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NET OPERATING LOSSES AND THE ALTERNATIVE TAX: FINE-TUNING THE TAX COMPUTATION PROVISIONS

I. INTRODUCTION

A disharmony between two widespread and frequently used palliative provisions of the Internal Revenue Code (Code), the alternative tax\(^1\) and the net operating loss carryback-carryover\(^2\) has been the subject of eight recently decided cases\(^3\) and is the point at issue in numerous cases currently in various stages of litigation.\(^4\) The difficulty is created when a taxpayer carries a net operating loss to a year\(^5\) in which the alternative method is used to compute the taxpayer's tax liability: it is then necessary to determine the amount of the remaining net operating loss available to be carried forward to the next year to which the loss may be carried.\(^6\) The issue is whether a taxpayer is permitted to carry forward the excess of the net operating loss over the ordinary taxable income\(^7\) for that year, or whether the carryover is limited to the excess of the net operating loss over the total taxable income for that year.\(^8\) Predictably, the courts which have

1. INT. REV. CODE OF 1954, § 1201. For the relevant text of this section, see note 8 infra.
2. Id. § 172. For the relevant text of this section, see note 8 infra.
4. As of November, 1974 there were pending "some 99 cases involving approximately $20,000,000 in taxes." Mutual Assur. Soc'y of Va. Corp. v. Commissioner, 505 F.2d 128, 138 n.21 (4th Cir. 1974).
5. Section 172(b)(1)(A)(i) of the Code permits a net operating loss to be carried "to each of the 3 taxable years preceding the taxable year of such loss." INT. REV. CODE OF 1954, § 172(b)(1)(A)(i). Section 172(b)(1)(B) permits a net operating loss to be carried to each of the 5 taxable years following the taxable year of such loss." Id. § 172(b)(1)(B).
6. In certain situations, the succeeding year may itself be a loss year and the loss from prior (or subsequent) years will effectively be carried to the year following the succeeding loss year, unless the 9-year period (see note 5 supra) has been exhausted.
7. Ordinary taxable income is, for corporate taxpayers, taxable income minus the net long-term capital gain, or, for noncorporate taxpayers, taxable income minus one-half of the net long-term capital gain.
8. Section 172(b)(2) of the Code provides:
   [T]he entire amount of the net operating loss for any taxable year (hereinafter in this section referred to as the 'loss year') shall be carried to the earliest
decided the question have reached conflicting results: taxpayers have prevailed in six cases; the Commissioner has succeeded in persuading two of the taxable years to which (by reason of paragraph (1) [see note 5 supra]) such loss may be carried. The portion of such loss which shall be carried to each of the other taxable years shall be the excess, if any, of the amount of such loss over the sum of the taxable income for each of the prior taxable years to which such loss may be carried. . . .

**INT. REV. CODE OF 1954, § 172(b)(2).**

Section 1201(a) provides:

If for any taxable year a corporation has a net section 1201 gain [excess of net long-term capital gain over net short-term capital loss], then, in lieu of the [regular] tax . . . there is hereby imposed a tax (if such tax is less than the [regular] tax . . .) which shall consist of the sum of a tax computed on the taxable income reduced by the amount of the net section 1201 gain, at the rates and in the manner as if this subsection had not been enacted, plus—

. . . a tax of 30 percent of the net section 1201 gain.

_Id._ § 1201(a).

A 25 percent, rather than a 30 percent, tax rate upon capital gains in section 1201(a) was in effect for the taxable years involved in the recent cases, but the 30 percent rate effective for taxable years beginning in 1975 produces results meaningful to tax planners, and avoids the complications fostered by the transitional rates.

On March 29, 1975, the Income Tax Reduction Act of 1975 became law. Pub. L. No. 94-12 (March 29, 1975). This act provides for a lower corporate tax rate and for an increase in the surtax exemption to $50,000 in 1975. Since these changes are of a temporary nature, this Comment will not consider their ramifications. An illustration of the problem is detailed as follows (For purposes of simplification, all illustrations in this Comment will reflect an assumption that year 1 is the taxpayer's first year of existence. See Appendix infra. All numbers are expressed in thousands.):

| Year 1:         | Taxable income | 300 |
|                | Capital gain   | 200 |
|                | Ord. income    | 100 |
| Year 2:        | Ord. income    | 140 |
| Year 3:        | Ord. loss      | (150) |
| Recomputed year 1 tax: |          |      |
| Regular (§ 11) |               | 65.5 |
| Alternative (§ 1201): |          |      |
| Ord. income    |                | 100  |
| NOL from year 3|                | (150)|
|                | (50)           | -0-  |
| Capital gain   | $200 \times .30| 60   |
|                |                | 60   |

The issue is whether taxpayer has a net operating loss carryover of $50,000, because although the total taxable income exceeds the net operating loss by $150,000, the net operating loss exceeds the ordinary taxable income by $50,000. For the arguments developed to support the contrary positions of the Commissioner and the taxpayers, see section IIIA infra.

9. Foster Lumber Co. v. United States, 500 F.2d 1230 (8th Cir. 1974), _cert. granted_, 95 S. Ct. 1443 (1975) (No. 74-799); Olympic Foundry Co. v. United States, 493 F.2d 1247 (9th Cir. 1974); Chartier Real Estate Co. v. Commissioner, 428 F.2d.
courts of appeals to reverse decisions of the Tax Court which had been in the taxpayers' favor. The issue is far from settled, but every court which faces it must do so constrained by two implications of sections 172 and 1201. First, section 172(c) provides that

the term "net operating loss" means . . . the excess of the deductions allowed by this chapter over the gross income. Such excess shall be computed with the modifications specified in subsection (d) [which include elimination of personal exemptions, nonbusiness deductions of noncorporate taxpayers, certain corporate dividends received deductions, net operating loss deductions and for noncorporate taxpayers, capital losses and the section 1202 capital gain deduction]. Second, in computing the alternative tax, the capital gain tax rate (30 percent) must be applied to the entire taxable capital gain, unreduced by the excess of deductions over ordinary income. Similarly, the alternative tax computation in a year to which a net operating loss has been carried is based upon the entire taxable capital gain, undiminished by the net operating loss carryback-carryover. It should be noted that in the com-


11. The Supreme Court, which has granted certiorari in United States v. Foster Lumber Co., 95 S. Ct. 1443 (1975) (No. 74-799), granting cert. to 500 F.2d 1230 (8th Cir. 1974), should decide the issue before an unacceptable number of the pending cases reach the trial stage. See text accompanying note 114 infra.

12. Int. Rev. Code of 1954, § 172(c). Thus, in many situations capital gains will eradicate an excess of deductions over ordinary income. See Axelrod v. Commissioner, 507 F.2d 884, 889 n.4 (6th Cir. 1974). Nonetheless, a corollary of the present issue may also develop into a serious question:

We note that in each of the years . . . petitioner's deductions were in excess of its ordinary income but less than the sum of its ordinary income and net long-term capital gain. We have not been asked to decide whether, under such circumstances, petitioner has a net operating loss for any of those years — an issue which we expressly leave unanswered . . . . Continental Equities, Inc., 33 CCH Tax Ct. Mem. 812, 813 n.5 (1974), appeal docketed, No. 75-1562, 5th Cir., March 24, 1975. The question had been left unanswered in a previous case, Lone Manor Farms, Inc., 61 T.C. 436 (1974), aff'd by unpublished order, 3d Cir. (1975), because threshold determinations concerning the opening of prior tax years were determined in the Commissioner's favor, denying the taxpayer the opportunity to argue that the alternative tax was optional and not mandatory. For an explanation of how resolution of the present issue would also resolve the potential question, see text accompanying notes 120-34 infra. For an explanation of why in certain situations the taxpayer would prefer to determine its tax liability under section 11 — even though greater than that determined under section 1201 — see Appendix infra.


putation of the regular tax, no distinction is made for computation purposes between capital gain or loss and ordinary gain or loss.  

The problem illustrating the issue can affect both corporate and noncorporate taxpayers; however, it arises infrequently for individuals since the interplay of sections 1201(b), 1202, and 172(d)(2)(A) of the Code discourages the use of the alternative tax, but it can, in very rare situations, adversely affect individuals. In the interest of simplicity, analysis of the problem and its solutions will be limited to corporate taxpayers; however, the fundamental principles which are discussed and developed can apply equally to noncorporate taxpayers so long as the differences in the details of the mechanics are placed in proper perspective.  

After tracing the 50-year histories of both the alternative tax and the net operating loss carryback-carryover provisions, this Comment will analyze the arguments presented by the Commissioner and by the taxpayers, and will conclude with a suggestion for congressional reform which should alleviate the discord between the two provisions which has materialized only in the recent past.  

II. THE LEGISLATIVE HISTORY OF SECTIONS 172 AND 1201  

The first provision for permitting taxpayers to deduct one year's excess of expenses over gross income from the prior or succeeding year’s income was enacted in the Revenue Act of 1918. During the years immediately following World War I, capital gains were taxed no differently from any other form of income. In 1921, Congress enacted special provisions for noncorporate taxpayers who realized capital gains “in order to permit such [capital asset] transactions to go forward without fear of a prohibitive tax.” The alternative tax at that time was the sum of a partial tax upon ordinary income, based upon the regular tax rates, and a partial tax of 12.5 percent of the capital gains, the total tax not to be less than 12.5 percent of the total net income. Since capital gain was defined so that it would be unaffected by deductions in excess of ordinary income, and since the net operating loss carryback-carryover provisions were still in effect, situations similar to those afflicting the taxpayers in the recent past involved an "unimportant and seldom occurring question." Chartier Real Estate Co. v. Commissioner, 428 F.2d 474, 475 (1st Cir. 1971) (per curiam).  

17. See text accompanying notes 120–27 infra.  
19. As recently as 1971, the First Circuit labelled the issue an "unimportant and seldom occurring question." Chartier Real Estate Co. v. Commissioner, 428 F.2d 474, 475 (1st Cir. 1970) (per curiam).  
25. Act of Nov. 23, 1921, ch. 136, § 204(b), 42 Stat. 231.
cases could have arisen if the taxpayer had incurred capital gains and deductions in excess of ordinary income. Apparently, however, no such case arose.26

Three years later, in the Revenue Act of 1924 (1924 Act), Congress removed the academic dilemma by providing that capital gain would be defined so that it would be reduced by deductions exceeding ordinary income.27 If a net operating loss exceeded the ordinary income, it would be applied, first, to the ordinary income, and then to the capital gain, with any excess available to be carried to the next year, if any, to which such excess could be carried.28 The minimum tax provision of 12.5 percent of total net income was abolished.29 For the next 9 years, the provisions of the 1924 Act were repeatedly reenacted.30

The National Industrial Recovery Act31 was then enacted, abolishing, inter alia, all carrybacks and carryovers.32 In the following year, Congress removed the alternative tax and imposed, in its place, provisions requiring certain percentages of realized capital gain to be included in net income, the percentages being based upon the holding period of the capital asset.33 In 1938, Congress superimposed the pre-1934 alternative tax principles upon the percentage exclusion scheme of taxing capital gain.34 The Revenue Act of 1938, however, defined capital gain not as had the 1924 Act — gain affected by the excess of deductions over ordinary income — but as

26. One reason may be that the alternative tax computation was merely optional. Act of Nov. 23, 1921, ch. 136, § 206(b), 42 Stat. 233. A more probable explanation is that the underlying conditions existed for only a brief 3-year period. See text accompanying notes 27-29 infra.

27. The provision stated:
The term “capital net gain” means the excess of the total amount of capital gain over the sum of (A) the capital deductions and capital losses, plus (B) the amount, if any, by which the ordinary deductions exceed the gross income computed without including capital gain.


28. Act of June 2, 1924, ch. 234, § 206(b)-(c), 43 Stat. 261. The revision was explained as follows:

Under the existing law the tax under the capital gain section is the tax on the ordinary net income plus 12½ percent of the capital gain. If the taxpayer has no ordinary net income but has a deficit, the tax under the existing law is still 12½ percent of the capital gain, although the capital gain may thus be in excess of the net income of the taxpayer. In the bill . . . [changes in the existing laws are made] in order to revise the definition of capital net gain so that the tax in cases where there is a deficit in ordinary income will be 12½ percent of an amount determined by subtracting from the capital net gain the amount of the deficit in ordinary net income. This provision is in the interest of the taxpayer.


had the Revenue Act of 1921 — gain unreduced by the excess of deductions over ordinary income.\textsuperscript{85}

Finally, the 1938 provisions were codified 1 year later.\textsuperscript{36} A net operating loss carryover (to the two succeeding years) provision was reintroduced,\textsuperscript{37} and in 1942 a provision for alternative tax computations for corporate taxpayers was inserted into the 1939 Code.\textsuperscript{38} The percentage exclusion-alternative tax computation provisions and the net operating loss carryover provision eventually developed into sections 1201, 1202 and 172 of the current Code.\textsuperscript{39} Although the statutory framework for the problem has existed since 1942, it was not until 1969 that taxpayers found themselves in court taking issue with the Commissioner over the interrelationship of sections 1201 and 172.\textsuperscript{40}

III. THE CASE LAW AND COMMENTARY

A. The Argument of the Parties

1. The Taxpayers

Taxpayers have presented two arguments to demonstrate that so long as the alternative tax is used in a year to which a loss has been carried, only so much of the loss as is required to offset that year's ordinary taxable income should be exhausted and the remainder of the loss should continue to be available as a carryover, assuming that there is a year to which such an excess may be carried.\textsuperscript{41}

The first argument is that the purpose of section 172 is to equalize income over a period of time through the use of carrybacks and carryovers. Permitting a "waste" of the net operating loss carryover (in an amount equal to the net operating loss carryback-carryover less the ordinary taxable income for the year)\textsuperscript{42} is contrary to the equalization scheme of section 172 and subjects taxpayers in similar situations to the effects of arbitrary

\textsuperscript{35} Act of May 28, 1938, ch. 289, § 117(a) (8), 52 Stat. 501. This led to the decision in Walter M. Weil, 23 T.C. 424 (1954), aff'd, 229 F.2d 593 (6th Cir. 1956), in which the taxpayer was not permitted to reduce capital gain, for purposes of computing the alternative tax, by the excess of his deductions over his ordinary income. No net operating loss carryback or carryover was involved since at the time the provisions for such remained repealed.

\textsuperscript{36} INT. REV. CODE OF 1939, §§ 117(b), (c) (2).

\textsuperscript{37} Act of June 29, 1939, ch. 247, § 211, 53 Stat. 867.

\textsuperscript{38} Act of Oct. 21, 1942, ch. 619, § 150(c), 56 Stat. 843.

\textsuperscript{39} INT. REV. CODE OF 1954, §§ 172, 1201-02.

\textsuperscript{40} Chartier Real Estate Co., 52 T.C. 346 (1969), aff'd per curiam 428 F.2d 474 (1st Cir. 1970).

\textsuperscript{41} See text accompanying notes 5-8 supra.

\textsuperscript{42} See the illustration in note 8 supra. In the illustration, $50,000 of net operating loss carryback is "wasted." If the net operating loss is greater than the total taxable income of the year to which it has been carried, the regular tax will be zero, the alternative tax will not be used, the excess of the net operating loss over the total taxable income will be available as a carryover, assuming that a year to which it can be carried exists, and, therefore, there is no "waste." See
timing differences, the very inequity which Congress intended to alleviate by enacting section 172. Support for the premise appears in an early committee report: "But [ignoring losses] does not adequately recognize the exigencies of business, and, under our present high rates of taxation, may often result in grave injustice." The court in Chartier Real Estate Co. was impressed by the argument and accorded it considerable weight:

The purpose of such provisions [for applying net losses from one taxable year to other taxable years] is obviously to ameliorate somewhat the arbitrary nature of the annual accounting period, especially in the case of businesses with great fluctuations in income from year to year.

The court in Foster Lumber Co. v. United States also recognized and accepted this argument. However, in none of the other cases in which the taxpayer prevailed did the court address itself to this contention.

The second argument, involving a statutory interpretation, is that in section 172(b)(2), the phrase "to which such loss may be carried" must modify "taxable income" and not "each of the prior taxable years," in order for the phrase not to be superfluous. The Chartier court accepted this interpretation and further held that "taxable income," as modified by the phrase, meant the taxable income to which the excess net operating loss was actually applied in computing the actual tax liability, that is, the ordinary taxable income in situations in which the tax liability is computed by the alternative method. The court reasoned that since the regular tax computation was merely tentative and was eventually disregarded, the total taxable income did not absorb the net operating loss.

43. See text accompanying notes 97–106 infra.
44. S. REP. No. 617, 65th Cong., 3d Sess. 7 (1918). Such harsh results do not occur as often in situations of fluctuating income: corporate taxpayers are taxed at a uniform rate (48 percent) as soon as taxable income exceeds $25,000, INT. REV. CODE of 1954, §§ 11(a)–(c), and noncorporate taxpayers, despite the progressive tax structure to which they are subjected, can usually avail themselves of the income averaging provisions of sections 1301 to 1303 of the Code, id §§ 1301–03.
45. 52 T.C. 346 (1969).
46. Id. at 357.
47. 500 F.2d 1230 (8th Cir. 1974), cert. granted, 95 S. Ct. 1443 (1975) (No. 74–799).
48. 500 F.2d at 1232.
49. The other cases relied upon Chartier despite the fact that Chartier is binding precedent only in the Tax Court and not in the courts of appeals. See id. at 1232, where the Foster court stated:

Nevertheless, we cannot dismiss lightly the cumulative weight of our fellow judges' decisions or the divisiveness and administrative confusion that a contrary conclusion at this point might foster.

Such considerations did not deter the courts of the Fourth and Sixth Circuits. See text accompanying note 10 supra.
50. INT. REV. CODE of 1954, § 172(b)(2). For the text of this section, see note 8 supra. The Commissioner contends that such an interpretation is erroneous. See text accompanying notes 63–70 infra.
51. 52 T.C. at 357–58.
52. Id. at 358.
excess. Furthermore, the *Chartier* court held that it was an exaltation of form over substance for the Commissioner to contend that a normal tax computation necessarily had been made in order to determine whether the results of the alternative tax computation would be lower than the results of the regular tax computation, and that the net operating loss excess was thus fully absorbed by total taxable income in the process of selecting the alternative tax method as the basis for the year’s tax liability. The *Foster* court did not go so far as the *Chartier* court in its interpretation of section 172(b)(2). Stating that

> [given the typically tortured wording of the Code . . . each of the parties’ interpretations present[ed] a plausible reading of Section 172 (b)(2) on its face,]

the court relied upon the purpose and policy argument to support its approval of the taxpayer’s interpretation of the section. In contrast, the court in *Olympic Foundry Co. v. United States*, in one sentence, held that the interpretation contended for by the taxpayer was necessarily the correct one in order to prevent the phrase “to which such loss may be carried” from being mere surplusage. Once again, the other courts which held in the taxpayer’s favor merely concurred with the *Chartier* court.

In addition to these arguments, the dissentor in *Mutual Assurance Society of Virginia Corp. v. Commissioner* suggested that the taxpayers’ interpretations found support in Congress’ acquiescence in the construction of the statute set forth by the courts in *Chartier* and the cases which followed.

2. The Commissioner

The Commissioner has presented suitable replies, and has even advanced arguments to which the taxpayers have made no direct response. The first argument initially rejects the taxpayers’ contention that the phrase “to which such loss may be carried” necessarily modifies “taxable income.” The Commissioner claims that the phrase, as a matter of syntax,
should modify "years." The court in *Mutual Assurance* accepted such a construction, stating that not only is the phrase not superfluous, but that it is good draftsmanship in that it informs the reader to which taxable years he or she is being referred. Moreover, the court noted that the phrase did not appear in the post-1939 predecessors of section 172, and that the legislative history of the present Code made no mention of its significance. As a result, the purpose of inserting the phrase was one of identification, to replace the words "intervening years" which had existed in the prior versions. The argument continues that, even if the phrase modifies "taxable income," the meaning of "taxable income" as defined in section 63(a) does not change. Since the add-back adjustments required by section 172(c) to compute net operating loss would make little sense unless Congress had intended the add-back to negate a deduction which is allowed in the first place, taxable income necessarily must be determined as set forth in section 63(a). By such a definition, in light of section 61, capital gains are as much a part of taxable income as is ordinary taxable income. Second, section 1201, the alternative tax provision, does not redefine taxable income.

The Commissioner's second argument is an analogy drawn to non-corporate taxpayers and the provisions of section 172. Section 172(d)(2)(B) provides that in computing a noncorporate taxpayer's taxable income in the year to which a net operating loss is carried in order to determine the excess available as a carryover, the deduction for long-term capital gains is disallowed. Since the statute does not indicate that Congress intended "taxable income" to be two different concepts for the purpose of determining excess net operating loss carryovers, taxable income

63. Id. at 134.
64. Id. at 134 n.10.
65. See, e.g., Act of Sept. 23, 1950, ch. 994, § 215, 64 Stat. 937, in which the section reads in part: "[T]he carry-over in the case of each such succeeding taxable year . . . shall be the excess, if any, of the amount of such net operating loss over the sum of the net income for each of the intervening years . . . ." Id. 64 Stat. 938.
66. INT. REV. CODE OF 1954, § 63(a). The section states in relevant part: "[T]he term 'taxable income' means gross income, minus the deductions allowed by this chapter . . . ." Id.
67. See text accompanying note 12 supra.
68. 505 F.2d at 134–35. See also 8 S. DgEO L. Rev. 442, 445 (1971).
69. INT. REV. CODE OF 1954, § 61(a). The section provides that gross income includes "all income from whatever source derived . . . ." Id.
70. See 8 S. DgEO L. Rev. at 445. Section 1201 refers to "the taxable income." INT. REV. CODE OF 1954, § 1201(a) (emphasis added). For the text of this section, see note 8 supra.
71. See, e.g., 505 F.2d at 134–36; Axelrod v. Commissioner, 507 F.2d 884, 888 (6th Cir. 1974).
72. INT. REV. CODE OF 1954, § 1202.
must include all capital gains for corporate as well as noncorporate taxpayers.\(^{74}\)

A third argument is based upon a common-sense reading of the Code as a whole, with emphasis upon the other carryover provisions contained therein. Two such provisions of the Code are offered as proof that the taxpayers' parsing of the second sentence in section 172(b)(2)\(^{75}\) is incorrect: The first provision is contained in sections 812\(^{76}\) and 825,\(^{77}\) which permit insurance companies to carryback and carryover certain operating losses.\(^{78}\) Section 812(b)(2)\(^{79}\) is analogous to section 172(b)(2), except that certain terms reflect the peculiarities of the tax treatment of the life insurance industry. In order for the taxpayers' argument—that is, that the phrase "to which such loss may be carried" modifies "taxable income"—to apply equally to life insurance companies, that same phrase in section 812(b)(2) would have to modify "offset," a term which describes the amount of a hypothetical deduction which coincidentally is equal to the taxable income.\(^{80}\) One commentator,\(^{81}\) and presumably the Commissioner,\(^{82}\) contended that a loss cannot be "carried to" a hypothetical deduction. Likewise, the same analysis can be applied to section 825(e), which differs from section 812(b)(2) only in the substitution of "unused loss" for "loss from operations" and the removal of "(by reason of paragraph (1))."\(^{83}\) However, "offset" is defined for the purpose of computing a loss carryback as "taxable income for the offset year;"\(^{84}\) the definition is unlike that in section 812(d)(1) since no use is made of a hypothetical

\(^{74}\) 505 F.2d at 134–36; Axelrod v. Commissioner, 507 F.2d 884, 888 (6th Cir. 1974). The conclusion is based upon statutory construction and not policy. Taxable income for a corporate taxpayer is a concept somewhat dissimilar to that for a noncorporate taxpayer because of the difference in the deductions allowed by Congress. \textit{See} \textsc{Int. Rev. Code of 1954}, §§ 211 et seq., providing additional itemized deductions for individuals.

\(^{75}\) For the text of the section \textit{see} note 8 supra.

\(^{76}\) \textsc{Int. Rev. Code of 1954}, § 812.

\(^{77}\) \textit{Id.} § 825.

\(^{78}\) Section 812 applies to life insurance companies, whereas section 825 applies to mutual insurance companies.

\(^{79}\) The section states:

The entire amount of the loss from operations for any loss year shall be carried to the earliest of the taxable years to which (by reason of paragraph (1)) such loss may be carried. The portion of such loss which shall be carried to each of the other taxable years shall be the excess (if any) of the amount of such loss over the sum of the offsets (as defined in subsection (d)) for each of the prior taxable years to which such loss may be carried.


\(^{80}\) Section 812(d)(1) defines "offset" as an amount equal to that increase in the operations loss deduction for the taxable year which reduces the life insurance company taxable income ... for such year to zero.

\textit{Id.} § 812(d)(1).

\(^{81}\) 8 S. Diego L. Rev. at 447–48.

\(^{82}\) No court has addressed itself to this argument; it is not known if the Commissioner advanced such an argument.

\(^{83}\) \textsc{Int. Rev. Code of 1954}, § 825(e).

\(^{84}\) \textit{Id.} § 825(f).
deduction. This apparent weakness in the argument is negated by the fact that in certain carryover situations "offset" means taxable income plus "the amount required to be subtracted from the protection against loss account." Once again, in order for the taxpayers' first argument to be valid, the phrase "to which such loss may be carried" would have to modify an "offset" which would oftentimes be a transitional concept.

The second provision is the minimum tax for tax preferences. The Code provides that if a taxpayer has a net operating loss carryover not exhausted in the taxable year and items of tax preference in excess of $30,000, an amount equal to the lesser of the minimum tax or 10 percent of the net operating loss carryover shall be a deferred tax liability in subsequent years in which the net operating loss carryover reduces the taxpayer's taxable income. The argument is that section 56(b) was designed to relieve the burdens of taxpayers who incurred no tax liability for the taxable year on account of net operating loss carryovers, but yet incurred a minimum tax: the deferral exists only if the taxpayer has no tax liability for the taxable year and has a net operating loss carryover. The taxpayers' desired treatment of net operating loss excesses would create situations in which the taxpayer would be able to defer the minimum tax in a year in which it had a tax liability based upon the alternative tax and a net operating loss carryover, a boon to the taxpayer not contemplated by Congress when it enacted section 56(b).

A fourth argument, in response to the suggestion by the dissent in Mutual Assurance that Congress has acquiesced in the construction given to section 172(b)(2) by the courts in Chartier and the cases following it, is that Congress has not acquiesced in such a construction since relatively little time has elapsed since the decisions in favor of the taxpayer. Additionally, this position continues, Congress' failure to reenact the scheme existing from 1924 to 1933 when viewed with the fact that regulation section 1.172-4 has existed since before Chartier was decided, should be interpreted as Congressional approval of the Commissioner's position.

85. See note 80 and accompanying text supra.
86. INT. REV. CODE OF 1954, § 825(f) (2) (A).
87. 8 S. DIEGO L. REV. at 447-48. See note 82 supra.
88. INT. REV. CODE OF 1954, § 56. The minimum tax is designed to guarantee that taxpayers have a tax liability equal to at least 10 percent of tax preference items in excess of $30,000.
89. Benefits incurred as a result of preferential tax treatment of, e.g., accelerated depreciation on real property, capital gains, stock options, depletion. See id. § 57.
90. Id. § 56(b).
91. 8 S. DIEGO L. REV. at 448-49. Once again no court has addressed this argument. See note 82 supra.
92. See note 9 supra.
93. See notes 26-30 and accompanying text supra.
95. 505 F.2d at 138 n.21. In addition, Congress may not have been keenly aware of a problem which only recently has concerned the courts. See text accompanying notes 19 & 40 supra.
B. The Arbitrary and Discriminatory Results Encouraged by the Arguments

The taxpayers' argument emphasizes the inequities produced by the Commissioner's interpretation. An illustration demonstrates the effect of denying a corporate taxpayer the "wasted" carryover\(^6\) as a deduction in the succeeding year.\(^7\)

<table>
<thead>
<tr>
<th>Year</th>
<th>Corp. A</th>
<th>Corp. B</th>
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<td></td>
<td>Capital gain</td>
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<td>100</td>
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<td>NOL from year 3</td>
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<td>(100)</td>
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<td>Tax (§ 1201)</td>
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<td>Year 2</td>
<td>Ord. taxable income</td>
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<td>140</td>
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<td>Tax (§ 11)</td>
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</tr>
<tr>
<td>Year 3</td>
<td>Ord. taxable loss carried to year 1 as NOL</td>
<td></td>
</tr>
<tr>
<td></td>
<td>(150)</td>
<td>(100)</td>
</tr>
<tr>
<td>Total 3-year income:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Capital gain</td>
<td>200</td>
<td>200</td>
</tr>
<tr>
<td>Ord. taxable income</td>
<td>90</td>
<td>140</td>
</tr>
<tr>
<td></td>
<td>290</td>
<td>340</td>
</tr>
<tr>
<td>Total 3-year tax liability</td>
<td>120.7</td>
<td>120.7</td>
</tr>
</tbody>
</table>

The taxpayers' argument is that the regressive nature of the tax treatment of both taxpayers, in the illustration, a result dictated by the Commissioner's interpretation of section 172(b)(2), is arbitrary and inconsistent with the purpose of section 172(b)(2)\(^8\) and the overall progressive nature of the federal income tax.\(^9\) A second illustration demonstrates the strange effect which the Commissioner's interpretation and the definition of net operating loss\(^100\) has upon the capital gains tax rate:

---

96. See note 42 supra.
97. See also note 8 supra.
98. See notes 42–49 and accompanying text supra.
99. Such inconsistency is even more acute for noncorporate taxpayers, the taxing of whom rests upon a fundamental policy of progressive rates. See Int. Rev. Code or 1954, § 1. See also Appendix infra. Using the taxpayers' interpretation, however, also leads to inequitable results. See illustration following text accompanying note 102 infra.
100. See note 12 supra. See also text accompanying note 125 infra.
<table>
<thead>
<tr>
<th></th>
<th>Corp. A</th>
<th>Corp. B</th>
</tr>
</thead>
<tbody>
<tr>
<td>Year 1: Capital gain</td>
<td>100</td>
<td>100</td>
</tr>
<tr>
<td>Ord. taxable (loss)</td>
<td>(100)</td>
<td>-0-</td>
</tr>
<tr>
<td>Taxable income</td>
<td>-0-</td>
<td>100</td>
</tr>
<tr>
<td>Tax (§ 1201)</td>
<td>-0-</td>
<td>30</td>
</tr>
<tr>
<td>Year 2: Ord. taxable income</td>
<td>100</td>
<td>-0-</td>
</tr>
<tr>
<td>Tax (§ 11)</td>
<td>41.5</td>
<td>-0-</td>
</tr>
<tr>
<td>Total 2-year income: Capital gain</td>
<td>100</td>
<td>100</td>
</tr>
<tr>
<td></td>
<td>-0-</td>
<td>-0-</td>
</tr>
<tr>
<td></td>
<td>100</td>
<td>100</td>
</tr>
<tr>
<td>Total 2-year tax liability</td>
<td>41.5</td>
<td>30</td>
</tr>
<tr>
<td>Effective capital gains tax rate</td>
<td>41.5%</td>
<td>30.0%</td>
</tr>
</tbody>
</table>

Such disparity is obviously a result of arbitrary and fortuitous timing differences, the existence of which was the primary motivation for the enactment of section 172 and its predecessors.101

The Commissioner, however, is not without illustrations to support his viewpoint.102 First, the taxpayers' analysis also produces inequitable results:

<table>
<thead>
<tr>
<th></th>
<th>Corp. A</th>
<th>Corp. B</th>
</tr>
</thead>
<tbody>
<tr>
<td>Year 1: Capital gain</td>
<td>200</td>
<td>200</td>
</tr>
<tr>
<td>Ord. taxable income</td>
<td>100</td>
<td>100</td>
</tr>
<tr>
<td>NOL from year 3</td>
<td>(150)</td>
<td>(200)</td>
</tr>
<tr>
<td>Taxable income</td>
<td>150</td>
<td>100</td>
</tr>
<tr>
<td>Tax (§ 1201)</td>
<td>60</td>
<td>41.5</td>
</tr>
<tr>
<td>Year 2: Ord. taxable income</td>
<td>140</td>
<td>140</td>
</tr>
<tr>
<td>NOL from year 1</td>
<td>(50)</td>
<td>-0-</td>
</tr>
<tr>
<td>Taxable income</td>
<td>90</td>
<td>140</td>
</tr>
<tr>
<td>Tax (§ 11)</td>
<td>36.7</td>
<td>60.7</td>
</tr>
</tbody>
</table>

101. See notes 44-46 and accompanying text supra.

102. See 8 S. DIEGO L. REV. at 449-50.
Year 3:  Ord. taxable loss carried
to year 1 as NOL  (150)  (200)

Total 3-year income:
Capital gain  200  200
Ord. taxable income  90  40

Total 3-year tax liability  96.7  102.2

Arguably, it is quite inequitable that a lower taxable income should produce
a greater tax liability. 103 A second illustration demonstrates unfairness
even more pronouncedly: 104

<table>
<thead>
<tr>
<th>Corp. A</th>
<th>Corp. B</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital gain</td>
<td>100</td>
</tr>
<tr>
<td>Ord. taxable income (loss)</td>
<td>10</td>
</tr>
<tr>
<td>NOL carryover from a prior year</td>
<td>(25)</td>
</tr>
<tr>
<td>Taxable income</td>
<td>85</td>
</tr>
<tr>
<td>Tax (§ 1201)</td>
<td>30</td>
</tr>
<tr>
<td>NOL carryover available to a succeeding year</td>
<td>(15)</td>
</tr>
</tbody>
</table>

This result, which is in part due to the definition of net operating loss, 105 is also attributable to fortuitous timing differences. 106

Moreover, the Commissioner contends that the excess carryover claimed by the taxpayers would reduce ordinary taxable income in the subsequent year, whereas in the 1924–33 period it was used to offset capital gain in the second step of the alternative tax computation. 107 Since capital gains are usually taxed at rates lower than the regular tax rates, 108 ac-

103. See Appendix infra.
104. See 8 S. DIEGO L. REV. at 449–50.
105. See text accompanying note 12 supra.
106. It is true that taxpayers can, to some extent, control the timing of deductions and income, but the ability to do so is quite limited because of the nature of modern business. There should also be a limit to the extent to which taxpayers must permit tax planning to pervade every detail of their daily operations in order to maximize the benefits of net operating loss treatment.
107. See notes 26–30 and accompanying text supra.
108. Taxable income below $25,000 is taxed at a rate (22 percent) which is less than that imposed upon capital gains (30 percent), but all ordinary taxable income in excess of $25,000 is taxed at the highest rate (48 percent). INT. REV. CODE OF 1954, §§ 11, 1201(a).
ception of the taxpayers' argument would give the modern-day taxpayer more relief than that given to the taxpayer from 1924 to 1933.109

C. Can Anyone Be Right if Everyone is Wrong?

Despite the fact that both the taxpayers' and the Commissioner's interpretations of section 172(b)(2) yield inequities,110 the courts which will face the issue must decide it one way or the other. It is submitted that the language of section 172(b)(2) is explicit,"111 and that upon analyzing the statute's language in light of the analogous noncorporate taxpayer provision in section 172(d)(2)(B), the insurance company provisions in sections 812 and 825, and the deferral of minimum tax provision in section 56(b), the courts should conclude that the Commissioner is correct. The taxpayers' argument requires a court to stretch the parsing and meaning of section 172(b)(2) beyond acceptable limits. The inequity resulting from the Commissioner's position is alone an insufficient reason for a court to

109. For example, assuming that the rates are equivalent in both periods, under the taxpayers' approach the following discrepancy results:

<table>
<thead>
<tr>
<th>Year</th>
<th>1924 to 1933</th>
<th>1975</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Capital gain</td>
<td>200</td>
</tr>
<tr>
<td></td>
<td>Ord. taxable income</td>
<td>100</td>
</tr>
<tr>
<td></td>
<td>NOL from year 3</td>
<td>(150)</td>
</tr>
<tr>
<td></td>
<td>Taxable income</td>
<td>150</td>
</tr>
<tr>
<td></td>
<td>Tax (§ 1201)</td>
<td>45</td>
</tr>
<tr>
<td>Year 1:</td>
<td>Ord. taxable income</td>
<td>140</td>
</tr>
<tr>
<td></td>
<td>NOL from year 1</td>
<td>-0-</td>
</tr>
<tr>
<td></td>
<td>140</td>
<td>90</td>
</tr>
<tr>
<td></td>
<td>Tax (§ 11)</td>
<td>60.7</td>
</tr>
<tr>
<td>Year 2:</td>
<td>Ord. taxable loss carried to year 1 as NOL</td>
<td>(150)</td>
</tr>
<tr>
<td></td>
<td>Total 3-year income:</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Capital gain</td>
<td>200</td>
</tr>
<tr>
<td></td>
<td>Ord. taxable income</td>
<td>90</td>
</tr>
<tr>
<td></td>
<td>290</td>
<td>290</td>
</tr>
<tr>
<td></td>
<td>Total 3-year tax liability</td>
<td>105.7</td>
</tr>
</tbody>
</table>

See Appendix infra.

110. For an extensive mathematical analysis of the reasons why neither interpretation always yields an equitable result, see Appendix infra.

111. The Court in Mutual Assurance said: "But, a clause which expressly resolves a matter which might have been left to implication is hardly 'meaningless and superfluous'; it is just good draftsmanship." 505 F.2d at 134 (footnote omitted).
contravene the result seemingly dictated by a thoughtful analysis of section 172(b)(2); moreover, the taxpayers' position will at times yield results quite as inequitable. In addition, any court accepting the taxpayers' reasoning will be required to analyze the results of each case in order to apply the Chartier holding only if there is no inequitable result because application of this interpretation in an inequitable situation would be contrary to the reasoning in Chartier that sections 1201 and 172(b) must be applied in a manner consistent with the Congressional intent of eliminating the inequitable results of fortuitous timing differences. As one commentator succinctly explained:

There is no known legislative or statutory authority for making the size of the net operating loss the decisive factor in determining whether such net operating loss must be absorbed in the carryback year or not.

IV. A PROPOSED SOLUTION

Many have suggested that, although the Supreme Court might resolve the conflict, Congress should act to remove the inequities that will arise regardless of the Court's decision. One possibility which has been suggested is that

a net operating loss carried to a year in which the alternative tax computation was used will be absorbed against the net ordinary income and then against capital gains, with a consequent tax savings as under the Revenue Act of 1924.

In order to avoid disparities, this solution should require reformation of the second step of the alternative tax computation so that even in years unaffected by net operating loss excesses, ordinary loss would offset capital

112. See text accompanying notes 102-06 supra.

113. Nagel, Planning to Avoid Wastage of NOL Carryovers: A Lesson from Chartier Realty, 42 J. Tax 26, 28 (1975). The calculation of the point at which the taxpayer is indifferent to the size of the net operating loss is developed in the Appendix infra.

114. For example, it has been urged that:

With the present circuit split, tax results become a matter of geography. Significant amounts of money can be won or lost depending upon where taxpayers have their tents pitched. Hopefully the Supreme Court will resolve the issue. Sixth Circuit Widens Split On Net Operating Loss Carryovers, 6 P-H 1975 Fed. Taxes ¶ 60,050. The effects of this split are also felt in the Tax Court, which must follow the precedent established by the particular court of appeals to which the case at bar would be appealed. Jack E. Golsen, 54 T.C. 742 (1970), aff'd, 445 F.2d 985 (10th Cir.), cert. denied 404 U.S. 940 (1971). The Supreme Court will decide the issue, having granted certiorari in United States v. Foster Lumber Co., 500 F.2d 1230 (8th Cir. 1974), cert. granted, 95 S. Ct. 1443 (1975) (No. 74-799).

115. See, e.g., Nagel, supra note 113, at 29.
gains for purposes of the section 1201 tax; otherwise, the effect of differences in timing will be severe.117 Even with such an adjustment to section 1201, inequities may yet occur for the same reason:

<table>
<thead>
<tr>
<th>Year 1:</th>
<th>Corp. A</th>
<th>Corp. B</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital gain</td>
<td>200</td>
<td>200</td>
</tr>
<tr>
<td>Ord. taxable (loss)</td>
<td>(100)</td>
<td>-0-</td>
</tr>
<tr>
<td>Taxable income</td>
<td>100</td>
<td>200</td>
</tr>
<tr>
<td>Tax (proposed § 1201)</td>
<td>30</td>
<td>60</td>
</tr>
<tr>
<td>Year 2:</td>
<td>Ord. taxable income</td>
<td>100</td>
</tr>
<tr>
<td>Tax (§ 11)</td>
<td>41.5</td>
<td>-0-</td>
</tr>
<tr>
<td>Total 2-year income:</td>
<td>200</td>
<td>200</td>
</tr>
<tr>
<td>Capital gain</td>
<td>200</td>
<td>200</td>
</tr>
<tr>
<td>Ord. taxable income</td>
<td>-0-</td>
<td>-0-</td>
</tr>
<tr>
<td>Total 2-year tax liability</td>
<td>71.5</td>
<td>60</td>
</tr>
</tbody>
</table>

A second proposal is

to make the alternative tax computation binding once made, thereby limiting the use of the net operating loss to the net ordinary income in the carryback or carryover year, with any balance being carried over to a subsequent year.118

The problem with such a solution is that it locks the taxpayer into a tax computation, which, upon reexamination of the facts in subsequent loss

117. For example, consider the following illustration:

<table>
<thead>
<tr>
<th>Year 1:</th>
<th>Corp. A</th>
<th>Corp. B</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital gain</td>
<td>200</td>
<td>200</td>
</tr>
<tr>
<td>Ord. taxable income (loss)</td>
<td>100</td>
<td>(50)</td>
</tr>
<tr>
<td>NOL from year 2</td>
<td>(150)</td>
<td>-0-</td>
</tr>
<tr>
<td>Taxable income</td>
<td>150</td>
<td>150</td>
</tr>
<tr>
<td>Tax (§ 1201)</td>
<td>45</td>
<td>60</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Year 2:</th>
<th>Ord. taxable (loss) carried to year 1 as NOL</th>
<th>(150)</th>
<th>-0-</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total 2-year income:</td>
<td>200</td>
<td>200</td>
<td></td>
</tr>
<tr>
<td>Capital gain</td>
<td>200</td>
<td>200</td>
<td></td>
</tr>
<tr>
<td>Ord. taxable (loss)</td>
<td>(50)</td>
<td>(50)</td>
<td></td>
</tr>
<tr>
<td>Total 2-year tax liability</td>
<td>45</td>
<td>60</td>
<td></td>
</tr>
</tbody>
</table>

years, may not be to its benefit, even with the proposed carryover of the potentially "wasted" net operating loss excess. Moreover, there would be questions of unequal treatment of taxpayers since the proposal does not suggest that a *regular* tax computation be binding once made. Even if such a suggestion were read into the proposal in order to eliminate any possibility of unequal treatment problems, the result would be that all taxpayers would be locked into irrevocable and possibly detrimental decisions which they would be required to make before the facts of the subsequent years, which might produce losses, are known.

This Comment offers a third proposal, a simplification of policies already apparent in the Code, which recognizes that disproportion in the ratio of tax liability to total income is a problem of policy application reaching beyond the scope of the present issue, because different taxpayers are entitled to various special tax credits, capital gains preferences and, for corporate taxpayers with taxable income below $25,000 and non-corporate taxpayers vis-à-vis corporate taxpayers with income in excess of $25,000, the progressive nature of the tax rates. By suggesting the following changes in the Code, this proposal seeks only to equalize the

119. This result would occur in the following situation:

Year 1:  
Capital gain 200  
Ord. taxable income 100  

| Tax (§ 1201) | 0.30 × 200 = 60  
| § 11 tax on 100 | = 41.5  
| 101.5 |

Year 2:  
Ord. taxable income (loss) (200)  

Year 1 tax recomputed:

| .30 × 200 = 60  
| § 11 tax on (100) = -0-  
| 60 |

Had the taxpayer not been bound by proposed alternative tax election:

Year 1 tax recomputed:

| Capital gain 200  
| Ord. taxable income 100 |

NOL from year 2 (200)  

| Taxable income 100 |

| Tax (§ 11) 41.5 |


121. *See id. §§ 1201-02.*

122. *See id. §§ 1, 11.*
tax burden of taxpayers in similar situations experiencing similar amounts of each type of income and enjoying similar special tax credits:

1. Capital gain or loss and ordinary income or loss shall be separate tax bases at all times, each taxed at its own rate.

2. Ordinary taxable loss which is not used to reduce ordinary taxable income in a year to which the loss has been carried shall be available as a carryforward to any remaining year within the 9-year period.

3. Net operating loss carrybacks-carryovers are created by ordinary taxable losses even in years in which the capital gain exceeds that loss.

4. Capital losses in excess of capital gains are available as carrybacks-carryovers.

This scheme is basically a mandatory “alternative” tax. Since the present alternative tax rate (30 percent) is greater than the regular tax rate for income under $25,000 (22 percent), certain taxpayers with taxable income below $25,000 realizing capital gains would be in worse positions under the proposal than under current law, unless one of two ameliorative devices is incorporated into the scheme. One is that Congress would readjust all the rates to maintain the same revenue amount; the other is that Congress would make the capital gains tax progressive.

The benefits of this proposal are threefold. First, full effect is given to the Congressional intent to tax capital gains at a lower rate and to spread ordinary taxable income (loss) over a period of time. There is no reason not to treat capital gains and ordinary taxable income as separate concepts for tax computation purposes since the alternative tax imposes a mandatory tax.

123. This would resolve the potential question of whether the excess of deductions over ordinary taxable income is a net operating loss if total taxable income exceeds the deductions. See text accompanying note 12 supra.

124. This period could be adjusted without damaging the overall scheme.

125. Such capital gain would be fully taxed. See text accompanying note 123 supra. This removes the inequities of the type described in note 28 supra. In addition, it solves the problem suggested in note 12 supra that capital gains might absorb net operating losses in the base year. Even though the express provisions of section 172(c) (see text accompanying note 12 supra) render the taxpayers' purpose and inequity arguments meaningless, both problems are manifestations of the same fundamental disharmony in the Code, and resolution of one necessarily involves resolution of the other.

126. Otherwise, total revenue would increase. All net long-term capital gains would be taxed at a 30 percent rate, whereas under current provisions many net long-term capital gains are taxed at an effective rate of 22 percent. It is probable that the savings in taxes created by the avoidance of the “waste” of net operating loss excesses would not offset the increase in taxes upon long-term capital gains.

127. This would greatly simplify and restore equity to noncorporate tax rate structures as well.

128. See section II of this Comment supra.

129. See notes 42-49 and accompanying text supra.

130. The court in Foster Lumber stated, “[W]e see no reason why the chance relative timing of basically unrelated economic events should negate the cumulative impact of the separate provisions.” 500 F.2d at 1232.
icates that Congress considers capital gain to be a unique type of gross income worthy of its own basis of tax liability.\textsuperscript{131} Of course, resort to a mandatory regular tax computation through elimination of the alternative tax would solve the instant problem, but it would ignore Congress' recognition of the extraordinary nature of capital gains income.\textsuperscript{132} Second, taxpayers who do not experience operating losses will be unaffected, except to the extent that the proposal requires readjustment of the tax rates.\textsuperscript{133} Third, even though the two previous proposals would result in improvements over the current law, they are arguably not as refined an approach as the one suggested.\textsuperscript{134}

Application of this proposal to the situations described in the four illustrations of the arbitrary results emanating from both the Commissioner's and taxpayers' interpretations of section 172(b)(2)\textsuperscript{135} produces equitable tax liabilities. In the taxpayers' first illustration,\textsuperscript{136} the separate taxation of capital gain and ordinary taxable income makes the tax burden more proportionate to the total income.\textsuperscript{137}

<table>
<thead>
<tr>
<th>Year 1:</th>
<th>Corp. A</th>
<th>Corp. B</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital gain</td>
<td>200</td>
<td>200</td>
</tr>
<tr>
<td>Ord. taxable income</td>
<td>100</td>
<td>100</td>
</tr>
<tr>
<td>NOL from year 3</td>
<td>(150)</td>
<td>(100)</td>
</tr>
<tr>
<td></td>
<td>(50)</td>
<td>-0-</td>
</tr>
<tr>
<td>Tax (§ 1201)</td>
<td>60</td>
<td>60</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Year 2:</th>
<th>Corp. A</th>
<th>Corp. B</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ord. taxable income</td>
<td>140</td>
<td>140</td>
</tr>
<tr>
<td>NOL from year 1</td>
<td>(50)</td>
<td>-0-</td>
</tr>
<tr>
<td></td>
<td>90</td>
<td>140</td>
</tr>
<tr>
<td>Tax (§ 11)</td>
<td>36.7</td>
<td>60.7</td>
</tr>
</tbody>
</table>

\textsuperscript{131} The court in \textit{Chartier} explained that the legislative history demonstrates that Congress did intend to make ... a distinction between the two elements of the "alternative" tax [i.e., ordinary taxable income (loss) and capital gain (loss)] . . . . \textsuperscript{52 T.C. at 356.}

\textsuperscript{132} See section II of this Comment \textit{supra.}

\textsuperscript{133} In addition, if rate adjustments are ignored, taxpayers with taxable income below $25,000 would incur a tax liability of 30 percent of net long-term capital gain, rather than 22 percent. See note 126 \textit{supra.}

\textsuperscript{134} Furthermore, if Congress is to take remedial steps it should enact a problem-removing and not a problem-obfuscating solution.

\textsuperscript{135} See text accompanying notes 97-104 \textit{supra.}

\textsuperscript{136} See illustration following text accompanying note 97 \textit{supra.}

\textsuperscript{137} See text accompanying notes 120-22 \textit{supra.}
Likewise, the taxpayers in the second illustration\textsuperscript{138} are similarly affected:

\begin{align*}
\text{Year 1:} & \\
\text{Capital gain} & \quad 100 \quad 100 \\
\text{Ord. taxable (loss)} & \quad (100) \quad -0- \\
\text{Tax (§ 1201)} & \quad 30 \quad 30 \\
\text{Year 2:} & \\
\text{Ord. taxable income} & \quad 100 \quad -0- \\
\text{NOL from year 1} & \quad (100) \quad -0- \\
\text{Tax (§ 11)} & \quad -0- \quad -0- \\
\text{Total 2-year income:} & \\
\text{Capital gain} & \quad 100 \quad 100 \\
\text{Ord. taxable income} & \quad -0- \quad -0- \\
\text{Total 2-year tax liability} & \quad 30 \quad 30 \\
\text{Effective capital gains tax rate} & \quad 30\% \quad 30\%
\end{align*}

The inequities caused by application of the taxpayers' interpretation of section \textit{172(b)(2)} are similarly removed.\textsuperscript{139}

\textsuperscript{138} See illustration following text accompanying note 100 supra.

\textsuperscript{139} See illustration following text accompanying note 102 supra.
I.

Year 1:  

<table>
<thead>
<tr>
<th>Corp. A</th>
<th>Corp. B</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital gain</td>
<td>200</td>
</tr>
<tr>
<td>Ord. taxable income</td>
<td>100</td>
</tr>
<tr>
<td>NOL from year 3</td>
<td>(150)</td>
</tr>
<tr>
<td></td>
<td>(50)</td>
</tr>
<tr>
<td>Tax (§ 1201)</td>
<td>60</td>
</tr>
</tbody>
</table>

Year 2:  

<table>
<thead>
<tr>
<th>Corp. A</th>
<th>Corp. B</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ord. taxable income</td>
<td>140</td>
</tr>
<tr>
<td>NOL from year 1</td>
<td>(50)</td>
</tr>
<tr>
<td></td>
<td>90</td>
</tr>
<tr>
<td>Tax (§ 11)</td>
<td>36.7</td>
</tr>
</tbody>
</table>

Year 3:  

<table>
<thead>
<tr>
<th>Corp. A</th>
<th>Corp. B</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ord. taxable loss carried to year 1 as NOL</td>
<td>(150)</td>
</tr>
<tr>
<td>Total 3-year income:</td>
<td></td>
</tr>
<tr>
<td>Capital gain</td>
<td>200</td>
</tr>
<tr>
<td>Ord. taxable income</td>
<td>90</td>
</tr>
<tr>
<td></td>
<td>290</td>
</tr>
<tr>
<td>Total 3-year tax liability</td>
<td>96.7</td>
</tr>
</tbody>
</table>

II.  

<table>
<thead>
<tr>
<th>Corp. A</th>
<th>Corp. B</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital gain</td>
<td>100</td>
</tr>
<tr>
<td>Ord. taxable income (loss)</td>
<td>10</td>
</tr>
<tr>
<td>NOL carryover from a prior year</td>
<td>(25)</td>
</tr>
<tr>
<td></td>
<td>(15)</td>
</tr>
<tr>
<td>Tax (§ 1201)</td>
<td>30</td>
</tr>
<tr>
<td>NOL carryover available to a succeeding year</td>
<td>(15)</td>
</tr>
</tbody>
</table>

Nonetheless, problems would still exist for taxpayers with no ordinary taxable income to absorb the ordinary taxable losses. Such problems have existed and will exist so long as the negative income tax remains an unenacted proposal.\footnote{141} Even under the current scheme, a net operating loss

\footnote{140. See illustration following text accompanying note 104 supra.  
141. Even if enacted, the benefits of a negative income tax might not extend to any, or all, corporate taxpayers, or perhaps even certain noncorporate taxpayers engaging in business for profit.}
excess is useless if the taxpayer has not recognized some type of income within the 9-year period.\textsuperscript{142} Although the proposal would reintroduce the supposed problems which Congress eliminated in 1924,\textsuperscript{143} there are at least six reasons why the pre-1924 minimum tax upon capital gains\textsuperscript{144} is not the harsh provision it may appear to be. First, non-corporate taxpayers would be able to avail themselves of the 50 percent deduction for long-term capital gains,\textsuperscript{145} a provision not available in the pre-1924 period.\textsuperscript{146} Second, capital losses may be used to offset capital gains,\textsuperscript{147} another provision not available when capital gains were subject to a minimum tax. Third, since taxpayers would face less difficulty in carrying net operating losses to other years under the proposal and since 9, rather than 2, years are, and would presumably still be, available to absorb net operating loss excesses, the burden of paying such a mandatory capital gains alternative tax would be alleviated by the tax refunds generated by the net operating loss.\textsuperscript{148} Fourth, adjustments to the minimum tax upon tax preferences\textsuperscript{149} might be provided by Congress if it finds that such compensatory relief is warranted. Fifth, taxpayers would be able to avail themselves of the provisions for non-recognition and deferral of recognition of capital gains, which likewise did not exist in the pre-1924 period.\textsuperscript{150} Finally, such a tax would be consistent with the notion that the capital gain is extraordinary income which should be taxed in a manner independent of the treatment given to the taxpayer's ordinary taxable income (loss).\textsuperscript{151}

It should be noted that it is almost inevitable that under the proposed structure very few taxpayers would be in the same position vis-a-vis other taxpayers as they are under the current law. Since the proposed structure eliminates the troublesome "mixing" of capital gain or loss and ordinary taxable income or loss for tax computation purposes, most of the difference in position would be the result of the removal of the (dis)advantages which taxpayers experienced by virtue of the "mixing" of capital gain or loss and ordinary taxable income or loss. The remaining difference in position

\textsuperscript{142} Limitations upon the deductability of capital losses create similar problems. See Int. Rev. Code of 1954, § 1211.
\textsuperscript{143} See note 28 and accompanying text supra.
\textsuperscript{144} See text accompanying note 23 supra.
\textsuperscript{145} Int. Rev. Code of 1954, § 1202.
\textsuperscript{146} The percentage exclusion method, which was the forerunner of the 50 percent deduction, was not introduced until 1934. See text accompanying note 33 supra.
\textsuperscript{147} Int. Rev. Code of 1954, § 1212. It would be possible for Congress to remove the limitation upon capital loss carrybacks and carryovers contained in this section — that a net operating loss in the year to which the capital loss is carried should not be created or increased — because, under the proposal, the capital loss excess would not affect the ordinary taxable income (loss). See text accompanying note 123 supra.
\textsuperscript{148} Presumably the quick refund procedure would still be operative. Int. Rev. Code of 1954, § 6411.
\textsuperscript{149} Id. § 56.
\textsuperscript{150} Id. §§ 1031 et seq.
\textsuperscript{151} In fact, this notion is the linchpin of the proposal, and is consistent with the policies expressed by Congress. See notes 128-30 and accompanying text supra.
would be due to the readjusted rates,\textsuperscript{152} the proposed progressive nature of the capital gains tax,\textsuperscript{153} or both.

V. Conclusion

The solution suggested is not a panacea, probably creating problems of its very own,\textsuperscript{154} but it nonetheless functions as a tonic at the least. Hopefully, its curative benefits sufficiently outweigh its side effects so that taxpayers will be given tax treatment upon more logical and rational bases. Although all the inequities in the Code cannot be removed at one time, and although the proposed solution would affect a somewhat esoteric and heretofore latent inequity, it would be one of the many small steps which Congress should take to restructure the Code in an attempt to make each taxpayer feel that he or she is carrying a fair share and only a fair share of the national fiscal burden.

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\textsuperscript{152} See note 126 and accompanying text supra.
\textsuperscript{153} See text accompanying note 127 supra.
\textsuperscript{154} Such problems may not be discovered for several years, although it is improbable that more than two decades would ever again elapse between the time Congress creates the underlying conditions for a problem and the time a taxpayer actually experiences that problem.
APPENDIX

A complete analysis of the interrelationship between sections 172 and 1201 requires the use of extremely complex equations. These symbols will be used to represent certain concepts:

- **TI** — taxable income
- **CG** — net long term capital gain
- **NOL** — net operating loss
- **T** — total tax liability
- **TR** — § 11 tax liability
- **TA** — § 1201 tax liability
- **TI** — taxable income in year x
- **TA(T/P)** — § 1201 tax liability according to the taxpayers' interpretation of § 172(b) (2)
- **TA(Comm)** — § 1201 tax liability according to the Commissioner's interpretation of § 172(b) (2)

Even if certain simplifying assumptions are made — a corporate taxpayer, no special tax credits, 3 years of operation, capital gain and ordinary taxable income in the first year, ordinary taxable income in the second year, and a net operating loss in the third year — a series of equations is necessary to reflect the tax, expressed as a function of income, because of the discontinuous nature of the relationship between tax and income caused by the tax surcharge and the use of section 1201 tax computations in one year, and section 11 tax computations in another. For example, the equations for the section 11 tax in this somewhat simplified situation would be rather complex:

\[
0 \leq NOL_3 \leq TI_1-25 : T_R = .22(TI_1-NOL_3) \\
+ .26[ (TI_1-25)-NOL_3] \\
+ .22(TI_1)-NOL_3 \\
+ .22(TI_2)
\]

\[
TI_1-25 \leq NOL_3 \leq TI_1 : T_R = .22(TI_1-NOL_3) + .22(TI_2) \\
+ .26(TI_2)
\]

\[
TI_1 \leq NOL_3 \leq TI_1 + TI_2-25 : T_R = .22[TI_2-(NOL_3-TI_1)] \\
+ .26[ (TI_2-25)-(NOL_3-TI_1)]
\]

\[
TI_1+TI_2-25 \leq NOL_3 \leq TI_1+TI_2 : T_R = .22[TI_2-(NOL_3-TI_1)]
\]

\[
TI_1+TI_2 \leq NOL_3 : T_R = 0
\]

In light of the fact that the alternative tax equations are much more complicated, it would be very cumbersome to interrelate such equations in the current context, in order to derive the equations to express tax liability as reflected by the computation yielding the lower tax.

Rather, a further simplification can be made which will remove the analysis from the abstract morass in which it would otherwise become entangled. It will be assumed that the hypothetical corporate taxpayer has taxable income of $300,000 in the first year, of which $200,000 is...
capital gain and $100,000 is ordinary taxable income; $140,000 of ordinary taxable income in the second year; and a net operating loss in the third year, the amount of which will be the controlled variable. (This is the basis for the illustrations in the text accompanying notes 97, 102 & 137, and in notes 8, 109, 117 & 119 supra.)

A set of equations reflects the results of using a section 11 tax computation in both years one and two, even if the section 1201 tax is lower:

\[
\begin{align*}
0 \leq NOL_3 & \leq 275 & T_R &= 198.2 - .48NOL_3 \\
275 < NOL_3 & < 300 & T_R &= 126.7 - .22NOL_3 \\
300 \leq NOL_3 & \leq 415 & T_R &= 204.7 - .48NOL_3 \\
415 < NOL_3 & < 440 & T_R &= 96.8 - .22NOL_3 \\
440 \leq NOL_3 & \leq 440 & T_R &= 0
\end{align*}
\]

The use of a section 1201 tax computation as defined by the taxpayers' interpretation of section 172(b)(2) in year one (even if the section 11 tax liability is lower) and a section 11 tax computation in year two is reflected by the following set of equations:

\[
\begin{align*}
0 \leq NOL_3 & \leq 75 & T_A(T/P) &= 162.2 - .48NOL_3 \\
75 < NOL_3 & < 100 & T_A(T/P) &= 142.7 - .22NOL_3 \\
100 \leq NOL_3 & \leq 215 & T_A(T/P) &= 168.7 - .48NOL_3 \\
215 < NOL_3 & < 240 & T_A(T/P) &= 112.8 - .22NOL_3 \\
240 \leq NOL_3 & \leq 440 & T_A(T/P) &= 60
\end{align*}
\]

Similarly, the equations reflecting the use of a section 1201 tax computation as defined by the Commissioner's interpretation in year one (even if the section 11 tax liability is lower) and a section 11 tax computation in year two are as follows:

\[
\begin{align*}
0 \leq NOL_3 & \leq 75 & T_A(Comm) &= 162.2 - .48NOL_3 = T_A(T/P) \\
75 < NOL_3 & < 100 & T_A(Comm) &= 142.7 - .22NOL_3 = T_A(T/P) \\
100 \leq NOL_3 & \leq 300 & T_A(Comm) &= 120.7 \\
300 < NOL_3 & < 415 & T_A(Comm) &= 264.7 - .48NOL_3 \\
415 < NOL_3 & < 440 & T_A(Comm) &= 156.8 - .22NOL_3 \\
440 \leq NOL_3 & \leq 440 & T_A(Comm) &= 60
\end{align*}
\]

The corporate taxpayer's tax liability will be reflected by equations representing the use of either the section 11 or the section 1201 computations, whichever is lower, for each interval. The tax liability using the Commissioner's interpretation of section 172(b)(2) is determined as follows:

If the NOL_3 is between 0 and 75, \( T_A(Comm) = 162.2 - .48NOL_3 = T_A(T/P) \). \( T_R \) exceeds \( T_A(Comm) \) by 36 which, incidentally, is the capital gain of 200 multiplied by the .18 difference in the .48 section 11 and .30 section 1201 tax rates. Therefore, the tax liability in that range will be \( 162.2 - .48NOL_3 \).

If the NOL is between 75 and 100, \( T_A(Comm) = 142.7 - .22NOL_3 \) and \( T_R = 198.2 - .48NOL_3 \). \( T_R \) exceeds \( T_A(Comm) \) by 55.5 - .26NOL_3. Since the
greatest value which the NOL₃ has in this range is 100, TR will exceed
TA(Comm) by at least 29.5. Therefore T=142.7-.22NOL₃.

In the next range, that is, as the NOL₃ varies from 100 to 275,
TA(Comm)=120.7, whereas TR=198.2-.48NOL₃. Since the NOL₃ can
be as small as 100 or as large as 275 in this range, TR will exceed
TA(Comm) below a certain point and will exceed it above that point.
That point is the value of NOL₃ which will produce the same tax under
either method of computation:

\[
\begin{align*}
120.7 & = 198.2 - 0.48NOL₃ \\
77.5 & = 0.48NOL₃ \\
162 & = NOL₃
\end{align*}
\]

Thus, as NOL₃ ranges from 100 to 162, T=TA(Comm)=120.7, and from
162 to 275, T=TR=198.2-.48NOL₃.

Similar derivations are possible for the remaining NOL₃ ranges (in
which TR<TA(Comm)), and the final set of equations is summarized:

\[
\begin{align*}
0 \leq NOL₃ & \leq 75 : T(Comm)=162.2-.48NOL₃ \\
75 \leq NOL₃ & \leq 100 : T(Comm)=142.7-.22NOL₃ \\
100 \leq NOL₃ & \leq 162 : T(Comm)=120.7 \\
162 \leq NOL₃ & \leq 275 : T(Comm)=198.2-.48NOL₃ \\
275 \leq NOL₃ & \leq 300 : T(Comm)=126.7-.22NOL₃ \\
300 \leq NOL₃ & \leq 415 : T(Comm)=204.7-.48NOL₃ \\
415 \leq NOL₃ & \leq 440 : T(Comm)=96.8-.22NOL₃ \\
440 \leq NOL₃ & : T(Comm)=0
\end{align*}
\]

The derivation for the set of equations reflecting the tax liability
as the lower of the regular tax or the alternative tax as reflected by
the taxpayers’ interpretation of section 172(b)(2) are analogous to those
developed for the Commissioner’s interpretation of section 172(b)(2).

Since in the first two NOL₃ ranges, TA(T/P)=TA(Comm), it follows
that T(T/P)=T(Comm). In the next range, 100≤NOL₃≤162, TA(T/P)
<Tₚ. Even though in the 162≤NOL₃≤215 range, TA(T/P)<Tₚ by
29.5, once the NOL₃ exceeds 162, the section 11 tax is less than the
section 1201 tax in year one, and thus TR=T. The final set of equations is
summarized as follows:

\[
\begin{align*}
0 \leq NOL₃ & \leq 75 : T(T/P)=162.2-.48NOL₃ \\
75 \leq NOL₃ & \leq 100 : T(T/P)=142.7-.22NOL₃ \\
100 \leq NOL₃ & \leq 162 : T(T/P)=168.7-.48NOL₃ \\
162 \leq NOL₃ & \leq 275 : T(T/P)=198.2-.48NOL₃ \\
275 \leq NOL₃ & \leq 300 : T(T/P)=126.7-.22NOL₃ \\
300 \leq NOL₃ & \leq 415 : T(T/P)=204.7-.48NOL₃ \\
415 \leq NOL₃ & \leq 440 : T(T/P)=96.8-.22NOL₃ \\
440 \leq NOL₃ & : T(T/P)=0
\end{align*}
\]
The sets of equations can be graphically illustrated:
A comparison of the two tax liability functions indicates that it is only in the $100 \leq \text{NOL}_3 \leq 162$ interval (on the graph, AB vs. AC) that $T(T/P) \neq T(\text{Comm})$. The first discrimination — that of the Commissioner — is in this range. Although the taxpayer's total income decreases as $\text{NOL}_3 \leq 162$, the section 1201 tax, according to the Commissioner's interpretation, which is less than the section 11 tax, does not decrease. This phenomenon reflects the "waste" of the $\text{NOL}_3$ carryback. (The tax is the sum of $.3CG_1$ and the section 11 tax on the 140 OTI$_2$.)

Once $\text{NOL}_3$ exceeds 162, it reduces total income in year one to a level such that the section 11 tax on it is less than $.3CG_1$. As the $\text{NOL}_3$ increases, it absorbs total income until it reaches 440, at which point another type of waste described in the text accompanying notes 141 to 142 supra, occurs, viz. the lack of TI to which the $\text{NOL}_3$ can be carried. Points F and G on the graph illustrate a comparison of the treatment of a taxpayer with $\text{NOL}_3=150$ under both interpretations and the disparity of the results.

The second discrimination — that of the taxpayers — occurs in the $162 \leq \text{NOL}_3 \leq 215$ interval (on the graph BD and AC). This phenomenon is a result of the inability of the taxpayer to "purchase" a net operating loss carryover. Once $\text{NOL}_3$ exceeds 162, the section 1201 tax exceeds the section 11 tax. The taxpayer, however, would be in a better position if its tax liability was the section 1201 tax, since the excess of the $\text{NOL}_3$ over 100 is a greater benefit in year two since it can offset ordinary taxable income taxed at 48 percent; nonetheless, the taxpayer must have a section 11 tax liability since it is the lesser of the two liabilities. Until the $\text{NOL}_3$ reaches 162, it is reducing ordinary taxable income, which in turn reduces tax liability by an amount equal to $.48 \text{NOL}_3$. Once the section 11 tax is exceeded by the section 1201 tax, the $\text{NOL}_3$ is applied against the $CG_1$. At the critical point (BC on the graph), the $\text{NOL}_3$ of 162 has reduced the 100 OTI$_1$ and 62 of the 140 OTI$_2$. Suddenly — the trait which distinguishes discontinuous functions from continuous ones — it is reducing 100 OTI$_1$ and 62 $CG_1$ (which reduces tax liability by only .30 $\text{NOL}_3$). The difference is the loss of the carryover benefit ($.48 \times 62=29.76$).

This is the amount by which $T_A(T/P) < T_R$ in that interval, $[198.2-.48\text{NOL}_3]-[168.7-.48\text{NOL}_3]=29.5$, and is the benefit which is no longer available. (The .26 difference between 29.5 and 29.76 is due to rounding error, since the critical point B is not precisely at $\text{NOL}_3=162$.)

This is the reason that under the taxpayers' interpretation of section 172(b)(2), taxpayers in the $162 \leq \text{NOL}_3 \leq 215$ interval may have tax liabilities greater than those in the $100 \leq \text{NOL}_3 \leq 162$ range; for example, a taxpayer with a $\text{NOL}_3$ of 190 (point H on the graph) has a tax liability greater than that of a taxpayer with a $\text{NOL}_3$ of 140 (point J on the graph).

The proposed solution is illustrated on the graph presented above. The tax between $T=0$ and $T=KL$ represents the tax liability on the capital gain; once the loss decreases and the taxpayer has OTI, there is an additional section 11 tax thereon (LM on the graph).
Illustrations of the changes in tax revenue if no rate adjustments are enacted can also be read from the graph: taxes would increase for taxpayers with NOL\(_a\)'s in excess of 300 (point P) and decrease for taxpayers with NOL\(_a\)'s between 100 and 300 (points A, O).

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