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United States v. Foster Lumber Co.: Net Operating Losses and Capital Gains - You Can Have Two, but You Only Get One

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CASE COMMENTS

UNITED STATES v. FOSTER LUMBER CO.: 
NET OPERATING LOSSES AND CAPITAL GAINS — 
YOU CAN HAVE TWO, BUT YOU ONLY GET ONE

IN 1974 A CONFLICT DEVELOPED AMONG circuit courts over the application of the net operating loss carryback provisions of the Internal Revenue Code to years in which a corporate taxpayer enjoyed the benefit of the “alternative” method for the computation of the capital gains tax. In November 1976, the United States Supreme Court resolved the conflict in favor of the Internal Revenue Service in United States v. Foster Lumber Co.1 This Case Comment will analyze Foster Lumber, as well as some of the earlier conflicting decisions, in an effort to determine if the Supreme Court has effectively resolved the problem.

I. THE NATURE OF THE PROBLEM

A. “These Unimportant and Seldom Occurring Questions”

The question presented to the Court in Foster Lumber involved two sections of the Internal Revenue Code that are brought into conflict in relatively rare factual circumstances. The question appeared so esoteric that in 1970 the First Circuit found no need to consider in depth “these unimportant and seldom occurring questions.”2 Unfortunately, by 1974 some ninety-nine cases had arisen;3 with a conflict among circuits and some $20,000,000 in taxes in dispute,4 the “unimportant” question was ready for Supreme Court review.

Section 172 of the Code allows taxpayers to carry back net operating losses of the current year to offset the income of prior profitable years.5 There is no dispute over the fact that the taxpayer owes no tax for the current year, the loss year.6 What the taxpayer is attempting to do, however, is carry back the current year’s loss to a prior profitable year, offset the income of the prior year with the loss of the current year, reduce the tax on the prior year’s income, and generate an immediate tax refund. Section 172 provides for this kind of carryback of losses.

The motivation behind the enactment of section 172 was that arbitrary annual accounting periods often impose drastic consequences

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2 Chartier Real Estate Co. v. Commissioner, 428 F.2d 474, 475 (1st Cir. 1970).
4 Id.
5 I.R.C. § 172 also allows the taxpayer to carry forward losses for use in future years. Although all of the cases discussed in this Case Comment involved loss carrybacks, many of the same issues arise in the computation of carryforwards.
6 The corporate income tax is imposed when the taxpayer generates taxable income but not when it suffers a loss. I.R.C. § 11(a) read with id. § 63(a).
on taxpayers with cyclical income patterns. Section 172 permits lean years to be offset against lush ones, and permits the tax to be computed based upon something akin to an average taxable income over a period of years. In this way, taxpayers with cyclical income patterns are not taxed more heavily than those with more stable income patterns.\(^7\)

Section 1201 also confers a benefit on the taxpayer. The corporate taxpayer first computes its tax under the "regular" method. This is the tax that would be imposed without regard to section 1201. The taxpayer then computes its tax under the section 1201 "alternative" method. This is the regular tax imposed on the ordinary income element of earnings, plus a flat-rate tax of 30 percent on capital gains. The tax under the regular method is then compared with the tax under the alternative method, and the taxpayer must pay under the method that produces the lower tax.\(^8\) The benefit conferred upon the taxpayer by section 1201 is that capital gains are taxed at a 30 percent rate under the alternative method, rather than at rates which can range as high as 48 percent under the regular method.\(^9\) Furthermore, the 30 percent rate on capital gains is only imposed when it would yield a tax lower than that imposed by the regular method.\(^10\) The fact that section 1201 provides two methods for the computation of the tax, but then levies the tax under only one of the methods, is important to much of the analysis that follows.\(^11\)

It has been shown that section 172 allows taxpayers to pay tax based on income averaged over a period of years, and that section 1201 provides for reduced taxes on capital gains. Both sections confer benefits on the taxpayer in the form of reduced taxes. The two sections are brought into conflict when a corporate\(^12\) taxpayer incurs a net operating loss in a given year and seeks to carry back that loss to a year in which the alternative method for the computation of capital gains was utilized. It is given that there is no tax due for the current year since the taxpayer incurred a loss. It is also given that there was a tax paid in the prior year and that the alternative method produced a lower tax on that year's activities than would have been produced under the regular meth-

\(^8\) I.R.C. § 1201(a).
\(^9\) Id. §§ 1201(a), 11(a). The 48 percent figure would apply to any amount in excess of the $50,000 surtax exemption provided in section 11(d).
\(^10\) See I.R.C. § 1201(a).
\(^11\) The policy behind the reduced tax on capital gains is to encourage the formation and development of capital for investment by business. Theoretically, this investment stimulates the economy and helps to create new jobs. This policy was the subject of much discussion during the congressional consideration of the Tax Reform Act of 1976. See generally Surrey, Reflections on the Tax Reform Act of 1976, 25 CLEV. ST. L. REV. 303, 313-15 (1976) (discussed the debates on the capital gains tax on individuals).
\(^12\) There is a similar conflict in the Code sections which deal with the noncorporate taxpayer in a situation like that described in the text. Though different sections are involved, they are conceptually analogous to sections 172 and 1201, and similar analysis is used to resolve the conflict. The leading noncorporate taxpayer case is Axelrod v. Commissioner, 507 F.2d 884 (6th Cir. 1974).
In this factual situation, the Foster Lumber conflict is triggered. When the taxpayer attempts to carry back the current year’s loss to the prior year, two questions arise. First, can the loss carryback be offset against the prior year’s capital gains for purposes of determining the alternative tax in the prior year? The courts have consistently responded to this question in the negative. Second, given that the loss carryback cannot be used to offset the capital gain for purposes of the alternative tax calculation, can the carryback loss in excess of the ordinary income of the carryback year be used to offset a later year’s income? It is this second question that was presented to the Court in

13 This occurs when there is a relatively large capital gain and little or no ordinary income. In numerical terms the situation often appears as follows:

<table>
<thead>
<tr>
<th>Year</th>
<th>Ordinary Income (Loss)</th>
<th>Capital Gain</th>
<th>Total Taxable Income (Loss)</th>
</tr>
</thead>
<tbody>
<tr>
<td>19X1</td>
<td>$ 100,000</td>
<td>1,000,000</td>
<td>$1,100,000</td>
</tr>
<tr>
<td>19X2</td>
<td>$ 0-</td>
<td>-0-</td>
<td>$ 0-</td>
</tr>
<tr>
<td>19X3</td>
<td>$(500,000)</td>
<td>-0-</td>
<td>$(500,000)</td>
</tr>
</tbody>
</table>

The taxpayer has incurred a net operating loss for the current year, 19X3. It seeks to carry back that loss to 19X1. The tax in 19X1 was paid based upon the alternative method because, with the large capital gain and relatively small ordinary income, that method produced the lower tax.

14 Chartier Real Estate Co. v. Commissioner, 52 T.C. 346 (1969), the first case to consider the conflict, bifurcated the analysis. Id. at 346-47. All of the cases since have adopted a similar approach.

15 In terms of the example presented in note 13 supra, can the $500,000 loss from 19X3 be used to reduce the $1,000,000 capital gain in 19X1, or is the application of the loss carryback limited to the $100,000 of ordinary income in 19X1?

16 Chartier Real Estate Co. v. Commissioner, 52 T.C. 346, 350-56 (1969), which relied heavily on Weil v. Commissioner, 23 T.C. 424 (1954), aff’d, 229 F.2d 593 (6th Cir. 1956). In Chartier, the corporate taxpayer had ordinary income of $1,115 and capital gains of $83,787 for the year 1962. It computed and paid taxes based on the alternative method because this computation resulted in a lower tax than could be obtained under the regular method. In 1964, the taxpayer filed for a refund of a portion of its 1962 taxes. The taxpayer’s claim was that it should be permitted to offset 1962 income by an $11,458 loss carryback from 1963 and 1964.

The Commissioner conceded that had the taxpayer paid 1962 taxes based on the regular method, it would be permitted to offset both regular and capital gain income with the loss carryback. He asserted, however, that because the taxpayer had paid tax under the alternative method, its use of the loss carryback would be limited to $1,115, the amount of ordinary income. The Tax Court agreed with the Commissioner, noting:

The Commissioner’s computation under the “alternative” method follows scrupulously the terms of the statute. He first determined a “partial tax” under section 1201(a)(1) which, admittedly, was zero; and then he added under section 1201(a)(2) “an amount equal to 25 percent of . . . [the] excess” of the net long-term capital gain over the short-term capital loss. The provisions of the statute are set forth with such specificity that they admit of no such reading as that urged by petitioner, which seeks to subtract from “such excess” that portion of the carryback loss that was not absorbed in the computation of the “partial tax” in (a)(1). We hold that the Commissioner must be sustained. In so holding we have found that the issue is indistinguishable from the one decided in Walter M. Weil, . . . and that the legislative history supports the result reached.

17 In terms of the example presented in note 13 supra, does the portion of the $500,000 loss carryback from 1963 and 1964.
Foster Lumber. In statutory terms, the conflict centers around the meaning of a sentence in section 172(b)(2): "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."

B. Prior Case Law: Twelve to Nothing After the Eighth

1. First Up, Chartier

*Chartier Real Estate Co. v. Commissioner*\(^\text{18}\) was the first case to consider the conflict between sections 172(b)(2) and 1201. An understanding of the court's reasoning in *Chartier* is essential because most of the later case law on the question relies on *Chartier*.

Chartier engaged in the rental of real estate; it occasionally sold some of its rental property. During 1962, Chartier generated ordinary income of $1,115\(^{19}\) and a capital gain of $83,787.\(^{20}\) Ignoring any loss carryovers, the federal tax on Chartier's 1962 activities was $38,649 under the regular method and $21,281 under the alternative method.\(^{21}\) As section 1201(a) required, the tax paid was based upon the lower of the two methods, in this case, $21,281 under the alternative method. This is a basic section 1201 computation and it posed no particular problem.

In 1964, Chartier incurred an $11,458\(^{22}\) net operating loss that it sought to carry back to 1962. If it could do so, Chartier would have reduced its 1962 income and thereby reduced the $21,281 tax paid on its 1962 activities. The Commissioner agreed that the 1964 loss of $11,458 could be carried back to 1962 to reduce that year's income. Since the 1962 tax was computed using the alternative method, however, the question was how to apply the 1964 loss to the 1962 income. In a simplified tabular form the situation is set out below. Asterisks have been used to represent those numbers that have no relevance to this discussion.

<table>
<thead>
<tr>
<th></th>
<th>1962</th>
<th>1963</th>
<th>1964</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ordinary Income</td>
<td>$1,115</td>
<td>*</td>
<td></td>
</tr>
<tr>
<td>Capital Gain</td>
<td>83,787</td>
<td>*</td>
<td>*</td>
</tr>
<tr>
<td>Total Taxable Income (Loss)</td>
<td>$84,902</td>
<td>*</td>
<td>$(11,458)</td>
</tr>
</tbody>
</table>

loss from 19X3 in excess of $100,000 (the 19X1 ordinary income) survive for use in 19X2 and later years?

\(^{18}\) 52 T.C. 346 (1969), aff'd per curiam, 428 F.2d 474 (1st Cir. 1970). While both section 172 and section 1201 have been amended since the *Chartier* decision, the statutory language analyzed in *Chartier* and in the other cases discussed in this Case Comment has not been changed by the amendments.

\(^{19}\) For ease of reference, cents have been dropped from all figures used in the text.

\(^{20}\) These were the amounts after certain adjustments were agreed to by Chartier and the Commissioner. 52 T.C. at 347-48. The adjustments are not relevant to this discussion.

\(^{21}\) Id. at 348.

\(^{22}\) $6,095 was from its 1963 operations and $5,363 was from 1964. The fact that

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Both parties agreed that for purposes of the regular method computation for 1962, the $11,458 carryback from 1964 could be utilized in full and offset against the $1,115 of ordinary income and $10,343 of capital gain. That agreement was mooted, however, by the fact that the 1962 tax was paid under the alternative method, not the regular method. Even with the full utilization of the 1964 carryback, the 1962 tax would still be lower under the alternative method than under the regular method; any concessions under the regular method were of little concern to Chartier.

The dispute arose over the computation of the 1962 alternative method. Under that method, the taxpayer pays the regular tax on ordinary income but a flat-rate tax of 25 percent on capital gains. The first question was whether to apply the $11,458 loss from 1964 only against the ordinary income of 1962 or whether some of the loss could be applied against the capital gains of 1962. Relying heavily on Weil v. Commissioner and legislative history, the Tax Court held that Chartier could not use the 1964 loss carryback to offset 1962 capital gains for purposes of the alternative method calculation. So, for purposes of the alternative method calculation, Chartier could use its $11,458 loss from 1964 to offset $1,115 of ordinary income from 1962, but it could not use any of its $11,458 loss to offset any of its $83,787 of 1962 capital gains. This part of the Chartier decision has not been seriously challenged.

It was the second issue in Chartier that made the case important for purposes of Foster Lumber. Did any part of the 1964 loss survive for use in 1963 and subsequent years? Recall that the Commissioner conceded that Chartier could fully utilize its 1964 loss carryback in computing its 1962 tax under the regular method, but even with that utilization, the regular method still produced a tax of $32,691 for 1962—a tax higher than the 1962 alternative computation produced. The alternative tax was $21,281 before the 1964 carryback utilization and the losses were generated in different years does not affect the analysis. For convenience, the $11,458 total will be referred to as the 1964 net operating loss.

The effect of this was to reduce the regular tax on 1962's activities from $38,649 to $32,691. The tax was 25 percent during the years in question in Chartier. It has since been increased to 30 percent. I.R.C. § 1201(a).

Disregarding the carryback, the 1962 alternative tax was $21,281. See text accompanying note 21 supra. If the carryback was fully utilized in 1962, offsetting the $1,115 of ordinary income in full and reducing the capital gain to $73,444, the tax would be $18,361 (25 percent of $73,444). If the carryback were limited to ordinary income and it could not be used to offset capital gains, the tax would be $20,947 (25 percent of $83,787).

A good comparison of Weil and Chartier is found in 48 J. Urb. L. 999 (1971). The point is developed in note 16 supra.

As discussed in note 25 supra, limiting the carryback application to ordinary income resulted in little change in Chartier's alternative tax. The company owed $21,281 before utilization of the carryback and $20,947 after its utilization.

See note 16 supra; see also 55 B.U. L. Rev. 134, 137 n.14 (1975).

See text accompanying note 23 supra.

Note 23 supra.
The Commissioner asserted that the 1964 carryback was fully utilized in 1962 (and therefore none of the loss survived for use in later years) because the carryback reduced income for purposes of the 1962 regular tax computation by the full amount of the loss. He was not impressed by the fact that the carryback of the $11,458 loss had affected the 1962 alternative computation, and therefore the tax paid, by only $334. This may be seen more readily in the following table:

<table>
<thead>
<tr>
<th></th>
<th>Regular Tax Liability</th>
<th>Alternative Tax Liability</th>
<th>Tax Payable³³</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tax before 1964 carryback</td>
<td>$38,649</td>
<td>$21,281</td>
<td>$21,281</td>
</tr>
<tr>
<td>Tax after 1964 carryback</td>
<td>$32,691</td>
<td>$20,947</td>
<td>$20,947</td>
</tr>
</tbody>
</table>

Note that the utilization of the 1964 carryback produced a substantial change in the 1962 regular tax liability because the loss was utilized in full to offset both ordinary income and capital gains. Under the alternative method, however, the carryback produced very little change since it was utilized only to the extent of ordinary income;³⁴ the carryback could not be used to offset capital gains under the alternative method. Chartier argued that it is grossly unfair to assert that the carryback has been fully utilized in a tax year similar to the one depicted in the table because the carryback produced so little change in the tax payable. Therefore, Chartier asserted, the loss carryback in excess of ordinary income (that portion not utilized under the alternative method) should survive for use in subsequent years.

The Tax Court agreed with Chartier and advanced two theories to support its holding that the 1964 carryback had not been fully utilized in 1962. First, without citing any authority, the court found that the purpose of carrybacks is to ameliorate the sometimes arbitrary effects of annual tax accounting periods. If the Commissioner's argument that the 1964 carryback was fully utilized in 1962 had been accepted, Chartier would not have fully enjoyed the benefit of the net operating loss provisions in any year. The carryback had little effect on its 1962 tax liability, and under the Commissioner's theory, none of the carryback survived for use in years subsequent to 1962. The court found this to be contrary to the intended purpose of section 172 and held that $10,343 of the 1964 loss survived for use in years subsequent to 1962.³⁵

The Tax Court also found support for its decision in section 172(b)(2).³⁶ The court held that the term "taxable income," as used in this

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³² $1,115 of 1962 ordinary income had been offset by the 1964 carryback, and this offset reduced the alternative tax by $334.

³³ This column represents the amount which is the lower of the two methods. I.R.C. § 1201(a).

³⁴ The carryback was utilized under the alternative method to the extent of $1,115 of 1962 ordinary income. Note 32 supra.

³⁵ $1,115 was utilized to offset the 1962 ordinary income, therefore, $10,343 remained for use in later years.

³⁶ The relevant portion of section 172(b)(2) is reproduced in the text preceding note 18.
section of the Code, meant "that taxable income to which the loss is actually applied in computing actual tax liability." By adopting this narrow construction, the court was able to read section 172(b)(2) in such a way that the 1964 loss survived for use in years subsequent to 1962.

While the commentators have shown that the Chartier court's analysis was weak, the case is important since it demonstrated that in certain situations sections 172 and 1201 conflict and can produce a result that seems anomalous given that both sections were designed to confer a benefit on the taxpayer. The glaring flaw in Chartier is its superficial analysis of the carryback utilization question. The portion of the opinion dealing with that question covers only two full pages, cites little legislative history to support its policy arguments, and, most importantly, fails to undertake the kind of detailed statutory analysis so important in tax cases. Thus, Chartier must be viewed as a case dealing with the issue, but little else. Its precedential value is slight because its analysis was so superficial.

While the Chartier decision leaves a good deal to be desired, criticism of it should be tempered by the knowledge that it was a case of first impression and that the arguments presented to the court were not nearly as refined as they would be later on. The unfortunate thing about Chartier, however, is not the weaknesses in the case itself, but the fact that so many other courts readily accepted its holding with so little analysis of their own.

2. After Chartier

In 1970, the First Circuit affirmed Chartier in a decision that would stand for some time as the only appellate authority on the conflict

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37 52 T.C. at 357-58.
38 See id.
39 E.g., Nagel, Planning to avoid wastage of NOL carryovers: A lesson from Chartier Realty, 42 J. Tax. 26 (1973); 8 SAN DIEGO L. REV. 442 (1971).
40 52 T.C. at 356-58.
41 At this point, Chartier should be distinguished from a factually similar situation. In Chartier, the tax in the carryback year, 1962, would have been paid under the alternative computation whether the Commissioner's or Chartier's argument on the first question was accepted. Under both arguments, the alternative computation produced a lower tax liability than the regular method. It is possible, however, for a situation to arise in which the tax in the carryback year will be computed under one method if the Commissioner's position is accepted, and under the other method if the taxpayer's position is accepted. This situation arose in Lone Manor Farms, Inc. v. Commissioner, 61 T.C. 436 (1974), aff'd, [1977] STAND. FED. TAX REP. (CCH) 91,351 (3d Cir. Jan. 27, 1975) (unpublished opinion). The Lone Manor court was careful to distinguish the case from Chartier, although they are factually and analytically similar. 61 T.C. at 442. For a comparison of the two cases, see Nagel, Planning to avoid wastage of NOL carryovers: A lesson from Chartier Realty, 42 J. Tax. 26, 27-28 (1975).
42 The trend began with the appeal of Chartier. The First Circuit affirmed in an opinion that said little more than that there was nothing wrong with the Tax Court's holding. Chartier Real Estate Co. v. Commissioner, 428 F.2d 474 (1st Cir. 1970) (per curiam). See also note 41 supra.
between sections 172 and 1201. Despite the criticism of Chartier, eight other cases followed its holding; none of those opinions engaged in much more than one page of analysis of the question. The First Circuit's affirmance of Chartier was accorded great weight by the courts despite its cursory treatment of the question and the criticism of commentators.

When the Eighth Circuit considered Foster Lumber, it affirmed an unreported district court decision and followed Chartier. By late 1974, the First, Eighth, and Ninth Circuits had all adopted Chartier, and the Tax Court considered the issue so settled that it was disposing of Chartier-type cases in memorandum decisions. The conflict between sections 172 and 1201 appeared to be resolved but for one nagging problem — the Commissioner had not acquiesced in any of these cases and was still litigating the issue. His persistence was to be rewarded in Mutual Assurance Soc'y Corp. v. Commissioner.

3. Mutual Assurance: The Commissioner Scores in the Fourth

Despite the unbroken line of cases supporting Chartier, the Commissioner appealed the case of Mutual Assurance Soc'y Corp. to the Fourth Circuit. He conceded that the facts in the case could not be distinguished from Chartier, but asserted that Chartier was wrongly decided and should not be adopted as the rule in the Fourth Circuit. In a 3-1 decision, the Fourth Circuit refused to follow Chartier and reversed the Tax Court.

Mutual Assurance is important because it was the first case to reject the Chartier decision, and because it was the first case after Chartier to engage in a detailed analysis of the conflict between sections 172 and 1201. It is worthwhile to consider Mutual Assurance because much of

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44 See note supra.
46 Foster Lumber Co. v. United States, 500 F.2d 1230 (8th Cir. 1974). The eight decisions cited in note 45 supra, the circuit and lower court decisions in Foster Lumber, plus the two in Chartier represent a total of twelve decisions rendered against the Commissioner.
47 Foster Lumber Co. v. United States, 500 F.2d 1230 (8th Cir. 1974); Olympic Foundry Co. v. United States, 493 F.2d 1247 (9th Cir. 1974); Chartier Real Estate Co. v. Commissioner, 428 F.2d 474 (1st Cir. 1970).
49 The Commissioner has taken no action in response to any of the cases cited in note 45 supra, Chartier, or Foster Lumber.
the reasoning presented in it was later utilized by the Supreme Court in *Foster Lumber*.

The Fourth Circuit conceded that every case prior to *Mutual Assurance* had followed *Chartier*, however, the court criticized the cases on the ground that none of them had analyzed the section 172 problem, but rather had blindly followed *Chartier*.52 Because of this lack of analysis, the Fourth Circuit was unimpressed by the unanimous precedent favoring *Chartier*, and undertook its own examination of the section 172 question.

While the court examined both the statute and its legislative history, it indicated that in federal tax cases the analysis should begin with the statute.53 The statutory analysis focused on the term “taxable income” in the phrase, “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.”54 Mutual Assurance asserted that the term taxable income means “income on which the tax is actually paid.” Since the tax was paid based upon the alternative method, and only a portion of the loss was utilized in the calculation of that method, there was some excess to be carried to later years.55

The Commissioner was not so ready to add words to section 172(b)(2). He asserted that since section 172 did not redefine the term taxable income, the general definitions of sections 61(a) and 63(a) controlled. If so, taxable income encompasses both ordinary income and capital gains, and the loss carryback would have to exceed both of those elements before it would survive for use in a later year. In the classic *Chartier* factual situation, however, the loss carryback exceeds ordinary income in the carryback year but not the sum of ordinary income plus capital gains. Thus, under the Commissioner’s definition of taxable income, there would be no carryback in excess of taxable income that could survive for use in years subsequent to the carryback year.

Rather than discussing at length the argument over section 172(b)(2), the *Mutual Assurance* court concluded that there was “positive evidence, on the face of the statute,” that the Commissioner’s definition was correct.56 The evidence was the existence of section 172(d)(2)(B).

52 505 F.2d at 133.
53 See id. It will be developed later in this Case Comment that the legislative history of section 172 may support the taxpayer while the statute supports the government. Thus, whether the statute or the legislative history is analyzed first may make a difference. It would appear, however, that the analysis must begin with the statute since that represents the congressional statement of the law. Only if the statute is unclear is there any need to refer to the legislative history behind the statute. See Helvering v. Stockholms Enskilda Bank, 293 U.S. 84, 93-94 (1934).
54 I.R.C. § 172(b)(2) (emphasis added).
55 Recall that the alternative tax is the sum of the tax on ordinary income plus the flat-rate tax on capital gains. I.R.C. § 1201(a). Weil and *Chartier* established that the carryback could not be used to offset the capital gain but could be used to offset ordinary income. Since the carryback affected the tax actually payable only to the extent of ordinary income, any loss carryback in excess of ordinary income is “excess” under section 172(b)(2) and available for use in later years.
56 505 F.2d at 134.
That section made certain adjustments to the taxable income of non-corporate taxpayers. While it was not itself relevant to the issue before the Mutual Assurance court, its existence was important because, if Mutual Assurance's narrow construction of the term taxable had been adopted, section 172(d)(2)(B) would have been rendered superfluous.\footnote{57} Certainly any construction of section 172(b)(2) that would render another section of the Code superfluous must be viewed with suspicion.

The Fourth Circuit also found support for the Commissioner's definition of taxable income in the legislative history. Although the history behind sections 172 and 1201 did not address the conflict between the two sections,\footnote{58} the Mutual Assurance court focused on the different kinds of legislation that had dealt with net operating loss carrybacks.\footnote{59} The court noted that from 1924 to 1934, the Code specifically allowed a loss carryback in excess of ordinary income in the carryback year to be offset against capital gains. In this way, the loss was fully utilized in the carryback year in both the regular and alternative calculations, the carryback always affected the tax liability for the carryback year, and the problem presented to the court in Mutual Assurance would not have arisen. The court reasoned that since for ten years Congress structured the Code in such a way that the problem presented in this case could not have arisen, and since Congress later changed the Code, it implicitly intended the result which Mutual Assurance complained of.\footnote{60}

The court also noted that if the Eighth Circuit had considered the legislative history from 1924 to 1934 and section 172(d)(2)(B), it might not have followed the rule announced in Chartier.\footnote{61} Regardless of what the Eighth Circuit might have done, however, the Sixth Circuit, in Axelrod v. Commissioner,\footnote{62} also decided not to adopt the Chartier rule, thus setting the stage for the Supreme Court review of the conflict between sections 172 and 1201.

\footnote{57} 505 F.2d at 134-35. \textit{See} text accompanying notes 80-83 \textit{infra}.


\footnote{59} I.R.C. \S\ 172 and its predecessors.

\footnote{60} 505 F.2d at 136-38.

\footnote{61} 505 F.2d at 136-38 & n.22.

Two articles have suggested that the special loss carryover provisions for life insurance companies, contained in I.R.C. \S\ 812, are analogous to section 172, and that since section 812 codifies a rule similar to that adopted by Chartier section 172 should be construed to achieve a result similar to that codified in section 812. In other words, since section 812 codified the Chartier construction of section 172, this codification should be interpreted to mean that Chartier was correct. \textit{See} Bixler \& Voght, \textit{Is the answer to the Chartier principle dilemma contained in Subchapter L?}, 43 J. TAX. 344 (1975); contra, 8 SAN DIEGO L. REV. 442 (1971). Mutual Assurance was an insurance company but, apparently, it was not within the purview of section 812 because it was not a life insurance company. Despite the fact that an insurance company was involved, the Mutual Assurance opinion did not discuss the section 812 analogy.

\footnote{62} 507 F.2d 884 (6th Cir. 1974). Although the case involved a noncorporate taxpayer, the Sixth Circuit cited Mutual Assurance to support its theory that Congress intended a carryback result different from that obtained in Chartier. \textit{Id.} at 888.
II. THE SUPREME COURT INTERVenes: 
United States v. Foster Lumber Co. 
A. The Facts, As Usual 

The factual situation in Foster Lumber fit the pattern set by Chartier. In 1966, Foster Lumber had ordinary income of $7,236 and capital gains of $166,634. It sustained a loss of $42,203 in 1968 and sought to carry the loss back to offset its 1966 income. It offset in full the $7,236 of ordinary income in 1966 and filed a claim for refund, asserting that $34,967 ($42,203 less $7,236) of its 1968 loss survived for use in years subsequent to 1966. The Commissioner disallowed the claim for refund. Both the trial court and the Eighth Circuit agreed with Foster Lumber and allowed the claim for refund. 

B. The Majority 
1. The Statute 

Writing for the majority, Justice Stewart attempted to discern the meaning of section 172(b)(2) by reading the statute without the aid of legislative history. He first addressed the two statutory arguments which Foster Lumber advanced; the majority found neither persuasive. Foster Lumber's first statutory argument turned on the last clause in section 172(b)(2). "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." The argument was that the italicized phrase modifies the term "taxable income" as well as the phrase "each of the prior taxable years." If Chartier was correct in holding that taxable income means only that income upon which the tax is actually computed, then the loss would not be fully utilized in 1966; part of Foster Lumber's loss ($34,967) would survive for use in a later year. 

The Court did not accept the argument, for to do so would mean that the phrase "taxable income ... to which such loss may be carried" would have to be read "taxable income to which such loss may be carried and deducted, resulting in a reduction of tax liability." The prob-
lem with Foster Lumber's reading is that to accept it, the term taxable income, a term of art, must mean something different for purposes of section 172(b)(2) than it does for any other section of the Code. For reasons that will be developed below, the Court properly rejected the idea that the existence of the words "to which such loss may be carried," gives some added, special meaning to the term taxable income.

The second statutory argument also involved the meaning of the term taxable income as used in section 172(b)(2). In this argument, however, the Court attempted to ascertain the meaning of the term by reference to other sections of the Code rather than to other parts of section 172(b)(2).

The Court reasoned that since taxable income is not specifically defined within section 172(b)(2), the general definitions of the term elsewhere within the Code should control. There is no doubt that those general definitions encompass both capital gains and ordinary income. Accordingly, the loss carried back to 1966 would have had to exceed both 1966 ordinary income and capital gains before any of the carryback would survive for use in years subsequent to 1966. In Foster Lumber, the loss carryback from 1968 was $42,203, and the total taxable income in 1966 was $173,870. The carryback did not exceed total taxable income (though it did exceed ordinary income). Therefore, all of the 1968 loss was absorbed in 1966; none survived for use in subsequent years.

The Court's analysis of the definition of taxable income for purposes of section 172(b)(2) is persuasive. One part of section 172(b)(2) does modify the general definitions of the term taxable income, but that modification was not relevant to the case before the Court. Given that section 172(b)(2) makes no relevant modifications to the term, there is nothing to suggest that Congress intended the term to mean anything other than what is found within the general definitions elsewhere in the Code. As the Court suggested, these general definitions clearly include both capital gains and ordinary income, and defeat Foster Lumber's argument.

It appears that the Court is correct in this conclusion. Section 172(b)(2) is very specific. Congress redefined the term for some purposes covered by that section but not for the one in question. To argue that Congress did not redefine the term for purposes of the question before the Court because of an inadvertent omission, seems tenuous at best, especially when the section is as specific as section 172(b)(2).

The Court pointed out that Congress redefined the term taxable income in other sections of the Code which are analogous in language.
and policies to section 172(b)(2), but it rejected the argument that congressional redefinition of the term in these analogous sections demonstrated an intent to redefine the term for purposes of section 172(b)(2). The Court's rejection of this argument is appropriate. Again, section 172(b)(2) is quite specific. To suggest that Congress intended a redefinition of taxable income in section 172(b)(2) because of a redefinition in analogous sections, seems to strain reasonable statutory construction.

Both of these statutory arguments are variations of the same idea. Neither argument disputed the fact that section 172(b)(2) does not redefine the term taxable income for purposes of the question before the Court in Foster Lumber. The argument was that while section 172(b)(2) does not redefine the term, the general definitions of the Code do not control. As discussed above, the fact that Congress modified the definition of taxable income in analogous sections and in other parts of section 172(b)(2) does not seem to be particularly persuasive evidence that Congress inadvertently omitted an intended modification of the term in this part of section 172(b)(2). This "omission" argument seems to be further rebutted by the fact that Congress undertook a major revision of the Code in 1976, but did not correct the pertinent "omission" even though there was a minor modification to section 172(b)(2).

The Court could have buttressed this statutory analysis with its discussion of section 172(d)(2)(B). In a later footnote, the Court cited that section in support of the proposition that the term taxable income includes capital gains. This was an argument advanced, and more fully developed, in Mutual Assurance. The argument concerned the treatment of noncorporate taxpayers, but the part of the Code involved, section 172(d)(2)(B), shed some light on the meaning of the term taxable income within section 172(b)(2). For purposes of the argument, it is important to note the difference between the treatment of capital gains for corporate taxpayers and the treatment for noncorporate taxpayers. Corporate taxpayers have the benefit of the section 1201(a) alternative tax which provides a flat-rate tax of 30 percent on capital gains, when that rate produces a tax lower than the regular method. Noncorporate taxpayers, under section 1202, are permitted to deduct from gross income one-half of the net capital gains for the year, and then compute their tax on this reduced taxable income. Corporate taxpayers enjoy a reduced tax rate on capital gains; noncorporate taxpayers enjoy a deduction from taxable income.

Section 172(b)(2)(A) notes that the term taxable income, as used in section 172(b)(2), is modified for some purposes by section 172(d)(2)(B).

77 429 U.S. at 37 n.3.
78 The argument was advanced in Bixler & Voght, Is the answer to the Chartier principle dilemma contained in Subchapter L?, 43 J. Tax. 344 (1975); contra, 8 SAN DIEGO L. Rev. 442, 447-48 (1971). See note 61 supra for a development of the argument.
80 429 U.S. at 48 n.18.
81 See Mutual Assurance Soc'y Corp. v. Commissioner, 505 F.2d 128, 134-35 (4th Cir. 1974).
Section 172(d)(2)(B) prohibits noncorporate taxpayers, in computing taxable income, from deducting one-half of capital gains as allowed by section 1202. The Mutual Assurance court reasoned that the existence of section 172(d)(2)(B), and its disallowance of the section 1202 deduction, was evidence that taxable income, as used within section 172(b)(2), must include capital gains. The Mutual Assurance court's reasoning was that because section 172(d)(2)(B) disallows the deduction of one-half the capital gains for noncorporate taxpayers, the purpose must be to negative the section 1202 deduction when computing taxable income for purposes of section 172(b)(2). Section 172(d)(2)(B) would exist only if Congress assumed that taxable income within section 172(b)(2) included capital gains. Otherwise, section 172(d)(2)(B) would be superfluous; there would be no need to disallow deductions for capital gains if, as Foster Lumber argued, taxable income for purposes of section 172(b)(2) did not include capital gains.

The following hypothetical may help to illustrate the section 172(d)(2)(B) argument. Assume a corporate and a noncorporate taxpayer have computed their respective taxable incomes, first for general tax purposes and then for purposes of section 172(b)(2):

<table>
<thead>
<tr>
<th></th>
<th>Corporate</th>
<th>Noncorporate</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>For general tax purposes:</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Ordinary Income</td>
<td>$100</td>
<td>$100</td>
</tr>
<tr>
<td>Capital Gains</td>
<td>50</td>
<td>50</td>
</tr>
<tr>
<td>Gross Income</td>
<td>150</td>
<td>150</td>
</tr>
<tr>
<td>Section 1202 deduction for noncorporate taxpayers</td>
<td>—</td>
<td>25</td>
</tr>
<tr>
<td><strong>Taxable Income for general tax computation purposes</strong></td>
<td>$150</td>
<td>$125</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th>Corporate</th>
<th>Noncorporate</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>For section 172(b)(2) purposes:</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Ordinary Income</td>
<td>$100</td>
<td>$100</td>
</tr>
<tr>
<td>Capital Gains</td>
<td>50</td>
<td>50</td>
</tr>
<tr>
<td>Gross Income</td>
<td>150</td>
<td>150</td>
</tr>
<tr>
<td>Section 1202 deduction denied by section 172(d)(2)(B)</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td><strong>Taxable Income for section 172(b)(2) purposes</strong></td>
<td>$150</td>
<td>$150</td>
</tr>
</tbody>
</table>

Note that taxable income for purposes of section 172(b)(2) is the same for both taxpayers, and that the achievement of such equality appears to be the reason for the enactment of section 172(d)(2)(B). The fact that taxable income for general tax computation purposes is different for corporate and noncorporate taxpayers is not significant. The taxable income for the corporate taxpayer will be treated more favorably in the computation of the tax liability through the use of the section 1201(a) alternative tax. Thus, even though the taxable income for tax computation purposes appears to be unfairly different, the difference is compensated for in the computation of the tax itself.

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Section 1202 would not permit a deduction for one-half of capital gains when those gains have not been included in gross income, nor would section 172(d)(2)(B) deny a section 1202 deduction for capital gains not included in gross income for section 172(b)(2) purposes. Only the government’s construction of section 172(b)(2) avoids making section 172(d)(2)(B) superfluous. Thus, it appears that taxable income within section 172(b)(2) must include capital gains. Though confusing, this argument supports the decision in Foster Lumber, but, regrettably, the Court did not develop the argument in its opinion.83

One statutory argument that the Court mentioned only in passing is the existence of regulations that deal with the problem presented in Foster Lumber. The majority opinion mentioned in a footnote that the regulations do not support Foster Lumber’s interpretation of section 172(b)(2);84 the dissent did not discuss them at all.85 While the Supreme Court is not bound by the regulations,86 they may be useful in attempting to discern congressional intent. In this case, there were long-standing regulations contrary to the result in Chartier and the position taken by Foster Lumber.87

Generally, the existence of long-standing regulations indicates congressional approval of the interpretation of the statute contained therein. This implication is especially strong when the Code section has been amended, but Congress has not changed it to counter the regulations’ interpretation. In such a case, it appears that the legislature has implicitly approved of the regulations’ interpretation, otherwise it would have acted to counter that interpretation.88 In Foster Lumber, there were long-standing regulations interpreting section 172(b)(2) contrary to the rule of Chartier. The Court could have inferred from the long-standing existence of the regulations that Congress implicitly approved of that interpretation. While the inference certainly is not strong enough to be determinitive of the issue,89 it does buttress the Court’s conclusion that Chartier was incorrect.

83 Again, however, this support is drawn from inferences provided by other sections of the Code. See also text accompanying notes 77-79 supra.
84 429 U.S. at 41 n.8.
85 See 429 U.S. at 49-59.
89 It has also been asserted that Congress’ inaction after the Chartier decision implies congressional approval of the result in that case. Mutual Assurance Soc’y Corp. v. Commissioner, 505 F.2d 128, 138 (4th Cir. 1974) (dissent). A stronger inference, however, would be that if Congress implicitly approved of anything, it was the regulation rather...
In summary, the Court accepted neither of Foster Lumber's statutory arguments. There is nothing within section 172(b)(2) to indicate that the term taxable income means anything other than what is stated in the general definition sections of the Code. Likewise, the other sections of the Code related to operating losses provide no clear-cut indication that Congress intended to modify the definition of taxable income for purposes of section 172(b)(2); in fact, section 172(d)(2)(B) seems to imply that the broad definition of taxable income for purposes of section 172(b)(2) is correct. Both of Foster Lumber's statutory arguments require some rather strained statutory construction, therefore, the Court properly rejected them. The majority could have found additional support for its position in the regulations, but apparently because the validity of the regulations was not put in issue, the Court did not consider their effect on the question.

2. Policy and Legislative History

Although the government presented a strong statutory case, Foster Lumber effectively supported its position with policy arguments. The company argued that both section 172 and section 1201 confer benefits on the taxpayer and that when two ameliorative Code provisions conflict, the statute should not be read in such a way that the benefit of one of the provisions is denied. Unfortunately, as discussed above, Foster Lumber's asserted result would have required a rather strained construction of the statute.

Three policy and legislative history arguments were presented to the Court. First, Foster Lumber contended that the government's construction of section 172 would frustrate the policy behind loss carrybacks. Second, the history of carryback legislation from 1924 to 1934 showed

than the Chartier holding. The regulation had been in force since 1956, see note 87 supra, Chartier was not affirmed until 1970. Congress probably viewed Chartier as an aberration and, consequently, took no action to correct it. It was not until 1974 that two other circuits adopted Chartier. See note 47 supra and accompanying text. Thus, when Foster Lumber came before the Supreme Court in 1975, if there was any inference to be drawn from congressional inaction, it would seem to be the approval of a nineteen-year-old regulation rather than approval of two cases, one six years old and the other two years old.

90 An excellent article which analyzes the statute and adopts the Court's construction is May, Net Operating Losses and Capital Gains — A Deceptive Combination, 29 TAX LAW. 121, 129-33 (1975).

91 The appellate decision did not mention them, see Foster Lumber Co. v. United States, 500 F.2d 1230 (8th Cir. 1974), and in its brief for the Supreme Court, Foster Lumber did not discuss them. See Brief for Respondent, Foster Lumber Co. v. United States, 429 U.S. 32 (1976).


93 A substantial portion of Foster Lumber's brief was devoted to a discussion of the policy behind sections 1201 and 172 and to how Foster Lumber's interpretation of section 172 best reflected those policies. Brief for Respondent at 12-26. The dissent in Foster Lumber addressed some of the policy arguments. See text accompanying notes 121-23 infra.
that Congress in the past legislatively dictated the result adopted in Mutual Assurance and rejected in Chartier. Third, the construction advanced by Foster Lumber may confer a greater benefit than either section 172 or section 1201 alone, and therefore may be unreasonable.

Foster Lumber’s main policy argument, and a very effective one, was that the government’s construction of section 172(b)(2) frustrated the policy behind loss carrybacks. The chart below illustrates this point:

<table>
<thead>
<tr>
<th>Year Ended</th>
<th>Ordinary Income</th>
<th>Capital Gain</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>(Loss)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1966</td>
<td>$7,000</td>
<td>$167,000*</td>
<td>$174,000</td>
</tr>
<tr>
<td>1967</td>
<td>114,000*</td>
<td>115,000*</td>
<td>229,000</td>
</tr>
<tr>
<td>1968</td>
<td>(42,000)</td>
<td>-782,000*</td>
<td>(42,000)</td>
</tr>
<tr>
<td>Total</td>
<td>$79,000</td>
<td>$282,000</td>
<td>$361,000</td>
</tr>
</tbody>
</table>

Under the government’s statutory construction, the 1968 loss of $42,000 would be carried back to offset in full the 1966 ordinary income of $7,000; none of the loss would survive for use in years subsequent to 1966. If that construction is correct, no tax would be paid on the 1968 activities since that was a loss year; also no tax would be paid on the 1966 ordinary income since that amount had been fully offset by the 1968 carryback. Thus, after the government’s carryback, tax would be levied on the 1967 activities and on the 1966 capital gains (those items marked with asterisks). The income subject to tax would be $396,000. As the total column shows, however, Foster Lumber’s total income during this period was only $361,000. The difference is $35,000 of the 1968 loss that the government asserted was utilized in 1966.

Foster Lumber’s policy argument was patent. If the purpose behind loss carryovers is to ameliorate the sometimes arbitrary effects of annual accounting periods, why, when only $7,000 of the 1968 loss was used to offset income in 1966, should not the remaining $35,000 of 1968 loss have survived for use in subsequent years? If Foster Lumber’s construction of section 172 had been accepted, the remaining $35,000 of 1968 loss carryback could have been used to offset 1967 ordinary income, and Foster Lumber would have been taxed on only $361,000, its total income for the three years. This approach would have effectively implemented the policy behind loss carrybacks. Foster Lumber would have paid tax based upon its total income for the three years, irrespective of the pattern of those earnings within the three-year period.

The rebuttal to the argument that $35,000 of the 1968 carryback should have been applied to 1967 ordinary income is that Foster Lumber enjoyed the benefit of the 1968 carryback even though it did not

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94 See text accompanying notes 5-7 supra.
95 See Brief for Respondent at 10, United States v. Foster Lumber Co., 429 U.S. 32 (1976). The figures in this chart were rounded to the nearest thousand dollars.
96 Recall that the carryback cannot be offset against either year’s capital gains. Weil v. Commissioner, 229 F.2d 593 (8th Cir. 1956).
97 This figure represents the company’s capital gains from 1966 and 1967 and $79,000 of ordinary income from 1967.
survive for use subsequent to 1966. Because of the relatively large capital gains in 1966, Foster Lumber’s tax was computed under the alternative method, which accords favorable treatment to corporate taxpayers with large capital gains. The regular method yields a larger tax in this situation and, under the provisions of the Code, would not be used. The government argued that Foster Lumber had enjoyed the benefit of the carryback because it served to reduce the tax under the regular method. This argument is rather weak, however. One would have a difficult task convincing Foster Lumber, or any other taxpayer, that it enjoyed the benefit of its 1968 carryback because the carryback served to reduce the 1966 regular tax, when the 1966 tax liability was computed under the lower alternative method, not the regular method. Rather than asserting that Foster Lumber enjoyed the benefit of a carryback which did not affect its tax liability, the government should have formulated the issue in policy terms: Should the taxpayer enjoy the benefit of having a loss carryback survive for use in subsequent years when the tax on the year to which the loss was first carried was based on the ameliorative alternative method? Unfortunately, the majority did not address this policy question, rather, the majority relied on the bare language of the section 172.

In examining the history of carryback legislation, the Court appropriately noted that Congress had often permitted the “wasting” of net operating losses and, therefore, that Foster Lumber’s argument against such waste was not persuasive without further support. Although Foster Lumber raised the issue, the Court did not discuss the history of carryback legislation from 1924 to 1934. In Mutual Assurance, the Fourth Circuit was impressed with the fact that from 1924 to 1934 the Code specifically provided for the result reached by the Chartier court. When the Code was amended in 1934, Congress enacted the predecessor to the current section 172. The Mutual Assurance court interpreted this action to mean that Congress specifically rejected the result later adopted by the Chartier court; in other words, when Congress amended the Code, it was specifically rejecting prior law. What the Fourth Circuit failed to recognize, and what the Court in Foster Lumber did not discuss, was the fact that the legislation in question expressly allowed loss carrybacks in excess of ordinary income to be offset against capital gains. The problem treated by this legis-

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98 See I.R.C. § 1201.
99 The dissent did discuss this issue, however. See text accompanying notes 121-23 infra.
100 429 U.S. at 43-46.
101 Foster Lumber advanced several arguments based upon the legislation in effect during this period. Brief for Respondent at 39-42. Surprisingly, the dissent also failed to address this issue. See 429 U.S. at 49-59.
102 Mutual Assurance Soc’y Corp. v. Commissioner, 505 F.2d 128, 136-38 (4th Cir. 1974); see text accompanying notes 59-60 supra.
103 505 F.2d at 138.
lation was very different from that before the Fourth Circuit in Mutual Assurance. In the discussion of Chartier in this Case Comment, it was noted that there were two questions before the Tax Court in that case. First, could Chartier offset its loss carrybacks against capital gains? The Chartier court held that the carryback could not be used to offset capital gains. The Tax Court then asked whether any part of the carryback in excess of ordinary income survived for use in subsequent years, since it could not be used to offset capital gains in the earliest carryback year. It was this second question that was important in Chartier, and only the second question was before the courts in Mutual Assurance and Foster Lumber.

The Fourth Circuit in Mutual Assurance mistakenly attempted to draw some negative inference from the fact that Congress, at one time, had specifically allowed loss carrybacks to be offset against capital gains, but later disallowed such offsets. This history dealt only with the first question discussed above. As long as that question (whether loss carrybacks could be offset against capital gains) was answered affirmatively by section 172, there was no need to proceed to the second question; the carryback was fully utilized through a reduction of capital gains, and there was no question of survival for use in subsequent years. The fact that Congress subsequently amended the statute to answer the first question in the negative sheds no light on congressional intentions concerning the second question (whether any part of the carryback survived for use in later years). It strains implication to say that simply because Congress amended the Code to remove a provision that allowed carrybacks to be offset against capital gains, it also intended to prohibit the survival of those carrybacks for use in subsequent years. On its face, the Code in effect from 1924 to 1934 appeared more liberal than the result reached by Chartier. Under the old Code, the taxpayer enjoyed the benefit of the loss carryback in the earliest carryback year; the loss could be offset against the capital gains of that earliest year, a result prohibited under the post-1934 Code by Weil. See note infra. As a practical matter, however, Chartier was more liberal than the old Code. While Chartier would not allow the loss to be offset against capital gains in the earliest carryback year, it did allow the loss to survive for use in a subsequent year, a year in which the loss could be offset against ordinary income. The taxpayer would prefer this treatment. Rather than use the loss to offset capital gains income, which is taxed at 30 percent, the taxpayer would much rather offset ordinary income, which is taxed at 48 percent. So while the old Code appeared more generous on its face, Chartier reached a result the taxpayer would prefer in most situations. See May, Net Operating Losses and Capital Gains — A Deceptive Combination, 29 Tax Law. 121, 136-38 (1975).

The text notes that under the old Code, the second question was never reached because the loss could be offset in full against the capital gains of the earliest carryback year. If, however, the loss exceeded both the ordinary income and the capital gains of that earliest year, the survival question arose. There were no cases on point, but it appears that the language of the old Code was broad enough to allow the loss in excess of ordinary income and capital gains to survive for use in a later year. See Act of June 2, 1924, Pub. L. No. 68-176, 43 Stat. 260. It is clear that under the present Code, any loss in excess of both ordinary income and capital gains would survive for use in later years. See text accompanying notes 72-74 supra.

Although the statute was amended in 1934, the fact that the carryback could not be offset against capital gains probably was not clear until 1956. See Weil v. Commissioner, 229 F.2d 593 (6th Cir. 1956).
more likely that when Congress repealed the provision allowing for
carrybacks to be offset against capital gains, it was unaware that it
was creating a second question about whether those carrybacks in ex-
cess of ordinary income could survive for use in subsequent years.

Foster Lumber's third policy argument concerned how two ameliora-
tive provisions of the Code, sections 172 and 1201, should be con-
strued when they conflict. It is important to make several distinctions
at this point. First, the taxpayer must compute the amount of its
net operating loss. The Code is quite specific in its provisions on
the computation of the loss, and it is clear that under section 172(c),
only the loss in excess of both ordinary income and capital gains is
available for carry to another year. The amount of the loss itself must
be distinguished from the amount of loss to be carried to another year.
After computing the amount of the loss, the taxpayer then computes
the amount of loss that can be carried from the loss year to another
year. This procedure is controlled by the now-familiar section 172(b).
Finally, after carrying the loss to another year, the Code gives specific
directions on how to deduct the carryback from the income of prior
years.

One commentator has suggested that the result adopted by Chartier
and urged by Foster Lumber creates "superdeductions." The argu-
ment is worthy of consideration. Suppose a taxpayer suffers an ordinary
loss of $6,000 in 1966, and capital gains of $1,000,000. The taxpayer
would pay its tax based on the lower alternative method; the $6,000
loss would not be offset against the capital gains nor would it be
available to carry to another year. Thus, the $6,000 loss is "wasted;
" it serves to offset the taxable income of neither the current
year nor any other year. Suppose also that in a later year, 1969, the
taxpayer incurs a $10,000 net operating loss which it carries back to

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108 Reference to the chart in the text following note 22 supra may prove help-
ful. The distinctions are discussed in Pomeroy, What is a Net Operating Loss?, 14 W.
Res. L. Rev. 233, 233 (1963). For illustrations of the operation of loss carryovers, see
219, 254 n.208 (1976); Note, Foster Lumber: Scratching the Surface of the Problem, 1 J.
Corp. L. 164 (1975).

109 This computation is controlled by I.R.C. § 172(c).

110 See I.R.C. § 172(c).

112 I.R.C. § 172(a).

112 May, Net Operating Losses and Capital Gains — A Deceptive Combination, 29
Tax Law. 121, 133-36 (1975). See also Branda, Net Operating Losses and Capital Gains
— Some Bizarre Consequences of the Alternative Tax Computation, 28 Tax Law. 455
(1975); 8 SAN DIEGo L. Rev. 442 (1971).

113 The alternative tax would be 30 percent of the capital gain, irrespective of the
ordinary loss. See I.R.C. § 1201(a). With such a large capital gain, the 30 percent rate
under the alternative method would produce a lower tax than would the 48 percent rate
under the regular method. Compare I.R.C. § 11(b) with id. § 1201(a).

114 No carryover would be available since deductions cannot exceed gross income in this
fact pattern in which there is an ordinary loss of $6,000 but capital gains of $1,000,000.
See I.R.C. § 172(c).

115 Since it cannot be offset against capital gain.

116 The $6,000 also cannot be carried to another year. Note 114 supra.
Although Chartier did not deal with this situation specifically, presumably, the Chartier court would hold that the $10,000 carryback from 1969 survived for use in a year subsequent to 1966 because the carryback did not affect the 1966 tax liability. This carryback survival creates the "superdeduction." The $6,000 ordinary loss had no effect on the 1966 tax liability because it did not offset that year's capital gains. Yet, the $10,000 loss carried to 1966 would be allowed by Chartier to survive for use in subsequent years because it had no effect on the 1966 liability. If an ordinary loss incurred in 1966 had no effect on 1966 liability and could not be carried to another year, why should a loss incurred in 1969, which then carried to 1966 not affect liability for that year, be permitted to survive for use in a year subsequent to 1966? Under the Chartier theory, the loss from 1969 is allowed to be carried from year to year until it is used, while the 1966 loss is forever "wasted." Thus, more favorable treatment is accorded to carryback losses than to those incurred in the carryback year.

The argument is persuasive and it was one only alluded to by the Foster Lumber majority. It shows that a logical extension of the argument presented by Foster Lumber can lead to unreasonable results that were probably not intended by Congress.

C. The Dissent

The dissenters in Foster Lumber seem to have been impressed by the unfairness of the majority decision and by Foster Lumber's various policy arguments. They pointed out that both the carryback and capital gains provisions favored the taxpayer, but that the majority decision favored the government. Unfortunately, the dissent did not engage in a detailed analysis of the statute, but rather, pointed to the long list

117 The situation is illustrated below. Asterisks indicate figures irrelevant to the hypothetical.

<table>
<thead>
<tr>
<th>Ordinary Income (Loss)</th>
<th>1966</th>
<th>1967</th>
<th>1968</th>
<th>1969</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital Gains</td>
<td>$6,000</td>
<td>*</td>
<td>*</td>
<td>*</td>
</tr>
<tr>
<td>Total Taxable Income (Loss)</td>
<td>$994,000</td>
<td>*</td>
<td>*</td>
<td>$(10,000)</td>
</tr>
</tbody>
</table>

118 In Chartier, the portion of the carryback in excess of ordinary income was allowed to be carried to subsequent years. See text accompanying notes 22-38 supra. One of the court's primary reasons for allowing the use in subsequent years was the fact that the carryback in excess of ordinary income did not affect the tax liability of the earliest carryback year. In the hypothetical above, the carryback would not affect the tax liability because the loss could not be offset against the capital gains and because no ordinary income remained to be offset due to the ordinary loss incurred in 1966. See May, Net Operating Losses and Capital Gains — A Deceptive Combination, 29 Tax Law. 121, 135-36 (1975); 8 San Diego L. Rev. 442 (1971).

119 429 U.S. at 47-48.

120 This argument is an extension of, and effectively rebuts, Foster Lumber's argument presented in the text accompanying notes 94-99 supra.

121 The dissenting opinion in Foster Lumber was authored by Justice Blackmun; Chief Justice Burger, Justice Brennan, and Justice Powell joined. 429 U.S. at 49.

122 Id. at 50-51.
of decisions that supported the taxpayer’s position. While the unfairness of the decision may seem apparent, there are two things the dissent failed to develop. First, nearly all of the decisions cited merely rubber-stamped Chartier instead of engaging in any independent analysis. Because of this fact, their precedential value is weak. Second, as the majority so carefully developed, the statute simply does not support the result urged by Foster Lumber.

The dissent dismissed the analysis of section 172(d)(2)(B) as irrelevant because that section deals with noncorporate taxpayers while Foster Lumber was a corporate taxpayer. The dissent is correct in its assertion that section 172(d)(2)(B) has no independent significance in this case, as was also noted by the majority. Its significance lies not in the section itself, but with its relation to section 172(b)(2). As developed earlier, if the Chartier theory were followed, section 172(d)(2)(B) would be rendered superfluous. Therein lies its importance. Any construction of section 172(b)(2) that renders section 172(d)(2)(B) superfluous should be closely scrutinized.

Finally, the dissent urged that section 172(c) is irrelevant, since it deals with the loss year, which was not in question in Foster Lumber. This proposition again misses the mark. The dissent is correct in that section 172(c) has no independent significance; its importance lies only in its relation to the carryback year. The section illustrates that Congress often treats loss years differently from carryback years and that Congress often permits the “wasting” of losses.

III. CONCLUSION

Based upon the statute standing alone, the Court quite accurately found for the government. Foster Lumber’s statutory arguments required a strained reading; reference to related statutory provisions seems to imply that the government’s interpretation is correct. The Court supported its decision with detailed statutory analysis, although it did appear to be somewhat confused by section 172(d)(2)(B). The majority, however, did not draw upon the regulations, which also support the decision.

Foster Lumber was able to present two strong policy arguments. One was that when Congress has enacted two ameliorative tax provisions, they should not be construed to deny the benefit of one of them when there is a conflict. While the argument makes sense as a general

\[^{123}\text{Id. at 54-56.}\]
\[^{124}\text{Id. at 58.}\]
\[^{125}\text{Id. at 48 n.18.}\]
\[^{126}\text{See text accompanying notes 80-83 supra.}\]
\[^{127}\text{429 U.S. at 58.}\]
\[^{128}\text{See id. at 46-48; see also text accompanying notes 108-20 supra.}\]

Justice Stevens wrote a somewhat confusing one paragraph concurrence which seems to be based on the arguments presented in the text accompanying notes 108-20 supra. He noted that he would have liked to have adopted the dissent’s result but could find no statutory basis enabling him to do so. 429 U.S. at 48-49.

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FOSTER LUMBER CO.

proposition, its implementation in this case would require such strained statutory reading that it would be difficult to justify. The second policy argument demonstrated the unfairness of the majority decision. However, a logical extension of Foster Lumber's reasoning shows that the interpretation advanced would create a "superdeduction" not contemplated by Congress. Thus, while at the outset Foster Lumber's position would appear to stand on firm policy ground, it is unworkable in its logical conclusion and probably not correct. Unfortunately, the Court did not develop the argument to its logical conclusion or use it to support the decision.

Considering policy factors, legislative history, and the Code itself, the Foster Lumber decision appears to be correct. Why, then, was the decision so close — four for affirmance, one concurring, and four dissenting? The answer seems to rest with the proposition that when two ameliorative provisions of the Code conflict, the taxpayer should not be denied the benefit of one of them. Since the statute, policy, and legislative history all support the government, however, the only remaining hope for clarification and relief appears to rest with Congress, not the courts.

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