FEDERAL INCOME TAX—OPERATING LOSS CARRYOVER ALLOWED UNDER INT. REV. CODE OF 1954 WHERE SURVIVING BUSINESS ENTITY SUFFERED NO LOSS; LIBSON SHOP DOCTRINE REJECTED. *Frederick Steel Co. v. Commissioner* (6th Cir. 1967).

In the early part of 1952, the Cleveland Home Brewing Company had accumulated net operating losses in excess of $400,000 from prior years' operations in the beer and ice business. In order to reduce further losses, the shareholders resolved to discontinue all brewing activities while continuing the ice business for several months. Thereafter over 90 percent of the outstanding shares were purchased by Abe Byer, a Cincinnati entrepreneur, who expected to make a quick profit[1] from the auction of certain assets held by Home Brewing. Some of the assets were sold, with the corporation later attempting to complete a sale of the remaining assets.[2] In July, 1954, the assets of a steel finishing business previously operated as a division of the American Compressed Steel Corporation (the shares of which were owned by Byer) were purchased by Home Brewing, which then changed the steel finishing business' name to the Frederick Steel Company.

The Frederick Steel Company income tax returns for the years 1954 through 1957 indicated that profits produced by the steel finishing assets were offset by deductions for the net operating losses sustained prior to the acquisition of these assets. The Commissioner of Internal Revenue disallowed these deductions,[3] and the Tax Court upheld the disallowance stating that "the pre-1954 losses which grew out of an entirely different enterprise may not be carried over in computing net operating loss deductions in the circumstances before use [*sic*]."[4] On appeal to the Sixth Circuit Court of Appeals, *held*, reversed: "[T]he corporation . . . was entitled to utilize the loss carry-over, *even though it was not the same business enterprise that had sustained the loss.*"[5] It was irrelevant "that the bundle of assets which produced the losses did not contribute to the subsequent profits."[6] *Frederick Steel Co. v. Commissioner*, 375 F.2d 351 (6th Cir. 1967).[7]

1 Frederick Steel Co., 42 T.C. 13, 15 (1964).

2 The remaining assets consisted of real property in the industrial part of Cleveland, Ohio, upon which the brewing plant was located.

3 42 T.C. at 19.

4 *Id.* at 22.

5 Frederick Steel Co. v. Commissioner, 375 F.2d 351, 354 (6th Cir. 1967).

6 *Id.*

7 *See* Liles, *New Case Reaffirms View that Libson Shops Doctrine Does Not Apply under Present Code,* 26 J. TAXATION 322 (June 1967).

The net operating loss deduction has been included within the statutory scheme of the Internal Revenue Code almost from its inception.[8] The deduction can be broadly defined as the excess of allowable deductions over gross income.[9] The 1939 Code contained no specific provisions in regard to the survival of the deduction[10] when there was a corporate reorganization or when there was a change in business activity or stock ownership;[11] thus this question was left for judicial consideration. Courts faced with this problem relied upon the fact that section 122 of the 1939 Code authorized "the taxpayer" who suffered the loss to take the net operating loss deduction.[12] Hence, if it could be shown that the taxpayer claiming the loss was in fact the same as the taxpayer who incurred the loss, the deduction would be allowed.

The courts developed two theories in defining "taxpayer."[13] The "legal entity" theory, represented by *New Colonial Ice Co. v. Helvering*,[14] required that the corporate entity, which had originally suffered the loss, emerge as the surviving corporation in a reorganization transaction in order to preserve the loss carryover.[15] This naturally resulted in manipulations designed to produce the survival of the appropriate corporation regardless of the economic or business facts underlying the transaction.[16]

The second theory was initially enunciated in *Helvering v. Metropolitan Edison Co.*,[17] which concerned the statutory merger of a parent and subsidiary corporation. The Court ruled that "the corporate personality of the transferor is drowned in that of the trans-

---

8 Revenue Act of 1918, ch. 18, § 204(b), 40 Stat. 1061.

9 INT. REV. CODE of 1954 § 172(c), "For purposes of this section, the term 'net operating loss' means . . . the excess of the deductions allowed by this chapter over the gross income." *See generally* Pomeroy, *What is a Net Operating Loss?*, 14 W. RES. L. REV. 233 (1963).

10 3 U.S. CODE CONG. & AD. NEWS, 83d Cong., 2d Sess. (1954) at 4066.

11 In 1943 Congress enacted INT. REV. CODE of 1939, § 129 which was applicable to this type of situation. However, this section resulted in disallowance only when it could be shown that the "principal purpose" of the transaction was "income tax avoidance." This proved to be a difficult fact question. The section was carried over into the INT. REV. CODE of 1954 as § 269. *Cf.* B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS, § 13.02, at 606 (2d ed. 1966).

12 INT. REV. CODE of 1939 § 122(b)(2)(B) which provides *inter alia*, "[i]f for any taxable year beginning after December 31, 1949, the taxpayer has a net operating loss, such net operating loss shall be a net operating loss carry-over for each of the five succeeding taxable years . . . ."

13 B. BITTKER & J. EUSTICE, *supra* note 11, at 607.

14 292 U.S. 435 (1935).

15 B. BITTKER & J. EUSTICE, *supra* note 11, at 609.

16 B. BITTKER & J. EUSTICE, *supra* note 11, at 607-08.

17 306 U.S. 522 (1939).

feree."[18] Furthermore, it made no difference which legal entity survived the transformation so long as the legal identity of one corporation was submerged by operation of law into that of the acquiring corporation.[19]

In 1957, the Supreme Court in *Libson Shops Inc. v. Koehler*,[20] injected a new requirement—continuity of business—into the loss carryover area. *Libson Shops* involved the statutory merger of sixteen corporations, each of which operated a retail store, into a single corporation. The sixteen corporations were owned by the same shareholders and these persons retained their same proportionate interest in the new corporation. Three of the retail units operated at a loss both before and after the merger. The new corporations sought to deduct the pre-merger losses of the three from the post-merger income of the profitable stores. The Supreme Court disallowed the net operating loss deduction on the grounds that "the prior year's loss can be offset against the current years income only to the extent that this income is derived from the operation of substantially the same business which produced the loss."[21] This rule has been applied and extended by later cases to embrace a rule known as "continuity of business enterprise," which requires, generally speaking, that the ultimate beneficiaries of the loss carryover be substantially the same persons as those who were shareholders when the loss was sustained.[22]

The Court in *Libson Shops* stated that the primary purpose of net operating loss deductions is the relief of the burdens of annual accounting for tax purposes.[23] In a business with fluctuating loss and profit years, annual accounting results in a higher tax burden than that which is placed on a business that has no loss years but has a comparable total income for the same period.[24] It was made equally clear that the practice of "trafficking in loss corporations"[25] would

---

18 *Id.* at 529.

19 B. BITTKER & J. EUSTICE, *supra* note 11, at 609.

20 353 U.S. 382 (1957). *See* B. BITTKER & J. EUSTICE, § 13.02, at 609, where it is commented:

> [I]n Libson Shops v. Koehler . . . the Supreme Court overturned (or ignored) several well-settled assumptions in this area, propounded a new doctrinal limitation on the carryover of corporate tax attributes, and generally stirred up a hornet's nest of confusion, the outer limits of which are still unresolved.

21 353 U.S. at 386.

22 Wilson, *Survival of Net Operating Loss Carryovers and Carrybacks*, U. SO. CAL. 1966 TAX INST. 231, 253.

23 353 U.S. at 386.

24 *See* Burnet v. Sanford & Brooks Co., 282 U.S. 359 (1930).

25 353 U.S. at 385. This is the practice of buying loss corporations at bargain prices

not be tolerated by the Court because of the windfall character of the tax use made of the relief provision.

The net operating loss provisions of the 1954 Code represented a substantial change from those of the 1939 Code. The term "taxpayer" was omitted from the provision authorizing the deduction.[26] In addition, the 1954 Code has extensive rules relating to the survival of the deduction through a corporate transformation. Section 381 provides for the survival of the deduction in certain situations; and section 382 provides for certain limitations of the survival. These rules are not concerned with the tax motives of the parties involved.[27]

---

for the purpose of taking the net operating loss carryovers. It acquired such a common place status that advertisements were placed in leading publications regarding the availability of such loss corporations. *E.g.*, N.Y. Times, Feb. 7, 1960, § 3, at 11, col. 1.

26 *Compare* INT. REV. CODE of 1954 § 172. *Net operating loss deduction.*

(a) *Deduction allowed*—There shall be allowed as a deduction for the taxable year an amount equal to the aggregate of (1) the net operating loss carryovers to such year, plus (2) the net operating loss carrybacks to such year.

with INT. REV. CODE of 1939 § 122(b)(2)(A).

[I]f . . . the taxpayer has a net operating loss, such net operating loss shall be a net operating loss carry-over for each of the two succeeding taxable years . . . .

27 INT. REV. CODE of 1954 § 381. *Carryovers in certain corporate acquisitions.*

(a) *General rule.*—In the case of the acquisition of assets of a corporation by another corporation—

(1) in a distribution to such other corporation to which section 332 (relating to liquidations of subsidiaries) applies, except in a case in which the basis of the assets distributed is determined under section 334(b)(2); or

(2) in a transfer to which section 361 (relating to nonrecognition of gain or loss to corporations) applies, but only if the transfer is in connection with a reorganization described in subparagraph (A), (C), (D) (but only if the requirements of subparagraphs (A) and (B) of section 354(b)(1) are met), or (F) of section 368(a)(1),

the acquiring corporation shall succeed to and take into account, as of the close of the day of distribution or transfer, the items described in subsection (c) of the distributor or transferor corporation, subject to the conditions and limitations specified in subsections (b) and (c).

INT. REV. CODE of 1954 § 382. *Special limitations on net operating loss carryovers.*

(a) *Purchase of a corporation and change in its trade or business.*

(1) *In general.*—If, at the end of a taxable year of a corporation—

(A) any one or more of those persons described in paragraph (2) own a percentage of the total fair market value of the outstanding stock of such corporation which is at least 50 percentage points more than such person or persons owned at—

(i) the beginning of such taxable year, or

(ii) the beginning of the prior taxable year,

(B) the increase in percentage points at the end of such taxable year is attributable to—

(i) a purchase by such person or persons of such stock, the stock of another corporation owning stock in such corporation, or an interest in a partnership or trust owning stock in such corporation, or

(ii) a decrease in the amount of such stock outstanding or the amount of stock outstanding of another corporation owning stock in such corporation, except a decrease resulting from a redemption to pay death taxes to which section 303 applies, and

In light of these statutory provisions, it was argued by some commentators that the rule announced in *Libson Shops* should be limited in application to cases arising under the 1939 Code.[28] The point was not squarely passed upon until *Maxwell Hardware v. Commissioner*,[29] which involved a hardware company with approximately a million dollars in net operating losses. Through a complex arrangement employing a preferred stock issue and a common stock voting trust, a real estate development division was added to the corporation's hardware business and operated with funds supplied by the real estate developers to whom the preferred stock had been issued. Even though the court recognized that the primary purpose of the transaction was the avoidance of federal income taxes, it held that a net operating loss deduction was proper.[30]

The court in *Maxwell* met the argument for the application of the *Libson Shops* rule with the statement: "By enacting the 1954 Code, Congress destroyed the precedential value of the rule of decision of Libson Shops . . . ."[31] The Ninth Circuit in *Maxwell* decided that in situations governed by the 1954 Code, the statutes enacted by Congress must be the sole criterion for disallowance.[32] Since both section 269 and 382 disallow the deduction when voting control is acquired, the use of preferred non-voting stock and a voting trust effectively prevented the acquisition of control. The court ruled that the deduction should be allowed since it was not denied by either section 269 or 382.

The Ninth Circuit stated that the Commissioner, the Tax Court,

---

(C) such corporation has not continued to carry on a trade or business substantially the same as that conducted before any change in the percentage ownership of the fair market value of such stock, the net operating loss carryovers, if any, from prior taxable years of such corporation to such taxable year and subsequent taxable years shall not be included in the net operating loss deduction for such taxable year and subsequent taxable years.

28 *E.g.*, Sinrich, *Libson Shops—An Argument Against Its Application Under the 1954 Code*, 13 TAX L. REV. 167 (1958): Levine & Petta, *Libson Shops: A Study in Semantics*, 36 TAXES 445 (1958). *But cf.* 66 COL. L. REV. 338 (1966).

29 343 F.2d 713 (9th Cir. 1965).

30 *Id.* at 723.

31 *Id.* at 716.

32 *Id.* at 723, where the court says:

> Taxation is peculiarly a matter of statutory law, and in applying that law to the determination and computation of income and deductions, the Courts do not make moral judgments. There is nothing perfidious or invidious in enjoying a statutory deduction from reportable income. It is not a matter of conscience but of statute and the determination of Congressional intent. In our opinion, Congress has quite plainly said that net operating loss deductions should be allowed unless the special circumstances interpreted within the letter and spirit of Sections 382(a) and 269 obtain.

For a good discussion of *Maxwell Hardware* see 3 SAN DIEGO L. REV. 85 (1965).

and the petitioner agreed that if the *Libson Shops* fact situation had arisen under the 1954 Code, specific provisions of section 381 would have allowed the merged corporation to use the carryovers.[33] This fact lead the court to conclude that Congress intended the statutory rules of the 1954 Code to be the sole test of allowability of the deductions.

The Internal Revenue Service reacted to *Maxwell* by issuing *Technical Information Release No. 773*, which stated that the Service would not "follow the decision . . . in the case of Maxwell Hardware Co. v. Commissioner . . . ."[34] The IRS based its rejection of the *Maxwell* decision on the ground that the *Libson Shops* doctrine retained vitality under the 1954 Code "since to permit a loss carryover in such cases would run counter to the legislative objectives of the carryover privilege."[35]

In reaffirming[36] its reliance on the *Libson Shops* decision under particular circumstances, the Service recapitulated its position on loss carryovers in terms appropriate to the *Maxwell* situation. By the terms of this announcement, net operating loss carryovers were to be disallowed by the IRS

> where there has been both a 50 percent or more shift in the benefits of a loss carryover (whether direct or indirect and including transactions having the effect of shifting the benefit of the loss by shifting assets, stock, profit interests or other valuable rights) and a change in business as defined in section 382(a) and the regulations thereunder.[37]

In 1958, the Service stated that *Libson Shops* would "not be relied upon . . . as to a merger or any other transaction described in section 381(a) of the 1954 Code."[38] The extent to which *Libson Shops* would be applied to other acquisitions not specified in section 381, and to the survival of the acquiring corporation's own tax attributes (the situation in both *Maxwell* and the instant case) was clarified in 1963, when the Service ruled that "it would apply *Libson* to 1954 Code transactions where a single corporation discontinued a loss business and purchased a profitable business if, at about the same

---

33 343 F.2d at 718.
34 CCH 1965 STAND. FED. TAX REP. ¶6751; 1965 P-H FED. TAX ¶55,063.
35 *Id.*
36 For an earlier statement of IRS views see Rev. Rul. 63-40, 1963-1 CUM BULL. 46.
37 *See* material cited note 34 *supra.*
38 Rev. Rul. 58-603, 1958-2 CUM. BULL. 147.

time, a significant change in stock ownership occurred."[39] The subsequent *Technical Information Release No. 773* is, therefore, a modification of the Service's 1963 position that *Libson Shops* may apply even though sections 269 and 382 do not deny the deduction for the net operating loss carryover.[40]

The standards established by the IRS, for the determination of whether there has been a change in business, are restrictive to the point of preventing, because of the unfavorable tax consequences, reasonable and desirable business practices. For example, the acquisition of control of a corporation to secure the use of multipurpose assets is fraught with the peril of lost tax benefits[41] if a new line of business is added, accompanied by a discontinuance of an unprofitable line.[42] An organization engaged in a process of gradual business evolution must secure the continuity of at least 50 percent of its stock ownership to keep its tax position intact.[43]

The decision in *Clarksdale Rubber Co.*[44] indicates that the section 382 regulations pertaining to "change in business," concern economic endeavors, while this *Libson Shops* test relates "to an economic concept prohibiting separate business *units* from combining so that profits from one separate enterprise might be offset against losses of another . . . ."[45]

The Tax Court reasoned that:

> The *Libson Shops* decision did not contrue the phrase "same business" to mean the same type of business, indicating an identity or similarity of economic endeavor. But it is clear from the legislative history that section 382(a)(1)(C) does require such identity or substantial similarity of economic endeavor. Since the phrase "same

---

39 B. BITTKER & J. EUSTICE, *supra* note 11, at 664, *commenting on* Rev. Rul. 63-40, 1963-1 CUM. BULL. 46.

40 *Accord*, B. BITTKER & J. EUSTICE, *supra* note 11, at 649.

> [T]he extent to which *Libson's* "continuity of business enterprise" notions have been (or can be) infused into the business continuity rules of § 382(a) is unclear, but the attempt to do so on the part of the Service in its regulations under § 382(a) is unmistakable (footnote omitted).

41 Treas. Reg. § 1.382(a)-1(h)(5) (1964).

> (5) In determining whether a corporation has not continued to carry on a trade or business substantially the same as that conducted before any increase in the ownership of its stock, all the facts and circumstances of the particular case shall be taken into account. Among the relevant factors to be taken into account are changes in the corporation's employees, plant, equipment, product, location, customers, and other items . . . .

42 Treas. Reg. § 1.382(a)-1(h)(7) (1964).

43 Treas. Reg. § 1.382(a)-1(h)(8) (1964).

44 45 T.C. 234 (1966).

45 B. BITTKER & J. EUSTICE, *supra* note 11, at 667.

> business" in *Libson Shops* does not mean the same thing as it does under section 382, the application of *Libson Shops* to the facts of this case would render section 382 meaningless.[46]

The Service, however, states that it will apply *Libson Shops* when there has been a 50 percent or more shift in benefits of a loss carry-over and a "change in business *as defined in § 382(a) and the regulations thereunder.*"[47]

Additionally, two critical observations of the IRS position may be made at this point. First, no time was specified within which the change of ownership, or the change in corporate organization resulting in a shift in the use of the net operating loss carryover, must occur to be considered in connection with a change of business for the purpose of deciding allowability under the *Libson Shops* rule. The Senate Committee, which considered the original draft of the 1954 Code with regard to the prevention of "trafficking in loss carry-overs" specifically provided a two-year limitation to discriminate between deserving and undeserving taxpayers.[48] Such a time limitation has the effect of imposing a requirement of transactional nexus between the change in business and the change in ownership.

Second, the application by the Revenue Service of the *Libson Shops* rule leaves uncertain which persons are to be considered in determining when the necessary change of ownership has occurred. This uncertainty was eliminated in the 1954 Code by the specific provision calling for consideration of the ten persons holding the greatest percentage of the fair market value of the stock.[49] If *Libson Shops* is to be applied independently of section 382 the uncertainty remains. It is conceivable that a greater than 50 percent change of ownership could occur without any prior arrangement between the parties in a corporation with stock ownership spread among many people in varying amounts.

Congress clearly stated that elimination of this type of uncertainty was a primary purpose in the enactment of the 1954 Code. The

---

46 45 T.C. at 244 (citation omitted).

47 CCH 1965 STAND. FED. TAX REP. ¶6751; 1965 P-H FED. TAX ¶55,063 (emphasis added).

48 3 U.S. CODE CONG. & AD. NEWS, 83d Cong., 2d Sess. (1954) at 4684. INT. REV. CODE of 1954 § 382(a)(1)(A) is the codified version of this time limitation.

49 INT. REV. CODE of 1954 § 382(a). The distribution of burden and benefit intended by Congress in enacting the 1954 Code is suggested in INT. REV. CODE of 1954 § 269 (c). A presumption of income tax avoidance motives arises when the consideration paid is substantially disproportionate to the sum of the adjusted basis of the assets acquired and the tax benefits thereby made available. *Cf.* B. BITTKER & J. EUSTICE, *supra* note 11, at 644-45.

House Committee report states with regard to section 382: "This special limitation on net operating loss carryovers provides an objective standard governing the availability of a major tax benefit. . . ."[50]

In addition to the advantage to be gained from increased certainty in construction, Congress intended to make this "major tax benefit," dependent on practical economic realism rather than legal formalism.[51] This is reiterated by the court in *Frederick* when it quotes *Maxwell* to the effect that "it was the clearly expressed intention of Congress to attempt to bring some order out of chaos, and, in effect, to countenance 'trafficking' in operating loss carryovers except as affected by the special limitations of Section 382 and the general limitations of Section 381."[52]

Assuming that the *Maxwell* court correctly identified the legislative purpose, should the courts, in applying the provisions of the Internal Revenue Code be limited to a theory of statutory construction without a consideration of whether there is an abuse of the tax relief provision or whether there is an intended use of this deduction? The courts might be well advised to return to a consideration of the reason why a loss sustained in a prior year should be permitted in one situation and denied in another, namely, the prevention of unjust burdens and unjustified windfalls.[53]

The Supreme Court has declined to review the *Frederick* case.[54] As a final statement of the law regarding the survival of net operating loss carryovers in corporate transformations, *Frederick* delineates certain situations in which survival is assured. These situations can be generally categorized as follows: (1) the transactions enumerated under section 381, (2) an acquisition of a corporation, providing that (a) no change of business or trade occurs, or that (b) the change in business or trade occurs more than two years following the acquisition, (3) a transformation resulting in a change in business or trade but which does not result in a greater than 50 percent shift in ownership. However, the complexity of the subject coupled with the variety

---

50 3 U.S. CODE CONG. & AD. NEWS, 83d Cong., 2d Sess. (1954) at 4067.

51 *Id.* "Tax results of reorganizations are thereby made to depend less upon the form of the transaction than upon the economic integration of two or more separate businesses into a unified business enterprise."

52 375 F.2d at 354.

53 *See generally* Comment, 69 YALE L.J. 1201, 1291 (1960); *cf.* 1 U.S. CODE CONG. & AD. NEWS, 87th Cong., 1st Sess. (1961) at 1129.

54 Certiorari was denied on October 16, 1967. 88 S. Ct. 219 (1967).

of fact situations to which the foregoing rules are applicable leaves a great deal of uncertainty to be resolved in determining whether a loss carryover should be allowed.[55]

IRWIN L. SCHROEDER

[55] *See* WOFAC v. United States, 269 F. Supp. 654 (D.N.J. 1967) and Commercial Indus. Corp. v. United States, 268 F. Supp. 52 (D.N.J. 1967).