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Carry-Over and Carry-Back of Net Operating Loss

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Prior to the enactment of the present provisions for carrying over net operating losses contained in the Revenue Act of 1939, Congress had recognized the fact that there are great fluctuations in the earnings of companies engaged in certain businesses and that such companies paid a greater income tax proportionately than companies whose income varied little from year to year. To prevent this inequality the Revenue Act of 1918, section 204, provided that "net losses" attributable to the operation of a trade or business might be carried-over and deducted from the net gains of the two succeeding years. This provision was retained in succeeding revenue acts through 1932. The Revenue Act of 1939 restored the carry-over provisions.

The privilege of carrying-over losses to succeeding years did not, however, meet the war situation where companies converted their plants to the production of war materials and earned high incomes while so engaged. At the end of the war when the demand for such products ceased, they would be under the burden of reconverting their plants to the production of peacetime goods. There was bound to follow a period in such cases of no profits and large losses. To encourage companies to aid in the war effort, the Revenue Act of 1942 contained a provision whereby "net operating losses" could be carried back two years and charged against the high income of war time.1

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Section 122 (b) of the Internal Revenue Act reads:

Amount of Carry-Back and Carry-Over.

(1) Net Operating Loss Carry-Back.—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 operating loss carry-back for each of the two preceding taxable years, except that the carry-back in the case of the first preceding taxable year shall be the excess, if any, of the amount of such net operating loss over the net income for the second preceding taxable year computed (A) with the exceptions, additions, and limitations provided in subsection (d) (1), (2), (4), and (6), and (B) by determining the net operating loss deduction for such second preceding taxable year without regard to such net operating loss.

(2) Net Operating Loss Carry-Over.—If for any taxable year the taxpayer has a net operating loss, such net operating loss shall be a net operating loss carry-over for each of the two succeeding taxable years, except that the carry-over in the case of the second succeeding taxable year shall be the excess, if any, of the amount of such net operating loss over the net income for the intervening taxable year computed (A) with the exceptions, additions, and limitations provided in subsection (d) (1), (2), (4), and (6), and (B) by determining the net operating loss deduction for such intervening taxable year without regard to such net operating loss and

(Footnote Continued on Following Page)
Similar provisions for carry-over of excess profits credits were provided in Section 710 of the Internal Revenue Code.\(^2\) The Senate Finance Committee in its 75th report to the 77th Congress said:

"The bill affords relief in the following situations:

1. It relieves the hardships which may be caused by the sharply fluctuating earnings of many types of companies, the activities of which are dependent upon business cycles, by allowing unused excess-profits credits to be carried over into the two succeeding taxable years, thereby tending to level off the usual effects due to rise and fall of income. In addition, the allowance of such an excess profits credit carry-over will be of substantial benefit to new companies and to old corporations undergoing a period of expansion."\(^3\)

The first question that courts must decide when a case under the carry-back or carry-over provisions is presented is whether the loss in question is the result of operating a trade or business. The courts in deciding cases have stressed the fact that the loss must be one incurred in operating a trade or business. A case, furthermore, must not come within any of the limitations set out in section 122 (d) (1), (2), (4), and (6), and (B) as pointed out in section 122 (b). Subsection (d) (1) limits the deduction for depreciation in computing the gross income, (2) excludes the amount of interest paid on indebtedness incurred in carrying tax-exempt obligations, (4) excludes gains or losses from sales or exchanges of capital assets, and (6) covers deductions for certain taxes.\(^4\)

\(^2\) Section 710 (c) (B) provides for the carry-over of unused excess-profits credits and is somewhat similar in wording to section 122 (b) quoted in note 1.

\(^3\) As quoted by the Tax Court in Masaba-Cliffs Mining Co., 10 T. C. 1010 (1948).

\(^4\) Section 122 (d) Exceptions, Additions, and Limitations.—The exceptions, additions, and limitations referred to in subsections (a), (b), and (c) shall be as follows:

1. The deduction for depletion shall not exceed the amount which would be allowable if computed without reference to discovery value or to percentage depletion under section 114 (b) (2), (3), or (4);

2. There shall be included in computing gross income the amount of interest received which is wholly exempt from the taxes imposed by this chapter, decreased by the amount of interest paid or accrued which is not allowed as a deduction by section 23 (b) relating to interest on indebtedness incurred or continued to purchase or carry certain tax-exempt obligations.

3. No net operating loss deduction shall be allowed;

4. Gains and losses from sales or exchanges of capital assets shall be taken into account without regard to the provisions of section 117 (b). As so computed the amount deductible on account if such losses shall not exceed the amount includible on account of such gains.

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As the cases show the right to carry-over or to carry-back losses incurred in operating a trade or business is open to an individual as well as a corporation. The United States Supreme Court entertained a case arising under the Revenue Act of 1924, where an inventor who had organized a corporation for manufacturing and selling his patents suffered a loss because of the failure of the corporation. He sought to carry-over the amount paid for the stock as well as bad debts due him from the corporation. He was denied the relief asked because the losses were not attributable to the operation of his inventing business and could not be classed as operating losses. The loss came from his investment in the corporation and was therefore a capital loss.  

During the past year there have been several cases where persons had losses incurred from the sale of land or buildings which they had used in carrying on a business. In each instance the Tax Court did not allow them to carry the loss over. In Joseph Sic the taxpayer sold land on which he had carried on the business of farming. In the case of Milton H. Pettit and Lena Winn Pettit the taxpayers sustained a loss from the sale of land, buildings, and equipment which they had used in the production and sale of citrus fruit since 1931. The court said the loss was derived from the ultimate sale of the property and not from carrying on the business. Also in Hartwig N Baruch v Commissioner, the taxpayer sold a farm in Virginia which he had operated as a business since 1917. The court sustained the Commissioner in disallowing the loss incurred in the sale of the farm in 1942 as a carry-over to 1943 and 1944. The Tax Court said that the loss

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(5) Deductions otherwise allowed by law not attributable to the operation of a trade or business regularly carried on by the taxpayer shall (in the case of a taxpayer other than a corporation) be allowed only to the extent of the amount of the gross income not derived from such trade or business. For the purposes of this paragraph deductions and gross income shall be computed with the exceptions specified in paragraphs (1) to (4) of this subsection.

(6) There shall be allowed as a deduction the amount of tax imposed by Subchapter E of chapter 2 paid or accrued within the taxable year, subject to the following rules—

(A) No reduction in such tax shall be made by reason of the credit for income, war-profits, or excess-profits taxes paid to any foreign country or possession of the United States.

(B) Such tax shall be computed without regard to the adjustments provided in section 734; and

(C) Such tax, in the case of a consolidated return for excess profits tax purposes, shall be allocated to the members of the affiliated group under regulations prescribed by the Commissioner, with the approval of the Secretary.

6 10 T. C. 1096 (1948).
7 CCH Dec. 16, 448 (M); Dkt. 126.50 June 10, 1948; aff'd June 3, 1949; 495 CCH par. 9296.
was not attributable to the operation of a trade or business regularly carried on by the taxpayer. Likewise, in the Circuit Court case of *Lazier v U S.* a loss sustained by a farmer in the sale of his farm and farm machinery was held not to be a “net operating loss” which could be charged against income taxes paid in prior years since the loss was not sustained in the business of farming. The Circuit Court also affirmed the Tax Court’s holding in the case of *Reo Motors, Inc.* that a parent company could not carry-over losses resulting from the stock of a subsidiary company becoming worthless.

Where the court has found the taxpayer was engaged in the selling of real estate, it has allowed him to carry-over the loss sustained by him in disposing of apartment and store buildings in the course of his trade or business of renting and selling real estate. It ruled the loss was attributable to the “operation of a trade or business, regularly carried on by the taxpayer within the meaning of section 122 (d) (5) of the Internal Revenue Code.” Also where the taxpayer incorporated three corporations to carry on fruit and vegetable packing, canning, and dehydrating operations which he had previously conducted as an individual and to which corporations he leased his plants; the Circuit Court held he was engaged in the “business of acquiring, owning, expanding, equipping plants” within the meaning of the statute relating to net operating loss carry-over. Where a manufacturer of silk, who carried a large stock of silk on hand, sold futures on the Commodity Exchange as a hedge and he suffered loss because of the great increase in the price of silk because of the war, it was held that the transaction was for the purpose of protection against business risks and the loss was deductible in full and could be carried-over.

A different result was reached, however, where the taxpayer undertook to carry-over the loss resulting from bad debts due an *inter vivos* trust. The loss was held not attributable to the operation of any trade or business. The same was true in regard to the loss suffered by a retiring partner who had transferred his interest to his partners. He claimed his loss was due to his participation as a partner in the firm. The court said it resulted from a capital transaction, sale of his interest in the partnership, and could not be carried over.

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9. 170 F. 2d 521 (1948).
Two recent cases concerned with the question of carry-over and carry-back of excess profits credits, have been before the courts, *Masaba-Cliffs Mining Co.*\(^{16}\) and *Wier Long Leaf Lumber Co.*\(^{17}\). In the first of these cases the taxpayer mined iron-ore and sold it to its stockholders, various steel companies. During the year in question, sales gave a return slightly above cost, not more than the fair market value. It had an excess profits credit for 1940 and 1941. It proposed to use this credit under Section 710 of the Code. The court disallowed the carry-over as the taxpayer was operating in 1940 on a non-profit basis. It observed:

"We think that the statutory provisions under consideration should be construed as making the excess profits credits carry-over, as well as the carry-back, available only to those taxpayers who during both the taxable period and the preceding or succeeding periods have maintained a normal going business, devoted substantially to the production of profits. No other construction would be consonant with the manifest purpose of the statute."\(^{18}\)

In the *Wier Long Leaf Lumber Company* case the corporation began liquidation in 1942 and continued it in 1943 and 1944. It sought to avail itself of the benefit of the unused excess profits credit carry-back provisions of Section 710 (c) (3) (A) of the Internal Revenue Code.

The Tax Court held the word "corporation" in the statute did not include a liquidating corporation. It said:

"the excess profits tax credit carry-back was intended by Congress to benefit only corporations which had been in active production throughout the war period and which had projected their activities to 'peacetime years. The amendment was surely not adapted to permit a corporation during wartime years to cease all productive activity and obtain a substantial profit at the expense of the Federal revenue for doing nothing. Such an interpretation would permit a needless and unreasonable diversion of wartime revenue, would promote inflation and would not assist reconversion to peacetime economy."\(^{19}\)

The Tax Court held the taxpayer was not entitled to a carry-back of the unused excess profits since it was in process of liquidation. The Circuit Court did not agree on this point and reversed the Tax Court's ruling thereon as to 1943. It said that since the corporation was still

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\(^{16}\) T. C. 1010 (1948).


\(^{18}\) *Supra* note 16, p. 1014.

\(^{19}\) T. C. at p. 1002.
doing business in 1943 it was entitled to carry-back for that year but that since the liquidation had proceeded so far in 1944 that it had really ceased to be a corporation under the Texas law, it was not entitled to carry-back excess profits credits of 1945 and 1944.

Another question that arises under the carry-back and carry-over of the revenue law is as to how the net operating loss is to be computed and the law of which year is to govern. In Virgilia Mining Corporation,\textsuperscript{26} the court pointed out that "section 122 (d) (1) does not grant a deduction for depletion, but is only intended to limit in certain cases a deduction granted by other provisions of the code." Since the taxpayer in the case had no net income from its property that year there was no depletion to be deducted. This result was due to the fact that it is provided that the percentage depletion "shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property." The taxpayer contended it should be allowed to compute the depreciation under section 122 (d) but the court said it had elected to compute the depreciation on a percentage basis and must abide by the result. Likewise in Louisiana Delta Hardwood Company,\textsuperscript{21} the petitioner took a deduction for percentage depletion and the court ruled that the carry-over from 1940 must be reduced by an amount equivalent to the deduction taken by the petitioner in 1941 for percentage depletion. And in Monroe Coal Mining Company,\textsuperscript{22} the company elected to use the percentage method of computing its depletion in arriving at the amount of operating loss in 1939. It was held not entitled to deduct for depletion in its carry-over for 1940. It had added an amount representing depletion for 1939 computed on a cost or unit basis. The exception or limitation of subsection (d) here pertinent was: "(1) The deduction for depletion shall not exceed the amount which would be allowable if computed without reference to discovery value or to percentage depletion under section 114 (b) (2), (3) or (4);"

In Bush Terminal Building Company\textsuperscript{23} the taxpayer included in its tax return for 1939 accrued interest on accounts receivable which later proved to be noncollectible. In computing its 1939 net loss carry-over for its 1940 return, it eliminated this item of accrued interest from its 1939 income on the ground that it was improperly accrued on a bad debt. The taxpayer made a compromise in 1940 for considerable less than the principal amount of the debt due to it in 1939.

\textsuperscript{26} T.C. 385 (1946).
\textsuperscript{21} T.C. 994 (1946).
\textsuperscript{22} T.C. 1334 (1946).
\textsuperscript{23} T.C. 793 (1946).
It was held the interest was improperly eliminated in the computation of the 1939 net loss carry-over.

The question whether a net operating loss carry-over should be computed under the law in effect the year the loss occurs or the year when the deduction is claimed was decided in Moore, Inc. to be the year when the deduction is claimed. The court also considered in this case the matter of carry-over of losses provided for under the 1942 amendment to section 122 (d) (4). It said the plain effect was to nullify for the purposes of computing this carry-over deduction the distinction between long-term and short-term capital losses and gains.

The Tax Court in Cambria Collieries Co. has more recently taken a contrary view to that of the Circuit Court and held that deductions in computing a net operating loss are determined under the law applicable to the loss year rather than the law applicable to the year when the deduction is allowed. The burden of determining the net loss is, of course, on the taxpayer. He must show the amount of the operating loss.

The courts have had the problem presented whether interest on deficiencies which have been eliminated by carry-backs should be allowed. Two recent cases arising in different District Courts do not seem to be wholly in agreement, Brandtjen & Kluge, Inc. v United States and Seeley Tube and Box Co. v Manning. In the first of these cases the plaintiff paid a deficiency assessment of excess profits tax with interest thereon, for the year 1941. The deficiency assessment and interest were paid in 1943. In 1944 plaintiff claimed a refund on the ground that the unused excess profits credit for the years 1942 and 1943 should be carried back and applied against the 1941 excess profits net income. The Commissioner agreed to this and filed a certificate of overassessment but did not include interest upon the excess profits tax deficiency. This was on the ground that the interest payments on the deficiency were not illegal when the assessments were made, and the Commissioner's action in regard to disallowance of refund of interest was lawful and proper. The court took the view that since the statute did not specifically state that "an overassessment of any tax" includes interest, Congress did not intend to include interest in the refund. The Commissioner had followed the ruling of the Internal Revenue Service.

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24 151 F. 2d 527 (1945).
25 10 T.C. 1172 (1948).
26 Birch Ranch and Oil Company v. Commissioner, CCH Dec. 16, 310 (M), Dkt 8770, March 24, 1948.
28 78 F. Supp. 937 (1948), reversed by Circuit Court, 49 USTC par. 9113.
Revenue Department and the court said the taxpayer had the burden of proving the practice adhered to by the Commissioner was contrary to legislative intent and acquiescence.

In the Seeley case deficiency assessments were filed against the taxpayer for the tax year of 1941. Losses occurred in 1942 and the Commissioner recognized a right to a “net operating loss carry-back” and issued a certificate of overassessment. He refused to abate the interest assessed on the deficiency. Judge Smith of the District Court said that Sections 28(s) and 122(a) and (b) “may extinguish the tax liability for the preceding taxable years, as it has here, but the application of these sections will not extinguish the liability for interest assessed on deficiency taxes.” He took the position that the interest collected was not part of the tax but was compensation to the government for the plaintiff's delay in their payment. Judgment was given in favor of the defendant since the assessment was lawful when made.

The Circuit Court of Appeals for the Third Circuit in an opinion written by Judge Goodrich reversed the District Court’s holding and allowed the plaintiff to recover the interest. This ruling under the circumstances seems more equitable than that in the Brandtjen case which the court failed to distinguish from the case before it. Judge Goodrich observed:

“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.”

Finally, there is the problem whether one who succeeds to a business can avail himself of the right of carry-over or carry-back his predecessor would have. Here we find little in judicial decisions to help in the solution of the question. The Supreme Court in New Colonial Ice Co. v Helvering held that net losses sustained by a predecessor corporation could not be carried over to the successor corporation under section 204 (b) of the Revenue Act of 1921. Here a new corporation was organized to take over the capital structure of the old, in exchange for a portion of its stock which was distributed.

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29 Section 292 deals with interest on deficiencies and reads as follows:

“(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 per centum 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) to the date deficiency is assessed.”

30 49-1 USTC, par. 9113.

to the stockholders of the old company. There was a change in corporate identity and ownership. In answer to the claims of the petitioner that "for all practical purposes the new corporation was the same entity as the old one and therefore the same taxpayer," Mr. Justice Van Devanter replied:

"This is not in accord with the view on which the stockholders and creditors proceeded when the new company was brought into being. They deserted the old company and turned to the new one because they regarded it as a distinct corporate entity and therefore free from difficulties attending the old one."

The Tax Court was confronted with practically the same facts in Alphosa Watch Corporation last year and reached an opposite result. There was a change in the business of the corporation, a complete change in the ownership of the stock, a change in the location of the business, and even a change in the corporate name. The Tax Court, in spite of all these changes, allowed net operating loss carry-over and unused excess profits credit carry-over from taxable years prior to the corporate change to a taxable year after the change.

In Stanton Brewery, Inc. the Tax Court refused to allow a carry-over of net operating loss from a merging corporation to the corporation that resulted from the merger. It took the view that it was immaterial that the merging and merged corporations qualified as "acquiring" and "component" corporations under section 742 prior to the merger.

These Tax Court decisions make it evident that the Tax Court does not sympathize with any attempt on the part of a successor corporation to avail itself of a right of carry-over or carry-back of losses or unused excess profits credits that could have been used by its predecessor.

**Conclusion**

We have seen that under section 122 of the Internal Revenue Code net operating losses may be carried over and set-off against net operating gains of the two succeeding years or carried-back and set off against gains of the two preceding years. The purpose of these provisions is to spread losses over a longer period than one year as was formerly done and thus make the tax burden of companies subject to business cycles more nearly comparable to those paid by companies that have an income that does not vary from year to year. The courts
have stressed the fact that the net losses must be due to the operation of a trade or business. If it comes from the sale of the instrumentalities used in carrying on the business, it is a capital loss, one not due to carrying on the business, and cannot be carried-over or carried-back.

As an aid to encourage firms to change to the production of war materials, Congress, in 1942, enacted section 710 of the Code allowing unused excess profits credits to be carried-over or carried-back as in the case of net operating losses. As the excess profits tax law was repealed in 1946, problems under section 710 will soon cease to come up for judicial settlement.

We have seen, furthermore, that where the corporation is not doing business with a view to earning a profit, it does not come within the carry-over and carry-back provisions. Where a company was in the process of liquidating while it was carrying on its usual business it was allowed the benefit of the provisions for the carry-back of unused excess profits credit but not after it ceased to carry on any business and was continuing its existence solely for the purpose of liquidation.

We found a conflict as to whether the law in force at the time the loss is incurred or the law in force at the time the operating loss is computed should govern. The District Court said the law in force when the deduction was claimed, governed. The Tax Court said the law in force when the loss occurred should be followed. Difficulties arise as to the method to be followed in computing depreciation in arriving at the net loss. If a taxpayer elects to use percentage depletion he will not be allowed later to change to the cost or unit method in order to show a carry-back loss.

Where interest has been paid on deficiency assessments the latest District Court decisions allowed the taxpayer to recover back his interest on the overassessment.

Finally, courts have in two or three cases been called upon to decide whether one who succeeds to a business can have the benefits of carry-over and carry-back which his predecessor could have had had he continued the business. The latest decision has answered the question in the negative.

Section 122 has been criticized and the Special Tax Study Committee has suggested changes. Like our whole tax system, this section can be improved. Its purpose, however, is a sound one and it tends to produce uniformity in the tax burden imposed on those having net losses in operating a trade or business.

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35 See a critique of section 122 by Charles W. Bate, 26 Taxes 297 (1948).