Catch-269

Cynthia Kappus
There was only one catch and that was Catch-22, which specified that a concern for one's own safety in the face of dangers that were real and immediate was the process of a rational mind. Orr was crazy and could be grounded. All he had to do was ask; and as soon as he did, he would no longer be crazy and would have to fly more missions. Orr would be crazy to fly more missions and sane if he didn't, but if he was sane he had to fly them. If he flew them he was crazy and didn't have to; but if he didn't want to he was sane and had to. Yossarian was moved very deeply by the absolute simplicity of this clause of Catch-22 and let out a respectful whistle.

Joseph Heller—CATCH-22

One of the Catch-22's of the Internal Revenue Code is section 269. The section provides that the Commissioner of Internal Revenue may disallow a deduction claimed by a taxpayer who has acquired control of a corporation for the principal purpose of securing a tax deduction, claim or benefit not otherwise available. In other words, in

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1. INTERNAL REVENUE CODE of 1954 [hereinafter cited as INT. REV. CODE].
2. INT. REV. CODE § 269 [hereinafter cited as section 269] originally appeared as section 129 of the INTERNAL REVENUE CODE of 1939. It was passed by the Congress as section 128(a) of the Revenue Act of 1943, 58 Stat. 21. The section was renumbered and substantially amended in 1954. The amendments are discussed in detail on pages 174-175 infra.
3. Section 269 says:

§ 269. Acquisitions made to evade or avoid income tax.
(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 the transferor corporation, and the principal purpose for which such acquisition was made is evasion or avoidance of Federal income tax by securing the benefit of a deduction, credit, or other allowance which such person or corporation would not otherwise enjoy, then the Secretary or his delegate may disallow such deduction, credit, or other allowance. For purposes of paragraphs (1) and (2), control means the ownership of stock possessing at least 50 percent of the total combined voting power of all classes of stock entitled to vote or at least 50 per-
order to obtain the benefits of certain tax deductions you must organize your affairs to comply with the requirements for those deductions. But if you organize your affairs principally to take advantage of the deduction, the Internal Revenue Service may disallow the deduction. The statute causes concern to tax planners and business decision makers and has frequently been the subject of litigation.\textsuperscript{4} Much of the litigation has involved tax benefits such as pre-acquisition loss carryovers\textsuperscript{5} or multiple surtax exemptions.\textsuperscript{6} In applying section 269 to these benefits of the total value of shares of all classes of stock of the corporation.

(b) Power of Secretary or his delegate to allow deduction, etc., in part.

In any case to which subsection (a) applies the Secretary or his delegate is authorized—

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

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

(3) to exercise his powers in part under paragraph (1) and in part under paragraph (2).

(c) Presumption in case of disproportionate purchase price.

The fact that the consideration paid upon an acquisition by any person or corporation described in subsection (a) is substantially disproportionate to the aggregate—

(1) of the adjusted basis of the property of the corporation (to the extent attributable to the interest acquired specified in paragraph (1) of subsection (a)), or of the property acquired specified in paragraph (2) of subsection (a); and

(2) of the tax benefits (to the extent not reflected in the adjusted basis of the property) not available to such person or corporation otherwise than as a result of such acquisition,


4. According to records kept by the Department of the Treasury during the period of July 1967 through March 1973 there were seventy-five reported decisions in cases involving section 269. The Internal Revenue Service [hereinafter cited as the Service] won forty of them, lost twenty-six and there was a split decision in the other nine. Eleven cases involved loss carryovers. Of these the Service won eight, lost four and had a split decision of four. There were thirty-four cases involving the principal purpose test with the Service winning eighteen, losing thirteen, and splitting three decisions. Letter from John H. Hall, Deputy Assistant Secretary, Department of the Treasury, to Senator Charles H. Percy, October 31, 1973.

5. Intra Rev. Code § 172 defines net operating losses and provides that losses incurred in one year may be carried over to subsequent years. § 1212 provides rules for the carryover of capital losses as defined in § 1222, § 381 and § 382 specifically deal with loss carryovers in the context of acquisitions and reorganizations.

6. Intra Rev. Code § 11 imposes a surtax on all corporations. § 11(d) provides a $25,000 exemption for each corporate taxpayer. § 1562 provides that a commonly controlled group of corporations can elect to file separate returns with each member corporation receiving a separate surtax exemption. Because of continuing abuses the Congress repealed § 1562 in the Tax Reform Act of 1969, P.L. 91-172, effective December 31, 1974.
fits the courts have left the taxpayer very narrow ground from which to challenge application of the statute.\(^7\) However, where the Service has enlisted section 269 to disallow other deductions, such as post-acquisition net operating losses, some circuits have added to the taxpayer’s defenses consideration of the relationship between section 269 and the legislative purpose for the deduction being disallowed.\(^8\) Because the circuits have divided\(^9\) on the issue of whether section 269 may be enlisted to disallow post-acquisition net operating loss deductions, the division may be ripe for resolution by the United States Supreme Court.\(^10\) There may also be a Congressional review since the Joint Committee on Internal Revenue Taxation has recommended amendment of section 269.\(^11\) This note will try to thread together the history of section 269 into a framework for understanding the issues that would be involved in either a Supreme Court or a Congressional review of section 269.

**HISTORICAL CONTEXT—THE PROBLEM**

At the beginning of the Second World War Congress enacted the excess profits tax.\(^12\) Given the natural motivation of business to protect profits, Congress foresaw efforts to limit tax burdens under the new law. Profits were soaring in those industries affected by the surge of demand that accompanied war. One of the most obvious ways to limit tax burdens without cutting into profits was to purchase someone else’s tax deductions. The waning Depression had provided ample opportunity for such schemes. Corporate capital and operating losses during the Depression had been immense and widespread. Many insolvent businesses with unused tax losses were available for

\(^7\) A typical statement of these grounds is found in Vulcan Metals Co. v. United States, 446 F.2d 690, 696-97 (5th Cir.), cert. denied, 404 U.S. 942, rehearing denied, 404 U.S. 1006 (1971):

[We are concerned with two lines of inquiry: (a) whether there has been an acquisition of control as contemplated by section 269, and, if so, (b) whether the principal purpose of the merger was to evade or avoid taxes.]

\(^8\) The Sixth Circuit in Zanesville Investment Co. v. Commissioner, 335 F.2d 507 (6th Cir. 1964), and the Third Circuit in Hercules Protective Fabrics Corp. v. Commissioner, 387 F.2d 475 (3d Cir. 1968), have held that post-acquisition net operating loss deductions may not be disallowed under section 269. These cases are discussed in detail on pages 180 and 182 infra.

\(^9\) The First, Second, Fifth, Seventh and Ninth Circuits have sustained section 269 disallowance of post acquisition operating loss deductions. The cases are discussed in detail on pages 178-182 infra.

\(^10\) Hereinafter cited as the Supreme Court.

\(^11\) The Joint Committee on Internal Revenue Taxation introduced legislation to repeal certain obsolete and rarely used provisions. It provided for repeal of section 269(c). No action was taken by the House Ways and Means Committee. H.R. 25, 92d Cong., 1st Sess. § 150 (1971).

\(^12\) Excess Profits Tax Act of 1940, 54 Stat. 975 (1940).
sale at bargain prices. The prospect of corporate taxpayers offsetting the billions in Depression losses against the profits of the war years posed a serious threat to the revenue-raising potential of the excess profits tax. What Congress needed was a mechanism to protect the revenue without interfering in the reorganization of business resources that was inevitable and healthy as the country moved from depression to war.13

HISTORICAL CONTEXT—THE SOLUTION

The legislative solution was section 269. The legislative history is very explicit about the purpose of the statute. The House Ways and Means Committee stated in its report:

This section is designed to put an end promptly to any market for or dealings in, interests in corporations or property which have as their objective the reduction through artifice of the income or excess profits tax liability.14

The Senate Finance Committee restated the purpose of section 269 in its report:

The objective of the section, as stated in the report on the House Bill, is to prevent the distortion through tax avoidance of the deduction, credit, 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.15

Congress was aware of the difficulty of formulating a statutory mechanism for achieving its purpose16 and turned for guidance to a group of contemporaneous Supreme Court cases17 involving tax reduction through adroit use of corporate identities. The Senate Finance Committee was explicit18 about its intention to codify the principle of

16. Id. at 1016.
17. Your committee also recognizes the difficulty of formulating a proper general provision which will be helpful in administration and decision in distinguishing between business conduct which effectuates the basic purposes of the deduction, credit, and allowance provisions of the code and arrangements which distort, pervert, and defeat such basic purposes.
18. S. REP. NO. 627, supra note 15 at 1016.

[T]he legal effect of the section is, in large, to codify and emphasize the
Higgins v. Smith\(^{19}\) that it is the substance not the form of a transaction that determines tax incidence.\(^{20}\) The Committee also cites Gregory v. Helvering.\(^{21}\) This case articulates the "substantial business purpose" doctrine that mere compliance with the code provisions allowing a tax benefit is enough only when there is, independent of tax consequences, a substantial business or economic purpose.\(^{22}\) Primarily concerned about trafficking in tax benefits, the Committee also cites Griffiths v. Commissioner.\(^{23}\) This case states that benefits, like income, must be attributed to the economic entity that earned them.\(^{24}\) These concepts constitute the legal theory upon which section 269 was constructed.

The problem was serious, the legislative purpose was explicit, and the legal theory of section 269 was a codification of decisions of the Supreme Court. The drafting Committees were, however, aware of three difficulties their statutory mechanism would have to overcome. First, it would have to be sufficiently flexible to deal with the complex and varied forms in which corporate acquisitions occur.\(^{25}\) Second, it would have to effectively distinguish between tax avoidance schemes and bona fide business transactions.\(^{26}\) Third, section 269 would have to be designed to operate without distorting the legislative plans of the other code sections allowing deductions and benefits.\(^{27}\) Congress

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20. Id. at 477:
The purpose here is to tax earnings and profits less expenses and losses. If one or the other factor in any calculation is unreal, it distorts the liability of the particular taxpayer to the detriment or advantage of the entire tax-paying group.

\[\ldots\] The government may not be required to acquiesce in the taxpayer's election of that form for doing business which is most advantageous to him. The government may look at actualities and upon determination that the form employed for doing business or carrying out the challenged tax event is unreal or a sham may sustain or disregard the effect of the fiction as best serves the purpose of the tax statutes.

22. Id. at 469.
24. Id. at 358. See also Lucas v. Earl, 281 U.S. 111, 115 (1930).
25. H.R. REP. No. 871, supra note 14 at 938:

[T]he section has not confined itself to a description of any particular methods for carrying out such tax avoidance schemes but has included within its scope those devices in whatever form they may appear.

26. See supra note 16.
27. S. REP. No. 627, supra note 15 at 1017:

To determine what transactions constitute the condemned evasion or avoidance, section (269) must be read in its context and background. It is superimposed on the several existing provisions of the income and excess profits tax law. . . . It is nonconformity to the basic policies of these provisions
believed it had designed a mechanism that could meet these tests. The litigation provides some evidence of how well section 269 has accomplished its purpose and overcome these difficulties.

**Flexibility**

Section 269 has clearly demonstrated that it is sufficiently flexible to reach a wide variety of transactions. The question of what constitutes an “acquisition” within the reach of section 269 has been extensively litigated. In an early case, *Alprosa Watch Corp. v. Commissioner*, the United States Tax Court suggested that section 269 could reach only deductions claimed by an acquiring corporation, not those claimed by an acquired corporation. Because an acquirer can assume the corporate identity of the acquired corporation by a quick shuffle of papers, subsequent decisions have discredited the dicta of *Alprosa Watch*. These cases clearly hold that for purposes of section 269 there is no distinction between an acquired and an acquiring taxpayer.

Another skirmish over the term “acquisition” was decided in favor of broad construction in the cases challenging the application of section 269 to the disallowance of multiple surtax exemptions. In *James Real- of the code which is denoted by tax avoidance in section (269), and it is in the light of these basic policies that section (269) would necessarily have to be applied and administered. . . . The test of this nonconformity is . . . whether the transaction or a particular factor thereof “distorts the liability of the particular taxpayer” when the “essential nature” of the transaction or factor is examined in the light of the “legislative plan.”

28. 11 T.C. 240 (1948).
29. Hereinafter cited as the Tax Court.
30. 11 T.C. at 245.
31. An example is found in Julius Garfinckel & Co. v. Commissioner, 335 F.2d 744 (2d Cir. 1964), cert. denied, 379 U.S. 962 (1965). In this case the taxpayer purchased two other corporations. The two acquired corporations were consolidated into the loss corporation which then assumed the name of the profit maker. In this way the survivor was technically the loss corporation.
32. See, e.g., Coastal Oil Storage Co. v. Commissioner, 242 F.2d 396 (4th Cir. 1957); Mill Ridge Coal Co. v. Patterson, 264 F.2d 713 (5th Cir.), cert. denied, 361 U.S. 861 (1959), rehearing denied, 363 U.S. 832 (1960); Commissioner v. British Motor Car Dist. Ltd., 278 F.2d 392 (9th Cir. 1960); James Realty Co. v. United States, 280 F.2d 394 (8th Cir. 1960); Thomas E. Snyder Sons Co. v. Commissioner, 288 F.2d 36 (7th Cir.), cert. denied, 368 U.S. 823 (1961); Urban Redevelopment Corp. v. Commissioner, 294 F.2d 328 (4th Cir. 1961); Southland Corp. v. Campbell, 358 F.2d 333 (5th Cir. 1966).
33. There is one situation in which it still does make a difference whether the taxpayer in an acquiring or acquired corporation. In Kolker Brothers, Inc. v. Commissioner, 35 T.C. 299 (1960), the Tax Court allowed a loss carryover and suggested that a taxpayer engaged in a losing business should be encouraged, not penalized, for getting himself out of the losing business and into a profitable one through acquisition. The same point was discussed by the Second Circuit in Norden-Ketay v. Commissioner, 319 F.2d 902, 906 (2d Cir. 1963). In a subsequent Revenue Ruling (Rev. Rul. 63-40, 1963-1 CUM. BULL. 46) the Service announced its intention not to apply section 269 where a loss corporation acquires a profitable business and there is “little or no” change in the ownership of the loss corporation.
ty Co. v. United States\textsuperscript{34} the taxpayer unsuccessfully argued that incorporation was not an “acquisition” within the reach of section 269. Buttressed by the express Congressional mandate that section 269 be used to prevent abuse of the multiple surtax exemption\textsuperscript{35} the government successfully argued that initial incorporation\textsuperscript{36} is an “acquisition” within the reach of section 269.

The courts have narrowly construed section 269 only where its terms are precisely drawn. For example, the statute defines “control” as ownership of stock constituting either 50 per cent of the value or 50 per cent of the voting power of all classes of stock.\textsuperscript{37} The courts have willingly considered an increase in stock ownership that carried the acquirer over the 50 per cent mark as an acquisition for purposes of the statute.\textsuperscript{38} They have not sustained application of the statute if the taxpayer does not actually own a controlling interest.\textsuperscript{39}

The litigation has confirmed the Congressional expectation that section 269 would be broad and flexible enough to deal with the complex forms in which corporate acquisitions occur. The problem is whether, having encompassed such a range of transactions within its reach, section 269 fairly and consistently distinguishes allowable from disallowable tax benefits. One aspect of this problem is the focus of section 269 on the motive of the taxpayer. The inherent difficulty in determining tax liability on the basis of a subjective standard is the subject of an ongoing debate,\textsuperscript{40} and section 269 has long been a target of those who favor objective rather than subjective standards.

\textsuperscript{34} 280 F.2d 394 (8th Cir. 1960).
\textsuperscript{35} I.R.T. REV. CODE § 1551(c) provides:
The provisions of section 269(b), and the authority of the Secretary under such section, shall, to the extent not inconsistent with the provisions of this section, be applicable to this section.
\textsuperscript{36} 280 F.2d at 398.
\textsuperscript{37} § 269(a) at supra note 3.
\textsuperscript{38} In Southland Corp. v. Campbell, 358 F.2d 333, 337 (5th Cir. 1966) the court held that the purchase of a few shares of stock that increased the taxpayer's share of ownership from 49.9 to 50.4 percent could constitute an “acquisition” within the reach of section 269.
\textsuperscript{39} In one such case, Maxwell Hardware Co. v. Commissioner, 343 F.2d 714, 721 (9th Cir. 1965), a real estate developer incorporated his business by purchase of non-voting stock in Maxwell Hardware Corp. in an amount equal to about two-fifths of the value of the outstanding common stock. Operating as a division of the hardware company, the real estate developer protected his interests by requiring that all common stock be placed in trust in a bank obliged as trustee to elect him to the three person board of directors. These arrangements gave him operating control of the business, but the court held that this did not constitute “control” within the definition of section 269. Also see Ach v. Commissioner, 358 F.2d 342, 345-46 (6th Cir. 1966), for a discussion of “beneficial ownership” as the standard for determining control for purposes of the application of section 269.
\textsuperscript{40} Two of the classic cases on taxpayer motivation are United States v. Isham, 84 U.S. 496, 506 (1873), and Gregory v. Helvering, 293 U.S. 465, 468-69 (1935). Also see Alinco Life Insurance Co. v. United States, 373 F.2d 336, 341 (Cl. Ct. 1967): Few subjects in taxation have been as vexing to the courts as that of tax
Distinguishing Tax Avoidance Schemes from Bona Fide Business Transactions

Congress chose the "principle purpose" test as the mechanism for distinguishing tax avoidance schemes from bona fide business acquisitions. Section 269 directs the Secretary to disallow deductions secured by a corporate acquisition if the "principle purpose for which such acquisition was made is evasion or avoidance of Federal income tax."\(^41\)

The Senate Committee Report defines "principal purpose" as one which "outranks or exceeds in importance any other one purpose."\(^42\)

The "principal purpose" test of section 269 goes a significant step beyond the "substantial business purpose" doctrine.\(^43\) Gregory suggests that a transaction with no substantial business purpose may be disregarded.\(^44\) Section 269 suggests that a transaction with some substantial business purpose may also be disregarded if that business purpose was not the "principal purpose." But subsection (b)\(^45\) of the statute and the Senate Committee Report\(^46\) suggest that if there is some substantial business purpose, there may be partial allowance of the tax deduction. There is no evidence in the litigated cases that this aspect of section 269 has been applied to bridge the difference between no avoidance. There is a wealth of case material, most of it singularly unenlightening except in the context of the peculiar facts in individual cases, particularly those which "exude an odor piscatorial." Rice, Judicial Techniques in Combating Tax Avoidance, 51 MICH. L. REV. 1021 (1953). As Randolph E. Paul once observed, the subject of tax avoidance "has virtually no philosophical pathways" and visibility is low, indeed. Paul, Restatement of Tax Avoidance, Studies in Federal Taxation, Callaghan and Co. (1937). The frustrating anarchy in the decisions is no doubt due, in part at least, to the elements of subjectivity which seems inevitably to attend upon the search for a taxpayer's intention or motivation. There has resulted a rather remarkable accumulation of conveniently vague maxims, such as the substance, not the form, of a transaction must control tax incidence, that an unreal or sham transaction must be disregarded, that what was actually done rather than what was said is the important criterion, that a taxpayer is privileged to reduce his taxes by means which the law permits, etc. See the discussion and numerous case citations in Rice, Judicial Techniques in Combating Tax Avoidance, supra at p. 1026 et seq. "General propositions do not decide concrete cases," however, and in the end the particular facts of this case must bear the responsibility for decision.

41. § 269(a) at supra note 3.
42. S. REP. NO. 627, supra note 15 at 1017.
43. An alternative explanation of the relationship between taxpayer motive and the "substantial business purpose" doctrine is articulated by the United States Court of Claims in A.P. Green Export Co. v. United States, 284 F.2d 383, 390 (Ct. Cl. 1960):

The question always is whether the transaction under scrutiny is in fact what it appears to be in form. A corporate reorganization may be illusory; a contract of sale may be intended only to deceive others. In such cases the transaction as a whole is different from its appearance. It is the intent that controls, but the intent which counts is one which contradicts the apparent transaction, not the intent to escape taxation.

44. 293 U.S. at 469-70.
45. See supra note 3.
46. S. REP. NO. 627, supra note 15 at 1018.
and some substantial business purpose. There is no case where the partial allowance scheme of the statute has been applied, though taxpayers have argued the point.47

Of more immediate concern to taxpayers are the practical difficulties of applying the “principal purpose” test. Application involves a determination of the motivations behind an acquisition and a weighing of the motivations to determine which is the principal one. In United States v. Donruss48 the Supreme Court expressed its skepticism about the workability of any “principal purpose” test because it necessarily depends on the “vagaries of corporate motive.”49 On this ground, the Court refused to construe “the purpose” used in the accumulated profits tax provisions of the Code50 to mean “the dominant or principal purpose.” The Court did, however, distinguish section 269, noting that it explicitly required application of a “principal purpose” test.51 In United States v. Generes52 the Court indicated its willingness to support a “principal purpose” test where it is explicitly required by statute. The Court found no conflict between this position and the skepticism it had expressed in Donruss.53 Based on these precedents the Supreme Court would probably not entertain a general attack on the “principal purpose” test of section 269. Such an attack should more appropriately be taken to the Congress.

In 1954 Congress expressed doubts about the workability of the “principal purpose” test of section 269. The 1954 recodification of the law included a substantial amendment to section 269. The House and Senate Committee Reports note that “the effectiveness of this provision has been impaired by the difficulty of establishing whether or not tax avoidance was the principal purpose of the acquisition.”54

49. Id. at 307-308:
   Respondent would have us adopt a test that requires that tax avoidance purpose need be dominant, impelling, or controlling. It seems to us that such a test would exacerbate the problems that Congress was trying to avoid. Rarely is there one motive, or even one dominant motive, for corporate decisions. Numerous factors contribute to the action ultimately decided upon. Respondent’s test would allow taxpayers to escape the tax when it is proved that at least one other motive was equal to tax avoidance. We doubt that such a determination can be made with any accuracy, and it is certainly one which will depend almost exclusively on the interested testimony of corporate management.
50. INT. REV. CODE § 531-537.
51. 393 U.S. at 302.
52. 405 U.S. 93 (1973).
53. Id. at 105.
The Congressional solution was subsection (c). Subsection (c) raises a presumption that the principal purpose of an acquisition is tax avoidance whenever the consideration paid is substantially disproportionate to the adjusted tax basis of the acquired property and the value of the tax benefits made possible by the acquisition. According to the Committee Reports, Congress believed that subsection (c) would strengthen enforcement of section 269 by shifting the burden of proof from the Service to the taxpayer. The effectiveness of the subsection (c) presumption as an indicator of taxpayer motivation is at best doubtful. It is more likely to entrap the innocent taxpayer who is unaware of the tax benefits of his acquisition than the sophisticated taxpayer actually motivated by tax avoidance. Its usefulness to the taxpayer as an indicator of how far he may go without running afoul of section 269 is also doubtful. It has never been clear exactly what constitutes "substantially disproportionate," and tax benefits unlike most other corporate assets are no bargain to the acquirer if he pays full value for them.

The Tax Court has made its doubts about subsection (c) very clear, and the Joint Committee on Internal Revenue Taxation has recommended its repeal. The Congressional purpose, shifting the bur-

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55. § 269(c) at supra note 3.
56. H.R. REP. No. 1337, supra note 54 at 4057:
A provision added by your committee has the effect of throwing on the corporation the burden of proving that there was no purpose of evasion or avoidance in cases where the consideration paid in acquiring control of another corporation, or corporation property, is substantially disproportionate to the sum of the adjusted basis of the property and the tax benefits not otherwise available. This provision will apply to cases where the tax basis of the property acquired for depreciation and other purposes, together with the tax value of other tax benefits, such as operating loss carryovers, is substantially greater than the amount paid for the property. Disparities of this type generally arise where the old basis is continued in the hands of the new owner. The corporation in such cases is to be required to establish by a clear preponderance of the evidence that the purpose of the acquisition was not tax avoidance.

It is believed that the addition of this new provision will strengthen enforcement of existing law in an area that has presented a serious tax-avoidance problem.

There is similar language in S. REP. No. 1622, supra note 54 at 4670.
58. See Glen Raven Mills, Inc., 59 T.C. 1, 10 (1972):
We have noted previously that the relationship between the test of section 269(c) and tax avoidance motives is far from clear and that the provision is merely a "procedural device" which adds weight to the presumption of correctness already existing in the Commissioner's determination.

Also see H.R. 25, 92d Cong., 1st Sess. § 150 (1971). The Joint Committee on Internal Revenue Taxation explained the purpose of the repeal in its Explanation of H.R. 25 Prepared by The Staff of The Joint Committee on Internal Revenue Taxation at 7 (October 13, 1971):

This amendment repeals the presumption of a tax avoidance purpose in cer-
den of proof, has been achieved by judicial precedent and the procedural rules of the Code. Once the Commissioner has determined that the principal purpose of an acquisition was tax avoidance, the burden is on the taxpayer to prove that some other purpose was more important than tax considerations. The proposed repeal of subsection (c) would not change this burden and is important to resolution of the problems surrounding section 269 only insofar as it may provide an opportunity for full Congressional review of section 269.

Ultimately, the questions of fairness and workability of section 269 can be answered only by reviewing judicial application of the "principal purpose" test. A comprehensive analysis of all the inconsistencies that appear in section 269 cases would be beyond the scope of this note, but a few examples will dramatize the difficulties the taxpayer faces in court. One of the inconsistencies is in the definition of "principal." Some courts, following the language of the regulation, require the taxpayer to prove that tax avoidance was not more important than any other purpose. Others require the taxpayer to prove tax avoidance was not more important than all other purposes. Another inconsistency arises in the use of a "but for" test to measure the taxpayer's intent. According to the regulations the "principal purpose" test is not a "but for" test. In court, proof that "but for" the tax advantages there would have been no acquisition supports the presumption that the principal purpose was tax avoidance. But the converse will not defeat

60. Tax Court Rules, Rule 32 INT. REV. CODE § 7453 says: The burden of proof shall be upon the petitioner, except as otherwise provided by statute, and except that in respect of any new matter pleaded in his answer, it shall be upon the respondent.

61. See, e.g., American Pipe and Steel Corp. v. Commissioner, 243 F.2d 125, 126-27 (9th Cir.), cert. denied, 355 U.S. 906 (1957).

62. Treas. Reg. § 1.269-3(a)(2) (1962): If the purpose to evade or avoid Federal income tax exceeds in importance any other purpose, it is the principal purpose.

63. See, e.g., Hawaiian Trust Co. Ltd. v. United States, 291 F.2d 761, 765 (9th Cir. 1961): "To constitute the 'principal purpose' the tax avoidance purpose must exceed in importance any other purpose." (emphasis added).

64. See, e.g., Bobsee Corp. v. United States, 411 F.2d 231, 239 (5th Cir. 1969): As we view the operation of the statute, there are only two relevant classes of purposes: tax-avoidance and non-tax-avoidance; the statute applies only if the former class exceeds the latter.

65. Treas. Reg. § 1.269-3(a)(2) (1962): This does not mean that only those acquisitions fall within the provisions of section 269 which would not have been made if the evasion or avoidance purpose was not present.

66. The test is more frequently applied where courts conclude that the taxpayer's
the presumption. 67

In most section 269 cases the determination of "principal purpose" depends upon the credibility of the taxpayer's assertions as to his non-tax motives. Some courts measure credibility by economic rationality while others reject economic rationality as a standard of credibility. 68 Some courts do little more than assert that the taxpayer was or was not "persuasive." 69

The inconsistencies in the application of the "principal purpose" test constitute one possible ground for a general challenge to section 269 in the courts or in Congress. Another focus for a challenge could be the relationship between section 269 and the rest of the Code. Difficulties arise in two situations. First, where the Code allows a benefit with no mention of motive, section 269 imposes an additional condition on the taxpayer. Second, where a benefit or deduction is supported by a substantial business purpose, section 269 may disallow the deduction if there is also a tax avoidance purpose that can be proved to be principal. In either case section 269 may be working at cross purposes with the rest of the Code.

THE RELATIONSHIP BETWEEN SECTION 269 AND OTHER PROVISIONS OF THE CODE

It is clear from the House and Senate Committee Reports that the drafters of section 269 foresaw no conflict with the other provisions of

principal purpose must have been tax avoidance because his asserted non-tax purpose could have been achieved by means other than acquisition or could not have been achieved at all. See, e.g., Coastal Oil Storage v. Commissioner, 242 F.2d 396, 397 (4th Cir. 1957); J.G. Dudley Co. v. Commissioner, 298 F.2d 730, 753-54 (4th Cir. 1962); Bobsee Corp. v. United States, 411 F.2d 231, 239 (5th Cir. 1969); Scroll, Inc. v. Commissioner, 447 F.2d 612, 617 (5th Cir. 1971); Pepsi, Inc. v. Commissioner, 448 F.2d 141, 145-47 (2d Cir. 1971); and contra Southeastern Canteen Co. v. Commissioner, 410 F.2d 615, 624-25 (6th Cir. 1969).

67. In his dissent in United States v. Donnus, 393 U.S. 297, 309-13 (1969), Justice Harlan suggests that a "but for" test would be the fairest test of intent. It would protect the taxpayer from an equation of knowledge of tax advantages with intent to avoid tax.

68. The distinction appears to depend on whether the taxpayer is arguing that economic absurdity proves that his principal purpose could not have been tax avoidance, e.g., Commissioner v. British Motor Car Dist. Ltd., 278 F.2d 392, 395 (9th Cir. 1960); R.P. Collins v. United States, 303 F.2d 142, 145-46 (1st Cir. 1962); and F.C. Publication Liquidating Corp. v. Commissioner, 304 F.2d 779, 780 (2d Cir. 1962); or whether the government is arguing that tax avoidance is the only economically rational explanation for the acquisition and so tax avoidance must be the principal purpose, e.g., Brumley-Donaldson Co. v. Commissioner, 443 F.2d 501, 505 and 511 (dissent) (9th Cir. 1971).

the Code. The House Committee specified its intent that section 269 "supplement and extend the present provisions of the Code" by preventing "their distortion through tax avoidance." The drafters of section 269 assumed that if the principal purpose of an acquisition was tax avoidance, any resulting tax benefits would distort tax liability and should be disallowed.

In some cases the relationship between section 269 and other provisions of the Code has been specified by Congress. In the case of the multiple surtax exemption the application of section 269 was written into the Code. In the case of pre-acquisition loss carryovers the role of section 269 is specified in the Senate Committee Report accompanying sections 381 and 382 that allow carryovers where there is continuity of business activity. Following this clear Congressional mandate courts have disallowed under section 269 loss carryovers that were in all other respects allowable under sections 381 and 382.

Where the Service has enlisted section 269 to disallow other benefits, courts have been more reluctant to find the "principal purpose" test conclusive. Some courts have examined for themselves the relationship between section 269 and the other Code provisions at issue. For example, in Alinco Life Insurance Company v. United States the Court of Claims refused to sustain a section 269 disallowance of special tax

70. H.R. REP. No. 871, supra note 14 at 938.
71. See, supra note 35.
72. S. REP. No. 1622, supra note 54 at 4923.
73. The business continuity test of sections 381 and 382 has also been the source of some confusion in the courts. In 1957 the Supreme Court in Libson Shops v. Kohler, 353 U.S. 382 (1957), applied a business continuity test to disallow a carryover of pre-consolidation losses to post-consolidation profits. Discussion of whether the "business continuity" test of Libson Shops was the same as that of sections 381 or 382, or was superseded by them, or was to be applied in addition to them seems to have been resolved in favor of the conclusion that the standards are not the same, and that section 381 and 382 have superseded Libson Shops. See Coast Quality Construction Corp. v. U.S., 463 F.2d 503, 510-11 (5th Cir. 1972).
74. A subsequent Congressional statement is not technically a part of the legislative history of section 269 but is construed as an authoritative statement of opinion as to the relationship between section 269 and sections 381 and 382. See Bobsee Corp. v. United States, 411 F.2d 231, 237 n. 18 (5th Cir. 1969).
76. The finding of a principal purpose of tax avoidance is a finding of fact and reviewable on appeal only if "clearly erroneous." See, e.g., J.T. Slocomb Co. v. Commissioner, 334 F.2d 269, 275 (2d Cir. 1964); Luke v. Commissioner, 351 F.2d 568, 572 (7th Cir. 1965); and Made Rite Inv. Co. v. Commissioner, 357 F.2d 647, 648 (9th Cir. 1966).
77. 373 F.2d 336 (Ct. Cl. 1967).
treatment for the income of the insurance subsidiary of the taxpayer. The ground for reversal was the court's finding that the legislative plan allowing special tax treatment of insurance company income was not meant to depend on the taxpayer's motive for going into the insurance business. The Fifth Circuit took a similar approach in *Supreme Investment Corporation v. United States.* The court insisted that section 269 must be read "in light of" the rest of the Code and was not intended to apply to every acquisition having tax benefits. The court held that in the instant case Congress could not have intended section 269 to apply to a deduction allowed by a section that was recently amended specifically to eliminate the taxpayer's motive as a standard for determination of qualification.

The focus of *Alinco* and *Supreme Investment* on the "legislative plan" of the deduction at issue is of critical importance to understanding the division in the circuits over post-acquisition net operating loss deductions. The central issue in that division is the relationship between section 269 and the policies underlying the consolidated return regulations. The circuits that have held section 269 inapplicable to post-acquisition net operating losses have said that allowance may not constitute a distortion of the consolidated return privilege. The circuits that have sustained application of section 269 have said that it was intended to apply to all credits and allowances and a principal purpose of tax avoidance is conclusive of distortion. The division in the circuits makes a Supreme Court test of the application of section 269 to post-acquisition losses a tempting prospect. There are, however, at least three good reasons for caution: *Libson Shops,* *J.D. & A.B. Spreckels Company v. Commissioner,* and a careful look at the decisions that have been made by the circuit courts.

The First Circuit in *R.P. Collins v. United States* has taken the

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78. *Int. Rev. Code* § 801.
79. 373 F.2d at 341.
80. 468 F.2d 370 (5th Cir. 1972).
82. 468 F.2d at 376-78.
84. See, *supra* note 73.
85. 41 B.T.A. 370 (1940). This case was cited in the Committee Reports that accompanied section 269, *supra* notes 14 and 15. Relying on *Gregory v. Helvering* the Board of Tax Appeals held that where a consolidation served no business purpose as distinguished from a tax-reducing purpose the group was not affiliated within the meaning of the consolidated return statute.
86. In *Newmarket Mfg. Co. v. United States*, 233 F.2d 493 (1st Cir. 1956), *cert. denied*, 353 U.S. 983 (1957), the First Circuit had allowed carryback of post-acquisition losses where the taxpayer had established that the tax deduction was "otherwise available" and was not a consequence of the acquisition.
87. 303 F.2d 142 (1st Cir. 1962).
position that post-acquisition operating loss deductions can be disallowed on either of two theories. The court construed Section 269 as applicable to all tax benefits arising out of an acquisition "tarred by the brush of tax avoidance motivation."88 Alternatively the court cited the rule of J.D. & A.B. Spreckles89 that affiliation serving no business purposes as distinguished from a tax-reducing purpose does not qualify for the privilege of filing a consolidated return. It is not clear whether the court considered the "no business purpose" test and the "principal purpose of tax avoidance" test as equivalents, but it is clear that it was not prepared to distinguish post- from pre-acquisition loss deductions under section 269. A vigorous dissent questioned the application of a statute designed to discourage a taxpayer from buying the tax deduction of another to disallow a deduction based on a taxpayer's own out-of-pocket losses.90

The Second Circuit expressly followed Collins in J.T. Slocomb v. Commissioner.91 Slocomb involved disallowance of both pre- and post-acquisition losses. The court held that "... where the principal purpose of a transaction within the scope of section 269 is to secure a tax benefit, then any tax benefits which the acquiring corporation or shareholders would not have been entitled to but for the acquisition should also be disallowed. The disallowance is not restricted to the deduction in which the acquiring parties were primarily interested."92 Three other Second Circuit cases have sustained disallowance of post-acquisition net operating losses where there has been a finding that the principal purpose of an acquisition was tax avoidance.93

The Third Circuit has decided cases on both sides of the dispute. In Elko Realty Co. v. Commissioner94 post-acquisition net operating loss deductions were claimed on a consolidated return filed by the corporate owner and manager of several apartment buildings. The court affirmed the Tax Court disallowance citing the Spreckels rule that substantial business purpose is a condition of qualification for the privilege of filing a consolidated return. Nine years later Frank Ix and Sons Virginia Corp. v. Commissioner95 disallowed both pre- and post-acquisi-

88. Id. at 146.
89. 41 B.T.A. 370, at 378. See, supra note 85.
90. 303 F.2d at 147-50.
91. 334 F.2d 269 (2d Cir. 1964).
92. Id. at 275.
94. 260 F.2d 949 (3d Cir. 1958).
tion loss deductions, but no distinction in treatment was urged on the court by the taxpayer until the appeal. The court suggested that the distinction would receive careful hearing if it were properly raised.\textsuperscript{96} It was raised and considered the next year in \textit{Herculite Protective Fabrics Corp. v. Commissioner}.\textsuperscript{97} The Third Circuit held in that case that only the pre-acquisition loss deduction could be disallowed under section 269. Since the \textit{Herculite} decision does not discuss the \textit{Elko} decision, it is not clear what relationship the Third Circuit would find between them. It is clear that in the Third Circuit section 269 cannot reach post-acquisition losses where, as in \textit{Herculite}, the deduction is found to be "in no sense artificial and represents no unjust enrichment of the taxpayer."\textsuperscript{98} This holding constitutes a double standard for application of section 269. There is one standard, "principal purpose of tax avoidance," in the cases of pre-merger carryovers and multiple surtax exemptions where the legislative mandate is clear. There is a different standard, that of \textit{Herculite}, "in the absence of a clear legislative mandate."\textsuperscript{99}

The most recent post-acquisition loss case was decided last year in the Fifth Circuit. \textit{Hall Paving Co. v. United States}\textsuperscript{100} involved a net operating loss deduction claimed on a consolidated return filed by a road paving company that had purchased five bowling alleys. The district court\textsuperscript{101} had ruled that section 269 could not reach these post-acquisition operating losses as a matter of law. The court of appeals remanded for a finding on the question of principal purpose. Relying heavily on the legislative history of section 269, the Fifth Circuit found the "clear legislative mandate" for disallowance of post-acquisition losses that the Third Circuit was unable to find. The court cited the House Committee's reference to "anticipated expense of other deductions"\textsuperscript{102} and the Senate Committee's reference to "prospective losses."\textsuperscript{103} It further noted the Senate Committee's explicit reference to the \textit{Spreckels} case and the consolidated return provisions\textsuperscript{104} as support-

\begin{itemize}
  \item \textsuperscript{96} \textit{Id.} at 874.
  \item \textsuperscript{97} 387 F.2d 475 (3d Cir. 1968).
  \item \textsuperscript{98} \textit{Id.} at 476.
  \item \textsuperscript{99} \textit{Id.}
  \item \textsuperscript{100} 471 F.2d 261 (5th Cir. 1973).
  \item \textsuperscript{101} 338 F. Supp. 670 (N.D. Ga. 1971).
  \item \textsuperscript{102} H.R. REP. No. 871, \textit{supra} note 14 at 938.
  \item \textsuperscript{103} S. REP. No. 627, \textit{supra} note 15 at 1017.
  \item \textsuperscript{104} \textit{Id.}
\end{itemize}

The National Securities and \textit{Spreckels} cases cited above aptly illustrate such nonconformity, violating in those cases the basic policies of the deduction.
ing the government's contention that section 269's principal purpose test was intended to supersede the "no business purpose" test that had been applied in *Spreckels.*\(^{105}\) The court admitted that it had taken the opposite approach in *Supreme Investment Co.*\(^{106}\) the year before. In that case the court had looked to the legislative plan of the deduction to determine the limits of section 269. In *Hall* the court was looking to section 269 to determine how the legislative plan of the deduction was to be construed.

On the issue of the relationship between section 269 and the consolidated return regulations, *Hall* placed the Fifth Circuit in direct conflict with the Sixth. The Sixth Circuit took its stand in 1964 in *Zanesville Investment Co. v. Commissioner.*\(^{107}\) As in *Hall* only post-acquisition net operating losses had been deducted on the consolidated return. The losses had been generated in attempting to open a new face on an existing coal mine that was one of several enterprises owned by a profitable newspaper publisher. There had been no change in the ownership of the controlling parent corporation. The acquisition consisted in the transfer of the mine from one to another of the commonly owned subsidiaries. The court carefully distinguished *Spreckels* and *Elko Realty* on the facts. Both of those cases were read as involving built-in\(^{108}\) rather than post-acquisition net operating losses.\(^{109}\) The court concluded that the test for application of section 269 was not only the motive of the taxpayer but also the relationship of the case to the legislative plan of the deduction challenged. The court reviewed the legislative history of the consolidated return\(^{110}\) and concluded:

In this case, it may well be, as the Tax Court found, that the taxpayer desired to offset anticipated losses against income; but there is no evidence that such objective is violative of the legisla-

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\(^{105}\) 471 F.2d at 264 n.8.
\(^{106}\) 468 F.2d 370 (5th Cir. 1972).
\(^{107}\) 335 F.2d 507 (6th Cir. 1964).
\(^{108}\) *Id.* at 510. Built-in losses are defined as losses accruing prior to the acquisition but realized after the acquisition.
\(^{109}\) *Id.* at 510-11.
\(^{110}\) One of the difficulties in determining the legislative plan for the consolidated return privilege is that INT. REV. CODE § 1502 delegates to the Secretary authority to make the necessary regulations. These regulations do make provision for special treatment of post-acquisition net operating losses.
tive plan which permits just that in an effort to counter-balance
profits with losses.\textsuperscript{111}

The disallowance was reversed.

The Seventh Circuit has sustained disallowance of post-acquisition
operating losses in two cases. \textit{Luke v. Commissioner}\textsuperscript{112} expressly fol-
lowed \textit{Collins} in refusing to distinguish between pre- and post-acquisi-
tion losses. The court found the post-acquisition losses to be a neces-
sary incident of an overall plan and therefore tainted by the tax avoid-
ance motive. \textit{Consolidated-Hammer Dry Plate & Film Co. v. Com-
missoner}\textsuperscript{113} also refused to distinguish between pre- and post-acquisi-
tion losses. The case involved a pre-1954 tax year and deductions were
disallowed under the \textit{Libson Shops}\textsuperscript{114} rule without reference to section
269.

There have been no true post-acquisition loss cases in the Ninth
Circuit, but two cases involving built-in losses did discuss the consoli-
dated return regulations. \textit{American Pipe & Steel v. Commissioner}\textsuperscript{115}
affirmed a Tax Court holding that because the "principal purpose" of
the transaction was tax avoidance, the taxpayer could not qualify for
the privilege of filing a consolidated return under the \textit{Spreckels} rule. In
\textit{Hawaiian Trust Co. Ltd. v. United States}\textsuperscript{116} the court concluded that
the principal purpose of the transaction had not been tax avoidance.
In dicta it implied that the "principal purpose" test of section 269 and
the "no business purpose other than tax avoidance" test of \textit{Spreckels}
were interchangeable.\textsuperscript{117}

The Tax Court has joined both sides of the issue.\textsuperscript{118} In \textit{Temple
Square Mfg. Co. v. Commissioner}\textsuperscript{119} the court disallowed a deduction
for post-acquisition operating losses. It read the language and legisla-
tive history of section 269 to apply to any deduction that would not
otherwise be available once the acquisition is found to have had a
principal purpose of tax avoidance.\textsuperscript{120} Seven years later in \textit{Industrial

\begin{footnotes}
\item 111. 335 F.2d at 514.
\item 112. 351 F.2d 568 (7th Cir. 1965).
\item 113. 409 F.2d 1077 (7th Cir. 1969).
\item 114. See supra note 73.
\item 115. 243 F.2d 125 (9th Cir.), cert. denied, 355 U.S. 906 (1957).
\item 116. 291 F.2d 761 (9th Cir. 1961).
\item 117. \textit{Id.} at 769: Where there is in fact no business purpose and the sole or principal purpose
is tax evasion, the benefits of a consolidated return may be denied under ei-
ther section [269] or the \textit{Spreckels} rule.
\item 118. See Jack E. Golsen, 54 T.C. 742 (1970) explaining that when there is a split
in the circuits, the Tax Court will decide an issue in accord with the circuit to which
an appeal will go if an appeal is taken.
\item 119. 36 T.C. 88 (1961).
\item 120. \textit{Id.} at 95.
\end{footnotes}
Suppliers, Inc. v. Commissioner\textsuperscript{121} the Tax Court, without reference to the earlier decision, held that section 269 is not applicable to net operating losses incurred subsequent to the acquisition, whatever the taxpayer's motive.\textsuperscript{122}

The Tax Court in Industrial Suppliers, the Third Circuit in Herculis and the Sixth Circuit in Zanesville have held that as a matter of law section 269 does not reach post-acquisition net operating losses. The Zanesville decision is the narrowest holding that post-affiliation operating losses "standing by themselves" are not within the reach of section 269.\textsuperscript{123} The First, Second, Fifth and Seventh Circuits have held that where the principal purpose is tax avoidance, section 269 may be applied to disallow any benefit resulting from the acquisition. These circuits make no distinction between pre- and post-acquisition loss deductions. To complicate the division in the circuits the Third Circuit in Elko Realty and the Ninth Circuit in American Pipe have held that, regardless of section 269, post-acquisition losses may be barred under the Spreckels rule that a consolidation made for no business purpose other than tax reduction does not qualify for a consolidated tax return.

A carefully drawn post-acquisition case could bring the division of the circuits to the Supreme Court for resolution. The strongest case for application is probably the drafters' reliance on Spreckels and the fact that the consolidated return provisions, allowing the application of post-acquisition losses to post-acquisition gains, that were relied on in Zanesville are regulations authorized but not written by Congress. There is no clearly articulated "legislative plan" as was found in Alinco and in Supreme Investment. The strongest arguments against application are probably the policy and economic considerations raised by the dissent in Collins. The difficulty with these arguments is that it is easiest for the Court to rely on construction of legislative intent and most difficult for the Court to rely on policy considerations. Ultimately it is for the legislature, not the courts, to decide whether the allowance of post-acquisition losses is consistent with the purposes of the consolidated return. It is for the Congress to determine, as they did in the case of the loss carryover, whether an objective test will serve the ends of tax policy better than the subjective test of taxpayer motive.

There are two realistic possibilities for Congressional review of section 269. The recommended repeal of subsection (c) may bring sec-

\textsuperscript{121} 50 T.C. 635 (1968).
\textsuperscript{122} Id. at 649-50.
\textsuperscript{123} 335 F.2d 507 at 511.
tion 269 up for review. Alternatively, continuing interest in conglomerate acquisitions may provide the impetus for a more comprehensive review of all the Code provisions that affect acquisitions including section 269. Certainly Congressional action would clarify the issue for both the Supreme Court and the taxpayer. Until there is such a review, section 269 will continue to be a Catch-22 for any business carefully planning an acquisition with tax advantages in mind. Until there is such a review, the Court could do little more than dull the edge of section 269 by holding it inapplicable to post-acquisition net operating losses. The Court resolution of that issue cannot resolve the basic problems of dependence on the subjective "principal purpose test" or the failure of the section 269 sanction to distinguish between some and no business purpose. Perhaps of greatest concern is that Court resolution of the post-acquisition loss question will not restrict efforts to extend the reach of section 269 in other directions to disallow other benefits that arise directly or indirectly from acquisition or incorporation.

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