Volume 74
Issue 1 *Number 1-2*

Article 23

August 1971

Taxation--Loss Carry-back Privileges of F Reorganizations

Michael J. Moyle
West Virginia University College of Law

> principles relating to implied warranties should be reasonably extended, and that similarly conceived principles relating to the doctrine of *caveat emptor* should be reasonably restricted in scope in the light of the vast change in the nature of chattels commonly sold and purchased in this day.[24]

Perhaps the language in *Williams* and *Nettles* could be used as a basis for applying the UCC to non-sales transactions in West Virginia.

Baker v. City of Seattle is an example of an accelerating trend towards using UCC policy in non-sales cases. *Baker* and the other cases like it could provide a strong base for extending UCC policy to bailments for hire in West Virginia. Its theory should not be overlooked.

Gary L. Hunt

Taxation—Loss Carry-Back Privileges of F Reorganizations

An individual owned 123 corporations, each engaged in one of three activities: supplying building materials, constructing low-cost housing, or marketing houses. These corporations substantially dealt among themselves and were centrally managed by the Lee Development Construction Company, Inc. Although each of these corporations was itself an independent unit, it was also a member of a larger integrated commercial organization. In 1962 the owner was seeking continued expansion and merged all the corporations into Lee Quality Homes Corporation to establish a better credit basis. Two years later, the corporation changed its legal name to Home Construction Corporation of America. The only operational changes caused by the consolidation were adoption of a common tax year and simplified accounting procedures. The 123 former corporations became 123 divisions of the Home Construction Corporation of America.

The parent corporation suffered net operating losses in 1963 and 1964 and filed claims for tax refunds by carrying back the losses and setting them off against the taxable income of the 83 previous

---

[24] 152 W. Va. 9, 21, 159 S.E.2d 206, 214 (1968).

corporations which had experienced profitable operations. The Internal Revenue Service denied the refunds. The district court held the consolidation was an F reorganization under § 368(a)(1)(F) of the Code, and allowed the carry-backs.[1] The circuit court *held,* affirmed and remanded. The consolidation of the 123 corporations constituted "a mere change in identity, form or place of organization" and qualified as an F reorganization. Therefore, the corporation was entitled to a refund based upon carrying back the loss to profits of the pre-merger corporations. However, there is a limitation to the carry-back—"only such portion of the overall loss as can be shown to be attributable to each respective separate division within the new structure may be carried back, and then only be offset against gains of such division's pre-merger counterpart."[2] *Home Construction Corporation of America v. United States,* 439 F.2d 1165 (5th Cir. 1971).

The F reorganization provision of the Code[3] has had a perplexing career. Two contrary arguments have been advanced concerning its definition. The first contends it pertains exclusively to single corporations, while the second asserts that it refers to the consolidation of several corporations. Both arguments have been advanced by the Commissioner and taxpayers at various times depending on the context in which the issue arose. The significance of a particular contention depends upon whose interest is involved in the litigation. It may be the tax consequences to the shareholder or the carry-back position of the newly organized corporation.

Assuming the shareholders are substantially the same in the post-merger corporation as in the pre-merger entity, the cash received by the shareholders in a liquidation/reincorporation may be treated as follows: (1) if the reincorporation is treated as an F reorganization, the cash received is taxed as a cash dividend, *i.e.,* ordinary income;[4] (2) if the liquidation/reincorporation is not an F reorganiza-

---

[1] Home Constr. Corp. of America v. United States, 311 F. Supp. 830 (S.D. Ala. 1969).

[2] Home Constr. Corp. of America v. United States, 439 F.2d 1165, 1172 (5th Cir. 1971).

[3] INT. REV. CODE of 1954, § 368(a)(1) [hereinafter, references to the Internal Revenue Code will be to the section number alone] sets forth six definitions of the term "reorganization." Reorganizations have been classified as A,B,C,D,E or F according to the subparagraph of § 368(a)(1) which defines each. An F reorganization is defined as "a mere change in identity, form, or place of organization, however effected." § 368(a)(1)(F).

[4] §§ 354-56.

tion, the cash received is taxed at the lower capital gains rate.[5] Therefore, it is not personally advantageous to the shareholders to have a liquidation/reincorporation classified as an F reorganization.

The shareholders in *Pridemark, Inc. v. Commissioner*[6] argued that the merger of brother and sister corporations did not constitute an F oganization, but the Commissioner contended such reorganization included a consolidation of multiple corporations.[7] The court agreed with the Commissioner and did not limit the F reorganization to single corporations.

The Commissioner reasserted the *Pridemark* argument in *Davant v. Commissioner*[8] where the shareholders also merged two corporations. They engaged in a transaction characterized as a "sale" so they could obtain gains treatment on the cash received for their stock. The court declared that multi-entity reorganizations can constitute F reorganizations.

Unfortunately, the Commissioner may have realized too late the repercusions which his arguments in *Pridemark* and *Davant* would have on the carry-back privileges of some corporations.[9] If a reincorporation receives an F classification, the newly formed corporation is entitled to loss carry-back privileges under § 381 of the Code.[10] This becomes important if, for example, a newly formed acquiring

[5] §§ 331, 337, 1002.

[6] 345 F.2d 35 (4th Cir. 1965). Brother and sister corporations, *X* and *Y*, sold part of their assets to Z, a corporation with which they had dealings. *X* and *Y* then distributed the remainder of their assets and proceeds from the sale. Upon liquidation the individuals reassigned the assets and part of the cash to a trust. The trust then exchanged the cash and assets for stock in a newly created corporation. The tax court held that an F reorganization had taken place and not a complete liquidation as claimed by the stockholders. Therefore, distribution of cash was a dividend and not property received in exchange for the stock upon a complete liquidation. On appeal, the court found no substantial discontinuance of business and characterized the liquidation/reincorporation as an F reorganization.

[7] *Id.* at 42.

[8] 366 F.2d 874 (5th Cir. 1966), *cert. denied,* 386 U.S. 1022 (1967). *X* and *Y* were two integrated corporations owned by the same shareholders. The shareholders decided to transfer the operating assets of *X* to *Y*, while withdrawing the excess corporate assets at capital gains rates. They sold the stock of *X* corporation to a "straw man" who in turn sold the assets of *X* to *Y*, thus "liquidating" *X*. The Commissioner contended there was not a bona fide liquidation. The tax court characterized the reorganization as an F type. On appeal the circuit court affirmed the tax court's holding.

[9] Pugh, *The F Reorganization: Reveille for a Sleeping Giant,* 24 Tax L. Rev. 437, 459 (1969).

[10] Section 381(b)(3) prohibits the acquiring corporation in a reorganization from carrying back a net operating loss to the pre-merger corporations unless the reorganization is an F one.

corporation experiences a loss during its initial years of post-merger operation.[11]

Therefore, when the interest in the litigation relates to the carry-back privilege of the acquiring corporation, the litigant's contentions regarding F reorganization are directly opposed to those advanced when the interest is the tax consequences to the shareholder. Two closely related cases, *Stauffer v. Commissioner*[12] and *Associated Machine v. Commissioner,*[13] illustrate this. In both instances the corporate taxpayers were the result of business mergers and had post-merger losses to carry back to the pre-merger corporations. The Commissioner completely reversed his argument of *Pridemark* and *Davant* and asserted that those decisions were erroneous.[14] Of course the taxpayers were more than willing to use the precedent he had established in those cases. The court, undaunted by the Commissioner's reversal of position, emphasized that the definition of F reorganization encompasses multi-corporation reorganizations.[15]

Subsequently, the Internal Revenue Service released a Revenue Ruling declaring that it would not follow the *Pridemark, Davant, Stauffer* and *Associated Machine* decisions.[16] *Home Construction* was decided after the ruling and affirmed the previous cases, completely disregarding the Commissioner's ruling.

The *Home Construction* case is also of some significance because it was decided subsequent to the Tax Reform Act of 1969.[17]

---

[11] *See* Pugh, *supra* note 10, at 457.

[12] 403 F.2d 611 (9th Cir. 1968). *X, Y* and *Z* were corporations operating in different states and conducting separate but similiar businesses. The three corporations consolidated into new *M* corporation. All the stock in *X, Y,* and *Z* and the new *M* corporation was owned by the same person. *M* corporation realized unexpected losses and wished to carry them back to the pre-merger corporations. The tax court ruled there was not an F reorganization, but the circuit court reversed stating that a multi-corporation reorganization can constitute an F reorganization.

[13] 403 F.2d 622 (9th Cir. 1968). *X,* a profitable corporation, was merged into the operating but unprofitable *Y* corporation. Both were owned by the same shareholders. The court held that the merger was an F reorganization.

[14] *See* Pugh, *supra* note 10, at 459-60.

[15] *See* Stauffer v. Commissioner, 403 F.2d 611 (9th Cir. 1968); Associated Machine v. Commissioner, 403 F.2d 622 (9th Cir. 1968).

[16] Rev. Rul. 69-185, 1969-1 CUM. BULL. 108:

> The Internal Revenue Service will not follow the decisions of the court of appeals for the Ninth Circuit . . . nor that portion of the decision of the court of appeals for the Fifth Circuit . . . dealing with the question whether a combination of two or more commonly owned operating corporations may qualify as a reorganization within the meaning of section 368(a)(1)(F) of the Internal Revenue Code of 1954.

[17] Tax Reform Act of 1969, Pub. L. No. 91-172, 83 Stat. 487.

If Congress had intended the interpretation given an F reorganization by the Commissioner, the Tax Reform Act might have reflected this. The lack of change in the subsection would seem to indicate that the prior court decisions accurately reflected congressional intent.[18]

The court searched through the legislative history for a definition of F reorganization, but it could not find one. Therefore, it took cognizance of the economic realities involved, *i.e.,* the new corporation was identical in substance to the 123 former corporations. The form of the organization had changed, but the nature of the entity had remained substantially the same. "A mere change in identity [or] form" depends on a change in *form* rather than a change in the *substance.*[19] Home Construction was merely an alter ego of the pre-merger corporations. The court realized no precise definition was possible.[20]

It also realized that restriction to "a mere change in identity [or] form" must be guaranteed by imposing some limitations. Those applied in this case were: (1) There must be "identity of proprietary interests in the transferor and transferee."[21] Substantially the same ownership must exist in the post-merger corporation as the pre-merger corporation. (2) It is necessary to have an "uninterupted continuity of business."[22] The fundamental business operations of the merging corporations cannot cease or change prior to or during the reorganization. (3) The pre-merger corporations must engage "in the same or integrated activities."[23] The reorganized entities are required to be in the same type of business. (4) And naturally "a

---

[18] This theory was advanced in Brief for Appellee at 27, Home Constr. Corp. of America v. United States, 439 F.2d 1165 (5th Cir. 1971):

> On December 30, 1969, Congress passed the Tax Reform Act of 1969 which was the most exhaustive and comprehensive rewriting of the substantive tax laws in our history. This amendment which was 313 pages in length, was written with full knowledge and benefit of the rule expressed in the *Davant, Stauffer* and *Associated Machine* decisions that an F reorganization depends not on a "one active corporation" rule but rather on continuity of business substance—yet it contained not one word to alter that rule . . . . [I]t contained nothing to limit F reorganizations to cases involving only one operating corporation.

[19] Home Const. Corp. of America v. United States, 439 F.2d 1165, 1170 (5th Cir. 1971).

[20] The court noted that the definition of an F reorganization sometimes overlaps definitions of the other § 368 categories, but it stated that reorganizations which fit within both the F classification and another are still entitled to the benefits of the F category.

[21] 439 F.2d at 1171.

[22] *Id.*

[23] *Id.*

legitimate business purpose independent of and in addition to the tax consequences of the merger" is essential.[24]

The resultant enterprise in *Home Construction* satisfied these conditions. The 123 corporations were owned by the same shareholder. The corporate aspects of manufacturing, construction and selling were not substantially affected by the reorganization. The pre-merger corporations continued in the low-cost housing business, and the primary reason for the reorganization was to secure a better credit basis.

Even though all limitations are met, an F reorganization has no benefits without proper accounting procedures. It is basic that "an after-merger taxpayer may not obtain any more favorable tax treatment than it would have received had the loss occurred under the business's pre-merger form."[25] Therefore, the taxpayer is required to separate the net operating loss into taxable units identical to the pre-merger corporations, and only the net operating losses of those units which had pre-merger profits may be carried back. The loss carry-back attributed to the taxable unit is limited to the prior years' profits of that unit's pre-merger counterpart.[26] To allow the total loss to be offset against the total profits would permit a more favorable tax treatment to the taxpayer.

The F reorganization requirements reveal that the tax consequences are of importance primarily to small, closely held corporations and not to larger, publicly held enterprises. Although many public mergers are substantially within these limitations, there is usually little or none of the required identity of ownership in the transferor and transferee. If this is true, the decision in *Home Construction* may enable close corporations owned by substantially the same shareholders to merge without the consequence that income tax credits of the pre-merger corporations will automatically be lost.

Michael J. Moyle

---

[24] *Id.* at 1172.

[25] *Id.*

[26] *Id. See also* § 172 which provides the proper procedures for carrying back loss.