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RECENT DEVELOPMENTS

Net Operating Loss Sustained by Taxpayer Prior to Marriage Cannot Be Applied Subsequently Against Spouse's Income— *Calvin v. United States**

Prior to marriage, plaintiff-wife sustained net operating losses which she was entitled to carry over under section 172 of the Internal Revenue Code.¹ For the year 1959, the plaintiffs filed a joint return in which they applied the wife's net operating loss carryover deduction to both of their incomes. The Commissioner allowed the loss carryover to be applied to the wife's but not to the husband's income. In a suit for refund of taxes withheld from the husband's wages, *held*, judgment for defendant. If a husband and wife elect to file a joint return, net operating losses sustained by the wife prior to marriage may be applied against her subsequent income but not against the income of her husband.

Since 1919, married taxpayers have enjoyed the privilege of filing either joint or separate returns.² According to section 1.6013-4(b) of the treasury regulations, if a married couple elects to file a joint return the couple's tax liability is computed upon aggregate income and aggregate deductions, although each spouse is a separate taxpayer.³ Thus, if a joint return is filed, aggregate income may be used in computing the maximum charitable gift deduction,⁴ and capital losses sustained by one spouse may be used to offset capital gains realized by the other in the same year.⁵ With respect to net operating loss carryovers, section 1.172-7(b) of the regulations makes it clear that if a taxpayer is entitled to carry over a net operating loss that was sustained during marriage but during a year for which separate returns were filed, that carryover may be applied against the income of both spouses provided a joint return is filed in the year to which

* 235 F. Supp. 594 (D. Colo. 1964).

1. INT. REV. CODE OF 1954, § 172. For a general discussion of the section, see Pomeroy, *What Is a Net Operating Loss?*, 14 W. RES. L. REV. 233 (1963).

2. Revenue Act of 1918, ch. 18, § 223, 40 Stat. 1074. Presently, the privilege of electing to file a joint return is found in INT. REV. CODE OF 1954, § 6013.

3. Treas. Reg. § 1.6013-4(b) (1959). "If a joint return is made, the gross income and adjusted gross income of husband and wife on the joint return are computed in an aggregate amount and the deductions allowed and the taxable income are likewise computed on an aggregate basis. . . . Although there are two taxpayers on a joint return, there is only one taxable income."

The right to aggregate has always been a part of the joint return privilege. See Sol. Op. 90, 4 CUM. BULL. 236 (1921). "In cases, therefore, in which the husband or wife has allowable deductions in excess of his or her gross income, such excess may, if joint return is filed, be deducted from the net income of the other for the purpose of computing both the normal and surtax."

4. See *Taft v. Helvering*, 311 U.S. 195 (1940).

5. *Helvering v. Janney*, 311 U.S. 189 (1940).

the loss is carried.⁶ However, if, as in *Calvin*, the loss is sustained prior to the marriage, the regulations are ambiguous and case law is nonexistent.

Considering the scope of the joint return privilege and the import of section 1.172-7(b) of the regulations, it seems that the principal case should have been decided for the taxpayers. Regardless of whether the loss was sustained before marriage or during marriage but in a year in which separate returns were filed, the taxpayers would not be entitled to joint return privileges at that time because separate returns were filed. The two situations differ only in that the right to elect to file jointly was not available to the taxpayers in *Calvin* because they were not then married, whereas the election was available though not exercised in the other situation which is clearly approved by the regulation. In both situations, however, in the year to which the loss was carried, the wife was entitled to a deduction and the taxpayers did elect to file a joint return. Since the joint return privilege permits computation of tax liability upon aggregate income and deductions,⁷ once the wife established a valid loss carryover deduction for a year in which a joint return was filed, the availability of the deduction to her, coupled with the election to file jointly, should have permitted the taxpayers to aggregate.⁸ Indeed, section 1.172-7(b) of the regulations can easily be interpreted to permit a joint deduction in the *Calvin* situation; the only distinction between *Calvin* and the case in which a deduction is clearly permitted by the regulation—the availability of the right to elect to file jointly in the year the loss was sustained—is immaterial in determining the scope of the joint return privilege in the subsequent year.⁹

In support of its position, the *Calvin* court advanced several unconvincing arguments. The court felt that the taxpayers' position was weakened by congressional curtailment of an extension of joint

6. Treas. Reg. § 1.172-7(b) (1956): "If a husband and wife, making a joint return for any taxable year, did not make a joint return for any of the taxable years involved in the computation of a net operating loss carryover or a net operating loss carryback to the taxable year for which the joint return is made, such separate net operating loss carryover or separate net operating loss carryback is a joint net operating loss carryover or joint net operating loss carryback to such taxable year."

In a community property state, where a taxpayer and his second wife sought to carry over a net operating loss sustained by the taxpayer and his first wife in a previous joint return year, the Internal Revenue Service denied this deduction, ruling that the regulations contemplate the existence of the same husband and wife for all taxable years involved. Rev. Rul. 60-216, 1960-1 CUM. BULL. 126.

7. See note 3 *supra* and accompanying text.

8. Cf. *Van Vleck v. Commissioner*, 80 F.2d 217, 218 (2d Cir. 1935) (dictum), *cert. denied*, 298 U.S. 656 (1936).

9. The crucial point in the regulation is that a loss deduction of one spouse may be carried from a separate return year into a joint return year. The regulation makes no mention of whether the taxpayers were married and had the right to elect to file a joint return in the year in which the loss was sustained. See Treas. Reg. § 1.172-7(b) (1956).

return benefits to premarital years.¹⁰ Typifying the attempted extension which provoked congressional action was *McClure v. United States*.¹¹ In *McClure* a married taxpayer received in a single year more than eighty per cent of the compensation he earned for services performed over a twenty-year period, and he was entitled to treat the income as if he had received it ratably during the twenty-year period.¹² The Court of Appeals for the Fourth Circuit held that the taxpayer and his wife were entitled to split the compensation not only for the years in which joint returns were filed but for premarital separate return years as well. Shortly before the *McClure* decision but after the facts giving rise to *McClure* had occurred, Congress amended the Code to limit income splitting to that portion of the spread back income which is treated as if it had been earned in a joint return year.¹³ Although Congress thereby prevented the extension of joint return benefits to premarital years in future situations similar to *McClure*, it does not follow that the *Calvin* case should have been decided for the Commissioner. In the *McClure* situation compensation was received in a joint return year but it was spread back and was treated as if it were received in a premarital year. Thus, splitting for the full period of the spread back would extend joint return privileges to premarital separate return years. The situation is quite different in *Calvin*. Although the loss was sustained prior to marriage, the carryover provision permits the loss to be treated as if it were sustained in a joint return year. Therefore, even if the taxpayers' position had been sustained in *Calvin*, benefits would not have been extended to a premarital year. The real issue in *Calvin* was whether joint return privileges should have been limited in a joint return year, not whether they should have been extended to a premarital year.

The *Calvin* court also relied upon the general rule enunciated in *New Colonial Ice Co. v. Helvering*¹⁴ and *Libson Shops, Inc. v. Koehler*¹⁵ that the benefit of a net operating loss carryover must inure only to the taxpayer who sustains the loss.¹⁶ In *New Colonial* the Court held that a new corporation, organized to take over the business of another corporation, could not deduct losses sustained by its predecessor. In *Libson Shops* seventeen corporations merged and the

10. *Calvin v. United States*, 235 F. Supp. 594, 598 (D. Colo. 1964).

11. 228 F.2d 322 (4th Cir. 1955).

12. See Int. Rev. Code of 1939, § 107(a), ch. 247, § 220(a), 53 Stat. 878 (1939), as amended, ch. 619, § 139(a), 56 Stat. 837 (1942).

13. Int. Rev. Code of 1954, ch. 736, § 1307(c), 68A Stat. 336 (1954). This provision was eliminated in 1964 when the spread back provision was replaced by the new income averaging provisions, INT. REV. CODE OF 1954, §§ 1301-04.

14. 292 U.S. 435 (1934).

15. 353 U.S. 382 (1957).

16. See *Calvin v. United States*, 235 F. Supp. 594, 596 (D. Colo. 1964).

surviving corporation was not permitted to deduct pre-merger losses sustained by three of the affiliated corporations.¹⁷

The *Calvin* court's heavy reliance upon *New Colonial* and *Libson Shops* was not well founded. Mergers, reorganizations, and sales of corporations with net operating loss carryovers may be motivated by a desire to avoid taxes, and from a policy standpoint it is desirable to prevent abusive use of loss corporations. However, similar considerations are not applicable in the principal case because it is quite unlikely that decisions to marry will be influenced by tax considerations.¹⁸

In addition, *Libson Shops* and *New Colonial* may be of limited value as precedent because those cases were governed by the Internal Revenue Code of 1939 and the Revenue Act of 1921, respectively. The net operating loss carryover provision in both the Revenue Act of 1921 and the 1939 Code made specific reference to "the taxpayer." Illustratively, section 204(b) of the Revenue Act of 1921 provided: "If for any taxable year . . . it appears . . . that any taxpayer has sustained a net loss, the amount thereof shall be deducted from the net income of the taxpayer for the succeeding taxable year . . ."¹⁹ On the other hand, section 172(a) of the 1954 Code does not refer directly to "the taxpayer." It merely provides that, "there shall be allowed as a deduction for the taxable year an amount equal to the aggregate of (1) the net operating loss carryovers to such year, plus (2) the net operating loss carrybacks to such year."²⁰ Since the 1954 Code provision no longer emphasizes loss to "the taxpayer" and deduction by "the taxpayer," arguably the general rule set forth in *Libson Shops* and *New Colonial* has lost its vitality.

Furthermore, the value of both *Libson Shops* and *New Colonial* as precedent and their use as a viable analogy is questionable because the incorporation of sections 381 and 382 into the Code in 1954²¹ indicates a departure from the rule of those cases.²² Although section 382 limits carryovers when changes are made in ownership and busi-

17. In *Libson Shops*, the deduction was denied primarily because the subsequent consolidated income was not derived from the operation of substantially the same business that produced the loss. The Court indicated that only to the extent that there is a continuity of enterprise is the "same taxpayer" involved. *Libson Shops v. Koehler*, 353 U.S. 382, 386 (1957).

18. See *Calvin v. United States*, 235 F. Supp. 594, 597 (1964); Oldman & Temple, *Comparative Analysis of the Taxation of Married Persons*, 12 STAN. L. REV. 585, 602 (1960).

19. Revenue Act of 1921, ch. 136, § 204(b), 42 Stat. 231 (1921). (Emphasis added.) Similar language was found in the Int. Rev. Code of 1939, § 122(b), as amended, ch. 619, § 153(a), 56 Stat. 847 (1942): "If for any taxable year . . . the taxpayer has a net operating loss. . . ." (Emphasis added.)

20. INT. REV. CODE OF 1954, § 172(a).

21. INT. REV. CODE OF 1954, §§ 381, 382. For a discussion of these provisions, see generally N.Y.U. 21ST INST. ON FED. TAX. 1247 (1963).

22. See Rev. Rul. 58-603, 1958-2 CUM. BULL. 147; Levine and Petta, *Libson Shops—A Study in Semantics*, 36 TAXES 445 (1958); 43 IOWA L. REV. 669 (1958).

ness activity, section 381 permits a corporation which acquires the assets of a loss corporation to benefit from the net operating loss carryover of the transferor²³ when certain types of transactions are involved.²⁴

The *Calvin* court also relied upon the similarity between affiliated corporations filing a consolidated return²⁵ and spouses filing a joint return.²⁶ The court admitted that its analogy was imperfect, but it felt that at least an arguable parallel existed.²⁷ Upon careful consideration, however, it is clear that the joint return privilege is more extensive than the privilege of filing a consolidated return²⁸ and that the analogy provides no support for the court's position. Pre-affiliation corporate losses cannot subsequently be applied against post-affiliation income earned by other corporations in the affiliated group.²⁹ In addition, however, losses sustained during affiliation but in a year in which separate returns are filed may not be applied against subsequent income of other group members in a year in which a consolidated return is filed.³⁰ And, since the corporate loss carryover may not be applied against the income of another member of the affiliated group even in this situation, which is analogous to a joint return situation clearly approved by section 1.172-7(b) of the regulations, failure to permit pre-affiliation corporate losses to be applied against the income of other members of the affiliated group in a consolidated return year does not support persuasively the contention that the deduction should have been denied in *Calvin*.

The arguments put forth by the *Calvin* court in support of its decision are weak and unconvincing. On the other hand, although not supported by policy arguments or a strong line of authority, the taxpayers' position does rise considerably above a mere refutation of the court's reasoning. In the year in which the taxpayers elected the privilege of a joint return, the wife had a legitimate deduction. Since the joint return privilege permits aggregation of income and deductions and since section 1.172-7(b) of the regulations can easily be interpreted to allow the deduction, it seems that the taxpayers should have prevailed.

23. In addition to the net operating loss carryover, a number of other items may be carried over subject to certain conditions and limitations. INT. REV. CODE OF 1954, § 381(c).

24. Qualifying transactions are enumerated in INT. REV. CODE OF 1954, § 381(a).

25. Consolidated returns are dealt with in INT. REV. CODE OF 1954, §§ 1501-05.

26. See *Calvin v. United States*, 235 F. Supp. 594, 597 (D. Colo. 1964).

27. *Ibid.*

28. For example, each year a married couple has the right to elect to file joint or separate returns, INT. REV. CODE OF 1954, § 6013(a); O.D. 968, 5 CUM. BULL. 195 (1921), but once an affiliated group elects to file a consolidated return, it is bound by that election, Treas. Reg. § 1.1502-11(a) (1955). In addition, prior to 1964 there was a two per cent surtax penalty on affiliated groups for utilizing the consolidated return, Int. Rev. Code of 1954, § 1503(a), ch. 736, 68A Stat. 367 (1954).

29. See *Woolford Realty Co. v. Rose*, 286 U.S. 319 (1932).

30. See Treas. Reg. § 1.1502-31(a)(3) (1955), as amended, T.D. 6674, 1963-2 CUM. BULL. 392.