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Reflections on Section 382: Searching for a Rationale

*J. Clifton Fleming, Jr.**

I. INTRODUCTION

Under federal income tax law, certain corporate acquisitions will preserve an unprofitable corporation's net operating loss (NOL) carryover. Where the acquisition occurs via an integrated taxable transaction, preservation is the general rule if the transaction was (1) an acquisition of stock with the loss corporation remaining in existence or (2) an acquisition of assets by the loss corporation. Where the acquisition is through a nontaxable transaction, preservation generally occurs if the deal was covered by section 381(a)¹ or if the loss corporation remained in existence.² This list of "preservation" transactions seems to reflect a stable consensus as to the types of business acquisitions which should permit survival of a corporate NOL carryover; there appears little pressure for change.

But even if a corporate acquisition occurs through a transaction permitting survival of the loss corporation's NOL carry-

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1. I.R.C. § 381(a) provides:

(a) GENERAL RULE.—In the case of the acquisition of assets of a corporation by another corporation—

(1) in a distribution to such other corporation to which section 332 (relating to liquidations of subsidiaries) applies, except in a case in which the basis of the assets distributed is determined under section 334(b)(2); or

(2) in a transfer to which section 361 (relating to nonrecognition of gain or loss to corporations) applies, but only if the transfer is in connection with a reorganization described in subparagraph (A), (C), (D) (but only if the requirements of subparagraphs (A) and (B) of section 354(b)(1) are met), or (F) of section 368(a)(1),

the acquiring corporation shall succeed to and take into account, as of the close of the day of distribution or transfer, the items described in subsection (c) of the distributor or transferor corporation, subject to the conditions and limitations specified in subsections (b) and (c).

The "items described in subsection (c)" include NOL carryovers.

2. For a more detailed summary of transactions which both do and do not permit preservation of corporate NOL carryovers, see B. BITTKER & J. EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS* ¶ 16.03 (4th ed. 1979).

over as the general rule, can there nevertheless be circumstances justifying restrictions on the survival of the carryover in a particular case? If so, what are the circumstances and what restrictions are justified? There is no settled agreement on these issues.

This lack of consensus is due largely to the absence of a clearly identified governing principle or rationale for use in resolving the issues. For instance, settled answers are lacking for several central questions. Is a corporate NOL carryover an asset which the owners should be allowed to realize on? If so, who are the owners—the shareholders at the time the loss was sustained, shareholders who have newly acquired control, or the corporation itself? Is a corporate NOL carryover an income averaging device limited to the corporation suffering loss and inherently incapable of surviving an asset transfer to another corporation? Should a corporate NOL carryover follow the business assets that created it? What effect should a change of business or change in shareholders have on a corporate NOL carryover?³ It is clear from these unanswered questions that until basic principles are established for determining the extent to which corporate NOL carryovers should survive in particular preservation transactions, our tax law cannot be structured to deal adequately with this matter.

Although lacking these basic principles, Congress nevertheless proceeded to impose detailed and complicated rules in this area by the 1954 enactment of section 382.⁴ These rules were

3. See generally AMERICAN LAW INSTITUTE, FEDERAL INCOME, ESTATE AND GIFT TAX PROJECT—FEDERAL INCOME TAX PROBLEMS OF CORPORATIONS AND SHAREHOLDERS 341-48 (1958) [hereinafter cited as ALI PROJECT].

4. The pre-1976 Tax Reform Act version of § 382 (Internal Revenue Code of 1954, ch. 736, § 382, 68A Stat. 3) was principally divided into § 382(a), dealing with taxable changes in corporate ownership and § 382(b), dealing with tax-free corporate acquisitions.

[Section 382(a)] provided that where new owners buy 50 percent or more of the stock of a loss corporation during a 2-year period, its loss carryovers from prior years were allowed in full if the company continued to conduct its prior trade or business or substantially the same kind of business. It could add or begin a new business, however, and apply loss carryovers incurred by the former owners against profits from the new business (unless tax avoidance was the principal purpose for the acquisition). If the same business was not continued, however, loss carryovers were completely lost. In the case of a tax-free reorganization, loss carryovers were allowed on a declining scale (sec. 382(b)). If the former owners of the loss company received 20 percent or more of the fair market value of the stock of the acquiring company, the loss carryovers were allowed in full. For each percentage point less than 20 which the former owners received, the loss carryover was reduced by 5 percentage points. It was immaterial whether the business of the loss company was continued after the reorganization (sec. 382(b)).

STAFF OF JOINT COMMITTEE ON TAXATION, 94TH CONG., 2D SESS., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1976, at 190 (Comm. Print 1976). It was stated with respect to

significantly amended in 1976 with a quantum increase in complexity,⁵ but the effective date has been delayed until 1980 to permit further study.⁶

Since the degree of survival of corporate NOL carryovers in connection with preservation transactions is a current and open question, this Article will investigate the rationale that should be used in resolving the issue. The investigation will be facilitated by a brief look at history and economics.

II. WHAT IS THE CORPORATE INCOME TAX?

In 1909 Congress levied, without apportionment among the states, a one percent tax on corporate annual net incomes exceeding \$5000. Perhaps because 1909 fell between the unfortunate *Pollock* decision,⁷ which declared the unapportioned 1894 income tax unconstitutional, and the adoption of the sixteenth amendment, Congress did not openly call the new exaction an income tax. Instead, it was styled a "special excise tax with respect to the carrying on or doing business."⁸ Presumably, this terminology was used because excises had earlier been classified indirect taxes that were exempt from the Constitution's apportionment requirement.⁹

Confident that this congressional camouflage would be disregarded and that the new levy would be declared an invalid income tax under *Pollock* for lack of apportionment, taxpayers went to court. The result was *Flint v. Stone Tracy Co.*,¹⁰ which held that the tax was "an excise upon the particular privilege of doing business in a corporate capacity" and that no apportionment was required.¹¹

pre-1976 § 382 that "the basic criticism of the present Code provisions regulating transferability of loss carryovers is directed to the lack of a uniform underlying principle upon which to construct effective statutory provisions." ALI PROJECT, *supra* note 3, at 341.

5. Tax Reform Act of 1976, Pub. L. No. 94-455, § 806 (e), 90 Stat. 1520 (codified at I.R.C. § 382, applicable to tax years beginning after June 30, 1980). For a thorough discussion of the new rules, see Eustice, *The Tax Reform Act of 1976: Loss Carryovers and Other Corporate Changes*, 32 TAX L. REV. 113 (1977).

6. Revenue Act of 1978, Pub. L. No. 95-600, § 368, 92 Stat. 2763. See STAFF OF JOINT COMM. ON TAXATION, 95TH CONG., 2D SESS., GENERAL EXPLANATION OF THE REVENUE ACT OF 1978, at 225 (Comm. Print 1979).

A bill has been introduced in the House that would delay the effective date until 1982. H.R. 5505, § 12(e), 96th Cong., 1st Sess., 125 CONG. REC. H9899, H9901 (daily ed. Oct. 30, 1979).

7. *Pollock v. Farmer's Loan & Trust Co.*, 157 U.S. 429, *rehearing*, 158 U.S. 601 (1895). "That decision is only one of many that make constitutional law an easy route to an enviable reputation for critical scholarship." L. EISENSTEIN, *THE IDEOLOGIES OF TAXATION* 18 (1961).

8. Act of Aug. 5, 1909, ch. 6, § 38, 36 Stat. 112 (repealed 1913).

9. See, e.g., *Spreckels Sugar Ref. Co. v. McClain*, 192 U.S. 397, 412-13 (1904).

10. 220 U.S. 107 (1911).

11. *Id.* at 151-52.

Now that the sixteenth amendment has buried the apportionment bugaboo as to levies on income, we openly call the section 11¹² corporate exaction an income tax. However, consideration of the tax's incidence and the implications thereof gives substantial cause for concluding that Congress was closer to the truth in 1909 when it used the title "special excise tax."

The question of who ultimately bears the corporate income tax remains frustratingly resistant to a precise answer; but this much is clear—the tax is not borne by those legal entities called corporations. Its burden rests on some or all of the following in unknown proportions: investors through a lower rate of return, employees through lower compensation, and consumers through higher prices for goods and services.¹³

The foregoing points are significant because an income tax is ordinarily conceived of as a system for defining the taxable income of the taxpayers and imposing a set of rates, usually rates that rise as taxpayer income increases. The minimum objective, often missed, is to tax equal amounts of income equally. The section 11 corporate tax does not fit within this conception of an income tax. Since the incidence of the corporate tax cannot be determined with any precision, its progressive rates¹⁴ cannot be correlated with the income levels of the ultimate payors. Even if it could be established that the corporate level tax was borne entirely by shareholders, it seems impossible to construct such a tax with generally applicable progressive rates that would correspond with the varying income levels of individual shareholders. And even if the tax were imposed as a single rate levy, with the individual income tax following the same pattern, our uncertainty over the extent to which the corporate tax was ultimately being borne by incomes below the exemption levels of the individual income tax would prevent assurance that the section 11 tax conformed to ability-to-pay notions.¹⁵

12. I.R.C. § 11.

13. J. PECHMAN, *FEDERAL TAX POLICY* 106, 111-15 (rev. ed. 1971); U.S. DEP'T OF THE TREASURY, *BLUEPRINTS FOR BASIC TAX REFORM 4* (1977); Klein, *The Incidence Of The Corporation Income Tax: A Lawyer's View Of A Problem In Economics*, 1965 *WIS. L. REV.* 576.

14. The § 11 tax now has five graduated rate brackets.

15. *TAX POLICY AND TAX REFORM: 1961-1969*, at 662 (W. Helmuth & O. Oldman eds. 1973) (testimony of Stanley S. Surrey to the Committee on Ways and Means); U.S. DEP'T OF THE TREASURY, *supra* note 13, at 68; Goode, *Corporation Income Tax Rates*, in *STAFF OF HOUSE COMM. ON WAYS AND MEANS, TAX REVISION COMPENDIUM 2281, 2285* (Comm. Print 1959); McLure, *Integration of the Personal and Corporate Income Tax: The Missing Element in Recent Tax Reform Proposals*, 88 *HARV. L. REV.* 532, 539 (1975).

The corporate tax is simply not an income tax in the same sense as the section 1¹⁶ individual income tax. The corporate tax has been blended into the income tax portions of the Internal Revenue Code; but that is the result of historical drafting decisions, not the result of the nature of the levy. The corporate income tax is what it was originally styled in 1909—an excise on doing business in corporate form.¹⁷

III. WHAT IS THE NATURE OF THE NOL CARRYOVER IN THE CORPORATE INCOME TAX?

The section 172¹⁸ NOL mechanism is commonly considered an averaging device for mitigating discrimination between taxpayers with both positive and negative income years in a given time period and taxpayers who have the same net income as the former group over the same time period but who receive it in level amounts without loss years.¹⁹ The following is a representative statement of this view:

[L]osses incurred in business now can be carried back²⁰ to the three years preceding the loss year, and then forward for the seven succeeding years, as a deduction from the positive income of each of those prior or subsequent periods. In effect, an eleven-year span is covered if one includes the loss year itself. Companies which experience fluctuating profits and losses—say a \$500 net operating loss in Year 1 followed by \$1,000 of profit in Year 2—are thus treated the same in overall terms as companies with a flat income stream, that is, with \$250 of profit in both years. Since interperiod loss-offsets are important to an equitable tax system, most would agree that the averaging period should be limited only by considerations of administrative feasibility.²¹

This quotation accurately describes the effect of section 172 on individuals. In the individual income tax, section 172 directly

16. I.R.C. § 1.

17. For an econometric study reaching the same conclusion, see Harberger, *The Corporation Income Tax: An Empirical Appraisal*, in STAFF OF HOUSE COMM. ON WAYS AND MEANS, TAX REVISION COMPENDIUM 231, 232, 239 (Comm. Print 1959).

18. I.R.C. § 172.

19. See, e.g., *Treasury Department Report on "Business Loss Offsets"* (Oct. 1947), in 1 S. SURREY, W. WARREN, P. McDANIEL & H. AULT, FEDERAL INCOME TAXATION 769, 770 (1972).

20. This Article does not discuss the carryback feature of § 172 because NOL carrybacks are not § 381(c) items. For a proposal as to the survivability of NOL carrybacks, see Metzger, *An Effective Use of Plain English—The Evolution and Impact of Section 368(a)(1)(F)*, 32 TAX LAW. 703, 740-44 (1979).

21. M. CHIRELSTEIN, FEDERAL INCOME TAXATION 199-200 (2d. ed. 1979).

mitigates discrimination between taxpayers with level incomes and taxpayers with both gain and loss years by averaging the incomes of the latter group. Since the section 1 tax on the business incomes of individuals is borne by them and not shifted to others,²² the taxpayers who directly benefit from section 172 in the individual income tax are those who suffered loss and who then would have had to pay higher taxes in the carryforward years but for section 172.

Matters are significantly different with respect to the section 11 tax. Section 172 also averages income in the corporate income tax, but only at the corporate level. The effects must then filter through the corporation to the ultimate payors of the section 11 tax. But because these ultimate payors may be changing daily, with the result that many who are investors, employees, or customers of a given corporation at the end of the carryforward period may not have been such at the time of loss or beginning of the carryforward period, the primary role of section 172 in the corporate tax cannot be averaging the incomes of the ultimate payors.²³

22. R. GOODE, *THE INDIVIDUAL INCOME TAX* 60 (rev. ed. 1976); J. PECHMAN & B. OKNER, *WHO BEARS THE TAX BURDEN?* 25, 30, 37 (1974).

23. For this reason, conclusions herein are not based on an assertion that a corporate NOL carryover is an asset which "belongs" directly to any particular group of ultimate payors of the § 11 tax. See note 25 *infra*. This raises the question of whether § 172 should be applicable to the § 11 tax at all. Analysis of the issue from the standpoint of shareholders cuts both ways.

For some shareholders, the corporate tax may produce increased burdens on corporate equity investment income, thus resulting in discrimination against the conduct of business in corporate form and in other related economic distortions. See J. PECHMAN, *supra* note 13, at 120-21; U.S. DEP'T OF THE TREASURY, *supra* note 13, at 68-69. Since § 172 mitigates these inequities and distortions by lowering the burden of the § 11 tax, this analysis indicates that § 172 should continue to be applicable to the corporate tax.

However, the § 11 tax confers a 46% maximum rate plus the opportunity to realize corporate earnings on a deferred basis at the shareholder level in the form of increased stock values taxed as capital gain. For some shareholders, this combination results in corporate investment income being taxed more lightly than other investment income. See McLure, *supra* note 15, at 537-42. As to these shareholders, the corporate income tax creates discrimination in favor of the corporate form and may produce related economic distortions. Since § 172 has the effect of lowering the § 11 tax burden, it exacerbates the discrimination in this case and increases any accompanying economic distortions. Elimination of § 172 from the corporate income tax is thus indicated under this line of argument.

This Article assumes that in spite of the foregoing conflict, § 172 will continue to be part of the § 11 tax. There seems to be no serious pressure to the contrary.

The presence of § 172 in the § 11 tax has been rationalized as a needed subsidy to business. See, e.g., H.R. REP. No. 855, 76th Cong., 1st Sess., reprinted in 1939-2 C.B. 504, 510-11. This approach, however, involves the complicated questions of whether corporate business should have a subsidy and of the relative advantages and disadvantages of tax

Having decided what the primary role of the corporate NOL carryover is not, we must now determine what it is. That matter can best be resolved by examining the principal effect of NOL carryovers in the corporate income tax. A corporation's carryover accomplishes a reduction in the corporation's section 11 tax for future years.²⁴ It has the effect of a corporate level excise tax prepayment which can be recouped from the tax liability of later periods. Viewed in this manner, a corporate NOL carryover is a prepaid business expense that, for purposes of determining the extent to which it survives a transfer of the corporation's assets or stock, should be analyzed like a corporate prepayment of utility bills or other current business costs.

IV. A RATIONALE FOR SECTION 382

Assume X Corporation carries on its books a prepayment of its electricity bill and an unused NOL carryover. If X is sold to a third party, whether the sale is taxable or tax free or whether the sale is a stock or asset transaction, the consideration should be adjusted upward to reflect the electricity prepayment. This item is clearly a corporate asset for which the shareholders would rightly expect compensation.²⁵ Should the NOL carryover be treated any differently once it is seen to be primarily a prepaid corporate excise tax?²⁶ Shouldn't it be freely transferable like other corporate assets without running the gauntlet of section 382?

expenditures—matters far beyond the scope of this Article. See Surrey, *Tax Incentives as a Device for Implementing Government Policy: A Comparison with Direct Government Expenditures*, 83 HARV. L. REV. 705 (1970).

24. Since the carryover is a deduction, the amount of tax reduction is less than the amount of the carryover and will depend upon the corporation's marginal rate for each carryover year.

25. The fact that the purchaser would not be able to deduct for income tax purposes the portion of the purchase price allocable to the prepayment or that there might be tax accounting problems with respect to the prepayment at the corporate level is irrelevant. The relevant considerations are that the prepayment will offset future electricity charges to the economic benefit of the purchaser and that the purchaser will be expected to pay the shareholders for this benefit because they control it.

26. Granted, the superficial issue here is whether the corporate NOL carryover should survive the transaction and continue to be deductible for the economic benefit of the purchaser. But the real issue is whether X Corporation's shareholders can get compensated for this prepaid expense item. The only way in which the benefit of the corporate NOL carryover can be realized as a prepayment of excise tax is through deducting the NOL from the § 11 excise tax base in future years. Thus, the purchaser will not be willing to compensate the X shareholders for this item unless assured of continued deductibility. Therefore, the question of deductibility after purchase is really a question of whether the shareholders will be allowed to sell the asset as part of the purchase transaction.

Note that this Article is not arguing that a corporate NOL carryover should be transferable other than in connection with a preservation transaction as described in the text accompanying notes 1-2 *supra*.

Various reasons have been advanced for answering this last question negatively. One commentator recently stated that the "major flaw" in suggesting that corporate NOL carryovers should be freely transferable "is that it totally distorts the purpose of the loss carryover provision," which, the commentator asserts, "was designed to average out the profits and losses of the taxpayer and not those of different taxpayers."²⁷ However, as noted above, section 172 does not play the direct income averaging role for the ultimate payors of the section 11 tax that it plays for the individual income taxpayer. Since the corporate NOL carryover has only an indirect and often negligible averaging effect on those who bear the corporate income tax, it seems better to characterize it according to its primary effect—a prepayment of a corporate excise tax.

It has also been suggested that the folly of free trade in corporate NOL carryovers would become more apparent if the matter were analyzed in terms of direct government subsidies. This argument has been made as follows:

It may be observed that the whole question of the transferability of losses arises because of the mechanism used to give some tax recognition to net losses in the usual situation. If, for example, a subsidy payment had been the mechanism chosen, so that a direct government payment in the year of loss were made, no issue of transferability of loss carryovers would arise If outsiders would not benefit in . . . [this situation], should they be allowed to benefit under the loss carryforward mechanism?²⁸

The central premise of the foregoing suggestion is that "[i]f . . . a subsidy payment had been the mechanism chosen, so that a direct government payment in the year of loss were made, no issue of transferability of loss carryovers would arise." This statement is presumably an assertion that no one would think of permitting the loss corporation to anticipate receipt of its subsidy check by selling its subsidy claim to a third party for cash in advance. But is that so? If corporate management determines that present cash is worth more than a future subsidy check, there seems nothing wrong with allowing the corporation to re-

27. Salem, *Limitations on NOL, ITC and Other Carryovers: A Suggested Reform of the 1976 Reform*, 36 N.Y.U. TAX INST. 815, 824 (1978).

28. AMERICAN LAW INSTITUTE, FEDERAL INCOME, ESTATE AND GIFT TAX STATUTE—INCOME TAX PROBLEMS OF CORPORATIONS AND SHAREHOLDERS—REPORT FOR 1957-58, at 47 (1958).

ceive its subsidy through a present discounted sale rather than waiting for the Treasury's draft.²⁹ Analysis of the corporate NOL carryover in subsidy terms seems only to strengthen the free trade argument.³⁰

It has been also asserted that since we would be intuitively outraged if individuals were allowed to sell deduction carryovers, we should be equally offended at the thought of corporations transferring NOL carryovers.³¹ That assertion involves a non sequitur. To the extent deduction carryovers are incorporated in the individual income tax to produce a more equitable income definition for the taxpayers generating the deductions, they should not be transferable to other taxpayers. To permit transfer would defeat the purpose of the carryover. But for reasons given above,³² the corporate NOL carryover's primary purpose cannot be to produce a more equitable definition of the incomes of those who ultimately bear the tax. Thus, the fact that income-defining carryovers in the individual income tax should be nontransferable does not require nontransferability of the corporate NOL carryover. Moreover, to the extent that a deduction carryover is granted for subsidy purposes in the individual income tax, analysis in the preceding paragraph indicates that it would not be outrageous to allow individuals to sell such a carryover.

Another attack is based on the assertion that free trade would give corporate NOL carryover buyers an unacceptable windfall since the price paid will usually be a fraction of the carryover's worth. The following is a prominent statement of this view:

[F]ree traffic in loss offsets would mean large windfalls for buyers. Thus, in situations where today a net loss can legally be

29. Granted, such a sale may be illegal under present law. See 31 U.S.C. § 203 (1976); Korbelt, *The Anti-Assignment Statute in the Tax Field: A Trap for the Unwary Practitioner*, 18 TAX L. REV. 473 (1963). However, Congress can easily remove this obstacle with an appropriate amendment. Furthermore, § 203 is based on considerations of administrative convenience and prevention of fraud. *Patterson v. United States*, 354 F.2d 327, 329 (Ct. Cl. 1965). Thus, it is irrelevant to the issue of whether free transferability of NOL carryovers represents sound tax policy.

30. This analysis also argues for repeal of the limitation on certain subsidy carryovers contained in I.R.C. § 383.

31. "If one taxpayer who had medical expenses which he could not deduct were to transfer those deductions, for a price, to another taxpayer who could take advantage of them on his income tax return, it would be a shocking thing. In principle, trafficking in net operating losses is no different." *Tax Reform Act of 1975: Hearings on H.R. 10612 Before the Senate Comm. on Finance*, 94th Cong., 2d Sess. 3286 (1976) (statement of Michael Waris, Jr.).

32. See text accompanying notes 18-23 *supra*.

obtained on the purchase of a corporation, according to the observations of some practitioners loss positions have been acquired for 10 to 15 cents on the dollar or less. A considerable windfall is thus present, since one dollar paid may bring up to five dollars of tax benefit. Even if restrictions were removed, buyers would still be able to purchase the losses at considerable discounts because of the weak bargaining positions of the sellers and the general business risks faced by buyers. The basic concern, in this light, would be that of cutting down on the ability of buyers to obtain these tax windfalls, rather than that of furnishing tax relief to sellers.³³

There is a strong probability, however, that the low price for carryovers results from the presence of sections 269³⁴ and 382. These sections do not create total nontransferability but do produce considerable doubt as to whether a given buyer will get full use of an NOL carryover. In that situation it is perfectly reasonable to find buyers paying heavily discounted prices.³⁵ The inevitable result is that buyers who successfully penetrate sections 269 and 382 reap substantial windfalls. If our concern is to mitigate this windfall feature, making section 382 more rigorous is not the indisputable answer. A perfectly rational course would be to make NOL carryovers freely transferable and thus remove the discount arising from uncertainty. The extent to which buyers would still be able to command discounts because of distress

33. ALI PROJECT, *supra* note 3, at 341-42.

34. I.R.C. § 269(a) provides:

(a) 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 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 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.

35. ALI PROJECT, *supra* note 3, at 339; Aidinoff, *Utilization of Acquired Net Operating Loss Carryovers and the Tax Reform Act of 1976—A Face-Lift for Section 382*, 55 TAXES 874, 887 (1977).

positions of sellers under this alternative would result from the business reality that distress sales of any item usually bring a lower price unless there is a free and active market to minimize the distress element.³⁶

The only compelling argument against free trade in corporate NOL carryovers is one of practical politics. If the national conscience is not offended by free trade in utility prepayments, it ought not to be outraged by trafficking in corporate NOL carryovers.³⁷ However, public attitudes are matters of fact, not reason; and there is considerable evidence that Americans view corporate NOL carryovers as being different from utility prepayments regardless of whether to do so is rational. This point has been stated as follows:

[T]his view of freedom to sell loss offsets . . . does appear to many as partaking of tax immorality. It would be difficult to rationalize as a bona fide and regular part of the business world the acceptance of the methodical purchase and sale of corporate shells because of their loss offsets³⁸

Thus it appears necessary to limit the transferability of corporate NOL carryovers in order to foster within the public the feelings of confidence and goodwill essential to sustaining a self-assessment income tax system.³⁹

This observation leads to troubling conclusion for those en-

36. This is as good a place as any to state that restrictions on transfers of corporate NOL carryovers have been advocated as inhibitors of undesirable economic concentration. ALI PROJECT, *supra* note 3, at 342. But there is an effective rebuttal to this argument:

[I]t seems unlikely that a revenue act can be adequately selective by its terms to encourage the reorganizations which will result in growth, and to discourage those which will have monopolistic or other economically unfortunate tendencies [I]t would seem better to obtain enforcement of the antitrust and related statutes by reliance upon those agencies of Government which are responsible in that area and which presumably can make intelligent differentiation between transactions according to standards relevant to the statutes they are charged with administering and enforcing.

Brown, *An Approach to Subchapter C*, in STAFF OF HOUSE COMM. ON WAYS AND MEANS, TAX REVISION COMPENDIUM 1619, 1622 (Comm. Print 1959).

37. The foregoing analysis also indicates that the principal purpose for which a business combination was effected should have no bearing on the survivability of an NOL carryover (except to the extent preservation depends on the combination transaction being treated as a tax-free reorganization so that the business purpose requirement is applicable, (Treas. Reg. § 1.368-1(c) (1955)) and that § 269 should be inapplicable to the preservation issue.

38. ALI PROJECT, *supra* note 3, at 341.

39. An alternative would be an attempt by the business community to create a favorable public attitude concerning free trade in corporate NOL carryovers. The chance of success seems slim.

amored with logical solutions.⁴⁰ It suggests that all attempts to produce a section 382 flowing harmoniously from the structure and assumptions of the income tax or embodying some external standard derived from reason as to when corporate NOL carryovers should be transferable are fruitless. There is nothing inherent in the nature of the section 11 tax or in logic which requires limitations on the transferability of corporate NOL carryovers. The "reform" of section 382 is a sociopolitical problem. The limitations on survivability of NOL carryovers lack a firm basis in logic. They have been imposed because of the political demands of noncorporate taxpayers. This suggests that the objective or rationale of any section 382 revision must be the creation of limitations that go far enough to satisfy the great body of "ordinary" taxpayers while doing as little damage as possible to the orderly progress of commerce.⁴¹

V. WHITHER SECTION 382?

The 1976 Tax Reform Act (TRA) version of section 382 fails this standard. It increases the difficulty of transferring corporate NOL carryovers and the complexity and uncertainty of the law without any hard evidence of public demand for change.⁴² A move in the direction of pre-1976 law would be appropriate.⁴³

Congress should not totally return to the pre-1976 version of section 382, however. For instance, the business continuation rule⁴⁴ of old section 382(a) had the potential for inhibiting the purchasers of a failing business from restructuring it.⁴⁵ Elimination of this rule by the 1976 TRA was sound. But since removal of the business continuation rule makes the law more stringent when increased rigor is not desired, some mitigating tradeoff is needed. An appropriate solution would be to change the 50% rule of old section 382(a) to an 80% rule, while returning to the old 20%

40. It also irritates lawyers and academicians by diminishing the importance of their expertise.

41. This suggestion that the proper structure of § 382 is a political question is not a radical view. Questions as fundamental to our income tax system as whether it should be progressive and how progressive should it be are matters which can be ultimately resolved only by reference to the political process. See L. EISENSTEIN, *THE IDEOLOGIES OF TAXATION* 33 (1961).

42. See Aidinoff, *supra* note 35, at 886-87; Salem, *supra* note 27, at 815, 819.

43. Since there was never any significant evidence of public concern regarding I.R.C. § 383 carryover items, that provision, which applies § 382 restrictions to certain corporate tax credits, foreign taxes, and capital losses, could well be abolished.

44. See note 4 *supra*.

45. ALI PROJECT, *supra* note 3, at 339; Salem, *supra* note 27, at 825-26.

rule in the case of section 382(b).⁴⁶ This would balance the loss of the advantages of the business continuation rule of section 382(a), move back towards the principal features of the pre-1976 law, and create consistency between the percentage tests of sections 382(a) and (b).

The old section 382(a) was also objectionable in that a minute encroachment on its percentage test could result in the complete loss of the NOL carryover. The graduated "scale down" concept of the new section 382(a)(2) is an improvement that should be retained.

The new section 382 removes *Libson Shops, Inc. v. Koehler*⁴⁷ from the law applicable to corporate NOL carryovers.⁴⁸ Internal Revenue Service concessions had left *Libson Shops* with only limited viability anyway,⁴⁹ and eradication of the remainder of its uncertain reach will add something to the law's certainty⁵⁰ without a major change in coverage. This feature of the 1976 TRA should be retained.

Finally, the legislative history of the new section 382 reduces the influence of section 269 on transferability of corporate NOL carryovers but does so in language that makes the extent of the reduction uncertain.⁵¹ Although its potency has increased in re-

46. As originally passed, § 382(b) "was applicable only to changes of ownership through a tax-free reorganization, under which the carryover [was] reduced proportionately if the old owners receive[d] less than 20 percent of the stock of the reorganized corporation and [was] eliminated if they received none." B. BITTKER & J. EUSTICE, *supra* note 2, ¶ 16.22, at 16-54. The 1976 TRA increased the 20% figure to 40%. *Id.* § 16.24, at 16-74.

47. 353 U.S. 382 (1957). In *Libson Shops* 16 separately incorporated retail stores were merged into a single corporation. Three of the premerger corporations had NOL carryovers which the postmerger corporation wished to offset against its postmerger profits. The retail activities of the three corporations which had generated the NOL carryovers continued to be unprofitable after the merger. Consequently, the only postmerger income from which the carryovers could be deducted was that produced by the 13 profitable operations. The Supreme Court concluded that "petitioner is not entitled to a carry-over since the income against which the offset is claimed was not produced by substantially the same businesses which incurred the losses." *Id.* at 390. The meaning and reach of this decision have never been adequately clarified. See generally B. BITTKER & J. EUSTICE, *supra* note 2, ¶ 16.26.

48. STAFF OF JOINT COMM. ON TAXATION, 94TH CONG., 2D SESS., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1976, at 202 (Comm. Print 1976).

49. See Rev. Rul. 63-40, 1963-1 C.B. 46; Rev. Rul. 58-603, 1958-2 C.B. 147; IRS Tech. Info. Release No. 773 (Oct. 13, 1965).

50. See B. BITTKER & J. EUSTICE, *supra* note 2, ¶ 16.26, at 16-94 to -95.

51. S. REP. No. 938, 94th Cong., 2d Sess. 206, reprinted in [1976] U.S. CODE CONG. & AD. NEWS 3439, 3638:

The Committee has not amended section 269 of present law because the application of this general disallowance provision should be retained for transac-

cent years, section 269 has historically not been a major weapon against transfers of corporate NOL carryovers.⁵² Nevertheless, it adds an element of unpredictability to tax planning for corporate acquisition transactions. If Congress excised the remainder of section 269 from this area, it would make the law more certain without removing a major historical barrier.

The political rationale suggested earlier for section 382 can certainly be served by statutory configurations different from the one given above. However, a return to old section 382 with the foregoing modifications would satisfy the political rationale while resulting in a provision with contours similar to those which taxpayers and practitioners have learned to live with since 1954.

tions not expressly within the fixed rules as changed by the amendment. Section 269 is retained, for example, to deal with "built-in loss" transactions and other exchanges or transfers which are apparent devices to exploit continuing gaps in the technical rules for tax avoidance purposes. The committee believes, however, that section 269 should not be applied to disallow net operating loss carryovers in situations where part or all of a loss carryover is permitted under the specific rules in section 382, unless a device or scheme to circumvent the purpose of the carryover restrictions appears to be present.

52. ALI PROJECT, *supra* note 3, at 345; B. BITTKER & J. EUSTICE, *supra* note 2, ¶ 16.21, at 16-45 to -46, ¶ 16.22, at 16-53.