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Applicability of the "Libson Shops Rationale" under 1954 Code Cases

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A recent article in the "Quarterly" by this author expressed the fear that the Internal Revenue Service and the courts would continue to apply the "Libson Shops Doctrine" to 1954 Code cases even though the Libson case was decided under the 1939 Code.

In summary, the Libson Shops decision held that a corporation's net operating loss carryovers would survive a corporate liquidation or merger only when there was a continuity of business enterprise. This decision was handed down by the Supreme Court in 1957 and there has been considerable discussion as to the real meaning of the Court's language.

Recent months have brought a fulfillment of the expected application of "Libson" to 1954 Code cases. As might be expected, the Treasury Department has jumped in with both feet and pronounced in T.I.R. 773 that it will continue to invoke Libson Shops in certain 1954 Code cases. This T.I.R. states that Libson will be applied where there has been a change in business coupled with a 50% or more change in "beneficial ownership". The Treasury is thus enlarging the Code by using the phrase "beneficial ownership" instead of the definition of ownership under Section 382.

Further, the IRS says it will also use its broad powers under Section 269 and under Section 482 to reallocate income if this seems an appropriate way to eliminate trafficking in loss corporations.

Early action by the Courts on 1954 Code cases went along with the IRS. In Maxwell Hardware Company, 41 T.C. 386, the corporation had sustained losses in the hardware business. The hardware operations were discontinued after the corporation entered the real estate development business, the funds for such new operation being furnished by the issuance of non-voting preferred stock to the former owners of the real estate. The value of this preferred stock was two-fifths of the value of the common stock. The operating losses suffered in the hard-

A supplement to an article on net operating loss carry-overs of affiliated corporations which appeared in The Quarterly *in September.*

ware business were then used to offset the profits of the real estate operations.

The Tax Court relied upon the decision of the Supreme Court in Libson Shops using the following language, "We conclude 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". It is interesting to note that in the Maxwell case, the Commissioner, the Tax Court and petitioner all agreed that if Libson Shops had arisen under the 1954 Code, the same decision could not have been made since Section 381 of the 1954 Code would expressly allow the net operating loss carryover and the limitations of Section 382 would be inapplicable.

The Ninth Circuit Court of Appeals has reversed the Tax Court in Maxwell (343 F. 2d 713) using very clear and precise language. The Tax Court had already disposed of most of the Government's contentions and found that the net operating loss carryover could not be disallowed under Section 382, Section 269 or Section 482. This is highly important since the entire decision by the Circuit Court pertains to the applicability of Libson Shops to 1954 Code cases. The Court stated, "Libson Shops, decided under the 1939 Act, *is no longer law*. It has been superseded by the 1954 Internal Revenue Code which, in Section 382, *dealt specifically and differently* with the concept of continuity of business enterprise upon which the Libson Shops decision was based." (Underscoring supplied)

The Court went into considerable detail explaining that Congress, after years of thorough and careful committee consideration, adopted specific limitations on net operating loss carryovers and that it was not the intention of Congress that such provisions be disregarded by the Courts.

A more recent case, Clarksdale Rubber Company, 45 TC No. 22, decided by the Tax Court itself, appears to add weight to the Circuit Court's reversal of the Tax Court's decision in Maxwell. In summary, Clarksdale suffered losses in the manufacture of rubber products, the stock was sold and for a time the operations were transferred to a sister corporation. After about three years the operations were transferred back to Clarksdale. The earlier losses were then used to offset the currently profitable operations. The IRS once again attempted to apply Libson Shops.

The Tax Court allowed the carryovers but was not as specific or emphatic as the Ninth Circuit as to the inapplicability of Libson to 1954 Code cases. In fact, the Tax Court stated that the facts in Clarksdale and Libson were entirely different, leaving the impression that they might have applied Libson if the facts had been similar. The Tax Court expressed its belief that where a "change in ownership" under Section 382 has come to pass, the definition of "change in business" under the same section should exclusively govern the right to use the net operating loss carryover. When the "change in ownership" test is not met, the Tax Court indicated that it still has the right to apply Libson Shops.

In summary, it appears the Government will continue to apply the "Libson Shops" rationale whenever and wherever possible. The Tax Court may or may not apply it, and the highest Court to rule on the issue to date, the Ninth Circuit, has indicated that it will definitely and emphatically not apply the rationale. It is quite probable that this question will be brought before other Circuit Courts and unless unanimity develops, it may well be decided by the Supreme Court.

At this point, taxpayers do have the knowledge that one circuit court has decided wholeheartedly in their favor. Unfortunately, the favorable decisions will not deter the IRS so any taxpayer facing a situation which is subject to challenge under "Libson Shops" should be prepared for battle.