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THE INFLUENCE OF DISALLOWED PREACQUISITION LOSSES ON THE RECOGNITION OF POSTACQUISITION LOSSES UNDER SECTION 269

INTRODUCTION

Assume the following situation: L corporation has suffered substantial losses in the operation of its business. A, after examining the corporation's status, decides there is a possibility of making the business profitable. A then purchases control of L principally to obtain the benefit of L's loss carryovers. But A also intends to make the business profitable and, in order to bring this about, invests a substantial sum of money in L. L, however, continues to incur losses. A then liquidates L. In the example given here, it is assumed that the preacquisition losses will be denied recognition under section 269.¹ But will A be allowed the benefit of the losses suffered after acquisition of L? In order to answer this question, consideration will have to be given to section 269 as well as to the pertinent case law.

Section 269(a)² provides that a deduction or other tax benefit, unavailable but for the acquisition of control³ of a corporation or its as-

1. INT. REV. CODE of 1954, § 269.

2. In General.—If—

(1) any person or persons acquire, or acquired on or after October 8, 1940, directly or indirectly, control of a corporation, or

(2) any corporation acquires, or acquired on or after October 8, 1940, directly or indirectly, property of another corporation, not controlled, directly or indirectly, immediately before such acquisition, by such acquiring corporation or its stockholders, the basis of which property, in the hands of the acquiring corporation, is determined by reference to the basis in the hands of the transferor corporation,

and the principal purpose for which such acquisition was made is evasion or avoidance of Federal income tax by securing the benefit of a deduction, credit, or other allowance which such person or corporation would not otherwise enjoy, then the Secretary or his delegate may disallow such deduction, credit, or other allowance. For purposes of paragraphs (1) and (2), control means the ownership of stock possessing at least 50 percent of the total combined voting power of all classes of stock entitled to vote or at least 50 percent of the total value of shares of all classes of stock of the corporation. INT. REV. CODE of 1954, § 269(a).

3. "Control" is defined by § 269(a) to mean the ownership of stock possessing at least fifty percent of the total combined voting power of all classes of stock entitled to vote or at least fifty percent of the total value of all classes of stock.

sets, is to be disallowed if the acquisition had as its "principal purpose" the avoidance of income tax by securing such tax benefit. Thus, not all acquisitions resulting in tax savings are within the prohibitions of the section.⁴ Section 269 is "operative only if the evasion or avoidance purpose outranks, or exceeds in importance, any other one purpose."⁵ Even where there has been a tax avoidance purpose in the acquisition, section 269(b)⁶ still authorizes the allowance by the Commissioner of such part of the deduction or other tax benefit as will not result in the tax avoidance or evasion sought by the acquisition.⁷

The thesis of this discussion is that postacquisition losses should be recognized unless such losses were built-in or were incidental to the realization of the preacquisition losses where the obtaining of such losses was for the principal purpose of tax avoidance. Before defining what is meant by this, however, consideration will briefly be given to the background of the section.

4. The test, according to the Senate Finance Committee, is:

. . . whether the transaction or a particular factor thereof 'distorts the liability of the particular taxpayer' when the 'essential nature of the transaction or factor is examined in the light of the legislative plan which the deduction or credit is intended to effectuate. S. REP. No. 627, 78th Cong., 1st Sess. 58 (1943) *reprinted at* 1944 CUM. BULL. 1017.

This explanation is now included in the Treasury Regulation and reads:

Characteristic of such circumstances are those in which the effect of the deduction, credit, or other allowance would be to distort the liability of the particular taxpayer when the essential nature of the transaction or situation is examined in the light of the basic purpose or plan which the deduction, credit, or other allowance was designed by Congress to effectuate. Treas. Reg. § 1.269-2(b) (1962).

5. 1944 CUM. BULL. 1017.

6. INT. REV. CODE of 1954, § 269(b).

7. Power of Secretary or His Delegate to Allow Deduction, etc., in Part.—In any case to which subsection (a) applies, the Secretary or his delegate is authorized—

(1) to allow as a deduction, credit, or allowance any part of any amount disallowed by such subsection, if he determines that such allowance will not result in the evasion or avoidance of Federal income tax for which the acquisition was made; or

(2) to distribute, apportion, or allocate gross income, and distribute, apportion, or allocate the deductions, credits, or allowances the benefit of which was sought to be secured, between or among the corporations, or properties, or parts thereof, involved, and to allow such deductions, credits, or allowances so distributed, apportioned, or allocated, but to give effect to such allowance only to such extent as he determines will not result in the evasion or avoidance of Federal income tax for which the acquisition was made; or

(3) to exercise his powers in part under paragraph (1) and in part under paragraph (2). INT. REV. CODE of 1954, § 269(b).

HISTORICAL BACKGROUND OF SECTION 269

The predecessor of section 269, section 129 of the Internal Revenue Code of 1939, was adopted in 1943. The World War II excess profits tax had just been enacted with a resultant sharp increase in the corporate tax burden. This increase gave added impetus to the discovery of new tax reduction schemes.⁸ One such tax avoidance device was the acquisition of corporations or corporate property to obtain the benefit of losses or deductions or a more favorable excess profits position.⁹ Concerned with the loss of tax revenues in this critical war period, the Treasury in 1943 sought congressional assistance in reducing this tax avoidance. This request resulted in the passage of section 129 of the Code.¹⁰

At the time section 129 was adopted, there were other methods also available for the control of tax evasion practices. Section 45¹¹ was in force, as were certain judicially-developed restraints. Moreover, some of this case law was understood to have been included in section 129 as enacted.¹² Indeed, the legislative history of the section clearly states that congressional intent in passage of 129 was not to detract from previously developed controls,¹³ but to make more certain the law as to the newer types of tax avoidance involving the acquisition of corporate control.¹⁴

The principal objectives of section 269, as stated in its legislative history, are to prevent the reduction of tax liability through "distortion

8. See Rudick, *Acquisitions to Avoid Income or Excess Profits Tax: Section 129 of the Internal Revenue Code*, 58 HARV. L. REV. 196 (1944); 7 MERTENS LAW OF FEDERAL INCOME TAXATION at 190 (1967 rev.).

9. Thus, the New York Times of October 31, 1943, carried the following advertisement: "For sale. Stock of corporation having 1943 tax loss deduction \$120,000. Sole assets are \$80,000 in cash and equivalent." In the Wall Street Journal of July 15, 1943, a similar advertisement appeared: "Wanted. To acquire all the outstanding stock of a corporation with original invested capital of several hundred thousand dollars with present assets at nominal values." Rudick, *supra* note 8, at 196.

10. Now INT. REV. CODE of 1954, § 269.

11. Now INT. REV. CODE of 1954, § 482.

12. See S. REP. NO. 627, 78th Cong., 1st Sess. 58 (1943) which declares that the: . . . legal effect of the section is, in large, to codify and emphasize the general principles set forth in *Higgins v. Smith*, 308 U.S. 473, and in other judicial decisions, as to the ineffectiveness of arrangements distorting or perverting deductions, credits, or allowances so that they no longer bear a reasonable business relationship to the interests or enterprises which produce them and for the benefit of which they were provided.

13. See 1944 CUM. BULL. 1070.

14. *Id.* at 1017.

or perversion effected through tax avoidance devices”¹⁵ and to end “any market for, or dealings in, interests in corporations or property which have as their objectives the reduction through artifice of . . . tax liability.”¹⁶ The aims of this section have specific reference to the prohibition of dealings in loss corporations which, as stated before,¹⁷ were in great demand after the passage of the excess profits tax. The general legal effect of the section is to codify the policies of certain judicial decisions¹⁸ which refused to recognize the utility of artifices attempting to distort deductions and other tax benefits “so that they no longer bear a reasonable business relationship to the interests or enterprises which produced them.”¹⁹

But section 269, it is to be emphasized, was not enacted to hinder good faith business activities, but rather was to facilitate “bona fide business transactions.”²⁰ The section was based on a policy which contemplated “the bona fide conduct of business in the ordinary way.”²¹ But how do these objectives and policies square with the decisions under section 269 dealing with the treatment of postacquisition losses where the principal purpose of the acquisition was tax avoidance or evasion?

INFLUENCE OF DISALLOWED PREACQUISITION LOSSES ON RECOGNITION OF POSTACQUISITION LOSSES UNDER SECTION 269

Postacquisition losses suffered either by the acquirer or by the ac-

15. H.R. REP. NO. 871, 78th Cong., 1st Sess. 49 (1943), *reprinted in* 1944 CUM. BULL. 938.

16. 1944 CUM. BULL. 938.

17. Rudick and MERTENS, *supra* note 8; *see also* n. 9, *infra*.

18. *E.g.*, Higgins v. Smith, 308 U.S. 473 (1940). *See* 1944 CUM. BULL. 1016. The Higgins rationale was as follows:

A taxpayer is free to adopt such organization of his affairs as he may choose and having elected to do business as a corporation, he must accept the tax disadvantages. On the other hand, the Government may not be required to acquiesce in the taxpayer's election of that form for doing business which is most advantageous to him. The Government may look at actualities and upon determination that the form employed for doing business or carrying out the challenged tax event is unreal or a sham may sustain or disregard the effect of the fiction as best serves the purposes of the tax statute. To hold otherwise would permit the schemes of taxpayers to supersede legislation in the determination of the time and manner of taxation. 308 U.S. at 477-478.

19. 1944 CUM. BULL. 1016.

20. *Id.* at 1017.

21. *Id.*

quired corporation²² are usually deductible unless the corporation or property was acquired for the principal purpose of tax avoidance. Where there is such purpose, postacquisition losses have been denied recognition in some cases²³ and recognized in others.²⁴ The cases denying recognition have generally relied upon section 269 as well as upon case law holding that a corporate group formed "without a business purpose" cannot file a consolidated return.²⁵

Before examining this apparent divergency of view, the derivation of postacquisition losses should be understood. These losses may originate either in the sale of acquired property which has depreciated in value or from postacquisition operating losses or from a combination of the two. A loss on the sale of acquired property can result from a decline in the value of such property either before or after acquisition. Where the decrease in value has occurred prior to the acquisition, the loss is properly described as built-in, while in the case of depreciation in value

22. At first section 129 (now section 269) was held not to apply to an acquired corporation in any event. *Alprosa Watch Corp.*, 11 T.C. 240 (1948) (dictum). *Alprosa* stated that: "That section [129] would seem to prohibit the use of a deduction, credit or allowance only by the acquiring person or corporation and not their use by the corporation whose control was acquired." *Id.* at 245. See, for a full discussion of this issue, U. So. CAL. 1962 TAX INST. 444. This "period of misconstruction" continued until 1957, when the Fourth Circuit Court of Appeals reversed the Tax Court on this point. *Coastal Oil Storage Co. v. Commissioner*, 242 F.2d 396 (4th Cir. 1957), *rev'g* 25 T.C. 1304 (1956). In 1960 the Tax Court acceded to this view in *Thomas E. Snyder Sons Co.*, 34 T.C. 400 (1960), stating that: ". . . we were in error. . . . We now agree with that reasoning [of the Court of Appeals for the Ninth Circuit in *Commissioner v. British Motor Car Distributors, Ltd.*, 278 F.2d 392 (9th Cir. 1960)]." *Id.* at 406, 407. In the latter case the court said: ". . . [T]he persons who have acquired the corporation did so to secure for themselves a very real tax benefit to be realized by them through the acquired corporation and which they could not otherwise have realized." 278 F.2d at 394.

23. *Luke v. Commissioner*, 351 F.2d 568 (7th Cir. 1965); *R. P. Collins & Co. v. United States*, 303 F.2d 142 (1st Cir. 1962); *Elko Realty Co.*, 29 T.C. 1012, *aff'd per curiam*, 260 F.2d 949 (3d Cir. 1958). For a discussion of these decisions see Adlman, *Recent Cases Increasingly Extend Section 269 to Disallow Post-Acquisition Operating Losses*, 17 J. TAXATION 282 (1962); Note, *Section 269 of the Internal Revenue Code and the Status of Postacquisition Losses*, 33 U. CHI. L. REV. 577 (1966).

24. *Herculite Protective Fabrics Corp. v. Commissioner*, 387 F.2d 475 (3d Cir. 1968) *rev'g in part* T.C. Memo. 1966-277 and *Zanesville Investment Co. v. Commissioner*, 335 F.2d 507 (6th Cir. 1964), *rev'g* 38 T.C. 406 (1962).

25. Sections 1501-1505, the provisions of the Code relating to the filing of consolidated returns, basically require that a group of corporations be affiliated in a parent-subsidary relationship for the filing of such return. INT. REV. CODE of 1954, § 1504(a). Since, in the cases here under discussion, the acquisitions were usually made through the corporation's obtaining control of, rather than the assets of, another corporation, deductions generally could only be had by filing consolidated returns.

of the assets after acquisition or in the case of postacquisition operating losses, this is not an accurate description, at least in an economic sense. If the loss is of the "built-in variety," there is no reason why section 269 should not operate to disallow it, if the acquisition was made for the principal purpose²⁶ of tax avoidance. However, the tax benefit has been denied not only in such cases as this, but also where the losses were incurred in an economic sense after the acquisition, principally on the basis that such losses were tainted by the tax avoidance purpose in the acquisition.²⁷

CONSIDERATION OF CASES DENYING RECOGNITION TO POSTACQUISITION LOSSES—PREACQUISITION LOSS TAINT

Although no postacquisition losses were involved in *J. D. & A. B. Spreckels Co.*,²⁸ this is a leading theory case which must be considered in any discussion of postacquisition losses. *Spreckels* set forth the requirement that a business purpose²⁹ underlie the acquisition of a corporation for it to be included in a group of affiliated corporations entitled to file consolidated returns.³⁰ Since the acquisition in the cases to be considered were made by one corporation acquiring control, rather than all the assets, of another corporation, only by the filing of consolidated returns³¹ could deductions for current losses have been effected. In a decision which did involve postacquisition losses, *Elko Realty Co.*, this business purpose rationale was imposed as a require-

26. According to Treas. Reg. § 1.269-3(a)(2) if the purpose to evade or avoid Federal income tax exceeds in importance any other purpose, it is the principal purpose.

27. E.g., *R. P. Collins & Co. v. United States*, 303 F.2d 142 (1st Cir. 1962).

28. 41 B.T.A. 370 (1940). The facts briefly stated are as follows: The parent corporation of an affiliated group of corporations acquired all the stock of A corporation. No business purpose was shown for the acquisition. *Held*: A corporation was not a member of the affiliated group of corporations for the purpose of section 141 of the Revenue Act of 1932.

29. For a definition of the business purpose doctrine, see B. BITTKER & J. EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS*, 451-454 (2d ed. 1967). The leading case is *Gregory v. Helvering*, 293 U.S. 465 (1935).

30. The Court in *Spreckels* stated that:

It is apparent that the privilege [of filing consolidated returns] was granted in order that the tax liability of a group of corporations which were combined for business purposes into one business unit might be based upon the true net income of the business unit. . . . It is believed that they [the framers of the statute] did not intend that the privilege be enjoyed . . . where the affiliation relied upon as the basis for the privilege to make a consolidated return is without a business purpose. 41 B.T.A. at 375.

31. See note 25, *supra*.

ment in addition to those of section 269.³² In *Elko Realty*, the taxpayer corporation acquired all the stock of two corporations which were operating at a loss at the time of their acquisition and which continued to operate at a loss. When taxpayer purchased the stock it apparently knew nothing of the financial performance of the business.³³ Taxpayer filed consolidated returns with the two corporations for the years 1951-1953 and deducted from the taxpayer's income the postacquisition operating losses of the business. The Commissioner disallowed the deduction of the losses of the two acquired corporations. The Tax Court agreed on the ground that taxpayer had failed to show under section 129 (now 269) that the principal purpose of the acquisitions was not the evasion or avoidance of Federal income tax and further that taxpayer had failed to show that the acquisition had a bona fide business purpose, other than tax avoidance, and thus the acquired corporations were not affiliates within the meaning of section 141 of the 1939 Code.³⁴ In *Elko Realty*, however, no distinction was made between those losses incurred before and after acquisition.³⁵ Both were simply disallowed on the ground that no business purpose, other than tax reduction, was shown for the acquisition, citing *Spreckels*³⁶ and section 129 (now 269).³⁷

The leading case specifically denying recognition to postacquisition losses is *R. P. Collins & Co. v. United States*.³⁸ The taxpayer, a corporation engaged in selling wool, purchased a controlling interest with an option to buy the rest of the outstanding stock in Priscilla Woolen Mills, which manufactured worsted yarn. Priscilla had been operating at a loss and thus the stock purchase price was less than the tax basis of the assets. Taxpayer exercised the option and, as Priscilla continued to operate at a loss, decided to terminate its operation. The plant and equipment were sold but Priscilla was not insolvent. Some months after the sale, Priscilla became engaged in the business of selling wool

32. *Elko Realty Co.*, 29 T.C. 1012, *aff'd per curiam*, 260 F.2d 949 (3d Cir. 1958).

33. 29 T.C. 1012, 1014.

34. In support of this proposition the Tax Court cited *J. D. & A. B. Spreckels Co.*, 41 B.T.A. 370 (1940) which set down the rule that where the ownership of a subsidiary's stock by a parent corporation is without a business purpose other than a tax reducing one, the subsidiary is not an affiliate within the intent of section 141. No postacquisition losses were involved in *Spreckels*. Thus *Elko Realty* would seem to extend this rule to postacquisition losses also.

35. 29 T.C. at 1026.

36. *Id.*

37. *Id.*

38. 303 F.2d 142 (1st Cir. 1962).

—the same line of business as taxpayer. The taxpayer filed a consolidated return³⁹ with Priscilla in which the postaffiliation operating losses and the loss on the sale of the plant and equipment were deducted in full against consolidated income. The following year the taxpayer deducted as a carryover the unused postacquisition losses as well as some preacquisition net operating loss carryovers. The Commissioner denied all these deductions on the ground that the principal purpose for the acquisition of Priscilla was tax avoidance. The district court upheld the Commissioner's determination.⁴⁰ On appeal, the taxpayer did not contest the lower court's disallowance of Priscilla's preacquisition losses but argued that it should be permitted to deduct the losses economically suffered after the acquisition regardless of the purpose for the acquisition. Taxpayer reasoned that since a loss is worth at most only 52 percent of its amount, no one would have a primary purpose of losing one dollar to save at most fifty-two cents in taxes. But the First Circuit Court of Appeals affirmed the result obtained in the district court, stating:

We find this argument unpersuasive. . . . [I]t unrealistically attempts to segregate into isolated segments a course of conduct which is essentially unitary both in conception and in impact. Assuming . . . that the court could conclude that the "overall" purpose of the acquisition was to avoid taxes . . . then we believe that it must have been within the fair contemplation of the taxpayer that certain operating losses would necessarily be incurred before the ultimate purpose could be effectuated and, to that extent, the operating losses would be included as a necessary incident of the "overall purpose." In effect once it is conceded that Priscilla was acquired with a view toward obtaining the tax advantages stemming from a corporate dismemberment, then we believe that all the losses which immediately precede this ultimate act are constituent elements of a course of conduct prescribed by Section 129. They are tarred by the same brush.⁴¹

Thus the appellate court, once the tax avoidance purpose was found, refused to fragment the losses. The result reached was objected to in a

39. Taxpayer could only file a consolidated return after exercising the option as section 141 of the 1939 Code (now INT. REV. CODE OF 1954, §§ 1501-1505) required 95% stock ownership.

40. *Collins v. United States*, 193 F. Supp. 602 (D.C. Mass. 1961).

41. *R. P. Collins & Co. v. United States*, 303 F.2d 142, 146 (1st Cir. 1962).

strong dissent by Judge Aldrich, who said that the majority misinterpreted the statute "carrying on . . . the penalty notion. . . ." ⁴² In Judge Aldrich's view, the statute should be applied only to "allowances artificial to the taxpayer, not [to] losses actually incurred by it." ⁴³ In other words the dissent would only have disallowed built-in losses.

The *Collins* rationale was followed in *Brick Milling Co.*⁴⁴ There two brothers acquired control of a corporation in the manufacture and sale of ice. They then transferred their stock to taxpayer corporation of which they were the sole stockholders. Brick Milling then liquidated the acquired corporation and received a distribution of its assets. Taxpayer claimed as deductions both the net operating loss carryovers as well as the postacquisition operating expenses of the ice business. The Tax Court denied the deduction on the basis that section 269 applies to postacquisition as well as preacquisition losses where the principal purpose of the acquisition was the evasion or avoidance of taxes by securing the benefit of these losses.⁴⁵ In support of its position, the Tax Court cited *Collins*⁴⁶ and Treas. Reg. § 1.269-3 (b)(1).⁴⁷

In the more recent case of *Luke v. Commissioner*,⁴⁸ the postacquisition losses were again denied recognition, the Court again citing *Collins*.⁴⁹ In *Luke*, Arlington (taxpayer) had sustained heavy losses. Its

42. *Id.* at 148, 149.

43. *Id.* at 149. In support of this statement Judge Aldrich cited the legislative history of section 129. The aim of the section was to prevent "reduction through artifice" of tax liability. H.R. REP. NO. 871, 78th Cong., 1st Sess. 49 (1943).

44. *Brick Milling Co.*, ¶ 63, 305 P-H Memo. T.C. (1963).

45. *Id.*

46. 303 F.2d 142 (1st Cir. 1962).

47. Treas. Reg. § 1.269-3(b)(1) provides in part:

(b) *Acquisition of control; transactions indicative of purpose to evade or avoid tax.* If the requisite acquisition of control within the meaning of paragraph (1) of section 269(a) exists, the transactions set forth in the following subparagraphs are among those which, 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:

(1) A corporation or other business enterprise (or the interest controlling such corporation or enterprise) with large profits acquires control of a corporation with current, past, or prospective credits, deductions, net operating losses, or other allowances and the acquisition is followed by such transfers or other action as is necessary to bring the deduction, credit, or other allowance into conjunction with the income (see further § 1.269-6). . . .

48. 351 F.2d 568 (7th Cir. 1965).

49. *Id.* at 572.

stock was worthless and its principal "asset" was its unused net operating loss of approximately \$390,000. The Conant Group acquired control of Arlington in 1956. In 1958 the latter acquired the assets of two Conant-controlled corporations which had undivided profits of almost \$1,500,000. Prior to its acquisition by Conant, Arlington had obtained a franchise to manufacture a trailer hitch but had not yet begun to make the product. Arlington hoped to realize profits therefrom but the actual operations of Arlington during the postacquisition period resulted in substantial losses. Taxpayer claimed both the preacquisition and postacquisition losses. Both were denied but as to the postacquisition losses the court said:

To advance any claim to the substantial pre-acquisition net operating loss carryovers it was essential that the Conant group give Arlington at least the appearance of being alive . . . to comply with the requirements of Section 382 of the code . . . and a post-acquisition loss, which occurred, was expected in the attempt to manufacture and sell the new product. The objective of Section 269 "is to prevent . . . acquiring corporations with current, past or prospective losses. . . ." And, the rationale of . . . *Collins* . . . is applicable here.⁵⁰

From these cases, it is apparent that postacquisition losses have been denied recognition both on the basis of *Collins* and its "taint" rationale⁵¹ and on the basis that no business purpose was shown for the acquisition.⁵² But before considering these cases and the underlying rationale further, it is advisable to examine a few of the numerous cases which have allowed the deduction of postacquisition losses.

CONSIDERATION OF CASES ALLOWING RECOGNITION TO POSTACQUISITION LOSSES—TRUE ECONOMIC LOSS THEORY

Although section 129 (now 269) has been applicable to loss corpo-

50. *Id.*

51. See also *Temple Square Mfg. Co.*, 36 T.C. 88 (1961); *American Pipe & Steel Corp. v. Commissioner*, 243 F.2d 125 (9th Cir. 1957), *cert. denied*, 355 U.S. 906 (1957); and *J. D. & A. B. Spreckels Co.*, 41 B.T.A. 370 (1940). These decisions generally disallowed the use of postacquisition losses which were built-in at the time of the § 269 acquisition. For similar provisions under the consolidated returns regulations see *Treas. Reg. § 1.1502-31A(b)(9)*. As stated above, however, *Brick Milling Co.*, ¶ 63,305 P-H Memo T.C., held, relying on *Collins*, that § 269 applied to disallow postacquisition operating losses.

52. See notes 28, 29 and 30, *supra*, and the accompanying text.

rations since 1943, prior to 1955 only two cases concerning loss corporations were decided and neither involved postacquisition losses.⁵³ But then *Elko* and *Collins* were handed down and it seemed that postacquisition losses would be disallowed whether they were built-in or whether they were true economic losses whenever there was a principal purpose of tax avoidance or evasion in the acquisition. This was true until 1964 when *Zanesville Investment Co. v. Commissioner*⁵⁴ was decided. In *Zanesville*, one Jones owned all the stock of taxpayer corporation which had a successful newspaper publishing subsidiary with which it had been filing consolidated returns for a number of years. Jones also owned most of the stock of Muskingum Coal Company. Muskingum had suffered substantial operating losses for several years. During 1954 taxpayer loaned the coal company a substantial amount in the hope that by investing in new equipment Muskingum would return a profit. Because of the new method of mining coal to be used, however, it was anticipated that Muskingum would continue to sustain operating losses for some time. Therefore, in 1955 Jones transferred all his stock in the coal company to taxpayer. Thus Muskingum became a member of the consolidated group and eligible to file a consolidated return, thereby hopefully making it possible for its anticipated losses to be deducted from the income of the rest of the group. The coal company continued to operate at a loss until 1956 when it sold its property at a further loss and filed a petition in bankruptcy. The Tax Court⁵⁵ disallowed a deduction for the postacquisition losses, both operating and capital, citing case authority⁵⁶ holding that where a commonly-owned affiliated group of corporations acquires a loss corporation in order to use such loss corporation's postacquisition losses on the consolidated return to offset the earnings of that affiliated group, either section 269 or sections 1501 to 1505 (the consolidated return provisions) may be used to disallow the utilization of such losses.⁵⁷ The Sixth Circuit reversed, stating:

53. See Feder, *The Application of Section 269 to Corporations Having Net Operating Loss Carryovers and Potential Losses*, N.Y.U. 21ST INST. ON FED. TAX. 1284 (1963). These cases were *Alprosa Watch Corp.*, 11 T.C. 240 (1948) and *WAGE, Inc.*, 19 T.C. 249 (1952).

54. 335 F.2d 507 (6th Cir. 1964).

55. *Zanesville Investment Co.*, 38 T.C. 406 (1962).

56. *R. P. Collins & Co. v. United States*, 303 F.2d 142 (1st Cir. 1962); *Elko Realty Co. v. Commissioner*, 260 F.2d 949 (3d Cir. 1958); as well as reference to *J. D. & A. B. Spreckels Co.*, 41 B.T.A. 370 (1940).

57. *Zanesville Investment Co.*, 38 T. C. 406 at 414 (1962).

Until this case, the Commissioner made no attempt in the approximately twenty years since enactment of Section 129 (now Section 269), so far as the reported cases indicate, to deny a taxpayer the right to offset an out-of-pocket dollar loss incurred after affiliation with post-affiliation income. We do not believe Section 269 requires such a result.⁵⁸

The appellate court conceded that section 269 prohibited the acquiring of corporations in order to utilize their tax losses or the built-in, but as yet unrealized, losses or other tax benefits of such corporations, but held that section 269 did not apply to the use of post-affiliation losses against post-affiliation consolidated income. The court distinguished *Spreckels*,⁵⁹ *Elko*,⁶⁰ and *Collins*⁶¹ on the ground that all these cases involved the recognition of losses which, in an economic sense, had been incurred prior to affiliation.⁶² *Spreckels* was cited for the proposition that pre-affiliation losses cannot be utilized against the income of other members of the new affiliated group,⁶³ rather than for the proposition that the affiliation must serve a business purpose or consolidated returns will not be allowed,⁶⁴ which would include postacquisition as well as preacquisition losses. *Elko Realty* was distinguished on the ground that the losses there represented preacquisition depreciation of assets. No mention was made in *Zanesville* of the postacquisition operating losses in *Elko* or of the proposition that where no business purpose other than tax avoidance is shown, the acquired corporation will not be recognized as affiliated within the meaning of section 141 of the 1939 Code.⁶⁵ This proposition, as stated above in reference to *Spreckels*, would include postacquisition as well as preacquisition losses and the court in *Elko Realty* so held.⁶⁶ *Collins* was disposed of as merely representing the view that as the primary purpose of the acquisition was the obtaining of the built-in loss, and as this was within the proscription of section 269, this purpose tainted the postacquisition losses and thus all were disallowed. The court assumed that postaffiliation operating

58. *Zanesville Investment Co. v. Commissioner*, 335 F.2d 507, 509-510 (6th Cir. 1964).

59. 41 B.T.A. 370 (1940).

60. 260 F.2d 949 (3d Cir. 1958).

61. 303 F.2d 142 (1st Cir. 1962).

62. *Zanesville Investment Co. v. Commissioner*, 335 F.2d 507, 510 (6th Cir. 1964).

63. *Id.* at 511.

64. See note 30, *supra*.

65. See note 28, *supra*.

66. 260 F.2d 949 (3d Cir. 1958).

losses standing by themselves would have been allowed.⁶⁷ This may be a proper interpretation of *Collins*, but it would seem that its implications are broader and that all postacquisition losses would be included where the principal purpose of the acquisition was tax avoidance and *Collins* had been so interpreted.⁶⁸

Thus it is evident that *Zanesville* may be reconciled with case law denying recognition to postacquisition losses. However, there can be no reconciliation of that case law with *Herculite Protective Fabrics Corp. v. Commissioner*.⁶⁹ In *Herculite*, one Sidney Hyman purchased all the stock of taxpayer corporation in May of 1960, after the latter had suffered substantial losses for several years. The facts established a statutory presumption under section 269(c) that "the principal purpose" of the acquisition was "the evasion or avoidance of Federal income tax."⁷⁰ Hyman operated taxpayer at a loss until January, 1961, when a profitable Hyman-controlled corporation was acquired by taxpayer. The tax return for 1961 claimed both preacquisition and postacquisition operating loss deductions. The Commissioner disallowed the claim in its entirety as being contrary to the provisions of both section 269 and section 382. The Tax Court sustained the Commissioner under section 269 but did not pass upon the application of section 382. The Third Circuit upheld the Tax Court's disallowance of the preacquisition losses but reversed the court's holding on those sustained after acquisition. The decision cited with approval the dissenting opinion of Judge (now Chief Judge) Aldrich in the *Collins* case, which reasoned that disallowance of postacquisition losses constitutes a penalty that should

67. 335 F.2d 507 (6th Cir. 1964).

68. Brick Milling Co., ¶ 63,305 P-H Memo. T.C. (1963).

69. 387 F.2d 475 (3d Cir. 1968) *rev'g in part* ¶ 66,277 P-H Memo. T.C. (T.C. Memo. 1966-277).

70. INT. REV. CODE of 1954, § 269(c) provides:

(c) Presumption in Case of Disproportionate Purchase Price.—The fact that the consideration paid upon an acquisition by any person or corporation described in subsection (a) is substantially disproportionate to the aggregate—

(1) of the adjusted basis of the property of the corporation (to the extent attributable to the interest acquired specified in paragraph (1) of subsection (a)), or of the property acquired specified in paragraph (2) of subsection (a); and (2) of the tax benefits (to the extent not reflected in the adjusted basis of the property) not available to such person or corporation otherwise than as a result of such acquisition, shall be prima facie evidence of the principal purpose of evasion or avoidance of the Federal income tax. . . .

not be imposed without a clear legislative mandate.⁷¹ The Third Circuit⁷² emphasized the fact that such postacquisition losses would be clearly deductible by way of carryover had not losses suffered before acquisition been claimed. *Herculite* concluded:

Thus, their [postacquisition loss] deduction is in no sense artificial and represents no unjust enrichment of the taxpayer. . . . We conclude, therefore, that section 269 does not preclude the claimed post-acquisition loss deduction.⁷³

The dissent would have upheld the Tax Court on the ground that the situation should be viewed as an entirety and as Hyman's acquisition of the assets was a vital part of the plan to secure the benefit of taxpayer's losses, all losses, including those incurred after taxpayer was acquired by Hyman but before the acquisition of the profit-making assets, should be disallowed.⁷⁴ It should be noted that the case was remanded to the Tax Court for consideration of the Commissioner's contention that the postacquisition losses should be disallowed under section 382 in any event.⁷⁵

The result in *Zanesville* and *Herculite* is apparently based upon a true economic loss theory. If the loss has actually been incurred by the one claiming it, section 269 should not be used to deny the deduction claimed. These cases would not disallow postacquisition losses merely because of a tax avoidance purpose in the acquisition of control of a corporation or its assets. To be disallowed, the losses must have been built-in, i.e., losses incurred in an economic sense prior to the acquisition. Taint is a theory incompatible with the view of these decisions. This is more true of *Herculite* than *Zanesville*. Whereas *Zanesville* may perhaps be reconciled, *Herculite* explicitly rejects the majority view in *Collins*.

AN ARGUMENT FOR RECONSIDERATION OF SECTION 269 AND ITS CASE LAW

The cases denying recognition to postacquisition losses have generally done so on the ground that (1) the loss was built-in, or (2) there

71. *Herculite Protective Fabrics Corp. v. Commissioner*, 387 F.2d 475, 476 (3d Cir. 1968).

72. *Id.*

73. *Id.*

74. *Id.* at 476, 477.

75. *Id.* at 476.

was no business purpose for the acquisition other than tax reduction, or (3) the tax avoidance purpose for the acquisition tainted the allowance of the postacquisition losses. The decisions are generally in accord that if the losses are built-in, they are within the proscription of section 269. This would seem to accord with the realities of the situation in that such losses are actually accrued, in an economic sense, before acquisition and thus are to be treated as any other preacquisition loss. To superimpose a business purpose test on section 269 might seem to accord with the legislative history of the section.⁷⁶ But even that is arguable as to postacquisition losses, since the same entity which produced the loss is now claiming it and since section 269 was aimed only at those "arrangements distorting or perverting deductions . . . so that they no longer bear a reasonable business relationship to the interests or enterprises which produced them. . . ." ⁷⁷ This rationale appears unsound as to postacquisition losses since under the existing corporate income tax each dollar of loss would create a tax savings of only forty-eight cents.⁷⁸

Perhaps some would contend, however, that while no one would intend to spend one dollar to save forty-eight cents, the principal purpose was to secure the tax benefits of the preacquisition losses and that all the deductions relating to the realization of such benefits should be disallowed to deter such tax avoidance purposes. This seemingly was the rationale of the cases holding that the preacquisition losses tainted those incurred after acquisition and thus both should be disallowed. The *Collins* court, for example, viewed the entire course of conduct as essentially unitary and held that "all the losses which immediately precede this ultimate act [of termination of the corporation's existence] are constituent elements of a course of conduct proscribed by Section 129. They are tarred by the same brush."⁷⁹ But this view goes too far. The purpose of section 269 is not to disallow automatically the entire claimed deduction, but only so much of it as results in tax avoidance.⁸⁰ The Commissioner is specifically empowered to allow such part of the deduction as will not result in tax avoidance.⁸¹

This is not to say that postacquisition losses other than those that

76. See S. REP. NO. 627, *supra* note 12.

77. 1944 CUM. BULL. 1016.

78. INT. REV. CODE OF 1954, § 11.

79. *R. P. Collins & Co. v. United States*, 303 F.2d 142, 146 (1st Cir. 1962).

80. See notes 2 and 4, *supra*.

81. See note 7, *supra*.

are built-in should always and invariably be recognized. If the corporation was acquired with the principal purpose of tax avoidance and if the preacquisition losses could only be realized by the retention of the corporation for a time, and during this time after-acquisition losses were incurred, such postacquisition losses should be disallowed as being incidental to the realization of the tax benefit for the purpose of which the corporation was acquired. But where postacquisition losses were incurred in a bona fide attempt to rehabilitate the corporation, such losses should be recognized. In many instances it may be difficult to determine whether or not the postacquisition loss was merely incidental to obtaining the tax benefit of the preacquisition loss, but an attempt should be made. Such factors as the making of substantial investments in the business during the postacquisition period, bona fide attempts to obtain loans for revitalizing the business, and revamping the company should be recognized in making this determination.⁸² It must be remembered that section 269 should not operate to hinder bona fide business transactions. Indeed, its aim was to assist them.⁸³ This would also seem to encourage rehabilitation⁸⁴ of unprofitable corporations which is certainly a desirable social and business objective.

As noted above, two of the more recent cases in this area recognized postacquisition losses. While *Zanesville*⁸⁵ attempted to reconcile its holding with *Collins* and other decisions disallowing postacquisition loss deductions, it apparently stands for the proposition that only those future losses which are built-in and accrued in the economic sense at the time of the acquisition come within the proscription of section 269. *Hercu-*

82. Two examples follow. One depicts a situation where the postacquisition losses should be denied recognition. The other should yield a contrary result.

Example (1). L Corporation was acquired by A in the hope of obtaining the benefit of L's large preacquisition losses. But in order to utilize these losses, A had to operate the corporation for a time after the acquisition to make the acquisition appear to have a business purpose behind it other than tax avoidance. Such postacquisition losses are incidental to the realization of the preacquisition losses and should not be allowed.

Example (2). L Corporation was acquired by A. L had suffered large preacquisition losses and this was the principal purpose for its acquisition by A. However, A also believed that L had potentiality and could be made a profit-producing corporation. In this belief A expended substantial sums in renovation. But the corporation still operated at a loss and so A sold it. Here the postacquisition losses were not incidental to the realization of the preacquisition losses and should be allowed.

83. See 1944 CUM. BULL., *supra* note 20 and accompanying text.

84. See 78 HARV. L. REV. 1479 (1965).

85. *Zanesville Investment Co. v. Commissioner*, 335 F.2d 507 (6th Cir. 1964).

*lite*⁸⁶ clearly stands for this proposition and rejects the taint rationale of the *Collins* decision. It appears that both were correctly decided in light of their respective factual patterns. The taint rationale of *Collins* should be rejected. However, as stated above, those postacquisition losses which are incidental to the realization of the preacquisition loss deductions should be denied recognition. The trend of the recent cases seems to be toward the *Zanesville-Herculite* result. However, the rationale of *Collins* and *Elko* is by no means dead as the *Luke* decision shows.

CONCLUSION

Neither the *Collins* nor the *Herculite* line of cases is entirely erroneous. While postacquisition losses should not be automatically disallowed, as *Collins* would seemingly do, tax avoidance should not be permitted. *Collins* goes too far and thus violates the intent of section 269. Conversely, *Zanesville* and more especially *Herculite* would apparently recognize any postacquisition loss not built-in. This also oversteps the apparent intent of section 269, for if the postacquisition loss was incurred in order that the tax benefit might be derived from the preacquisition loss, this is as much a part of the tax avoidance scheme as the obtaining of the preacquisition loss and should not be permitted. Rather each transaction should be closely examined to see whether the postacquisition losses were merely incidental to the realization of the tax benefit for the purpose of which the acquisition was made. If so, they should be disallowed. Otherwise such loss deductions should be recognized. This would seemingly more accord with the underlying policy of section 269 not to hinder the bona fide conduct of business than either of the present lines of decisions.

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86. *Herculite Protective Fabrics Corp. v. Commissioner*, 387 F.2d 475 (3d Cir. 1968).