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LOSS CARRYOVERS IN INSOLVENCY REORGANIZATIONS

Edward J. Hawkins, Jr.¹

Just as any benefit in excess may become a burden, so an excess of net operating losses, despite the tax advantages, many prove detrimental to the continued existence of a business. In some such cases, the business clearly dies, and its loss carryovers clearly perish with it. The problem to be considered in this article, however, is whether the loss carryovers also perish if, instead of dying, the business undergoes an insolvency reorganization and re-emerges for another try, carrying on much the same operations as before but stripped of much of its former debt burden.

This question has been considered in three recent cases, and the decisions of the courts in these cases have been unanimous in denying the loss carryover. It is the thesis of this article, however, that for many insolvency situations, these cases are either distinguishable or wrong, and that while only a very brave attorney would give an unqualified opinion in any insolvency proceeding that the loss carryover will be available, only an unnecessarily pessimistic attorney would conclude that in every case the carryover is hopeless.¹a

LOSS CARRYOVER TO NEW ENTITY VIA SECTION 381

Section 381 expressly authorizes the transfer of a net operating loss from one corporate entity to another in transactions meeting certain requirements. The requirements here relevant are that the transaction be described in section 361, and be pursuant to certain definitions of reorganization contained in section 368.² The question is whether these requirements are met in an insolvency reorganization.

The structure of the Internal Revenue Code of 1954 implies that insolvency reorganizations are not within the meaning of sections 361 and 368. Insolvency reorganizations are specifically covered by sections 371-82, and section 371 is almost parallel to sections 361 and 354, which deal with reorganizations generally. The definitions of section 368, fur-

¹. Acknowledgement is made of valuable suggestions in the preparation of this article by the late George Cameron, Esq.

¹a. The three cases in question are Willingham v. United States, 289 F.2d 283 (5th Cir. 1961) (discussed below at 286); Wisconsin Cent. R.R. Co. v. United States, 296 F.2d 750 (Ct. Cl. 1961), cert. denied, 369 U.S. 885 (1962) (discussed below at 280); and Huyler's, 38 T.C. No. 77 (Aug. 30, 1962) (discussed below at 285).

². INT. REV. CODE OF 1954, §§ 381 (a) (2), 361, 368 [hereinafter cited as CODE §]. The requirements of CODE § 381 have been discussed in Adelson, Carrying Losses to a Different Taxpayer, at 262 supra.
Thermore, are expressly made applicable only to that part of subchapter C preceding sections 371-74.\(^3\)

That a choice is intended between the application of sections 361 and 368, on the one hand, and the insolvency sections, on the other hand, may also be indicated by the fact that section 381 expressly provides certain results for transactions falling within section 361, but makes no reference to section 371. Perhaps more important is the fact that the receipt of boot by the stockholders of an old corporation is treated differently in an exchange governed by section 354 than in an exchange governed by section 371.\(^4\) Hence, both sections cannot apply, and, if a choice must be made, the section more specifically dealing with insolvencies normally would be assumed to govern.

To balance the foregoing arguments for the non-applicability of section 381, three contrary considerations should be noted.

**Legislative History**

In 1942, the United States Supreme Court held that it was possible for insolvency reorganizations to qualify within the general reorganization definitions in certain early revenue acts.\(^5\) Two years later the statutory provisions now contained in section 371 were introduced in the Senate. The Senate Finance Committee adopted a provision governing all insolvency reorganizations, differing in treatment from the provisions governing normal reorganizations, and stated that the reorganization provisions now contained in sections 354 and 361 "shall not apply to any transaction within the provisions of this paragraph."\(^6\) This provision, if enacted, would clearly have resolved the problem of overlapping definitions. On the floor of the Senate, however, the Committee's version was replaced by the present statutory framework. Senator Johnson, its author, stated the purpose of the change as follows:

> It attempts to give to a corporation going through insolvency proceedings exactly the same treatment which is accorded solvent companies should they reorganize. If a solvent company were to reorganize today, it would have a certain status and certain tax advantages because of the historical basis allowed it as a policy of the tax laws enacted by the Congress, but the Treasury has contended that a company which be-

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1. CODE \(\S\) 361 refers to an exchange "in a pursuance of the plan of reorganization." CODE \(\S\) 371 refers to a transfer to a corporation organized "to effectuate a plan of reorganization." The words "plan of reorganization" have a different meaning in the two cases, however, since CODE \(\S\) 361 but not CODE \(\S\) 371 is governed by the reorganization definitions in CODE \(\S\) 368. Treas. Reg. \(\S\) 1.371-1 (a)(4) (1955) (hereinafter cited as Reg. \(\S\) 1). H.R. REP. No. 1079, 78th Cong., 2d Sess.; 1944 CUM. BULL. 1059, 1067.

2. Boot may be taxed as a dividend under CODE \(\S\) 354 and 356(a), but not under CODE \(\S\) 371(b).


4. 90 CONG. REC. 98 (1944).
comes insolvent, when it comes out of insolvency and reorganizes must start out as a new company, and, therefore, if it comes out as a new company naturally it loses the historical basis for tax treatment which is accorded all other companies. The object of this amendment is not to give an insolvent company any advantage or to take anything away from it, but to maintain the status quo. That is the object of the amendment. 7

This language, combined with the elimination of the Committee provision making the insolvency provisions exclusive, might also be deemed to resolve the question. It is doubtful, however, if the quoted statement does accurately set forth the purpose of the amendment, 8 and corresponding language is conspicuous by its absence from the conference report. 9 Nevertheless, the overall point of the legislation seems to have been not to preclude the application of sections 354 and 361, but to assure that the rules of those and related sections would in fact be applicable to insolvency reorganizations.

Statutory Interpretation

A second reason for permitting the application of section 381 rests on statutory interpretation. Section 371 is not in itself inconsistent with the application of section 381. If an insolvency reorganization also literally qualifies under section 368 — which it may 10 — the literal meaning of the Code is that it also qualifies for the consequences of section 368, such as section 381.

There are many other illustrations of overlapping Code provisions, and if one is meant to exclude the other, Congress has found the words necessary to say this. 11 The inconsistency as to boot is troublesome, but perhaps unreal. It could arise only where the insolvent corporation makes a distribution out of earnings and profits that would be taxable as a dividend under section 356(a)(2). If not impossible, this is at least so unlikely an event that it is doubtful if it should control the extremely real and important problem of loss carryovers.

Inapplicability of Section 381

A final reason for permitting section 381 to cover qualified insolvency reorganizations is that not all insolvency reorganizations are cov-
An example of such a reorganization would be a transfer not pursuant to court order. It would seem odd if the court-directed exchange, for which Congress especially wished to assure reorganization-like treatment, must receive worse treatment as to carryovers than a type of exchange which Congress did not attempt to protect. Conversely, should the non-court insolvency exchange be denied the benefits of section 381 simply because if court-directed it would have been within section 371? This is meant as a strictly rhetorical question.

Another route for avoiding the overlap between sections 361 and 371 would be an exchange of stock and debt interests in the insolvent corporation solely for voting stock of a successor corporation, if this proved practical. Subject to the possibility discussed below that a recapitalization of a single company will cut off carryovers, such an exchange would seem to set the stage for the successful application of section 381(a)(1) relating to liquidations of subsidiaries under section 332, without the necessity of a reorganization qualifying under section 381(a)(2). A loss carryover in a transaction following this pattern, but without the liquidation step, was permitted by Rev. Rul. 59-222, 1952-1 Cum. Bull. 80.

The liquidation step, standing alone, would seem clearly to fall within section 332, and without section 371. Subject to the possibility discussed below that a recapitalization of a single company will cut off carryovers, such an exchange would seem to set the stage for the successful application of section 381(a)(1) relating to liquidations of subsidiaries under section 332, without the necessity of a reorganization qualifying under section 381(a)(2).

Possible Problems Under Section 382(b)

Assuming, without deciding, that the foregoing considerations have been sufficient to bring an insolvency reorganization within section 381, the loss carryover may still be defeated by section 382(b). Section 382(b) applies to all reorganization exchanges (but not liquidations) which qualify under section 381. If applicable, its effect can only be avoided by bringing the transaction within section 371, which would seem possible only if the liquidation step were pursuant to court order.

12. See discussion in text at 283-88, esp. 287-88 infra.
14. Reg. § 1.371-1(a)(3) (1955) might seem to extend the statutory language of Code § 371 to cover the case supposed. Whether such a Regulation would be effective to override the clear application of another statutory section is uncertain.
15. Reg. § 1.382(b)-1(a)(6) (1960). The taxpayer is not indifferent as between a liquidation and a reorganization, however, since Code § 382(b) applies to the latter but not the former. The Commissioner may find that from his viewpoint as well, bringing transactions within Code § 368(a)(1)(C) is a precedent not without danger. See Bittker, Federal Income Taxation of Corporations and Shareholders, 366 n.10 (1959).
by meeting one of two tests. The first, hereafter referred to as the "twenty per cent test," is that the shareholders of the loss company immediately before the reorganization own immediately after reorganization, as the result of owning stock of the loss company, twenty per cent of the stock of the new company.10 The second test, hereafter referred to as the "common ownership test," is that both the loss company and the new company be "owned substantially by the same persons in the same proportion."17

Prima facie, neither test would be met in an insolvency transfer to a new corporation if the shareholders of the loss company had been eliminated, completely or almost completely. On the other hand, at some point in such a reorganization process, the creditors must have ceased to have simply a fixed interest, and have acquired an effective command over the assets of the business as a whole. This process has been described by the Supreme Court as follows:

When the equity owners are excluded and the old creditors become the stockholders of the new corporation, it conforms to realities to date their equity ownership from the time when they invoked the processes of the law to enforce their rights of full priority. At that time they stepped into the shoes of the old stockholders. The sale 'did nothing but recognize officially what had before been true in fact.'18

It will be noted that the twenty per cent test turns on stock ownership immediately before the reorganization, and that the Supreme Court seems to place the shifting shoes phenomenon somewhat earlier in time.

On the other hand, the foregoing quotation related only to the stock ownership necessary to satisfy the "continuity of interest" rule. On the very same day, in a different case, the Court also discussed the applicability to an insolvency reorganization of what is now section 368(a)(1)(D). That definition requires control in the transferor corporation or its "shareholders," and the creditors did not qualify:

But it is one thing to say that the bondholders 'stepped into the shoes of the old stockholders' so as to acquire the proprietary interest in the insolvent company. It is quite another to say that they were the 'stockholders' of the old company within the purview of clause (C). In the latter, Congress was describing an existing, specified class of security holders of the transferor corporation. That class, as we have seen, received a participation in the plan of reorganization. . . .

Indeed, clause (C) contemplates that the old corporation or its stockholders, rather than its creditors, shall be in the dominant position of 'control' immediately after the transfer and not excluded or relegated to a minority position. Plainly the normal pattern of insolvency reorganization does not fit its requirements.19

17. Code § 382(b)(3).
If the creditors have not stepped into the former owners' shoes sufficiently to become "shareholders" for purposes of section 368(a)(1)-(D), it is doubtful if they have become "stockholders" for purposes of the twenty per cent test of section 382(b). The common ownership test, however, like the concept of continuity of interest, is less specific. To be precise, one should refer either to ownership of a corporation's stock or to ownership of the corporation's assets, neither of which is exactly ownership of the corporation. The fact that both alternatives were avoided, and a mongrel criterion used instead, suggests that a very practical concept of ownership was intended. This is exactly the sort of real but inelegant ownership which the Supreme Court has found the creditors to possess in an insolvency reorganization. Indeed, even the ambiguity between ownership of stock and ownership of the corporation's assets is present in the Court's position. Thus, a few months after the decisions quoted above, the Court held that the creditors in an insolvency reorganization qualify as the owners of the assets of the insolvent company for purposes of what is now section 351.

Under that approach the ownership of the equity in these debtor companies effectively passed to these creditors at least when §77B proceedings were instituted. But however their interest in the property may be described, it clearly was an equitable claim in or to it. It was the equitable interest with which the plan dealt. . . . Thus it is fair to say that the property transferred was property in which the creditors had an equitable interest, and that the transfer was made with their authority and on their behalf. Certainly, 'property,' as used in §112(b)-(5), includes such an interest in property. And we see no reason to conclude that a beneficial owner of, or equitable claimant to, property is precluded from consummating an exchange which qualifies under §112(b)(5) merely because the actual conveyance is made by his trustee or title holder.20

On the basis of Alabama Asphaltic and Cement Investors, it is predicted that any court willing to surmount the problems of bringing an insolvency reorganization within section 381 in the first place will have little trouble with section 382(b). Even the requirement that the common ownership be "in the same proportion" should be readily met if the insolvency exchange does "nothing but recognize officially what had before been true in fact."21

The remaining hurdles, Libson Shops22 and section 269, are easier.

21. For a more detailed analysis of the relationship of the common ownership test to insolvency reorganizations, see Krantz, Loss Carryovers in Chapter X Reorganizations, 16 TAX L. REV. 359, 374-86 (1961). The author there discusses, inter alia, the question of creditor "ownership" where some creditors receive stock and others remain creditors. At least where the two groups of creditors are in separate classes, this problem seems resolved by the highly practical, though incomplete, application of the "shifting shoes" doctrine in Rev. Rul. 50-222, 1952-1 CUM. BULL. 80. But cf. Krantz, supra at 402.
The Commissioner has stated that he will not apply *Libson Shops* to carryovers governed by section 381. Section 269 is inapplicable unless the tax benefit is the principal purpose of the transaction. Where control of the new corporation is in the hands of former creditors, their business reasons for participating in the reorganization would seem overwhelming. Furthermore, any plan under Chapter X, or arrangement under Chapter XI, is submitted to the Secretary of the Treasury in advance, and, under Chapter X, the judge shall “refuse to confirm the plan” if “tax avoidance” is even one of the principal purposes.

**LOSS CARRYOVER TO NEW ENTITY WITHOUT SECTION 381**

*Non-Statutory Principles*

A considerable body of case law had developed as to loss carryovers in reorganizations antedating section 381. If insolvency reorganizations are not covered by section 381, it is with this case law that any analysis must be concerned.

The story began inauspiciously in 1934 with *New Colonial Ice Co. v. Helvering*. There, a company had been reorganized out of court, but under pressure from creditors, in a transaction approximating the reorganizations definitions now contained in section 368(a)(1)(C) and (D). This resulted in a new corporate entity owned by the same shareholders, subject to the same creditors, and carrying on the same business, and the issue was whether the net operating losses of the old corporate entity also carried over. The Supreme Court resolutely set its face against what might loosely be termed “business realities,” and denied the deduction on the ground that the technical change in corporate entity was determinative.

The unappealing *New Colonial Ice* rule gave rise to considerable litigation in the course of which a line of authority developed permitting loss carryovers to a different entity provided the reorganization plan was a statutory merger. This merger exception reached the Supreme Court in 1957, in *Libson Shops, Inc. v. Koehler*, but the Court avoided the

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24. See Harvey, *Acquisitions to Obtain Benefits of Losses-Section 269*, at 294 infra.
26. The fact that Code § 381 does not cover a transaction does not in itself bar a carryover. See note 61 infra and accompanying text.
entire corporate entity question, returned to "business realities," and denied the deduction on the ground that the loss arose in a different business operation from that which sought the benefit of the carryover.

Libson Shops was followed by Revenue Ruling 59-395, in which the Internal Revenue Service stated its own view of the net effect of the foregoing cases. It held that losses may be carried over or back across a reorganization exchange governed by the 1939 Code provided, first, that the reorganization was in the form of a statutory merger or consolidation, and, second, that the income and loss both arose from the same assets used in the same business operation. The illogical distinction between mergers and other forms of reorganization was maintained, as the most doubtful point of the ruling. In F. C. Donovan, Inc. v. United States, the Court of Appeals for the First Circuit had already rejected the distinction and held that a carryover or carryback was permissible across the line of any tax-free reorganization.

The foregoing authorities relating to the reorganization of solvent corporations were sought to be applied to a reorganization under section 77 of the Bankruptcy Act in Wisconsin Cent. R. R. Co. v. United States. There a loss carryback to the corporate predecessor was attempted across the line of a reorganization which had wiped out the predecessor's common stockholders, preferred stockholders, and unsecured creditors.

In its opinion, the Court of Claims pointed out that the transaction in question did not qualify even under the most liberal exceptions to the New Colonial Ice corporate entity test: it was not a statutory merger or consolidation, and, in fact, it was not a tax-free reorganization at all. This would seem to have ended the case, but the Court of Claims proceeded to another area, which it seemed to regard as still more important. This was the "continuing enterprise" test of Libson Shops. The Court of

31. 261 F.2d 470 (1st Cir. 1958) (Magruder, J.). The legal entity test was held to defeat the purpose of the statutory provisions relating to reorganizations, and the New Colonial Ice case was distinguished on the ground that it was decided under a Revenue Act antedating the reorganization provisions. The government did not seek certiorari. See also, Koppers Co. v. United States, 133 Ct. Cl. 22, 32-33, 134 F. Supp. 290, 296-97 (1955), cert. denied, 353 U.S. 983 (1957). But cf. Patten Fine Papers, Inc. v. Commissioner, 249 F.2d 776 (7th Cir. 1957). New Colonial Ice may be further distinguished under the 1954 Code. There the Supreme Court stressed the statutory wording that the same "taxpayer" get the carryover as the "taxpayer" which incurred the loss. The "taxpayer" wording was omitted from the 1954 Code.
32. 296 F.2d 750 (Ct. Cl. 1961), cert. denied, 369 U.S. 885 (1962). Before the Libson Shops decision, loss carryovers and carrybacks across the line of a Section 77B reorganization (not a merger) were denied by the simple application of the New Colonial Ice legal entity test. Donohue v. United States, 112 F. Supp. 660 (E.D. Mo. 1953); Follansbee Steel Corp. v. United States, 109 F. Supp. 635 (W.D. Pa. 1953).
33. Insolvency reorganizations governed by CODE §§ 371, 374 are tax free. Certain railroad insolvency reorganizations before August 1, 1955, are governed by CODE § 373 and its 1939 Code predecessor, § 112(b) (9), which provided for a carryover of basis and non-recognition of loss, but gain to the corporate transferor is recognized.
Claims held that this test had not been met since the new company had not assumed all of the predecessor’s debts, all of the old stockholders had been eliminated, and the new stockholders were some of the former creditors of the business.

Since the Wisconsin Cent. R. R. case did not even involve a tax-free reorganization, its result, the denial of the carryback, would seem correct. The argument that this result was compelled by a change in stock ownership, however, seems unfortunate. A change in ownership is an important factor in determining whether the elements of continuity in a reorganization outweigh the elements of discontinuity, i.e., whether the transaction was really a sale. It is not a recently discovered factor, however. The statute has long imposed requirements as to the nature of the consideration in a reorganization and dealt expressly with acquisitions of corporate ownership for a tax purpose. Even more in point, the courts have developed the “continuity of interest” test to meet precisely this question. It is not a simple matter: the change can come in many forms and degrees, and clearly a special dimension is added to the problem when the new owners are former creditors. Accordingly, the case law is extensive, and includes the Alabama Asphaltic decision and several lower court decisions dealing specifically with the question of the change of status from creditor to stockholder in an insolvency reorganization.34

The Court of Claims’ position seems to be, however, that Libson Shops has, in fact, imposed a new requirement as to stock ownership as a condition of loss carryovers, and thus, whether wisely or not, the Supreme Court has spoken. The Court of Claims expressed the point as follows:

We do not feel that the rules developed in reference to continuity of interest in the Alabama Asphaltic sense are equally applicable to a determination of continuing ownership in the Libson Shops sense.35

This language is particularly curious since Libson Shops involved no change in ownership and made no reference to change in ownership. In context, that opinion dealt unmistakably with the single question of the nature of the business operation being carried on. No one contended that the loss-carryover could survive unless the merger had been tax-

34. It might be suggested that the “continuity of interest” test relates to whether a reorganization is tax-free at all, and that a stricter test as to ownership is appropriate in determining when a loss carryover is to be allowed. The problem is that a corporation has many attributes; CODE §381(c) lists twenty-two and is not complete. For all or most of these, the same basic question of continuity obtains, but many differences in degree might be defensible. Nevertheless, to apply a different test to the change of ownership element in the overall continuity problem for each individual carryover item, and to do this through the uncertainties of judicial legislation, would seem to add a wholly impractical burden of complexity and uncertainty to a field already complex and uncertain.

35. 296 F.2d 750, 755 n.10 (Cr. Cl. 1961).
free, and this depended in part upon there being sufficient continuity of interest (ownership). Hence, the question of continuing ownership had been met once as a condition of even reaching the question dealt with by the Supreme Court, i.e., the effect on a carryover of a tax-free merger. Thus, there was no reason for the Court to deal with the question again, and there is no indication whatever that it intended to do so.36

Libson Shops, in fact, supported the carryover. The Court there identified the critical factor as continuity in the business operation. That continuity was present in Wisconsin Cent. R. R.

The Court of Claims' second reason for denying the loss carryover was that the new corporate entity did not assume all of the debts of its predecessor. If it is a rule that loss carryovers do not survive the cancellation of indebtedness, the question as to such carryovers is solved in almost all insolvency reorganizations. Furthermore, such a rule would not be without logic. Many of the expenses which gave rise to the debt also presumably gave rise to the loss carryover. If the debt does not have to be paid, the expenses in a sense have proved to be unreal, and the loss carryover is also unreal. On the other hand, of course, there is no reason to assume that the amount of the cancelled debt will be the same as the amount of the loss carryover. Also, the losses are by no means unreal from the standpoint of the creditors whose claims have been reduced or who have been issued stock in place of debt.

The problem of balancing these conflicting factors is not easy, nor is it limited to the question of loss carryovers. The same point as to "unreal" expenditures bears upon the carryover of basis, the carryover of earnings and profits, and the question of income from the discharge of indebtedness. All these questions have histories of extended tax litigation, and the results have not been wholly consistent.37 Nevertheless, the general pattern is that the cancellation of indebtedness in bankruptcy proceedings does not break up tax continuity, and it would seem unfortunate if an inconsistent rule were introduced as to loss carryovers, without legislation and on the authority of a Supreme Court decision which did not involve the point.

The problem of change of ownership and cancellation of indebted-

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36. Although there is no support in Libson Shops for a new continuity of ownership test, it may find support in certain language in F. C. Donovan, Inc. v. United States, 261 F.2d 470 (1st Cir. 1958), and Willingham v. United States, 289 F.2d 283 (5th Cir. 1961). Thus an error may acquire respectability through repetition.

Part of the explanation for the Court of Claim's inadequate deference to the existing continuity of interest test may have been its excessive deference to that test in an earlier decision. See Wisconsin Cent. R.R. v. United States, 296 F.2d 750, 756 (Ct. Cl. 1961).

37. The questions of basis and of income from the discharge of indebtedness have resulted in a complex body of law beyond the scope of this article. The result is simple, however, in cases covered by Code §§ 371, 372 and 374: no income is realized and basis is unchanged. For the quite different result as to earnings and profits, see note 38 infra.
ness may be presented in a different way. This is the theory that the process by which the debt was reduced consisted of two steps: the distribution of the corporation's assets to its creditors, and the contribution of the assets by the creditors to a new corporation. On this theory, there would be no direct relationship between the old corporation and the new corporation and hence no grounds for carrying over net operating losses or any other attribute of the old corporation.

The two-step analysis is not without judicial support, including the Supreme Court's holding in Cement Investors that the creditors owned, at least equitably, the assets of the insolvent company. Nevertheless, it leads to trouble. First, it is inconsistent with the general reincorporation doctrine that where a corporation liquidates, and the business is promptly reincorporated by the prior owners, the liquidation step is disregarded. Second, the two-step analysis is inconsistent with the Alabama Asphaltic doctrine that the corporate entity continues and the creditors take over an interest as shareholders, not as asset-owners. Third, the two-step analysis conflicts with the statutory provision for carryover of basis. Fourth, it would give rise to a taxable gain or loss on the hypothetical liquidation.

To summarize, the decision in the Wisconsin Cent. R. R. case is correct, since it did not involve a tax-free reorganization in the first place. It is neither good law nor good tax policy, however, to say that in a tax-free insolvency reorganization, Libson Shops bars a carryover because of a change in stock ownership and the cancellation of indebtedness.

LOSS CARRYOVER IN SAME ENTITY

The 1954 Code denies the carryover of the net operating losses of a continuing corporate entity in certain situations described in section 269 and section 382 (a). In many or most insolvency reorganizations section


39. Reg. § 1.331-1(c) (1955). Contra, Joseph Gallagher, 39 T.C. No. 13 (Oct. 17, 1962). Perhaps it begs the question to assume that the reincorporation is by the former "owners."


41. Such a taxable liquidation would be contrary to the express provision of Reg. § 1.371-2(a) (2) (1955) (last sentence), in a reorganization governed by Code § 371.

42. If it is held that an insolvency reorganization permits a loss carryover outside of Code § 381, the remaining problems do not seem difficult. As already noted, Libson Shops relates to the business operation, which would be continued. Code § 382(b) would not apply since
269 will be inapplicable for the reasons already discussed. The same will probably be true of section 382(a). That section applies in cases where there has been both a change in stock ownership and a change in the nature of the business operation. However, the stock ownership test is met only if the change occurs in a transaction such that the new stockholders do not have a carryover basis, which former creditors presumably would have. Also, the reorganized company will usually continue to operate substantially the same business, although there is some uncertainty as to exactly how much is necessary to constitute a change in business within the meaning of section 382.

Judicial Tests Under 1939 Code

In addition to meeting the statutory tests, there has been some concern that in the case of continuing corporate entities the carryover of net operating losses may be contingent upon meeting certain additional judge-made tests. The analysis of this problem requires a brief review of certain case law arising under the Internal Revenue Code of 1939.

For many years, the strictness of the New Colonial Ice doctrine in denying loss carryovers to a new corporate entity led to complete freedom for carryovers within the same entity. The carryover was not denied even where both the nature of the business and the ownership of the business changed completely.

The legal atmosphere changed sharply when the Supreme Court, in Libson Shops, denied a loss carryover because of a change in the business operation. That case involved a merger, and the Supreme Court declined to pass on the question of a change of business by a single corporate entity. The Treasury, less hesitant, took the view that a change in business by itself would destroy a loss carryover in a single continuing corporation.

The courts which have ruled on the question so far have also been willing to apply the test based on continuity of business operation to deny loss carryovers in single corporate entities, but only where some other change was added to the picture. In the cases decided so far, that ele-

its coverage is limited to reorganizations covered by CODE § 381. CODE § 382(a) would not apply since a new corporate entity would be involved. CODE § 269 should not apply for the reasons discussed above. See discussion in text at 279 supra.

43. See discussion in text at 279 supra.
44. See Pomeroy, Limitations Where the Same Taxpayer Seeks to Carryover the Loss, supra at 256-57.
45. E.g., Alprosa Watch Corp., 11 T.C. 240 (1948).
47. This position was announced by the non acquiescence, 1960-2 CUM. BULL. 8, in Northway Securities Co., 23 B.T.A. 532 (1931), acq. withdrawn, X-2 CUM. BULL 52 (1931).
48. This modification of the rule avoids many problems: e.g., loss carryovers by a sole proprietor, and loss carryovers based on casualty losses by an individual not in business. See Pomeroy, supra note 44 at 259.
ment has always been, or included, a substantial change in stock ownership of the corporation. 49

As has been discussed, *Libson Shops* did not deal with a change in stock ownership, and the introduction of a new test based on stock ownership would be redundant and confusing in reorganization cases involving a new corporate entity. 50 Where a single entity is involved, however, no “continuity of interest” test presently applies, except perhaps in recapitalizations. 51 Accordingly, a combination of a stock ownership test and a business operations test might be a sensible and convenient solution for the problem of loss carryovers in single entities, for the cases antedating the specific legislation on this point contained in the 1954 Code.

Simultaneously with the application of the new doctrine to solvent corporations, an even more extreme group of cases has arisen in reference to insolvency reorganizations. Logically, though not chronologically, the first of these was *Huyler's*. 63 Here, a restaurant corporation went through a Chapter X reorganization in which the former shareholders were wiped out. In addition, forty-eight per cent of the stock was issued to new investors. The restaurant business was gradually dropped, and an aluminum products business was added. Also, the former owners of the aluminum products business bought out the previous “new investors” and took over management of the company.

The loss carryovers of the restaurant business were not allowed against the aluminum profits because of the

... radical changes in the ownership of the business, in the capital structure of the business, in the location of the business operations, in the management of the business, and in the type of the business and its products. 53

The decision seemed clearly right if the similar decisions relating to solvent corporations were right. It was not even necessary to consider very closely the nature of the Chapter X adjustments. The degree of change in stock ownership required as a make-weight or supplement to a change in business operations has not been articulated, and perhaps even the forty-eight per cent change after the reorganization would have proved sufficient, especially since it seems to have been sufficient to transfer control of the corporation. 54

50. See note 34 *supra* and the following three paragraphs of text.
53. *Ibid*.
54. It seems likely that some of the forbidden loss carryover arose from restaurant operations after the completion of the Chapter X reorganization but before the sale of stock to the aluminum interests. Also, the same judge, Pierce, who decided *Huyler's* also decided Norden-
The second step was *Willingham v. United States*.\(^{55}\) Here, the same corporate entity survived a Chapter X reorganization, and there was no change in the kind of business carried on. On the other hand, part of its debts were cancelled and all of its post-reorganization stock was held by an entirely new investor, Mr. Willingham. The carryover of pre-reorganization losses against post-reorganization profits was denied.

The Court of Appeals for the Fifth Circuit went through the customary ritual of stating that the "principal support" for the denial of the carryover was *Libson Shops*. Since *Libson Shops* involved a change in business operation, but no change in ownership, whereas *Willingham* involved a change in ownership, but no change in business operation, this is not self-evident. Presumably, however, *Libson Shops* was broadly read as holding that technicalities relating to continuity of corporate charter are no longer controlling, and that courts are now free to examine whatever other factors seem to them significant.

If, in a continuing corporation, a change in ownership, standing alone, is ever to defeat a loss carryover, *Willingham* was correctly decided. The transfer of all of the equity interest to a new investor would presumably have precluded the transaction from qualifying as a reorganization, even for purposes of section 371 and its predecessors.\(^{66}\) Thus, if a new corporate entity had been used, the carryover would have been lost before even reaching the question of *Libson Shops*. On the other hand, it should be remembered that the Commissioner firmly denies that the carryover rules as to continuing corporate entities apply to most reorganization transfers to new entities.\(^{57}\) Thus, equating the two cannot be regarded as automatic justification of a decision.

In addition to the change of ownership in *Willingham*, the court also stressed the cancellation of indebtedness, and again applied the universal authority, *Libson Shops*:

\[\text{[T]he carryover law, [was] 'designed,' as the Supreme Court said in} \text{Libson, to permit a taxpayer to set off its lean years against its lush years, and to strike something like an average taxable income over a period longer than a year.' . . . . This loss taxpayer 'set off its lean years' by having them wiped out in reorganization proceedings.}^{68}\]

\(^{55}\) Ketay, 21 CCH TAX CT. MEM. DEC. 1316 (1962), which involved a change of business and stock ownership in a solvent corporation. He held the *Huyler's* decision to be controlling: "Also, in *Huyler's*, there was a Chapter X bankruptcy reorganization. But these are mere distinctions, without any real underlying difference of legal principle which would call for a different result here." *Id.* at 1317.


\(^{57}\) *Willingham v. United States*, 289 F.2d 283, 287 (5th Cir. 1961). The court also relied on certain other features of the reorganization, in addition to the change of ownership and
This argument was also involved in the *Wisconsin Cent. R. R.* case.\(^{59}\) *Willingham* differs only in carrying the issue into the area of the cancellation of indebtedness of a continuing entity.

The next step in the progression was a Tax Court decision, *Denver & Rio Grande W. R. R.*,\(^ {60}\) which did not involve loss carryovers but represented a development of *Willingham*. The railroad had been "re-organized" under section 77 of the Bankruptcy Act, and the issue was assumed to be whether an expense arising before or during the reorganization related to the trade or business of the corporation after the reorganization. This in turn was said to depend upon whether there had been a change in entity for tax purposes during the reorganization even though the railroad had in fact continued to use the same corporate charter. The Tax Court held that there was a change in entity and denied the deduction. It noted that there had been changes in the charter, that "the equity interest in the corporation was completely changed," and that the "petitioner apparently did not assume all the debts of the old corporation." The court then cited and summarized *Willingham*.

Having decided that it was dealing with two corporate entities, the Tax Court then pointed out that the deduction might be allowed by section 381(c)(16), which relates to reorganizations involving a change in corporate entities. It held, however, that section 381 related only to tax-free reorganizations, that this transaction qualified under section 373 and hence was not tax-free, and that if section 381 does not apply to a situation, Congress intended to deny the deduction in question.\(^ {61}\)

Although the *Denver & Rio Grande* decision relies on *Willingham*, it involves a significant difference as to change of ownership. In *Willingham* an entirely new investor bought up the stock of the corporate entity. In *Denver & Rio Grande* the stock was apparently taken over by former creditors in a change fully complying with the "continuity of interest" test. It is one thing to say, with *Willingham*, that a change of ownership which would defeat a carryover in an inter-corporate transfer should also defeat the carryover in a continuing entity. It is much more extreme to say that the single continuing entity should meet a stricter test.

A doctrine that an exchange of debt for stock may in itself create a new taxable entity is of great importance not only for court-directed bankruptcies but also for many "normal" recapitalizations. It is regrettable that the Tax Court seems to have come close to some such doctrine with no real consideration of the issues. However, the court stated that

cancellation of debt, which were idiosyncrasies of the particular transaction and might serve in the future as handles of distinction.

59. See text at 282-83 *supra*.


61. The court is wrong as to the effect of Code § 381 on transactions not covered thereby. Reg. § 1.381(a)-1(b) (3) (1960); SEN. REP. NO. 1622, 83rd Cong. 2d Sess. 277 (1954).
the petitioner did not contend it was the same entity, so that perhaps this aspect of the case can be distinguished as simply an unlitigated concession by the taxpayer.

EFFECT OF 1954 CODE

Regardless of the validity of the change of ownership test in cases governed by the 1939 Code, it is to be assumed that the test will be inapplicable under the 1954 Code. It is hard to conceive of the test being applied to reorganizations of solvent corporations governed by section 381. Even the Treasury holds that the test based on change of business operations is inapplicable in such a case, and that test, unlike the stock ownership test, really does have support in Libson Shops. If a single continuing solvent corporation recapitalizes, or if its stock is purchased by a new investor, the same result should follow for several reasons.

First, the 1954 Code expressly imposes restrictions on loss carryovers both to new entities and in continuing entities based upon very specific statutory tests as to change of stock ownership. It would seem an improper exercise of the judicial function to supersede these specific statutory tests with a general judge-made test that any substantial change of stock ownership defeats the carryover.

Second, one purpose of the specific statutory tests was to defeat carryovers in the specified cases. A second purpose was, by instituting an objective test, to reduce the reliance on section 269 which had "been so uncertain in its effects as to place a premium on litigation and a damper on valid business transactions." The effect on the uncertainty level of replacing the statute's objective tests with the case law discussed in this article would be — one searches in vain for an adequate word.

Third, the 1954 Code expressly provides for the carryover of losses to different entities where certain explicit conditions are met. It is the clear meaning of the Committee Reports that this is intended to equate the specified reorganizations with the treatment of single continuing entities, not to create an advantage in favor of transfers to new entities.

Fourth, any attempt by judicial legislation to apply either a change-of-ownership or change-of-business-operation test to single corporations but not to reorganizations covered by section 381 involves great conceptual difficulty, in addition to violating the congressional purposes discussed above. The tests in question are assumed to arise under section 172, and section 381 allows the deduction only of "carryovers determined under section 172." Therefore, if the tests apply at all, they would seem to apply to transactions under section 381. If not, there is a new difficulty. The effect of the tests on a single entity is to divide it into

two entities. A transaction which is outside section 381 if involving one entity may be within it if involving two entities, and hence the tests in question may have the effect of bringing the transaction within a section to which the tests do not apply. This was the problem which the Tax Court faced in Denver & Rio Grande, but was able to avoid on the ground that even with two entities the transaction was not tax free.

Fifth, both the Supreme Court's opinion and the government's briefs in Libson Shops stressed the limitation of carryovers under the language of the 1939 Code to losses of the same "taxpayer." They also noted that this language was omitted from the 1954 Code. 64

It may be suggested that the courts have already crossed the bridge of applying Libson Shops to cases governed by the 1954 Code. In support of this suggestion, it should be noted that several of the cases involve deductions in 1954 and later years, even though the reorganizations occurred earlier. It is submitted, however, that these cases are irrelevant to the issue, as has been clearly set forth by the Tax Court in Huyler's. The argument as to the effect of the 1954 Code on continuing entities turns on the effect of section 382(a). This subsection relates only to changes in stock ownership and business which occurred after June 22, 1954, 65 which is true of none of the cases so far decided.

To conclude that the judge-made change-of-stock-ownership and change-of-business-operation tests would not apply under the 1954 Code, since the 1954 Code already has statutory tests on the same points, does not necessarily resolve the question as to insolvency reorganizations. It should be remembered that the change-of-stock-ownership test has always been applied in the insolvency cases in conjunction with a comment that part of the corporation's debt burden was extinguished. It has also been noted that the debt reduction factor is a legitimate policy consideration, and that as a conceptual argument it has been successful in defeating the carryover of earnings and profits. On the other hand, in the various other contexts in which it is presented, the opposite result has generally been reached. 66 The overall pattern being one of continuity, a court presumably should hesitate to impose an inconsistent result in the loss carryover area by judicial legislation. 67 Also, if it is held that section 381 does apply to some insolvency reorganizations involving a new corporate

64. Libson Shops, Inc. v. Koehler, 353 U.S. 382, 384 nn.1 & 2 (1957). In view of the changed statutory pattern, the change in language may not have been entirely inadvertent. Also, it is understood that one of the grounds on which the government opposed a rehearing in this case was that it clearly could not apply under the 1954 Code.

65. CODE § 382 (a).

66. The Treasury has ruled by implication that a loss carryover is allowed in an insolvency recapitalization where debt is partly cancelled and partly exchanged for stock. Rev. Rul. 59-222, 1959-1 CUM. BULL. 80, involved such a recapitalization, and it was held that, in effect, CODE § 382 (a) did not bar the carryover. CODE § 382 (a) is not even relevant unless CODE § 172 applies, and that is the section on which the recent adverse decisions are based.