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III

LIMITATIONS WHERE SAME TAXPAYER SEeks TO CARRY
LOSS TO ANOTHER YEAR

Harlan Pomeroy

There are at least three different rules of law which may prevent the same taxpayer from carrying a loss to another year. Two of these rules are statutory and one is a judicially determined rule.

SECTION 382 (a)

The first pertinent statutory provision is section 382 (a) of the Internal Revenue Code. This provision prevents the carryover of a net operating loss by a corporation when two changes occur. First, there must be a change in ownership and, second, there must be a change in the trade or business. If section 382 (a) is applicable, the effect of its application is entirely to eliminate all loss carryovers.\(^1\) Carryovers to all years beginning with the year of change of ownership from all years ending with the year of change of ownership are explicitly prohibited if the statute's terms are met.\(^2\) However, it should be noted that the statute prevents carryovers only and does not purport to cover carrybacks. Moreover, the applicability of the statute in no way depends upon the corporate taxpayer's intent or purpose either in changing ownership or in changing its trade or business.\(^3\) If the terms and provisions of section 382 (a) of the Code are met, elimination of all loss carryovers is mandatory.

Change in Ownership

Generally, there has been a change in ownership when fifty per cent or more of the corporation's stock changes hands in a taxable transaction. In determining whether there has been a change in ownership, the statute requires that a determination first be made of the ten persons who own the greatest amount of stock at the end of the year. For this purpose all outstanding shares, except non-voting shares which are limited and preferred as to dividends, are considered.\(^4\) All shares considered for determining a change in ownership are considered upon the basis of their

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1. Treas. Reg. § 1.382 (a)-1 (a) (1) (1962) [hereinafter cited as Reg §].
2. Reg. § 1.382 (a)-1 (h) (2) (1962).
fair market value. Moreover, the rules of attribution of stock ownership are applicable for purposes of determining the ten largest shareholders. If two or more persons own the same percentage of stock and one is included in the group of the ten largest shareholders, all others owning the same percentage must be included.

**Purchase of Stock**

Under the statute and the Regulations the change in ownership must be brought about either by purchase or by decrease in the outstanding stock, or by both methods. The purchase may be either the purchase of stock of the corporation which has sustained the loss or the purchase of stock of a corporation owning the loss corporation's stock. For purposes of determining whether there has been a purchase, a purchase from one whose ownership is attributed to the purchaser of the stock is not considered to be a purchase.

**Decrease in Outstanding Stock**

In the case of changes in ownership brought about by a decrease in the outstanding stock, this again may be a decrease in the stock of the corporation sustaining the loss or a decrease in the stock of a corporation owning the stock of the loss corporation. However, a decrease in stock resulting from a stock redemption under section 303 of the Internal Revenue Code to pay death taxes is not considered in determining whether there has been a change in ownership.

Decreases in the ownership of stock of the ten largest shareholders of the corporation are not offset against increases in stock so that the effect of the statute is to recognize all eligible increases in stock ownership but to ignore any decreases, whether by purchase or otherwise. While neither the statute nor the Regulations are explicit on the point, it

5. Reg. § 1.382(a)-1(c) (1) (1962).
6. Reg. § 1.382(a)-1(a) (2) (1962). Section 318(a) of the Internal Revenue Code applies in determining stock ownership, but the fifty per cent limitation for attribution of ownership under § 318(a) (C) of stock held by a corporation is inapplicable; i.e., stock owned by a corporation is owned, by attribution, proportionately by its shareholders without regard to whether the particular shareholder owns at least fifty per cent of the stock of the holding company.
7. Reg. § 1.382(a)-1(c) (1) (1962).
8. Reg. § 1.382(a)-1(e) (1) (1962). There is a purchase only if the basis of the purchased stock is determined solely by reference to its cost to the purchaser.
9. Reg. § 1.382(a)-1(e) (1) (1962). However, the statutory sanction cannot be avoided merely by a prior acquisition of stock designed to prevent a later acquisition from being a purchase. Reg. § 1.382(a)-1(e) (2) (1962). Moreover, negligible holdings are ignored in determining whether there has been a purchase. Ibid.
10. Reg. §§ 1.382(a)-1(b) (2), -1(g) (1962).
11. Reg. § 1.382(a)-1(b) (2) (1962). But this is so only to the extent that the amount distributed in the § 303 redemption does not exceed the sum of the items described in paragraphs (1) and (2) of § 303(a).
would seem that a decrease in stock brought about by some method other than a stock redemption, such as a recapitalization converting voting stock into nonvoting preferred stock, would constitute a decrease in stock to be used in determining whether there has been the requisite percentage change in ownership.

When Change of Ownership Is Determined

The change of ownership is determined as of the end of the taxable year and is compared with the ownership of the stock either at the beginning of that taxable year or at the beginning of the preceding taxable year.¹² Thus, the change in ownership must take place over a period of not more than two years. However, the increase in ownership may take place in several transactions over the two-year period.¹³ Moreover, a change in business made in contemplation of a change in ownership will be treated as if the change in business had occurred after the change in ownership.¹⁴ The Regulations provide that stock acquired by option is considered as having been acquired when the option itself is acquired.¹⁵

Size of Change

Under the statute there has not been a change in ownership which will invoke the prohibitory provisions of section 382(a) unless the aggregate increase in ownership of the stock has been at least fifty percentage points in terms of fair market value of the stock of the ten largest shareholders selected as mentioned above.¹⁶ There is a difference between fifty per cent and fifty percentage points. Thus, an increase from ten to fifteen per cent of the stock would be a fifty per cent increase but an increase of only five percentage points, whereas an increase from ten to sixty per cent of the stock would be an increase of fifty percentage points.

Change in Trade or Business

A change occurs in a trade or business if the corporation does not continue to carry on substantially the same trade or business as it carried on before the change in ownership. The test imposed by the Tax

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¹². Reg. § 1.382(a)-1(d) (1962).
¹³. Ibid.
¹⁵. Reg. § 1.382(a)-1(a) (2) (1962).
¹⁶. Reg. § 1.382(a)-1(d) (3) (v) (1962).
Court is whether the *basic character* of the business remains unchanged. The Regulations\(^{17}\) indicate that among the relevant factors to be considered are changes in employees, plant, equipment, product, location, and customers.

Any substantial change counts and must be considered if it occurs after the first increase in percentage points of ownership during the two-year period which is taken into account in determining the change in ownership.\(^{18}\) However, under the Regulations a change in business *prior* to the two-year period, made by the old owners in contemplation of a change in ownership, will be treated as if the change occurred after the change in ownership.\(^{20}\) This view has been adopted by the Tax Court.\(^{21}\)

There have been only two cases decided to date under section 382(a) of the Internal Revenue Code. In one,\(^{22}\) the court held that the business remained substantially the same despite the addition of a dry-goods line to the existing hard-goods line, a move of the wholesale outlet and the office to another state in the five-state area covered by the company, and the expansion of its operation from wholesale into retail. In the other case,\(^{23}\) the court held that there had been a change in the basic character of the business where there was a change from the production of lightweight aggregate, a construction material, prior to the change in ownership, to the business of electrical contracting subsequent to the change in ownership. Each of these cases is now pending on appeal. The decisions of the respective appellate courts should throw additional light upon the meaning of the phrase "continued to carry on a trade or business substantially the same as that conducted before any change in the percentage ownership," as used in the statute.\(^{24}\)

**Change in Location**

The proposed Regulations under section 382(a) published at the end of 1960 have just become final.\(^{25}\) They throw considerable light

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24. INT. REV. CODE OF 1954, § 382(a) (1) (C).
upon the question of what constitutes a change in a trade or business. Thus, the Regulations deal with a change in location of a portion of the business activities. They provide that a change in location of a major portion of the business activities resulting in a substantial alteration of the business is not a continuation of the same business. Thus, a manufacturer's move to another state, attended by the sale of its plant and equipment and a change in its employees, but not in its customers, is viewed as giving rise to a different business; whereas a department store's move from a city to its suburb is not a substantial change in the business although attended by the sale of its building and equipment, where the products, employees, and customers remain substantially the same.

More Than One Business

The Regulations also purport to deal with the situation where there is more than one business. Thus, where one business is terminated, the business is not considered to be the same business unless only a minor portion of the business is discontinued. In determining whether the portion of the business which has been discontinued is minor, the Regulations require, by begging the question, that consideration be given to whether the termination of a portion of the business has the effect of utilizing the carryover of a loss to offset income of a business unrelated to that which produced the loss. The Regulations, following the committee reports, provide that the mere addition of another business is not the failure to carry on substantially the same business if the corporation continues its prior business activities "substantially undiminished." It is interesting to read this provision of the Regulations in the light of Libson Shops, Inc. v. Koehler, for the Regulations appear to equate discontinuing a minor portion of the business with the Libson Shops rule requiring that the loss be produced by substantially the same business that produced the income against which the loss is to be offset.

27. Id., example 1.
28. Id., example 2. Compare example 3, involving a transfer of business to a town five miles distant, a sale of a building and liquor license, new customers, retention of five out of ten employees, which is viewed as a substantial change. In the Regulations as originally proposed, the examples referred to sale of products to "substantially the same customers." The final Regulations have liberalized the test by adding, in the alternative, the phrase "or to customers drawn from substantially the same area." Reg. § 1.382(a)-1(h) (9), examples 2, 3 (1962).
Inactive Corporations

It may be anticipated that considerable controversy will arise in connection with inactive corporations. Thus, the Regulations provide that there has been a change in a business where a taxpayer has not continued its trade or business substantially the same as it was conducted “immediately” prior to the first change in ownership. In a specific application the Commissioner has ruled that the same business was not continued where adverse economic factors caused the termination of a general insurance business for a short period of time after which the very same business was reactivated by the new owners. The Regulations adopt the view of this ruling. A contrary result is indicated in the Regulations where a fire disrupts the business operations and continuing efforts are made following the fire to resume business operations. There would appear to be conceptual difficulties in the Commissioner’s attempt to differentiate between disruptions of business due to economic factors and disruptions due to physical conditions. The theory behind section 382(a) is that losses should not be carried over and offset against income from a business unrelated to the business which produced the loss. This theory is no more violated where the disruption is economic rather than physical in origin.

Personal Service Corporations

In the case of personal service corporations, the Regulations provide that there is a substantial change in a business if a corporation is “primarily engaged in the rendition of services by a particular individual or individuals” and after the ownership change, it is primarily engaged in rendering services by different individuals. The Regulations also contain a provision to the effect that the holding, purchase, or sale of securities and similar property for investment purposes will not be considered to be a trade or business unless, historically, this has been the corporation’s primary activity.

32. Reg. §§ 1.382(a)-1(d) (2) (v), -1(h) (1) (1962).
34. Reg. § 1.382(a)-1(h) (6) (1962).
35. Id., example 2.
A second statutory limitation on the use of loss carryovers and carrybacks by the same corporation is contained in section 269 of the Internal Revenue Code.\(^\text{39}\)

**LIBSON SHOPS DOCTRINE**

A third limitation on the use of loss carryovers, and probably of carrybacks, is judicial in its origin. This is the limitation articulated in the famous case of *Libson Shops, Inc. v. Koehler*.\(^\text{40}\) In that case the Court held that a management corporation into which sixteen separate incorporated clothing businesses were merged could not carryover and deduct from post-merger income the pre-merger net operating losses of three of the clothing companies where the businesses conducted by those three companies continued to operate at a loss after the merger and where the merged group had not filed consolidated returns prior to the merger.

The broad rule of the decision is that a carryover is not available unless there is a continuity of business enterprise from the year of the loss continuing through the year to which the loss is carried. In other words the income to be offset by the loss must be produced by substantially the same business. While this decision was reached under the 1939 Code, the case may continue to have importance in situations arising under the 1954 Code.

**Applicability Under 1954 Code**

It will be noted that the facts of the *Libson Shops* case involved a merger of separate corporate entities. The Supreme Court there expressly commented that it was not passing on the question of the carryover of a loss by the same corporation where there had been a change in its business.\(^\text{41}\) Treating this as an invitation from the Court, the Commissioner thereupon withdrew an acquiescence of nearly thirty years standing in a case where a carryover had been allowed to a continuing corporate entity despite a complete change in its business.\(^\text{42}\)

There has been considerable discussion as to whether the *Libson Shops* case is applicable in situations governed by the 1954 Code. While

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39. For a detailed discussion of § 269 see at 290-303 supra.
40. 353 U.S. 382 (1957).
41. Id. at 390 n.9.
42. The acquiescence in Northway Securities Co., 23 B.T.A. 532, X-2 CUM. BULL. 52 (1931), was withdrawn and a nonacquiescence substituted in 1960-2 CUM. BULL. 8.
the Commissioner has ruled that the continuity of business requirement of the *Libson Shops* case is not applicable to a merger or other transaction described in section 381(a) of the 1954 Code,\(^4\) he has issued no ruling either way as to loss carryovers in a continuing corporation, the situation dealt with by section 382(a). However, the withdrawal of his acquiescence in the *Northway Securities* case\(^4\) may be an indication that he will seek to apply the *Libson Shops* rule in cases arising under the 1954 Code.\(^4\) Moreover, in a dictum, one court has said that the rule of the *Libson Shops* case would apply to a continuing corporation, even if the case arose under the 1954 Code.\(^4\) On the other hand, it can be argued that the specific statutory tests of section 382(a) are designed to deal with situations where the same entity, following a change in business and stock ownership, seeks to carry over the loss and that this section should not be superseded by a judicial doctrine resting upon inferences drawn by the Court from a statutory provision (section 172) not purporting to deal with such situations.\(^4\)

If the courts should hold that the *Libson Shops* rule is applicable to cases arising under the 1954 Code involving the same taxpayer, the rule will be applied, at the very least, to cases involving the same taxpayer where there has been both a change in ownership and a change in business.\(^4\)

Several questions remain to be answered. Will the *Libson Shops* rule apply where there has been a change of business without a change in ownership?\(^4\) If a change in ownership is also required, how large


\(^4\) See note 42, *supra*.

\(^4\) While withdrawal of the acquiescence and substitution of the non-acquiescence in the *Northway Securities* case may have been intended to clear the way to apply the *Libson Shops* rule under the 1939 Code to carryovers within the same entity, it seems unlikely that the Commissioner would have disturbed an acquiescence of such long standing and waited for more than three years after the *Libson Shops* decision to substitute his non-acquiescence unless he wished to clear the way administratively for applying the *Libson Shops* rule as well as to cases arising under the 1954 Code involving the carryover of a loss in the same entity where there has been a change in its business.

\(^4\) J. G. Dudley Co. v. Commissioner, 298 F.2d 750 (4th Cir. 1962). For the effective date of § 382(a), see § 394(b).

\(^4\) For an extended discussion of the applicability of the *Libson Shops* case to loss carryovers in a single corporate entity, see Hawkins, *Loss Carryovers in Insolvency Reorganizations*, at 284-88 *infra*.

\(^4\) The carryover has been denied under the 1939 Code in J. G. Dudley Co. v. Commissioner, 298 F.2d 750 (4th Cir. 1962); Commissioner v. Virginia Metal Products, Inc., 290 F.2d 675 (3d Cir.), *cert. denied*, 368 U.S. 889 (1961); Mill Ridge Coal Co. v. Patterson, 264 F.2d 713 (5th Cir.), *cert. denied*, 361 U.S. 816 (1959); Huyler’s, 38 T.C. No. 77 (Aug. 30, 1962); Norden-Ketay Corp., P-H 1962 TAX CT. REP. & MEM. DEC. (31 P-H Tax Ct. Mem.) § 61076 (Oct. 23, 1962). The carryover was permitted on the ground that the same business, despite alterations, was being continued in Kolker Bros., 35 T.C. 299 (1960).

\(^4\) In each of the cases applying the *Libson Shops* rule to a single corporation, there has been a substantial change in stock ownership, except in Kolker Bros., 35 T.C. 299 (1960), in