders obtained at least a twenty percent interest in the acquiring corporation after the reorganization, there was no reduction of the loss carryover. Had the shareholders of the loss corporation received only a ten percent interest in the acquiring company, a fifty percent reduction in loss carryover would have resulted. When determining the twenty percent limit, only that stock received by the stockholders of the loss corporation by reason of their holdings in the loss corporation should be considered.

The pre-1976 law could be manipulated for tax avoidance purposes. Buyers of stock could extract windfalls by taking advantage of the weak bargaining position of the owners of a loss business and acquire large loss carryovers for only a few cents on the dollar. This would produce a tax shelter for future profits, whereas such buyers starting a new business with their capital would not have the loss offsets available.

Section 382 has undergone significant changes in the 1976 Tax Reform Act, principally in the area of continuity of shareholder proprietary interest for the preservation of a corporation's loss carryover history. The 1976 revision preserves the net operating loss carryover provision to loss corporations, but doubles the minimum stock ownership that the original shareholders must have in the acquiring company in order to maintain the new continuity of interest. For example, if the shareholders of the loss corporation own less than forty percent, but at least twenty percent of the participating stock of the acquiring corporation after the reorganization, the net operating loss carryovers of the loss corporation will be reduced by three and one-half percent for each percentage point of ownership less than forty percent. When the ownership falls below twenty percent, the net

122. Int. Rev. Code of 1954, ch. 1, § 382(b), 68A Stat. 130 (now I.R.C. § 382(b)).
126. See I.R.C. § 382. One effect is that the minimum continuity of interest line for shareholders of the loss corporation is doubled to forty percent. Id. § 382(b)(1)(B); S. REP. No. 94-1236, 94th Cong., 2d Sess. 449 (1976).
128. I.R.C. § 382(b)(2). See generally Eustice, The Tax Reform Act of 1976: Loss Carryovers and Other Corporate Changes, 32 TAX L. REV. 113, 131 (1977). The author states in part: The continuity percentage test is a dual one; it is applied by reference to the lesser of either the value of the loss company shareholders' "participating" stock or of all their other "stock" in the reorganized loss company (which is also the approach utilized in section 382(a)). Thus, large corporation acquisitions of small corporations are even more stringently inhibited under the new rules for loss carryovers; in effect, "minnow-whale" fusions have been sharply restricted by the new section 382(b) continuity lines to the point where loss carryover deductions will be cut down unless the acquisition involves either two "whales," two "minnows," or two "dolphins."
Id. at 130.
operating loss carryovers of the loss corporation will be reduced one and one-half percent for each percentage point below twenty percent.129

The major impetus for the change in the continuity of interest rules was the abuse of the tax system, principally in the area of trafficking in net operating losses.130 For a nominal price, a profitable corporation could shelter millions of dollars of taxable income simply by purchasing losing firms for the purpose of acquiring their net operating loss carryovers.131 Based exclusively on advertisements appearing in the Wall Street Journal in 1974, it was estimated that this loophole results in at least 125 million dollars of revenue loss every year.132 Trafficking in loss carryovers has been labeled an abuse of the fundamental concepts upon which our federal tax system is based.133 Eliminating this loophole would foreclose the ability of a taxpayer to sell unused loss carryforwards to an unrelated taxpayer.134

Section 382(b)(3) also provides that neither a holding company,135 nor a "triangular" reorganization can be used to avoid reduction of the net operating loss carryover.136 In a triangular reorganization a parent corporation arranges for a controlled subsidiary to acquire a loss corporation.137 Section 382(b)(3)(B) effectively disregards the triangular nature of the reorganization, treating the acquisition as having been made by the parent.138 Under "present law, a 'triangular' reorganization can be used to avoid the limitations in section 382(b)."139

129. I.R.C. § 382(b)(2)(B). For example, if the loss company's shareholders receive 20% of the stock of the acquiring corporation, the carryovers are reduced by 70%. If 30% of the stock is held after reorganization, 35% of the carryover will be disallowed. Where only a 10% interest is acquired, the reduction would be 85%.

A more complex example is presented where L (loss corporation) had a 17% interest in P after the reorganization. L's net operating loss carryovers are reduced by 73% (70% for the 20 percentage points of ownership under 40% but above 19%, plus 3% for the two percentage points of ownership under 20%). Treas. Reg. § 1.382(c)-1 (1976).

131. Id. at 3285.
132. Id. at 3285. See Wall St. J., May 20, 1974, at 22, col. 3.
134. Id. at 3285-86.
135. S. Rep. No. 94-1236, 94th Cong., 2d Sess. 450 (1976) states: "In the case of taxfree reorganizations, the conference agreement adds a rule to cover a situation under which the new rules could otherwise be escaped by using a holding company (which owns one or more loss companies as controlled subsidiaries) as a party to the reorganization."
138. Id. at 206.
139. Id. at 206. The Senate Report states in part:
Under present law, if an acquiring company arranges for a controlled subsidiary to acquire a loss company for stock of the parent company, the limitations on loss carryovers are applied by comparing the value of the loss shareholders' stock in the parent company with the value of all the stock of the loss company (sec. 82(b)(6)). If the loss
The related transaction rule in section 382(b)(4)(A) prevents circumvention of the continuity of interest requirement by a corporation acquiring loss corporation stock immediately before reorganization.\(^{140}\) If one or more shareholders of the loss corporation have acquired stock in the loss corporation within thirty-six months prior to a reorganization, and such shareholders own more than fifty percent of the stock in another corporation which is a party to the reorganization, or any such shareholder is a corporation controlled by another corporation which is a party to the reorganization, then such shareholders are not treated as shareholders of the loss corporation for purposes of satisfying the continuity of interest requirement.\(^{141}\)

A special rule for determining the forty percent continuity of interest test is established in section 382(b)(4)(B) in the event a corporation which is a party to the reorganization has owned stock in the loss company for thirty-six months or more prior to the reorganization.\(^{142}\) It allows the total fair market value of the participating stock\(^{143}\) and all the loss company stock owned by the acquiring company to be considered in determining the continuity of interest.\(^{144}\)

The limitations on loss carryovers do not apply when substantially all of the stock in both the acquiring corporation and the other corporation is owned by the same persons in the same proportions.\(^{145}\) To illustrate this company receives no new assets, however, the loss shareholders will usually be treated as having a sufficient percentage interest (under this rule) to qualify for a full carryover. The amendment changes this rule and requires that the percentage limitations be applied by reference to the loss shareholders’ actual percentage interest in the parent company.

\(^{140}\) Id. at 206.

\(^{141}\) S. REP. No. 94-1236, 94th Cong., 2d Sess. 450 (1976).


If G’s 60 percent shareholder P buys 50 percent of L’s stock in 1978 and, in 1980, L merges into G for 40 percent of G’s stock, P is not treated as a shareholder of L as to the 50 percent of L’s stock it previously purchased, so that only qualified L shareholders are the unrelated stockholders who received 20 percent of G’s stock in the reorganization, with the result that 70 percent of L’s carryovers would be disallowed by section 382(b)(2).

\(^{143}\) Id. at 138.


\(^{145}\) I.R.C. § 382(b)(6) (common ownership exception).
common ownership exception: "[i]f a common parent company, P, merges L, a wholly owned loss subsidiary, into S-2, a wholly owned second-tier profit subsidiary of P, the common ownership exception will apply because P will be treated as being the common owner of both L and S-2."146 The exception, however, does not apply to a net operating loss carryover from a taxable year in which all of the stock of the loss corporation and at least forty percent of the fair market value of the participating stock was owned by the acquired or acquiring corporation at all times during the last six months of the taxable year.147

CONCLUSION

Since Davant the F reorganization has been used as an important tool for procuring eligibility for the net operating loss carryback exemption permitted by section 381.148 The Internal Revenue Service concessions in Revenue Ruling 75-561 made available multicorporate F reorganizations,149 yet the de minimis problem has been dodged by the courts through the redemption150 and the functionally unrelated steps doctrines.151 It is a difficult problem, one that requires judicial or legislative interpretation if the taxpayer is to enjoy a degree of certainty in the F reorganizational area. The new restrictions on continuity of interest152 enhance the importance of a binding decision on what constitutes a de minimis change. The Aetna court had an opportunity to deal effectively with the problem, but relied on present decisions, declining as had the majority in Casco, "to attempt to navigate these treacherous shoals." As Judge Raum stated in the Casco dissent, the question cannot be sidestepped, but must be faced.153 Without guidance the taxpayer may be wise to eliminate minority interests before attempting a reorganization.

147. I.R.C. § 382(b)(6).
151. See Reef Corp. v. Commissioner, 368 F.2d 125, 134 (5th Cir. 1966), cert. denied, 386 U.S. 1018 (1967).
152. See I.R.C. § 382(b).