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Capital Gains As Well As Ordinary Income Absorb Net Operating Loss Deductions

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Capital Gains As Well As Ordinary Income Absorb Net Operating Loss Deductions

In *United States v. Foster Lumber Co.,*[1] the U.S. Supreme Court, in a 5-4 decision, held that a §172[2] net operating loss deduction is absorbed by both ordinary and capital gains portions of taxable income, even though it does not reduce capital gains subject to tax in the §1201 alternative tax method.

A net operating loss deduction is taken against income to the extent of net operating losses that carry over or carry back to the taxable year.[3] In general, a net operating loss arises in a taxable year to the extent the income tax deductions—excluding a net operating loss carried to that year—exceed gross income.[4] Section 172, as effective in the years in question in *Foster Lumber,* required that a net operating loss be carried back to the third taxable year before the year in which the loss arose, and be applied as a deduction of the gross income of the year.[5] To the extent the net operating loss was not used up—it could not reduce taxable income below zero—it had to be carried to the next year.[6] This process continued for the three taxable years before the year of the loss and the five years after it. Any part of the loss not used up in the eight years was simply lost.[7] Since the Supreme Court held that the net operating loss deduction is absorbed by both ordinary and capital gains portions of taxable income, a net operating loss will be carried to the succeeding taxable year only to the extent the loss exceeds both portions of taxable income.[8] When there are

1. ___U.S. ___, 97 S. Ct. 204, 50 L. Ed. 2d 199 (1976). *Foster Lumber* dealt with a corporate taxpayer. The same problem can exist with an individual taxpayer who incurs a net operating loss with respect to business and investment losses. The principle set out in *Foster Lumber* should apply to the individual taxpayer, because the same general statutory scheme governs the net operating losses of individuals. *See* INTERNAL REVENUE CODE §172. (All statutory references, unless otherwise indicated, are to theInternal Revenue Code of 1954 as amended, 26 U.S.C.A. Treasury Regulations are those promulgated by the Department of Treasury pursuant to I.R.C. §7805.) *See also* Axlerod v. Comm'r, 507 F.2d 884 (6th Cir. 1974).
2. I.R.C. §172.
3. I.R.C. §172(a); Treas. Reg. §1.172-1(a) (1960).
4. I.R.C. §172(c), (d)(1). Treas. Reg. §1.172-2 (1960), §172-3(a)(1)(ii) (1965). See I.R.C. §172(d) for certain modifications in the deductions.
5. I.R.C. §172(b)(1)(A), (2).
6. I.R.C. §172(b).
7. I.R.C. §172(b)(1)(A) and (B). See I.R.C. §172(b)(1) for variation in the length of carry-back and carryover periods for certain corporations and trusts. For changes made by the 1976 Tax Reform Act, see the text accompanying notes 29 and 30, *infra.*
8. 97 S. Ct. 204, 50 L. Ed. 2d 199 (1976). *See* I.R.C. §172(b)(2). For the purpose of computing the taxable income that the net operating loss must exceed to carry to the succeeding carryback and carryover years, the amount of the taxable income is determined "without regard to the net operating loss for the loss year or any year thereafter." I.R.C.

carrybacks or carryovers from more than one net operating loss year, those from the earliest taxable years are used first.[9]

Foster Lumber Company incurred a net operating loss in its 1968 taxable year. Only a small amount of the loss was carried back and absorbed in the taxable year 1965, its earliest carryback year. The remaining net operating loss, $42,203.12, was carried as a deduction to its next carryback year, 1966; no net operating losses were carried over or carried back to 1966 from taxable years other than 1968.[10]

In its 1966 taxable year, Foster Lumber's taxable income before the use of the net operating loss deduction totaled $173,870.86, consisting of $7,236.05 ordinary income and $166,634.81 capital gains.[11] It was not disputed in *Foster Lumber* that the carryback of the net operating loss deduction did not reduce the capital gains subject to tax when the §1201 alternative tax method was used. Only the $7,236.05 ordinary income was reduced in 1966, which left the $166,634.81 capital gains unreduced.[12]

The problem in *Foster Lumber* was whether any of the $34,967.07 net operating loss that did not reduce ordinary income in the taxable year 1966 could be carried forward to reduce ordinary income in 1967 and, if any remained, in the carryover years after the loss year of 1968.

I.R.C. §172(b)(2) provides:

> The portion of such [net operating] loss which shall carry to each of the other taxable years shall be the *excess*, if any, of the amount of such loss *over the taxable income* for each of the prior years to which such loss may be carried. [Emphasis supplied.]

The issue was whether the carryover or carryback of the net operating loss deduction can be carried to later carryover or carryback years to the extent that it exceeds ordinary income *actually reduced* or only to the extent that it exceeds *both* ordinary income and unreduced capital gains portions of

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§172(b)(2)(B)(i); Treas. Reg. §1.172-5(a)(3)(i) (1966).

9. Treas. Reg. §1.172-4(a)(4) (1965).

10. 97 S. Ct. 207-209, 50 L. Ed. 2d at 205-206. Capital gains income refers to the "net capital gain" formerly known as the "net section 1201 gain"—the excess of net long term capital gain over the net short term capital loss for the year. *See* I.R.C. §§ 1201(a), 1222(11).

11. 97 S. Ct. at 208, 50 L. Ed. 2d at 205-207. The §1201 alternative tax method of computing taxes for a corporation or an individual does not provide for reducing capital gains by the net operating loss deduction. Chartier Real Estate Co. v. Comm'r, 52 T.C. 346 (1969), *aff'd*, 428 F.2d 474 (1st Cir. 1970) (corporate taxpayer); Axlerod v. Comm'r, 507 F.2d 884 (6th Cir. 1974) (noncorporate taxpayer). Rev. Rul. 56-247, 1956-1 CUM. BULL. 383. The alternative corporate tax method must be used if it produces a lower tax than the regular corporate tax method of I.R.C. §11. I.R.C. §1201(a). When the regular method produces a lower tax, the capital gains income is taxed like ordinary income and is reduced by the net operating loss deduction. In *Foster Lumber*, the alternative tax method produced the lower tax rate, even though the net operating loss reduced only ordinary income in it. Foster Lumber's alternative tax was $41,658.70 in 1966. The regular method with full use of the net operating loss deduction produced a higher tax of $58,200.52. See text accompanying notes 16 and 17, *infra*.

12. 97 S. Ct. at 207-209, 50 L. Ed. 2d at 204-206.

taxable income. The Court stated the issue in terms of whether the carryback or carryover was absorbed by both ordinary and capital gains income or just income taxed as ordinary income.[13]

The problem was first raised in *Chartier Real Estate Co. v. Commissioner,*[14] in which the U.S. Tax Court ruled on two issues: (1) whether the §172 net operating loss deduction reduced capital gains in the alternative tax method and (2) how much of the net operating loss carried to the next carryback or carryover year under §172(b)(2).

On the first issue, which was not even argued in *Foster Lumber,* the Tax Court held that the net operating loss deduction carryover and carryback does not reduce capital gains in the alternative corporate tax method.[15] The alternative method gives a preferred rate to capital gains income and comes into use when it produces a lower rate than the ordinary method in §11. A partial tax is first computed solely on the ordinary income—reduced by the net operating loss deduction—under the §11 method just as if there were no alternative method. Then the tax on capital gains is computed by multiplying the capital gains tax rate for the taxable year by the "net section 1201 gain"— the net long-term capital gains minus the short-term capital loss—without an allowance for the net operating loss deduction.[16]

On the second issue in *Chartier*—the issue the Supreme Court faced in *Foster Lumber*—the Tax Court held that the net operating loss that does not reduce the capital gains in the alternative tax method can be carried to the other carryback and carryover years to the extent that the loss exceeds ordinary income alone. The court held that "taxable income" in §172(b)(2) meant only the income actually reduced by the net operating loss deduction in computing tax liability, because the phrase "to which such loss may be carried" modified "taxable income." Therefore, the capital gains, which were not reduced in the alternative tax method, did not absorb the net operating loss deduction.[17]

Three of the circuit courts of appeals that have addressed this issue have

13. 97 S. Ct. at 207, 50 L. Ed. 2d at 204.

14. 52 T.C. 346 (1960), *aff'd,* 428 F.2d 474 (1st Cir. 1970).

15. *Id.* at 356. The tax court ruled on the §1201(a) alternative tax method for corporations. The same interpretation applies to the noncorporate taxpayer. Rev. Rul. 56-247, 1956-1 CUM. BULL. 383. Axlerod v. Comm'r, 507 F.2d 884 (6th Cir. 1974).

16. 52 T.C. at 351-356. The term "net section 1201 gain" was changed in the 1976 Tax Reform Act to "net capital gain." I.R.C. §1222 (11).

17. *Id.* at 356-358. The Tax Court in *Chartier* rejected the Commissioner's contention that the corporation's regular tax method under I.R.C. §11 absorbs the net operating loss deduction carryback or carryover that does not reduce the capital gains under the alternative tax method. The court said the regular method is tentative and does not apply when the actual tax is computed under the alternative method of §1201(a). The Commissioner did not argue the literal language of I.R.C. §§61, 63 and 172(b)(2), which were part of the basis for the *Foster Lumber* decision. *See* Branda, *Net Operating Losses and Capital Gains—Some Bizarre Consequences of Alternate Tax Computation,* 28 TAX LAW. 455, 459 (1975). See text accompanying notes 24-26, *infra.*

followed the *Chartier* construction of §172(b)(2).[18] The Fourth and Sixth Circuits, however, refused to follow *Chartier* and held that the net operating loss deduction can be carried to other carryback and carryover years only to the extent it exceeds both ordinary and capital gains portions of taxable income.[19] In *Foster Lumber Co. v. United States,* the Eighth Circuit followed *Chartier* and affirmed the district court's ruling for the corporate taxpayer.[20] The Supreme Court granted a writ of certiorari to the Eighth Circuit to resolve the split among the circuits.[21]

The Supreme Court refused to follow the second holding in *Chartier* and reversed the Eighth Circuit. It decided that all of the $42,203.12 net operating loss deduction was absorbed by the entire taxable income of $173,870.86;[22] so there was no net operating loss to be carried to the other years, even though only the $7,236.05 ordinary income could be reduced when the alternative tax method was used.

The Court noted that §172 did not specifically cover the problem before it. The Court said the question was whether the net operating loss deduction and alternative tax method "must be each maximized independently of the other or whether Congress instead anticipated that the benefit by the loss deduction might on occasion be subsumed in the greater benefit provided by the alternative tax method."[23]

The literal language of §172(b)(2) provides that the deduction is carried to the other years to the extent it exceeds "taxable income," which is defined in §61 and §63 to include income from whatever source—capital gains income is specifically included by §61(a)(3)—reduced by the income tax deductions.

The Supreme Court said the *Chartier* construction of §172(b)(2)was not justified by the language.[24] If Congress had intended that the net operating loss be carried to the other years to the extent it exceeds only ordinary income, the Court said, Congress would have said so. The phrase "taxable income for each of the prior years to which such loss may be carried" does not mean "taxable income to which such loss may be carried and deducted." The Court conceded that in statutory construction an unattached modifier often changes the meaning of a defined term, but the clause in §172(b)(2), "to which such loss may be carried," did not modify "taxable income."[25]

18. Foster Lumber Co. v. United States, 500 F.2d 1230 (8th Cir. 1974); Olympic Foundry Co. v. United States, 493 F.2d 1247 (9th Cir. 1974); Chartier Real Estate Co. v. Comm'r, 428 F.2d 474 (1st Cir. 1970).

19. Mutual Assurance Soc'y v. Comm'r, 505 F.2d 128 (4th Cir. 1974); Axlerod v. Comm'r, 507 F.2d 884 (6th Cir. 1974).

20. 500 F.2d 1230 (8th Cir. 1974).

21. 420 U.S. 1003 (1975).

22. 97 S. Ct. at 207-208, 50 L. Ed. 2d at 206-207.

23. 97 S. Ct. at 209, 50 L. Ed. 2d at 206.

24. 97 S. Ct. at 209-210, 50 L. Ed. 2d at 206-207.

25. The Court said in a footnote that Congress will provide a different or modified defini-

Still, the Court did not discard Foster Lumber's case right away. Even though the contended construction did not "fairly" occur within the statutory language, the Supreme Court said, it was still proper to see whether the *Chartier* construction harmonized with the statute as a whole.

The purpose of the net operating loss deduction, the Court said, is to produce a result similar to income-averaging. By allowing a net operating loss in one taxable year to carry over or carry back as a deduction, the consequences of taxation on an annual basis are reduced: There is a leveling effect on net income. If each year is treated separately, without a deduction for a net opeating loss, the taxpayer is taxed on what is considered to be a return of capital, or expenses used to make money. This leveling effect, the Court said, lessens the impact of taxation on a shareholder of a corporation with fluctuating net income in relation to a shareholder of a corporation with stable net income.[26]

Looking at the statute as a whole, the Court said the intent of Congress was to reduce but not to end all inequities caused by one-year tax periods. The Court recognized that an inequity would result when capital gains absorbed the net operating loss in a carryover or carryback year without a corresponding reduction in taxable income under the alternative tax method.

The Court reasoned that Congress did not intend to remedy the "waste" of the net operating loss deduction. It knew of the waste when it provided that the deduction did not reduce the capital gains subject to tax in the alternative tax method. Neither the 1939 nor the 1954 Internal Revenue Codes included a remedy that was in the 1924 Code: a reduction in the capital gains subject to tax in the alternative method for noncorporate taxpayers. The Court noted that the 1939 Code even caused further waste of the deduction. For a loss to be carried to the other carryover and carryback years, according to the 1939 Code, the loss deduction had to exceed tax-exempt income as well as ordinary and capital gains portions of taxable income. That this tax-exempt interest income could by happenstance arise in a year in which it would be wasted demonstrated that Congress did not intend to remedy all inequities caused by the use of one-year tax periods.

The definition of a net operating loss that will give rise to a carryback

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tion of "taxable income" when the one in I.R.C. §61 and §63 is inadequate. Modifications were provided in §172(b)(2), but they do not say that "taxable income" does not include capital gains. 97 S. Ct. at 207 n. 3, 50 L. Ed. 2d at 204 n.3.

26. 97 S. Ct. at 210-211, 50 L. Ed. 2d at 207-208. The Court did not explain what it meant by shareholders of a corporation. It did, however, refer to a report which explains the concept. This report states that net operating losses should not be deducted over the corporation's complete life. Because shareholders change, losses of one group of shareholders would be deducted from income by another group of shareholders. U.S. TREASURY DEP'T & JOINT COMM. ON INTERNAL REVENUE TAXATION, BUSINESS LOSS OFFSETS 2-11 (1947), *excerpted in* B. BITTKER & L. STONE, FEDERAL INCOME ESTATE AND GIFT TAXATION 858 (1972).

or carryover best demonstrated that Congress did not intend to remedy this waste caused by the capital gains, the Court said. The net operating loss for a taxable year is the amount that the income tax deductions—except for the net operating loss deduction—exceed the gross income. An ordinary income loss may create a net operating loss to carry back or carry over. Capital gains income, however, prevents the creation of a net operating loss, since capital gains are part of the gross income that the deductions must exceed. Furthermore, this ordinary loss would not reduce the capital gains subject to tax under the alternative tax method in the taxable year in which the loss occurred.

As interpreted in *Foster Lumber*, §172(b)(2) means that the taxpayer receives the benefit of the greater of the two tax breaks. The dissenting opinion expressed the view that the Court had made a strained interpretation of the section and defeated the policies favoring the taxpayer in both §172 and §1201.[27] The dissent said the purpose of the net operating loss deduction was to encourage investments in enterprises with fluctuating net income. The other policy, lower tax rates for capital gains in the alternative tax method, was intended to encourage the formation of capital.

The odd result of the Court's interpretation of §172(b)(2) is that the taxpayer cannot fully use both the net operating loss deduction and the alternative-tax treatment of capital gains when capital gains occur in the year to which a net operating loss is carried. Both tax breaks could be fully used if the capital gains income came in a year without the deduction.[28] The ultimate result, however, is a policy decision on whether both tax breaks or just the greater tax break should be given effect. Congress either has not contemplated the problem or has not stated that it had contemplated the problem. The Court could only make the best and most logical decision in light of the language of §172.

Congress has the task of determining the mechanics of tax laws. Part of the problem of §172(b)(2) is fortunately reduced by the 1976 Tax Reform Act. The taxpayer may irrevocably elect to relinquish the entire three-year carryback period for any net operating loss that arises in a taxable year ending after December 31, 1975.[29] For that net operating loss year, the taxpayer then uses only the carryover period, which the 1976 Tax Reform Act extended to seven years regardless of whether the taxpayer relinquishes the carryback.[30]

The election lets a taxpayer who had capital gains before he knew of the carryback avoid having the gains absorb part of the carryback without actually reducing his tax on those gains. The taxpayer now can plan capital-gains transactions to avoid net capital gains in carryover years;

27. 97 S. Ct. at 214-215, 50 L. Ed. 2d at 212-213 (Blackmun, J., dissenting).
28. *See* 97 S. Ct. at 215-216, 50 L. Ed. 2d at 214.
29. I.R.C. §172(b)(3)(E).
30. I.R.C. §172(b)(1)(B).

with only ordinary income to absorb the net operating loss deduction, the deduction will not be wasted. The problem with waiting is that the taxpayer spins the wheel of fortune in business planning. Consequently, the deduction could become a major factor in determining when transactions that give rise to capital gains are made. Tax consequences should not be such a factor in business planning. The taxpayer, and certainly Congress, cannot see into the future to decide whether it is wise from a business standpoint to delay a capital gains transaction.

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