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# Tax Utilization of Net Operating Losses

## I

### WHAT IS A NET OPERATING LOSS?

Harlan Pomeroy

#### DISTINCTION BETWEEN NET OPERATING LOSS AND NET OPERATING LOSS DEDUCTION

The starting point in any problem involving a net operating loss deduction, either for a loss corporation or for a corporation which wishes to acquire a loss corporation, is the *net operating loss*. A net operating loss should be distinguished from a net operating loss *deduction*. A net operating *loss* relates to the year of the loss. A net operating loss *deduction* relates to a prior or subsequent, presumably profitable, year to which a net operating loss is carried. The computation and determination of a net operating *loss* itself is but one of the steps in the determination of a net operating loss *deduction*. Thus, three steps are taken in determining a net operating loss deduction:<sup>1</sup> (1) determining the net operating *loss* for the appropriate year preceding or following the particular tax year; (2) determining the net operating loss *carryovers* and *carrybacks* to that particular tax year; and (3) determining the amount of the net operating loss *deduction* for that particular year by adding such *carryovers* and *carrybacks*.

#### *Statutory Definition of Net Operating Loss*

A net operating loss itself is defined by statute.<sup>2</sup> Generally speaking, it is the excess of deductions over gross income. However, the Internal Revenue Code of 1954 also requires that certain *modifications* be made in determining the excess of deductions over income, *i.e.*, the amount of the loss.<sup>3</sup> The general effect of these modifications is to limit a net operating loss to losses incurred in a trade or business, to casualty and theft losses, and to losses from the sale of property used in a trade or business. The number and type of modifications which are made in determining a net operating loss depend upon whether a corporate or a non-corporate taxpayer is involved. However, for both corporate and non-

1. Treas. Reg. § 1.172-1(b) (1956) [hereinafter cited as Reg. §]. Section 172(a) of the Internal Revenue Code of 1954 defines "net operating loss deduction;" § 172(c) defines "net operating loss."

2. INT. REV. CODE OF 1954, § 172(c) [hereinafter cited as CODE §].

3. CODE § 172(d).

corporate taxpayers a net operating loss deduction, that is, the carryover or the carryback to the loss year, must first be eliminated.<sup>4</sup>

### *Additional Modifications for Non-Corporate Taxpayers*

The following additional modifications<sup>5</sup> are made for non-corporate taxpayers:

(1) The deduction for losses on sales or exchanges of capital assets cannot exceed the gain from such sales or exchanges.

(2) No deduction is allowed for fifty per cent of the excess of net long-term capital gain over short-term capital losses as provided in section 1202 of the Internal Revenue Code.

(3) No deduction is allowed for personal exemptions allowable under section 151.

(4) And deductions not attributable to a taxpayer's trade or business cannot exceed the amount of gross income not derived from such trade or business.

This last or fourth modification means that to the extent that a loss is not attributable to a taxpayer's trade or business, it cannot figure into the net operating loss. There are, however, two statutory exceptions to the foregoing rule in regard to deductions not attributable to a trade or business. First, gain or loss from a sale or other disposition of depreciable or real property used in a trade or business is to be attributed to the trade or business.<sup>6</sup> Second, casualty and theft loss deductions are not subject to this limitation on non-business deductions.<sup>7</sup> This means that casualty and theft losses are fully deductible whether or not they are attributable to a taxpayer's trade or business.

### *Additional Modifications for Corporate Taxpayers*

The additional modifications<sup>8</sup> for corporate taxpayer's are: there is no deduction for partially tax-exempt interest;<sup>9</sup> the special deduction for Western Hemisphere Trade Corporations<sup>10</sup> is not available; the limitation under section 246(b) on the aggregate amount of deductions for dividends received<sup>11</sup> and the limitation on the amount of the deduction

4. CODE § 172(d) (1).

5. CODE § 172(d) (2), (3), (4).

6. CODE § 172(d) (4) (A) (i), (ii).

7. CODE § 172 (d) (4) (C).

8. CODE § 172(d) (5), (6).

9. CODE § 242.

10. CODE § 922.

11. CODE §§ 243-45.

for dividends paid by public utilities on certain preferred stock<sup>12</sup> are not applicable.

### *Limitations on Capital Losses*

Due to the statutory limitation on losses from a sale or exchange of capital assets to an amount not in excess of the gain from the sale or exchange of capital assets and the limitation on deductions not attributable to a trade or business to the amount of income not attributable to the trade or business, it is necessary, in the case of non-corporate taxpayers, to allocate a *capital* loss carryover, if one is available, between that portion of the carryover attributable to business and that portion not attributable to business. This is spelled out in the Regulations<sup>13</sup> which in effect allocate a portion of the net capital loss to business losses by applying to the net capital loss the ratio of the portion of the capital loss, which is a business capital loss, to the total of business and non-business capital losses for the year of the capital loss.

### INCOME AND DEDUCTIONS ATTRIBUTABLE TO A TRADE OR BUSINESS

Most of the problems in the actual determination of a net operating loss arise in determining whether a particular item of income or a particular deduction is or is not *attributable* to a taxpayer's trade or business. Again it must be remembered that this particular modification is one that is required only of non-corporate taxpayers. The Regulations specify that non-business deductions and non-business income are those items "not attributable to, or derived from," a taxpayer's trade or business.<sup>14</sup> While this definition in the Regulations hardly lends clarity or brings insight to the problem, there is a substantial amount of case law for guidance.

At the outset it should be noted that the 1954 Code represents a major and significant change in connection with the modification limiting non-business deductions to non-business income. Under the 1939 Code for a deduction to be a business deduction and hence to figure in the determination of a net operating loss, it was necessary for the particular deduction to be attributable to the "*operation of a trade or business regularly carried on* by the taxpayer."<sup>15</sup> (Emphasis added.) This has been changed in the 1954 Code by the elimination of the requirement that the deduction be attributable to the "*operation*" of a business. Now

12. CODE § 247.

13. Reg. § 1.172-3(b) (1956).

14. Reg. § 1.172-3(a)(3)(i) (1956).

15. Int. Rev. Code of 1939, ch. 1, § 122(d)(5), as amended, ch. 521, § 344(a), 65 Stat. 517 (1951). The 1954 Code also no longer requires that the business be "regularly carried on."

it is merely necessary that the loss or deduction be "attributable" to a business. The result is that it is no longer required that a business be in active operation when the loss is sustained or the deductible expense is incurred for a loss to qualify as a net operating loss. Thus, it has been ruled that a loss incurred on the sale of accounts receivable upon the sale of an entire business is a business loss even though such a loss would not be considered to be attributable to the *operation* of the business.<sup>16</sup>

### *Determining What Is a Trade or Business*

Determining whether a taxpayer is engaged in a trade or business or whether a particular activity constitutes a trade or business is a fairly common problem under the tax laws. Thus, for example, it has been necessary to determine whether a taxpayer is engaged in a particular trade or business for purposes of determining whether gain or loss from the sale of property constitutes capital gain or loss or ordinary gain or loss,<sup>17</sup> or for determining whether the distribution of stock of a controlled corporation is tax free.<sup>18</sup> Likewise it has been necessary to make a similar determination in connection with the deduction of business expenses under section 162 of the Internal Revenue Code. Under section 166 certain limitations are imposed upon the deduction of non-business bad debts. Under section 167 depreciation is deducted on property used in a trade or business. And under section 174 certain research and experimental expenses are deductible and need not be capitalized provided they are paid or incurred by the taxpayer in connection with his trade or business. There are numerous other examples in the Code where the tax treatment of an item may require a determination of whether a taxpayer is engaged in a particular trade or business. It would seem that generally the principles applicable in determining whether a taxpayer is engaged in a certain trade or business elsewhere in the Internal Revenue Code may properly be used for purposes of determining whether a particular loss or deduction is attributable to a taxpayer's trade or business under section 172 of the Code.<sup>19</sup>

### *Salaried Taxpayers*

Generally, salary and wages are considered to be business income.<sup>20</sup>

16. Rev. Rul. 57-563, 1957-2 CUM. BULL. 175. The accounts must have arisen under the accrual method of accounting and in the ordinary course of the taxpayer's business. See § 1221. See also at 239-40 *infra*.

17. CODE §§ 1221, 1231. See also § 1237.

18. CODE § 355.

19. See, *e.g.*, *Penton v. United States*, 259 F.2d 536 (6th Cir. 1958).

20. *E.g.*, Reg. § 1.172-3(a)(3)(i) (1956); *Batzell v. Commissioner*, 266 F.2d 371 (4th Cir. 1959); *Folker v. Johnson*, 230 F.2d 906 (2d Cir. 1956); *Godfrey M. Weinstein*, 29 T.C. 142, 146 (1957).

Accordingly, a loss resulting from the repayment of earlier over-compensation is considered to be a business loss.<sup>21</sup>

### *Promoters*

Persons who are engaged in promoting various business enterprises, either by investing in the stock of such enterprises or by lending money to such enterprises, may be considered to be in the business of promoting enterprises. A loss from the worthlessness of their stock investment or a loss sustained when their debt against the corporation becomes worthless may be considered to be a business loss for purposes of the net operating loss.<sup>22</sup> However, it would seem that a taxpayer must be able to prove substantial and numerous investments of a promotional nature in a variety of enterprises before he will be permitted to treat such losses as business losses. Moreover, a taxpayer's personal contribution of time and effort to the operation of the enterprises tends to show that the taxpayer is in the business of promoting.<sup>23</sup> The general rule, however, is that a loss on the sale of stock or from stock becoming worthless is a capital loss and not a business loss.<sup>24</sup> This, of course, would not be so in the case of a person active as a dealer in buying and selling securities.<sup>25</sup> Moreover, if an investment in stock can be shown to bear some relationship to the taxpayer's regular business so that it benefits such business, it is possible that a loss on from the sale or worthlessness of the stock would be considered a business loss.<sup>26</sup>

### *Partners*

Generally, the sale of a partnership interest is considered to give rise to a non-business loss or non-business income.<sup>27</sup> However, a loan to a partnership may constitute a business loan.<sup>28</sup>

### *Investment in Real Estate*

In connection with taxpayers who invest in real estate, two main questions may arise. The first relates to whether the taxpayer is dealing in real estate, that is, whether he is in the business of buying and selling real estate. The second question relates to whether the holding of rental

21. *Goldsworthy v. Commissioner*, 262 F.2d 435 (9th Cir. 1958).

22. *Henry E. Sage*, 15 T.C. 299 (1950), *acq.*, 1951-1 CUM. BULL. 3. Compare *Dalton v. Bowers*, 287 U.S. 404 (1932).

23. *Henry E. Sage*, 15 T.C. 299 (1950), *acq.*, 1951-1 CUM. BULL. 3.

24. *Dalton v. Bowers*, 287 U.S. 404 (1932). For an exception in the case of stock in small business concerns, see Reg. § 1.1244(d)-4 (1960).

25. *Oscar E. Rehm*, 21 B.T.A. 243 (1930), *acq.*, X-1 CUM. BULL. 54.

26. *Charles H. Van Etten*, 8 B.T.A. 611 (1927), *acq.*, VII-1 CUM. BULL. 32.

27. I.T. 2185, IV-2 CUM. BULL. 119 (1925); *Joseph L. Merrill*, 9 T.C. 291 (1947), *aff'd on other grounds*, 173 F.2d 310 (2d Cir. 1949).

28. *Harding v. United States*, 125 Ct. Cl. 585, 113 F. Supp. 461 (1953).

property constitutes a business. In determining whether a person is a dealer in real estate, it should be noted that there are literally hundreds of cases passing on this essentially factual issue.<sup>29</sup> Suffice it to say here that such tests as the frequency and the continuity of sales and sales related activities, the time and effort devoted by the taxpayer to acquiring, improving, and promoting the sale of property, and the like, are important factors in determining whether a taxpayer is in fact in the trade or business of buying and selling real estate.

The Tax Court takes the view that the holding of a single piece of rental property constitutes the business of renting property.<sup>30</sup> And this rule has been extended to situations where a taxpayer passively holds the property as well as where a taxpayer has an agent operate the rental property for him.<sup>31</sup> As a result, income and deductions or losses from the rental of the property itself are treated as business income and deductions. Of course, under the broadened concept of the 1954 Code, to the effect that gain or loss from a sale or other disposition of property used in a trade or business is considered to be attributed to the trade or business, any gain or loss from the *sale* of a single piece of rental property will be considered to be business income or loss.<sup>32</sup>

### *Separate Businesses*

A taxpayer engaged in more than one business cannot separate the businesses for net operating loss purposes, treat income from one business as separate from a loss in the same year from another business, and then carryback the loss from one business without first reducing that loss by the income derived in the same year from the other business.<sup>33</sup>

### *Income and Deductions "Attributable" to a Trade or Business*

There are numerous cases in which it was decided when an item of income or a deduction is "attributable" to a trade or business. For example, war losses,<sup>34</sup> losses from the abandonment of property,<sup>35</sup> legal fees,<sup>36</sup>

29. See Pomeroy, *Tax Clinic on Capital Gains — Capital Gain Problems in Particular Areas — Dispositions of Real Estate*, 12 W. RES. L. REV. 364 (1961).

30. Mae E. Townend, 27 T.C. 99 (1956); Adolph Schwarcz, 24 T.C. 733, 739, (1955), *acq.*, 1956-1 CUM. BULL. 5; Anders I. Lagreide, 23 T.C. 508 (1954). Accord, *Lorenzo Alvory v. United States*, 302 F.2d 790 (2d Cir. 1962).

31. Adolph Schwarcz, 24 T.C. 733, 739 (1955), *acq.*, 1956-1 CUM. BULL. 5.

32. See Rev. Rul. 57-563, 1957-2 CUM. BULL. 175.

33. *Pierce v. United States*, 254 F.2d 885 (9th Cir. 1958).

34. Adolph Schwarcz, 24 T.C. 733 (1955), *acq.*, 1956-1 CUM. BULL. 5.

35. *Moberly Fuel & Transfer Co.*, 17 B.T.A. 1242 (1929), *acq.*, X-1 CUM. BULL. 44. Compare *I. T. 2017*, III-1 CUM. BULL. 69 (1924), where a loss from the sale of property acquired for but never actually used in the business was ruled not to have resulted from the operation of a business.

36. *Willard F. Meyers Mach. Co.*, 18 B.T.A. 1069 (1930), *acq.*, IX-2 CUM. BULL. 40.

amortization and depreciation,<sup>37</sup> misappropriations of corporate funds,<sup>38</sup> and the default of a subcontractor<sup>39</sup> have all been held to be attributable to a trade or business.

### *Taxes*

Some problem seems to arise in connection with state and federal taxes, interest on such taxes, and related legal and accounting expenses. The Commissioner has ruled that state taxes on business property and state taxes on gross income which is directly attributable to a taxpayer's business are considered to be attributable to a trade or business.<sup>40</sup> However, he continues to insist that state and federal income taxes on *net* business income are not attributable to a trade or business and hence such taxes, related legal and accounting expenses, and interest on such taxes would not qualify as business deductions for purposes of the net operating loss.<sup>41</sup> The decisions do not support the Commissioner, for they in effect hold that such income taxes, interest, and related expenses, to the extent that they are attributable to a business and are otherwise deductible items, constitute business expenses.<sup>42</sup>

### *Income and Losses During and Following the Suspension or Termination of a Business*

Under the 1939 Code it had been held that losses sustained or income received by a non-corporate taxpayer in a year when business was not being carried on might give rise to a net operating loss or to business income.<sup>43</sup> Generally, however, such losses and expenses incurred in the termination of a business were held not to qualify as net operating losses.<sup>44</sup> The change in the 1954 Code, permitting deductions to figure

37. I.T. 1986, III-1 CUM. BULL. 67 (1924); Seymour Mfg. Co., 19 B.T.A. 1280 (1930), *aff'd in part, rev'd in part and remanded on other grounds*, 56 F.2d 494 (D.C. Cir. 1932).

38. Gottlieb Realty Co., 28 B.T.A. 418 (1933), *acq.*, XII-2 CUM. BULL. 6.

39. John Thatcher & Son, 30 B.T.A. 510 (1934), *rev'd on other grounds*, 76 F.2d 900 (2d Cir. 1935).

40. Rev. Rul. 58-142, 1958-1 CUM. BULL. 147; I.T. 3951, 1949-1 CUM. BULL. 84.

41. See note 40 *supra*.

42. Elmer Reise, 35 T.C. 571 (1961), *aff'd*, 299 F.2d 380 (7th Cir. 1962); Clarence Wood, 37 T.C. 70 (1961); Greenleaf Textile Corp., 26 B.T.A. 737 (1932), *aff'd per curiam*, 65 F.2d 1017 (2d Cir. 1933). See Frank Polk v. Commissioner, 31 T.C. 412 (1958), *aff'd*, 276 F.2d 601 (10th Cir. 1960); James J. Standing v. Commissioner, 28 T.C. 789 (1957), *non-acq.*, 1958-2 CUM. BULL. 9, *aff'd*, 259 F.2d 450 (4th Cir. 1958).

43. Joe K. Swisher, 33 T.C. 506 (1959). See also Penton v. United States 259 F.2d 536 (6th Cir. 1958), in which the court permitted a net operating loss to be recognized in a year when the taxpayer could not operate for lack of a liquor license, where he had operated in earlier years, and during the particular loss-year maintained his inventories, carried insurance, paid rent and utility charges, and retained a bookkeeper and guard. Compare Aloph Schwarcz, 24 T.C. 733 (1955), *acq.*, 1956-1 CUM. BULL. 5.

44. Puente v. Commissioner, 199 F.2d 940 (9th Cir. 1952).



into a net operating loss even though such deductions are not attributable to the *operation* of a business, has considerably liberalized the net operating loss requirements in connection with the termination of a business by a non-corporate taxpayer. This more liberal treatment under section 172(d)(4) of the 1954 Code for purposes of determining the amount of a net operating loss itself should be compared with the Commissioner's restrictive interpretation under section 382(a), where any substantial suspension of business activities, other than from causes such as fire and the like, are construed to mean that there has been a substantial change in a taxpayer's trade or business which may result in denial of a loss carryover.<sup>45</sup>

The Internal Revenue Code of 1954, in liberalizing the net operating loss provisions, specifies that gains and losses on a sale of depreciable or real property used in a trade or business are to be treated as being attributable to the taxpayer's trade or business.<sup>46</sup> But the Commissioner has ruled that losses on a sale of other business assets may qualify as business losses.<sup>47</sup> Now losses and expenses incurred or sustained in a sale of an entire business or assets generally qualify as deductions or losses attributable to a taxpayer's trade or business.<sup>48</sup>

In the case of corporate taxpayers, the Commissioner has been unsuccessful in urging that there could be no net operating loss in the year in which a corporate taxpayer was liquidated where the liquidation occurred during the year at the end of the loss period in a cyclical business just before the business was expected to become profitable.<sup>49</sup> Generally, losses and expenses incurred by corporate taxpayers upon the sale of their assets and business have been recognized in determining the net operating loss.<sup>50</sup> However, the Commissioner has been sustained in his position that no net operating loss can be recognized after there has been a de facto corporate dissolution.<sup>51</sup>

#### PERSONS AND ENTITIES WHICH CAN USE A NET OPERATING LOSS

A net operating loss can be used by most taxpayers including members of partnerships,<sup>52</sup> estates and trusts,<sup>53</sup> and participants in common

45. See at 259 *infra*.

46. CODE § 172(d)(4)(A).

47. Rev. Rul. 57-563, 1957-2 CUM. BULL. 175.

48. See Claude J. Morris, 20 CCH Tax Ct. Mem. 341 (1961).

49. *Diamond A. Cattle Co. v. Commissioner*, 233 F.2d 739 (10th Cir. 1956), *modifying and remanding*, 21 T.C. 1 (1953).

50. *Gorman Lumber Sales Co.* 12 T.C. 1184 (1949), *acq.*, 1949-2 CUM. BULL. 2.

51. Rev. Rul. 61-191, 1961-2 CUM. BULL. 251; *Wheeler Insulated Wire Co.*, 22 T.C. 380 (1954).

52. Reg. § 1.702-2 (1956).

53. CODE § 642(d).