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Effect of a Carry-Back of Loss on Right To Interest

By W LEWIS ROBERTS*

In 1948, Judge Smith of the Federal District Court in New Jersey was called upon to decide a problem of abating interest assessed upon an income tax deficiency. The net operating loss of a later year was more than sufficient to wipe out the deficiency and interest under the carry-back provision of the internal revenue law. He said the question presented was one which the parties to the suit conceded was a question "of novel impression."¹

The plaintiff corporation paid the amounts shown in its income and excess-profits tax returns for 1941. The Commissioner assessed a deficiency in taxes together with interest thereon in 1943 and additional deficiency taxes in 1944. The deficiency taxes were not paid. The returns filed by the taxpayer in 1943 showed a net operating loss, and it filed on March 15, 1944, a claim for refund of the full sum paid for income taxes in 1941, basing its claim under the carry-back provision of Section 122 of the Internal Revenue Code of 1940.² It also asked for an abatement of the unpaid deficiency assessments and interest thereon. The Commissioner allowed a refund of the taxes paid for 1941 and abated the unpaid deficiency assessments, but declined to abate the interest assessed on the deficiency taxes. The amount of this interest he deducted from the sum taxpayer was entitled to have carried-back. The taxpayer sued to recover this amount. In holding for the defendant, the district court said interest was not part of the tax but was to compensate the government for the delay in payment of taxes and that the application of Section 122 (b) "abolished the right of the defendant to collect the deficiency taxes but not his right to collect the interest as compensation for the plaintiff's delay in their payment."

In passing, it is to be noted that Section 292 of the Revenue Code, which covers the subject of interest on deficiencies says interest "

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¹ Seeley Tube & Box Co. v. Manning, 76 F. Supp. 937 (D. C. N. J. 1948).

Section 122 (b) (1) provides: "If for any taxable year beginning after December 31, 1941, the taxpayer has a net operating loss, such net operating loss shall be a net loss carry-back for each of the two preceding taxable years." A similar provision applied in the case of excess profits credits.

shall be collected as a part of the tax, ³ Furthermore, the opinion of the district judge contains no mention of the fact that the taxpayer was adjudged a bankrupt and a receiver was appointed on July 7, 1943, and that the Commissioner on August 3 of that year resorted to the accelerated procedure provided for in bankruptcy cases. He assessed deficiencies in the 1941 taxes with interest from the date the tax was due to the assessment date. Section 298, which covers such a case, states that interest shall be collected "as a part of such amount."⁴

As pointed out by one tax authority, the court did not consider the definition of deficiency. To quote:

"At no place in the opinion does the court touch on the definition of deficiency. It appears to the writer that the court overlooked the key to the entire problem. Section 292 requires the payment of interest only on a deficiency. To decide this issue without reference to the statutory definition of deficiency seems to beg the question."⁵

The district court's finding that the Commissioner committed no error in crediting to interest part of the refund due to the carry-back of net operating loss for the year 1943, met with reversal in the Court of Appeals for the Third Circuit. Before the appeal from the district court's finding was passed upon by the Court of Appeals, a somewhat similar question was brought before the federal district court in Minnesota. The facts at first glance might seem to be the same.⁶ A Minnesota corporation paid the Commissioner a deficiency assessment of excess profits tax, together with interest, for the year 1941. Plaintiff there had paid its income and excess profits taxes on time. Deficiencies with interest thereon were assessed in 1943 and were paid by the corporation on September 4, 1943. On June 4, 1943, it had filed amended returns for both income and excess profits taxes for the year 1941, electing to accrue income from installment sales under Section 736 (a) of the Code as amended by Section 222 (d) of

³ "292. Interest on deficiencies.

"(a) General Rule. Interest upon the amount determined as a deficiency shall be assessed at the same time as the deficiency, shall be paid upon notice and demand from the collector, and shall be collected as a part of the tax, at the rate of 6 percentum per annum from the date prescribed for the payment of the tax (or, if the tax is paid in installments, from the date prescribed for the payment of the first installment), to the date the deficiency is assessed, "

⁴ Section 298. "Bankruptcy and Receiverships.

If the unpaid portion of the claim allowed in a bankruptcy or receivership proceeding, as provided in section 274, is not paid in full within ten days from the date of notice and demand from the collector, then there shall be collected as a part of such amount interest upon the unpaid portion thereof at the rate of 6 percentum per annum from the date of such notice and demand until payment."

⁵ DeFosset, *Interest on Potential Deficiencies*, 27 TAXES 33 (1950).

⁶ *Brandtjeant Kluge, Inc. v. United States*, 78 F. Supp. 509 (D.C. Minn 1948).

the 1942 Act. This reduced the profits for 1941 on installment sales. A claim for refund was filed, based upon these amended returns, on the ground that the unused excess profits credit for the years 1942 and 1943 should be carried back and applied as a credit against the excess profits net income for 1941. The Commission allowed a refund for the amount claimed except for \$472.50 interest paid upon the excess profits tax deficiency for 1941. Suit was brought for this amount. The plaintiff contended that any interest on such an assessment made after the period of limitation was an over-payment and should be refunded. The court admitted that the interest asked to be refunded was not "in the nature of a penalty," but was compensation due the defendant. The plaintiff based its case on Section 322 (a) of the Internal Revenue Code,⁷ claiming that "over-assessment" included interest paid on the tax.

The court, holding for the defendant, referred to the *Seeley Tube and Box Company* case which stressed the argument that the interest was intended as compensation to the government for the delay in paying the tax. It admitted, however, that the "plaintiff's argument is appealing, forceful and persuasive of the lack of logic in the Bureau's refusal to return the interest when the tax is refunded."

The facts in this case are different from those in the *Seeley* case since in this case the plaintiff was seeking a refund of interest actually paid the government, whereas in the *Seeley* case the plaintiff was asking for a return of the principal he was entitled to under the carry-back provision as to a net operating loss and the Commissioner was seeking to deduct from that amount interest on an assessment which, as it turned out, was not due the government.

The opinion of the Circuit Court in the case of *Seeley Tube and Box Company v Manning*⁸ was given by Judge Goodrich. The holding of the district court was reversed. The government claimed it was entitled to the interest on the unpaid deficiency from the time the assessment was made until the obligation was swept away by the application of the carry-back provision. The taxpayer, on the other hand, maintained that it did not owe interest for non-payment of deficiencies of taxes that subsequent events had shown were not due. The court pointed out that the taxpayer was not claiming interest from the government, but to get back money which was coming to it because of

⁷ Section 322 (a) reads:

"Where there has been an overpayment of any tax imposed by this chapter, the amount of such overpayment shall be credited against any income, war-profits, or excess-profits tax or installment thereof then due from the taxpayer, and any balance shall be refunded immediately to the taxpayer."

⁸ 172 F (2d) 77, 49-1 USTC Par. 9113 (C.A. 3d 1948),

the carry-back clause. It asked for the return of principal only
Judge Goodrich said:

“Interest not contracted for by the terms of an agreement between the parties is generally described as damages for the detention of money to which another is entitled.⁹ The government adopts that theory in this case. But what money was the government entitled to here? As it turned out, taxpayer not only did not owe any money, but had money coming back to it. We think that the inchoate liability is not sufficient to call for the payment of anything but inchoate interest, whatever that may be, and so far as real money is concerned the taxpayer is entitled to get it back.”

The case was then carried to the Supreme Court under the title *Manning v Seeley Tube and Box Company*,¹⁰ where the Circuit Court's holding in turn was reversed. The Chief Justice speaking for the court said:

“The problem with which we are concerned in this case is whether the interest on a validly assessed deficiency is abated when the deficiency itself is abated by the carry-back of a net operating loss.”

He points out that since a net operating loss or an unused excess profits credit cannot be determined until the close of a future tax year, the taxpayer must file his return and pay his tax without regard to such deduction. There is, he points out, “a positive obligation to the United States: a duty to pay its tax.” By failing to pay, the taxpayer has the use of money that “rightfully should have been in possession of the United States.” The reference to Code sections prescribing “penalties and additions to the tax for negligence and fraud” might lead one fairly to infer that the court regarded the interest in the instant case in the nature of a penalty. The Chief Justice also stresses the loss of use of the interest money to the government as a reason for not abating the interest in this case. The court rejected the contention of the taxpayer that interest is a part of the tax.

If one accepts the assumptions made by the court, he will readily agree with its holding in the case. It seems worthwhile, therefore, to examine more in detail the grounds set forth by the court for its decision. The court stressed the following points in its opinion:

1. The government is entitled to the use of the money until the assessed deficiency is wiped out by the carry-back provisions of the Code.
2. The carry-back provisions of the 1942 Act do not show an intent

⁹ Citing 15 AM. JUR. Damages, Sec. 159 (1938), and RESTATEMENT, CONTRACTS, Sec. 137 (1932).

¹⁰ 70 S. Ct. 386 (February 6, 1950),

on the part of Congress to encourage taxpayers to cease paying taxes promptly

3. The taxpayer's contention would place a premium on failure to pay promptly and would be inconsistent with the Code as amended by the 1945 Act.

4. The court seeks to disprove the taxpayer's claim that not to abate the assessed interest is unfair and discriminates against the taxpayer whose deficiency is assessed under the accelerated bankruptcy procedure and favors one whose deficiency is assessed under Section 272 (a) (1).

5. It finally considers the taxpayer's reliance on the principle that interest is an "accretion and part of the tax" and as such entitled to abatement.

In considering these statements in detail, we should, perhaps, bear in mind that most authorities say tax laws are to be construed in favor of the taxpayer. Cooley, in his learned treatise on taxation, in dealing with income taxes, makes the following statement:

"Income tax statutes, whether a federal statute or a state, are subject to the rule of strict constructions the same as other tax statutes; but it is the duty of the courts to observe the fundamental rule to ascertain and give effect to the intention of the legislature."¹¹

The Supreme Court, in laying down the proposition in *Treat v White*¹² that legislative intent should be made to govern, quoted from Pollock, C. B., that "a tax cannot be implied without clear and express words for that purpose."¹³

Mr. Justice Pitney, in giving the opinion of the court in *United States v Field*,¹⁴ stated the rule in similar terms. He said:

"Applying the accepted canon that the provisions of such acts are not to be extended by implication (*Gould v. Gould*, 245 U.S. 151, 153), we are constrained to the view — notwithstanding the administrative construction adopted by the Treasury Department — that the Revenue Act of 1916 did not impose an estate tax upon the property under the testamentary execution of a general power of appointment."

Turning now to the propositions considered by the court in its opinion in the *Seeley* case, we will take them up in their order. The first is that the Government is entitled to the use of the money until the assessed deficiency is wiped out by the carry-back provision of

¹¹ COOLEY, 4 TAXATION sec. 1759 (4th Ed. 1924). He cites *Commercial Health & Accident Co. v. Pickering*, 281 Fed. 539 (D.C. S.D. 1922).

¹² 181 U.S. 264, 267, 45 L. Ed. 853, 21 S. Ct. 611 (1900).

¹³ *Cirt v. Scudds*, 11 Exch. 191 (1855).

¹⁴ 255 U.S. 257, 262, 41 S. Ct. 256, 65 L. Ed. 617 (1920).

the Code. The interest the court refused to abate when it abated the deficiency, of course, represents the use of money involved from the time it became payable until the abatement of the deficiency. The court says that it appears from an inspection of the Code that Congress intended the Government to have the use of this money and it then refers to sections that impose penalties and additions to the tax for negligence and fraud. It fails to point out either negligence or fraud in the instant case unless to be adjudged a bankrupt be negligence or fraud. In fact, a study of the purpose for enacting carry-over and carry-back provisions would seem to lead to an opposite conclusion from that reached by the court.

As early as the Revenue Act of 1918, Congress took steps to equalize tax burdens in businesses where large earnings one year might be followed by large losses the next. Section 204 of the 1918 Act allowed "net losses" of one year to be carried-over and deducted from net gains of the two succeeding years. In this way a corporation engaged in a business where earning fluctuations were great would pay an income tax on its average net gains for a period of three years and be put upon a basis comparable to that of a corporation having an income that did not vary from year to year. This provision was contained in succeeding revenue acts through 1932. The Revenue Act of 1939 restored the carry-over provisions, but this was found not enough to encourage manufacturers to convert their plants to the production of war materials when they were certain to face great losses during the following years in reconverting to the production of peacetime products. To overcome this difficulty, Congress stipulated in the Revenue Act of 1942 that "net operating losses" could be carried back two years and charged against high earnings of war years. Under these provisions of carry-over and carry-back, a net operating loss could be spread over several years.

Now in the *Secley* case the taxpayer had very large earnings in the year 1941 and great losses in subsequent years. It seems that the purpose of the carry-back provision entitled it to recover as much of this loss out of the profits of 1941 as possible, including interest on the assessed deficiency. Otherwise the taxpayer's taxes for the period of years covered would not be equalized as much as they could have been equalized.

The second objection the court raises to abating the interest on the deficiency is that the carry-back provisions of the 1942 Act do not show an intent on the part of Congress to encourage the taxpayer to cease prompt payment of taxes. This claim does not seem to apply to the facts in the instant case, as at the time of the assessment of deficiency tax and interest thereon the taxpayer had already been ad-

judged a bankrupt and its assets were in the hands of the bankruptcy court. Sections 274 (a) and 274 (b)¹⁵ apply in such case.

The court, in the third place, argues that an acceptance of the taxpayer's contention would place a premium on failure to conform diligently with the law, and would be inconsistent with Sections 3779 and 3780 of the Code, which are applicable to taxable years ending after September 30, 1945. The first of these sections allows a corporation expecting a carry-back for the succeeding year an extension of time for payment of the prior year's income or excess profits taxes. Interest is charged in such a case.¹⁶ Section 3780 sets forth the method of making final adjustments in such cases. The decreased amount of the tax is to be credited "against the deficiencies (*and additions to the tax*)."¹⁷ (Italics added.)¹⁷ Clearly, these sections provide that credit is

¹⁵ Section 274:

(a) "Immediate Assessment.—Upon the adjudication of bankruptcy of any taxpayer in any bankruptcy proceeding on the appointment of a receiver for any taxpayer in any receivership proceeding before any court of the United States or of any State or Territory or of the District of Columbia, any deficiency (together with all interest, additional amounts, or additions to the tax provided for by law) determined by the Commissioner in respect of a tax imposed by this chapter upon such taxpayer shall, despite the restrictions imposed by section 272 (a) upon assessments, be immediately assessed if such deficiency has not heretofore been assessed in accordance with law. In such cases the trustee in bankruptcy or receiver shall give notice in writing to the Commissioner of the adjudication of bankruptcy or the appointment of the receiver, and the running of the statute of limitations on the making of assessments shall be suspended for the period from the date of adjudication in bankruptcy or the appointment of the receiver to a date 30 days after the date upon which the notice from the trustee or receiver is received by the Commissioner; but the suspension under this sentence shall in no case be for a period in excess of two years. Claims for the deficiency and such interest, additional amounts and additions to the tax may be presented, for adjudication in accordance with law, to the court before which the bankruptcy or receivership proceeding is pending, despite the pendency to the Board; but no petition for any such redetermination shall be filed with the Board after the adjudication of bankruptcy or the appointment of the receiver."

(b) "Unpaid Claims.—Any portion of the claim allowed in such bankruptcy or receivership proceeding which is unpaid shall be paid by the taxpayer upon notice and demand from the collector after the termination of such proceeding. Extensions of time for such payment may be had in the same manner and subject to the same provisions and limitations as are provided in section 272 (j) and section 296 in the case of a deficiency in a tax imposed by this chapter."

¹⁶ Section 3779 (i) reads as follows:

"Interest.—In the case of an amount the time for payment of which has been extended there shall be collected *as part of such amount interest* from the dates on which payments would have been required if there had been no extension and the taxpayer and elected to pay the tax in four equal installments as provided in section 56 (b) —

"(1) upon so much of such amount as is satisfied under section 3780 (b) interest at the rate of 3 per centum per annum; and

"(2) upon the remainder of the amount interest at the rate of 6 per centum per annum to the date such amount is paid." (Italics added.)

¹⁷ Section 3780 (b) reads: " and any remainder shall be credited—

"(1) against the deficiencies (*and additions to the tax*) assessed under this section."

to apply to the interest that is assessed as well as to the taxes the time of payment of which has been extended.

In the instant case, the Seeley Tube and Box Company paid as income tax for 1941, \$17,383.59, and \$27,514.41 as excess profits tax. The Commissioner assessed a deficiency income tax of \$11,494.31 and \$1,125.97 as interest on the same. He also assessed a deficiency in the excess profits tax of \$36,294.99 and \$3,555.42 interest on this deficiency. In 1943 the Commissioner allowed a total carry-back of \$218,612.51 and this finding was accepted as correct by the taxpayer. In spite of the fact that this amount was far more than was necessary to wipe out the taxes paid in 1941 and the deficiencies assessed together with interest on the same, the Commissioner deducted the amount of the interest assessed on the deficiencies, \$4,513.34, from the \$44,898.00 that was actually paid by the taxpayer in 1941 and turned over to it the sum of \$40,384.66. Furthermore, Section 292 (a), which deals with interest on deficiencies, was amended in 1944 by adding: "If any portion of the deficiency assessed is not collected by reason of a prior satisfaction, in whole or in part, of the tax, proper adjustment shall be made *with respect to the interest on such portion.*" (Italics added.)¹⁸ The third paragraph of this section applies specifically to deficiencies resulting from carry-back cases and states that in determinations made under Sections 3771 (e) and 3780 (b), "no interest shall be assessed or paid under subsection (a) with respect to such part of the deficiency for any period during which interest was not allowed with respect to such overpayment or for a period prior to the application of such decrease."¹⁹

The court next seeks to disprove the taxpayer's claim that not to abate the assessed interest is unfair and discriminates against the taxpayer whose deficiency is assessed under the accelerated bankruptcy procedure and favors one whose deficiency is assessed under Section 272 (a) (1).

As pointed out in the opinion, under Section 272 (a) (1), the Commissioner sends a notice of the deficiency to the taxpayer by registered mail. Within 90 days thereafter, the taxpayer may petition the Tax

¹⁸ See note 3 *supra*.

¹⁹ Section 292 (c). "Deficiency Resulting from Carry-Back and Related Matters.—If any part of a deficiency is determined by the Commissioner to be attributable (A) to a carry-back to which overpayment described in section 3771 (e), or a decrease determined under section 3780 (b), in any other tax is attributable, as (B) to an error in the amount as effect of a carry-back which resulted in a credit or refund of an overpayment with interest computed pursuant to section 3771 (e), or in a decrease determined under section 3780 (b), no interest shall be assessed or paid under subsection (a) with respect to such part of the deficiency for any period during which interest was not allowed with respect to such overpayment or for a period prior to the application of such decrease."

Court for a redetermination of the deficiency. The Tax Court decides whether there is a deficiency and if it finds there is, it determines the amount and interest is assessed at the same time. In a case like the one before the court, the taxpayer contends the court would find no deficiency because of the net operating loss carry-back and consequently no interest would be assessed. The court considers this contention not applicable to the case under consideration because at the time the deficiency was assessed no net operating loss had been reported and the validity of the assessment had not been questioned. The method of making the assessment, it believes, should not lead to a difference in results.

The Circuit Court in passing on the case supported the taxpayer's view. Since it turned out no deficiency was due from the taxpayer, it could not be charged with the payment of interest. To quote again from the opinion:

"As it turned out, taxpayer not only did not owe any money, but had money coming to it. The only thing on which an interest claim could be predicated is the inchoate liability of the taxpayer which disappeared under the application of the carry-back provisions of the statute. We think that inchoate liability is not sufficient to call for the payment of anything but inchoate interest, whatever that may be, and so far as real money is concerned the taxpayer is entitled to get it back."²⁰

The contention of the Supreme Court that no net operating loss had been reported at the time the Commissioner assessed the deficiency in question and the interest thereon seems to be open to question since the taxpayer had been adjudged a bankrupt at the time the deficiency was assessed and its financial status was a matter of court record.

The last part of the court's opinion concerns the taxpayer's reliance on the principle that interest is an "accretion and part of the tax" and as such entitled to abatement. The court dismissed this part of the taxpayer's case by pointing out that the cases it relies on are cases dealing with compromises of taxes which were incorrectly assessed in the first instance and not cases involving the problem of a subsequent abatement of a tax correctly assessed at the outset. It also notes that the two rulings on the carry-back provisions cited were made under the Revenue Act of 1918.

The court makes no mention of the wording of the various provisions of the Code already mentioned above; the last clause of Section 292 (a)²¹ which states that a "proper adjustment shall be made with respect to interest on such portion," Section 3780 (b) that the amount of carry-back "shall be credited — (1) against the deficiency

²⁰ 172 F. (2d) 77 at 79 (C.A. 3d 1948).

²¹ See note 3 *supra*.

and additions to the tax) ²² and to statements like the one in Section 292 (a) that interest shall be collected as a *part of the tax*. (Italics added.) It is interesting to note that under the common law rule in the federal courts taxes were recoverable as debts, with interest in all cases where equitably due, unless forbidden by statute.²³

It seems that the conclusion reached by a contributor to *Taxes*²⁴ concerning the decision in the District Court that the *Seeley Tube and Box Company* case was improperly decided is also applicable to the finding of the Supreme Court in the same case. What seemed to weigh most in the minds of the Supreme Court judges seemed to be the fact that the Government was deprived of the use of the amount from the time of the assessment of the deficiency to the time it was wiped out by the carry-back of the net operating loss for 1943. The court does not go into the question of the actual loss to the Government. In this case the interest assessed at 6 per cent amounted to \$4,513.34. The Government at that time could have secured a loan at half the rate of interest charged to the taxpayer. That would make the loss approximately \$2,000, which is a mere trifle in Government financing and not enough to be the basis of a new rule of tax law in the absence of a statutory provision for the same.

The court's decision would be right if the interest assessed were a penalty. The fact that reference is made in the opinion to several sections of the Code which prescribe penalties and additions to the tax for negligence and fraud might be taken to indicate that the court may have been influenced by some such idea. The law in federal courts seems clear that interest on unpaid taxes is not a penalty.²⁵

It is possible that the amendments to the pertinent sections of the Code made since *Manning v Seeley Tube & Box Co.* arose, may lead to a difference result in future cases involving the abatement of interest where the deficiency is abated because of a carry-back of a net operating loss. It has been suggested that the 1944 amendment to Section 292 (a), which was not effective until after the date of its adoption, may have that effect.²⁶ Such a result would more clearly conform to the purpose of the carry-over and carry-back provisions of the Code. It would make a more equitable distribution of the tax burden than can be accomplished under the Supreme Court's decision in *Manning v Seeley Tube & Box Co.*

²² See note 17 *supra*.

²³ *Billings v. United States*, 232 U.S. 261 at 284; 34 S. Ct. 421, 425; 58 L. Ed. 596 (1913); *United States v. Proctor*, 286 Fed. 272 (D. C. S. D. Tex. 1923).

²⁴ See note 5 *supra*.

²⁵ *United States v. Childs*, 266 U.S. 304, 45 S. Ct. 6, 68 L. Ed. 509 (1924); *In re John Semon, Bankrupt*, 80 F. (2d) 81 (C.C.A. 2d 1935); *United States v. Grant*, 150 Fed. 121 (1907); and *Priess v. United States*, 42 Fed. Supp. 89 (D. C. E. D. Wash. 1941).

²⁶ See note 5 *supra*.