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Thomas N. Lawson
University of Nebraska College of Law, tlawson@loeb.com

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Use of Multicorporate F Reorganizations To Carry Back Net Operating Losses


I. INTRODUCTION

A corporate reorganization involving the transfer of the assets of one or more corporations to another corporation often raises questions regarding the ability of the transferee corporation to carry back postacquisition net operating losses under Internal Revenue Code section 172 to the preacquisition taxable years of the transferor corporations. Suppose for example, that A, B, and C Corporations transfer all of their assets to newly formed ABC Corporation on January 1, 1977. For the taxable year ending on December 31, 1977, ABC Corporation sustains a net operating loss. The question is to what extent, if any, the 1977 loss of ABC Corporation may be carried to the preacquisition taxable years of A, B, and C Corporations to offset income.

Section 381 (b) (3) of the Code generally disallows the carryback by a transferee corporation of a postacquisition net operating loss to the preacquisition years of the transferor corporations. Section 381 (b), however, makes an exception to this restriction for acquisitions in connection with an F reorganization. Thus, if the above described transaction constitutes an F reorganization, at least part of ABC's net operating loss may qualify for carryback to the preacquisition years of A, B, and C.

The question is thus one of determining whether the contemplated transaction qualifies as an F reorganization. The Internal Revenue Code's definition of an F reorganization is ambiguous. An F reorganization is defined as "a mere change in identity,

1. INT. REV. CODE OF 1954 § 172(a) [hereinafter cited as Code]: "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."
2. CODE § 381(b) (3).
3. See Code § 368(a) (1) (F).
form, or place of organization, however effected." Although the meaning of "a mere change in identity" and "place of organization" may be obvious, the meaning of "a mere change in form" certainly is not. Furthermore, the regulations provide no explanation or interpretation of the scope of section 368(a)(1)(F).

For many years the Internal Revenue Service maintained that the F reorganization provisions should be narrowly construed to apply only to changes in identity, form, or place of operation of one corporation only. Thus, in the Service's view, a merger of three corporations into a new corporation, as in the above example, would not constitute an F reorganization and so would not qualify for the exception from the section 381(b)(3) prohibition against carrying postacquisition losses of the transferee corporation back to preacquisition taxable years of the transferor corporations.

Under the Service's restrictive view of the F reorganization, it would not be a viable tool with which practitioners could avoid the prohibition of section 381(b)(3) in corporate reorganizations. At least one commentator has so stated, and in 1954 the House of Representatives proposed the repeal of the F reorganization provisions. The F reorganization provisions were not repealed, and developments of recent years now seem to lend them increased importance. After losing in a series of litigated cases, the Service recently changed its position and conceded in Revenue Ruling 75-561 that an F reorganization may, under some circumstances, include more than one corporation. Thus, transactions such as the one contemplated in the above example will be recognized by the Service as F reorganizations if they meet the criteria of Revenue Ruling 75-561.

This note more fully examines the provisions and significance of Revenue Ruling 75-561. The discussion will be divided into three parts: (1) a brief historical overview of the case law that gave rise to Revenue Ruling 75-561; (2) an examination of the provisions of the ruling; and (3) an examination of some of the questions and problems the ruling leaves unanswered.

4. Id.
II. PRIOR CASE LAW RELATING TO MULTICORPORATE F REORGANIZATIONS

The Service's concession in Revenue Ruling 75-561 that an F reorganization may involve multiple corporations developed from litigation wherein the Service tried to use the F reorganization provisions as a tool to combat liquidation-reincorporation schemes. One of the earlier attempts by the Service to use the F reorganization provisions in this manner was in Pridemark, Inc. In 1958, two corporations under common control sold most of their assets to another corporation, and then dissolved. In 1959 the shareholders of the dissolved corporations transferred those assets received in liquidation to a newly formed corporation which conducted the same business as had the two liquidated corporations. The Service contended that there had been no liquidation, but rather a C or an F reorganization of the two corporations so that any proceeds retained by the shareholders would be taxable as a dividend rather than as a capital gain. The Tax Court agreed with the Service and held that the transaction did constitute an F reorganization, rather than the liquidation of two corporations and incorporation of a third. On appeal to the Court of Appeals for the Fourth Circuit, the Tax Court decision was reversed on the grounds that a complete liquidation had taken place. The court of appeals did not, however, rule that an F reorganization could never encompass more than one operating corporation.

The Service's big victory in using the F reorganization to attack liquidation-reincorporation schemes came in Davant v. Commis-

9. Liquidation followed by reincorporation was an attempt by shareholders to draw earnings out of the corporation at the more favorable capital gains rates, rather than at the ordinary income rates at which a dividend distribution would be taxed. The corporation would liquidate and distribute its assets to the shareholders. The shareholders would report capital gains to the extent that the fair market value of the assets received exceeded their basis in their stock, and would then transfer most of the assets received to a new corporation in exchange for its stock. The result was that the shareholders could withdraw earnings at capital gains rates, increase the basis in their stock, and increase the corporation's basis in the assets. The Service argued that this kind of transaction was merely a reorganization, not a liquidation, and that any cash received by the shareholders should be taxable as a dividend to the extent of the corporation's earnings and profits, with the same basis being retained in the stock and assets. See, e.g., James Armour, Inc., 43 T.C. 295 (1964); David T. Grubbs, 39 T.C. 42 (1962).
11. 42 T.C. at 527.
12. 345 F.2d at 42.
One corporation (Water) owned farm land, operated an irrigation canal, and through various leasing arrangements, grew rice on the land. The other corporation (Warehouse) dried, cleaned and stored the rice grown on Water's land. Both corporations were owned in equal proportions by four families. The shareholders wished to transfer Warehouse's assets to Water and in the process draw some earnings out of Warehouse at capital gain rates. To accomplish this, their attorney devised an intricate plan whereby a third party borrowed money from a bank and bought all of the Warehouse stock. Warehouse sold all of its assets to Water for cash whereupon Warehouse liquidated and distributed its only asset, cash, to the third party. The third party used the cash to repay the bank loan. The sales prices were established so as to allow the third party a reasonable profit. The result the taxpayers hoped to accomplish was to sell their Warehouse stock for cash, thus giving rise to capital gain treatment of the proceeds received, and also, transfer all of Warehouse's assets to Water.

The Service, however, took a different view of the transactions. It argued before the Tax Court that the transactions in substance constituted a D or an F reorganization, and that any cash received by the shareholders was taxable as a dividend to the extent of the earnings and profits of both corporations. The Tax Court held that the transactions constituted a D reorganization, and that the cash received by the shareholders was taxable as a dividend, but only to the extent of the earnings and profits of Warehouse.

In Pridemark and Davant the Service had been arguing that multicorporate reorganizations could be F reorganizations apparently without considering the favorable impact that F reorganization treatment could have for the corporations involved with regard to the carryback of net operating losses under section 381(b). After the Tax Court decision in Davant, the Service realized the double-edged nature of the sword it was wielding, and when the taxpayer appealed the Davant decision, the Service argued only that the transaction was a D reorganization. The F reorganization argument was conspicuous by its absence.

14. 43 T.C. at 566.
15. Id. at 572.
16. See Rev. Rul. 69-185, 1969-1 CUM. BULL. 108. Similarly, when the taxpayer petitioned the United States Supreme Court for certiorari, the Service, in opposition to the petition, argued that the transaction in question was a D reorganization.
On appeal, the court found that the transaction was both a D and an F reorganization, in spite of the fact that the Service had argued only that it was a D reorganization. The court said: "At least where there is a complete identity of shareholders and their proprietary interests, as here, we hold that the type of transaction involved is a type (F) reorganization."\textsuperscript{17}

The first successful tax benefit use of the multicorporate F reorganization by a taxpayer came shortly after Davant in Estate of Stauffer v. Commissioner.\textsuperscript{18} Bernard Stauffer was the sole shareholder of three corporations, referred to as Stauffer California, Stauffer Illinois, and Stauffer New York. All three corporations were engaged in the business of selling mechanical weight and posture control devices. In 1959, Mr. Stauffer incorporated Stauffer New Mexico and merged the three existing companies into it. None of the actual operations or assets of the three corporations was ever transferred to New Mexico. All operations continued as before the merger. Prior to the merger, Stauffer had obtained a ruling from the Service that the transaction would constitute a statutory merger under section 368(a)(1)(A). After the merger, Stauffer took the position that an F reorganization had taken place, and accordingly, final income tax returns for the three transferor corporations were not filed. Instead all operations were accounted for in the return filed by Stauffer New Mexico.\textsuperscript{19} In a later year, Stauffer New Mexico suffered a net operating loss which it sought to carry back to the preacquisition years of Stauffer California, Illinois, and New York. A refund was granted, but the Service later proposed a deficiency on the ground that carryback was not allowed because the transaction was not an F reorganization. The Service's position was upheld by the Tax Court,\textsuperscript{20} but reversed by the ninth circuit.

The ninth circuit paid little attention to the Service's arguments based on legislative history, or the fact that such an interpretation of the F reorganization provisions was inconsistent with other sections of the Code. The main premise of the holding seemed to be that if the taxpayer had effected the reorganization by merging Stauffer New York and Illinois into Stauffer California, section 381(c) would have allowed the California corporation to carry back its postmerger losses to its premerger taxable years. The court felt that merely because the taxpayer had chosen a new

\textsuperscript{17} 366 F.2d at 884.
\textsuperscript{18} 403 F.2d 611 (9th Cir. 1968), rev'g 48 T.C. 277 (1967).
\textsuperscript{19} This procedure accorded with Rev. Rul. 57-276, 1957-1 CUM. BULL. 126. See text accompanying note 66 infra.
\textsuperscript{20} 48 T.C. at 304.
corporate entity, it should not be denied the carryback that would have been available under another form of transaction.\textsuperscript{21} Accordingly, the court held that the transaction was an F reorganization and that Stauffer New Mexico could carry its losses attributable to the operations of each of the three transferor corporations back to the premerger taxable years of those corporations. That is, the losses of Stauffer New Mexico due to operations formerly conducted by Stauffer California could be carried back to the premerger taxable years of Stauffer California, and likewise with the other two transferor corporations.

\textit{Associated Machine v. Commissioner},\textsuperscript{22} which was decided at the same time as \textit{Stauffer}, had slightly different facts. Two wholly-owned corporations were merged into a third wholly-owned corporation. The transferee corporation subsequently sustained a net operating loss which it sought to carry back to the premerger years of the transferor corporation by virtue of the fact that the transaction was an F reorganization. The Service contended that the transaction was an A reorganization and that carryback was prohibited by section 381 (b). The Tax Court sustained the Service's position,\textsuperscript{23} but again the ninth circuit reversed, holding that the transaction qualified as an F reorganization. The court again rejected all of the Service's arguments and held that an F reorganization can include more than one corporation if the proprietary interest in the transferor and transferee is identical, and the business is not interrupted.\textsuperscript{24}

Even after the two defeats in \textit{Stauffer} and \textit{Associated Machine}, the Service was far from ready to concede the struggle and issued Revenue Ruling 69-185\textsuperscript{25} specifically rejecting the ninth circuit's decisions in \textit{Stauffer} and \textit{Associated Machine} and the fifth circuit's decision in \textit{Davant}. The Service reiterated its view that the legislative history and general statutory scheme of the Code mandate against an F reorganization involving an amalgamation of two or more operating corporations.

The courts did not find Revenue Ruling 69-185 any more persuasive than they had found the Service's arguments in the earlier cases. \textit{Home Construction Corp. of America v. United States},\textsuperscript{26} decided after Revenue Ruling 69-185, represented possibly the broadest interpretation of section 368 (a) (1) (F) to that date. In

\begin{itemize}
\item \textsuperscript{21} 403 F.2d at 619.
\item \textsuperscript{22} 403 F.2d 622 (9th Cir. 1968), \textit{rev'd} 48 T.C. 318 (1967).
\item \textsuperscript{23} 48 T.C. at 326.
\item \textsuperscript{24} 403 F.2d at 624.
\item \textsuperscript{25} 1969-1 \textit{Cum. Bull.} 108.
\item \textsuperscript{26} 439 F.2d 1165 (5th Cir. 1971), \textit{aff'd} 311 F. Supp. 830 (S.D. Ala. 1969).
\end{itemize}
Home Construction Corp., 123 separate corporations under common ownership merged into a new corporation. There was no change in the business or in the proprietary interests in the corporations. When the transferee corporation sustained a net operating loss it attempted to carry it back to the premerger taxable years of 83 of the transferor corporations. The application for refund was denied and suit was brought in United States district court. The court upheld the taxpayers' position that the transaction was an F reorganization and that the transferee corporation was entitled to carry back its net operating loss.27 The fifth circuit affirmed the finding of an F reorganization and remanded the case to the district court for a factual determination of to which transferor corporations the net operating loss was attributable, holding that the losses traceable to the operations of a given transferor corporation could be carried back to the premerger taxable years of that corporation to offset its income in those years.28

Part of the basis for the fifth circuit's finding of an F reorganization was its reliance on precedent established previously by another fifth circuit panel in Davant.29 However, the court also found the Service's arguments unpersuasive and concluded that Davant had established that a multicorporate amalgamation could qualify as an F reorganization if: (1) an identity of shareholders and their proprietary interests was maintained, and (2) the essential business enterprise was continued unimpaired, in a form that was the alter-ego of the old.30

At this point it should be noted that all of the cases thus far had involved a merger of corporations under the common ownership of the same individuals. Thus, all of the amalgamations had involved so-called brother-sister corporations. To this point, none of the cases had involved parent-subsidiary mergers.

The first case to arise involving a merger of a subsidiary corporation into its parent provided the Service with a new argument against allowing the net operating loss carryback. In Performance Systems, Inc. v. United States,31 a subsidiary corporation was merged into its parent. Subsequently, the parent attempted to carry back its postmerger losses to the premerger years of the subsidiary. The Service argued that even if this transaction was

27. 311 F. Supp. at 839.
28. 439 F.2d at 1172.
29. The fifth circuit's panel precedent rule is explained in Home Constr. Corp. of America v. United States, 439 F.2d 1165, 1169 n.5 (5th Cir. 1971).
30. 439 F.2d at 1172.
an F reorganization, it was also a section 332 liquidation. Section 381(b) does not exempt a section 332 liquidation from its prohibition against carryback of postacquisition net operating losses to preacquisition taxable years of the transferor corporations. The Service also argued that section 332 should take precedence over section 368(a)(1)(F), and that the carryback should not be allowed.

The court began its analysis by noting that the transaction came within three statutory definitions: (1) a statutory merger under section 368(a)(1)(A); (2) a mere change in identity, form, or place of operation under section 368(a)(1)(F); and (3) a subsidiary liquidation under section 332. The court noted that the fact that the transaction was both an A and an F reorganization did not disqualify it from F reorganization treatment under section 381. The court then turned its attention to the argument that section 332 should predominate over section 368. The court did not attempt to carefully analyze the language of the Code, but merely concluded that there was no reason for any section of Subchapter C to apply to the exclusion of any other section, unless such intent was clearly indicated. The court saw no reason why an F reorganization that happened to also qualify as a section 332 liquidation should be precluded from receiving the benefits of F reorganization treatment under section 381. The court pointed out that if the parent had merged into the subsidiary instead of the subsidiary merging into the parent, the net effect would have been the same, but the F reorganization provisions would clearly have applied because the transaction would not have been a section 332 liquidation. The court felt that this kind of technicality should not preclude favorable treatment under section 381(b).

A similar situation was presented in Movielab, Inc. v. United States. In 1967, a subsidiary corporation was merged into its parent. In 1969, the parent incurred a net operating loss which it sought to carry back to the 1966 taxable year of the subsidiary.

33. The net effect may not be the same if one corporation has a net operating loss it seeks to carry over. In Rev. Rul. 76-36, 1976 Int. Rev. Bull. No. 5, at 5, the Service held that in the case of a parent into subsidiary merger, § 382(b)(3) does not operate to limit the effect of § 382(b)(2), which requires reduction of the net operating loss carryover where the stockholders of the loss corporation own less than 20% of the fair market value of the outstanding stock of the acquiring corporation. The limitation would not apply to subsidiary into parent liquidations defined by § 332 because § 382(b) applies only to transactions described in § 381(a)(2). A § 332 liquidation is described only in § 381(a)(1).
34. 494 F.2d 693 (Ct. Cl. 1974).
Again, the Service argued that since the transaction was within the scope of section 332, that section should take precedence over the reorganization section, and the net operating loss carryback should not be allowed.

The Service propounded an additional argument in *Movielab* as well. The substance of this argument was that the taxpayer can gain access to section 381(b) (and the corresponding favorable treatment of F reorganizations) only through section 381(a). To come within the scope of section 381(a) the transaction must either be (1) one to which sections 332 and 334(b) (1) apply; or (2) an A, C, D, or F reorganization to which section 361 applies. Clearly section 361 did not apply to this transaction because the subsidiary had received no stock of the parent corporation. Thus, the Service contended, the taxpayer's only access to section 381(b) was through section 381(a)(1), dealing with section 332 liquidations. Since section 381(b) does not except section 332 liquidations, section 381(b)(3) would operate to ban the carryback of the net operating loss.

The court agreed that this complicated argument may be partially correct, at least as to the Service's contention that section 361 did not apply to this transaction. The court rejected the Service's suggested result, however, by holding that section 381(b) was broader than section 381(a), and access to section 381(b) was not limited to the provisions of section 381(a). Under the provisions of section 381(b), any F reorganization was eligible for net operating loss carryback, not just F reorganizations to which section 361 applied. The court found that the previously established criteria of continuity of shareholder identity and proprietary interest and uninterrupted business enterprise were present. Thus there was an F reorganization, and net operating loss carryback was allowed.

In *Eastern Color Printing Co.*, the Service made the same argument, and the Tax Court rejected it for the same reasons the Court of Claims used in *Movielab*. It should be noted that *Eastern Color Printing* involved the merger of a subsidiary into a parent that had been merely a holding company with its sole asset prior to the merger being the subsidiary's stock. The Tax Court, how-

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35. Code § 381(a)(1).
36. Code § 381(a)(2).
37. Code § 361(a). This section provides for nonrecognition of gain or loss to a corporation that, pursuant to a plan of reorganization, exchanges property solely for stock or securities in another corporation that is a party to the reorganization.
ever, steadfastly agreed with the Service that an F reorganization could encompass only one operating company. Even though the court rejected the Service's section 332 argument, it specifically reaffirmed its position that the ninth circuit's decisions in *Stauffer* and *Associated Machine* were wrong. Other cases have also reached these same conclusions.

The purpose here is not to analyze the merits of the various arguments made by the taxpayers and the Service or the bases upon which the various courts have premised their decisions. Such analysis of the substantive merits of the various positions has been ably conducted elsewhere. The purpose in examining the preceding case history was to establish a historical foundation for the concession made by the Service in Revenue Ruling 75-561. The fifth, sixth, and ninth circuits, as well as the Court of Claims had held that an F reorganization could encompass an amalgamation of more than one operating corporation if: (1) shareholder identity and proprietary interest were maintained; and (2) the business enterprise were uninterrupted. The sixth circuit and Court of Claims had additionally held that a subsidiary into parent liquidation that came within the provisions of section 332 could nonetheless still constitute an F reorganization for purposes of section 381(b). The Tax Court, although concurring with the sixth circuit and the Court of Claims as to the subsidiary-parent

39. Id. at 34.

The general conclusion is that the Service's position has the greater merit. But McManus and the author of the Michigan Comment cited above argue that policy considerations support the allowance of the carryback.

42. 1975 CUM. BULL. 129.
43. Home Constr. Corp. of America v. United States, 439 F.2d 1165 (5th Cir. 1971); Davant v. Commissioner, 366 F.2d 874 (5th Cir. 1966).
45. See Associated Mach. v. Commissioner, 403 F.2d 622 (9th Cir. 1968); Estate of Stauffer v. Commissioner, 403 F.2d 611 (9th Cir. 1968).
46. See Movielab Inc. v. United States, 494 F.2d 693 (Ct. Cl. 1974).
48. See Movielab Inc. v. United States, 494 F.2d 693 (Ct. Cl. 1974).
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liquidation, steadfastly agreed with the Service that an F reorganization could involve only one operating corporation.49

With this background in mind, attention is now turned to the provisions of Revenue Ruling 75-561.

III. REVENUE RULING 75-561

Rather than continue the litigation battle or appeal to Congress for a legislative clarification of the F reorganization provisions, the Service in Revenue Ruling 75-561 conceded that if certain conditions are met, an amalgamation of more than one operating corporation could qualify as an F reorganization and be eligible for the net operating loss carryback under section 381(b).

The ruling imposes three conditions for qualification as an F reorganization. The first is that there must be complete identity of shareholders and their proprietary interests in the transferor corporations and acquiring corporations. The ruling specifically covers the wholly-owned subsidiary into parent merger by stating that the first requirement will be satisfied where the shareholders and their proprietary interests in the parent do not change as a result of the merger.

The second requirement is that the transferor corporations and acquiring corporation be engaged in the same business activities or integrated activities before the combination. If this language were interpreted literally, it could prove to be somewhat troublesome. A literal interpretation would seem to preclude the merger of existing corporations into a newly incorporated shell. If the merger takes place immediately upon the formation of the acquiring corporation, there is no way that it can be engaged in the same or integrated business activities as the transferor corporations before the merger.50 Thus, the example posited in the beginning of this note would not qualify as an F reorganization under the ruling. The language of the requirement should not be read literally for at least two reasons. In the ruling itself, an example is given to explain the net operating loss carryback requirements imposed by the ruling in which three corporations merge into a newly formed corporation. The example explains the extent to which a net operating loss of the acquiring corporation can be carried back to the premerger taxable years of the transferor corporations. This is an implicit recognition that a newly formed

50. If the acquiring corporation is newly incorporated solely for the purposes of the reorganization, it will not have assumed any business activity prior to the merger.
acquiring corporation does not have to be in the same or integrated business as the transferor corporations before the merger.

Another reason that this requirement should not be read literally is that Revenue Ruling 75-561 is specifically premised upon the cases previously discussed. Many of these cases involved mergers of the operating corporations into newly incorporated shells.\textsuperscript{51} Since the courts in the above discussed cases consistently held such mergers to be F reorganizations, it seems only logical that the ruling which acquiesces in those decisions would also allow such mergers.

The third requirement of the ruling is that the business enterprise of the transferor corporations and the acquiring corporation continue unchanged after the combination. The argument against a literal reading of the second requirement also applies to this requirement. Obviously a newly formed corporation must be allowed to assume the business activities of the transferor corporations merged into it. It would be illogical to say that the acquiring corporation must continue with no business activity.

If these three criteria are met, a transaction will qualify as an F reorganization. However, to be eligible to carry back postacquisition net operating losses, two additional requirements must be met. The first is that it be shown that the losses sought to be carried back are attributable to a separate business unit or division formerly operated by the transferor corporations. The second requirement is that the transferor corporation have income in its preacquisition taxable years against which such losses can be offset.

The carryback requirements are illustrated in the ruling by an example. $X$, $Y$, and $Z$ Corporations are all engaged in the same business, and all of the stock of each corporation is owned by $A$, an individual. On December 1, 1972, $X$, $Y$, and $Z$ merge into the new XYZ Corporation, with $A$ exchanging all of his $X$, $Y$, and $Z$ stock for all of the stock of XYZ. For its taxable year 1973, XYZ sustains a net operating loss of $70,000, of which $50,000 is attributable to the former business of $X$ and $20,000$ is attributable to the former business of $Y$. $X$ had taxable income of $10,000$ in 1972, $15,000$ in 1971, and $20,000$ in 1970. $Y$ had taxable income of $10,000$ in 1972, and net operating losses in all prior years. $Z$ had taxable income in all prior years.

XYZ is allowed to carry back $45,000 of the $70,000 net operating loss to the preacquisition years of $X$. Although $50,000$ of

\textsuperscript{51} See Stauffer v. Commissioner, 403 F.2d 693 (Ct. Cl. 1974); Home Constr. Corp. of America v. United States, 439 F.2d 1165 (5th Cir. 1971).
XYZ's loss was attributable to the business of X and thus allowable under the first requirement, the second requirement further limits the carryback to the amount of X's taxable income in the allowable carryback years. X's total taxable income in the three allowable carryback years was $45,000. Thus the carryback of XYZ's loss attributable to X's operations is limited to this amount.

Although $20,000 of XYZ's loss was attributable to Y's business operations, only $10,000 of this amount may be carried back. Again the carryback is limited to Y's taxable income in the carryback years. No portion of XYZ's loss may be carried back to a preacquisition taxable year of Z. Although Z had income in each preacquisition year, the first requirement provides that the loss carried back to a transferee corporation's preacquisition years must be attributable to the business operations of that corporation. No part of XYZ's loss was attributable to the operations of Z Corporation.

Thus, the total allowable carryback is $55,000. The remaining $15,000 net operating loss may only be carried forward.

IV. SOME UNANSWERED QUESTIONS AND PROBLEMS

Although the provisions of Revenue Ruling 75-561 are seemingly straightforward, they raise some questions which must be answered before practitioners can rely on a transaction being within the provisions of the ruling. Additionally, some of the requirements imposed on loss carrybacks may be without legal justification in the Code.

A. F Reorganization Requirements

The first F reorganization requirement is a complete identity of shareholders and proprietary interests in the transferor corporations and acquiring corporations. The requirement actually has two standards. First, there must be a complete identity of shareholders. This would seem to mean that everyone who was a shareholder of the transferor corporations must also be a shareholder of the acquiring corporation. This was true in all of the litigated cases involving mergers of brother-sister corporations. In fact, in all but Davant, there was only a single shareholder in the transferor corporations and acquiring corporations.

In Revenue Ruling 66-284,52 the Service ruled that if less than one per cent of the shareholders of the transferor corporations did

not receive stock in the acquiring corporation the transaction would still qualify as an F reorganization. Revenue Ruling 75-561 makes no mention of the application of Revenue Ruling 66-284. However, in light of the fact that the requirement mandates complete shareholder identity and the fact that all of the litigated cases upon which Revenue Ruling 75-561 is based involved complete identity, it would be unwise for a practitioner to rely on such a de minimis exception as is set forth in Revenue Ruling 66-284 without first obtaining a ruling from the Service.

The second standard imposed by the complete identity requirement is potentially even more troublesome. Complete identity of the shareholders' proprietary interests is required. The cases upon which the ruling is based provide the most obvious examples. If one individual owns all of the stock of each transferor corporation and he owns all of the stock of the acquiring corporation, complete identity of proprietary interest is maintained. Similarly, if 25 per cent of each transferor corporation is owned by the same four persons and they each receive 25 per cent of the stock of the acquiring corporation, complete identity of proprietary interest is maintained.\(^5\)

Apparently no problem arises from a situation where the transferor corporations are not owned in equal proportion by the shareholders, so long as each shareholder owns the same percentage of each corporation.\(^4\) This can be illustrated by the following example. Assume that the transferor corporations are X and Y. Each has a net worth of $100,000. Individual A owns 60 per cent of the stock of each corporation and individual B owns 40 per cent of the stock of each corporation. X and Y then merge into the new corporation, XY. A receives 60 per cent of XY's stock and B receives 40 per cent. Here, complete identity of proprietary interest has been maintained. Before the merger, A theoretically owned $60,000 of X's net worth and $60,000 of Y's net worth. After the merger he owns $120,000 of XY's net worth. The same is true of B ($40,000 each of X and Y before the merger and $80,000 of XY after the merger). Before the merger, A theoretically owned 60 per cent of X's assets and 60 per cent of Y's assets. He now owns 60 per cent of XY's assets which can be theorized to consist of 60 per cent of the assets formerly owned by X and 60 per cent of the assets formerly owned by Y. The same can be said for B, as to his 40 per cent interest.

\(^3\) In Davant, four family groups each owned 25% of the stock. Within the family groups, the number of individual owners varied from family to family, but each individual owned the same percentage interest of each corporation. 43 T.C. at 544.

\(^4\) This was the case in Davant. See id.
Now alter the facts only slightly. Before the merger, assume that A now owns 60 per cent of X and 40 per cent of Y. B owns 40 per cent of X and 60 per cent of Y. A and B each own net worth of $100,000. After the merger A and B would each own 50 per cent of the stock of XY. This would result in each still owning net worth of $100,000 (50 per cent each of XY's net worth of $200,000). However, the theoretical ownership of assets has changed. Before the merger A theoretically owned 60 per cent of X's assets and 40 per cent of Y's assets. After the merger, A would theoretically own 50 per cent of XY's assets but his 50 per cent would be comprised of 50 per cent of the assets formerly owned by X and 50 per cent of the assets formerly owned by Y. Unless the definition of proprietary interest is limited to a percentage ownership in the net worth of the corporation, there has been a change of proprietary interest in this instance.

This idea can be carried to its ultimate extension in the situation where A owns all of X and B owns all of Y. After the merger each owns 50 per cent of XY, and each has maintained his same net worth. However, the theoretical composition of the assets each owns has altered radically.

This would seem to be beyond the scope of the F reorganization provisions defined in Revenue Ruling 75-561. Once again, the practitioner should confine himself to the fact situations of the prior cases, unless he first obtains a ruling.

The second F reorganization requirement—that the transferor and acquiring corporations be engaged in the same business activity before the merger—has been previously discussed. What would constitute the same or integrated business activities is difficult to forecast. This would seem to be a factual determination which will have to be made in each individual case. Clearly, the further one ventures from the obvious situations, the more risky the transaction becomes.

The third requirement stipulates that the business enterprise of the transferor and acquiring corporations must continue unchanged after the combination. An examination of the prior case law could be helpful in determining some of the factors which may be involved in determining if the business enterprise has changed. Obviously, in each of the cases, the court found that no change had occurred and in most of the cases the court at least mentioned the factors that led it to that conclusion.

55. See text accompanying note 50 supra.
In Davant, the court merely stated that "absolutely no disruption was occasioned by the paper transfer."\textsuperscript{56} In Stauffer, the court found that the books of each premerger corporation were maintained, and the enterprises operated in the same manner at the same locations.\textsuperscript{57} The Associated Machine court noted that both corporations had the same officers and directors.\textsuperscript{58} The court in Home Construction noted several factors, including no changes in scope or type of overall business operations, and no change in location, location of management headquarters, overall assets, personnel employed in the operations, or methods of operations. The only changes were simplification of bookkeeping procedures.\textsuperscript{59} In Performance Systems, the court found no changes in the form or location of corporate assets, personnel or management, type or method of business operations, or officers and directors.\textsuperscript{60} The Movielab court noted that "[t]he same business was being conducted without interruption—at the same location, by the same management . . . ."\textsuperscript{61} In Eastern Color Printing, there was no change in assets, location, personnel, or management. With minor exceptions, the directors and officers were unchanged.\textsuperscript{62}

It can be seen that many of the same factors appear in several cases. Although these considerations should not be viewed as conclusive one way or the other, they do provide some general guidelines. They serve to reiterate the point that an F reorganization is a mere change in form.\textsuperscript{63} A reorganization that contemplates substantial physical relocation of assets or personnel changes would seem to be vulnerable to attack under this requirement.

\section*{B. Carryback Requirements}

Possible ramifications of F reorganization treatment for multi-corporate reorganizations have been discussed in other articles.\textsuperscript{64} Our scope will be limited to those problems presented by the

\begin{itemize}
\item \textsuperscript{56} 366 F.2d at 879.
\item \textsuperscript{57} 403 F.2d at 619.
\item \textsuperscript{58} 403 F.2d at 625.
\item \textsuperscript{59} 439 F.2d at 1167.
\item \textsuperscript{60} 382 F. Supp. at 532.
\item \textsuperscript{61} 494 F.2d at 699.
\item \textsuperscript{62} 63 T.C. at 28.
\item \textsuperscript{63} See Code § 368(a) (1) (F).
\item \textsuperscript{64} McManus, supra note 41, discusses the possible application of the F reorganization provisions to the liquidation of insolvent subsidiaries, and to liquidations in which § 334(b) (2) applies. In Vienna, Effect of a Multi-Corporate F Reorganization on Loss Carryovers and Carrybacks, 42 J. Tax. 130 (1975), the author discusses the possibility of there being multiple transferees in an F reorganization.
\end{itemize}
carryback of postacquisition net operating losses to preacquisition years of the transferor corporations.

An initial problem is that of the termination of the taxable years of the transferor corporations. Revenue Ruling 75-561 clearly requires that in order for an acquiring corporation to carry back postacquisition losses to preacquisition taxable years of the transferor corporations, the loss sought to be carried back must be attributable to a separate business unit formerly operated by the transferor corporation. However, section 381(b) exempts an F reorganization from the requirement of section 381(b) (1) that the taxable year of the transferor end on the date of the transfer. Revenue Ruling 57-276 provides that when an F reorganization occurs, the part of the acquiring corporation’s taxable year before the reorganization and after it constitute a single taxable year of the acquiring corporation. Additionally, the transferor corporations do not file income tax returns for that year. Only the acquiring corporation files a return and includes all of the operations of the combined group. Thus, at least for the year of the merger, the requirements of Revenue Ruling 75-561 apparently can be flouted.

Assume X and Y are both calendar year corporate taxpayers wholly owned by A, an individual. X has income and Y has a loss for taxable year 1976. If, on December 31, 1976, X merges into Y, section 381(b) (1) and Revenue Ruling 57-276 would allow Y to file a single return for the year, including both its operations and X’s. This would allow an offset of X’s premerger taxable income against Y’s loss for the part of the taxable year before the merger, in direct contravention of the policy of Revenue Ruling 75-561.

If, however, section 381(b) required that X’s taxable year terminate on the date of the transfer, and that a separate return be filed for the part year, such offset would not be possible because X’s income would then be locked in a preacquisition year and by the terms of Revenue Ruling 75-561 Y could carry back losses to that year only to the extent that such losses were attributable to X’s operations, which of course they would not be. The offset would also not have been possible if the merger had occurred one day later on January 1, 1977. In that case, each corporation would have filed a separate return for the full taxable year 1976. Thus, by executing the merger one day earlier, an immense tax advantage could be obtained.

65. See Code § 381(b) (1).
If the Service is to prevent the circumvention of the policy of the ruling it appears that at least in the case of F reorganizations involving two or more active corporations, the taxable year of the transferor corporations will have to be terminated on the date of the transfer. Terminating the tax years on the date of transfer would also eliminate many problems that could arise if the corporations have different fiscal years.

The requirement that the carryback of postacquisition losses to preacquisition years be limited to that part of the loss that was attributable to the business operations of the transferor corporation presents two additional questions. The first is whether this is a proper limitation to impose. The requirement was imposed by the prior case law. In *Stauffer*, the first case to allow net operating loss carryback, the court seemed to rely on the well known pre-1954 Code case of *Libson Shops, Inc. v. Kohler.* The case dealt with the allowability of loss carryovers. Sixteen separate corporations were merged into another corporation. Three of the corporations were loss corporations before the merger and continued to be unprofitable after the merger. The taxpayer attempted to carry over these premerger losses to offset postmerger income earned by those parts of the new corporation that were profitable both before and after merger. The Court said the losses should be permitted to be carried over only to offset income attributable to the same business operations after the merger. The underlying policy was that the taxpayer should not gain a tax windfall as a result of the merger. The Court reasoned that but for the merger, the losses never could have crossed business lines, and that therefore, the merger should not result in cross-over either. The same “but for” reasoning is apparent in *Stauffer* regarding carrybacks. *Home Construction* clearly applies the *Libson Shops* criteria, and the limitation was obviously retained by Revenue Ruling 75-561.

There is at least a legitimate question as to whether the *Libson Shops* case should be applicable to the 1954 Code in any way. Sections 381 and 382 regulate the carryover and carryback of net operating losses after corporate reorganizations under the 1954 Code. These provisions had no counterparts in the 1939 Code, under which *Libson Shops* was decided.

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67. 353 U.S. 382 (1957). Although the case was decided under the rules of the 1939 Code, it was actually decided after the adoption of the 1954 Code.
68. *Id.* at 388-90.
69. 403 F.2d at 621.
70. 439 F.2d at 1172.
CORPORATE REORGANIZATION

Courts have split on the question of whether Libson Shops has any application under the 1954 Code.\textsuperscript{71} Even if the principle is not applicable to carryovers, such fact would not automatically preclude the application of the same principle to carrybacks. However, one commentator has suggested that to require that the loss carrybacks not cross business lines is to deny that an F reorganization is a mere change of form.\textsuperscript{72} The suggestion is that if the new entity is really the alter-ego of the old, there is no reason to deny a cross-over of losses.\textsuperscript{73}

Although taxpayers may have room to argue that the ruling's carryback requirements have no statutory basis in the 1954 Code, this appears to be a difficult argument since the ruling's requirements were firmly entrenched in the case law upon which the ruling is based. Assuming the requirement is valid, we must now examine the problems it may cause.

The principal problems appear to be of definition and accounting. The question is what burden the taxpayer must sustain to show that a loss is attributable to a separate business unit or division formerly operated by the transferor corporation. Revenue Ruling 59-395,\textsuperscript{74} issued after Libson Shops, held that the taxpayer had the burden of proving the amount of deduction on credit allowable to the portion of the business of the resulting corporation which was conducted with the assets of the merged corporation. This same burden will probably remain on the taxpayer.

\textsuperscript{71} Compare United States v. Adkins-Phelps, Inc., 400 F.2d 737 (8th Cir. 1968); Frederick Steel Co. v. Commissioner, 375 F.2d 351 (6th Cir. 1967); Maxwell Hardware Co. v. Commissioner, 343 F.2d 713 (9th Cir. 1965); and WOFAC Corp. v. United States, 269 F. Supp. 654 (D.N.J. 1967), which hold that Libson Shops doctrine is not applicable to cases arising under the 1954 Code, with Frank Ix & Sons Va. v. Commissioner, 375 F.2d 867 (3d Cir. 1967); United States v. Jackson Oldsmobile, Inc., 371 F.2d 808 (5th Cir. 1967); Huyler's v. Commissioner, 327 F.2d 767 (7th Cir. 1964); and J.G. Dudley Co. v. Commissioner, 298 F.2d 750 (4th Cir. 1961), which hold that Libson Shops retains its value as precedent.

In TIR 773, ¶ 55,063 P-H 1965 FED. TAXES, the Service stated that it would not follow Maxwell Hardware and that the Libson Shops doctrine continued to be valid under the 1954 Code. The Service also said, however, that Libson Shops would not be applied to loss carryovers unless there had been a 50% or more shift in the benefits of the loss carryover and a change in the business as defined in § 382(a).

\textsuperscript{72} See McManus, supra note 41, at 291-92.

\textsuperscript{73} For a detailed discussion of the argument that Libson Shops should have no application under the 1954 Code see Sinrich, Libson Shops—An Argument Against Its Application Under the 1954 Code, 13 TAX L. REV. 167 (1958).

\textsuperscript{74} 1959-2 CUM. BULL. 475.
under Revenue Ruling 75-561. The taxpayer should be allowed to adopt a new accounting system as long as the operations of the merged corporations may be separately identified to the Service's satisfaction.

To the extent that any type of permissible centralization of management or administration occurs after an F reorganization, administrative overhead costs attributable to all corporations would in some way have to be allocated to the various businesses of the merged corporation for purposes of establishing the origin of the losses.

V. CONCLUSIONS

Although the concessions made by the Service in Revenue Ruling 75-561 have the potential of a new range of possibilities for the reorganization planner, the ruling is clouded with enough uncertainties to make it difficult to determine in advance whether a transaction will qualify as an F reorganization and consequently be eligible for net operating loss carryback.

One way to alleviate some of the problems would be for the Service to adopt a policy of ruling on proposed transactions with regard to compliance with the requirements of Revenue Ruling 75-561. However, even with advance rulings there is a practical problem of including enough facts in the ruling request so that the Service will be ruling on the same transaction as the planner contemplates executing. This could become especially difficult with regard to all of the criteria courts have used to determine if the business enterprise has continued unchanged.75

A better solution may be for the Service to issue a new set of regulations interpreting section 368(a)(1)(F) as to the definition of an F reorganization and section 381 relating to the allowability of loss carrybacks. Even with rulings and interpretive regulations, continued litigation in the F reorganization area can be expected as taxpayers begin to take advantage of the provisions of Revenue Ruling 75-561 and as counsel seek to determine how far the boundaries can be stretched.

Thomas N. Lawson '77

75. See text accompanying notes 56-63 supra.