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EXPANSION OF THE (F) REORGANIZATION

by

Edward C. Osterberg, Jr.*

PART III of subchapter C of the Internal Revenue Code of 1954 sets forth the rules governing the tax treatment of a variety of corporate readjustments referred to generically as "reorganizations."¹ If a corporate readjustment can be fitted into one of the tax definitions of a reorganization, the general scheme of Part III is to defer recognition of gain or loss on the transaction, on the theory that the transaction is not sufficiently "closed" to require the imposition of an immediate tax. This general scheme is carried out by providing for nonrecognition of gain or loss² and carryover of basis³ where a shareholder exchanges stock of a corporation that is a party to the reorganization.⁴

I. DEFINITION AND EARLY APPLICATION

Subsection (F) of section 368(a)(1) defines a reorganization as "a mere change in identity, form, or place of organization, however effected." The genesis of this definition can be found in section 202(c)(2) of the Revenue Act of 1921,⁵ which defined a reorganization to include "a mere change in identity, form, or place of organization of a corporation (however effected)." In 1924, the words "of a corporation" were deleted,⁶ but the legislative history indicates that the deletion was not intended to have any operative effect.⁷ Although in 1954 the House of Representatives proposed repeal of what is now the (F) reorganization since it was so little used by taxpayers,⁸ it was retained in the 1954 Code,⁹ and its previous lack of judicial interpretation has been more than compensated for in recent decisions.

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¹ INT. REV. CODE of 1954, § 368(a).

² *Id.* § 354. Often business exigencies dictate that the exchange involve the receipt of cash or other property in addition to stock or securities. If the reorganization exchange would be tax-free except for the fact that the exchanging shareholder receives not only stock but also money or other property (so-called "boot"), or receives securities the principal amount of which exceeds the principal amount of the securities surrendered, the gain, if any (but not the loss), is recognized. The recognition is limited to "an amount not in excess of the money and the fair market value of the other property" received in the exchange. *Id.* § 356. (The corresponding provision for boot received by a corporation in the exchange is *id.* § 361(b).) Thus, the boot received in a reorganization exchange is taxed only to the extent that gain is realized; this gain may be taxable as ordinary income to the extent of the shareholder's pro rata share of the distributing corporation's earnings and profits. See *Commissioner v. Estate of Bedford*, 325 U.S. 283 (1945). That part of the gain recognized may be taxed as ordinary income, rather than as capital gain, if the exchange "has the effect of the distribution of a dividend." INT. REV. CODE of 1954, § 356(a)(2).

³ INT. REV. CODE of 1954, § 358.

⁴ Similar provisions accord nonrecognition of gain or loss and carryover of basis to a corporation which is a party to the reorganization. *Id.* §§ 358, 361. In the case of the corporation exchanging its stock for property in the reorganization, the corporation's basis in the property is the same as the transferor's basis, *id.* § 362(b), and the corporation would not recognize gain or loss by virtue of *id.* § 1032, which provides for nonrecognition of gain or loss on the receipt by the corporation of money or other property in exchange for its stock.

⁵ Revenue Act of 1921, ch. 136, § 202(c)(2), 42 Stat. 230.

⁶ Revenue Act of 1924, ch. 234, § 203(h)(1)(D), 43 Stat. 257.

⁷ H.R. REP. NO. 179, 68th Cong., 1st Sess. 13 (1924).

⁸ See H.R. REP. NO. 1337, 83d Cong., 2d Sess. 115 (1954).

⁹ See S. REP. NO. 1622, 83d Cong., 2d Sess. 273 (1954).

The Supreme Court first considered the (F) reorganization in *Helvering v. Southwest Consolidated Corp.*¹⁰ The case involved a bankruptcy reorganization in which the assets of the old corporation were transferred to a new corporation and, under the creditors' plan of reorganization, the creditors of the old corporation emerged as controlling shareholders of the new corporation. The Supreme Court held that the transaction could not be regarded as a mere change of identity, form, or place of organization because of the substantial shift of the proprietary interest in the corporation due to the creditors of the old corporation becoming controlling shareholders of the new corporation. The Court stated: "[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' within the meaning of clause [F]."¹¹

Following the Supreme Court's enunciation of the lack of a shift in proprietary interest as the touchstone of the (F) reorganization, early applications of the (F) definition were limited to a narrow approach involving unambiguous transactions. Thus, a change in the state of incorporation, such as by merger into a wholly owned subsidiary newly organized in another state,¹² or the conversion of a federal savings and loan association into a state building and loan association,¹³ was held to constitute an (F) reorganization. However, in Revenue Ruling 66-284¹⁴ the Internal Revenue Service created a *de minimis* exception to the lack of a shift in proprietary interest where, in order to change the state of incorporation, the old corporation organized a subsidiary in another state and then merged into the new corporation. This plan was allowed even though approximately one percent of the shareholders of the old corporation dissented to the plan of reincorporation and received cash for their shares in the old corporation.

II. LIQUIDATION-REINCORPORATION

The most noteworthy developments in the (F) reorganization area have occurred where taxpayers have structured the transaction to gain some tax advantage by falling within one of the tax-free reorganization patterns, or conversely, where they have structured the underlying transactions to obtain other tax advantages by avoiding classification as a reorganization. The structures these transactions have taken have in turn produced "remarkable ingenuity"¹⁵ on the part of the courts in finding reorganizations even where the transactions do not literally conform to the reorganization definition, or in refusing to hold that the transactions constitute a reorganization even though the facts literally fall within the definition of a reorganization.

¹⁰ 315 U.S. 194 (1942).

¹¹ *Id.* at 202-03. It is interesting that the Supreme Court refused to treat the creditors of the old corporation as owners of the equity interest even though, by the time of the bankruptcy proceeding, the creditors were empowered to supplant the stockholders. *Cf.* *Helvering v. Alabama Asphaltic Limestone Co.*, 315 U.S. 179 (1942).

¹² *Newmarket Mfg. Co. v. United States*, 233 F.2d 493 (1st Cir. 1956), *cert. denied*, 353 U.S. 983 (1957); Rev. Rul. 64-250, 1964-2 CUM. BULL. 333.

¹³ Rev. Rul. 54-193, 1954-1 CUM. BULL. 106.

¹⁴ 1966-2 CUM. BULL. 115.

¹⁵ See Hjorth, *Liquidation and Reincorporations—Before and After Davant*, 42 U. WASH. L. REV. 737, 739 (1967).

The area in which the (F) reorganization has recently received considerable attention involves the so-called liquidation-reincorporation problem. Basically, a liquidation-reincorporation involves the liquidation of an existing corporation followed by a transfer of part or all of its operating assets to another corporation, often newly organized, which is generally owned by the same shareholders as the old corporation. If such a transaction is accepted for what it purports to be, the shareholders would generally recognize long-term gain on the liquidation.¹⁶ The basis of the property received by the shareholders would be its fair market value on the date of the liquidation-distribution,¹⁷ and the transfer of assets to the new corporation would be tax-free.¹⁸ The new corporation's basis in the property would be its fair market value on the date of the liquidation-distribution of the old corporation,¹⁹ thus giving the new corporation an increased basis in the operating assets for larger depreciation deductions. The old corporation would ordinarily recognize no income on the liquidation-distribution²⁰ except for the recapture of depreciation.²¹ Finally, the new corporation would commence operations with a zero balance in its earnings and profits account.²²

Classification as a (D) Reorganization. Until recently, the Commissioner of Internal Revenue was successful in his attempts to categorize the liquidation-reincorporation transaction as a (D) reorganization,²³ thus opening the way to taxation of the property taken out of corporate dissolution as a distribution of "boot," as well as preventing a step-up in basis in the operating assets. Because of the requirements necessary to effect a (D) reorganization,²⁴ the net effect is to define a (D) reorganization as either: (1) The transfer to a controlled corporation of substantially all the assets of the transferor corporation, followed by the distribution of all the transferor's assets (including the stock, securities and other property received by the transferor in connection with the transfer) to the transferor's shareholders;²⁵ or (2) The transfer to each controlled

¹⁶ INT. REV. CODE of 1954, § 331.

¹⁷ *Id.* § 334(a).

¹⁸ *Id.* § 351.

¹⁹ *Id.* § 362(a).

²⁰ *Id.* § 336.

²¹ *Id.* §§ 1245, 1250.

²² A good discussion of the multifarious forms the basic liquidation-reincorporation can take can be found in Hjorth, *supra* note 15, at 740-44. See also Lane, *The Reincorporation Game: Have the Ground Rules Really Changed?*, 77 HARV. L. REV. 1218 (1964); MacLean, *Problems of Reincorporation and Related Proposals of the Subchapter C Advisory*, 13 TAX L. REV. 407 (1958); Rice, *When Is a Liquidation Not a Liquidation for Federal Income Tax Purposes?*, 8 STAN. L. REV. 208, 219-22 (1956).

²³ INT. REV. CODE of 1954, § 368(a)(1)(D).

²⁴ To fall within the definition of a (D) reorganization, a transaction must meet two requirements: (a) there must be a transfer by one corporation of some or all of its assets to another corporation, eighty per cent of the stock of which, immediately after the transfer, is owned by the transferor corporation, one or more of its shareholders, or any combination thereof; and (b) as part of the plan of reorganization, stock or securities of the transferee corporation are distributed in a transaction which qualifies under §§ 354, 355 or 356. *Id.*

²⁵ *Id.* § 354(b). While not an integral part of this definition of a (D) reorganization, the requirements that the transferee corporation acquire substantially all the assets of the transferor and that the transferor distribute all its properties as a practical matter will result in the complete liquidation of the transferor corporation. Cf. David T. Grubbs, 39 T.C. 42 (1962).

transferee corporation of a separate active business conducted for at least five years prior to the distribution by the transferor corporation, and after the transfer of the separate business, the transferor corporation must either (a) have no assets other than stock or securities of the transferee corporation, or (b) carry on a separate business conducted for at least five years.²⁶

The (D) reorganization as defined in (2) above has had little utility in attacking a liquidation-reincorporation. The transferor corporation, by retaining only the liquid assets as an inherent part of the reincorporation scheme, would have assets other than the stock or securities of the transferee corporation and generally would not be engaged in a separate business after the transfer. Furthermore, by its terms, the devisive reorganization is not applicable where the transaction is used "principally as a device for the distribution of earnings and profits."²⁷ Therefore, until recently the Commissioner's success in attacking the liquidation-reincorporation transaction as a reorganization has come when the transaction has been categorized as a (D) reorganization in which a transfer of substantially all the assets of the transferor corporation to a controlled corporation is followed by a complete liquidation of the transferor corporation.

The reorganization provisions were designed primarily to prevent taxation in certain corporate adjustments where the corporate continuity was left undisturbed in substance. Use of these provisions in attacking liquidation-reincorporations to prevent tax avoidance has required judicial stretching of the interpretation of the reorganization sections, particularly the (D) definition.²⁸ Yet despite the judicial stretching of the (D) reorganization definition to fit a typical liquidation-reincorporation transaction, the possibility remained that taxpayers could be successful in having their transactions treated as true liquidations, with the attendant tax benefits outlined above. When the facts demonstrate a sufficiently long hiatus in the business operations, the courts have held that there is no reincorporation.²⁹

²⁶ INT. REV. CODE of 1954, § 355. This is the spin-off, split-up, or split-off type of divisive reorganization.

²⁷ *Id.* § 355 (a) (1) (B).

²⁸ For example, the judicial stretching has included the following deviations from the normal definition of the (D) reorganization: (1) The requirement that a transfer of substantially all the working assets of the old corporation be made has been interpreted as being met if all such assets remaining in a corporation after a preliminary distribution of assets are transferred. *Ralph C. Wilson, Jr.*, 46 T.C. 334 (1966). Support for this decision is found in *Helvering v. Elkhorn Coal Co.*, 95 F.2d 732 (4th Cir. 1937), *cert. denied*, 305 U.S. 605 (1938), and *Commissioner v. Mellon*, 184 F.2d 157 (3d Cir. 1950), *aff'g* 12 T.C. 90 (1949). (2) Similarly, though an exchange of stock of the transferor corporation for that of the transferee corporation must occur, this requirement has been disregarded. For instance, if the shareholders of the transferor corporation create the transferee corporation by paying for its stock, and the cash is used by the transferee corporation to purchase the operating assets of the transferor corporation, and the transferor corporation then distributes its retained liquid assets to its shareholders in complete liquidation, the original cash contribution has been disregarded and the steps taken have been viewed as the surrender of shares of the transferor corporation and the receipt of shares of the transferee corporation. See *Liddon v. Commissioner*, 230 F.2d 304 (6th Cir. 1956), *cert. denied*, 352 U.S. 824 (1957); *Keller v. Commissioner*, 147 F.2d 376 (9th Cir.), *cert. denied*, 325 U.S. 868 (1945); *David T. Grubbs*, 39 T.C. 42 (1962). The requirement of an exchange of stock is also disregarded where the transfer of assets is between two pre-existing corporations, both owned by the same shareholders in the same proportions. *Commissioner v. Morgan*, 288 F.2d 676 (3d Cir.), *cert. denied*, 368 U.S. 836 (1961).

²⁹ See *Pridemark, Inc. v. Commissioner*, 345 F.2d 35 (4th Cir. 1965), *rev'g in part*

A substantial shift in proprietary interest has probably been the most significant fact in avoiding reorganization classification. In *Joseph C. Gallagher*³⁰ the court refused to require treatment as a (D) reorganization where seventy-three percent of the stock of the transferee corporation was owned by shareholders of the transferor corporation. In *Berghash v. Commissioner*³¹ the court also found a complete liquidation, not a reincorporation, where fifty percent of the stock of the transferee corporation was owned by an employee who was not a shareholder of the transferor corporation. A proprietary shift has also been sufficient to avoid (D) reorganization status, even though the transferee corporation was itself owned by a third corporation controlled by the same shareholders as the transferor corporation. The court refused to apply the attribution rules to treat the individual shareholders of the third corporation as shareholders of the transferee corporation.³²

Classification as an (F) Reorganization. Because of the somewhat limited utility of the (D) definition in controlling tax avoidance in liquidation-reincorporations, the courts and the Commissioner, early in the 1960's, began to attack the problem by use of the (F) reorganization. Traditionally, the (F) reorganization had been seen as applicable only to the most formal and insubstantial corporate readjustments. Its utility in the liquidation-reincorporation area is discussed below.

1. *Functionally Unrelated Shifts in Ownership.* In using the (F) reorganization to attack the liquidation-reincorporation transactions, the Commissioner has attempted, as with the (D) reorganization, to stretch the (F) definition. Since an (F) reorganization is defined as "a mere change in identity, form, or place of organization,"³³ a shift in ownership interests of the corporation would appear to take a transaction out of the definition. The Commissioner has attempted to keep such transactions within the (F) definition by finding shifts in ownership "functionally unrelated" to the reorganization. In the following discussion of this problem it will be helpful to separate the case law and the position of the Internal Revenue Service as expressed in its rulings.

(a) *The Courts.* The first attempt to stretch the (F) reorganization to fit a liquidation-reincorporation transaction occurred in *Pridemark, Inc.*³⁴ The Tax Court held that where the transferor corporation was liquidated, but a year later its business was resumed by a successor corporation which had acquired its assets from the shareholders common to both corporations, an (F) reorganization had occurred.³⁵ However, *Pridemark* was reversed on appeal.³⁶ In finding

42 T.C. 510 (1964); *Sharp v. United States*, 263 F. Supp. 884 (S.D. Tex. 1966).

³⁰ 39 T.C. 144 (1962).

³¹ 361 F.2d 257 (2d Cir. 1966).

³² *Breech v. United States*, 439 F.2d 409 (9th Cir. 1971). The Government's attempt to find the requisite control by reading the "any combination thereof" language in INT. REV. CODE of 1954, § 368(a)(1)(D) as encompassing the individual shareholders of the third corporation which was in control of the transferee corporation was also rejected.

³³ INT. REV. CODE of 1954, § 368(a)(1)(F).

³⁴ 42 T.C. 510 (1964).

³⁵ It is interesting that the Commissioner did not attack these transactions as a (D) reorganization. Since the transferor's shareholders as a group emerged in control of the transferee corporation, the transactions would appear to fit the (D) definition.

³⁶ 345 F.2d 35 (4th Cir. 1965).

that a true liquidation had occurred, the Fourth Circuit emphasized the year-long hiatus in business activity. The court viewed the (F) definition as limited to cases where the corporate enterprise continues uninterrupted, except perhaps for a distribution of some of its liquid assets.³⁷

Soon after *Pridemark* the Commissioner was successful (on appeal) in *Reef Corporation*³⁸ in applying the (F) definition to prevent the transferee corporation from taking a stepped-up basis in the transferred assets. The transferor corporation was a Texas corporation owned by two groups of shareholders. One group (the active group) wanted to buy out the second group, which was not taking an active part in the management of the business. Accordingly, the active group formed a new corporation under Delaware law, and the transferor corporation contracted to sell its assets to the new corporation for the new corporation's notes. To carry out the transactions, all of the stock of the transferor corporation was sold to a third party, who in turn was to execute the sale of the transferor's assets to the new corporation. The transferor corporation liquidated, but the business which had been operated by it continued to be operated without interruption by the new corporation. At issue was whether this was a sale and not a reorganization such that the new corporation could claim a stepped-up basis in the assets of the transferor corporation. The Tax Court disregarded the role of the third party as a mere straw-man conduit, but held that an (F) reorganization could not have taken place because of the change that occurred in the proprietary interests, in other words, the elimination of the inactive shareholders was more than a mere change in identity, form, or place of organization. The court felt that the shift in proprietary interest was an inherent part of the over-all plan to eliminate the passive group of shareholders from an equity participation in the business. However, the Tax Court did find that these transactions amounted to a (D) reorganization.

On appeal,³⁹ the Fifth Circuit affirmed the Tax Court's holding that a (D) reorganization had occurred. The Commissioner contended on cross appeal that the transactions also constituted an (F) reorganization.⁴⁰ The Tax Court had followed the rationale of *Helvering v. Southwest Consolidated Corp.*⁴¹ in finding that the (F) type is inapplicable when there is a substantial shift in the shareholders' proprietary interest in the corporation. The Fifth Circuit, however, was able to find an (F) reorganization by separating the transactions into two

³⁷ The court cited Rev. Rul. 57-276, 1957-1 CUM. BULL. 126, where merger into a new corporation organized under a different state's laws was held to constitute an (F) reorganization. 345 F.2d at 42 n.8. The court noted a proprietary shift, pointing to the fact that the majority shareholders of eighty percent of the transferor corporation's common stock received but sixty-one percent of the stock in the transferee corporation plus stock options which, if exercised, would have reduced their holdings to forty-four percent. However, this shift in ownership did not form a basis for the court's holding.

³⁸ 24 CCH Tax Ct. Mem. 379 (1965).

³⁹ *Reef Corp. v. Commissioner*, 368 F.2d 125 (5th Cir. 1966), *cert. denied*, 368 U.S. 1018 (1967).

⁴⁰ Apparently this contention was made to increase the amount of tax owing, since in an (F) reorganization the transferor corporation cannot end its taxable year as of the date of the reorganization. INT. REV. CODE OF 1954, § 381(b)(1). Where a transaction qualifies as both an (F) and a (D) reorganization, the more stringent rules relating to accounting methods for (F) reorganizations are to be applied. *Reef Corp. v. Commissioner*, 368 F.2d 125, 136 (5th Cir. 1966), *cert. denied*, 368 U.S. 1018 (1967).

⁴¹ 315 U.S. 194, 202-03 (1942).

distinct and unrelated events: first, the holders of forty-eight percent of the stock of the transferor corporation (the passive group) had their stockholdings completely redeemed; secondly, the new corporation was formed and the assets of the transferor corporation were transferred to the new corporation, which was then owned entirely by the active shareholders of the transferor. The court felt that confusion flowed from the simultaneous reorganization and stock redemption, but held that these two events were functionally unrelated since the transferor corporation could have completely redeemed the stock of the passive group without changing its state of incorporation, and since redemption is not a characteristic of a reorganization.

Reef stands for the proposition that, while as a general rule if a substantial change in ownership takes place, the transaction cannot be an (F) reorganization, a substantial shift in proprietary interests which is contemporaneous with, but functionally unrelated to, the transaction can be ignored. The result appears to be that all (D) reorganizations are also (F) reorganizations, where a single new corporation emerges from a single old corporation, no new shareholders are injected into the new corporation, and a majority of the shareholders continue their equity participation in the new corporation.⁴²

The question becomes: Under what circumstances can a substantial proprietary shift be ignored as functionally unrelated in finding an (F) reorganization? If the substantial proprietary shift is considered an integral part of the reorganization, it should be sufficient to avoid classification as an (F) as well as a (D) reorganization.⁴³ It is interesting to note that in the early case of *Cushman Motor Works v. Commissioner*⁴⁴ a change in stock ownership resulting from the redemption of less than twenty percent of the stock of the old corporation was held to be so substantial as to disqualify the transaction from tax-free treatment as an (F) reorganization. This case would appear to be of little, if any, vitality in view of the *Reef* rationale that the retirement of some of the old shareholders can be ignored as a separate and functionally unrelated redemption. However, even the *Reef* court thought that if less than fifty percent of the shareholders continued their equity participation in the new corporation, the transaction would begin to look more like a sale of assets to the new corporation than a reorganization.⁴⁵

Whether the injection of shareholders in the new corporation, who were not

⁴² A similar approach was adopted in *Babcock v. Phillips*, 372 F.2d 240, 244 (10th Cir. 1967), *cert. denied*, 387 U.S. 918 (1968), where the court spoke of the new corporation as the "reincarnation" of the old corporation. But the court, in fact, went on to find a (D) reorganization, since at issue was the taxation of boot to the shareholders, and a finding of an (F) reorganization was unnecessary.

⁴³ *Helvering v. Southwest Consol. Corp.*, 315 U.S. 194, 203 (1942); *Commissioner v. Berghash*, 361 F.2d 257 (2d Cir. 1966); *United States v. American Institute of Marketing Sys., Inc.*, 345 F. Supp. 610 (E.D. Mo. 1972); *Estate of Henry P. Lammerts*, 54 T.C. 420 (1970), *remanded on another issue*, 456 F.2d 681 (2d Cir. 1972); *Joseph C. Gallagher*, 39 T.C. 144 (1962). It is arguable, however, that it is conceptually easier to view a shift in proprietary interest among shareholders as functionally unrelated to an (F) reorganization than to a (D) reorganization, since the (D) reorganization by definition clearly anticipates that some of the shareholders of the old corporation may drop out of an equity participation in the new corporation in the parenthetical clause in INT. REV. CODE of 1954, § 368(a)(1)(D). This may account for the willingness to find an (F) reorganization with a functionally unrelated redemption as well as a (D) reorganization.

⁴⁴ 130 F.2d 977 (8th Cir. 1942), *cert. denied*, 318 U.S. 756 (1943).

⁴⁵ See *LeTulle v. Scofield*, 308 U.S. 415 (1940).

also shareholders of the old corporation, may also be disregarded as functionally unrelated to a reorganization, so that no proprietary shift occurs as part of the reorganization, was considered in *Dunlap & Associates, Inc.*⁴⁶ Here, the old corporation owned less than eighty percent of the stock of three subsidiaries, but desired to acquire complete ownership of them. Accordingly, it organized a new corporation in a different state, the stock of which was exchanged for stock in the old parent corporation. Three weeks later, the new parent corporation made an exchange offer which the minority stockholders of the three subsidiaries accepted, and exchanged their stock for stock in the new parent corporation. Thus, at the end of the transactions, the shareholders of the old parent corporation did not emerge as the sole shareholders of the new parent corporation. The Commissioner contended that an (F) reorganization had taken place, and, therefore, the old parent corporation was not entitled to close its tax year under section 381. The taxpayer sought to avoid an (F) reorganization by contending that all the transactions were designed to further the common purpose of preparing a public offering of stock of the new parent corporation, and that the subsequent exchange offer was an integral part of the transaction, which resulted in a substantial proprietary shift because of the injection of new shareholders. However, the Tax Court refused to consider the merger of the old parent into the new parent and the subsequent exchange of stock as mutually interdependent events. The court viewed the merger of the old parent into the new parent as a reorganization functionally unrelated to and separate from the exchange of stock with the subsidiaries' minority shareholders. Consequently, there was no shift in stock ownership between the old and the new parent corporations, enabling the court to find an (F) reorganization.

The (F) reorganization question was avoided by the majority of the Tax Court in *Casco Products Corp.*⁴⁷ Here, a corporation desired to become the sole shareholder of Casco Corporation. Pursuant to a public tender, the acquiring corporation succeeded in acquiring approximately ninety-one percent of Casco's stock. To acquire the remaining nine percent of the stock, the acquiring corporation resorted to the technique of a statutory merger, under which the acquiring corporation formed a new corporation in the same state of incorporation, acquired 100 percent of its issued and outstanding stock, and then merged old Casco into the new corporation, with the nine percent minority shareholders of old Casco being paid in cash. The taxpayer-corporation contended that a carryback of an operating loss of new Casco should be allowed against old Casco's pre-merger income, on the ground that no reorganization took place and that, realistically, there was a legal identity between old Casco and new Casco, or, alternatively, on the theory that an (F) reorganization had occurred. The Commissioner contended that an (F) reorganization could not have taken place because there was a nine percent shift in the shareholders' proprietary interest. The court declined to rule on the (F) reorganization question.⁴⁸ Instead of facing the issue before it, the court held that what had

⁴⁶ 47 T.C. 542 (1967).

⁴⁷ 49 T.C. 32 (1967).

⁴⁸ *Id.* at 36.

in fact transpired was simply a redemption of the nine percent minority shareholders, and that the merger "was merely a meaningless detour along the highway of redemption."⁴⁹

The majority opinion in *Casco Products* seems to hold the reorganization not only functionally unrelated to the redemption, but in effect functionally meaningless. To do so is to ignore completely the form of the parties' transactions. It is submitted that the Tax Court in *Casco* shirked its duty in refusing to pass on the (F) reorganization question.

(b) *The Internal Revenue Service*. The Internal Revenue Service has acknowledged that certain transactions may be functionally unrelated to others and may be disregarded in assessing tax consequences. The Service has found an (F) reorganization where an old corporation reincorporated in a different state and concurrently merged its two wholly owned subsidiaries into the new corporation.⁵⁰ It was held that the simultaneous liquidation of the subsidiaries and their merger into the new corporation was incidental and unrelated to the reorganization.⁵¹

In Revenue Ruling 68-349,⁵² the old corporation formed a new corporation to which it transferred all of its assets in exchange for the new corporation's stock. Simultaneously, an individual transferred his appreciated property to the new corporation in exchange for the new corporation's stock. The individual attempted to treat his transfer of appreciated property as tax-free under section 351. The Service ruled that the new corporation was organized solely as a means for allowing the individual to transfer his appreciated assets to the ultimate owner, the old corporation, without recognition of gain. Therefore, the organization of the new corporation was considered merely the continuation of the old corporation, and the individual's transfer of assets to a continuing entity of which he was not in control was not tax-free under section 351. To reach this result, the Service had to rule that the old corporation's transfer of its assets to the new corporation was an (F) reorganization, although there was a shift in ownership to the extent that the individual who was not a shareholder in the old corporation received stock in the new corporation. A similar approach was employed by the Service⁵³ where an old corporation's merger into a newly-organized corporation was ruled to be an (F) reorganization even though the new corporation's assets were then acquired by a third corporation in exchange for its stock.

In Revenue Ruling 69-413,⁵⁴ the Internal Revenue Service was able to

⁴⁹ *Id.*

⁵⁰ Rev. Rul. 58-422, 1958-2 CUM. BULL. 145.

⁵¹ The Service has also found functionally unrelated shifts in ownership with regard to (E) reorganizations (recapitalizations). In Rev. Rul. 56-179, 1956-1 CUM. BULL. 187, where the preferred shareholders exchanged their preferred stock for cash the Service impliedly acknowledged a redemption functionally unrelated to, but simultaneous with, a recapitalization. The same result on substantially identical facts was reached in Rev. Rul. 56-586, 1956-2 CUM. BULL. 214.

⁵² Rev. Rul. 68-349, 1968-2 CUM. BULL. 143.

⁵³ Rev. Rul. 69-516, 1969-2 CUM. BULL. 56. See also BNA 1970 Tax Management Memorandum No. 70-09, Tidbit No. 4, at 14 (May 4, 1970); cf. Rev. Rul. 70-140, 1970-1 CUM. BULL. 73, where a transfer of a proprietorship's assets to a controlled corporation, followed by the acquisition of its stock by an unrelated corporation, was held not to be a § 351 transfer.

⁵⁴ Rev. Rul. 69-413, 1969-2 CUM. BULL. 55.

avoid the question of whether a proprietary shift prevented an (F) reorganization. The old parent corporation owned ninety-nine percent of the outstanding stock of its operating subsidiary. For adequate business reasons, the parent corporation created a new subsidiary, which acquired substantially all of the assets of the old subsidiary in exchange for the voting stock of the common parent corporation. The old subsidiary distributed the stock of its parent to its shareholders, *i.e.*, ninety-nine percent to its parent and one percent to its minority shareholder, and then dissolved. The transaction qualified as a (C) (stock-for-assets) reorganization since substantially all of the assets of the operating subsidiary were acquired by the new operating subsidiary in exchange for voting stock in the common parent. The question presented was whether the new subsidiary may carry back subsequently incurred operating losses to a taxable year of the old subsidiary ending before the date of the reorganization. The answer to this question depended on whether the reorganization could also constitute an (F) reorganization. The Service noted that if characterized as an (F) reorganization, section 361 (according nonrecognition of gain or loss on reorganization transfer at the corporate level) would not be applicable to the transfer of the property from the old subsidiary to the new subsidiary in exchange for the voting stock of the common parent since the common parent does not qualify as "a party to the reorganization" within the definition of section 368(b). Since section 361 of the Code was not applicable to the transfer of property from the old subsidiary to the new subsidiary *for purposes of the (F) reorganization*, the transaction was held not to be an (F) reorganization. What the Service appears to be saying is that the transaction could not qualify as an (F) reorganization because the transfer of property would not then be tax-free, since the parent corporation would not be a party to the reorganization. The ruling can be criticized in that it allows the conceptual definition of an (F) reorganization to be controlled by the applicability (or lack thereof) of a tax-free transfer under section 361. It would appear that the practical merger of the operating subsidiary into a newly organized corporate shell with no pre-existing tax attributes should clearly have been an (F) reorganization of the classic type, since only one operating corporation was involved, and the less-than-one-percent shift in proprietary interest could easily be disregarded as *de minimis*.⁵⁵ Neither of these aspects of the transaction was noted by the Service.⁵⁶

The pinnacle of the "functionally unrelated" doctrine must be Revenue Ruling 61-156.⁵⁷ Here, the old corporation transferred substantially all of its assets to a newly organized corporation in exchange for cash, notes, and forty-five percent of the stock of the new corporation. The remaining fifty-five percent of the stock of the new corporation was then sold to the public. Subsequently, the old corporation liquidated and distributed the proceeds of the

⁵⁵ Rev. Rul. 66-284, 1966-2 CUM. BULL. 115.

⁵⁶ The Service might have distinguished the injection of one percent new shareholders from the one percent withdrawal of existing shareholders in Rev. Rul. 66-284, 1966-2 CUM. BULL. 115, but it did not.

In *Moffatt v. Commissioner*, 363 F.2d 262 (9th Cir. 1966), *cert. denied*, 386 U.S. 1016 (1967), the dissenting opinion argued that the injection of 10% new shareholders precluded classification as an (F) reorganization.

⁵⁷ 1961-2 CUM. BULL. 62.

sale to its shareholders. The Service ruled that the issuance of fifty-five percent of the stock of the new corporation to the public could be disregarded as being a separate transaction, since it was unnecessary to the dominant purpose of the reorganization: withdrawing earnings while continuing business. Therefore, there was no substantial proprietary shift as part of the reorganization, and the Service was able to find both an (E) and an (F) reorganization disallowing the new corporation a stepped-up basis in the assets. Moreover, the liquidating distributions to the shareholders of the old corporation were taxed as a dividend of a going concern under section 301 rather than as the distribution of boot under section 356, so that the dividend-within-gain limitation of section 356 was inapplicable.⁵⁸

The ruling can be criticized in that it rationalizes the splitting of a transaction into two functionally unrelated events on the grounds of an improper "dominant purpose," and thereby introduces a subjective test which may or may not accord with the realities of the situation. Clearly, in any reorganization there may be many purposes, business as well as personal. It could be argued that the sale of new stock was interdependent with the reorganization, as in *Dunlap & Associates*,⁵⁹ and one could even imagine a situation where the effectiveness of the reorganization was contractually contingent on the completion of a public offering necessary to raise funds to replace those withdrawn in the reorganization.

The ruling seems to go further than the cases reviewed above in that it admits that the injection of new shareholders in the new corporation can be functionally unrelated to an (F) reorganization. Further, it represents an extension of the (F) reorganization past that definition given the (F) reorganization by the circuit court in *Reef Corp. v. Commissioner*⁶⁰ in that it does not seem to require the business carried on by the new corporation to be substantially the same as that conducted by the old corporation. Finally, the ruling fails to give sufficient weight to the business purposes which caused the parties to frame their transaction in the manner which they chose. It would seem that if there is a business purpose for shifting ownership interests, a liquidation used for the process of achieving that proprietary shift should be given weight in determining whether an (F) or (D) reorganization had occurred.⁶¹ The functionally unrelated approach, however, might be crucial where there is no business purpose interdependent with the reorganization. This would be the case, for example, where distributions are made incidental to a reorganization which serves no discernible business purpose.⁶²

2. *Functionally Unrelated Distributions.* The "functionally unrelated" doctrine has found usage not only in disregarding the disappearance of old shareholders or the injection of new shareholders concurrent with a reorganization, but also in finding, and taxing, a distribution incident to a reorganization as a going-concern dividend under section 301, rather than the distribution of

⁵⁸ See text accompanying note 63 *infra*.

⁵⁹ 47 T.C. 542 (1967).

⁶⁰ 368 F.2d 125 (5th Cir. 1966).

⁶¹ See *Commissioner v. Berghash*, 361 F.2d 257 (2d Cir. 1966).

⁶² This is the essence of *Bazley v. Commissioner*, 331 U.S. 737 (1947).

boot under section 356. This position has been asserted by the Service in various contexts and is embodied in the regulations:

A distribution to shareholders with respect to their stock is within the terms of section 301 although it takes place at the same time as another transaction if the distribution is in substance a separate transaction whether or not connected in a formal sense. This is most likely to occur in the case of a recapitalization, a reincorporation, or a merger of a corporation with a newly organized corporation having substantially no property.⁶³

Under the general scheme of section 301, corporate distributions are taxed as ordinary income to the extent of the corporation's earnings and profits, without the dividend-within-gain limitation imposed on a distribution of boot under section 356 incident to a corporate reorganization. While this regulation specifically states that such going-concern distributions may occur in connection with a recapitalization, a reincorporation, or a merger, it does not state whether an ordinary dividend can also occur coincidentally with a liquidation. Section 331, according capital gains treatment to liquidating distributions, specifically provides that "[s]ection 301 (relating to effects on shareholder of distributions of property) shall not apply to any distribution of property . . . in partial or complete liquidation."⁶⁴ Although the language in the statute seems clear as to the inapplicability of dividend treatment where a complete liquidation is found, the regulations under section 331 indicate that a going-concern dividend taxable under section 301 may be found where a reincorporation has occurred.⁶⁵ Thus, the relationship of the liquidation provisions according capital gain treatment, the reorganization provisions with their dividend-within-gain limitation, and the provisions for taxing going concern distributions as dividends under section 301, pose difficult questions of applicability. For example, in Revenue Ruling 61-156⁶⁶ where an (F) reorganization was found by disregarding the subsequent public issuance of stock of the new corporation, the Service nonetheless held that the distributions to the shareholders of the old corporation were to be treated as an unrelated going concern dividend taxable under section 301, so that the dividend-within-gain limitation of section 356 was not applicable.

(a) *The Courts.* The courts, however, have not been as willing to find a functionally unrelated dividend under section 301 where a purported liquidation is treated as a reincorporation. In *Joseph C. Gallagher*⁶⁷ the court found a true liquidation and stated that even if the liquidation were treated as a reincorporation, ordinary income would result only if the provisions of section 356, relating to reorganizations, were applied. In opposition to the Commissioner's position that regulation 1.331-1(c) requires dividend treatment in any case of a liquidation-reincorporation, even if a reorganization is not present, the court felt that reincorporation distributions must be taxed, if at all, under the reorganization sections. This raises the conceptual question of whether a reincorporation can ever occur when it does not meet the technical require-

⁶³ Treas. Reg. § 1.301-1(1) (1955).

⁶⁴ INT. REV. CODE of 1954, § 331(b).

⁶⁵ See Treas. Reg. § 1.331-1(c) (1955).

⁶⁶ 1961-2 CUM. BULL. 62; see text accompanying note 57 *supra*.

⁶⁷ 39 T.C. 144 (1962).

ments of the reorganization sections. The *Gallagher* court, in dicta, answered this question in the negative.⁶⁸ But under regulation 1.331-1(c) the distribution remains subject to ordinary income taxation as a going-concern dividend, apart from the reorganization sections.

Related to the taxation of a dividend incident to a reorganization is the question of how earnings and profits should be measured. Although, under section 356, a boot dividend is limited to the amount of gain realized, it is further limited by the shareholders' pro rata shares of the corporation's earnings and profits.⁶⁹

The leading case in this area is *Davant v. Commissioner*.⁷⁰ Two corporations, South Texas Rice Warehouse Company (Warehouse) and South Texas Water Company (Water) were each owned in equal proportions by four families. Both corporations had substantial earnings and profits. Warehouse had approximately \$230,000 in cash and \$700,000 in operating assets. Water had liquid assets of at least \$700,000, in addition to its operating assets. In 1960 a number of the stockholders of both corporations consulted an attorney about the possibility of transferring the operating assets of Warehouse to Water and consolidating the business operations. The following plan was devised: A third party (the attorney's son) borrowed \$914,000 from a bank, with which he purchased 100 percent of the stock of Warehouse. He then caused Warehouse to sell all of its assets to Water for \$700,000 of Water's surplus cash. This cash, together with \$230,000 cash in Warehouse's own surplus, was distributed to the third party, as sole shareholder, in complete liquidation of Warehouse. Of the total of \$930,000 received by him, \$914,000 was used to pay back the loan, and the remaining \$15,000 remained as his profit on the transaction.

Both the Tax Court and the Fifth Circuit ignored the role of the third party as a straw man. The Tax Court⁷¹ held that the transaction constituted a (D) reorganization, and that the gain was taxable as a dividend to the shareholders of Warehouse to the extent of Warehouse's earnings and profits, which were \$230,000. The taxpayer had contended that even if the third-party straw man were ignored, there was still a valid liquidation with capital gains treatment under section 331.

On appeal, the circuit court saw the transactions as consisting of the following steps: first, \$700,000 of earnings and profits of Water were distributed through Warehouse to its shareholders; second, \$230,000 in earnings and profits of Warehouse were distributed to its shareholders; finally, the operating assets of Warehouse were combined with Water's assets. The court viewed

⁶⁸ Support for this position can also be found in *Estate of John L. Bell*, 30 CCH Tax Ct. Mem. 1221 (1971); *Simon Trust v. United States*, 402 F.2d 272 (Ct. Cl. 1968).

⁶⁹ See, *Ralph C. Wilson, Sr.*, 46 T.C. 334 (1966), wherein the court found a (D) reorganization, and allowed taxation of the boot to the stockholders, in accordance with § 356. The court held that since a true liquidation had not occurred, the corporation's sale of property at the corporate level was not tax-free under § 337. The amount realized from its sale of assets could, therefore, be added to the corporation's earnings and profits account in computing the extent of dividend taxation under § 356. See also *Abegg v. Commissioner*, 429 F.2d 1209 (2d Cir. 1970), cert. denied, 400 U.S. 1008 (1971); *Pridemark, Inc.*, 42 T.C. 510, aff'd, 345 F.2d 35 (4th Cir. 1965).

⁷⁰ 366 F.2d 874 (5th Cir. 1966), cert. denied, 386 U.S. 1022 (1967).

⁷¹ *South Tex. Rice Warehouse Co.*, 43 T.C. 540 (1965).

the first two steps as unnecessary and motivated by hoped-for tax minimization. Only the last of the three steps was viewed as motivated by any business purpose.

The Fifth Circuit agreed with the Tax Court that a (D) reorganization had occurred, citing *Commissioner v. Morgan*⁷² as authority for the proposition that it was unnecessary to issue additional Water stock in exchange for the transfer of Warehouse's assets. The circuit court treated the purported sale of assets to Water as a contribution of assets, with a concurrent distribution of the "sales price" as a dividend to the Water shareholders. In so doing the court brushed aside the distinction between a contribution and a sale of assets⁷³ and was able to avoid the conceptual difficulties in finding a (D) or an (F) reorganization where the transferee pays fair value for the assets and there is no constructive exchange of stock.

In addition to agreeing with the Tax Court that a (D) reorganization had occurred, the Fifth Circuit in *Davant* also found that an (F) reorganization had occurred, since the corporate enterprise continued uninterrupted, except for the distribution of cash. There was merely a change of corporate vehicles, not a change in substance. However, in the classic (F)-type reincorporation, unlike *Davant*, an existing corporation is merged into a newly-formed corporation, and the business of the old corporation is conducted within the new corporate shell. In *Davant* the old corporation's assets were transferred to a pre-existing corporation with its own substantial business and assets. The court answered this difference on the theory that if Water had no assets of its own prior to the transfer of Warehouse's assets, Water would be no more than the alter ego of Warehouse, so that an (F) reorganization would have occurred. The fact that Water already had assets that were vertically integrated with Warehouse's assets should not change the fact that Water was the alter ego of Warehouse. Viewed in this manner, it should make no practical difference whether the operating assets were held by Water or Warehouse, so that a shift between them is a mere change in identity or form, at least where there is a complete identity of proprietary interests in both corporations. Thus, the (F) reorganization was held to encompass the amalgamation of two commonly-owned operating corporations.

Turning to the distribution in liquidation of Warehouse, the court held that the \$700,000 received from Water through Warehouse by the shareholders, together with the \$230,000 received from Warehouse, were dividends taxable

⁷² 288 F.2d 676 (3d Cir. 1961).

⁷³ Of course, there is a distinction. For example, suppose Water had operating assets worth \$1 million and cash of \$700,000 prior to the transfer, and Warehouse has operating assets worth \$700,000 and cash of \$230,000 prior to the transfer. If Warehouse transfers its assets to Water for no consideration, and then distributes its cash (\$230,000) to its shareholders in complete liquidation, it is clear that the shareholders are in exactly the same position as if stock of Water had been issued to Warehouse and then distributed to the shareholders. In either event, the shareholders receive \$230,000 in cash and continue to own Water stock with an increased value due to the contribution of Warehouse's assets. On the other hand, if Water pays \$700,000 in cash for Warehouse's assets, the transaction is substantially different. First, the shareholders actually receive \$930,000 instead of only \$230,000; second, there would be no appreciation in the value of the Water stock nor any occasion for the actual or constructive issuance of additional Water stock, since Water paid full value for the assets received in the reorganization.

under section 301, even though they were coincident to a reorganization. The court treated the shareholders as having received two dividends, one in the amount of \$230,000 from Warehouse, and another in the amount of \$700,000 from Water. Contemporaneously with the dividends was the contribution of Warehouse's assets to Water in what the court considered to be a (D) as well as an (F) reorganization. By treating the cash distribution as a functionally unrelated dividend, the dividend-within-gain limitation of section 356 was avoided.

The taxation of the dividend under section 301 as functionally unrelated to the reorganization may have some logical appeal where there is an identity of shareholders in both corporations with the same proprietary interests. The circuit court thought it illogical to say that \$700,000 would be used to measure the portion of the \$930,000 distribution to be treated as a dividend if Water were merged into Warehouse, whereas only \$230,000 would be used to measure that portion of the distribution to be treated as a dividend were Warehouse merged into Water. Therefore, the court ruled that where there is a complete identity of shareholders, the use of the earnings and profits of *both* corporations is the only logical way to test which distributions have the effect of a dividend.⁷⁴ This is so because it is virtually impossible to tell which corporation is in substance "the corporation" distributing the cash under section 356(a)(2).⁷⁵

It would appear that the holding that earnings and profits of both corporations could be combined in testing for a dividend under section 356 was unnecessary under the facts in the *Davant* case, in view of the holding that the total distribution represented two functionally unrelated dividend distributions that were coincident with a corporate reorganization and taxable under section 301. However, the Service has since ruled that, where there is complete shareholder identity, both corporations will be considered the distributing corporation for purposes of determining whether the distribution has the effect of a dividend under section 356(a)(2).⁷⁶

In the context of a *Davant*-type reorganization, where the shareholders of both corporations are identical and the distribution of cash is not necessary or bargained for as part of the reorganization, the reasoning that the distribution of cash is functionally unrelated to the reorganization is logical. In such a situation, the distribution of cash simultaneously with the reorganization should not be allowed to put the taxpayers in a better position, because of the section 356 limitation, than if the distribution had been made before or after the reorganization as a normal going concern dividend. The disregarding of the corporation chosen by the parties to survive and the combining of both corporations' earnings and profits to determine dividends also has logical appeal as a triumph of substance over form.⁷⁷ The thrust of *Davant* seems to affirm

⁷⁴ *But cf.* INT. REV. CODE of 1954, § 304(b)(2)(A), which provides that in determining the extent of the dividend upon the redemption of stock in a brother corporation by its sister corporation, only the sister corporation's earnings and profits are to be taken into account.

⁷⁵ *But see* American Mfg. Co., 55 T.C. 204 (1970); Estate of John L. Bell, 30 CCH Tax Ct. Mem. 1221 (1971).

⁷⁶ Rev. Rul. 70-240, 1970-1 CUM. BULL. 81.

⁷⁷ Support for this position might also be found in the fact that if the distribution had

the trend that in the liquidation-reincorporation area the courts will break down the reorganization to its barest elements, and may accord tax consequences to all contemporaneous transactions separately by treating them as functionally unrelated to the reorganization.

(b) *The Internal Revenue Service.* As a result of the broad language in *Davant*, several approaches may now be asserted by the Commissioner in attempting to tax liquidating distributions connected with a reincorporation as dividends. First, the Commissioner might argue that the transaction is a corporate reorganization with attendant boot taxable under section 356. If there is identity of shareholders and if the transfer of assets is to a going corporation with earnings and profits, the Commissioner can further argue that the earnings and profits of the two corporations may be combined in testing for dividend equivalence under section 356. Alternatively, the Commissioner could argue that the distribution is taxable without regard to the reorganization provisions as a functionally unrelated dividend under section 301. With respect to this last approach, *Davant* appears to have overruled the dicta in *Gallagher*⁷⁸ to the effect that boot taxation under section 356 must govern to the exclusion of section 301 where a reorganization is found to exist.

The Internal Revenue Service has given some insight into its current position on the *Davant*-type problem in Revenue Ruling 70-240,⁷⁹ where it ruled that a classic liquidation-reincorporation involving two corporations owned by a single shareholder was a (D) reorganization. A constructive exchange of stock was found even though the transferee corporation purported to pay fair value for the operating assets of the transferor. The distribution of liquid assets was held to be taxable as boot under section 356, with the earnings and profits of both corporations combined in determining the extent of the dividend. It is interesting that the Service omitted any consideration of a functionally-unrelated dividend taxable under section 301.⁸⁰

III. THE (F) REORGANIZATION AND LOSS CARRYBACKS

The Commissioner's success in *Davant*, holding that a practical merger of two going concerns could be an (F) reorganization, was soon seized upon by taxpayers as a shield from tax in situations where it was advantageous to achieve classification as an (F), rather than a (D) reorganization. The advantage arises from the operation of section 381 of the Code.

Section 381 was introduced into the Code in 1954 in order to liberalize the carryback and carryover provisions by making them accord with "economic realities rather than upon such artificialities as the legal form of the reorganization."⁸¹ The section provides generally for the carryover of certain corporate tax characteristics incident to corporate reorganizations. However, section

been postponed until the assets of the two corporations had been combined in the reorganization, and then subsequently made by the surviving corporation, the entire amount would have been taxable as a dividend, since the earnings and profits of the constituent corporations would have been combined. See INT. REV. CODE of 1954, § 381(c)(2).

⁷⁸ See text accompanying note 67 *supra*.

⁷⁹ 1970-1 CUM. BULL. 81.

⁸⁰ Cf. Rev. Rul. 61-156, 1961-2 CUM. BULL. 62; see text accompanying note 57 *supra*.

⁸¹ S. REP. NO. 1622, 83d Cong., 2d Sess. 52 (1954).

381(b) provides that, except in the case of an acquisition in connection with an (F) reorganization, the taxable year of the transferor corporation ends on the date of transfer, and the transferee corporation is not entitled to carry back a net operating loss or a net capital loss for a taxable year ending after the date of transfer to a taxable year of the transferor corporation.

The relationship between the (F) reorganization and the net operating loss carryover rules had received considerable judicial attention prior to *Davant*. However, since the (F) definition had been limited to the merger of a going concern into a corporate shell, the problem of offsetting losses of one business against the income of another did not arise.⁸² With *Davant's* holding that the practical merger of two going concerns could constitute an (F) reorganization, it became necessary to reconsider the carryback provisions of section 381 relating to (F) reorganizations. This was done by the Ninth Circuit in two recent cases arising in the Tax Court.

The first case was *Estate of Bernard H. Stauffer*.⁸³ A sole shareholder, Bernard H. Stauffer, owned three corporations, referred to as Stauffer of California, Stauffer of Illinois and Stauffer of New York, the businesses of which were substantially integrated. In order to reduce manufacturing and overhead costs, Stauffer decided to relocate all of the business in Albuquerque, New Mexico. Accordingly, he formed Stauffer of New Mexico in August 1959. Stauffer of New Mexico had the same officers and directors as the other three Stauffer companies, and Stauffer continued to be its sole stockholder. A plan of reorganization was formulated whereby the three old Stauffer companies would merge into Stauffer of New Mexico on October 1, 1959, in accordance with the statutory merger laws of the respective states.

The merger was consummated, but because of reversals in business, the contemplated relocation to Albuquerque was never carried out. Instead, Stauffer of New Mexico operated out of the Los Angeles office of the old Stauffer of California. It continued to carry on the operations previously conducted by the old Stauffer companies from the same location and in the same manner as before the merger. The accounting records continued to be kept as though the three old Stauffer companies were in existence, except that no intercompany profits appeared on the books. For its first taxable year, Stauffer of New Mexico showed a net loss of almost \$800,000, which it offset against the combined pre-merger incomes of the three old Stauffer corporations. For its next taxable year, Stauffer of New Mexico showed a net operating loss of roughly \$3.3 million, which it attempted to carry back by applying the loss of Stauffer of

⁸² See *Newmarket Mfg. Co. v. United States*, 233 F.2d 493 (1st Cir. 1956), *cert. denied*, 353 U.S. 983 (1957). Where taxpayers did attempt to offset losses of one going concern against the income of another going concern (both parties to the reorganization), prior to the advent of the specific prohibition of § 381(b) the courts refused to allow the carryover on the grounds that the losses and income were not incurred by the same "taxpayer." The leading case is *Libson Shops, Inc. v. Koehler*, 353 U.S. 382 (1957). With the advent of § 381(b), courts would allow carrybacks of post-merger losses against pre-merger income only where the successor corporation was a newly organized corporate shell with no pre-existing tax attributes, and as a practical matter functioned as the alter ego of the old corporation. See, e.g., *Holliman v. United States*, 275 F. Supp. 927 (S.D. Ala. 1967); *Dunlap & Associates, Inc.*, 47 T.C. 542 (1967). For a recent ruling, see Rev. Rul. 70-241, 1970-1 CUM. BULL. 84.

⁸³ 48 T.C. 277 (1967).

New Mexico against the pre-merger income of Stauffer of California. Thus, the Tax Court was faced squarely with the question of whether a net operating loss of Stauffer of New Mexico for a post-merger fiscal year could be carried back and offset against the income of Stauffer of California for its pre-merger fiscal years.

The Tax Court held that the merger was not an (F) reorganization, agreeing with the Government's position that an (F) reorganization is limited to the reorganization of a single corporation and does not include the more involved combination of two or more corporations where each has been conducting a separate business. The court felt that the merger of three going corporations into a single new corporate entity involved changes that were far too significant to be dismissed as mere changes in identity, form, or place of organization. The Tax Court stated that it would not accept the Fifth Circuit's interpretation of the (F) definition in *Davant*. Moreover, the Tax Court distinguished Revenue Ruling 58-422,⁸⁴ which had held that the merger of a parent corporation together with its two subsidiaries into a newly organized parent corporation constituted an (F) reorganization for purposes of section 381. It was distinguished on the ground that in that ruling the subsidiaries and their business were always under the same corporate umbrella of the parent, both before and after the parent's reincorporation. In *Stauffer*, however, it was impossible to single out the reincorporation of a parent corporation, since what was involved was the merger of three active brother-sister corporations.

On appeal, the Ninth Circuit reversed.⁸⁵ The circuit court placed considerable emphasis on Revenue Ruling 58-422 as well as on the holding in *Davant* that where there is a complete identity of shareholders, a merger of pre-existing corporations may be an (F) reorganization. In the court's words:

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. There is a change of corporate vehicles but not a change in the substance of the transferor corporation.⁸⁶

Taking a pragmatic approach, the Ninth Circuit noted that had Stauffer of Illinois and Stauffer of New York merged into Stauffer of California, the latter could have carried back a post-merger loss to one of its own pre-merger taxable years. In the alternative, had Stauffer of California reincorporated into Stauffer of New Mexico, and thereafter consummated mergers with Stauffer of New York and Stauffer of Illinois, a post-merger loss sustained by Stauffer of New Mexico could have been carried back to a pre-merger taxable year of Stauffer of California.⁸⁷

The Commissioner countered that anomalous tax results would follow were the transaction treated as an (F) reorganization. For example, section 381(b)(3) would permit Stauffer of New Mexico to carry back its post-

⁸⁴ 1958-2 CUM. BULL. 145. See also Rev. Rul. 57-276, 1957-1 CUM. BULL. 126.

⁸⁵ 403 F.2d 611 (9th Cir. 1968).

⁸⁶ *Id.* at 619.

⁸⁷ See Treas. Reg. § 1.381(c)(1)-1(b) (1960).

merger loss to a pre-merger taxable year of the transferor corporations. On the other hand, section 381(c)(1)(A) provides no exception for the (F) reorganization from the general rule that the taxable year of the acquiring corporation to which the net operating loss carryovers of the transferor corporation are first carried, is the first taxable year ending after the date of transfer.⁸⁸ This would prevent a carryback of a net operating loss of the transferor corporations to a pre-merger year of Stauffer of New Mexico. Thus, the Commissioner argued that if Congress had intended the (F) reorganization definition to encompass more than a single enterprise, it logically would have provided the same exception for the (F) reorganization in section 381(c)(1)(A) as it provided in section 381(b)(3). The court dismissed this argument, noting that Stauffer of New Mexico had no pre-merger taxable year to which any loss of the transferor corporations could have been carried back, and this fact alone strongly indicated that Stauffer of New Mexico was nothing more than the alter ego of the three constituent corporations. Furthermore, the court rejected the Commissioner's negative inversion of section 381(c)(1)(A):

Reading §381(c)(1)(A) *as written*, it provides that the pre-merger net operating loss of the transferor corporation may be carried *forward* to a post-merger year of the transferee corporation. Together with §381(b) (whereby the transferee corporation may carry back a post-merger loss to a pre-merger taxable year of a transferor corporation) it provides the transferee in an 'F' reorganization with a most favorable treatment of losses. With tax advantages such as these available to the 'F' reorganization, we fail to see an anomaly in the denial of the carryback of the transferor's pre-merger net operating loss to a pre-merger taxable year of the transferee.⁸⁹

The court also reasoned that since section 381(c)(1)(A) must apply to all corporate reorganizations, if the (F) reorganization were limited to the reincorporation of a single corporation, Congress would have excepted the (F) reorganization from the multi-corporation provisions in section 381(c)(1)-(A).

The Commissioner also posited the case where the three transferor corporations, prior to the merger, were not on the same taxable year. The Ninth Circuit expressly refused to decide whether different accounting methods of the transferor corporations would disrupt the requisite continuity for an (F) reorganization, but noted that section 381(c)(4) delegates to the Treasury authority to prescribe the methods of accounting to be used in such a case.⁹⁰

Having concluded that the merger was an (F) reorganization, the court turned its attention to the extent to which the loss carryback should be allowed.

⁸⁸ "The taxable year of the acquiring corporation to which the net operating loss carryovers of the distributor or transferor corporation are first carried shall be the first taxable year ending after the date of the distribution or transfer." INT. REV. CODE of 1954, § 381(c)(1)(A).

⁸⁹ 403 F.2d at 620 (emphasis in original).

⁹⁰ The acquiring corporation shall use the method of accounting used by the distributor or transferor corporation on the date of distribution or transfer unless different methods were used by several distributor or transferor corporations or by a distributor or transferor corporation and the acquiring corporation. If different methods were used, the acquiring corporation shall use the method or combination of methods of computing taxable income adopted pursuant to regulations prescribed by the Secretary or his delegate.

INT. REV. CODE of 1954, § 381(c)(4).

As discussed above, the court noted that had the merger been effected in a number of other ways, the post-merger loss of Stauffer of New Mexico could have been carried back to and applied against the pre-merger income of Stauffer of California to the extent that it represented the loss of Stauffer of California, but for the simultaneous merger of the three corporations. The court adopted this "but for" approach,⁹¹ and held that the portion of the losses of Stauffer of New Mexico attributable to the operations of Stauffer of California could be carried back to a pre-merger taxable year of Stauffer of California, but that the losses representing the business operations of Stauffer of Illinois and Stauffer of New York could not be carried back to or offset pre-merger income of Stauffer of California. Thus, the court allowed the carryback only with respect to the principal predecessor corporation, and therefore, as far as the loss carryback aspects are concerned, found in effect an (F) reorganization with the simultaneous merger of the two smaller corporations. This holding was similar to Revenue Ruling 58-422, except that in *Stauffer* the two smaller corporations were brother-sister corporations of the principal predecessor corporation rather than subsidiaries of it.

The day after its decision in *Stauffer*, the Tax Court filed its decision in *Associated Machine*.⁹² Here, the old corporation, Machine Shop, was wholly owned by one individual and was engaged in the operation of a general machine shop business. Its sole shareholder also owned another corporation, J & M Engineering, which conducted a sheet metal fabricating business. The separate existence of each corporate entity had been respected by keeping separate bookkeeping and accounting records and by purchasing supplies and services, and paying expenses, separately. Each corporation held separate shareholders' and directors' meetings, had its own employees, and contracted with its own customers.

On November 30, 1960, Machine Shop was statutorily merged into J & M Engineering, and, upon the merger, the surviving corporation changed its name to Associated Machine. After the merger, Associated Machine continued to operate both the general machine shop business and the sheet metal fabrication business. The precise question presented to the Tax Court was whether a net operating loss of Associated Machine for its fiscal year ended November 30, 1962, could be carried back and applied against pre-merger income of Machine Shop for its calendar year 1959. This in turn involved the question of whether the merger of Machine Shop into J & M Engineering was an (F) reorganization, so that the carryback would be permitted under section 381(b). The Commissioner contended that the statutory merger of two active brother-sister corporations could not be an (F) reorganization. The Tax Court agreed, finding that the transaction was not a mere change of identity, form, or place of organization.

On the same day as its reversal of *Stauffer*, the Ninth Circuit reversed the Tax Court's decision in *Associated Machine v. Commissioner*.⁹³ The circuit

⁹¹ See *Libson Shops, Inc. v. Koehler*, 353 U.S. 382 (1957); *Newmarket Mfg. Co. v. United States*, 233 F.2d 493 (1st Cir. 1956), *cert. denied*, 353 U.S. 983 (1957); note 82 *supra*.

⁹² 48 T.C. 318 (1967).

⁹³ 403 F.2d 622 (9th Cir. 1968).

court held that the Commissioner's position, that the transferee in an (F) reorganization must be a corporate shell with no pre-existing business or tax attributes, was too narrow, and that no logical distinction exists between a shell transferee and an active transferee when two factors co-exist: (1) the proprietary interest in the transferor and transferee corporations is identical, and (2) the business continuity is not interrupted.

As in *Stauffer*, the Commissioner contended that anomalous tax results would flow from the Ninth Circuit's decision. The Commissioner first questioned the result if the successor corporation were on a different tax year than the transferor corporation. The court brushed this aside by stating that the Commissioner failed to explain why the shell transferee corporation in a classic (F) reorganization could not be formed with an accounting year different from that of the transferor corporation which must present the Commissioner with the same dilemma.⁹⁴

The Commissioner also raised the anomaly, as in *Stauffer*, that if this were an (F) reorganization, section 381(b) would allow a carryback of a post-merger loss of the transferee corporation to a pre-merger year of the transferor corporation, but section 381(c)(1)(A) would prevent a carryover of a pre-merger loss of the transferor corporation to a pre-merger year of the transferee corporation. The court countered by stating that section 381(b) and section 381(c)(1)(A) are mirror images, allowing a post-merger loss to be carried from the transferee corporation to the transferor, and a pre-merger loss to be carried from the transferor to the transferee corporation. The court stated further that section 381(c)(1)(A) only prohibits offsetting the transferor's pre-merger loss with the transferee's pre-merger income, and that this is not a carryback but a horizontal transfer since the income and loss involved occurred simultaneously and not in sequence. After explaining away the alleged anomalies, the court held that the successor corporation (*Associated Machine*) could carry back a post-merger loss to offset the pre-merger profits of the transferor corporation, without regard to the fact that the post-merger losses may not have been sustained in the conduct of the transferor corporation's business.

In Revenue Ruling 69-185⁹⁵ the Service announced that it would not follow the decisions of the Court of Appeals for the Ninth Circuit in the *Stauffer* and *Associated Machine* cases, nor that portion of the decision of the Fifth Circuit in *Davant* dealing with the question of whether the combination of two or more commonly owned operating corporations may qualify as an (F) reorgani-

⁹⁴ Query whether the successor corporation in an (F) reorganization may indeed adopt a different tax year. The question was not reached in either *Stauffer* or *Associated Machine*. Under § 381(b)(1), the transferor's tax year does not end upon an (F) reorganization, and the regulations under § 381 seem to infer that for all purposes the tax year and tax accounting methods of the transferor corporation continue uninterrupted. See Treas. Reg. § 1.381(b)-1(a)(2) (1960). The answer may be that under § 422, a change in tax years is allowable, upon approval of the Service. Under the court's conceptual approach to the (F) definition, this becomes a minor technicality which does not go to the issue of whether certain operative facts in the transaction constitute an (F) reorganization. However, under the Commissioner's more pragmatic approach to the (F) definition, the change in accounting years would raise the further anomaly that the (F) reorganization status would depend on the Secretary's approval of a change in accounting methods where the transferee was on a different tax year than the transferor. *But see* INT. REV. CODE of 1954, § 381(c)(4), quoted in note 90 *supra*.

⁹⁵ 1969-1 CUM. BULL. 108.

zation. Echoing the Commissioner in the Ninth Circuit cases, the Service stated that if an (F) reorganization could encompass the amalgamation of multiple business entities, it is anomalous for Congress to have provided an exception in section 381(b) to the requirement of filing final returns and to have permitted the carryback of net operating losses without granting similar treatment to all amalgamating transactions encompassed by section 381. Similarly, the absence of an exception for the (F) reorganization in section 381(c)(1)(A) is anomalous unless the (F) reorganization is limited to the reorganization of a single business enterprise,⁹⁶ in which case the transferee merely continues the tax year and tax attributes of the transferor.

The Ninth Circuit in *Associated Machine* is in accord with the Fifth Circuit in *Davant*, in holding that an (F) reorganization can involve the amalgamation of more than one active corporation where there is identity in the proprietary interest of the transferor and transferee corporations, and where the business continuity is not interrupted. But the court in *Associated Machine* went beyond *Stauffer*, and decided an issue not raised in *Davant*, when it allowed post-merger losses of the "sister" corporation to be carried back to and offset by pre-merger income of the "brother" corporation. This obviated the necessity for tracing the source of the income and loss which formed the basis of the "physically-integrated assets" test in *Stauffer*. Thus, *Associated Machine* was the logical extension of *Davant*, while *Stauffer* adopted the more traditional "but for" approach in allowing loss carrybacks in (F) reorganizations.

Davant, *Stauffer*, and *Associated Machine* are logically appealing in that, for tax purposes, it should be immaterial whether a business enterprise is carried on in several corporations or is combined under a single corporate roof with several divisions.⁹⁷ The question becomes whether the rationale enunciated in *Libson Shops*,⁹⁸ that the income and losses must be produced by substantially the same business, has retained vitality in delineating the limits to which operating losses may be carried back under section 381. The *Associated Machine* court apparently answered this question in the negative.

The rule set out in *Stauffer* was followed in *Home Construction Corp. of America v. United States*.⁹⁹ In this case 123 brother-sister corporations owned by one individual were merged into a newly organized shell corporation owned by the same individual. All of the old corporations were actively engaged in various aspects of the home building field and their operations were economically, if not physically, integrated. The situation differed from that in *Stauffer*, however, in that the constituent corporations operated on diverse fiscal years for reporting federal income taxes. Upon the merger, the constituent corporations closed their respective tax years and adopted a common fiscal year coinciding with that of the successor corporation. The district court¹⁰⁰ held that

⁹⁶ See Treas. Reg. §§ 1.381(b)-1(a)(1) and (2) (1960); cf. *id.* § 1.381(c)(1)-1(b).

⁹⁷ This logical reasoning becomes even more appealing in view of the gradual withdrawal of the multiple surtax exemptions after 1969. See INT. REV. CODE of 1954, §§ 1561, 1564.

⁹⁸ 353 U.S. 382 (1957); see note 82 *supra*. In *Maxwell Hardware Co. v. Commissioner*, 343 F.2d 713 (9th Cir. 1965), the Ninth Circuit has held that *Libson Shops* has been superseded by sections 381 and 382, but the Service has stated that it will not follow the case. Treas. Inf. Rel. 773, Oct. 13, 1965.

⁹⁹ 439 F.2d 1165 (5th Cir. 1971).

¹⁰⁰ 311 F. Supp. 830 (S.D. Ala. 1970).

the merger constituted an (F) reorganization, so that post-merger losses of the successor corporation could be applied against pre-merger income of its constituent corporations. The court deviated from *Stauffer*, however, in allowing such application without regard to the business source of the income and losses.

On appeal, the Fifth Circuit affirmed the district court's holding that the multiple corporation merger constituted an (F)-type reorganization. The circuit court relied on both *Davant* and *Stauffer* in reaching this result, finding that both cases hold that an (F) reorganization occurs where there is an identity of proprietary interests in the transferor and transferee corporations and an uninterrupted continuity of business enterprise in a new form which is merely the alter ego of the old form. The court emphasized that, in substance, there is no difference between the pre-merger operation consisting of 123 closely affiliated corporations and the post-merger operation consisting of the conduct of the same business with the same assets and ownership through numerous divisions of a single corporation.

Unlike the district court, however, the circuit court in *Home Construction* imposed a limit on the allowable loss carryback. The court stated that the correct calculation of loss carrybacks could not allow an after-merger taxpayer to obtain any more favorable tax treatment than it would have received had the loss occurred under the pre-merger form of the business.¹⁰¹ In applying this rationale, the Fifth Circuit allowed the net operating loss carryback only to the extent that the losses of the transferee corporation could be "reunited" for the sake of tax accountability into the same taxable units which existed before the mergers. In this manner, only such portion of the overall loss as could be shown to be attributable to each respective separate division within the transferee could be carried back, and then only to offset against the income of such division's pre-merger counterpart. In effect, the Fifth Circuit limits the net operating loss carryback in the same manner as the Ninth Circuit in *Stauffer*.

IV. THE FUTURE OF THE (F) REORGANIZATION

In the liquidation-reincorporation area, it seems clear that the Internal Revenue Service will no longer press the (F) reorganization issue because of the adverse results under section 381, except where a single active business is reincorporated in a new corporate shell. For this reason, the Commissioner can be expected to revert to the (D) reorganization as the primary tool in combatting reincorporations.¹⁰² The Commissioner might also attempt to deny capital gains treatment on the theory that no true liquidation has occurred to bring section 331 into effect, apart from the question of whether the transaction can be fitted into a reorganization definition.¹⁰³ Moreover, the "functionally unrelated" approach seems bound to continue to play an important role in the reincorporation area.

¹⁰¹ The court here relied on *Libson Shops, Inc. v. Koehler*, 353 U.S. 382 (1957).

¹⁰² See Rev. Rul. 70-240, 1970-1 CUM. BULL. 81.

¹⁰³ See Judge Tannenwald's dissent in *Estate of Henry P. Lammerts*, 54 T.C. 420, 447 (1970).

The problem, of course, is in defining the outer limits of the "functionally unrelated" doctrine when applied to a specific transaction. While its application in abuse cases might produce equitable results, shall the disappearance of shareholders of the transferor corporation always be viewed as functionally unrelated to the reorganization when it can be accomplished by redemption without the need of a reorganization? Shall the injection of new shareholders always be viewed as functionally unrelated when it could have been accomplished by the issuance of additional stock without the need to change corporate vehicles? If so, one can conceive of extreme examples of shifts in proprietary interest contemporaneous with (F) reorganizations. If carried this far, the "functionally unrelated" doctrine could completely strip the reorganization provisions of their meticulously detailed statutory continuity of interest requirements and defeat the rationale of the reorganization sections to postpone recognition of gain or loss only on insufficiently closed transactions.¹⁰⁴ Even in the interest of protecting the revenues by combatting reincorporations, the "functionally unrelated" doctrine should not operate to ignore substantial proprietary shifts. Some shareholder continuity should be a prerequisite to finding a reincorporation, and the statutory continuity of interest requirements at least provide a line of demarcation between corporate restructuring and corporate liquidation or sale. The eighty percent continuity of interest requirement of the (D) reorganization and the requirement of shareholder identity in the (F) reorganization should be determined after taking into account all proprietary shifts occurring as part of the plan of reorganization, regardless of whether the proprietary shift is mutually interdependent with the other steps also part of the plan of reorganization.¹⁰⁵ While such a test would impose the task of determining what steps were part of the plan of reorganization, and thus might raise the same objection of uncertainty as does the functionally unrelated approach, it would permit all steps in the *plan* of reorganization to be viewed together in testing against the reorganization definition, regardless of whether some of those steps *could* have been accomplished without the others. The only alternative would seem to be a completely mechanical statute which views all shifts of proprietary interest within, for example, one year before and after the reorganization as a part of the reorganization.

One can find somewhat more sympathy for the "functionally unrelated" doctrine when applied to avoid the limitation of section 356 and to tax the reincorporation distribution as a going-concern dividend, as in *Davant*. The "functionally unrelated" dividend appears to be grounded in the Supreme Court's decision in *Bazley v. Commissioner*,¹⁰⁶ and thus has long been part of the judicial gloss in the reorganization area. Nevertheless, it does require a determination, by the courts, by tax planners, and by the Service, as to when a distribution incident to a reincorporation can be viewed as functionally unrelated, and, therefore, should be taxed as a going-concern dividend. *Davant* presented an easy solution on easy facts, but where there is no complete share-

¹⁰⁴ See Treas. Reg. § 1.368-1(b) (1955).

¹⁰⁵ See Pugh, *The F Reorganization: Reveille for a Sleeping Giant?*, 24 TAX. L. REV. 437, 448 (1969).

¹⁰⁶ 331 U.S. 737 (1947).

holder identity, it would be more difficult to characterize a distribution as functionally unrelated since it might be a necessary, or bargained-for, element of the reorganization.

In the loss carryback setting, the *Stauffer* and *Home Construction* result may not be wholly repugnant to the extent that it permits post-reorganization losses of the successor corporation's business to be carried back and applied against income from that corporation's own pre-reorganization business, since a similar carryback is allowed to the transferee operating corporation in an (A) or (C) reorganization.¹⁰⁷ However, the broader approach of *Associated Machine* departs from this rationale by permitting the carryback without regard to the corporate entity which earned the income thus offset. This appears to disregard the rationale underlying section 381(b) that loss carrybacks are allowed only within the framework of a single operating corporation. The *Associated Machine* result is appealing from an economic point of view, but the question of whether the losses and income of a business enterprise may be offset regardless of whether that business enterprise is conducted under one or many corporate roofs would seem to be a question of tax policy to be answered by Congress rather than the courts.

The Ninth and Fifth Circuit's concept of the (F) definition as including the amalgamation of two or more operating corporations where the twin factors of shareholder identity and uninterrupted business continuity are present, also raises a host of problems of application under the present structure of the Internal Revenue Code of 1954. If such an amalgamation is an (F) reorganization, how does one account for the express provision in section 381(b) that the transferor corporation's tax year does not close upon the date of the reorganization? The Ninth Circuit held that this is merely a question of accounting practice and does not go to the definitional concept of the (F) reorganization. But if the taxable years of the constituent corporations do not end by reason of the (F) reorganization, it would seem to follow that pre-merger income and losses of these corporations would be reported on the transferee corporation's tax return for its first tax year following the reorganization, thus permitting the constituent corporations to offset each other's income and losses from operations in the pre-merger period.¹⁰⁸ The Ninth Circuit agreed this result was anomalous in *Associated Machine*, although it failed to deal with the problem adequately. Similarly, the use of the singular tense in the last sentence of section 1244(d)(2), stating that "a successor corporation in a reorganization described in section 368(a)(1)(F) shall be treated as the same corporation as its predecessor," indicates that the 1954 Code and the regulations thereunder¹⁰⁹ are structured on the premise that an (F) reorganization can involve but one operating company.

In view of these technical discrepancies, as well as the legislative history of the (F) definition,¹¹⁰ one is forced to conclude that the extension of the (F)

¹⁰⁷ See Treas. Reg. § 1.381(c)(1)-1(b) (1960).

¹⁰⁸ The technical problems resulting from the Ninth Circuit holdings are discussed in Pugh, *supra* note 105, at 462.

¹⁰⁹ See, e.g., Treas. Reg. § 1.1502-75(d)(2)(i) (1966).

¹¹⁰ See text accompanying note 5 *supra*.

definition to cover reorganizations involving more than one operating corporation is unwarranted under the present structure of the Code. However, the Ninth Circuit's economic approach to loss carrybacks should cause some reconsideration of the present rules under section 381. There is much merit in allowing losses to offset income from the same business enterprise owned by the same shareholders, regardless of the type, or number, of corporate forms in which that business is conducted. In addition to the possibility of this expanded consolidated return concept, the situation could be relieved by the redrafting of section 381 to follow economic lines, rather than having the tax result dictated by the type of reorganization found for purposes of part III of subchapter C.

What is most needed, however, is an end to the uncertainties raised by the expansion of the (F) definition. If other courts follow the Fifth and Ninth Circuits and the Commissioner refuses to concede, taxpayers can be expected to continue to litigate the (F) reorganization issue. In the interests of making tax practice a more exact science, and, more importantly, to preclude the (F) definition from assuming an all-encompassing role in the reorganization area as well as permitting loss carrybacks probably unintended by Congress, it is submitted the answer must lie with a Supreme Court decision, or congressional amendment, limiting the (F) definition to a reorganization involving a single operating corporation.