***Commonwealth Container Corp. v. Commissioner of Internal Revenue*, 48 T.C. 483, 1967 U.S. Tax Ct. LEXIS 79 (1967)**

Section 382(b)(1) of the Internal Revenue Code limits the net operating loss carryover in corporate reorganizations when the former shareholders of a loss corporation, as a result of owning stock in the loss corporation, own less than 20% of the fair market value of the acquiring corporation's stock immediately after the reorganization.

Summary

Commonwealth Container Corp. sought to utilize the net operating loss carryovers of Tri-City Container Corp. after a merger. The Tax Court addressed whether Section 382(b)(1) of the 1954 Internal Revenue Code limited this carryover. The court held that because the shareholders of Tri-City, as a direct result of the merger, owned less than 20% of the fair market value of Commonwealth's stock, despite controlling both entities pre-merger, the net operating loss carryover was limited. This decision emphasizes the strict application of the statutory language and the requirement that the 20% ownership in the acquiring corporation must be a direct consequence of owning stock in the loss corporation.

Facts

Commonwealth Container Corp. (Petitioner) and Tri-City Container Corp. were both in the corrugated container manufacturing business, operating in different geographic regions. Paul and Irwin Densen, along with Abbot Greene, controlled both corporations. Tri-City had significant net operating loss carryovers. In 1961, Tri-City merged into Commonwealth in a tax-free reorganization. Under the merger plan, Tri-City shareholders received Commonwealth stock. However, because the Densens and Greene already held a majority stake in Commonwealth prior to the merger, the stock they received in exchange for their Tri-City shares constituted less than 20% of Commonwealth's total outstanding stock *as a result of the merger*. Elmer Hertzmark, a 25% shareholder in Commonwealth who had no prior stake in Tri-City, remained a shareholder after the merger.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in Commonwealth's income taxes for 1961 and 1962, disallowing the full net operating loss carryover from Tri-City. Commonwealth petitioned the Tax Court. The Commissioner conceded that a 65% carryover was allowable under Section 382(b)(2) but maintained that the limitations of Section 382(b)(1) applied. The Tax Court upheld the Commissioner's determination, limiting the net operating loss carryover.

Issue(s)

1. Whether Section 382(b)(1) of the Internal Revenue Code of 1954 applies to limit

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the net operating loss carryover from Tri-City to Commonwealth, given that the shareholders of Tri-City, as a result of the merger, owned less than 20% of the fair market value of Commonwealth's stock immediately after the reorganization.

2. Whether the exception in Section 382(b)(3) applies, which states that the limitations of subsection (b) do not apply if the transferor and acquiring corporations are owned substantially by the same persons in the same proportion.

Holding

1. Yes. The Tax Court held that Section 382(b)(1) applies because the stockholders of Tri-City, as a result of owning Tri-City stock, owned less than 20% of the fair market value of Commonwealth's stock immediately after the merger. This was true even though the same individuals controlled both corporations before and after the merger.

2. No. The Tax Court held that the exception in Section 382(b)(3) does not apply because Commonwealth and Tri-City were not owned substantially by the same persons in the same proportion. The presence of Hertzmark's 25% ownership in Commonwealth, with no corresponding ownership in Tri-City, demonstrated a lack of proportionate ownership.

Court's Reasoning

The Tax Court strictly interpreted the language of Section 382(b)(1), emphasizing the phrase "as the result of owning stock of the loss corporation." The court reasoned that Congress intended a mechanical test based on the percentage of ownership in the acquiring corporation received specifically because of the reorganization. The pre-existing ownership of Commonwealth stock by Tri-City's shareholders did not count towards the 20% threshold. The court stated, "To interpret the statute otherwise would require reading the phrase 'as the result of owning stock of the loss corporation' completely out of the statute; and this we are not justified in doing."

Regarding the exception in Section 382(b)(3), the court found that "substantially" should be narrowly construed. The court noted that Hertzmark's 25% ownership in Commonwealth, without any prior ownership in Tri-City, and the shifts in ownership percentages of the Densen and Greene families, demonstrated that the corporations were not owned substantially by the same persons in the same proportion. The court referenced Treasury Regulations that illustrated that even relatively small deviations in proportionate ownership could disqualify a merger from the exception.

Practical Implications

Commonwealth Container Corp. is a key case for understanding the limitations imposed by Section 382(b)(1) on net operating loss carryovers in corporate reorganizations. It establishes that the 20% continuity of interest requirement is

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applied rigorously, focusing solely on the stock ownership in the acquiring corporation that is directly attributable to the merger exchange. Pre-existing ownership in the acquiring corporation by shareholders of the loss corporation is disregarded for purposes of meeting this 20% threshold. Tax practitioners must structure mergers carefully, ensuring that loss corporation shareholders receive at least 20% of the acquiring corporation's stock *as a result of* the reorganization to avoid limitations on loss carryovers. The case also highlights the narrow interpretation of the "substantially the same ownership" exception under Section 382(b)(3), emphasizing that even moderate shifts in proportionate ownership can negate this exception. This decision reinforces a literal interpretation of tax statutes, even where taxpayers might argue for a more lenient application based on overall control or economic substance.

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