Corporate Taxation - Net Operating Loss Carryovers Do Not Make Otherwise Worthless Stock Valuable in the Hands of the Corporate Shareholder

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CORPORATE TAXATION—NET OPERATING LOSS CARRYOVERS DO NOT MAKE OTHERWISE WORTHLESS STOCK VALUABLE IN THE HANDS OF THE CORPORATE SHAREHOLDER.

Textron, Inc. v. United States (1st Cir. 1977)

Textron, Inc. (Textron) was the sole shareholder and major creditor of Hawaiian Textron, Inc. (Hawaiian), 1 a subsidiary corporation which had suffered a series of substantial operating losses since its acquisition by Textron in 1957. 2 After creditors had foreclosed on Hawaiian’s principal asset, 3 Textron claimed worthless stock and bad debt deductions on its 1959 federal income tax return pursuant to section 165(g)(3) 4 and section 166(a)(1) 5 of the Internal Revenue Code (Code). 6

1. Textron, Inc. v. United States, 418 F. Supp. 39, 41 (D.R.I. 1976), aff’d, 561 F.2d 1023 (1st Cir. 1977). As of June 2, 1959, Textron’s total investment in Hawaiian consisted of the following:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Basis of Hawaiian stock</td>
<td>$1,259,714.67</td>
</tr>
<tr>
<td>Basis of Hawaiian notes</td>
<td>2,725,724.63</td>
</tr>
<tr>
<td>Accrued and unpaid interest</td>
<td>213,374.61</td>
</tr>
<tr>
<td>Open account advances</td>
<td>1,646,376.78</td>
</tr>
<tr>
<td>Expenses paid on behalf of Hawaiian</td>
<td>85,000.00</td>
</tr>
<tr>
<td>Unamortized expenses in connection</td>
<td></td>
</tr>
<tr>
<td>with investment in Hawaiian’s assets</td>
<td>41,541.47</td>
</tr>
</tbody>
</table>

Total: $5,971,732.16

418 F. Supp. at 42-43. 2. 418 F. Supp. at 42. Hawaiian was in the business of running a single passenger ship, the Leilani, between Hawaii and the west coast of the United States. 3. Id. After foreclosure on the Leilani, Hawaiian’s only assets were a nominal amount of cash, accounts receivable, and office furniture. 4. Id. As of June 6, 1959, its total assets as shown in its books were $139,000, while its liabilities to creditors other than Textron amounted to $1,254,000. 5. Id. Hawaiian owed Textron $4,585,476.02 in unpaid debt and accrued interest. 6. I.R.C. § 165(g)(3) (amended 1971). Section 165(g)(1) of the Internal Revenue Code, I.R.C. § 165(g)(1), the general provision governing worthless stock deductions, provides that “[i]f any security which is a capital asset becomes worthless during the taxable year, the loss resulting therefrom shall . . . be treated as a loss from the sale or exchange, on the last day of the taxable year, of a capital asset.” Id.

Both the former version of § 165(g)(3) and the amended version, which applies to taxable years beginning on or after January 1, 1970, provide that “any security in a corporation affiliated with a taxpayer which is a domestic corporation shall not be treated as a capital asset.” Id. § 165(g)(3) (amended 1971). Prior to its amendment, this subsection further provided that such a corporation would be treated as affiliated with the taxpayer only if

(A) at least 95 percent of each class of its stock is owned directly by the taxpayer, and
(B) more than 90 percent of the aggregate of its gross receipts for all taxable years has been from sources other than royalties, rents (except rents derived from rental of properties to employees of the corporation in the ordinary course of its operating business), dividends, interest (except interest received on deferred purchase price of operating assets sold), annuities, and gains from sales or exchanges of stocks and securities.

Id. § 165(g)(3)(A), (B) (amended 1971). Subparagraph (A) was amended by the Act of Jan. 12, 1971, Pub. L. No. 91-687, § 1, 84 Stat. 2071. To be treated as an affiliated corporation under this amendment, the taxpayer must directly own at least 80% of the voting power of all classes of the corporation’s stock and at least 80% of each class of the corporation’s nonvoting stock. I.R.C. § 165(g)(3)(A). For a discussion of I.R.C. § 165(g), see notes 15-19 and accompanying text infra.

5. I.R.C. § 166(a)(1). The general rule of § 166(a)(1) provides that a deduction shall be allowed for “any debt which becomes worthless within the taxable year.” Id. To determine the
In 1960, after completing a search begun in 1958 for a new business for Hawaiian, Texttron changed Hawaiian's name to Bell Aerospace Corporation (Bell) and provided the subsidiary with funds to purchase the assets of a profitable business. The Internal Revenue Service (IRS) subsequently permitted Bell to offset the income of the newly acquired business on its federal income tax return by carrying forward Hawaiian's net operating losses (NOL's), pursuant to section 172 of the Code. The IRS, however, limited the amount of the deduction allowed under this provision, the basis is the adjusted basis provided in I.R.C. § 1011 for determining the loss from the sale or other disposition of property. Id. § 166(b). Partially worthless debts may also be deducted to the extent of worthlessness within the taxable year. Id. § 166(a)(2). It is further provided that § 166 "shall not apply to a debt which is evidenced by a security as defined in section 165(g)(2)(C)." Id. § 166(e). For a definition of an I.R.C. § 165(g)(2)(C) security, see note 16 infra. For a discussion of I.R.C. § 166, see text accompanying notes 31-34 infra.

6. 418 F. Supp. at 43.
7. Id.
8. Id.
9. Id. The IRS initially disallowed Bell's attempt to offset its income with the loss carryover generated by Hawaiian. Id. The IRS' reluctance to allow the deduction resulted from the confusion created by the Supreme Court's decision in Libson Shops v. Koehler, 353 U.S. 382 (1957). The Libson Shops Court held that a business could utilize its net operating loss carryovers to offset the current year's income, but only to the extent that such income was derived from the operation of substantially the same business in which the losses occurred. Id. at 386. In 1963, however, the IRS changed its position, and announced that the Libson Shops doctrine did not apply to the use by a single corporation of its own NOL carryovers against the income of a newly acquired business in the absence of any substantial intervening change of stock ownership. Rev. Rul. 63-40, 1963-1 C.B. 46. Accordingly, in the instant case, the disallowance was reversed and Bell was allowed a deduction in the amount of $6,745,025.35. 418 F. Supp. at 43. For a further discussion of the Libson Shops doctrine and its viability, see note 118 infra.

10. I.R.C. § 172. Section 172 provides in pertinent part:
(a) Deduction allowed
There shall be allowed as a deduction for the taxable year an amount equal to the aggregate of (1) the net operating loss carryovers to such year, plus (2) the net operating loss carrybacks to such year. . . .
(b) Net operating loss carrybacks and carryovers
(1) Years to which loss may be carried
(A)(i) Except as [otherwise] provided . . . , a net operating loss for any taxable year ending after December 31, 1957, shall be a net operating loss carryback to each of the 3 taxable years preceding the taxable year of such loss. . . .
(B) Except as [otherwise] provided . . . , a net operating loss for any taxable year ending after December 31, 1957, shall be a net operating loss carryover to each of the 5 taxable years following the taxable year of such loss. Except as [otherwise] provided . . . , a net operating loss for any taxable year ending after December 31, 1975, shall be a net operating loss carryover to each of the 7 taxable years following the taxable year of such loss.
. . . .
(2) Amount of carrybacks and carryovers
Except as [otherwise] provided . . . , the entire amount of the net operating loss for any taxable year (hereinafter in this section referred to as the "loss year") shall be carried to the earliest of the taxable years to which (by reason of subparagraph (1)) such loss may be carried. The portion of such loss which shall be carried to each of the other taxable years shall be the excess, if any, of the amount of such loss over the sum of the taxable income for each of the prior taxable years to which such loss may be carried.
. . . .
(c) Net operating loss defined
For purposes of this section, the term "net operating loss" means the excess of the deductions allowed by this chapter over the gross income. Such excess
disallowed the worthless stock and bad debt deductions claimed by Textron in 1959.\textsuperscript{11} In Textron's suit for refund, the United States District Court for the District of Rhode Island rejected the Government's claim that since the corporate shell had continuing value as a potential source of NOL carryovers, Hawaiian's stock and debt were not worthless.\textsuperscript{12} Consequently, the court awarded a refund to Textron for its 1959 taxable year.\textsuperscript{13} On appeal, the United States Court of Appeals for the First Circuit affirmed,\textsuperscript{14} holding that a parent corporation is entitled to worthless stock and bad debt deductions with respect to its insolvent subsidiary, notwithstanding the subsidiary's subsequent deduction of NOL's generated by its former business. \textit{Textron, Inc. v. United States}, 561 F.2d 1023 (1st Cir. 1977).

Section 165(g) of the Code\textsuperscript{15} permits a taxpayer to claim a capital loss deduction when any security,\textsuperscript{16} including stock, becomes worthless during the taxable year in which the deduction is claimed.\textsuperscript{17} The section also allows an ordinary loss deduction where corporate securities are held by an affiliated corporation owning a certain percentage of stock in a worthless corporation.\textsuperscript{18}

\textit{Textron, Inc. v. United States}, 561 F.2d 1023 (1st Cir. 1977).

\textbf{Footnotes:}

\textsuperscript{11} 418 F. Supp. at 43.

\textsuperscript{12} Id. at 39. The district court held that where a subsidiary's stock has no fair market value, the losses on the stock and debt obligation are deductible by the parent corporation. Id. at 46. It should be noted that the Government made the same argument on appeal to the First Circuit. 561 F.2d at 1024.

\textsuperscript{13} 418 F. Supp. at 48. The refund amounted to $3,706,028.03 plus statutory interest. Id.

\textsuperscript{14} Textron, Inc. v. United States, 561 F.2d 1023, 1027 (1st Cir. 1977). Chief Judge Coffin, joined by Judge Campbell, wrote the majority opinion, while Judge Bownes, sitting by designation, wrote a dissenting opinion.

\textsuperscript{15} I.R.C. § 165(g).

\textsuperscript{16} Security is defined in I.R.C. § 165(g)(2) as follows:

(A) a share of stock in a corporation;

(B) a right to subscribe for, or to receive, a share of stock in a corporation; or

(C) a bond, debenture, note, or certificate, or other evidence of indebtedness, issued by a corporation or by a government or political subdivision thereof, with interest coupons or in registered form.

\textsuperscript{17} Id. § 165(g)(1). For the text of § 165(g)(1), see note 4 supra. In order to qualify under this section for a deduction in an amount equal to the cost or other basis of the taxpayer's stock, the taxpayer has the burden of proving not only that his stock is worthless, but also that it became worthless in the year in which the deduction is claimed. Boehm v. Commissioner, 326 U.S. 287, 291 (1945); Eagleton v. Commissioner, 97 F.2d 62, 63-64 (8th Cir. 1938); Lincoln Bank & Trust Co. v. Commissioner, 51 F.2d 78, 80 (6th Cir. 1931), cert. denied, 285 U.S. 548 (1932); Treas. Reg. § 1.165-1(a), (b) (1960). To satisfy the latter requirement, the taxpayer must show that the stock had not lost its value at a time prior to the taxable year. [1973] 27-3d Tax MNGM'T (BNA) A-102. To satisfy the former requirement, the taxpayer must show that the corporation's liabilities exceed its assets, and that an identifiable event has transpired which eliminated the company's present and future business potential. \textit{Id.} See also notes 23, 24, 27 & 28 and accompanying text infra.

\textsuperscript{18} I.R.C. § 165(g)(3). For a discussion of the current version of § 165(g)(3) and its amendments, see note 4 supra. The purpose of this deduction is to more closely approximate the treatment that would have been accorded to the loss had it been incurred directly by the parent corporation. B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS 4-39 (3d ed. 1971) [hereinafter cited as BITTKER & EUSTICE].
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While neither the Code nor the regulations provide much guidance in determining worthlessness,19 courts generally have rested decisions upon a practical and flexible evaluation of "all pertinent facts and circumstances . . . regardless of their objective or subjective nature."20 For example, courts have examined such factors as the taxpayer's motivation in declaring his securities worthless and the value of the business as reflected by its balance sheet.22 Moreover, the presence or absence of such identifiable events as discontinuance or abandonment of the business,23 and sale or foreclosure of substantially all the assets have been considered to be condition precedents to recovery.24

In the oft-quoted Sterling Morton25 decision, the Board of Tax Appeals26 ruled that "stock may not be considered as worthless even when having no liquidating value if there is a reasonable hope and expectation that it will become valuable at some future time."27 Whether the taxpayer has a reasonable expectation that the stock will ultimately become valuable may turn, according to some courts, upon the continued operation of the corpora-

19. While § 165(g) does not define the term "worthless," the regulations suggest that stock is not worthless if it has "any recognizable value on the date claimed as the date of loss." Treas. Reg. § 1.165-4 (1960). Moreover, partial worthlessness or mere diminution in market value does not give rise to a deduction for worthlessness. Id.; § 1.165-5(f) (1960). See also Walter H. Goodrich & Co., 40 B.T.A. 960 (1939).


21. The Ninth Circuit has emphasized subjective motive as a factor, stating that the test should be whether a "prudent purchaser in an arms length transaction [would] have regarded the stock in this enterprise as representing any equity at all.” Ainsley Corp. v. Commissioner, 332 F.2d 555, 557 (9th Cir. 1964).


23. See, e.g., Kirby v. Commissioner, 102 F.2d 115, 116-17 (5th Cir. 1939), rev'd 35 B.T.A. 578 (1937); Industrial Rayon Corp. v. Commissioner, 94 F.2d 383, 383-84 (6th Cir. 1939); American Steel & Pump Corp. 21 T.C.M. (CCH) 109, 115 (1962). Cf. Gilbert H. Pearsall, 10 B.T.A. 467 (1928) (acts indicating abandonment of hope with regard to the company's future prospects considered an important factor in determining worthlessness).


25. 38 B.T.A. 1270 (1938), aff'd, 112 F.2d 320 (7th Cir. 1940).


27. 38 B.T.A. at 1278. The Board of Tax Appeals further noted that "such hope and expectation may be foreclosed by the happening of certain [identifiable] events." Id. It continued:

The ultimate value of stock, and conversely its worthlessness, will depend not only on its current liquidating value, but also on what value it may acquire in the future through the foreseeable operations of the corporation. Both factors of value must be wiped out before we can definitely fix the loss. If the assets of the corporation exceed its liabilities, the stock has liquidating value. If its assets are less than its liabilities but there is a reasonable hope and expectation that the assets will exceed the liabilities of the corporation in the future, its stock, while having no liquidating value, has a potential value and can not be said to be worthless. The loss of potential value, if it exists, can be established ordinarily . . . only by some "identifiable event" in the corporation's life which puts an end to such hope and expectation.

Id. at 1278-79. See also Miami Beach Bay Shore Co. v. Commissioner, 136 F.2d 408, 409 (5th Cir. 1943).
tion's existing business. For stock to be deemed worthless, a taxpayer must demonstrate only a reasonable expectation that the stock will not subsequently acquire value.

The determination of whether a debt is "bad" has involved the application of judicial standards similar to those employed in determining the worthlessness of a security. Section 166, which is analogous to section 165 of the Code, allows wholly worthless debts to be deducted as ordinary losses. The Code's treatment of bad debts, however, differs from that of worthless securities in two respects. First, section 166 permits a deduction for debts which are partially as well as wholly worthless. Second, section

28. For example, in Nelson v. United States, 131 F.2d 301 (8th Cir. 1942), the Eighth Circuit stated:

Neither the existence of a balance sheet of the corporation showing no equity for the stockholders, nor the appointment of a receiver, the appointment of a trustee in reorganization proceedings, nor the adoption of a resolution by the board of directors of a corporation providing for the liquidation is decisive upon the question of the worthlessness of stock where the evidence also establishes the existence of a potential value which may be realized on liquidation or through continuation of business. Id. at 302-03 (citations omitted) (emphasis added). See also Steadman v. Commissioner, 424 F.2d 1 (6th Cir.), cert. denied, 400 U.S. 869 (1970).

In a recent Revenue Ruling, the IRS gave further support to this principle when it found that a taxpayer's stock in a corporation had potential value. Rev. Rul. 77-17, 1977-1 C.B. 44, 46. The IRS declared that the stock in question was not worthless because of a reasonable prospect that the corporation would be reorganized and the corporation's assets included two subsidiary corporations in sound financial condition. Id.

29. See United States v. S.S. White Dental Mfg. Co., 274 U.S. 398, 401-03 (1927). As the Supreme Court stated in White Dental, "[t]he Taxing Act does not require the taxpayer to be an incorrigible optimist." Id. at 403.

30. The Board of Tax Appeals has defined a "worthless" debt as one "destitute of worth: having no value; valueless; useless." Higginbotham-Bailey-Logan Co. v. Commissioner, 8 B.T.A. 566, 578 (1927) (citation omitted). As with worthless stock, lack of potential value also falls within the definition of "worthlessness." See George E. Warren Corp. v. United States, 141 F. Supp. 935 (Ct. Cl. 1956); Herbert W. Dustin, 53 T.C. 491, 501 (1969), aff'd, 467 F.2d 47 (9th Cir. 1972).

The burden of proving worthlessness can generally be met by showing that some identifiable event has occurred which effectively demonstrates the absence of potential value. See, e.g., Ensley Bank & Trust Co. v. United States, 154 F.2d 968, 970 (5th Cir.), cert. denied, 329 U.S. 732 (1946). See text accompanying notes 23 & 24 supra. It should be noted that insolvency alone does not establish worthlessness. LeLandais v. Commissioner, 35 T.C.M. (CCH) 1580, 1583 (1976). The taxpayer must also prove that objective facts indicating worthlessness have transpired. See, e.g., Denver & Rio Grande W.R.R., 32 T.C. 43, 56 (1959), aff'd, 279 F.2d 368 (10th Cir. 1960); Elmar Ott, 26 T.C.M. (CCH) 540, 543 (1967). See also Treas. Reg. § 1.166-2(a) (1959) (suggesting that proof of worthlessness may turn on such objective facts as the value of the collateral securing the debt and the financial condition of the debtor). Cf. Sterling Morton, 38 B.T.A. 1270 (1938), aff'd, 112 F.2d 320 (7th Cir. 1940) (subjective factors also considered). A history of recurring losses, however, is not in itself sufficient to establish worthlessness. Max E. Riley, 26 T.C.M. (CCH) 436 (1967). In the case of a going concern, insolvency or lack of value of security may be only temporary, since circumstances may change and debts that would be wholly worthless if the debtor were presently liquidated may acquire some value in the foreseeable future. Rev. Rul. 71-37, 1971-1 C.B. 78. See Herbert W. Dustin, 53 T.C. 491, 502-03 (1969), aff'd, 467 F.2d 47 (9th Cir. 1972).

31. I.R.C. § 166.
32. Id. § 165.
33. Id. § 166(a)(1). For a summary of § 166(a)(1), see note 5 supra.
34. I.R.C. § 166(a)(2). For a summary of § 166(a)(2), see note 5 supra.
111, the codification of the tax benefit rule, provides that any amount attributable to the recovery during the taxable year of a bad debt which was allowed as a deduction from gross income in a prior taxable year must be included in gross income for the taxable year of recovery.

In addition to the provisions allowing deductions for worthless securities and bad debts, section 172 of the Code permits the deduction of certain business related operating losses, which are termed net operating losses, incurred by the taxpayer. Generally, a NOL generated by a corporate taxpayer in a taxable year may be carried back and applied against the gross income of the taxpayer for three preceding taxable years and, if the loss is not fully utilized, it may be carried forward and applied against the gross income of the taxpayer for seven succeeding taxable years. This statutory scheme thus permits a corporate taxpayer with fluctuating income to average his profits and losses to some extent.

35. I.R.C. § 111. Section 111 provides in pertinent part:
   (a) General rule
   Gross income does not include income attributable to the recovery during the taxable year of a bad debt, prior tax, or delinquency amount, to the extent of the amount of the recovery exclusion with respect to such debt, tax, or amount.
   (b) Definitions
   For purposes of subsection (a)—
   (1) Bad debt
   The term "bad debt" means a debt on account of the worthlessness or partial worthlessness of which a deduction was allowed for a prior taxable year.
   (2) Prior tax
   The term "prior tax" means a tax on account of which a deduction or credit was allowed for a prior taxable year.
   (3) Delinquency amount
   The term "delinquency amount" means an amount paid or accrued on account of which a deduction or credit was allowed for a prior taxable year and which is attributable to failure to file return with respect to a tax, or pay a tax, within the time required by the law under which the tax is imposed, or to failure to file return with respect to a tax or pay a tax.
   (4) Recovery exclusion
   The term "recovery exclusion," with respect to a bad debt, prior tax, or delinquency amount, means the amount, determined in accordance with regulations prescribed by the Secretary, of the deductions or credits allowed, on account of such bad debt, prior tax, or delinquency amount, which did not result in a reduction of the taxpayer's tax under this subtitle . . . reduced by the amount excludable in previous taxable years with respect to such debt, tax, or amount under this section.

Id.


37. I.R.C. § 111(a). For the text of § 111(a), see note 35 supra.

38. For the text of § 172, see note 10 supra.

39. I.R.C. § 172(b)(1)(A), (B). For the text of § 172, see note 10 supra.

40. See I.R.C. § 172(b)(1)(A), (B). For the text of § 172, see note 10 supra. If the loss is not fully deducted within the statutory period, it expires. See I.R.C. § 172(b)(1)(A), (B).

To insure that the benefits conferred by section 172 would not be abused, Congress enacted sections 269 and 382 of the Code. As cur-

42. See BITTKER & EUSTICE, supra note 18, at 15-5 to 16-6. It formerly was common practice for a corporation with no assets and a history of losses to be purchased for its tax attributes, the new owners gaining the tax benefit of applying the old losses against the profits of a completely unrelated business. Id. See generally D. SMITH, FEDERAL TAX REFORM 224-25 (1962). The practice of buying or selling a corporation having NOL carryovers which are to be used to shelter income from another source is generally termed “trafficking.” See BITTKER & EUSTICE, supra note 18, at 16-5.

43. I.R.C. § 269. Section 269(a) of the Code, id. § 269(a), provides in pertinent part:

(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 . . . ,

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.

Id. “Acquisition of control” does not include the revival of an existing, owned corporation. Challenger, Inc., 23 T.C.M. (CCH) 2096, 2112 (1964).

Congress enacted the predecessor of § 269 in order to prevent the distortion through tax avoidance of the deduction, credits, or allowance provisions of the code, particularly those of the type represented by the recently developed practice of corporations with large excess profits (or the interests controlling such corporations) acquiring corporations with current, past, or prospective losses or deductions, deficits, or current or unused excess profits credits, for the purpose of reducing income and excess profits taxes.


For a further discussion of § 269, see Adelman, Recent Cases Increasingly Extend Section 269 to Disallow Post-Acquisition Operating Losses, 17 J. TAX. 282 (1962); Feder, The Application of Section 269 to Corporations Having Net Operating Loss Carriers and Potential Losses, 21 N.Y.U. INST. ON FED. TAX. 1277 (1963); McDonald, Acquisitions Made to Evoke or Avoid Income Tax, 14 S. CAL. TAX INST. 435 (1962); Milefsky, Utilization of Acquired Corporate Loss Carriers, 3 J. CORP. TAX 28, 44-53 (1976); Peterson, Corporate Acquisitions for Tax Avoidance Purposes: The Ever-Tightening "Loophole," 19 J. TAX. 322 (1963).

44. I.R.C. § 382 (amended 1976). Section 382(a) of the Code, id. § 382(a) (amended 1976), provides that a corporation's NOL carryovers are extinguished where, within a two-year period any one or more of the ten largest shareholders of the loss corporation has increased their ownership by 50% or more by “purchase,” and the corporation ceases to conduct the business which it had conducted prior to the change of ownership. Id. The regulations accompanying § 382(a) expressly provide that this provision will apply to extinguish all NOL carryovers “if the corporation is not carrying on an active trade or business at the time of such increase in ownership.” Treas. Reg. § 1.382(a)-1(h)(6) (1968).

Section 382(b) of the Code, I.R.C. § 382(b) (amended 1976), provides for the reduction or elimination of a corporation's NOL carryovers where, as a result of a corporation's participation in a reorganization, its shareholders do not receive or retain at least 20% of the stock ownership of the surviving corporation. Id.

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rently codified, these provisions restrict the purchase of loss corporate shells by corporations seeking to employ the shell’s NOL carryovers to offset their profits. 45 Section 382 limits NOL carryovers where the corporation’s business and ownership have changed, provided that a certain set of objective criteria are satisfied. 46 In contrast, section 269 triggers a disallowance of a deduction upon a mere determination that control of a corporation was acquired for the principal purpose of reducing a tax liability. 47 These provisions, however, only restrict “trafficking” 48 in NOL carryovers; nothing in the Code expressly prohibits a shareholder from inserting a profitable new business within the loss corporate shell of a wholly owned corporation for the purpose of utilizing the former business’ NOL carryovers. 49

The issue of whether the availability of NOL carryovers in a corporation precludes the stock in that corporation from being deemed worthless was first confronted by the United States District Court for the District of Nebraska in Becker v. United States. 50 In Becker, the taxpayers, individual shareholders of a closely held corporation, 51 took a worthless stock deduction after the corporation had become insolvent. 52 The taxpayers subsequently placed a new business within the old corporate shell, and offset the profits of the new concern by carrying over the NOL’s generated by the shell’s former business. 53 Rejecting the Government’s contention that the existence of po-


45. See Brittker & Eustice, supra note 18, at 16-5. Section 381 of the Code, I.R.C. § 381, provides that some other corporate tax attributes other than NOL carryovers, such as earnings and profits, recovery of bad debts, and inventories, may be transferred in certain corporate acquisitions. Id. § 381(c). See generally Phelan, Carryover of Tax Attributes Under Section 381, 51 TAXES 273 (1973).


47. See I.R.C. § 269(a). For a discussion of § 269, see note 43 supra.

48. For a definition of “trafficking,” see note 42 supra.


In explaining the amendments to § 382 under the Tax Reform Act of 1976, Pub. L. No. 94-455, § 806(e), 90 Stat. 1520, the Staff of the Joint Committee on Taxation recognized that “when fixed rules are adopted for an area such as this, it is difficult to envision all possible abuses. It is equally difficult to assure that the rules will achieve equity in all situations. The present rules have defects of both of these kinds.” STAFF OF JOINT COMM. ON TAXATION, 94TH CONG., 2D SESS., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1976, 203 (Comm. Print 1976) [hereinafter cited as REFORM ACT EXPLANATION].


51. Id. at 556.

52. Id. The corporation had incurred a long series of losses, its liabilities exceeded its assets, and it ultimately ceased to operate. Id.

53. Id. After having claimed the worthless stock deduction, the taxpayers attempted to find a new business for the corporation and entered into negotiations toward this end. Id. The taxpayers alleged that these negotiations failed and that while they hoped that the losses previously incurred might still be utilized, they did not anticipate the acquisition of any particular business. Id.
tential NOL carryovers precluded a finding of worthlessness, the district
court concluded that where an insolvent corporation appears unable to re-
cover financially, its stock cannot be deemed valuable merely because of the
availability of NOL carryovers. In reaching this result, the court
evaluated all the facts of the case, reasoning that reliance on purely subjec-
tive criteria would prevent a taxpayer from ever taking a worthless stock
deduction.

Where a corporation’s utilization of NOL deductions generated by a loss
corporate shell has been challenged as an impermissible “double deduction,”
a different result has been reached. For example, in Charles Ilfeld Co. v.
Hernandez, the Supreme Court held that the utilization of a subsidiary’s
losses to reduce an affiliated group’s net income on a consolidated tax re-
turn and the subsequent deduction by the corporation for worthless stock
was tantamount to a double deduction. Since the consolidated return
election enabled the corporation to deduct the subsidiaries losses, the court
reasoned that the corporation should not be permitted to take a subsequent
deduction resulting from those same losses.

54. Id. at 557. The Government contended that the court should emphasize subjective fac-
tors in determining worthlessness. Id. For a discussion of the use of subjective criteria in de-
termining worthlessness, see notes 20, 21 & 29 and accompanying text supra. The Government
apparently reasoned that since the taxpayers were aware of the availability of NOL carryovers to
offset the potential income of any new business, the stock was not worthless. See 308 F. Supp.
at 557.

55. 308 F. Supp. at 556-57.

56. Id. The court reasoned that to adopt the Government’s theory would be to abandon the
traditional method of analyzing both objective and subjective factors in determining worthless-
ness. Id. at 557. If only an objective test were utilized, the court noted that there would be no
objective evidence of worthlessness for future years. Id. The court embraced the traditional
discussion of the Boehm standard, see text accompanying note 20 supra. The Becker court
indicated that if the taxpayer had had a definite and concrete plan in mind to utilize the losses
at the time the stock was declared worthless, it might have disallowed the deduction on the
ground that the stock had potential value. See 308 F. Supp. at 557 (dictum).

57. 308 F. Supp. at 557. To substantiate its position, the court reasoned:

If this Court adopts the government’s theory in this case every taxpayer, at least
every taxpayer who has the control of a closely held corporation, knowledge of the tax
advantages and a desire to utilize these advantages, will be unable to take a deduction for
worthless securities. . . . [U]nder this theory the tax advantages to his holdings would
prevent his declaring those holdings as worthless. This Court does not believe, where the
only evidence of some potential value remaining in a stock is carryforward losses and the
knowledge and desire to utilize them, that the taxpayer should be prevented from de-
claring the stock worthless. . . . [T]axpayer must not only prove a stock is worthless but
that it became worthless in the year in which the loss is taken. There would be no
objective evidence of worthlessness for subsequent years . . . .

Id.


59. Id. at 68-69. Where one corporation directly or indirectly owns a certain percentage of
stock in other corporations, it may elect to file a consolidated return on behalf of the entire
group, thereby causing corporations to be treated as a single corporation for many purposes. See
I.R.C. §§ 1501-1506. For example, by filing consolidated returns the losses of one affiliate may
be used to offset the profits of another. See BITTKER & EUSTICE, supra note 18, at 15-64.

60. 292 U.S. at 68-69.

61. Id. at 68. The Court stated:
The allowance claimed would permit petitioner twice to use the subsidiaries’ losses for the
reduction of its taxable income. By means of the consolidated returns in earlier years it
Against this historical background, the First Circuit in Textron confronted the issue of whether a corporate shareholder, which did not elect to file a consolidated return, may take worthless stock and bad debt deductions with respect to its wholly owned subsidiary, notwithstanding the subsidiary's subsequent deduction of the NOL's incurred by a former business.\(^{62}\)

Rejecting the Government's argument that the loss corporate shell had potential value as a source of NOL carryovers, the Textron court concluded that the stock had become worthless in 1959.\(^{63}\) The court recognized that "[t]he shell together with its losses could not be marketed to others," and determined that the subsequent infusion of new assets into the corporate shell by Textron, which enabled Bell to deduct Hawaiian's losses on its own tax return, was "an initiative which created a wholly new ball game and certainly could not retroactively create value."\(^{64}\) The First Circuit, specifically adopting the Becker court's rationale, rejected the Government's contention that a NOL carryover is incompatible with a finding that the stock was worthless.\(^{65}\) The court noted that to sustain such a position would introduce "great uncertainty" into the determination of stock worthlessness.\(^{66}\) According to the Textron court, this uncertainty would operate to deprive both the IRS and the taxpayer of all guidance in determining the taxable year in which the stock lost its value.\(^{67}\) In refusing to consider "such vague

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\(^{62}\) Id. at 1024.

\(^{63}\) Id.

\(^{64}\) Id. at 1025. The court posited that even if it were to adopt the IRS' approach with respect to the worthless stock deduction, it was doubtful that the approach would justify disallowance of the bad debt deduction. Id. at 1026 n.4. The court stated:

Textron's stock carried with it the power to control Hawaiian, and thus to orchestrate acquisition of a new business. It is this power to control that the government believes valuable. No such power attends Textron's status as a major creditor, so it is hard to see how Hawaiian's debts had any continuing value to Textron after 1959, except to the extent that any worthless debt has value as a deduction.

\(^{65}\) Id. For a discussion of Becker, see notes 50-57 and accompanying text supra.

\(^{66}\) Id. at 1025. The court reasoned that the logical extension of the Government's argument would be that stock which becomes otherwise worthless always has value as a tax deduction to its owner, thereby precluding a taxpayer from ever taking a worthless stock deduction. Id., citing Becker v. United States, 308 F. Supp. 555, 557 (D. Neb. 1970).
and subjective factors as the taxpayer's ability and desire to acquire another business,"68 the court reasoned, *inter alia*, that without adequate guidelines, a taxpayer might mistakenly forfeit a valid deduction.69 Moreover, it was suggested that the IRS would be inclined to challenge every such deduction for fear that the shell's losses would subsequently prove valuable to the corporate shareholder.70

Asserting that in the absence of a consolidated return, the "substance over form" doctrine should not be invoked to classify Textron and its subsidiary as a single taxpayer,71 the court found no double deduction.72 In the

deductions will be forfeited. *Id.* The court concluded that determining worth in light of events subsequent to the taxable year would not cure the uncertainty surrounding the value, if any, of the stock in a particular year. *Id.* at 1024, 1025 n.3, 1026. The First Circuit further suggested that even if the IRS were to adopt a retrospective analysis in determining stock worth, such an approach would be unduly burdensome for the IRS since the computation of taxes would be postponed to future years. *Id.* at 1025 n.3.

69. *Id.* at 1025.

68. *Id.* The court stated that under a subjective analysis, "[a] taxpayer who owned the bulk of a failed corporation's stock would be hard-pressed to determine . . . [the year in which] his stock became worthless. If he guessed wrong, he might well forfeit his deduction." *Id.* (citation omitted). Furthermore, the court posited that a taxpayer, "hoping to take advantage of . . . [a] loss shell, might acquire a second corporation that loses money." *Id.* at 1026. In such a situation, "[t]he shell's carryover losses will be worthless." *Id.* The First Circuit further stated that a taxpayer who retains a loss shell in anticipation of the acquisition of a new business might suffer unrelated losses which would preclude him from acquiring the second business. *Id.*

70. *Id.* at 1027. The court speculated that under the IRS' approach, the IRS "might very well become the ultimate victim of the doctrine it now advocates." *Id.* at 1026. A shareholder may prefer to take a worthless stock deduction at a later time when the carryovers could be used more advantageously. *Id.* This could be accomplished "by going through the motions of seeking a second business for its shell," with the "search" being abandoned "[w]hen the time for a deduction is more propitious." *Id.* According to the court, the IRS "will have trouble proving that the corporation's heart was not in the hunt." *Id.*

71. *Id.* The principle that a taxpayer's choice of form for a particular transaction may be disregarded by a court to reflect its substance was first articulated by the Supreme Court in *Weiss v. Stearn*, 265 U.S. 242 (1924). In *Weiss*, the Supreme Court stated: "Questions of taxation must be determined by viewing what was actually done, rather than the declared purpose of the participants . . . [W]hen applying . . . income tax laws . . . we must regard matters of substance and not mere form." *Id.* at 254. See generally *Chirelstein, Learned Hand's Contribution to the Law of Tax Avoidance*, 77 YALE L.J. 440 (1968); *Donaldson, When Substance--Over--Form Argument is Available to the Taxpayer*, 48 MARQ. L. REV. 41 (1964); *Eustice & Lyon, Federal Income Taxation*, 36 N.Y.U.L. REV. 642, 643-53 (1961).

The form of a transaction will not be given effect for tax purposes unless it serves some purpose other than tax avoidance. *Gregory v. Helvering*, 293 U.S. 465 (1935). The essence of this "business purpose" corollary to the "substance over form" doctrine is that, "a transaction heavily laden with tax-avoidance motives may be disregarded as a 'sham' or its form recast so as to reflect its economic 'substance,' or intermediate steps in a 'single transaction' may be collapsed in order to prevent overreaching taxpayers from doing indirectly what they cannot do directly." *Bittker & Eustice, supra* note 18, at 14-98. The business purpose doctrine generally has been applied to corporate reorganizations. See *Bittker, What is "Business Purpose" in Reorganizations?*, 8 N.Y.U. INST. ON FED. TAX. 134 (1950); *Michaelson, "Business Purpose" and Tax--Free Reorganization*, 61 YALE L.J. 14 (1952). See also *Blum, Motive, Intent and Purpose in Federal Income Taxation*, 34 U. CHI. L. REV. 485 (1967); *Note, State of Mind Analysis in Corporate Taxation*, 69 COLUM. L. REV. 1224 (1969).

For the "substance over form" argument advanced by the *Textron* dissent, see notes 81-84 and accompanying text infra.

72. 561 F.2d at 1026. For a discussion of the dissent's double deduction argument, see notes
court's view, "Textron's subsidiary was never a sham corporation lacking any substantial business purpose." 73 The court further suggested that even if it were to treat the two corporations as a single taxable entity, the tax benefit rule 74 militates toward the IRS challenging the most recent deduction for NOL's, rather than the earlier deductions for worthless securities and bad debts. 75 Recognizing that Congress probably did not intend to create a loophole whereby a parent corporation could take worthless investment deductions while its wholly owned subsidiary benefited from the NOL's carried forward from its former business, 76 the court concluded that remedial action was solely within the province of Congress. 77

Although it agreed with the majority's view that the stock and debt had become worthless in 1959, 78 the Textron dissent argued that by permitting Textron to receive a net tax saving in excess of its actual investment, 79 the majority had made the government "an insurer" of the business risks undertaken by the corporation. 80 In the dissent's view, the "financial realities" of the transactions, 81 as well as the Code's recognition that corporations and

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81-84 and accompanying text infra. For an historical perspective on the double deduction argument, see notes 58-61 and accompanying text supra.

73. 561 F.2d at 1026. The court further reasoned that to treat the two corporations as one taxable entity whenever it seems "fairer" to do so would not only ignore the distinction between parent and subsidiary in all tax cases, but would impair the careful planning characteristic of corporate taxation. Id. The court would not "inject so massive and unsettling a dose of 'equity' into the tax laws without a clear invitation from the Service." Id. at 1026-27.

74. For a discussion of the tax benefit rule, see notes 35-37 and accompanying text supra. For a discussion of the dissent's tax benefit argument, see notes 85-87 and accompanying text infra.

75. 561 F.2d at 1027. The court based this supposition upon the principle that a "[l]ater recovery of a properly deducted bad debt does not void the first deduction . . . . Rather, the recovery becomes income in the year of recovery." Id. (citations omitted).

76. Id. at 1025 & n.2. The court noted that Congress, in considering the abusive use of loss corporate shells, merely decided in § 269 and § 382 of the Code that purchasers of corporations could not take advantage of the tax attributes otherwise available as carryovers. Id. at 1025. Congress did not expressly prohibit a continuing owner from inserting a new business within a loss corporate shell for the purpose of utilizing the NOL carryovers of the former business. Id. See note 49 and accompanying text supra.

77. 561 F.2d at 1026. The court admitted, however, that "Textron ha[d] turned its Hawaiian sow's ear into a silk purse—and filled it at Treasury expense." Id. The court reasoned that "[l]oopholes cannot be repaired after the fact simply on the principle that to apply the law as written leads to a bad result." Id. at 1025 n.2. The IRS, suggested the court, might have legitimately gone beyond the language of the Code and constructed, "by regulation, a mechanism for limiting all deductions in this situation to one." Id. The court speculated that had the IRS anticipated the situation presented in Textron, it might have limited the subsidiary's subsequent use of the NOL deductions rather than the parent's worthless stock deduction. Id. For a discussion of the current status of disallowing a subsidiary's carryover of a NOL from a former business, see note 9 supra; note 118 infra.

78. 561 F.2d at 1030 (Bownes, J., dissenting). See text accompanying note 63 supra.

79. 561 F.2d at 1027 (Bownes, J., dissenting).

80. Id. at 1031-32 (Bownes, J., dissenting). Textron claimed worthless stock and bad debt deductions totaling $5,971,732.16. Id. at 1032 (Bownes, J., dissenting). Bell took NOL carryover deductions of $6,745,025.35. Id. at 1031 (Bownes, J., dissenting). Given the 52% corporate tax rate then in effect, the dissent noted that the aggregate deductions for Bell and Textron were worth over half a million dollars more than Textron's $5,971,000 investment in Hawaiian. Id. For a breakdown of Textron's total investment in Hawaiian, see note 1 supra.

81. 561 F.2d at 1031 (Bownes, J., dissenting), citing I.R.C. §§ 243, 332, 1501-1506.
their wholly owned subsidiaries are not completely distinct entities,\textsuperscript{82} compelled the conclusion that Hawaiian and Textron were separate taxable entities in form only.\textsuperscript{83} Consequently, the dissent, treating the two corporations as a single taxable entity, concluded that to permit Textron to take the worthless stock and bad debt deductions, in addition to allowing Bell to carry forward Hawaiian's NOL's, was tantamount to granting a "double deduction".\textsuperscript{84}

Alternatively, the dissent suggested that the tax benefit rule,\textsuperscript{85} applicable by implication to worthless securities which are treated as ordinary losses,\textsuperscript{86} required disallowance of Textron's worthless stock and bad debt deductions.\textsuperscript{87}

Although the vast majority of what are popularly termed "tax loopholes" are economic incentives deliberately inserted into the Code to foster certain activities, a few are true oversights which grant taxpayers benefits unintended by Congress.\textsuperscript{88} The \textit{Textron} case is illustrative of a loophole of this latter type.

\textsuperscript{82} 561 F.2d at 1031 (Bownes, J., dissenting). The dissent noted that in enacting various provisions of the Code, Congress recognized "that corporations and their wholly owned subsidiaries are not completely separate entities." \textit{Id.} See, e.g., I.R.C. § 332 (corporation may avoid recognition of gain on its liquidation of a subsidiary); \textit{id.} § 243 (parent corporations are subject to tax, for years prior to 1964, on only 15% of distributions of its subsidiary's earnings and profits, and for later years, may avoid taxation on any portion of such dividends).

The dissent neglected to add that § 165(g)(3), one of the provisions at issue in \textit{Textron}, permits a parent corporation to deduct the losses on its investment in a subsidiary's worthless stock as an ordinary loss rather than as a capital loss, as would be the case with other shareholders. \textit{See id.} § 165(g)(3). See notes 15-19 and accompanying text \textit{supra}.

\textsuperscript{83} 561 F.2d at 1031 (Bownes, J., dissenting). The dissent considered several factors to be of importance. First, Textron had published annual reports to its shareholders reporting the financial statements of Textron and Hawaiian on a consolidated basis. \textit{Id.} Second, Textron's funds were freely transferred to Hawaiian for the acquisition of Bell. \textit{Id.} Third, Hawaiian was subsidized by Textron's funds. \textit{Id.} \textit{See} note 1 \textit{supra}.

\textsuperscript{84} 561 F.2d at 1032 (Bownes, J., dissenting): For a discussion of the double deduction theory, \textit{see} notes 58-61 and accompanying text \textit{supra}.

\textsuperscript{85} \textit{See} notes 35-37 and accompanying text \textit{supra}.

\textsuperscript{86} 561 F.2d at 1029-30 (Bownes, J., dissenting). The dissent viewed the NOL carryovers utilized by Bell as the "receipt of amounts in respect of the previously deducted or credited section 111 items." \textit{Id.} at 1030 (Bownes, J., dissenting), \textit{quoting} Treas. Reg. § 1.111-1(a)(2) (1956). The dissent reasoned that "Regulation 1.111-1(a)(4) makes Section 111 specifically applicable to worthless securities which are treated as capital losses." 561 F.2d at 1030 (Bownes, J., dissenting). The dissent stated that it "saw no reason why it might not also include, by implication, worthless securities treated as ordinary losses under section 165(a)." \textit{Id.} This regulation provides that "[c]ertain bad debts arising from the worthlessness of securities . . . are treated as losses from the sale or exchange of capital assets." Treas. Reg. § 1.111-1(a)(4) (1956).

\textsuperscript{87} 561 F.2d at 1030 (Bownes, J., dissenting). The dissent agreed with the majority that it might have been more proper to challenge the second deduction for NOL carryovers. \textit{Id.} at 1032 (Bownes, J., dissenting). The dissent, however, viewed \textit{Ilfeld} as mandating the disallowance of whichever deduction is within the reach of the court. \textit{Id.} For a discussion of \textit{Ilfeld}, \textit{see} notes 58-61 and accompanying text \textit{supra}.

\textsuperscript{88} \textit{See} RALPH NADER CONGRESS PROJECT, THE REVENUE COMMITTEES 105-06 (1975). \textit{See} also S. SURREY, PATHWAYS TO TAX REFORM (3d ed. 1973). Examples of intentional loopholes, frequently referred to as "tax incentives," include the charitable deduction, which serves to foster philanthropy, I.R.C. § 170; the preferential treatment of qualified pension plans, which serves to foster broad pension plan coverage, \textit{id.} § 401(a); and the corporate surtax exemption, which serves to foster small business, \textit{id.} § 1372(a).
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In reaching its conclusion that Hawaiian's stock and debt were worthless, the Textron majority tacitly equated value with fair market value.\(^8^9\) Although sections 165 and 166 of the Code speak in terms of worthlessness,\(^9^0\) the Textron majority's interpretation of value was arguably warranted because of the IRS' consistent reference to fair market value in the regulations,\(^9^1\) and due to the occasional specific definition of value in terms of fair market value: "The value of the property is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell, and both having reasonable knowledge of relevant facts."\(^9^2\) In addition, in light of the Code's ban on trafficking in loss corporate shells which, absent their tax attributes, have no value,\(^9^3\) it is submitted that under the majority's fair market value test, Hawaiian's stock and debt were in fact worthless since Hawaiian could not be sold. The prevention of trafficking in corporate shells, however, does not prohibit the retention of the corporate shell and the infusion of new capital by the old owners.\(^9^4\)

The majority's definition of value, which totally precludes a finding that an asset has value to its owner when it has no value in the marketplace, ignores the fact that NOL carryovers still have value to the continuing shareholder since they can serve as a tax shelter for a profitable enterprise.\(^9^5\) In the absence of the restrictions imposed by sections 269 and 382,\(^9^6\) the corporate shell would have precisely the same value to the taxpayer as it would have had to prospective purchasers.

Despite the decision's congruence with the regulations' definition of value, it is submitted that the Textron majority, by restricting its focus to the objective criterion of marketability, implicitly narrowed the scope of the facts which traditionally have been examined with respect to the search for value.\(^9^7\) Notwithstanding this deviation from the traditional method of

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\(^8^9\) See text accompanying note 64 supra. The district court expressly advocated a fair market value test. 418 F. Supp. at 46.
\(^9^0\) See notes 4 & 5 supra; notes 16-18 & 30-33 and accompanying text supra.
\(^9^2\) Treas. Reg. § 25.2512-1 (1958) (gift tax). See also id. § 1.165-4(a) (1960) (stock not worthless if it has any recognizable value on the date claimed as the date of the loss).
\(^9^3\) See notes 42-48 and accompanying text supra.
\(^9^4\) See note 49 and accompanying text supra.
\(^9^5\) This point was recognized by the Joint Committee on Taxation which stated that those who take advantage of tax loopholes in § 382 "are effectively buying a tax shelter for their expected future profits, whereas if the same persons had used their capital to start a new business on their own, no such loss offsets would be available." Reform Act Explanation, supra note 49, at 191.
\(^9^6\) For a discussion of the restrictions imposed by § 269 and § 382, see notes 42-48 and accompanying text supra.
\(^9^7\) For a discussion of the method of analysis traditionally employed by the courts in determining worthlessness, see notes 19-29 and accompanying text supra.

Although the Textron court seemingly overlooked the traditional approach that both objective and subjective factors are to be examined in determining worthlessness, it is submitted that the same result would have been reached even if the traditional analysis had been
analysis employed in determining worthlessness, the net effect of the majority's approach is the preservation of the integrity of the taxable year. The importance of this concept has been frequently recognized in decisions holding that stock must be proven worthless in the year that the deduction is claimed. In contrast, the Government's view, which would operate to disallow the worthless stock and bad debt deductions because of later NOL carryovers, would require retrospective valuations, thus destroying both the predictability and logic inherent in the concept of the taxable year.

As the Textron majority recognized, consideration of events subsequent to the time at which a deduction is claimed lends uncertainty to the determination of stock worthlessness. While the majority's fair market value test involves the examination of objective factors to guide the court's determination, an analysis focusing on subjective factors would require that the IRS perform the difficult task of ascertaining a taxpayer's intent. Moreover, as the majority noted, the absence of adequate guidelines might not only cause a taxpayer to mistakenly forfeit a valid deduction, but might also result in an increase in litigation since the IRS would be inclined to challenge every deduction. The majority also correctly concluded that the Government's retrospective approach would all but destroy the statutory worthless stock deduction. Furthermore, such a rule would be clearly unfair to shareholders who, unlike a wealthy conglomerate like Textron, lack the capital necessary to insert a profitable business within a loss corporate shell in order to utilize that shell's NOL carryovers. Their options would be limited to selling their stock which, under sections 269 and 382, would destroy the carryovers - the only element of value.

Criticizing the majority's alleged allowance of a "double deduction," the dissent presents an argument which does not withstand close analysis. In employed. Hawaiian was deeply in debt, and possessed no resources with which it could escape insolvency after foreclosure on its principal asset. See note 3 supra. Moreover, examining the taxpayer's subjective motivation, the district court found that Textron had no specific plan, at the time the worthless investment deductions were claimed, to utilize Hawaiian's NOL carryovers by inserting a profitable business within the loss shell. 418 F. Supp. at 43, 47. The majority's opinion is also consonant with those cases which hold that in order for stock to be worthless, there can be no reasonable prospect at the time the deduction is claimed that the company's own resources could be used to restore value to its stock. See note 28 and accompanying text supra. In Textron, even if a reasonable possibility existed that during the taxable year in question Textron would place a profitable new business within Hawaiian's shell in order to utilize the NOL carryovers, such a prospect would depend on the use of Textron's, not Hawaiian's, resources. As the district court noted, the infusion by Textron of new assets into the corporate shell was a wholly distinct endeavor. 418 F. Supp. at 47.

98. See 418 F. Supp. at 47.
99. See cases cited note 17 supra.
100. See note 12 and accompanying text supra.
102. 561 F.2d at 1025. See note 70 and accompanying text supra.
103. 561 F.2d at 1027. See note 67 and accompanying text supra.
104. See REFORM ACT EXPLANATION, supra note 49, at 201; text accompanying notes 8 & 9 supra.
105. See notes 43-47 and accompanying text supra.
106. 561 F.2d at 1027, 1029-32 (Bownes, J., dissenting). Even the IRS admitted that the double deduction argument was a weak one, arguing in its brief that:
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the dissent's view, Bell and Textron were a single taxable entity attempting to receive a double deduction for a single loss. As the majority asserted, however, in the absence of a consolidated return, treating two corporations as one is ordinarily not justified. Although it is true that for certain purposes electing affiliated corporations are treated as a unit, neither the Code nor judicial decisions permit a parent and its subsidiary to be treated as a single taxable entity in the case sub judice. Moreover, taxpayers generally have been unsuccessful in their arguments that the status of a corporation as a separate taxable entity should be disregarded. The doctrine that substance must prevail over form should not operate to characterize two entities as one where a legitimate business purpose underlies the transaction or where business activity continues after the completion of the transaction. It seems reasonable to have concluded that Bell, a profitable going

Since the worthless stock and bad debt deductions here in question were the first to be claimed, and since the net operating losses were claimed by a separate corporate entity it may well be that the 'double' deduction rationale of Ilfeld Co. v. Marwais Steel would not provide a sufficient basis, standing alone, to disallow the worthless stock and debt deductions here in issue if the stock and debt could be deemed to have become wholly worthless by the end of the year in question.

561 F.2d at 1026 n.5 (Bownes, J., dissenting), quoting Brief for Appellant at 30.

107. 561 F.2d at 1031-32 (Bownes, J., dissenting). See notes 81-84 and accompanying text supra.


109. See notes 48 & 49 and accompanying text supra.

110. See Donaldson, supra note 71, at 46. Generally, transactions involving corporate subsidiaries, such as that at issue in Textron, have not been challenged as frequently as transactions involving individually owned corporations. See Cleary, The Corporate Entity in Tax Cases, 1 TAX L. REV. 3, 23 (1945). It has been suggested that [t]his may be due to the fact that ordinarily there are substantial business reasons for the formation and continuance of subsidiaries and for transactions between a parent corporation and its subsidiaries, which are less likely to be present where an individual is dealing with a wholly-owned corporation. See.

111. In Moline Properties v. Commissioner, 319 U.S. 436 (1943), the Supreme Court stated: The doctrine of corporate entity fills a useful purpose in business life. Whether the purpose be to gain an advantage under the law of the state of incorporation . . . or to serve the creator's personal convenience, so long as that purpose is the equivalent of business activity, or is followed by the carrying on of business by the corporation, the corporation remains a separate taxable entity.

Id. at 438 (citations omitted) (footnotes omitted).
concern, was not a sham corporation even though Textron's motive in acquiring Bell may have been to utilize Hawaiian's NOL carryovers. Furthermore, it is submitted that the Textron dissent erroneously concluded that the tax benefit rule was applicable in the present case. The tax benefit rule presupposes that the taxpayer who takes the deduction is the same taxpayer who later recovers the loss for which the deduction was taken. In Textron, however, Textron took the worthless investment deductions while Bell, a separate taxpayer, took the NOL deduction. Most importantly, as the majority noted, the tax benefit rule operates only to exclude from gross income the amount “recovered,” the NOL deduction, but this deduction was not challenged in Textron.

112. 561 F.2d at 1024.
113. See id.
114. Id. at 1029-30 (Bownes, J., dissenting). For a discussion of the dissent's “tax benefit” argument, see notes 85-87 and accompanying text supra.
115. See IRC § 111(a). For the text of § 111(a), see note 35 supra.
116. 418 F. Supp. at 43. See notes 4-10 and accompanying text supra.
117. 561 F.2d at 1027. See notes 74 & 75 and accompanying text supra.
118. See notes 74 & 75 and accompanying text supra. Judicial decisions and administrative policy regarding the disallowance of a subsidiary's NOL carryovers have created much confusion in this area of the tax law. See note 9 supra. Concern for the policy disfavoring double deductions evidently led the dissent to misread and misinterpret legal doctrine. The Textron dissent declared:

In Lisbon [sic] Shops, Inc. v. Koehler, 353 U.S. 382 ... (1957), the Court ruled that a net operating loss carryover could be used only against income from the very same business which incurred the loss. This was the case regardless of continuity of ownership or form of business . . . .

The 1954 Code provisions require a change in ownership as well as a change in business . . . . The Libson doctrine does not apply to transactions since the enactment of the 1954 Tax Code . . . . This result was recognized by the Internal Revenue Service at Rev. Rul. 63-40, 1963-1 C.B. 46.

This analysis is clearly incorrect for two reasons. First, whether or not Libson Shops has continuing viability under the 1954 Code is a matter of controversy. Despite the 1957 date of the decision, the factual pattern presented in Libson Shops occurred prior to the enactment of the 1954 Code and therefore prior to the enactment of § 382. While it is true that certain cases, primarily Maxwell Hardware Co. v. Commissioner, 343 F.2d 713 (9th Cir. 1965), cert. denied, 359 U.S. 901 (1967), have held that Libson Shops does not survive the 1954 Code, 343 F.2d at 715-16, others have maintained the contrary. See, e.g., United States v. Jackson Oldsmobile, Inc., 371 F.2d 808 (5th Cir. 1967); J.G. Dudley Co. v. Commissioner, 298 F.2d 750 (4th Cir. 1961). See generally BITTKER & EUSTICE, supra note 15 at 16-65. See also Sinrich, Libson Shops—An Argument Against Its Application Under the 1954 Code, 13 TAX L. REV. 167 (1958).

Second, the IRS did not indicate in Rev. Rul. 63-40, 1963-1 C.B. 46, that the Libson Shops doctrine was inapplicable to transactions occurring subsequent to the enactment of the 1954 Code, as suggested by the dissent. Rather, the ruling announced that the IRS would apply the Libson Shops doctrine to transactions governed by the 1954 Code where a single corporation discontinued a loss business and purchased a profitable business if, at the same time, a "substantial" change—a "more than a minor change" —in stock ownership occurred. Id. at 48. Subsequent to the Maxwell Hardware decision, the IRS retreated from, but quite clearly did not abandon, Libson Shops. The Service will not rely on Libson Shops under the 1954 Code in any loss carryover case where there has been less than a 50 percent change in the beneficial ownership of the loss or where there has been no change in business as defined in section 382(a) and the regulations thereunder. However, the Service will continue to rely on sections 269 and 482, where appropriate, in dealing with the carryover of losses. Revenue Ruling 63-40, C.B. 1963-1, will be modified to the extent inconsistent herewith.
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Even if the tax benefit rule could be construed as applying to Textron's bad debt deduction, it could not be applied to the worthless securities deduction. Section 111 of the Code specifically states that the rule applies only to the recovery of bad debts, prior taxes, and delinquency amounts. Moreover, the regulation upon which the dissent relied in arguing that worthless stock may be treated for purposes of the tax benefit rule as bad debt merely states that "certain bad debts arising from the worthlessness of securities" fall within the scope of section 111.

Although the majority's focus on the marketplace avoids searching the minds of taxpayers and reduces litigation, it trades flexibility for certainty and permits a taxpayer to receive the benefit of a loophole unintended by Congress. The dissent's view, while an attempt to cure this loophole, is premised upon such an erroneous interpretation of fundamental tax principles as to deny it any considerable weight. As presently written, however, the Code forces a choice between these two approaches and, on the philosophical level, the disagreement between the majority and the dissent is therefore simply one of policy. It is submitted that any one of a number of simple changes in the Code could render the debate moot and avoid the apparent "double deduction" allowed by the First Circuit.


More recently, in enacting § 806(e) of the Tax Reform Act of 1976, Pub. L. No. 94-455, § 806(e), 90 Stat. 1520, which amended § 382 of the Code, the Joint Committee on Taxation stated:

In Libson Shops, Inc. v. Koehler, the Supreme Court, in a case decided under the 1939 Code, adopted an approach to the loss carryover area under which loss carryovers would basically follow the specific business activities which gave rise to the losses. Some uncertainty existed after this decision as to whether the business continuity approach represents a separate, non statutory test for determining carryovers of net operating losses. As a result of the changes made by the Act, Congress intends that the so-called Libson Shops test should have no application to determining net operating loss carryovers after stock purchases or reorganizations to tax years governed by the new rules. However, Congress intends that no inference should be drawn concerning the applicability or nonapplicability of the Libson Shops case in determining net operating loss carryovers to tax years governed by prior law.

REFORM ACT EXPLANATION, supra note 49, at 202-03 (citation omitted) (footnotes omitted).

The Joint Committee's caveat was clearly intended to avoid undercutting the position of the IRS with respect to the effect of Libson Shops during the taxable years between 1954 and the effective date of the 1976 amendment to §382. Considering that the question of whether Libson Shops survived the enactment of the 1954 Code involves the ascertainment of congressional intent, this caveat is, from a strictly logical standpoint, quite perplexing. Congress has in effect stated that while it is aware of the confusion surrounding the continued viability of Libson Shops and the conflicting interpretations with respect to its intent, it expresses no opinion as to what that intention was.

119. I.R.C. § 111. For the text of § 111, see note 35 supra. While the scope of § 111 items is narrow, the Regulation's purview is relatively broad. See Treas. Reg. § 1.111-1(a)(1) (1956). This Regulation provides that "[t]he term 'section 111 items' as used in this section means bad debts, prior taxes, delinquency amounts, and all other items subject to the rule of exclusion, for which a deduction or credit was allowed for a prior taxable year." Id. However, whether the Regulation's expansion of § 111 is controlling is open to doubt, since it has never been contested.

120. 561 F.2d at 1030 (Bownes, J., dissenting). See notes 85-87 and accompanying text supra.


122. Compare 561 F.2d at 1026-27 with id. at 1027 (Bownes, J., dissenting).
Although the attempt by the Textron dissent to prevent a double deduction was unprecedented, even the majority was constrained to admit that the taxpayer was receiving the benefit of a loophole.123 Neither the dissent nor the majority, however, properly identified the source of the loophole as the abberational treatment afforded worthless stock and bad debts by the Code itself. As a general matter, the tax structure requires a sale or an exchange, defined as a relinquishment of all future rights, before gain or loss is recognized with respect to an asset.124 The deductions granted by sections 165 and 166 of the Code and by the Textron court are a departure from this requirement, since they allow a taxpayer to receive a current deduction while retaining the right to future value. Moreover, in the case of a subsidiary corporation, the favorable tax attributes remain in the corporate shell.125

A simple solution to the problems posed by Textron would be for Congress to repeal sections 269 and 382 of the Code in order to allow the free alienability of NOL carryovers. While an extensive defense of this admittedly radical suggestion is beyond the scope of this note, it is clear that if NOL carryovers could be bought and sold, Hawaiian would have owned a marketable and therefore valuable asset, thus preventing its stock and debt from becoming worthless.126

Another simple solution would be for Congress to amend the Code to require that taxpayers who wish to claim a worthless stock or bad debt deduction totally renounce any interest in the stock or debt. Indeed, it could be required that all allegedly worthless stock and debt be transferred to the federal government as a condition of the deduction. Such an arrangement would parallel a transaction in which a taxpayer sells for nominal consideration an asset which has declined in value in order to fix a realizable event for tax purposes.127 Taxpayers could not logically complain of such a rule for it would merely require the transfer of an asset which the taxpayer himself is claiming to lack all value.128

123. Id. at 1025 n.2, 1026. See note 77 supra.
124. See I.R.C. §§ 1001(a)-(c).
125. See 561 F.2d at 1024; I.R.C. §§ 165, 166.
126. The New York State Bar Association has recently suggested that the abandonment of all restrictions on the trafficking in NOL carryovers be considered as an alternative to the proposed revision of § 382 of the Code. Report on Section 382, supra note 44, at 285-86. Free traffic in NOL carryovers is believed desirable for the following reasons: 1) it would afford equality of treatment to all entrepreneurs, who under current law in effect receive a government subsidy for unprofitable enterprises by offsetting losses from one line of business against an existing line of business or against other sources of income; 2) it would stimulate new business ventures by alleviating the task of raising capital; and 3) it would reduce the possibility of windfalls to purchasers. Id. See also D. SMITH, supra note 42, at 224-25.
127. It is in fact a well-known practice for stockholders wishing to claim a deduction on partially worthless stock to sell the stock to their accountants for nominal consideration in order to establish a realizable event for tax purposes.
128. See notes 15-18 & 33 and accompanying text supra. A more narrow and perhaps more politically acceptable variation would be to require such a renouncement or transfer to the federal government as a condition to an ordinary loss deduction pursuant to § 165(g)(3) of the Code, but not if a capital loss were claimed.
A third and entirely different approach would be to require that corporate parents who wish to claim worthless stock deductions with respect to the stock of their subsidiaries eliminate from the books of those subsidiaries all corporate tax attributes which may be carried forward. 129 Such an approach would grant corporate parents an interest in true future appreciation of currently worthless subsidiaries but would foreclose the built-in advantage of a NOL carryover. After all, the tax attributes of Hawaiian are apparently what induced Textron to acquire the new assets for its corporate shell and to change Hawaiian's name, instead of simply beginning afresh with a new corporation.

In light of the dissent's strained application of judicial doctrine, the Government's unworkable approach, and the majority's complete failure to cure the loophole presented in Textron, 130 it is submitted that the need for legislative, rather than judicial action is appropriate. Any one of the suggested changes in the Code would eliminate the loophole that created a large windfall to Textron at the expense of United States taxpayers.

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129. This suggestion, however, does not resolve the bad debt deduction issue.
130. See text accompanying notes 122 & 123 supra.