SECTION 368(a)(1)(F) AND LOSS CARRYBACKS IN CORPORATE REORGANIZATIONS

Numerous and varied are the means by which a corporation can restructure itself. The restructuring may be internal, as in a recapitalization, or external, as in acquisition of control of another corporation. The tax consequences flowing from a corporate restructuring depend on the form and nature of the transaction. In the Internal Revenue Code of 1954, Congress defined six such transactions as "corporate reorganizations": statutory mergers and consolidations,1 acquisitions of the stock2 or assets3 of one corporation by another, transfers of substantially all the assets from one corporation to another,4 recapitalizations,5 and mere changes in form, identity, or place of organization.6 Congress distinguished these transactions from other restructurings by requiring specialized tax treatment: the corporations participating in a reorganization may not recognize gain or loss7 nor may they step-up the basis of their acquisitions.8 Through section 381(b)(3), Congress also made a distinction among the types of corporate reorganizations by allowing a loss carryback9 only to those corporations involved in a section 368(a)(1)(F) reorganization.10

2 Id. § 368(a)(1)(B).
3 Id. § 368(a)(1)(C).
4 Id. § 368(a)(1)(D).
5 Id. § 368(a)(1)(E).
6 Id. § 368(a)(1)(F).
7 Id. § 361.
8 Id. § 362(b). See B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS 499-500 (2d. ed. 1966) [hereinafter cited as BITTKER & EUSTICE].

Treasury Regulation § 1.1002-1(c) (1957) provides the best explanation of the reason for the nonrecognition of gain or loss and retention of basis when it states, "[T]he underlying assumption of these exceptions [to the general recognition of gain or loss and the basis change] is that the new property is substantially a continuation of the old investment still unliquidated; and, in the case of reorganizations, that the new enterprise, the new corporate structure, and the new property are substantially continuations of the old still unliquidated." See also SENATE COMM. ON FINANCE, REVENUE BILL OF 1924, S. REP. NO. 398, 68th Cong., 1st Sess. 14-15 (1924); HOUSE WAYS & MEANS COMM., REVENUE BILL OF 1924, H. R. REP. NO. 179, 68th Cong., 1st Sess. 13 (1924); R. HOLZMAN, CORPORATE REORGANIZATIONS: THEIR FEDERAL TAX STATUS 2.23 (2d ed. 1956).

9 INT. REV. CODE OF 1954, §172(c) defines a "net operating loss" as "the excess of the deductions allowed by this chapter [Id. subtit. A, ch. 1B] over the gross income."

10 Id. § 381(b). The section provides that:

Except in the case of an acquisition in connection with a reorganization described in subparagraph (F) of section 368(a)(1)—

(3) The corporation acquiring property in a distribution or transfer described in subsection (a) shall not be entitled to carry back a net operating
By introducing section 381 into the 1954 Code, Congress sought to liberalize the carryback and carryover provisions by basing them "upon economic realities rather than upon such artificialities as the legal form of reorganization," while at the same time, in section 382(b), limiting the then common practice of acquisition by a profitable corporation of a loss corporation, and the subsequent carryover of the transferee's losses as an offset against the taxable gains of the acquirer.

This practice evolved from the decisions in Helvering v. Metropolitan Edison Co., and Stanton Brewery, Inc. v. Commissioner, which, for the purpose of determining whether a loss carryover or carryback should be permitted, laid down a combination statutory merger and single corporate entity test. In Helvering v. Metropolitan Edison Co. the respondent underwent, as a financing measure, a statutory merger with one of its subsidiaries. The Supreme Court, in permitting the carryover of the subsidiary's tax attributes to the parent corporation, ruled that:

[A] transfer without valuable consideration, with the intent that the transferor shall, as the statute provides, cease to exist, made in accordance with the statute, has all the elements of a merger and comes within the principle that the corporate personality of the transferor is drowned in that of the transferee.

In Stanton Brewery v. Commissioner, a parent corporation underwent a statutory merger with a wholly-owned subsidiary and then attempted to carry over the unused excess profit credits of the subsidiary. Permitting the carryover, the Second Circuit noted that

loss for a taxable year ending after the date of distribution or transfer to a taxable year of the distributor or transferor corporation.

In addition to loss carrybacks, the taxable year of the distributor or transferor corporation in a corporate reorganization, id. § 381(b)(1), and certain losses on small business stock, id. § 1244(d)(2), also turn on whether there has been an F reorganization. However, this Comment will be concerned with § 368(a)(1)(F) only insofar as it relates to the loss carryback provisions of § 172 by way of § 381(b)(3).


12 This was usually attempted in either of two ways: by making the loss corporation the surviving corporation, or by satisfying the statutory merger requirements of the state of incorporation.

Representative Reed, who sponsored the House version of the Internal Revenue Code of 1954, stated that this section was designed to "eliminate the trafficking-in-loss corporations by which many businessmen [were] able to avoid their own tax liabilities." 100 CONG. REC. 3421 (1954); see id. 3427; Susser, New Aspects of the Net Operating Loss and Carry-over Provisions, in How to Work with the Internal Revenue Code of 1954, at 331, 338 (1954) [hereinafter cited as Susser].


14 176 F.2d 573 (2d Cir. 1949); see Susser 338.

15 306 U.S. at 529 (emphasis added).

16 The actual purpose of the carryover was to offset excess profits taxes rather than regular income taxes. For the purposes of this Comment, however, there is no functional difference between a carryover of unused excess profits credits and a carryover of net operating loss.
we must regard the "resulting corporation" as the union of component corporations into an all-embracing whole which absorbs the rights and privileges, as well as the obligations, of its constituents.17

To many taxpayers the Stanton decision seemingly permitted a net operating loss carryover in the case of a statutory merger,18 with the result that

thousands of companies having substantial losses from operations or "shell" companies that had no other assets than net-operating loss carry-overs were offered for sale. Thus, a widespread rash of mergers developed whereby profitable firms acquired control of corporations that were losing money for the purpose of offsetting the gains of the former against the losses and loss carry-overs of the latter. . . . Although the practice was abusive and extensive, it was difficult to check with [section 129 of the 1939 Code].10

However, if the reorganization did not involve a statutory merger, loss carryovers and loss carrybacks were ordinarily denied, under the rule of New Colonial Ice Co. v. Helvering.20 In New Colonial Ice, the "old" corporation transferred all of its assets and business to a "new" corporation which had substantially the same capital structure, shareholders, and creditors as the old, and which had been organized specifically for the purpose of taking over its business.21

In denying the deduction of the losses suffered by the old corporation from the income of the new, the Supreme Court ruled that section 204(b) of the Revenue Act of 1921 22 granted the loss deduction

17 176 F.2d at 575.
18 See Susser 338. The government, however, never accepted the application of the Stanton rationale to net operating carrybacks and carryovers, and the Tax Court in California Casket Co., 19 T.C. 32 (1952), a case involving a carryover of the unused excess profits of a subsidiary in a statutory merger, refused to follow the Stanton decision. Nevertheless, there was sufficient uncertainty in the law, and the practice of "trafficking in loss corporations" had developed to such an extent that Congress felt impelled to make statutory changes.
19 Susser 338.
21 While the issue was not discussed directly in the case, it would seem that the transaction in New Colonial Ice was within the "mere change in identity, form, or place of organization of a corporation, (however effected)" definition of a corporate reorganization contained in § 202(c)(2) of the Revenue Act of 1921. See BITTKER & EUSTICE 607.
22 Ch. 136, § 204(b), 40 Stat. 230 provided:
If for any taxable year . . . it appears upon the production of evidence satisfactory to the Commissioner that any taxpayer has sustained a net loss,
only to “the taxpayer who sustained the loss” and that the new corporation could not bring itself within that category.

The New Colonial Ice, Metropolitan Edison, and Stanton Brewery cases complicated the law in this area. Serious tax avoidance occurred when a statutory merger or loss corporation survivorship could be shown, and yet loss carrybacks or carryovers were denied in many legitimate reorganizations. Congress, in order to clarify the law, eliminate the importance of survivorship of the loss corporation, and limit trafficking in loss corporations, introduced sections 381 and 382(b) into the Internal Revenue Code of 1954. It is in this context that section 368(a)(1)(F) must be examined to determine the proper scope of the net operating loss carryback exception contained in section 381(b)(3).

Section 368(a)(1)(F), Pre-Davant

Under subsection F of section 368(a)(1), a corporate reorganization is defined to include a “mere change in identity, form, or place of organization, however effected.” Unlike sections 381 and 382(b), this provision was not new to the 1954 Code. Section 202(c)(2) of the Revenue Act of 1921 defined a reorganization to include, inter alia, a “mere change in identity, form, or place of organization of a corporation, (however effected).” In 1924, the words “of a corporation” were deleted. There is no indication, however, that this change in language was intended to have any operative effect, or

the amount thereof shall be deducted from the net income of the taxpayer for the succeeding taxable year; and if such net loss is in excess of the net income for such succeeding taxable year, the amount of such excess shall be allowed as a deduction in computing the net income for the next succeeding taxable year; the deduction in all cases to be made under regulations prescribed by the Commissioner with the approval of the Secretary.

(emphasis added).

23 292 U.S. at 440.

24 The strict entity theory of New Colonial Ice did not, however, prevent the merger terms from making the loss corporation the surviving corporation, and thereby preserving the loss carryover or carryback. See BITTKE & EDDIE’S 607; Richardson, Planning for Maximum Use of Net Operating Loss Deduction, Tul. 3d Tax Inst. 239, 247-48 (1954); cf. Susser 342.


26 See Susser 342.

27 See text accompanying notes 11-12 supra.

28 Ch. 136, 42 Stat. 230.

29 The legislative history of § 202(c)(2) is rather sparse. See S. Rep. No. 275, 67th Cong., 1st Sess. 11 (1921); H.R. Rep. No. 486, 67th Cong., 1st Sess. 3 (1921); S. Doc. No. 73, 67th Cong., 1st Sess. 12 (1921). Still, it seems reasonable to believe that this part of § 202(c)(2) was included to overrule United States v. Phellis, 257 U.S. 156 (1921), which found recognizable gain after exchanges of stock pursuant to a change of state of incorporation. See R. MOLLOY, FEDERAL INCOME TAXATION OF CORPORATIONS 165 (1966).

to be anything more than a "minor change in phraseology."  

The "mere change in identity, form, or place of organization, however effected" language was reenacted as section 112(g)(1)(E) of the Internal Revenue Code of 1939; in 1954, it was reenacted as section 368(a)(1)(F). Despite this legislative consistency, the meaning of the "mere change" provision has always been obscure. There has been no legislative clarification, no explanation in the Regulations, and, until recently, relatively little administrative or judicial attention.

The initial judicial construction of "mere change in identity, form, or place of organization" was in 1934 in Ahles Realty Corp. v. Commissioner. The Second Circuit stressed continuity of interest, continuance of the business, and a lack of new shareholders. Ahles Realty involved an exchange of its stocks and bonds, for reasons of convenience, by a new corporation for all the stock and assets of an old corporation. The sole owner of the old corporation remained the sole owner of the new corporation. The issue before the court was whether, in determining gain or loss on subsequent sales, the basis to the new corporation should be the fair market value of the property on the date of the transfer, or the cost basis to the old corporation. In ruling that the cost basis of the old corporation should apply, the court noted:

There was a continuity of interest in the transaction, a continuance of the business conducted by the old corporation under the modified corporate form. After reorganization, the sole stockholder became the sole stockholder of the new,

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32 Ch. 1, 53 Stat. 40.


35 See Treas. Reg. § 1.368-2 (1955); Bittker & Eustice 547.

36 Bittker & Eustice 547. The "until recently" qualification refers to Davant v. Commissioner, 366 F.2d 874 (5th Cir. 1966), cert. denied, 386 U.S. 1022 (1967), which touched off a virtual flood of litigation under § 368(a)(1)(F). See text accompanying notes 74-85 infra.


38 The trial court apparently accepted the taxpayer's assertion, and required no proof, that the reorganization would be more convenient. The Second Circuit did not discuss the issue.
and the new corporation at completion was possessed of the same assets as the old. . . . [I]t was "a mere change in identity, form or place of organization, however effected." 39

The Supreme Court did not construe "mere change in identity, form, or place of organization" until 1942 when it laid down a rather broad "shift in proprietary interest" test. Helvering v. Southwest Consolidated Corp. 40 involved a bankruptcy reorganization in which the assets of an old corporation were transferred under a creditors' plan to a new corporation. Over ninety per cent of the common stock went to the bondholders of the old corporation, and the rest was split between the unsecured creditors and former stockholders. Subsequently, the new corporation, using the old corporation's basis attempted to deduct a substantial amount for bad debt losses. The Commissioner disallowed the deduction on the grounds that the reorganization did not qualify for tax-free status under section 112(g)(1), 41 and therefore that the appropriate basis was the fair market value on the date of transfer. The Court, upholding the Commissioner's contention, examined and rejected the application of all the forms of reorganization contained in section 112(g)(1); as to the precursor of section 368(a)(1)(F) the Court noted simply that:

[A] transaction which shifts the ownership of the proprietary interest in a corporation is hardly "a mere change in identity, form, or place of organization" . . . 42

The Court gave no further indication whether this "shift in proprietary interest" test was meant to cover only an actual change in ownership, that is, the introduction of new equity interests, or whether it was broad enough to cover the ouster of a minority interest in an existing corporation without the introduction of any new owners. 43

No further light was shed on this question by the next major case, Newmarket Manufacturing Co. v. United States. 44 In Newmarket, the corporation changed its state of incorporation from Massachusetts to Delaware by establishing a shell, wholly owned subsidiary corporation in Delaware, and then merging the two. 45 Operat-

39 71 F.2d at 151. See also George Whittell & Co., 34 B.T.A. 1070 (1936).
40 315 U.S. 194 (1942).
41 Revenue Act of 1934, ch. 277, § 112(g)(1), 48 Stat. 705.
42 315 U.S. at 202-03.
43 Davant v. Commissioner, 366 F.2d 874 (5th Cir. 1966), cert. denied, 386 U.S. 1022 (1967), found a "mere change" where a 48% minority interest was ousted. See text accompanying notes 76-88 infra.
44 233 F.2d 493 (1st Cir. 1956).
45 This type of transaction has been referred to as the typical F reorganization situation. See Estate of Bernard H. Staufer, 48 T.C. 277, 299 n.6 (1967); R. Musselman, Alexander's Federal Tax Handbook, 1957, at ¶ 2612 (21st ed. 1957); R. Paul, Studies in Federal Taxation 82 (3d ser. 1940). Compare Newmarket with Marr. v. United States, 263 U.S. 536 (1925), a case arising under the Revenue Act of 1918.
ing under the 1939 Code, the surviving corporation attempted to carryback subsequent net operating losses to the pre-merger period. The Commissioner denied the carryback on the grounds that the Massachusetts and Delaware Newmarkets, being different legal entities, could not be the same taxpayer under the provisions of the 1939 Code. While the court rejected the Commissioner’s contention of a “different entity” and permitted the carryback on Stanton and Metropolitan Edison grounds, it did make specific reference to sections 381(b) and 368(a)(1)(F) of the 1954 Code, noting that “if the provisions of the 1954 Code were applicable to the present case, appellant Newmarket Mfg. Co. would be entitled to the claimed refund.”

The “shift in proprietary interest” test was re-emphasized in Hyman H. Berghash. Before corporate restructuring, a husband and wife were sole owners of a corporation, the husband owning 98 per cent; after the restructuring the husband owned 50 per cent, the wife nothing, and a new stockholder 50 per cent. During this process the husband and wife received a substantial amount of money. The Commissioner sought to tax it as a dividend, at ordinary income rates, rather than as a distribution in payment for the exchange of stock, at capital gains rates. The Commissioner contended that the transaction was a sham, or alternatively, that it involved an F or a D reorganization rather than a complete liquidation and distribution of the old corporation.

The court rejected the latter contention, noting with regard to the F question:

In the instant case there occurred a drastic shift in the proprietary interest of the owner of the predecessor corporation. . . . Hyman Berghash, who had owned all of the stock [except for the two per cent owned by his wife], wound up as the owner of only 50 percent of the stock of the successor corporation. . . . Despite the fact that all of the operating assets were carried over to the successor corporation, which continued exactly the same business, in the same location, as had been conducted by the predecessor, the radical shift in


47 See text accompanying notes 16-19 supra.

48 See text accompanying note 15 supra.

40 233 F.2d at 497.

50 43 T.C. 743 (1965), aff’d, 361 F.2d 257 (2d Cir. 1966).

CORPORATE REORGANIZATIONS

stock ownership which occurred precludes us from holding that the transaction amounted to no more than "a mere change in identity, form, or place of organization" within the meaning of section 368(a)(1)(F).

Despite the emphasis of the old owner's change in proportionate interest, the court's real worry seemed to be the reduction of that interest coupled with the introduction of a new equity interest. Indeed, where a court has found "a mere change in identity, form, or place of organization," there has been no indication that new equity interests were introduced into the corporation as part of the reorganization.

One question which none of these cases discussed is whether a reorganization can be an F reorganization when a minority interest is ousted from the corporation and no new shareholders are introduced. While the Southwest Consolidated and Berghash tests could not be construed to cover such ousters, the first clear answer was given in Revenue Ruling 66-284:

Where . . . a plan of merger is designed only to effect a change in the corporation's place of organization, the Internal Revenue Service considers the failure of dissenting shareholders owning a total of less than 1 percent of the outstanding shares to participate in the plan of merger to be such a de minimis change in the corporation's shareholders and its assets as not to disqualify the merger as a reorganization under section 368(a)(1)(F) of the Code.

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52 At another point in the opinion the court said that "if a change in stock ownership or a shift in proprietary interest occurs, the transaction will fail to qualify as an F reorganization." 43 T.C. at 752 (emphasis deleted and added). But the court did not make clear whether these are two independent tests or merely two different ways of saying the same thing. While Helvering v. Southwest Consol. Corp., 315 U.S. 194, 202-03 (1942), was cited for this proposition, perhaps a better explanation is that the court was combining the Southwest Consol. test with the "no change in the existing stockholders" test of Rev. Rul. 58-422, 1958-2 CUM. BULL. 145, 146.

53 See, e.g., Estate of Stauffer v. Commissioner, 403 F.2d 611 (9th Cir. 1968); Associated Mach. v. Commissioner, 403 F.2d 622 (9th Cir. 1968); Reef Corp. v. Commissioner, 386 F.2d 125 (5th Cir. 1966), cert. denied, 386 U.S. 1081 (1967); Davant v. Commissioner, 366 F.2d 874 (5th Cir. 1966), cert. denied, 386 U.S. 1022 (1967); Newmarket Mfg. Co. v. United States, 233 F.2d 493 (1st Cir. 1956); Ahles Realty Corp. v. Commissioner, 71 F.2d 150 (2d Cir. 1934). Compare above with Helvering v. Southwest Consol. Corp., 315 U.S. 194 (1942); Cushman Motor Works v. Commissioner, 130 F.2d 977 (8th Cir. 1942); Hyman H. Berghash, 43 T.C. 743 (1965), aff'd 361 F.2d 257 (2d Cir. 1965); Joseph C. Gallagher, 39 T.C. 144 (1962); and Stolberg Hardware Co., 46 B.T.A. 788 (1942). But cf. Rev. Rul. 61-156, 1961-2 CUM. BULL. 62, where the Commissioner ruled that a reorganization introducing new equity interests of 55% qualified under INT. REV. CODE OF 1954, § 368(a)(1)(F).

54 In such a case, there is obviously a change in the proportionate interests: the share of the "surviving" owners is increased.

Thus, prior to *Davant v. Commissioner*, section 368(a)(1)(F) was given a very narrow scope. It applied only in those situations in which "the surviving corporation [was] the same corporation as the predecessor in every respect, except for minor or technical differences;" when "the corporate enterprise continued uninterrupted, except perhaps for a distribution of some of its liquid assets," or when there was "a mere change of corporate vehicles, the transferee being no more than the alter ego of the transferor." It did not apply when a new shareholder was introduced as part of the reorganization, when more than a single corporation was involved, or when a significant number of the minority shareholders were ousted.

The Expanded Scope of § 368(a)(1)(F): Davant and Afterwards

For forty-five years, beginning with its inception in 1921, the "mere change in identity, form, or place of organization" type of corporate reorganization had been narrowly defined and little used. In 1966 the Internal Revenue Service initiated a major, two-pronged expansion of the meaning and scope of section 368(a)(1)(F). In *Davant v. Commissioner* an F reorganization was held to include the merger of brother and sister corporations, while in *Reef Corp. v. Commissioner* an F reorganization was held to include those transactions in which less than fifty per cent of the existing shareholders were ousted and no new shareholders came in.

In *Davant*, two vertically integrated corporations (*X* and *Y*) were owned in substantially equal proportions by four families. The original shareholders desired to transfer the operating assets of *X* to *Y* and at the same time to withdraw a substantial amount of *X*'s appreciated corporate assets at the capital gains rates. They attempted to sell the stock of *X* to "a person not connected with them or their corpora-

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67 366 F.2d 874 (5th Cir. 1966), cert. denied, 386 U.S. 1022 (1967).
69 Hyman H. Berghash, 43 T.C. 743, 752 (1965).
70 Pridemark, Inc. v. Commissioner, 345 F.2d 35, 42 (4th Cir. 1965).
71 Id.
72 See text accompanying notes 53-54 *supra*.
74 However, this position is the converse of that expressed in Rev. Rul. 66-284, 1966-2 CUM. BULL. 115. See text accompanying note 56 *supra*.
75 366 F.2d 874 (5th Cir. 1966), cert. denied, 386 U.S. 1022 (1967).
76 368 F.2d 125 (5th Cir. 1966), cert. denied, 386 U.S. 1018 (1967).
tions, who in turn sold the assets of X to Y, liquidated X and took a reasonable profit for his services. The Commissioner contended that there was no bona fide sale involved and that the transaction was a reorganization rather than a sale and liquidation. He took the position that to the extent of the earnings and profits of both X and Y the gain recognized by the shareholders must be reported as a dividend and taxed as ordinary income. The Tax Court ruled that the transfer of assets by X to Y constituted a reorganization under section 368(a)(1)(D), but that the gain was taxable as a dividend only to the extent of X's earnings and profits.

On the cross appeal of both parties, the Fifth Circuit held there was both an F and a D reorganization and that the gain was taxable as a dividend to the extent of earnings and profits of both corporations X and Y. As to the F question the court noted:

> Whatever the outer limits of section 368(a)(1)(F), it can clearly be applied where the corporate enterprise continues uninterrupted, except for a distribution of some liquid assets or cash. Under such circumstances, there is a change of corporate vehicles but not a change in substance.

Then, in the crucial part of the opinion, the court stated:

> If [Y] had no assets of its own prior to the transfer of [X's] operating assets to it, could we say that [Y] was any more than the alter ego of [X]? The answer is no. The fact that [Y] already had other assets that were vertically integrated with [X's] assets does not change the fact that [Y] was [X's] alter ego.

*Davant* was hailed as a major government victory that "materially expand[ed] the scope of the F reorganization definition as a potent weapon for combating the reincorporation device." But while the decision may have been a Government victory in the reincorporation field, it was an unnecessary and potentially costly one. It was unnecessary because the finding of a D reorganization alone would have been sufficient to handle the liquidation/reincorporation problem pre-

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67 366 F.2d at 878. In this case, the "unconnected" person was the son of the Davant's attorney; he neither participated in the negotiations nor put up any money for the financing of the transaction.


69 366 F.2d at 884.

70 Id.

The mere fact that the types of corporate reorganizations may overlap in certain cases does not mean that a decision must be grounded on all the possible ones within a given transaction. The decision was potentially costly because its expansion of the F definition to situations involving two (or more) ongoing concerns not only disregarded the original reasons for the existence of a section such as 368(a)(1)(F), but also the independent significance given section 368(a)(1)(F) by section 381(b)(3). There seems to be no justification for finding an F reorganization for the purpose of preventing a taxpayer from carrying out a liquidation/reincorporation scheme, but not for the purpose of permitting a taxpayer a net operating loss carryback.

While the net operating loss carryback ramifications of section 368(a)(1)(F) may have been overlooked by both the court and the Commissioner in Davant, they were not overlooked by the taxpayer in Estate of Stauffer v. Commissioner. In Stauffer, the sole owner of three separate corporations established a fourth corporation as a shell, and then merged into it the three previously existing ones. After the merger the stated capital, paid-in surplus and retained earnings of the fourth corporation were equal to the sum of the prior three; the liabilities and obligations of the fourth were the same and the business was operated as it had been before, from the same locations. Stauffer, relying on Revenue Ruling 57-276, filed a single tax return in which the merger was characterized as an F reorganization. At the time, the Commissioner contested neither the characterization of the merger as an F reorganization nor the filing of the single tax return.

72 The Government recognized the validity of this argument as well, for it argued in its opposition to Davant's petition for a writ of certiorari that the F question had not been properly presented to the Fifth Circuit, that it was unnecessary to the decision, and that Davant was not the proper case to test the meaning of an F reorganization. Memorandum in Opposition to Petition for Certiorari at 10-11, Davant v. Commissioner, 386 U.S. 1022 (1967).


74 The court treated the F issue in only two paragraphs, and there is no indication that any legislative history was either presented to, or examined by, the court. See 366 F.2d at 883-84.

75 See note 29 supra.

76 403 F.2d 611 (9th Cir. 1968). See also Associated Mach. v. Commissioner, 403 F.2d 622 (9th Cir. 1968). The Internal Revenue Service has stated that it will not follow the Stauffer and Associated Machine cases, nor that portion of Davant dealing with § 368(a)(1)(F). Rev. Rul. 69-185, 1969 Int. Rev. Bull. No. 16, at 11.

77 The corporations were incorporated in New York, Illinois, and California and were engaged in the same line of business: mechanical weight reduction. It is not clear whether the assets of the corporations were located in the states of incorporation. Although located in the same office, the books for each corporation were kept separately, and presumably each corporation had its own employees and clientele.

78 Although a physical transfer of the assets was apparently contemplated, it had not occurred by the time of the dissolution of the surviving corporation.

A subsequent business decline, however, produced net operating losses to the fourth, or surviving, corporation. The Commissioner first granted, and then denied loss carrybacks to the pre-merger period. The Tax Court upheld the Commissioner on the ground that there was no reorganization within the definition of section 368(a)(1)(F).80

On appeal, the taxpayer took the position, based largely on Davant, that the only indicium of an F reorganization was a continuity of ownership and business enterprise. The Commissioner, on the other hand, virtually disowned the Davant decision. He argued that it was an exception to the rule that "an 'F' reorganization is restricted in number of participating corporations to one;"81 that the finding of an F reorganization was unnecessary in Davant since the decision rested on the finding of D reorganization;82 that even if an F reorganization had occurred in Davant, it had not occurred in Stauffer because the contexts were entirely different;83 and that "unfortunately, the legislative evidence presented to the Tax Court and this court was not presented to [the court in Davant]."84 However, this recital of the Commissioner's litigative sins did not persuade the court to disregard or distinguish Davant. To the contrary, in holding that the Stauffer transaction constituted an F reorganization, the court relied on Davant:

The principle we derive from Davant is that a shift in operating assets from the transferor corporation to its alter ego wherein the identity of the proprietary interest remains intact and the business enterprise of the transferor corporation continues unimpaired results in an "F" reorganization.85

Having laid down its "identity of proprietary interest" and "unimpaired continuity of business enterprise" tests, the court proceeded to distinguish the case at bar from a situation in which operational assets are physically transferred:

Had the operational facilities of the three pre-merger corporations been dismantled and transported to New Mexico we would have a different situation. Then, the financial status of Stauffer New Mexico would have reflected a single operation. In such case, there would be no means by which a loss could be pro-rated among the pre-merger identities, and the combined losses of what was in fact the consolidation

81 403 F.2d at 616.
82 Id. at 618.
83 Id. at 619.
84 Id.
85 Id.
of three companies could not have been set off against the pre-merger income of only one of those companies, for this would have resulted in a windfall to the transferee.\textsuperscript{86}

But assuming, as the court did, an "identity of proprietary interest," and a uniform corporate tax rate, the court's language concerning the difficulty of prorating the loss and the possible windfalls to the transferee is without significance. In effect, all that the court has done is to present an example of impairment of the continuity of a business enterprise, and hence no F reorganization even under the expanded tests of \textit{Stauffer}.\textsuperscript{87}

In the final analysis, the issue presented in both \textit{Stauffer} and \textit{Davant} is: what constitutes a single economic entity. \textit{Davant} and \textit{Stauffer} expanded that concept by including brother-sister corporations within the definition,\textsuperscript{88} and by placing emphasis on whether there was "identity of proprietary interest" and "unimpaired continuity of business enterprise." This approach, by expanding the previously understood definition of an F reorganization, opens the door to a great number of loss carrybacks not intended by Congress.\textsuperscript{89} F reorganizations were excluded from the section 381(b)(3) prohibition of loss carrybacks only because it was felt that the long-standing policy of allowing corporations to "average" their gains and losses over a period greater than one year should not be defeated by a minor change in the corporation. The \textit{Davant} and \textit{Stauffer} analysis, however, would allow the result Congress intended to eliminate in 1954—offsetting taxable gains of a profitable corporation against the losses of another corporation through a merger with a loss corporation.\textsuperscript{90} Still, \textit{Davant} and \textit{Stauffer}, both limited to the merger of commonly-owned corporations engaged in the same or integrated activity, do not reach wholly unacceptable results. Arguably, a business divided into several subsidiary corporations is only a step removed from a corporation with several divisions, for which the "averaging" provisions of section 172 are available.\textsuperscript{91}

\textsuperscript{86}Id. at 622.

\textsuperscript{87}Furthermore, once a continuity of business enterprise and an identity of proprietary interest are established, whether or not the loss can be apportioned is irrelevant. The physical transfer of assets would be the determining factor only where the business was of such a nature that a transfer of assets would disrupt the business and cause a turnover in employees and customers. In the \textit{Stauffer} case a transfer of assets would cause disruption, but this is not necessarily the universal situation.

\textsuperscript{88}Compare \textit{Stauffer} and \textit{Davant} with \textit{Moldit}, Inc. v. Jarecki, 53-2 U.S. Tax Cases 48,486 (N.D. Ill. 1953).

\textsuperscript{89}Whether the rationale of \textit{Libson Shops}, Inc. v. Koehler, 353 U.S. 382 (1957), a case decided under the 1939 Code, will operate as a limiting factor is an open question.

\textsuperscript{90}See text accompanying notes 11-19 supra.

\textsuperscript{91}That a businessman has chosen for reasons related to state law to divide his enterprise among several corporations may not be determinative of federal tax consequences. It should be remembered, however, that by forming several corporations the businessman has also made a conscious decision related to tax consequences—that of taking multiple surtax exemptions. \textit{See Int. Rev. Code of 1954, §§11(d), 1561-63.}
But at the same time that Stauffer and Davant expanded the F provision to include brother-sister corporations, Reef Corp. v. Commissioner 92 expanded the concept of what constituted a sufficient continuity of proprietary interest for an F reorganization. In Reef, a group of stockholders (the Butler group) owning fifty-two per cent of a corporation (Reef Fields) wished to buy out the group owning the remaining forty-eight per cent. 93 The Butler group formed a new corporation (Reef) in a different state, and received all of Reef's common stock in return for a portion of their Reef Fields' stock. Reef Fields then, in return for Reef notes, sold all its stock to a straw party, who, in turn, sold the Reef Fields assets to Reef. Payments on the notes were made to the old shareholders as the money was received from Reef. Disregarding the straw man, as both the Tax Court and the Court of Appeals did, the transaction amounted to the transfer of a corporation's operating assets to a new corporation, wholly owned by fifty-two per cent of the shareholders of the original corporation, with the ousted group being paid in cash and notes.

Reef Fields then filed a tax return for the period up to the date of its dissolution, claiming a deduction for reincorporation expenses, and reporting a non-taxable gain 94 on the sale of its property to Reef. At the same time, Reef filed a return for the period from its incorporation to the end of its fiscal year, 95 deducting the interest payments to the straw man, and computing depreciation on a new cost basis, rather than the basis carried over from Reef Fields. The Commissioner disallowed the return of Reef Fields on the ground that the transaction constituted an F reorganization and, therefore, the return should have been filed for the whole year. 96 The Tax Court rejected the contention that there was an F reorganization, but disallowed the interest payments as de-

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92 368 F.2d 125 (5th Cir. 1966), cert. denied, 386 U.S. 1018 (1967).

93 It appears from the record that the minority group in Reef was perfectly willing to be bought out. However, the willingness or unwillingness of the minority group to leave the corporation is without significance; what matters is whether the majority has sufficient control to accomplish its aims. See Casco Products Corp., 49 T.C. 32 (1967), appeal dismissed per nolle pros., 2d Cir. June 11, 1968.


95 The fiscal years of Reef and Reef Fields coincided. Due to the fact that Reef was incorporated before Reef Fields was dissolved, there was an overlap in the accounting periods. Under neither the Commissioner's theory, nor that used in filing the original returns, should there have been a period which was not reported. However, the Commissioner sent a notice of deficiency to Reef for the whole year on the theory that it was the successor in name to Reef Fields; and as a protective measure sent a deficiency notice to Reef for the period from its incorporation until the end of the fiscal year. The Commissioner neglected to send a notice to Reef Fields for the period ending with its dissolution. As a result, there was a gap in the reporting which created a difference of approximately $40,000 in the total tax due.

96 There is no indication why, if the Commissioner was arguing from this position and alternatively that there was a § 368(a)(1)(D) reorganization, a deficiency notice was not sent to Reef Field for the short period.
ductions, and held, on the grounds of a D reorganization, that the depreciation basis was the cost of the assets to Reef Fields.\textsuperscript{97}

Both parties appealed, and the Fifth Circuit held that the transaction constituted both an F and a D reorganization, that the interest deduction and step-up in basis were not allowable, and that the taxable period was the entire fiscal year for Reef Fields/Reef. In short, it was a complete victory for the Commissioner. The court viewed the transaction as two separate and unrelated transactions: the redemption of the stock and a reorganization. It then examined whether accounting changes, under the provisions of section 381 (b), should be governed by the F or D reorganization rules. It held the F rules applicable.

The (F) rules are stricter than the (D) rules because a mere change of corporate charter or state of incorporation is not the proper occasion for wholesale accounting method changes that would not have been permitted if no reorganization had taken place.

Only those reorganizations which reflect a substantial change in the corporate operation should be viewed as solely (D) reorganizations qualifying for the more liberal rules [of § 381 (b)]. Where there is no substantial change in the corporate operation, (F) should be applied since it invokes the stricter rules.\textsuperscript{98}

If this quoted discourse is indeed the basis of the court's finding of an F reorganization in Reef, then its rationale is murky at best. Aside from the fact that the court was stretching matters in referring to the Reef and Reef Fields tax returns as involving "wholesale accounting method changes," the court's analysis seems to proceed either upon a disregard of section 381(b)(3) or a misreading of section 381(b). The court's statement that "[S]ection 381(b) excludes type (F) reorganizations from the liberal treatment accorded type (D) reorganizations"\textsuperscript{99} is unsupported either in the text or in the legislative history cited by the court.\textsuperscript{100} At least in regard to net operating loss carrybacks, section 381(b) is more liberal to F reorganizations than to any other. Further, to read sections 381(b)(1) and (2) as being designed for the purpose of permitting changes in accounting methods is to give them far too broad a scope. They are in the Code only to determine the taxable year in corporate reorganizations; the question of accounting method changes is governed by other sections.\textsuperscript{101}

\textsuperscript{98}368 F.2d at 136 (emphasis in original).
\textsuperscript{99}Id. at 136 n.12.
\textsuperscript{100}See id. at 135-36.
\textsuperscript{101}See, e.g., INT. REV. CODE OF 1954, §§ 381(c), 441-72.
Proceeding further on its redemption/reorganization dichotomy, the court noted:

The Tax Court's position [that there was no F reorganization] might have more force if the change in proprietary interests were to new persons and less than 50% of the former stockholders' interest in the old corporation remained in the new corporation. Then the change begins to look like a sale of the assets to a new and legally separate entity followed by a bona fide liquidation.\(^{102}\)

There are two problems with this reasoning. First, while it is true that there can be no F reorganization if new shareholders are introduced, the converse is not necessarily true. In other words, the absence of new shareholders (as in Reef) should not guarantee, without more, that a reorganization will be classified as an F reorganization. Secondly, there is no indication why the figure of fifty per cent is more relevant than any other figure or relevant at all in deciding if the transaction is a reorganization or a sale and liquidation.

Further, while giving full weight to the legislative directive that tax consequences should turn on economic realities rather than legal forms, the court's treatment of the Reef transaction as if it involved "two separate and unrelated transactions" would itself seem to turn more on form than substance. The economic significance in Reef is that there was a drastic reduction in capital, the stockholder list was cut virtually in half, and a group controlling only fifty-two per cent of the stock of the old corporation took complete control of the new corporation. Can such a change really be said to be without economic substance, that is, a mere change in identity or form?\(^{103}\) The court in its analysis of the transaction seemed to focus almost exclusively on the relocation aspects of an F reorganization, attributing the other aspects to the redemption; but for there to be an F reorganization there must be no more than "a mere change in identity, form, or place of organization, however effected." Surely, the "however effected" provision is broad enough to include redemptions.\(^{104}\)

**Conclusion**

The Reef decision even by itself distorts the intent of Congress as manifested in the Internal Revenue Code of 1954. Combined with the Stauffer and Davant expansions, it opens the way for great abuses.

\(^{102}\) 368 F.2d at 137.

\(^{103}\) See 3 MERTENS, supra note 34, at 466.

\(^{104}\) When the redemption and reorganization provisions overlap, the determination that a redemption occurred should not preclude an examination of the F question, nor should it necessarily control the F question. The redemption and reorganization questions are not necessarily separable in all situations. See Bittker & Eustice, supra note 8, at 500-01.
Carried to its logical conclusion, the Reef-Davant-Stauffer approach finds an F reorganization in any corporate restructuring when more than fifty per cent of the stockholders of the old corporation remain after the reorganization,\(^{105}\) no new shareholders come in, and there is continuity of business enterprise. While such an expansion may provide a significant weapon for combating liquidation/reincorporation schemes, it is questionable whether it is worth the price, or proper, in terms of net operating loss carrybacks. In arguing for an expansion of the F reorganization as he did in Davant and Reef, the Commissioner seemingly overlooked the fact that section 381(b)(3) made an expanded section 368(a)(1)(F) a two-edged sword that could be wielded by the taxpayer as well as the tax collector.

\(^{105}\) This, of course, assumes that in the case of a multi-corporation reorganization the over 50 per cent interest in each of the corporations is composed of the same stockholders. Cf. David T. Grubbs, 39 T.C. 42 (1962); Joseph C. Gallagher, 39 T.C. 144 (1962) with regard to § 368(a)(1)(D) reorganizations.