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Loss Carryovers Under the Internal Revenue Law

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LOSS CARRYOVERS UNDER THE INTERNAL REVENUE LAW

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I. NET OPERATING LOSS CARRYOVERS

The net operating loss carryover can be of vast importance in current business operations. A company may have a carryback giving it a refund of prior years' taxes if it has a loss this year. Or a profit this year may be eliminated by losses sustained in prior or future years. The opportunity for the carryback or the carryforward may stimulate or deter a great many possible business ventures. Here, for example, is a list of studies that may well be undertaken by a taxwise management:—

Business ventures which may result in possible losses may now be undertaken, if sound policies dictate, with the certainty of quick refunds of taxes previously paid. These taxes can often be recovered with sufficient speed to aid in the financing of the business loss.

Acquisitions of profitable business departments can be had by a company losing money or having a carryover with the certainty that part of the investment will be returned through reduced taxes on the operations. (But there may be a possible limitation in these rules when there is a deliberate acquisition of a credit, deduction or allowance.)

A profitable company may acquire a losing company if sound business dictates, with a reasonable assurance that net losses created for the business will be paid for in part by refund of prior years' taxes.

Study of the possibility of taking losses this year rather than in later years becomes very important. A loss gives a company the advantage of the carryback. It should review possible abandonments, inventory eliminations, depreciations, claims for obsolescence, and loss of useful values. Possibly it should sell discarded equipment. It should not hold equipment or worthless assets when it can have a carryback.

Conversion of business operations may be undertaken with more assurance when a company has a carryback. Business can now profitably study possible development, advertising costs, new market research, and new product costs which may be undertaken to build up future earnings.

Examination of the possible disbursements includes a far greater list than those concerned with the expansion of the business. We might also have costs for a great many items that might not have been undertaken without the carryover. For example—

Abnormal repairs and maintenance previously deferred.

Quick settlement of expenses that will give a deduction this year rather than in a later year. There may be possible deductions in settlements of obligations, leases, contract costs, etc.

Here then is a very powerful instrument—one that may well control a vast proportion of the steps made by business. What is it? How does it work? This article is, in the main, an exposition of the technical steps in computing carryovers.

History of the Carryover Section

Commencing with the 1918 Act, and except for the period between the 1933 Act and the 1939 Act, there have been provisions in our internal revenue laws for the carryback and carryforward of net operating losses. The 1918 Act permitted the loss to be carried to the preceding year and to the succeeding year.[1] The Acts of 1921,[2] 1924,[3] 1926,[4] and 1928[5] allowed the loss to be carried forward to the succeeding and next succeeding years. The 1932 Act limited the carryforward only to the succeeding year.[6]

The 1933 Act eliminated entirely all provisions for the carryback or carryforward of losses. Particularly it repealed the net loss carryforward section of the Revenue Act of 1932 as of January 1, 1933.[7] This provision was held constitutional even though a loss was sustained in 1932 and the 1932 Act would have permitted such loss to be carried forward to 1933.[8]

This omission of any provision for the carryover of net operating losses continued for a period of seven years. Under the 1939 Act, losses were permitted to be carried forward to the two succeeding years.[9] The application of this loss was limited to tax years beginning after December 31, 1939.

This carryforward provision was amended by the 1942 Act to the extent that the loss could also be carried back to the two preceding years.[10] But it was expressly provided that no loss could be carried back to any tax year beginning before January 1, 1941. To date, the rule of a two-year carryback and a two-year carryforward has not been altered.[11]

Although the basic concept of the net operating loss carryover was the same in each of the above described Acts, the earlier laws varied in their scope

[1]Revenue Act of 1918, § 204.
[2]Revenue Act of 1921, § 204.
[3]Revenue Act of 1924, § 206.
[4]Revenue Act of 1926, § 206.
[5]Revenue Act of 1928, § 117.
[6]Revenue Act of 1932, § 117.
[7]Revenue Act of 1933, § 218(a).
[8]Miller v. Comm'r, 115 F. 2d 479 (C. C. A. 9th 1940), *cert. denied,* 312 U. S. 703, 61 Sup. Ct. 808 (1941). The net loss sustained in 1932 was not allowed as a deduction in 1933.
[9]Revenue Act of 1939, § 211.
[10]Revenue Act of 1942, § 153.
[11]INT. REV. CODE §§ 23(s) and 122 (1945).

and application, and their provision for special limitations and exceptions. The following study will concern itself with the status of the present law. Reference will be made to the prior laws and to cases and rulings interpreting such laws only where they may be pertinent or may be cited as authority in the construction of the present law.

What Net Operating Losses Can Be Deducted?

Net operating losses of prior and later years are deductible in computing the normal and surtaxes of all types of businesses. They are deducted in this way:

General rule—for all individuals, partners, and corporations	Apply loss of current year in strict chronological order: first to second year preceding, then to the first year preceding, then to first succeeding year, and then to second succeeding year. See chart below.
Short years	Each period (even if the year consists of only one month) is treated as a full year in applying the loss. It is conceivable that a loss in one month could be absorbed by profits in two prior and two later months—provided each was a tax year under the law.
Short years annualized	In applying the carryover the loss is not annualized. In determining income of a short period for annualizing the actual loss of the period, it is first applied to its actual income.
Consolidated losses of corporations before 1942	Deducted in consolidated group or only by common parent company; not by subsidiary leaving group even if it created the loss. Separate carryforward loss before consolidation suffered by a member of a consolidated group is taken only by the member which experienced it. Subsequent losses after the severance of consolidation (before 1942) are deducted only by parent, by carryback.
Consolidated losses of corporations after 1941	Consolidated losses reduce prior or subsequent consolidated income. A loss sustained by a company before joining a consolidation should be applied to the income of that company. All losses before and after consolidation may be used in the consolidated return to the extent of the income of the company creating them.

How Net Operating Losses Are Carried Over

Here is the order of carryover of losses—

Losses of This Year	Reduce the Profits of These Years in This Exact Order: First	Second	Third	Fourth
1942*	1941	1943	1944	
1943	1941	1942	1944	1945
1944	1942	1943	1945	1946
1945	1943	1944	1946	1947
1946	1944	1945	1947	1948
1947	1945	1946	1948	1949

*You may not go back past 1941.

An example of the whole cycle may be secured from the following:

Example: Assume you had net income and net losses as follows:

Year	Net Profit	Net Loss	You Apply the Losses to Reduce Profits of 1942	1944	1945	1948	1949
1941		$10	$10				
1942	$20						
1943		30	10	$20			
1944	90						
1945	60						
1946		90		70	$20		
1947		80			40	$20	$5
1948	20						
1949	5						

Note that the net operating loss deduction for any year is the sum of the carrybacks and carryovers to that year. Thus—

> Example: You had a net operating loss of $6,000 in 1944, a net income of $8,000 in 1945 and a net operating loss of $4,000 in 1946. When your return for the year 1945 was filed the $6,000 net loss carryover from 1944 was included, resulting in a net tax income for 1945 of $2,000. You may now carryback the net loss for the year 1946 and apply it against the $2,000 remaining net income for 1945. That would leave $2,000 to be carried over to 1947.

Sometimes net operating losses have an indirect effect that goes beyond two years. For example:

1944 loss is	$12,000
1945 loss is	6,000
1946 profit is	12,000

The 1944 loss eliminates the 1946 profit and we may apply the full 1945 loss—$6,000 to reduce 1947 profits. Had there not been this loss in 1944, we should have had to reduce 1946 profits by the 1945 loss and there would not be a carryover to 1947.

Pointers When Net Operating Losses Are Available

The taking of long term capital gains in 1947 can be very costly if an individual has 1945 or 1946 net operating losses. A long term capital gain is included in gross income at only half the amount of the profit.[12] However, any net operating loss brought into 1947 must be reduced by the half of the long term capital gain not included in gross income.[13]

Before businesses deduct interest, taxes or carrying charges on real or personal property (regardless of what they do on their books), they ought to see if it would be better to capitalize them.[14] Losses may do no good if you may have prior year carryover losses adequate to wipe out current profit. If so, you can increase the cost basis of your asset by capitalizing.

Each short year is a tax year. That puts a penalty on the application of the carryover or carryback. An extreme situation may be assumed in which a company had two short periods of one month each in 1945, a full year in 1946 (during which the carryover or carryback was established), and then two short periods of one month each in 1947. It would use up its full carryover loss in the four months rather than in four years. You should study the effect of this rule when you expect to liquidate, change accounting periods, or take any other step that would create a short year.

The carryback system may suggest the best time to change a business form. It may be wise to change on the date during the year when you have sustained a loss. For example, if you are going to change a partnership to a corporation, and you have losses for the first six months of a year, but expect profits for the second six months, you might make the change on June 30. That gets you a refund of tax paid by the individual partners.

Or it may pay to make the switch during the year if you do not have a loss. The income may be small, resulting in a small tax for the individual partners. The change may also reduce the corporate income for its first fiscal year. Remember that tax brackets for corporations are also graduated.

The carryover of taxes means you must be careful to compute the greatest possible loss in years when you suffer deficits. Take every election and every alternative to get the greatest loss. Failure to do it may hurt in a later year. For example, one 1946 case concerned a company permitted to compute depletion on either the cost or the percentage basis. It used the percentage method which gave it no deduction, since it had no income.

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[12]INT. REV. CODE § 117(b) (1945).
[13]INT. REV. CODE § 122(d) (4) (1945).
[14]INT. REV. CODE § 24(a) (7) (Supp. 1946). U. S. Treas. Reg. § 29.24-5.

It sought to change later to the cost basis, but could not, even though that might give it a refund of taxes in a later year when it had a profit.[15]

One effect of the carryover may be to postpone loss taking. Assume that in 1947 you have a loss of $100 and that the loss will secure you a large return of 1945 and 1946 taxes. Assume, too, that you can sell securities this year at a profit of $100. If you do, you will not get back your 1945 and 1946 taxes. If you wait, perhaps you may have both the proceeds of the sale and your recovery of taxes—

> If you cannot postpone the sale, then see if you can effect an installment sale. That puts only part of the profit in this year; or

> See if you can make a contract to sell in a way not to pass title this year. That may put the profit over until next year.

What amount of refund can you get? Here is a table showing the refund of 1945 taxes available to a corporation with a 1947 loss of $10,000—

If Normal Tax Income in 1945 Was	Corporation Gets a Refund of	Corporation's Actual Loss is Therefore
$ 5,000	$1,050	$8,950
10,000	2,200	7,800
15,000	2,300	7,700
20,000	2,300	7,700
25,000	2,400	7,600
50,000	5,300	4,700
100,000	3,800	6,200

Losses Which an Individual May Carry Over

If an individual is engaged in his own trade, business or profession, he is allowed to reduce profits by carrying over losses sustained in his business in certain other years.

It is important to know what losses individuals may carry forward and backward.

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[15] Virgilia Mining Corp., 7 T C No. 46 (1946).

These May	These May Not*
Losses in your own business or profession applied to reduce income of other years in your own business or profession.[16]	Losses due to worthlessness of stock of a corporation in which you are the principal or sole stockholder; and the stock is held merely as an investment.[20]
Losses of your partnership carrying on a trade or business applied to reduce partnership profits or individual profits from another trade or business.[17]	Losses due to worthlessness of debts due you by a corporation in which you are a stockholder.[21]
Losses of a practicing attorney who became a partner in a business. He was forced to conduct its affairs because of financial difficulties.[18]	Losses of a decedent are not available to the estate of the decedent.[22]
Losses of a retired business man from operations of timberland acquired. He continued in activities associated with lumbering.[19]	Losses from occasional investments or isolated transactions in purchase and sale of securities by one other than a dealer.[23]

*But these may become capital loss carryovers.[24]

Computation of Net Operating Loss by Individuals

The net loss which may be carried over is not the loss shown upon the tax return of an individual.[25] He reduces the loss on his tax return this way:

1. All capital losses, long or short term, are to be deducted against all long and short term gains. That is, the long term gain or loss per-

[16] INT. REV. CODE § 122(d) (5) (1945); Miller G. Belding, 19 B. T. A. 642 (1930); Daniel Hecker, 17 B. T. A. 873 (1929).
[17] Jerome P. Burr, 11 B. T. A. 1005 (1928).
[18] Charles M. Bryan, 21 B. T. A. 364 (1930). It is well established that an individual may be engaged in two or more businesses. Snyder v. Comm'r, 295 U. S. 769, 55 Sup. Ct. 913 (1935); Marsch v. Comm'r, 110 F. 2d 423 (C. C. A. 7th 1940).
[19] III-1 CUM. BULL. 64 (1924).
[20] Van Dyke v. Helvering, 63 F. 2d 1020 (C. C. A. 9th 1933), *aff'd,* 291 U. S. 642, 54 Sup. Ct. 437 (1934), *rehearing denied,* 291 U. S. 650, 54 Sup. Ct. 526 (1934); Dalton v. Bowers, 287 U. S. 404, 53 Sup. Ct. 205 (1932); Rogers v. United States, 41 F. 2d 865 (Ct. Cl. 1930); A. J. Wallace, 23 B. T. A. 858, *aff'd,* 62 F. 2d 826 (C. C. A. 9th 1933), *cert. denied,* 289 U. S. 752, 53 Sup. Ct. 696 (1933); Charles C. Dickinson, 1945 P-H T C MEM. DEC. SERV. ¶ 45053. Even if an individual owns stocks in several corporations, it does not follow that he is in the business of buying and selling securities. Pabst v. Lucas, 36 F. 2d 614 (App. D. C. 1929), *cert. denied,* 281 U. S. 741, 50 Sup. Ct. 348 (1930).
[21] Burnet v. Clark, 287 U. S. 410, 53 Sup. Ct. 207 (1932); Strouse v. Comm'r, 59 F. 2d 600 (C. C. A. 4th 1932).
[22] Estate of R. R. Russell, 34 B. T. A. 715 (1936).
[23] Sacks v. Comm'r, 66 F. 2d 308 (C. C. A. 4th 1933). Losses may be considered if the individual devotes most of his time to speculating in stocks and makes his living from such dealings. Snyder v. Comm'r, 295 U. S. 134, 55 Sup. Ct. 739 (1935), *rehearing denied,* 295 U. S. 769, 55 Sup. Ct. 913 (1935).
[24] INT. REV. CODE § 117(e) (1945).
[25] U. S. Treas. Reg. § 29.122-3.

centage (50%) used on the return is disregarded for the purpose of determining the loss here. Then make this computation—

Nonbusiness capital losses may not exceed nonbusiness capital gains; and

Business capital losses may not exceed business capital gains; then,

Any net nonbusiness capital gain is applied against any net nonbusiness ordinary loss; and

Any balance of nonbusiness capital gain left is treated as a business capital gain.

2. Wholly exempt interest, as interest on State obligations, must be added to income. He subtracts from income the amounts paid as interest to purchase or carry these tax-exempt obligations.

3. Deductions not connected with his trade or business may only be used to reduce or eliminate income not arising from his trade or business. Any excess of nonbusiness deductions cannot be used and is wasted. But all business costs are deducted.

4. The loss of one year is not to be increased by a net operating loss carried over from another year.

5. The deduction for depletion is based on the cost of the property, not on the so-called "percentage or discovery" depletion.

6. In a joint return of a husband and wife, income and deductions of each are combined. Then the joint operating loss is figured as if one person was making the return.

7. In determining the net loss to be carried over he may find that the law in the two tax periods is different. If so, he uses the law of the year to which he is carrying the loss.[26] He does not use the law of the year in which the loss originated.

Example of finding an Individual's Net Operating Loss —

Assume net loss on line 3 of his return to be $5,000 (and then assume figures below are on the return) reduced by—

1. Capital asset transactions			
Business capital gains	$3,000		
Business capital losses	2,000		
Actual net capital gains		$1,000	
Amount taken in return at 50%		500	
Adjustment			$500
2. Wholly exempt interest income			
Amount excluded on return		$ 500	
Interest to carry this (deducted on return)		300	
Adjustment			200
3. Nonbusiness deduction			
Taxes on personal residence		$ 500	
Interest on nonbusiness loan		300	
Casualty on pleasure auto		400	
		$1,200	

[26]Comm'r v. Moore, Inc., 151 F. 2d 527 (C. C. A. 5th 1945).

Nonbusiness income	1,000		
Adjustment		200	
4. Net operating loss on return (from 1946)		500	$1,400
His net operating loss carryover for 1947 is			$3,600

If an individual has capital transactions, here are the adjustments[27] he must make to the loss shown on his return—

Step 1. Restore 50% of long term capital gains and losses which were excluded. This means reducing the loss on his return for such gains, and increasing it for losses. Note that this may change a gain on his return to an operating loss.

Step 2. Then make this classification of his transactions:
Business capital gains and losses
Nonbusiness capital gains and losses
Nonbusiness income and deductions

Step 3. Now reduce his loss as adjusted under Step 1 by eliminating any net loss in each group under Step 2, unless he has a net nonbusiness capital gain which can serve to allow a net loss from
1st—Nonbusiness income and deductions
2nd—Business capital transactions

An individual's adjustments may be found in the following table —

If, after taking in all capital transactions at 100%, he shows a gain (+) or loss (—) from

Nonbusiness Capital Transactions	Nonbusiness Income and Deductions	Business Capital Transactions	Decrease Your Adjusted Loss by
+10	+10	+10	0
—10	+10	+10	—10
+10	—10	+10	0
+10	+10	—10	0
—10	—10	+10	—20
+10	—10	—10	—10
—10	+10	—10	—20
—10	—10	—10	—30
0	+10	+10	0
0	—10	+10	—10
0	+10	—10	—10
+10	0	+10	0
—10	0	+10	—10
+10	0	—10	0
+10	+10	0	0
—10	+10	0	—10
+10	—10	0	0
0	—10	—10	—20
—10	—10	0	—20
—10	0	—10	—20

[27] INT. REV. CODE § 122(d) (4) and (5) (1945).

Limitation on Allowable Carryover for Individuals

A special provision decreases the net operating loss carryovers for individuals in unusual cases.[28] It is directed at individuals who have consistently lost over $50,000 a year for five consecutive years, beginning with 1940, in the conduct of a personal business. The maximum deductions allowed (exclusive of interest and taxes) is $50,000 plus the gross income from the business. The net operating loss from one of these five years to be carried over to another year is computed this way—

> Example: Assume that gross income in a business conducted by an individual was $10,000 in each of the years of 1942, 1943, 1944, 1945, and 1946. The business net loss was $75,000 during each of these years. There were no deductions for interest and taxes. In 1947, it earned $150,000. Ordinarily, the $150,000 might be fully eliminated by the same manner of net operating loss carryovers from 1945 and 1946. Under this special rule, the individual is only entitled to reduce the 1947 income by the excess of
>
> Deductions allowed for 1945 and 1946 ($50,000 plus $10,000 for each year)—$120,000
>
> Over the gross income for 1945 and 1946—$20,000
>
> The carryover to 1947 is therefore only $100,000.

Computation of Net Operating Loss by Corporations

The loss is not that shown on a corporation's tax return. It must recompute the loss shown on the return (and possibly interim years before and after) by the items checked in the following schedule.[29] In addition, it must alter the loss for the year to which the loss is carried by the five items in that schedule. Both of these steps are described in the following schedule:

	A Recompute the loss year this way	B Adjust the Year to which the loss is carried by these
Reduce the loss for		
1. Depletion so that the deduction is based on cost of assets, regardless of the method used	X	X
2. Any tax-exempt interest (possibly net of amortization). Note that this is to be reduced if it had incurred expenses to carry the tax-exempts	X	X
3. Any net operating loss carryover in its figures	X	X
4. Any partially tax-exempt interest subjected to the surtax		X
5. The dividends-received credit (usually 85% of the dividends)		X

[28] INT. REV. CODE § 130, added by § 129 (a) of the Revenue Act of 1943. § 129 (b) of that act made this provision applicable to tax years beginning after Dec. 31, 1939, and affecting only the tax liability for tax years beginning after Dec. 31, 1943.

[29] U. S. Treas. Reg. § 29.122-2.

If the corporation has a carryback or carryforward for but one year (say a 1947 loss used to reduce 1946 taxes), the operation is simple. It merely increases or reduces the year of loss (1947) by the Column A adjustments and reduces for the Column B adjustments found in the year to which the loss is carried (1946). The net figure is the company's net operating loss.

But if it moves backward and forward more than one year, the process can become enormously complicated. Follow these rules:

If the corporation shows a profit for 1947 and a loss in a prior or later year—

1. Start with its 1945 loss as shown on that year's tax return.
2. Make the A adjustments to it. The resulting operating loss, if any, is now ready to be carried forward into 1947 unless the company has already carried it, when preparing a previous year's return, into other profit years (1943, 1944, or 1946). However, any unabsorbed portion of this adjusted operating loss may be carried into 1947 as a deduction (after adjusting for B items in 1943, 1944, 1946 and 1947).
3. If the intervening year, 1946, having been adjusted for A items, also shows an operating loss, which had not been carried back to a previous year, the unabsorbed portion of this loss in addition may be carried into 1947. Thus, 1947 tax income may be reduced by losses carried over from 1945 and 1946.
4. If there remains income to be taxed in 1947 (after adjusting 1947 for B items) it may recover some or all of this tax in the future through a refund claim, if either of the next two succeeding years shows a loss that may be carried back into 1947.

Example A—Following is a simple computation of net operating loss. We assume the company had net operating loss of $17,000 in 1943. The figures for this company are:

	1944	1945	1946	1947
1. *Net Income* (before any net operating loss after deducting all items below item 2)	$10,000	$20,000	($36,000)	$26,000
2. *Excess Profits Tax Paid*		1,000	——	——
Assume the Following:				
3. Excessive depletion over cost basis	1,000	2,000	——	3,000
4. Capital losses deducted above	1,000	——	——	——
5. Tax exempt interest excluded above	1,000	500	2,000	1,500
6. Interest subject only to surtax excluded above	500	500	5,000	500
7. Dividend credit (85%) excluded above	500	500	5,000	500
Carryforward and Carryback loss is 1 — 2 + (3 to 5)			(34,000)	

Net Operating Loss Deduction

Sum of Carryforwards and Carrybacks			
1943	17,000		
1945	34,000		$13,500
	$51,000	$37,000	$13,500
Less: Items (3) to (7) for this year	4,000	3,500	5,500
	$47,000	$33,500	$ 8,000
Deduction Permitted	10,000	20,000	8,000
Carryforward	$37,000	$13,500	0

Note the adjustment for excess profits taxes "paid or accrued within the year."[30] This adjustment increases the net operating loss carryover. Some say that the adjustment is ordinarily available only to cash basis taxpayers, since no excess profits taxes would accrue in the year of the net operating loss except in very rare cases. But others argue strenuously that this would be an undue discrimination against accrual basis taxpayers, and that the words "paid or accrued" permit accrual basis companies to adjust for taxes accrued during the prior year but paid during the year of the operating loss.

If the corporation shows a loss for 1947 and a profit in a prior or later year—

1. Start with the company's 1947 loss. Adjust it for the A items. If it has a loss it now will try to carry that loss back to 1945.
2. Take its 1945 tax return gain or loss and make the B adjustments to it. If this computation shows a gain it may carry back the 1947 loss to the extent of that gain. However, that gain may have already been used up, in whole or in part, by a carryover loss from 1943 or 1944 or a carryback from 1946. It may carry back the 1947 loss only to the extent of the unused portion of the 1945 gain.
3. If there remains any part of the 1947 loss unabsorbed by the profits of 1945, then it may carry the unabsorbed loss back to 1946, after that year has been adjusted for B items. Here, too, it may find that 1946 gain is to be reduced for operating loss carryovers from 1945 and 1944. The 1947 loss carryback to 1946 may be applied only to the extent of the unused portion of the 1946 gain. The unabsorbed portion, if any, of the 1947 loss may be carried over into 1948 and 1949 if they turn out to be gain years.
4. If both 1945 and 1946, or either of them, show no gain after making the B adjustments, it should make the A adjustments to those years. The computations may show an operating loss to be carried forward or back.

[30] INT. REV. CODE § 122(d) (6) (1945).

Example B—Assume the following facts—here is the way to compute the carryovers:

	1943	1944	1945	1946	1947
1. Net income (as adjusted for appropriate A and B items)	$5,000	$20,000	($30,000)	$40,000	($60,000)
2. Carry back a portion of 1945 operating loss. This eliminates 1943 and 1944 gains.	(5,000)	(20,000)	25,000		
3. Carry forward to 1946 unabsorbed portion of 1945 operating loss.			5,000	(5,000)	
4. Carry back a portion of 1947 operating loss to absorb remainder of 1946 gain.				(35,000)	35,000
5. Unabsorbed operating loss that may be carried over to 1948 and 1949 if they are gain years.					$25,000

In determining the amount of the net operating loss, a recent case decided that the computation is made according to the law in effect for the year to which the loss is being carried rather than the year in which it was sustained.[31] This rule applies for individuals, as well as for corporations.

That case concerned the 1941 law. It provided that in computing the carryover, long term capital losses could be deducted only to the extent of long term capital gains. Under that rule, no part of the $15,000 loss could be deducted since there were no long term gains against which to offset it. For 1942, however, the law was amended so that all capital gains and losses were treated together, without regard to whether they were long term or short term. Under the 1942 law, therefore, $2,000 of the $15,000 capital loss was allowable as a deduction.

The court held that since the company was computing its tax for 1942, it had to apply the 1942 rules even though the loss being carried forward was sustained in 1941.

II—Special Relief Procedure on Carryback Refunds

Tax economy will require that one know how to take speedy advantage of net operating losses, which involves a knowledge of the following:

How to take quick advantage of carrybacks.
How to get an extension for payment of current taxes.

[31]See note 26 *supra.*

Cost of extension when a carryback is experienced.
Steps taken by individuals and corporations to get a quick refund.
Carryback periods if a quick refund is *not* sought.
How carryback interest is computed in ordinary cases.
Congress has helped the refund procedures in two ways:
If a corporation expects operations for the current year to result in a carryback refund, it may partially postpone payment of the preceding year's unpaid tax.[32] This extension is taken in the year in which the loss or unused credit is expected to arise, and before it is definitely known whether there will be a carryback from that year or what its amount will be.
After the close of the year in which the *corporate* or *individual business* operations gave rise to the carryback, the corporation, when it is in a position to determine the amount of the carryback refunds, may file a special claim for quick refund (called a "tentative carryback adjustment").[33] Within a 90-day period—if there are no material errors and omissions in the company's claim—the Treasury will either:
Credit the refund against the taxes it may have postponed in anticipation of the carryback (or against any other taxes that it owes); or
Make a tentative cash refund, subject to later review and correction.

These measures are available to *all* businesses that are entitled to, or anticipate, refunds as a result of carrybacks from any year *ending on or after September 30, 1945.* (The loss carryback applies to individuals, estates and trusts, as well as to corporations.) The quick refund claim complements the extension for corporations. It enables corporations to satisfy the postponed taxes without a cash outlay. If the quick refund claim is not filed, or if the anticipated refund does not materialize, the postponed taxes will have to be paid in cash with interest.

Extension for Payment of Current Taxes.

When are corporations entitled to an extension? A corporation gets an extension of time for currently due tax payments *only* when *all* of these conditions exist:

1. When it expects an unused excess profits credit or net operating loss as a result of operations for any year ending *after* August 31, 1945.

2. When the carryback of the loss or credit entitles it to a refund of taxes for any prior year (not necessarily the year for which the taxes are being deferred).

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[32]INT. REV. CODE § 3779, added by § 4(a) of the Tax Adjustment Act of 1945; see also T.D. 5498.
[33]INT. REV. CODE § 3780, added by 4 (a) of the Tax Adjustment Act of 1945.

3. When it has neither paid nor been required to pay the taxes for the year *immediately preceding* the year in which the carryback is expected to arise.

> Example: A company paid $5,000 in taxes for 1946. Its return for 1947 shows that it owes $25,000 in taxes. It pays its 1947 taxes in installments, so that it will still owe $12,500 on Sept. 1, 1948. On that date, it expects to lose money in 1948 and thus have a net operating loss carryback to 1946. That carryback, if it materializes, would entitle it to a refund of all the taxes paid for 1946. In addition, the carryback to 1945 would create a credit carryback from 1946 to 1944, resulting in an overpayment of $4,000 in 1944 taxes. Since the three conditions set out above have been met, $9,000 of the taxes still payable in 1948 for the year 1947 can be deferred. Thus only $3,500 more will have to be paid in 1948.

What taxes may corporations postpone? The only taxes that may be deferred are those *for* the year *immediately preceding* the year of the expected loss or credit. Also, they must be shown on the return or else assessed in the carryback year.

The extension applies not only to the income tax, but also to the unjust enrichment tax, the surtax on improper accumulations, and the tax on personal holding companies. The tax deferred is *not* necessarily limited to the tax that is reduced by the carryback. Thus, a refund in the income tax may be applied against *any* tax. Corporations can allocate it—

> Pro rata against all unpaid taxes; *or*
> Entirely against any one of the unpaid taxes; *or*
> In any other way they see fit.

What amount may a corporation defer? The amount of tax deferable is *the aggregate NET* reduction *in ALL prior years' taxes due to the anticipated carrybacks.* This must be reduced, however, by:

> Any postwar credits due to reductions in prior excess profits taxes; and
> Any taxes that are delinquent at the time an extension is claimed.

Pointers: Current disputes with the Treasury should be disregarded. Corporations should take into account only the taxes shown on their returns plus deficiencies actually assessed prior to the extension.

In determining the amount of the reduction due to the anticipated carrybacks, corporations should:

- Aggregate the reduction for all prior years. They may thereby be able to go back as many as four years.

Take only the net reduction—e.g., an overpayment of the excess profits tax must be offset by any resulting underpayment of the income tax.

Not disturb any item or figure in their return for any prior year, even though the Treasury is disputing it, unless a deficiency has actually been assessed. Adjustment of prior returns in determining the reduced amount of tax for the year should be made for—

Deductions that are limited by net or gross income (e.g. charitable contributions), and

The effect of the carryback on net operating loss deductions.

If only a part of the tax for any year is postponed, when must the remainder be paid? The remaining balance should be treated as though that balance had been the entire tax for the preceding year, and the corporation had elected to pay it in four equal installments.

Example: A corporation's 1947 return shows a tax for $1,000. It will pay one installment of $250 on March 15, 1948. On June 1, 1948, it will extend the time for payment of $600 of 1947 taxes, leaving $400 as the total amount to be paid during 1948. This $400 will be treated as though it were the entire tax due for 1947, payable in four $100 installments on the regular installment dates. Since it will have already paid $250 on March 15, 1948, it will have nothing to pay on June 15, only $50 to pay on Sept. 15th, and will pay the remaining $100 on Dec. 15th.

When does an extension expire? If a special claim for quick refund has been filed, the extension terminates on Treasury notification that the claim has been allowed or rejected. If the claim is allowed, the refund will be credited against the postponed taxes. Otherwise, it is payable immediately with interest. If no "quick refund" claim has been filed before the end of the month in which the return for the year of the anticipated carryback is due, the extension terminates on that date.

The extension may also be terminated before either of the dates mentioned:

If a revised statement of anticipated carrybacks is filed, and it shows that the refund will be less than the amount shown originally in prior statements (but in such a situation a corporation gets a new extension based on the reduced amount of carryback refunds); or

If, upon examination of the statement, the Treasury believes that it is unreasonable or erroneous in any material respect; or

If the Treasury believes that collection of the tax will be jeopardized by the extension.

When the extension is terminated because the Treasury believes collection of the tax to be in jeopardy, the entire amount of the postponed tax becomes payable upon notice and demand. If it is terminated for any other reason, the postponed taxes are payable on the dates they would have become due had they not been postponed, and had the corporation elected to pay them in four equal installments.

What steps are taken to get an extension? It will be granted *automatically* if Form 1138 is filed within the year in which the carryback is expected. No action on the part of the Treasury is required.

Form 1138 is used to get an extension of time for payment of current taxes when current operations are expected to result in carryback refunds. This form consists of a single sheet to which must be attached a detailed statement explaining why a carryback is expected. It must be signed, sworn to, and subscribed with the corporate seal.

The original statement may be revised as often as desired. Thus, erroneous prior estimates may be corrected. The revised statement is not an amendment of any prior statement; each new statement supersedes all previous ones, but the extension taken under a previous statement may be continued under the new statement.

Interests and Penalties on Extensions.

The extension to corporations, which permits them to retain amounts that would otherwise be paid in taxes, is essentially a loan from the Government. Accordingly, the law requires them to pay interest for the period of the extension.[34] Although the interest rate varies, the interest always begins to run from the date on which deferred taxes would have been payable if there had been no extension, and the corporation had elected to pay the tax in four equal installments. In addition, the law imposes a 5% penalty to guard against wilful or careless abuse of the extension privileges.[35] The aim of the law is to reward those making the most accurate guesses of the amount of the anticipated refunds, and to increase the cost of the extension in proportion to the amount by which the estimated refunds exceed the refunds that actually materialized.

The Interest Rate Is—

3% of the part of the deferred tax satisfied via the allowance of a "quick refund" claim of the kind outlined below.
6% of the deferred tax not satisfied that way.

In determining the deferred tax satisfied by the quick refund claim, corporations should consider only the *net effect* of the carryback, taking into

[34]INT. REV. CODE § 3779(i), added by § 4(a) of the Tax Adjustment Act of 1945.
[35]INT. REV. CODE § 294(e), added by § 4(b) of the Tax Adjustment Act of 1945; T.D. 5498, § 474.9.

consideration any resulting deficiencies. Note also that interest stops running when the tax is paid, if the 6% rule applies; or when the allowed refund is credited against the deferred tax, if the 3% rule applies.

This means that the 3% interest is *not* applicable:

When no "quick refund" claim has been filed prior to the last day of the month in which the return for the year of the anticipated refund was due;

When the extension is terminated either by the Treasury or the corporation before it would otherwise have been terminated (if only part is terminated, 6% is paid on the terminated portion and 3% on any balance satisfied by a quick refund claim);

When any part of the deferred tax was paid prior to the termination of the extension; or

To any portion of the tax not satisfied by the quick refund claim (when the refund is not sufficient to discharge the entire amount deferred).

The Penalty Is—

5% of the amount by which the deferred tax exceeds 125% of the amount that should have been deferred. The latter is the carryback refund that actually materialized.

This 5% is not interest, and is not calculated on a time basis; it is a flat penalty imposed in addition to the interest.

The penalty is intended only to prevent abuse of the extension provisions. It will not be imposed, therefore, if the corporation can prove that there was reasonable cause to anticipate a carryback refund at least as great as the amount of tax deferred. Note, too, that the corporation can always avoid the penalty by paying the deferred tax before the close of the year during which the extension was made. In that case, it will only pay interest at 6%.

Pointers to minimize penalty and interest charges:

The interest and penalty provisions place a premium on care and good judgment in exercising the extension privileges. If corporations defer too much of the tax, they may be required to pay 6% interest on the excessive deferment, plus 5% of it as a penalty.

Corporations exercising the extension privileges should ordinarily file the complementary quick refund claim. This will usually reduce the cost of the extension by as much as half, if they guess right on the amount of the refund.

Amended extension statements should be filed as often as necessary in the light of changed conditions or the discovery of errors in prior statements. This will save interest and perhaps penalties.

Companies not in need of cash, or in a position to borrow money at low interest rates, should weigh the advisability of postponing the payment of currently due taxes. The postponement will cost them a minimum of 3% interest, plus at least part of the 6% interest they would get on regular refund claims.

Quick Payment of a Carryback Refund.

Any corporation or individual can get a quick refund.[36] It is a refund claim designed to complement the extension provisions for corporations described above; it provides a method of discharging the liability for the postponed tax payments, and secondly a method of providing cash refunds within 90 days, for both corporate and other businesses instead of the considerably longer period it would normally take under regular refund procedures.

The "quick refund" claim is available to *all* businesses with refunds resulting from carrybacks. Very often, therefore, only the second of the purposes mentioned above will be involved. That is always the case for corporations when they have made no use of the extension privileges, or when no deferred taxes were owed at the time this "quick refund" claim was filed.

The "quick refund" procedure operates as follows.

Step 1

Calculate the amount of the refund to which companies are entitled. As a preliminary step in this computation, companies should resolve (usually in their favor) any current, unsettled disputes with the Treasury over the correct amount of any prior tax affected by the carryback.

Companies should assume that the tax shown on their return for the disputed year is correct; *but* they should:

Add any deficiencies already assessed or paid for that year;

Subtract any refunds, credits or rebates already allowed for that year; and

Add or subtract any increase or decrease in tax for that year due to the prior filing of a "quick refund" claim in connection with amortization deductions. In making this adjustment, the amortization claim is treated as though it had already been granted.

Step 2

A claim for a "tentative carryback adjustment" is filed on Form 1045 for individuals and on Form 1139 for corporations. This is filed along with, or after, the return for the year in which the carryback arose. But this must be done within twelve months after the close of that year.

36T.D. 5498, § 474.10.

Step 3

The Treasury will allow or reject the claim within 90 days after the date the claim was filed, or the last day of the month in which the return for the year giving rise to the carryback was due, whichever is later.

If any part of the claim is allowed, it is applied as follows:

First, against any taxes deferred under the extension rules outlined above;

Next against any other taxes that are owed.

The balance, if any, will be refunded in cash.

Since this is only a tentative allowance, and is subject to correction later on, the Treasury will not give it the careful review that regular refund claims normally get. It will check the company's claim only for material omissions and mathematical errors, including errors in applying the carryback rules. If the Treasury finds none, it will allow the claim.

If the Treasury does find any errors, it may correct them (if it has the time and the necessary information) and allow the claim in whole or in part. Otherwise, it will reject it.

Steps When Not Using the "Quick Refund" System.

The carryback of net operating losses (and unused excess profits credits for corporations) to a prior year may entitle individuals and corporations to a refund of taxes paid for that year. In order to get this refund, they must file a claim for it. They may now file their claim within three years after the due date of the return for the year in which the net operating loss arose.[37] (If it gives them more time, they are also permitted to file their claim within two years after the tax to be refunded is paid.)

Example: A company files its return on March 15, 1948, showing a net operating loss for 1947. This entitles it to a refund of its 1945 taxes. The rule gives it until 1951 to file its claim, three years after the due date of the return for the year in which the net operating loss arose. Under the old law the claim would have become outlawed on March 15, 1949.

The following discussion gives fuller consideration to the technical points that must be observed as to when a claim for a carryback must be filed.

A refund claim should be filed on or before the 15th day of the 39th month following the close of the year in which the carryback arose. Special rules apply in the case of a carryback due to an improper deduction for bad debts or worthless securities.[38] Individuals or corporations may claim their

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[37] INT. REV. CODE § 322(b) (6), added by § 5(b) of the Tax Adjustment Act of 1945.

[38] INT. REV. CODE § 322(b) (5), as amended by § 5(a) of the Tax Adjustment Act of 1945.

carryback refund due within seven years after the due date of the return for the year in which the carryback *originated.*

Refund claims filed within the three-year period must be acted upon by the Commissioner even though they would normally be barred for reasons having nothing to do with the time for filing. Thus, a court decision fixing liability for any particular year is ordinarily conclusive. It prevents one from filing refund claims for that year. The law, however, permits an individual or corporation to recompute its liability, if it is affected by a carryback. There are two exceptions to this rule. When tax liabilities are settled by compromise, or by closing agreements, one must check the Regulations.

The effect is, generally, to extend the period for filing to three years after the due date of the return for the year of the loss or unused credit.

> Example: Your company filed its returns for the calendar year 1944 on February 1, 1945. The return was not due until March 15, 1945. Operations for 1944 resulted in carrybacks to 1942 and entitle it to a refund of all taxes paid for 1942. The new rule gives the company until March 15, 1948, to file its refund claim, since that is the 15th day of the 39th month following the close of 1944. Its claim is *not* outlawed (as is usually true with normal refunds) on March 15, 1946.

How Carryback Interest Is Computed.

The following shows how interest is now computed *when the over-payments and under-payments are due to carrybacks.*

In over-payment of tax, companies get interest only from the time they file their carryback refund claim (or their Tax Court petition, if that is earlier).[39] This rule does not apply when they file a *special claim for a quick refund.*

> Example: Assume a business sustains a net operating loss in 1947 which results in a carryback refund for 1945. On March 15, 1948, it files its tax return for 1947 and also a regular claim for refund of its 1945 tax. In that case, interest starts to run on March 15, 1948, the day the refund claim was filed.

In deficiencies, companies pay interest on a deficiency due to a carryback only for the period beginning with the allowance of the carryback refund interest.[40] The law correlates the interest they pay on carryback deficiencies with the interest they get on carryback over-payments. *If a company gets no interest on a carryback refund for any period it pays no interest on the*

[39] INT. REV. CODE § 3771(e), as amended by § 6(b) of the Tax Adjustment Act of 1945.
[40] INT. REV. CODE § 292(c), added by § 6(a) of the Tax Adjustment Act of 1945.

resulting deficiency for that period. This rule is applicable not only to the ordinary type of carryback deficiency, but also to the deficiency assessed because the Treasury later discovers that a carryback refund or credit previously allowed was excessive.

> Example: Assume a company sustains a net operating loss for the calendar year 1947. When carried back to 1945, the loss produces an over-payment of income taxes for that year. On March 15, 1948, it claims a refund of $1,000 for 1945. The claim is allowed and paid. The Treasury later determines that the correct amount of the overpayment for 1945 was only $900. It therefore assesses a deficiency for the excessive refund of $100. The law requires the company to pay interest on the $100 from March 15, 1948.

III. Conclusion

So much for the technical explanation of this great technical weapon. Given a decent knowledge of its mechanics, your tax man is equipped to be of enormous service to business. Perhaps it is unfair to argue that the carryovers foment strikes, because industry can afford them, and delay conversion because losses may often be more profitable than profits and are half the bother.

But if that charge is not fair, then it is certainly true that a taxminded business has much to gain by attention to the problem. Here, for example, is a list of actual problems tossed at me during a month—

> What will net income be if you enter a normal business activity (e.g. develop a new product, a new operation, abandon some facilities, conduct an intensive marketing program, etc.) after all effects of the net operating loss, carryback and carryover provisions are considered?
>
> What is the effect of reorganizing or changing your business? How do carryovers affect the *new* corporation?[41]
>
> What is the effect of splitting up a corporation into two separate

[41]No matter how simple the reorganization or reincorporation, all the benefits of the carryovers of the capital losses, the net operating losses, and the unused excess profits credits are usually lost. New Colonial Ice Co. v. Helvering, 292 U. S. 435, 54 Sup. Ct. 788 (1934); General Finance Co. of Philadelphia v. Comm'r, 85 F. 2d 846 (C. C. A. 3d 1946); Weber Flour Mills Co. v. Comm'r, 82 F. 2d 764 (C. C. A. 10th 1936); McLaughlin v. Purity Investment Co., 75 F. 2d 30 (C. C. A. 9th 1935), *cert. denied,* 295 U. S. 753. 55 Sup. Ct. 834 (1935). A new corporation organized to take over the business and properties of another corporation is treated as a new entity. Many companies contemplate reorganizations or conversions into partnerships or new corporations following the end of the war. These companies should weigh the effect of this rule carefully. In many cases, the move might be deferred until the carryover benefits have been realized.

corporations, a manufacturing corporation and a selling corporation? How does the carryback affect that?

What is the effect of a proposed purchase for the business of another corporation? How does the carryover affect the vendor and vendee? How shall we proceed in the light of the carryover?

What is the carryover effect of sale of a substantial portion of assets, retaining only the proven income producing assets?

What is the carryover effect of opening a new branch of a business which will produce a heavy net loss during the first year?

What is the carryover effect of abandoning some expensive facilities? When should you do it? Now, or next year? The abandonment may produce a loss greater than your operating income.

All of the foregoing questions involved a serious business step.

In all the original design of management was altered in the light of the carryover consequences.

Q.E.D.—Businessmen had better understand the technical mechanics of the carryback.