The Hindsight Sections of the Internal Revenue Code

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Sections 269, 382, 482 and 1551 are sometimes called the "hindsight" or "sanitation" sections. The common general purpose of the sections is to deny to a taxpayer certain tax benefits, such as losses, surtax exemptions, etc., where the taxpayer has acquired another taxable entity in order to capture that entity's tax benefits.

Section 269 Useful to Government

Of the four sections, the most used section is section 269. This section was adopted in 1943 as section 129 of the 1939 Code to halt various tax avoidance abuses which became manifest during World War II. Because of extremely high surtax and excess profits rates during the war, it became quite fashionable for profitable corporations to acquire loss corporations so as to utilize those losses to offset wartime profits of the acquiring corporations. However, before section 269 hardly got off the ground, the Tax Court decided the case of Alprosa Watch Corp.²

The facts in the Alprosa case are as follows. Esspi Glove Corporation stock was purchased by new shareholders who changed the name of the corporation to Alprosa Watch Corp. and utilized the corporate entity in its jewelry and watch business. Shortly after acquiring this stock it sold the glove manufacturing machinery of Esspi Glove back to the original shareholders, who presumably continued to operate the glove business. The taxpayer carried forward prior losses generated in the glove business to offset its profits from the sale of Swiss watches. The Commissioner challenged the use of this loss but because the tax year involved was prior to the effective date of section 129, the Commissioner was forced to rely upon the cases of Gregory v. Helvering³ and Higgins v. Smith.⁴ In the course of his argument, the Commissioner contended that section 129 was intended only to codify pre-existing law and did not signify a change in the law applicable to loss corporations, citing as his authority references to the committee report underlying section 129. The petitioner countered that it had to acquire an existing corporation in order to market the Swiss watches—this because of a

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1 58 Stat. 47 (1943).
2 211 T.C. 240, 245 (1948).
3 293 U.S. 465 (1935).
4 308 U.S. 473 (1940).
unique contract provision it had with its Swiss supplier. The Tax Court, in a very important decision, held that so long as it is the loss corporation entity which utilizes the loss carryover, section 129 would not apply. In other words, an acquired corporation may use its own loss to offset profits which it later derives from any source whatsoever. Thus, although the reference to section 129 was strictly dictum, the rule was early established that section 129 did not apply to the corporation which itself had sustained the losses. The Tax Court used a very mechanical and technical test, namely, "Is the same tax entity which incurred the loss now using it to offset later profits?"

The Commissioner then challenged the holding of the Alprosa case in Wage, Inc. The facts were strikingly similar to Alprosa, where Revoir Motors, Inc., in 1943, changed its name to Wage, Inc., sold its automobile inventory to Mr. Revoir, individually, and thereafter engaged in the broadcasting business. The court said that Wage, Inc. was the taxpayer which incurred the loss and, thus, can use the Revoir Motors, Inc. excess profits credit. Because there were business purposes for the merger, the court held that tax avoidance was not the "principal" purpose. As will be discussed later, however, Alprosa and Wage, Inc. were both overruled, and since that time the government has enjoyed great success under section 269.

Since 1955, the Commissioner has been most successful in prosecuting cases under section 269. Perhaps the turning point case was American Pipe & Steel Corp. decided in 1955. In that case the petitioner acquired a loss corporation subsidiary and thereafter filed consolidated returns. The subsidiary's assets consisted of building lots which had a high basis and low value. Shortly after the subsidiary was acquired, these building lots were sold at a large loss, and the loss was used to offset American Pipe's war profits in the consolidated return. Thereafter, the subsidiary was a mere shell. For a cost of about $11,000 the taxpayer acquired a $400,000 loss. The Tax Court held that the principal purpose of this acquisition was tax avoidance and, therefore, section 129 was operative. This was one of the first victories for the Commissioner, having lost numerous cases, including Berlands, Inc. of South Bend, Alcorn Wholesale Grocery, and many others.

However, the Commissioner's most important victory to date occurred in 1957, when the Coastal Oil Storage Co. case was decided. In that case, an oil storage corporation transferred certain storage tanks

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6 Note 2 supra.
8 16 T.C. 182 (1951), acq., 1951-2 CUM. BULL. 1.
9 16 T.C. 72 (1951), acq., 1951-2 CUM. BULL. 1.
10 242 F. 2d 396 (4th Cir. 1957) (affirming on taxpayer's appeal and reversing on Commissioner's appeal).
to a subsidiary with the express purpose of segregating tanks leased to the Government from tanks leased to others. Thereafter, the subsidiary leased tanks only to the Government and the parent leased its tanks only to outside commercial lessees. The Commissioner claimed that section 15(c) (I.R.C. 1939) and section 129 denied separate surtax exemptions. The Tax Court had held that section 15(c) applied, but section 129 did not, and the parties took cross-appeals. The Fourth Circuit affirmed the Tax Court on the section 15(c) holding, but reversed it on the section 129 holding: In so doing, it expressly overruled the Alprosa Watch Corp.\(^{12}\) and Wage, Inc.\(^{12}\) cases; and squarely held that section 129 applied to the acquired corporation as well as to the acquiring corporation, and expressly disapproved the rather technical approach which the Tax Court had espoused in the Alprosa case.

Numerous cases have been decided under section 129 involving the acquisition of a loss corporation and including its operation in consolidated returns. The Commissioner has been very successful in attacking such transactions not only in American Pipe & Steel,\(^{13}\) but in Elko Realty Company v. Commissioner\(^{14}\) and Hawaiian Trust Company Limited v. U.S.\(^{15}\).

Another line of attack has been the so-called "rehabilitation" cases where a loss corporation is acquired and thereafter other profits are diverted into it. Such a device was formerly sheltered by the Alprosa doctrine, but since the Coastal Oil Storage case,\(^{16}\) the Government has been very successful in winning many of these cases. A good example is Urban Redevelopment Corporation,\(^{17}\) which was decided by the Tax Court, and affirmed by the Fourth Circuit, the same circuit which had decided the Coastal Oil Storage case. Urban Redevelopment had incurred large losses in 1950 through 1953, and for a period in 1952 was practically inactive. An individual bought the Urban stock, ostensibly to obtain some building plans. However, the evidence showed that the building plans in question had never even been seen by this taxpayer and that the building plans, if they did exist, had little or no value and were never used. The taxpayer paid about $12,500 for the Urban stock, and the Commissioner contended that he purchased the stock simply to carry over Urban's losses against profits which the corporation later derived from its construction business. On cross-examination the sole shareholder was asked why he bought the Urban stock at a cost of $12,500 when a new corporation could have been formed for about $400. He was unable to give a satisfactory answer to this question and the court

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11 Note 2 supra.
12 Note 5 supra.
13 Note 7 supra.
14 260 F. 2d 949 (3rd Cir. 1958) (affirming Tax Court per curiam).
15 291 F. 2d 761 (9th Cir. 1961) (reversing district court).
16 Note 10 supra.
17 34 T.C. 845 (1960), affirmed, 294 F. 2d 328 (4th Cir. 1961).
held that under *Coastal Oil Storage*, a "deduction should be disallowed, when . . . it is claimed by either the acquired corporation or by the person who acquired control of the corporation . . ." unless it can be established that the principal purpose for the acquisition of the stock was not tax avoidance.

Another case of interest is *Mill Ridge Coal Co. v. Commissioner*.

In that case the taxpayer had incurred large losses in the coal mining business, and thereafter disposed of its mining assets and sold all of its stock to new owners who then engaged in the oil transport business under the corporate name Mill Ridge Coal Co. The trial court rejected the Commissioner's contention that section 129 applied, but held that the *Libson Shops* doctrine applied, thereby denying the carryover of the losses. The new shareholders admitted that the principal purpose was to avoid tax, but claimed that section 129 could not apply to the acquired corporation. The court of appeals held that both *Libson Shops* and section 129 applied, and held that the purpose of section 129 was to forbid "tax windfalls resulting in unjust enrichment" and specifically adopted the *Coastal Oil Storage* rule. At this point the *Alprosa Watch* rule was a dead issue.

The Commissioner also had some success in litigating cases where common control of both corporations existed prior to the acquisition. A good example is *Zanesville Investment Co.* In that case an individual held controlling interest in Zanesville Investment Co. and in a coal mining corporation. Zanesville at the time held the controlling interest in a corporation which operated a successful newspaper. Its sole shareholder transferred to Zanesville a controlling interest in the coal mining corporation which had operated at a loss for several prior years with the prospect of future losses. The mining corporation was utilizing new equipment and machinery in mining coal and although the new equipment showed great promise, it had many mechanical difficulties and was unable to operate the mine profitably. Shortly after taking over control of the coal mining corporation, Zanesville sold the mining assets at a large loss. Zanesville took the post-acquisition mining losses and losses from the sale of the mining assets as deductions on its consolidated returns. The court held that the acquisition had as its principal purpose the use of the mining corporation's losses. The court also refused to "fragmentize" the operating losses and losses from the sale of the mining assets, holding that the conduct was unitary and that both losses were "tarred by the same brush." It has been suggested that the case goes too far because the real loser in this situation was the sole

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18 Note 10 supra.
19 264 F. 2d 713 (5th Cir. 1959).
20 533 U.S. 382 (1957) (affirming 8th Circuit Court of Appeals).
21 Note 10 supra.
22 Note 2 supra.
shareholder of Zanesville and the sole shareholder of the mining corporation. It has been suggested also that Revenue Ruling 63-40, Internal Revenue Bulletin 1963-12, p. 8 is an admission by the Service that the Zanesville Investment Co.\textsuperscript{24} rule is not equitable and will not be litigated thereafter. A careful reading of the ruling by the author leads me to believe that the ruling referred to does not go this far.

**Use of Disallowance of Multiple Surtax Exemptions**

The Commissioner has been most successful in using section 269 to disallow multiple surtax exemptions. (At this point it should be noted that sections 269 and 1551 are not mutually exclusive and both can apply to one fact situation.) The Commissioner's greatest success has come in the real estate field where subdividers and builders for many years have been using multiple corporations in order to obtain multiple surtax exemptions. Perhaps the leading case on the subject—certainly the one which carries the finest opinion—is *James Realty Company*\textsuperscript{25} which was affirmed by the Eighth Circuit. In that case a builder and subdivider named Fine organized a new corporation to engage in the home building business with other corporations organized by him. The Commissioner claimed that section 129 denied multiple surtax exemptions and minimum excess profits credits to these various entities. The taxpayer argued that section 129 could not apply to *newly organized* corporations, but only to existing corporations which were acquired to obtain tax benefits. The court held that it did apply to new corporations and specifically cited *Coastal Oil Storage*\textsuperscript{26} to the effect that section 129 applies both to *acquiring* and *acquired* corporation. The opinion is an excellent one and is the first one to hold specifically that section 129 applies to newly organized corporations.

Another case in the long line of successful "builder" cases is *Henry S. Alper.*\textsuperscript{27} In this case the partners organized twenty-seven corporations to build low-cost Veteran's Administration financed homes. The Commissioner disallowed surtax exemptions and excess profits credits under section 269, and the taxpayers countered by arguing that (1) section 269 does not apply to newly organized corporations, (2) section 269 doesn't affect acquired corporations, and (3) their purpose was to minimize the risk by having each corporation complete its homes before the next corporation started to develop its subdivision. This latter argument seems to have some merit. The petitioner argued that if, for example, it were to have all of the houses built by corporation No. 1 completed before it started any under No. 2, any adverse legislation or bureaucratic action by the Veteran's Administration which could make

\textsuperscript{24}Ibid.
\textsuperscript{25}176 F. Supp. 306 (D. Minn. 1959), affirmed, 280 F. 2d 394 (8th Cir. 1960).
\textsuperscript{26}Note 10 supra.
the first project a loser would be limited only to the subdivision which
was then complete. The court held, however, that none of the three
arguments was valid. It cited *James Realty*\(^{28}\) against the first proposi-
tion, and cited *Coastal Oil Storage*\(^{29}\) against the second. It also held
that the principal purpose of the multiple corporations was tax avoid-
ance and not as the petitioner claimed, the minimization of risk. This is
considered to be a strong case for the Commissioner because the argu-
ments advanced for the petitioners seem to have considerable validity.

Another case of importance is *Fine Realty, Inc. v. U.S.*,\(^{30}\) which in-
dicates functional division of real estate corporations is vulnerable. The
decision in this case, however, might have been colored somewhat by
the fact that the taxpayer was the same person who had litigated and
lost the *James Realty* case,\(^{31}\) Mr. Fine. Mr. Fine claimed that he had
organized eleven corporations for five purposes, namely, efficiency of
operation, separation of basic activities, limitation of risk, assistance in
estate planning and the retention of sales commissions which otherwise
would have to be paid to third parties. The evidence, however, showed
(most of it put in by the government through the taxpayers' bookkeeper)
that Fine was very interested in "balancing out" each corporation at
the year end so that none of them earned more than $25,000 in each
year. This evidence was damning. The court held that this operation
could have been just as well conducted through one corporation, and
cited the "balancing out" as a critical factor in its decision. It noted the
same parties had litigated and lost the *James Realty* case, thereby dis-
allowing all surtax exemptions. It should be noted that this was also a
fraud case. It seems, however, that the court went farther than neces-
sary in adopting the so-called "could have" test. It is submitted that any
test which says that the same thing could have been done another way
is not the same as establishing that the principal purpose of the method
used was tax avoidance. Although the decision is doubtless correct, the
opinion seems to go too far.

*Taxpayers Occasionally Win, Too*

We turn now to some successful cases for the taxpayers after having
reviewed cases in which the Commissioner has prevailed. An interesting
case is *Turner-Moore No. 22 v. U.S.*\(^{32}\) In that case the shareholders
organized twenty-four corporations, each of which operated a service
station in a particular trade area. The taxpayer claimed that the separate
corporations were needed because the service station business was ex-
tremely hazardous and there is a possibility of large losses due to gaso-
line wars. The court pointed out that the minimization of risk against

\(^{28}\) Note 25 *supra.*

\(^{29}\) Note 10 *supra.*


\(^{31}\) Note 25 *supra.*

\(^{32}\) 60-2 U.S. Tax Cas. 9675 (W.D. Texas 1960).
gas war losses is a valid business purpose, also mentioning the fact that the corporations had a "geographic separation." This "geographic separation" test is becoming more and more important in those cases which are being won by taxpayers.

One of the most resounding victories won by taxpayers is the case of *Stater Brothers, Inc.*,\(^3\) and the only question which arises in the author's mind is why the Government ever tried the case. The Stater Brothers partnership, consisting of two brothers, was organized prior to 1949. They operated various food markets on a partnership arrangement for many years wherein the market managers were entitled to 50% of the profits from their particular market, and the Stater Brothers partnership was entitled to the other 50%. The managers, after paying tax on their share of the profits, let their after-tax profits accumulate until their capital account came up to 50% of the total capital account. Thereafter the manager was entitled to an annual distribution of 50% of the profits, and the Stater Brothers continued to receive their 50%. In 1949 and 1950, the Stater Brothers contacted attorneys who advised them that the partner-manager system was too risky in that it put all of the partnerships at the risk of one. For example, if one store were to be sued and lose a large case involving food poisoning, the assets of all of the markets would be liable to this creditor. The attorneys made various suggestions, but the Stater Brothers had misgivings and disliked the complicated nature of the suggestions. Furthermore, the partner-managers objected to the suggestions advanced by the attorneys and the plan was dropped. Thereupon, joint venture agreements were entered into for a short period with the various partner-managers. The attorneys later developed a plan whereby each market would be incorporated separately with the Stater Brothers partnership owning 50% of the stock and the partner-manager owning 50% of the stock. Looking at the long and successful history of this arrangement and its obvious business purpose, the court held that valid business purposes existed for the formation of separate corporations. It relied heavily upon the facts that geographic separation existed and that the corporation setup was entered into as a substitute for the 50-50 partnership arrangement which had been in existence since 1943. The principal purpose was not tax avoidance, but was to carry on in corporate form and minimize the risk of operating many food markets with owner-partner managers.

A further enunciation of the "geographic separation" rule is contained in *Concord Supply Corporation*.*\(^4\) In that case, a contractor was negotiating with U.S. Rubber Company to build a warehouse. Before negotiations were completed, U.S. Rubber advised the contractor that it would like two warehouses adjacent to each other—one in which to

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\(^4\) 37 T.C. 919 (1962).
store shoes, and the other to store auto mats and foam rubber. Two corporations were organized by the contractor. No. 1 constructed a complete warehouse with office, toilet facilities, heat, water reservoir, sprinkling system, etc. The second corporation built the second warehouse. This warehouse was an appendage to No. 1, separated by a party wall and fire doors. However, that building had no office of its own and no other facilities except those furnished by the No. 1, warehouse. Taxpayer claimed that section 269 did not apply because No. 2 was set up to protect it and No. 1 against loss if "some unforeseen event" would occur, and also that he wanted to fairly divide the ownership of the buildings between his children. The court pointed out that there could be no unforeseen event which would make desirable the holding of these two warehouses in two corporations. First, the lease with U.S. Rubber was a good lease, and it was unthinkable that U.S. Rubber would not be able to perform under it. Secondly, Lincoln National Life Insurance Company loaned approximately 100% of the construction cost on the basis of the lease, and it apparently was satisfied that there were no contingencies which could cause loss of the buildings because of the prime credit of the lessee. The court, in its opinion, seems preoccupied with and puts undue emphasis on the fact that the buildings were adjacent and that No. 2 was not a completely equipped warehouse. It is submitted that from certain language in the opinion it can be inferred that if the warehouses had been separate—rather than adjacent—the court might have come to a different conclusion, even thought this does not seem to be a valid basis for distinction.

Another section 269 case in which the Commissioner was defeated is The Royle Co. In 1950, a plastic toy manufacturer, 100% owned by one, Glaser, commenced the manufacture and sale of model automobile kits. The corporation lost money in 1951 and its financial condition was poor and unattractive to investors. As a result, Glaser sought investment capital under a plan whereby the investor would be concerned only with the precise product in which he invested. Under this plan, a separate corporation would be formed to own the rights to each product manufactured. The investor would take 25% of the stock in return for his money, and Glaser 75% in return for his know-how. The investor would then lend the corporation the money necessary to buy the molds for the production of the plastic product. The corporation had the product manufactured at standard industry rates and sold it at a standard mark-up to the corporation, which would then market the product. In 1953, three corporations were formed pursuant to this plan. In 1952, one, Kramer, who was quite experienced in the hobby kit field, agreed to join Glaser under certain stringent conditions. The primary condition was that Kramer would make no substantial capital contribu-

tion and the enterprise must be arranged so there would be no possibility of loss to him, whatsoever. Kramer insisted upon forming a separate corporation for each particular toy produced, on the ground that the hobby kit business is highly speculative since it depends on fads, and he did not wish to have a profit which might be earned on one item exposed to loss which might be sustained on another. As a result sixty-seven corporations were formed by Glaser and Kramer during the 1953-1956 period. Kramer contributed substantial services to these various corporations in that he supervised the preparation of assembly instructions and supervised the coloring and lettering on boxes, etc. The corporations actually were operated separately although they all maintained the same address as the original corporation, but they had no particular portion of the premises set aside for the use of any one of them. The Commissioner contended that these sixty-seven corporations represent a single business enterprise and that the principal purpose for dividing it into a number of corporations was to avoid federal income taxes by obtaining a number of corporate surtax exemptions. The Tax Court held that tax avoidance did not exceed in importance any other purposes and, therefore, section 269 did not apply. Factors which the court relied upon were (1) the fact that these corporations each were concerned with only one product and that any loss on one should endanger the others, (2) Glaser had entered into this type of arrangement long before he associated with Kramer and it seems to be very logical, and (3) there were some tax disadvantages of a multiple corporate structure in that loss of one corporation could not be offset against the gains of another.

Another interesting case in which the Commissioner was unsuccessful in imposing section 269 was *Fedcal Distributing Co.* In that case, one, Murphy, operated four retail liquor concessions as a sole proprietor. He became quite concerned about the proprietorship system inasmuch as he couldn't sell shares in his business, nor could he diversify without risking all of his assets. Also, he was the holder of four licenses and feared that a violation in one store would adversely affect all. At the time, there was some agitation in California to limit licenses to one person or firm, and to limit the transfer of licenses. Under existing California law, transfer of an *interest* in a license required Liquor Board consent, whereas transfer of *stock* in a corporation holding a license did not. After conferring with his attorney, Murphy decided to create four retail liquor corporations. The Commissioner argued that many of Murphy's reasons for incorporating were not well founded and, therefore, his principal purpose in setting up the four corporations was to obtain multiple surtax exemptions. The court agreed that while some of Murphy's reasons for incorporating were not perhaps well

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founded, he believed them to be valid. The fact that he had misap-
prehensions about some of these problems was immaterial. The court
invoked the so-called *Sno-Frost* rule, and held that section 269 did not
apply.

Another recent development in section 269 is Revenue Ruling 63-
40. This ruling is in two parts. The first part rules that where there
has been no change in stock ownership of a corporation during or after
a period in which it incurred net operating losses, the Service will not
rely upon the rationale of the *Lisbon Shops* case to bar the corporation
from carrying over the losses under section 172 against income from a
new business enterprise acquired through cash purchase of assets at their
fair market value, solely because the losses are attributable to a dis-
continued corporate activity. The second part of the ruling holds that
where the facts are the same as above, except that the corporation after
a bona fide attempt to purchase the assets of another corporation was
unable to do so and, therefore, was forced to purchase its stock, and
immediately thereafter liquidated the acquired corporation, the Service
will not contend the acquisition and control of the immediately liqui-
dated corporation had as its principal purpose the evasion or avoidance
of federal income tax for purposes of section 269. The facts in the
ruling were as follows:

The *M* corporation was organized in 1947 by three individuals who
owned an equal number of shares of its stock. From the date of its in-
corporation until early 1958 it was engaged in the fabrication and sale
of household light steel products. The business was successful during
its early years of operation but commencing in 1953 it sustained losses,
and over the period ending December 31, 1957 had accumulated sub-
stantial net operating losses. In 1958 the corporation purchased for
cash at fair market value all the assets of *N* corporation, which had a
successful history of drive-in restaurants. *M* and *N* were unrelated
corporations and none of the stockholders of *M* owned any stock in *N*
corporation. The funds for the cash purchase were derived in part from
*M* corporation's own assets and in part from an equal contribution of
capital by its three stockholders. Shortly thereafter, *M* corporation dis-
continued its former business activities, sold the assets connected with
it, and engaged thereafter exclusively in the business of operating the
chain of drive-in restaurants formerly operated by *N* corporation. Under
the facts presented, neither section 269 nor section 382 would apply, and
the question raised is whether the *Lisbon Shops* decision bars the allow-
ance of the net operating loss attributable to losses incurred prior to the
acquisition of the new business activity in 1958. The ruling went on to
hold that since there was no change in stock ownership of *M* corpora-

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39 Note 20 supra.
tion, either before the discontinuance of its former business activity or after the commencement of its new business activity, a net operating loss deduction is allowable for its taxable year ending December 31, 1958. However, the ruling warns that if there is more than a minor change in stock ownership of a loss corporation which acquires a new business enterprise, the Service may continue to contest the deductibility of the carryover of the corporation's prior losses against income of the new business enterprise. On the question of what constitutes a substantial change in stock ownership, the court refers to various cases, including *Mill Ridge Coal Co.*, discussed above.

**Section 269 Regulations**

We now turn to the final regulations of section 269 which were finally promulgated in 1962, after an eight year wait since the enactment of the 1954 Internal Revenue Code.

These regulations begin with the proposition that certain fact situations listed in the regulations “in the absence of additional evidence to the contrary ordinarily are indicative that the principal purpose for acquiring control was evasion or avoidance of federal income tax.” This should be compared to the 1939 regulations which provide that “if the requisite acquisition and purpose exist,” then certain fact situations might be indicative of the principal purpose being tax avoidance. The regulations further go on to define principal purpose as “If the purpose to evade or avoid federal income tax exceeds in importance any other purpose it is the principal purpose.”

The regulations further take the position that although no change of ownership has occurred, the loss corporation as the result of merging in profitable assets has secured a tax benefit prohibited by section 269. The question, however, arises that when a losing corporation acquires a profitable business by merger or otherwise, isn't the corporate management simply doing its duty in trying to salvage a losing venture?

The regulations further provide that section 269 can still apply to a reorganization which meets the tests of section 382(b).

**Section 482 Prevents Shifting**

We next turn to a short review of section 482, which is old section 45 of the 1939 Code. The major thrust of this section is to prevent artificial shifting of income, deductions, credits and allowances among two or more commonly controlled enterprises. A so-called “fringe” purpose of section 482 is to disallow certain tax exemptions to multiple corporations. The leading case on section 482 in this regard is *Advance Machinery Exchange v. Commissioner*. In that case, the ostensibly

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40 Note 19 *supra.*
41 Treas. Reg. §1.269-3(a) (2).
42 Treas. Reg. §1.269-3(c) (2).
43 Treas. Reg. §1.269-6.
44 196 F. 2d 1006 (2d Cir. 1952).
separate businesses of four corporations were operated as a unitary business. The taxpayer claimed that section 482 could not be used so as to consolidate income. The court rejected the argument and pointed out that if the taxpayer's argument were accepted, it would exclude section 482 from operating in the case of the most flagrant violations of that section.

Under section 482, one or more corporate entities must be disregarded. The question still arises, do the terms "allocate," "apportion" and "distribute" as used in section 482 mean the same as "denial?" Many people still think they do not.

Section 1551 Becoming More Prominent

Section 1551 was enacted in 1951 (as section 15(c)) with the aim of inhibiting the use of multiple surtax exemptions and accumulated earnings credits. By its terms, the section applies if a "major" purpose of an acquisition is the securing of multiple surtax exemptions or accumulated earnings credits. The regulations claim that section 1551 can apply even if the transfer was effected for a valid business purpose and qualified as a reorganization under section 368.

There are, however, certain limitations on section 1551.
1. It applies only to transfers by corporations.
2. The transferee either must be a corporation formed to receive the transfer, or be an inactive corporation at the time it receives the transfer.
3. This section does not apply if the transferee receives only money as opposed to other property.
4. The transferor corporation, or its shareholders, must have 80% control of the transferee corporation.

There have been some recent interesting developments under this section.

A leading case is Hiawatha Home Builders, Inc., which was decided in 1961. In that case, a terrazzo and cement finishing corporation named "Minnehaha" owned by seven active shareholders decided to enter the homebuilding field on a small scale. Their business grew and the corporation bought sixty-three lots of major building projects. Various prime contractors for whom the terrazzo contractors had worked informed the shareholders that if the corporation was going to compete in home building, they would subcontract their terrazzo work elsewhere. This disturbed the shareholders who were also apprehensive about the risks inherent in the home building business. The shareholders organized Hiawatha, which bought lots and houses from Minnehaha. The Commissioner sought to disallow Hiawatha's surtax exemption under section 1551, which was then section 15(c). The court held that the term "transfer" includes the sale of lots and houses and the only ex-

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clusion is a transfer of money. However, the court was convinced that Hiawatha was formed to insulate Minnehaha from home-building risks and to avoid loss of the terrazzo business from prime contractors. I believe the decision can be characterized as standing for the proposition that a new and risky enterprise is a valid basis for avoiding the application of section 1551.

Another case decided at the same time is Cronstroms Manufacturing, Inc.46 In that case, a heating and metal corporation was in the business of heating and air conditioning during the period 1946 to 1948. In 1947, the petitioner marketed an aluminum picnic cooler and later added other metal items such as outdoor grills, etc., all on a small scale. Beginning in 1950, its manufacturing business became more active and a separate manufacturing division was set up. The heating part of the business moved into other quarters. The manufacturing division added aluminum siding, steel bridging, office equipment, etc., to its line. The two division managers began to argue about the relative performances of their divisions. In addition, the heating division was often threatened with explosion lawsuits. The corporation owned large amounts of rental property. The division managers suggested to the majority shareholder a buy-and-sell agreement, but the corporate assets were too high for either one of them to handle even a partial buy-out. The manufacturing manager urged a segregation of divisions. After considerable debate, two separate corporations were organized, the old company kept the heating business, new corporation No. 1 took the manufacturing business, and new corporation No. 2 took the rental properties. The court held that there were many valid purposes for this split-up, none of which involved tax minimization. The court believed the testimony of the witnesses that absolutely no thought was given to the acquisition of separate surtax exemptions.

Another case of some importance, although it is only a Tax Court Memorandum decision, is Pre-Mixed Concrete, Inc.47 In that case, a construction corporation formed and transferred property to new concrete “ready-mix” companies. The purpose was to avoid the conflict of Teamsters’ Union organization and to maintain a competitive edge over unionized manufacturers. Two major competitors in the area were unionized at the time. Home builders for whom the concrete companies did work repeatedly stated that they wanted a non-union source of concrete. Thus, the construction corporation owned the trucks and the new corporation owned the concrete plants, and each served a particular area of Wichita, Kansas. When the Commissioner sought to apply section 1551, the court held that even though the plant employees could have been unionized before, after, or together with, the Teamsters, the

shareholders believed the separate corporation method would thwart unionization. Under the *Sno-Frost* rule, the securing of separate surtax exemptions was neither a "principal" nor a "major" purpose.

*The Pitfalls of Section 382*

We next turn to a review of section 382. Section 382 applies to the *purchase* of loss corporations. In order for the section to apply, there must be an increase in percentage points of ownership of over 50 percentage points by new owners and the business must be changed. Section 382(b) has the sole function of limiting loss carryovers in some non-taxable acquisitions covered by section 381(a). It does not apply to section 332 liquidations, nor to (F) type reorganizations. It operates to bar or limit loss carryovers by use of the continuity of ownership approach. Twenty percent is the so-called "magic" number. If 20% of the stock of the surviving corporation is acquired by the shareholders of the loss corporation in exchange for their stock, then the full loss is intact. If only 19% is acquired, only 95% of the loss is preserved, etc. In any event, the shares which qualify for inclusion in the 20% continuity of interest must be received as a result of owning stock in the loss corporation.

Intent is not relevant in a section 382(b) situation; however, the regulations seek to superimpose section 269 on every section 382(b) transaction notwithstanding contrary statements in Senate Committee Report No. 1662 (83rd Cong., 2d Sess. 53, 284 (1954)). The regulations pose obvious "step transaction" loopholes. For example, a (B) reorganization followed by a section 332 liquidation normally would be outside of section 382(b) limitations. However, the regulations consider this as a (C) reorganization which is subject to section 382(b) limitations. This is the same approach taken by the Reorganization Branch of the Tax Rulings Division in issuing rulings on (B) reorganizations which are followed immediately by section 332 liquidations.

Another loophole covered by the Regulations is given by example. The example is as follows: A and B, the controlling shareholders of X corporation, purchase 40% of the stock of Y corporation, which is a loss corporation. Thereafter, Y corporation acquires the assets of X corporation in a reorganization described in section 391(a). In determining whether the 20% continuity test is met, the Y stock owned by A and B is disregarded.

The application of section 382(a), as mentioned briefly earlier, is that if there is an increase of 50 percentage points in the shareholdings of the ten largest holders and the acquisitions are by purchase and a

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48 *Note 37 supra.*
49 Treas. Reg. §1.269-6.
substantial change in trade or business occurs, then section 382(a) applies to deny the loss carryover.

A question which immediately arises is: "What constitutes a change in trade or business?" Regulations section 1.382(a)-1(h)(5) cites the following relevant factors: changes in corporation's employees, plant, equipment, product, location and other items which are significant in terms of continuity of the business activity. The regulations further go on to provide that an inactive corporation which later reactivates has changed its business.\(^5^0\) The Regulations further provide that the suspension of business activity temporarily by reason of fire and other casualty is not the type of cessation which requires forfeitures of the loss carryover.\(^5^1\)

The only case on the question of the application of section 382(a) is Goodwyn Crockery Company,\(^5^2\) which was affirmed by the Sixth Circuit. In that case the Commissioner contended that under section 382(a)(1)(C), the taxpayer did not continue to carry on a trade or business substantially the same as that conducted before the change in ownership of the shares. Prior to the ownership change the corporation was a wholesaler of durable household goods in Memphis and four nearby states. After the death of the principal owner, operating losses were suffered and the stock of the corporation was sold to the Turner Corporation, a wholesaler of dry goods. Shortly thereafter, Turner caused Goodwyn to buy the inventory of a wearing apparel and dry goods firm in Cairo, Illinois, and in conjunction therewith moved the operation to Cairo. It transferred to Cairo only 2 employees out of the 15 formerly employed. A year later Goodwyn moved to Kentucky and then opened retail stores in various locations. As a result of these changes it prospered, and the Commissioner claimed that Goodwyn had shifted from one business to another, discontinued a major portion of its business, changed its location and employees, and that, therefore, section 382(a) would disallow the loss carryover. The court of appeals affirmed the Tax Court and held that the changes made were of a trial-and-error nature and the addition of retail merchandising to wholesaling was not material. The court also rejected the Commissioner's section 269 argument as the new corporation was rebuilt internally.

Before leaving this section it should be pointed out that the tests of the Regulations for service corporations are extremely strict, and if there is going to be any percentage point changes of 50 or more in a service corporation, the Regulations should be carefully examined.

*Libson Shops Cuts Across All*

The case that cuts across all of the Code sections which we have

\(^5^0\) Treas. Reg. §1.382(a)-1(h)(6).
\(^5^1\) Ibid.
\(^5^2\) 315 F. 2d 110 (6th Cir.), *affirming* 37 TC 355 (1963).
been examining and which will bear some perusal is the famous *Libson Shops, Inc. v. Koehler*,\(^5\) decided in 1957. Libson Shops was incorporated in 1946 to provide management services for women’s wear retailers. At the same time, the same interests which owned Lisbon incorporated sixteen separate corporations to sell women’s apparel at retail at various locations. Each filed separate tax returns. In 1949, the sixteen corporations were merged into Lisbon Shops. Three of the sixteen which had pre-merger losses continued with post-merger losses. The government refused to allow the pre-merger losses to be carried over to post-merger earnings. The court held that taxpayer which sustained the loss is not the same one which earned the post-merger profits, and that there must be a continuity of business enterprise. Prior loss can be offset against current income only to the extent that income is derived from the operation of substantially the same business which produced the loss.

The *Libson Shops*\(^5\) case is probably one of the most important cases decided in the tax field by the Supreme Court in many years, and it has been used more and more by the lower courts in refusing to grant a carryover where two businesses merged and the losses of one division were sought to be offset against the gains of the other. The Revenue Service partially backed down on *Lisbon Shops* in Revenue Ruling 58-603,\(^5\) when it ruled that the Commissioner won’t rely on the *Libson Shops* rule in section 382(a) transaction; warning, however, that sections 269 and 382(b) might apply, even in a section 382(a) transaction.

**Conclusion**

In conclusion, it should be stated that *Libson Shops*\(^6\) plus the Code sections which we have discussed makes the use of multiple surtax exemptions and loss carryovers in other than conventional manner very difficult for the taxpayer to achieve. More than anything else, the lesson to be learned is caution beforehand, because hindsight works only for the Government!

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\(^5\) Note 20 *supra.*
\(^4\) Ibid.
\(^6\) Note 20 *supra.*