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Roberta Romano
Yale Law School

Mark Campisano

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RECOUPING LOSSES: THE CASE FOR FULL LOSS OFFSETS

Mark Campisano*
Roberta Romano**

All too frequently today, American businesses lose money. Under the current tax laws, a loss, by itself, has little or no significance: Unless the loss can offset other income, it goes unnoticed by the Internal Revenue Code. Our thesis is that this state of affairs is highly inequitable and distorts investment decisions. We propose instead that business losses give rise to tax refunds, paid out to corporations in an exact reversal of the process by which profitable corporations now pay their taxes. This proposal for recoupment of losses may at first glance appear quite novel, but it was suggested over thirty years ago by the United States Tax Court in Alprosa Watch,¹ and proposals endorsing recoupment have persisted,² despite vigorous criticism.³ We believe

* Law Clerk to the Honorable William J. Brennan, Jr., Associate Justice, United States Supreme Court.
** Assistant Professor of Law, Stanford Law School.

We have been greatly influenced by the views of our teacher, Marvin Chirelstein, who is the source of much of what is of interest in this article. We are also indebted to many individuals whose insights deepened our understanding of the issues. In particular we would like to thank Wayne Barnett, Henry Hansmann, Saul Levmore, Mitch Polinsky, Jeff Strnad, Alvin Warren, and Mike Woodford.

¹ Alprosa Watch Corp. v. Comm'r, 11 T.C. 240 (1948).
² See, e.g., Bravenec & Fraser, A Net Operating Loss Refundable Credit, 70 PROC. NAT'L TAX A.-TAX INST. AM. 360 (1977); Tarleau, Difficulties Faced by Taxpayer Trying to Take Tax Advantage of a Loss Carryover, 4 J. TAX. 91 (1956).
³ Much of this criticism focused on the need to prevent trafficking in loss corporations. See, e.g., Libson Shops, Inc. v. Koehler, 353 U.S. 382, 386-88 (1957) (establishing continuity-of-business rule, although Court indicated it was not ruling on situation presented in Alprosa Watch); S. REP. No. 1622, 83d Cong., 2d Sess. 52, reprinted in [1954] U.S. CODE CONG. & AD. NEWS 4621,
that upon closer examination, a compelling case can be made for preferring recoupment to the current loss deduction regime.

Under the current treatment of business operating losses, Internal Revenue Code section 172, taxpayers may deduct their net operating losses over an eighteen-year time span: Losses may be carried back three tax years before the year of the loss and forward fifteen tax years.\(^4\) The availability of loss carryovers in the context of business combinations and reorganizations is further restricted by three other Code sections: section 269 prohibits a carryover if the principal purpose of the acquisition was to avoid federal income taxes;\(^5\) section 381 restricts carryovers to only certain forms of tax-free corporate reorganizations and liquidations;\(^6\) and section 382 limits use of the carryover to corporations having a specified minimum level of continuity of stock ownership.\(^7\)

The present statutory scheme is usually supported by a rationale based on the concept of income averaging: that is, the idea that taxpayers whose incomes fluctuate from year to year should receive tax treatment equivalent to those with stable incomes.\(^8\) But we contend that the

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\(^{5}\) I.R.C. § 269 is a general provision allowing the Internal Revenue Service to deny the tax benefit of any deduction, credit, or other allowance, if the principal purpose of a corporate acquisition was to avoid taxes.

\(^{6}\) I.R.C. § 381 allows the carryover of corporate tax attributes, including net operating losses, to “A”, “C”, “D”, and “F” reorganizations as defined by I.R.C. § 368, see I.R.C. § 381(a)(2), and to subsidiary liquidations qualifying under I.R.C. § 332, in which the parent’s basis in the property received is the same as it was in the hands of the subsidiary, see I.R.C. § 381(a)(1).

\(^{7}\) Before the Tax Reform Act of 1976, I.R.C. § 382 also included a continuity-of-business requirement. The requirement has not yet been eliminated, as the effective date of the new section 382 has been delayed. See Tax Reform Act of 1976, Pub. L. No. 94-455, § 806(g)(2)-(3), 90 Stat. 1605 (1976), as amended by Revenue Act of 1978, Pub. L. No. 95-600, § 368, 92 Stat. 2857 (1978) and Act of Dec. 29, 1979, Pub. L. No. 96-167, § 9(e), 93 Stat. 1279 (delaying effective date of 1976 amendment to 1982). Indeed, the reform itself is unpopular, and has become the object of so many proposals for change that it may never become effective. For a comparison of the “old” and “new” section 382, see B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶¶ 16.22, 16.24 (4th ed. 1979).

\(^{8}\) See, e.g., AMERICAN LAW INSTITUTE, FEDERAL INCOME, ESTATE AND GIFT TAX PROJECT: INCOME TAX PROBLEMS OF CORPORATIONS AND SHAREHOLDERS 40 (1958) (1954 Code carryover provision as “step in the direction of averaging,” taken in a situation where the lack of averaging for a corporation is most serious) [hereinafter cited as 1958 INCOME TAX PROJECT]; id. at 41 (benefit of carryback as averaging factor); U.S. TREASURY DEP’T & JOINT COMM. ON INTERNAL REVENUE TAXATION, BUSINESS LOSS OFFSETS (1947), reprinted in B. BITTKER & L. STONE, FEDERAL INCOME, ESTATE, AND GIFT TAXATION 859, 859 (4th ed. 1972) (purpose of business-loss offsets to prevent discrimination against owners of firms with fluctuating incomes as compared to
policy underlying the compensation of taxpayers for net operating losses should instead be based on the concept of recoupment: that is, the full recovery of the tax value of a net operating loss. Under a policy of recoupment, all taxpayers sustaining net operating losses would be entitled to receive a refund from the United States Treasury Department for those losses. Such a system, like income averaging, would eliminate the unfairness intrinsic in an annual tax accounting system, by providing refunds on losses in the tax year of the loss. At the same time, however, recoupment would not discriminate in favor of some firms and against others—as does the current averaging system through its varying restrictions on loss deductibility. Moreover, because some firms can file consolidated returns, or simply diversify, a patchwork system of recoupment already exists sub rosa. Explicit adoption of the recoupment ideal would extend to all taxpayers the tax benefits now accruing only to established, diversified corporations and affiliated groups. From the perspectives of both fairness and efficiency, we contend that recoupment is a more satisfactory objective for tax policy than income averaging, and that the current deduction system should be replaced with a recoupment regime.

**Operation of the Recoupment System**

We begin our analysis by contrasting the treatment of business net operating losses under the current Code with the mechanics of loss recoupment. Suppose that the expenses of a business enterprise—a laundry, for example—exceed its revenues by $15,000 in the 1980 tax year. Under the present system, the corporation will pay no tax, but obtains a tax benefit for its net operating loss in the form of a deduction that reduces the tax due on its income in three situations.

If the laundry had profits in 1979, the Code provides that the 1980 loss of $15,000 can be carried back against the income of that earlier year. This means that the business’s 1979 taxes would be recomputed: if the laundry had taxable income of, say, $20,000 in 1979, then the 1980 loss would be offset against that amount, and the 1979 taxable income would be correspondingly reduced. The laundry would be deemed to owe taxes on only $5,000 ($20,000 less $15,000) for 1979. If
we assume for the purpose of simplicity a flat tax rate of 46 percent, the laundry's 1979 tax liability would be recalculated downward, from $9,200 to $2,300 as a result of the offset. The firm would therefore receive a refund from the Treasury for the difference—$6,900, which is 46 percent of the 1980 loss of $15,000.

If the laundry had no past earnings, it would next have to look to the future to use its net operating loss. If it earns a profit in 1981, it can carry forward its 1980 loss to offset that income. For example, if the laundry's taxable income in 1981 is $20,000, then, as before, the laundry will have to pay only $2,300 in taxes (tax due on $5,000), rather than $9,200 (tax due on $20,000). The firm receives a savings of $6,900 in the form of a "credit" against its subsequent tax liability, in compensation for the prior year's net operating loss.

Finally, if the laundry is part of a chain operated by the same owners, either through a number of corporate entities or as one among several divisions of a corporation, then the income from other, profitable laundries (or divisions) can be combined with the deficit from the unprofitable laundry in one tax return. Suppose, for example, that the owners have two other laundries, each of which earns a profit of $10,000 in 1980. The consolidated return filed by the three businesses will show a net corporate income of $5,000, and the tax due will be on that amount only. If the loss incurring laundry did not exist, or if its deficit could not be combined with the profits of the other businesses, then the owners would have to pay $9,200 in taxes, the tax due on $20,000, as opposed to $2,300, the tax due on $5,000. The difference is again $6,900 (46 percent of $15,000, the amount of the loss).

If our laundry has no past or future earnings, and no affiliation with more profitable entities, then the $6,900 tax savings on the 1980 net operating loss cannot be realized. Under a system of uniform recoupment of net operating losses, however, no such discrepancy in

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11 Except for taxes due on the first $100,000 of corporate income, the corporate tax is a proportional tax of 46 percent. I.R.C. § 11(b). The tax due on the first $100,000 of corporate income as of 1981 equals $26,750, see note 17 infra, which is $19,250 less than 46 percent of $100,000. As income increases, the effective rate of tax approaches 46 percent. For example, the tax due on $12,000,000 is $5,500,750, which represents an effective tax rate of 45.8 percent.
12 The tax benefit of a deduction equals the marginal taxation rate multiplied by the amount of the deduction, here 46 percent of the $15,000 loss.
13 I.R.C. § 172(a).
14 If all the laundries operate by means of one corporate entity, the consolidation of their profits and losses will occur as a matter of course when the corporation's tax return is prepared. If they operate through separate corporate entities, their owners may nevertheless file a consolidated return for all of the entities and thereby offset post-affiliation losses with the income of the other entities. See I.R.C. §§ 1501-1505 (consolidated returns for affiliated groups of corporations).
15 Because of the limited carryover period of eighteen years and the restrictions upon transferability of loss deductions, some taxpayers may never be able to use their net operating losses to reduce their taxable income in the manner contemplated by the Code. See notes 35-37 and accompanying text infra.
Recoupment of Business Losses

treatment would arise. The mechanics are quite simple. All business taxpayers who sustain net operating losses would be entitled to receive, in the tax year of the loss, a cash refund from the Treasury equal to the "tax value" of the loss—that is, the amount that the business would have paid in taxes on a profit equal to the loss, or, equivalently, the dollar value of the loss multiplied by the tax rate applicable to income of that amount. To continue our example of the deficit-ridden laundry, that business would receive, as a refund from the Treasury, $6,900, just as it would have paid $6,900 in taxes had it earned a net income of $15,000 in 1980.

In practice, the recoupment refund will be less than 46 percent because under the Code the corporate income tax is assessed at a progressive rate for the first $100,000 of corporate income, and only thereafter is it computed at the flat 46 percent rate. In fact, for losses over $100,000 the refund will be $19,250 less than the tax value of the loss as a deduction from income in excess of $100,000. The $19,250 represents the difference in tax due on the first $100,000: instead of $46,000, the corporate taxpayer only pays $26,750 under the modified rate structure applicable to that income. The value of the tax benefit received under the current system of net operating loss deductions does not reflect this reduced tax rate because the loss offsets the top "layer" of income, which is generally taxed at the higher 46 percent marginal rate, unless the corporation's offsetting income exactly equals, or is less than, the amount of the loss plus $100,000. In the recoupment system, the reduced tax rate (the tax savings for small businesses) is reflected in the amount refunded in all cases. The larger the loss, the closer the effec-

16 But the corporate tax rate is still primarily a proportional tax of 46 percent. Over 85 percent of all corporate income is assessed at that rate. D. KAHN & P. GANN, CORPORATE TAXATION AND TAXATION OF PARTNERSHIPS AND PARTNERS 6 (1979).

17 Under the recent tax cuts, this difference will be slightly greater with respect to the first $50,000 of corporate income because of the phased-in lowering of the corporate tax rate on this level of income. See Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 231(a), 95 Stat. 172 (1981).

18 Bravenec and Fraser favor a recoupment system—which they call a "net operating loss credit"—that imposes a flat refund rate of 20 percent. Bravenec & Fraser, supra note 2, at 362. Although such a proposal may prove to be less costly to the Treasury than ours, it would not mitigate the fairness and neutrality problems generated by the current system, see text accompanying notes 22-64 infra, to the same extent as would a refund rate that is symmetrical between gains and losses. Cf. H. SIMONS, PERSONAL INCOME TAXATION 157 (1938) (main purpose of income tax is to secure equitable, progressive distribution of tax burden among individuals and not to maximize revenue obtainable given a certain rate and exemption structure). A plausible alternative would be a recoupment system that ignores the slight progressivity in the rates, and refunds a full 46 percent of all net operating losses. This would be easier to administer and would be conceptually consistent with the objective of the rate differentials: the Code's subsidy to small businesses by taxing them at lower rates would be enhanced by giving small businesses larger, asymmetrical loss refunds. On the other hand, perfect symmetry in the treatment of losses and gains would be sacrificed.
The recoupment system will be to the 46 percent tax rate, as is true of the tax on positive income.

Thus far, the recoupment system has been discussed only in the context of business corporations. Of course many business enterprises are not conducted in corporate form, but are operated instead as partnerships or sole proprietorships. We propose that the recoupment system extend to these forms of doing business as well, so that the treatment of losses does not favor a particular business form. However, the mechanics of recoupment must be modified in these noncorporate contexts. To understand why, the operation of the current Code must again be considered.

The present tax on unincorporated business income is more steeply progressive than the corporate income tax: the marginal tax rate thus varies according to the taxpayer's total income, and the tax value of a deduction for the loss varies correspondingly. To take a simple example, if the laundry hypothesized earlier was operated by a taxpayer who also operated his own movie theater, that person's tax liability would depend on the sum of theater income (or loss) and laundry income (or loss). This means that the "tax value" of a loss incurred by the laundry will vary, depending on the amount of the income against which the loss can be offset. Suppose, for example, that our theater-operator-launderer loses $15,000 in the laundry in 1980 while enjoying a net profit in his theater business of $60,000. Because he can combine profits and losses, he must pay taxes only on his overall income of $45,000, which amount to $12,376. In the absence of the laundry losses, he would have to pay taxes on his full theater income of $60,000, which would amount to $19,678. So the $15,000 laundry loss has a "tax value" to him of $7,302, the difference between his taxes on $60,000 and on $45,000. Now suppose that the income from his theater is only $25,000. His taxes are now $1,062 (the tax due on $10,000) if the laundry loss is counted, or $4,633 (the tax due on $25,000) if the laundry loss is excluded. In this case, the laundry loss is worth only $3,571 ($4,633 less $1,062) to the taxpayer.

These brief examples demonstrate that as long as the Code allows the profits and losses of unincorporated businesses to be merged with the taxpayer's other income or losses, the tax value of a net operating loss varies with the amount of other income against which the loss can be offset. In extending a recoupment system to unincorporated businesses, this effect of the rate structure must be taken into account. Two possible responses immediately come to mind. We could prohibit the

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merging of unincorporated business losses with the other income of the taxpayer. In the case of our theater-operator-launderer, that would mean that the laundry’s $15,000 loss would be treated as a tax event separate from, and not subject to combination with, his theater income. The laundry loss would be worth a fixed amount, $2,055 (the tax due on $15,000), or, if we chose to apply the corporate tax rates, $2,550 (the tax due on $15,000 of corporate income), and our entrepreneur would be liable for the appropriate taxes due on the full amount of his theater income. The problem with this approach is that it contradicts one of the Code’s basic principles: the refusal to treat unincorporated businesses as separate tax entities. We are therefore inclined to support the other possible response: to allow the continued merging of the individual taxpayer’s various sources of income and to tolerate the varying tax value of net operating losses that will inevitably accompany such an allowance. Under this second approach, in the year of the loss owners of unincorporated businesses would first offset their other income. If their losses exceeded their other income, they would receive, like incorporated taxpayers, a cash refund calculated as before, by multiplying the amount of the net loss by the tax rate applicable to positive income of that amount.

ADVANTAGES OF THE RECOUPMENT SYSTEM

The current Code provisions for loss carrybacks and carryforwards promote seriously inequitable and inefficient tax treatment of business enterprises. The restricted availability of carryovers effectively imposes a “double tax” on certain loss corporations, and results in unfairly disparate tax treatment of corporations by favoring large, established, and diversified firms. In addition, the current system violates a basic principle of tax neutrality, by distorting business investment decisions away from riskier projects. Finally, the current provisions have necessarily resulted in a cumbersome and unwieldy administrative structure that invites costly litigation and other disputes. Recoupment, by contrast, is superior in all these respects: it treats similarly situated taxpayers equally; lessens the allocational distortion of tax-induced investment decisions; and reduces administrative complexity.

Equitable Tax Treatment of Business Entities

The current treatment of net operating losses fails to satisfy the

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20 Cf. I.R.C. § 183 (“hobby loss” provision imposing a source-restricted offsetting system on individuals for losses from activities not engaged in for profit); I.R.C. § 165(d) (allowing loss deductions from wagering transactions only to the extent of gains from such transactions).

21 See, e.g., I.R.C. § 701 (partnership not taxed as separate entity); W. ANDREWS, FEDERAL INCOME TAXATION OF CORPORATE TRANSACTIONS 861 (2d ed. 1979) (general pattern for taxing partnership income since beginning of income taxation is not to treat partnerships as taxable entities).
classical definition of income for tax purposes. The corporate income tax is a tax on net income. Calculation of income under the Code thus reflects the widely accepted and comprehensive definition of income formulated by Haig and Simons—total accretion to the taxpayer's wealth.\textsuperscript{22} Net operating losses, like ordinary and necessary business expenses, are a cost of doing business; they represent the aggregate of the firm's operating expenses in excess of its revenues. Since net income measures consumption plus increases in net worth, net operating losses, as costs of creating income, must be deducted to ensure that the corporate income tax taxes income and not capital.\textsuperscript{23} Yet under the current Code, when a company experiencing net operating losses does not earn a profit equaling the amount available for offset over the eighteen year period prescribed by section 172, or if the company undertakes a fundamental change in its corporate structure and does not meet the requirements of sections 381 and 382, the loss expires without having been deducted by the company.\textsuperscript{24} Under such circumstances, some of the expenses of earning income will not have been deducted, and to that extent, the income tax on that business becomes a tax on its capital.\textsuperscript{25} In order to refine the concept of net income in accordance with the Code's underlying intentions, net operating losses should be fully credited to a taxpayer's account. However, the temporal and transferability restrictions of the existing provisions do not always produce such a result.

This inequitable outcome, taxation of capital and not income, when viewed in conjunction with basic characteristics of the corporate capital structure, impairs the loss firm's capital so as to impose what we will term a "double tax."\textsuperscript{26} A firm's capital—the assets it uses to conduct its business—comes from savings, whether acquired by an owner's direct expenditure on tangible assets or his investment in the firm's financial instruments. In other words, investments are made with after-


\textsuperscript{23} R. Musgrave & P. Musgrave, supra note 22, at 345.

\textsuperscript{24} As described more fully at text accompanying notes 35-37 infra, full credit for the loss is attained only by an immediate refund, which is the effect of a carryback but not of a carryforward because of the time value of money. The situation of a loss expiring without use is not unimaginable; for instance, Chrysler's recent record losses probably will not be recoverable in full as net operating loss deductions.


\textsuperscript{26} See Bravenec & Fraser, supra note 2, at 360-61.
tax income, and the firm’s capital therefore consists of property that has already been taxed.\textsuperscript{27} As we have demonstrated, when a firm generates losses, its costs of producing income will not be fully accounted for by the tax system unless the loss can be deducted,\textsuperscript{28} and the nonavailability of a deduction against zero income effectively constitutes a tax on the loss firm’s capital. But since that capital has been taxed once before, prior to its investment in the firm, the business’s inability to recover the loss for tax purposes results in double taxation of the capital.

Our use of the concept “double tax” differs from its more familiar usage with respect to the corporate tax structure, which taxes the same income producing activity at two levels: when income is earned the corporation is taxed, and when that income is distributed the shareholders are taxed again. The corporate tax thus taxes the same income stream twice. In the case of net operating losses, while the activities producing the two income streams are distinct (they represent pre-investment activities and the firm’s post-investment activities), the tax effects of the failure to recover a net operating loss are conceptually similar to that of the two-tier tax structure. The shareholders’ efforts to earn the funds they subsequently invest in the corporation are taxed,\textsuperscript{27}

\begin{footnote}{\textsuperscript{27} See Spencer, Tax Inequities of the Net Operating Loss for Individuals, 52 Taxes 428, 429 (1974). One could argue that not all capital has been previously taxed because firms can finance their investments through borrowing, which is not treated as an income-producing event. But this argument is flawed because loans must be repaid from after-tax income and are not deductible as business expenses. M. Chirelstein, Federal Income Taxation 43 (2d ed. 1979). There is no loss of taxable revenues from the perspective of the Treasury. \textit{Id.} at 51-52.}

\begin{footnote}{\textsuperscript{28} Cf. Raum, supra note 3, at 52 n.20, 59 n.39 (one of the purposes of net operating losses is to allow the cost of producing income to be offset against the income so produced; because a deduction means the spending of money, a corporation will not have a net operating loss unless it incurs substantial expenditures). The firm’s capital does not lose its after-tax character by the formality of “change” in ownership from the individual shareholder, who puts his after-tax proceeds into the corporate entity, to the corporation. Though the corporate income tax recognizes the corporate entity as a separate taxpayer, it makes no sense to impose a formalistic distinction at the point where capital enters the firm, in order to strip that capital of its previously-taxed-property attribute.}

\end{footnote}

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and then the corporation's use of those funds is taxed again. The same 
corporate funds thus suffer a second tax.

Recoupment eliminates this double tax on corporate capital. The 
firm immediately cashes in its losses and its capital therefore remains 
unimpaired with respect to collections by the Treasury. The current 
Code permits a loss firm's capital to be taxed because not all entities 
can use the net operating loss deduction—it depends on their aggregate 
positive receipts over the statutory loss carryover period, or their pro-

perly structuring an acquisitive transaction to meet the Code's strict 
requirements.\footnote{Even if a merger successfully results in the 
transfer of the net operating loss, because of the uncertainty of that 
outcome the loss company will not receive the full tax value of the loss 
from the acquirer. It sells the loss at a discount that reflects the risk of 
the transaction's failure in the face of a Treasury challenge. \textit{See} 1958 
\textit{INCOME TAX PROJECT, supra} note 8, at 41 (losses acquired 
for 10 to 15 cents on the dollar).}

Income averaging does not resolve the problem of taxing corporate 
capital because the problem extends beyond the inequities generated by 
an annual accounting system. Income averaging—the theory behind 
section 172—mitigates the unfairness of disparate tax treatment due to 
use of an annual accounting system by seeking to equalize the treat-
ment of taxpayers whose income fluctuates and those whose income is 
stable over a given period.\footnote{\textit{See} 1947 \textit{TREASURY REPORT, supra} note 8, at 859-60 (averaging rationale for I.R.C. § 172 
to dispel inequitable tax treatment).} But from the perspective of the 
nature of a firm's capital and the Code's net income requirement, even 
lifetime accounting is "unfair" to the taxpayer whose expenses always exceed his 
income in the sense that his capital is being taxed. Only a system in 
which the government shares in both gains and losses, which accords 
with a common sense notion of fairness, eliminates the possibility of 
inequitable treatment. To argue that it does not seem "fair" to give a 
refund to a company that has only sustained losses and never paid any 
income taxes during its taxable existence misses the mark: the Code's 
fundamental premise of fairness, which views the taxpayer's enrich-
ment as best reflecting his ability to pay,\footnote{\textit{See} M. CHIRELSTEIN, supra 
note 27, at 86. \textit{See generally} R. MUSGRAVE & P. MUSGRAVE, 
\textit{supra} note 22, at 242-47, 344-45 (discussing principle of ability-to-pay and considerations of eq-

uity in choosing tax base incorporating net income concept). For a discussion of whether recoup-
ment will encourage inefficient enterprises, see text accompanying notes 76-77 \textit{infra}.} requires taxation of \textit{net} 
income. This in turn requires deducting \textit{all} costs of income production 
for all taxpayers, regardless of their contributions to tax revenues in 
other years.

One might argue that the inequity of the current deduction system 
is only theoretical because the value of the loss firm will not be equal to 
the investors' capital outlay: Since firm valuation is based on prospec-
Recoupment of Business Losses

tive earnings, shareholders choosing to sell their stock would recover the diminution in their capital by taking a capital loss on the stock transaction whether or not the firm receives a loss deduction. Under these circumstances, there would arguably be no need for loss recoupment to prevent double taxation. This argument fails, however, because the corporate income tax consists of a two-tier structure: Tax is paid separately at both the corporate and shareholder levels. Shareholders may recover some capital losses by liquidating their interests in the loss firm, but their recovery does not relieve the corporate entity (which pays its own tax) of its “share” of the operating losses. The tax benefit produced by the capital loss that selling shareholders receive is less than that generated by ordinary losses, the tax status of the loss deduction at the corporate level, because of the different rate structures for capital and ordinary income. If Congress were to adopt a fully integrated corporate tax system, which would levy a tax only at the shareholder level, then the double tax problem of net operating losses would be mitigated. But until that time, attention must be directed to operating losses incurred at the corporate level, regardless of the availability of shareholders’ capital losses.

In addition to the double tax inequity inherent in the current system, inequities arise in the differing tax treatment accorded firms with different business characteristics that are unrelated to the loss producing activity. The current Code provisions for loss carryovers and consolidated returns have the effect of favoring established firms over new ones, and large conglomerates over small nondiversified firms. As a result, recoupment exists in fact for the former types of businesses but not for the latter.

Consider two corporations, A and B, which are deciding whether or not to undertake a particular investment project, such as constructing a building. The building will be constructed and sold within a one-year period, so that all risks and returns will have materialized by the end of that year. Corporation A is an old, established firm with a history of past profits, while B is a new corporation, formed for the sole purpose of undertaking the project. The success of the project is not guaranteed: both companies accurately project that it has a 50 percent

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33 Cf. 1958 INCOME TAX PROJECT, supra note 8, at 41 (arguing against recoupment because loss corporation has paid no taxes and shareholders who sell stock can deduct their investment losses).
34 Further, under I.R.C. § 331 a liquidating distribution is generally treated as a sale of stock, and thus any loss to the shareholder will be treated as a capital loss. Only individual losses on qualifying section 1244 stock are treated as ordinary losses, with a maximum of $50,000 allowable per taxpayer. I.R.C. § 1244.
35 See Bowen, Taxation of Net Income from Business, 31 BULL. NAT'L TAX A. 72, 75-77 (1945).
chance of earning a profit of $20,000, a 20 percent chance of losing $20,000, and a 30 percent chance of breaking even. The expected value of the project to either firm—the sum of the probability of each outcome multiplied by its predicted return—is $6,000 \[($20,000 \times .50) + (0 \times .30) + (-$20,000 \times .20)\], discounted to present value at, say, 5 percent, for a present value of $5,714.29 before taxes. Corporation A knows that it will be able to offset the downside risk of a negative return with its past earnings under section 172 and receive an immediate refund of earlier taxes paid. Assuming for simplicity’s sake a flat tax rate of 46 percent, the expected value of the project to A is $3,240, which discounted to present value at 5 percent equals $3,085.71. Corporation B, however, with no past profits, has no such assurance, and thus the expected value of the same project to B is only $1,400, or $1,333.33 when discounted to present value at 5 percent. Table 1 compiles these results:

<table>
<thead>
<tr>
<th>Tax Free World</th>
<th>Corporation A*</th>
<th>Corporation B*</th>
</tr>
</thead>
<tbody>
<tr>
<td>($20,000)(.5)=$10,000</td>
<td>($10,000)(1-.46)=5,400</td>
<td>($10,000)(1-.46)=5,400</td>
</tr>
<tr>
<td>(0)(.3)=0</td>
<td>(0)(1-.46)=0</td>
<td>(0)(1-.46)=0</td>
</tr>
<tr>
<td>(-20,000)(.2)=-4,000</td>
<td>(-4,000)(1-.46)=-2,160</td>
<td>(-4,000)(1)=4,000</td>
</tr>
</tbody>
</table>

Expected Value: $6,000 $3,240 $1,400

*After-tax

The present value of the project is consequently higher for A than for B by the amount of the offset, (1-.46) (-4,000), simply because of the effect of the tax laws, which favor A’s prior activities and thus limit A’s downside risk, and not because of any economic difference between the two corporations with respect to undertaking the project.

The discrepancy in tax treatment of losses for old and new firms is further magnified by the effect of the time value of money. If B undertakes an investment that continues for longer than a year and, after losing $20,000 in the first year, earns a profit in the second year against which the loss can be offset, the tax value of the loss will nevertheless be worth less to B than it was to A because interest rates are positive. In other words, by receiving the money as a tax refund in the year of the loss, A can invest that amount and earn the current rate of return, whereas B, by receiving the same dollar amount that A received one year later, after the investment has earned a profit, has lost that opportunity of earning interest. The $20,000 loss, at a 46 percent rate, refunds $9,200, but that amount is worth only $8,761.90 to B (assuming a 5 percent discount rate) because it is received one year later. The value of a loss as a carryforward is always less than its value as a carryback.

As our example illustrates, the established corporation recoups its losses under the current net operating loss system because of the car-

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The practical effect is to favor old firms over new ones. Income averaging simply does not deal with this inequity, because it focuses only on differences between taxpayers with respect to fluctuating and stable incomes. More equitable or neutral treatment, which disregards the taxpayer's characteristics that are extraneous to the particular investment project, would make loss recoupment available to all corporations on the same terms. Moreover, with a continuing inflationary economy, and the current high level of interest rates, the value of a carryback or carryforward against income earned more than a few years apart is largely nullified. By providing the tax benefit of the loss in the year of the loss, recoupment mitigates these harsh consequences of inflation.36

In addition to the disparate treatment between old and new firms, the provisions for consolidated corporate tax returns favor conglomerate corporations over nondiversified ones. The allowance for consolidated returns permits current losses in one line of business to be offset by current income from other lines within the same corporate group.37 Similarly, a diversified corporation can offset divisional gains and losses by aggregating its net income. An unaffiliated business enterprise, by contrast, has no analogous opportunity to offset losses. The same effect on the expected value of an investment project as was demonstrated for old and new firms occurs: The value of the investment will be greater to the diversified firm because any losses it might incur will be directly matched by income from other divisions in the year of the loss. The nondiversified firm receives no such offset in the year of the loss, unless it has past profits equalling that amount. Loss recoupment is again available with virtual certainty to some taxpayers, namely, diversified conglomerate firms, but not others, the smaller, undiversified firms that cannot take advantage of income consolidation.

In sum, the limited availability of loss carryovers raises serious concerns of taxpayer equity. The present system imposes a double tax on corporations that does not satisfy the Code's net income requirements, and favors diversified and established corporations. A recoupment system, by contrast, would eliminate these inequities by allowing

36 The recent tax cuts changed the treatment of net operating losses by extending the carryforward period from seven to fifteen years. Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 207, 95 Stat. 172 (1981). While the amendment extends the possibility of recovery of losses to more businesses, the value of the loss deducted in years eight through fifteen will be virtually negligible, especially at current inflation rates. For example, if the project in the text did not earn a profit until year fifteen, the tax benefit of the $20,000 loss ($9,200 at 46 percent rate) would be worth today only $4,425.20 at the 5 percent discount rate used in the text, and using a more realistic discount rate, say, 15 percent, its value would be only $1,130.59. The reform thus does little to alleviate one of the fundamental inequities of the current system.

all business taxpayers, regardless of firm characteristics, to recover the tax value of their losses in the year incurred.

*The Tax Treatment of Net Operating Losses and Economic Efficiency: Applying the Principle of Tax Neutrality*[^38]

The principle of tax neutrality is another criterion according to which the appropriate treatment of net operating losses can be evaluated. As a matter of tax policy, the tax system should not interfere with taxpayers’ economic activities unless such interference is intended to promote particular policy goals.[^39] Unintended nonneutral tax effects are economically undesirable because allocative efficiency requires that the relative prices of goods reflect their marginal rates of substitution. A neutral tax is an efficient one because it does not interfere with the relative prices of goods and thus does not distort individual choices.

It has been argued that by not providing for recoupment, the current Code violates the principle of tax neutrality. Intuitively, when a tax is imposed on gains and no corresponding credit afforded for losses, the prospective positive yield of a risky undertaking is reduced, while its prospective negative yield is left unaltered. Thus some risky projects that would be worth undertaking in a tax free world will not be accepted under the present Code. This fact, it is argued, constitutes a violation of the principle of tax neutrality.[^40] Conversely, when a tax on gains is accompanied by a credit of equal magnitude for losses, then the prospective positive and negative yields of a risky undertaking are reduced proportionately. Under these circumstances, the expected after tax value of a risky undertaking more closely approximates its expected tax free value than does the expected after tax value of that undertaking in a tax-without-offset regime and the ranking of investments according to their expected values is preserved.

This intuitive argument, however, depends on a simplified model of investment decisionmaking. It assumes that the proper way to measure the neutrality of a tax provision is to compare investment behavior under the tax to that in a tax free world. It also fails to incorporate the

[^38]: We wish to express particular gratitude to Mike Woodford for his invaluable assistance in developing the argument in this section. Any errors, of course, are our own.

[^39]: It can be argued that interference should not be attempted under any circumstances. See Twentieth Century Fund, Comm. on Taxation, Facing the Tax Problem 129-31 (1937); Stein, What’s Wrong with the Federal Tax System? in H. Stein & J. Pechman, Essays in Federal Taxation 5, 13 (1959). Since the 1960s, however, the prevailing view has been that tax policy should be used to promote economic stability and growth. See J. Pechman, Federal Tax Policy 5-6 (3d ed. 1977). Even on this view, of course, unintended non-neutral tax effects are undesirable, since they may impede or prevent the attainment of the goals of conscious fiscal intervention. For the classic statement that the Code is never the best way of enacting an incentive device, see S. Surrey, Pathways to Tax Reform (1973).

phenomenon of risk aversion. But even a more complex investment decision model, which avoids these simplifying and restrictive assumptions, also suggests the intuitive model's conclusion that recoupment is the preferable tax policy.

The proper measure of tax neutrality is not a comparison between the tax in question and a tax free world. Such a comparison fails to distinguish between the income effect of a tax, changes in behavior due to the effective change in investable wealth caused by the tax—the effect of shifts in the budget constraint and the consequent move to a new indifference curve—and the substitution effect—changes in behavior along the same indifference curve due to the focus of the tax on a particular activity.41 A tax of a particular structure can have different effects on risk taking, depending upon the rate of the tax. In order to evaluate accurately the effects of different tax structures on investment behavior, one must ignore the effects that depend on the rate; in other words, it is necessary to correct for income effects and focus only on substitution effects. Consequently, a more appropriate measure of tax neutrality is a comparison between the tax in question and a lump-sum tax that raises the same revenue.42

The two-state model of investment behavior, as applied by Stiglitz,43 allows for the incorporation of this proper measure of tax neutrality, as well as the behavioral phenomenon of risk aversion. By adopting Stiglitz's model, the simplifications of the intuitive approach are avoided. The investor firm44 is assumed to begin the investment

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41 More specifically, the income effect represents changes in attitudes toward the tradeoff between risk and return due to the effective decrease in wealth from taxation, while the substitution effect refers to changes in the amount of risk an investor is willing to bear because of a change in the amount of return he is offered for bearing the added risk. See W. Nicholson, Microeconomic Theory 97-102 (2d ed. 1978) (discussing income and substitution effects in demand theory). For an application of the discussion of the income and substitution effects of taxes on consumer demand for goods to problems of investment portfolio choice, see A. Atkinson & J. Stiglitz, note 22 supra.

42 The income effect on risk taking will be the same for all taxes that reduce the investor's after tax income to the same degree, and is thus affected only by the choice of the overall tax rate and not the differential treatment of different types of investments. A neutral tax structure refers to the absence of a substitution effect, not to the presence of a substitution effect sufficient to cancel the income effect. See R. Musgrave & P. Musgrave, supra note 22, at 463-65 (noting neutrality of lump-sum tax); W. Nicholson, supra note 41, at 81-83 (lump-sum tax more economically efficient than other taxes of equal revenue because it incorporates only an income effect). Cf. Stiglitz, The Effects of Income, Wealth, and Capital Gains Taxation on Risk-Taking, 83 Q.J. Econ. 263, 282-83 (1969) (comparing effects of different taxes with effect of lump-sum tax of equal revenue). The lump-sum tax is specified before the investment decision, liability remaining the same regardless of the firm's investment behavior.

43 A. Atkinson & J. Stiglitz, note 22 supra; Stiglitz, note 42 supra.

44 Stiglitz's model was developed to explain the behavior of individual investors. The approach can be applied to the behavior of firms as well. Cf. Machlup, Marginal Analysis and Empirical Research, 36 Am. Econ. Rev. 519, 536-53 (1946) (discussing the study of firm behavior in terms of marginal analysis, developed for study of individual behavior).
period with a certain initial wealth, $W_0$. There are two projects in which it can invest its funds: a risky project and a safe one. The risky project produces a random return for each invested dollar of $e(\theta)$, where $\theta$ has a probability distribution of $F(\theta)$; the safe project produces a sure rate of return of $r$, $r > 0$. The firm wants to maximize the expected utility of its wealth at the end of the investment period, $W_f$. In order to do this, it invests proportion $a$ of $W_0$, $0 \leq a \leq 1$, in the risky project, and the remainder, $(1-a)W_0$, in the safe one. It follows that $W_f = W_0 [1 + ae + (1-a)r]$.47

![Figure 1](image)

**The Two-State Investment Decision Model.**

This series of assumptions is illustrated graphically in Figure 1. For simplicity’s sake, it is assumed that there are only two states of the world at the end of the investment period: $\theta_1$, with a probability of $p$; and $\theta_2$, with a probability of $1-p$. In the first state, the risky project

45 Feldstein criticizes models postulating the existence of riskless assets as being of little value in a world of uncertain price levels. Feldstein, *The Effects of Taxation on Risk-Taking*, 77 J. Pol. Econ. 755, 756-57 (1969). But as Stiglitz asserts, the analysis is unchanged if the safe asset yields a random return, so long as the safe asset is unambiguously safer, that is, one asset is not better than the other in both states of the world. Stiglitz, *supra* note 42, at 264 n.4.

46 This model thus assumes that both projects yield constant returns to scale. Constant returns always exist in the case of standardized investment instruments traded on financial exchanges. Buying a second share of the same type of security doubles the income.

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succeeds, \( e(\theta_1) > r \), while in the second state, the risky project fails, \( e(\theta_2) < r \). If the investor firm places all of its funds, \( W_o \), in the safe asset, its \( W_f \) is represented by point \( S \), with \( W(\theta_1) = W(\theta_2) = W_o(1 + r) \). If the firm invests only in the risky project, its \( W_f \) lies at point \( T \), with \( W(\theta_1) = W_o[1 + e(\theta_1)] > W(\theta_2) = W_o[1 + e(\theta_2)] \). If the firm divides its \( W_o \) between the safe and risky projects, it can achieve any outcome along the budget constraint, \( ST \). The proportion the firm will choose depends upon the shape of the set of indifference curves expressing its choice between risk and return. Implicit in the shape and configuration of the indifference curves is the assumption of risk aversion: that the marginal utility of wealth for the firm is positive and decreasing.\(^{48}\) The firm will invest in the proportion described by point \( M \), the point of tangency between the highest attainable indifference curve, \( II \), and the budget constraint. The amount invested in the risky asset can be seen geometrically to equal the ratio of \( SM \) to \( ST \).\(^{49}\)

Using this model, the effect on investment decisions of an income tax with full loss offsets—our recoupment proposal—and a tax without offsets—the effect on some entities of the current Code—can be evaluated and compared to the effect of a lump-sum tax of equal revenues.

\[ \text{Figure 2} \]

Proportional Income Tax With Recoupment of Losses.

\(^{48}\) That is, if \( U(W) \) is the investor's utility function for wealth, then \( U'(W) > 0 \), and \( U''(W) < 0 \). See A. Atkinson & J. Stiglitz, supra note 22, at 99-100.

\(^{49}\) Id. at 101-02. Because of the assumption of constant returns to scale, the return on any convex combination of portfolios \( S \) and \( T \) will yield a vector of expected returns that is a convex combination of the return vectors for \( S \) and \( T \).
In this way, the tax that better adheres to the principle of tax neutrality can be identified. Figure 2 compares the case of a proportional income tax with recoupment of losses and a lump-sum tax of equal revenue. The tax free budget constraint is $ST$. The tax-with-recoupment draws the budget constraint inward from the pre-tax line $ST$ along the rays from $W_o$ to points $S_o'$ and $T_o'$, so that the post-tax-with-recoupment budget constraint is $S_o'T_o'$, where the tax rate equals $S_o'S/W_oS = T_o'T/W_oT$.

If $M_o'$ is the investor firm’s expected utility maximization point (the investor looks to after-tax returns), the firm will allocate its $W_o$ so as to reach a $W_f$ depicted by $M_o$, which will be reduced by the tax-with-recoupment, shown here by vector $M_oM_o'$ to the equilibrium point $M_o'$. The lump-sum tax to which the tax-with-recoupment is properly compared is one of equal magnitude—i.e., it produces the same tax revenues. As the magnitude of the tax-with-recoupment is already known to be $M_oM_o'$, the lump-sum tax can be depicted with $M_oM_o'$ as a guide. Because this tax is a lump-sum, it is uniform in magnitude all along the pre-tax budget constraint $ST$. It thus produces the after lump-sum tax budget constraint $S_o'T_o''$, where $SS_o''$ is parallel to $M_oM_o'$ is parallel to $TT_o''$.

In order to compare the effects of the two taxes, it is necessary only to determine whether the maximization point chosen under the lump-sum tax results in an $a$ different from that arrived at under the tax-with-recoupment. Because the lump-sum tax vector is of equal magnitude all along $ST$, $S_o'T_o''$ must be parallel to $ST$. $S_o'T_o'$ is also parallel to $ST$ since the tax-with-recoupment is imposed on all income in equal proportion (positive and negative income are reduced symmetrically because losses are refunded at the same rate at which gains are taxed) whether derived from risky or safe ventures. Because $S_o'T_o'$ and $S_o'T_o''$ are both parallel to $ST$ and both contain point $M_o$, $S_o'T_o''$ must contain $S_o'T_o'$. Thus if $S_o'T_o'$ reached the highest available indifference curve at $M_o'$, $S_o'T_o''$ will do the same: the maximization point chosen under the tax-with-recoupment is the same as that chosen under the comparable lump-sum tax. A simple geometric proof shows that $S_o'M_o'/S_o'T_o'' = S_o'M_o'/S_o'T_o''$ and that $a$ is therefore the same under both taxes.

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50 The text uses a proportional tax rate because most corporate earnings are taxed at the flat 46 percent rate.

51 See H. Levy & M. Sarnat, Capital Investment and Financial Decisions 77 (1978) (corporate taxes must be taken into account when firm is evaluating project’s desirability).

52 Because $S_o'T_o'$ and $ST$ are parallel, the triangles $\Delta W_oSM_o$ and $\Delta W_oS_o'M_o'$ are similar, as are $\Delta W_oST$ and $\Delta W_oS_o'T_o'$. Thus $S_o'M_o'/S_o'T_o'' = SM_o/ST$. And because $SS_o'' = M_oM_o''$ and $TT_o''$ are parallel vectors of equal magnitude, $S_o'M_o'' = SM_o$ and $S_o'T_o'' = ST$. The textual result follows.

53 The proposition in the text assumes that the indifference curves are tangent to a point on $S_o'T_o'$ and do not yield a corner solution.
the lump-sum tax criterion, a proportional income tax with recoupment of losses satisfies the principle of tax neutrality.\textsuperscript{54}

Now the case of an income tax without recoupment, the current system,\textsuperscript{55} can be compared, as shown in Figure 3. (See next page). Under this tax, the pre-tax budget constraint $ST$ is reduced to $S_{NO}T_{NO}$. This line is not parallel to $ST$ because gains and losses are not reduced equally.\textsuperscript{56} Thus the budget constraint is drawn inward along rays from points $S$ and $T$ to the point $W_{NO}$. If the maximization point along $S'_{NO}T'_{NO}$ is $M'_{NO}$, the firm will allocate its $W_{O}$ so as to reach point $M_{NO}$ on the pre-tax budget constraint; the tax-without-recoupment vector $M_{NO}M'_{NO}$ will reduce $W_{T}$ to the equilibrium point $M'_{NO}$. A lump-sum tax of equal magnitude, however, will produce the after-tax budget constraint $S''_{NO}T''_{NO}$, where $SS''_{NO}$, is parallel to $M_{NO}M'_{NO}$, which is parallel to $TT''_{NO}$. This will not contain $S'_{NO}T'_{NO}$, because $S''_{NO}T''_{NO}$ is parallel to $ST$, while $S'_{NO}T'_{NO}$ is not. Consequently, the points of tangency between the constraints and the investor firm's indifference curves will differ. If the highest available indifference curve is tangent to $S''_{NO}T''_{NO}$ at $M_{NO}'$, that curve must intersect $S''_{NO}T''_{NO}$ from above at $M_{NO}'$.\textsuperscript{57} The indifference

\textsuperscript{54} Cf. Stiglitz, supra note 42, at 282 (effect on risk-taking of proportional income tax identical to that of equal revenue lump-sum tax).

\textsuperscript{55} The current system does provide for recoupment of losses under the carryback provisions of I.R.C. § 172, but not all taxpayers can avail themselves of that provision. Consequently, that system is here treated as a nonrecoupment one, that is, as a system in which losses are not offset, because it is in that respect that its treatment of losses differs from our proposal of recoupment and results in inequitable treatment. Once again, the diagram assumes a proportional tax.

\textsuperscript{56} If the tax did reduce gains and losses in equal proportion, the post-tax budget line would be the dashed line $S'_{NO}T'_{NO}$. In the no recoupment case, the post-tax budget constraint extends from $S'_{NO}$ to $T_{NO}$, which must lie directly below $T'_{NO}$. See note 57 infra. Thus as $S'_{NO}T'_{NO}$ is parallel to $ST$, $S''_{NO}T''_{NO}$ cannot be: $S''_{NO}T''_{NO}$ will always have a slope steeper than that of $S_{NO}T_{NO}$.

\textsuperscript{57} An exaggerated version of part of Figure 3 will illustrate this point. So long as $S'_{NO}T'_{NO}$ is steeper in slope than $S''_{NO}T''_{NO}$—and it should be noted that this is the case whenever the tax in question provides for less than full recoupment—then given our assumption of risk aversion, the highest

The curve that lies tangent to $S''_{NO}T''_{NO}$ must thus be further away from the origin than the one tangent to $S'_{NO}T'_{NO}$, and the point of tangency of $S''_{NO}T''_{NO}$ consequently must lie to the right of $M'_{NO}$ (that is, between $M'_{NO}$ and $T''_{NO}$). For the purposes of illustration, point $X'$ depicts the point of tangency, the maximization point of the investor firm under the lump-sum tax. Now, the only way in which the firm can reach the point $X'$ under the lump-sum tax is to allocate its $W_o$ so as to produce a pre-tax $W_f$ at point $X$. And because point $X'$ is necessarily to the right of $M'_{NO}$, point $X$ is necessarily to the right of the right of $M_{NO}$. In other words, under the lump-sum tax an investor firm will allocate $a = SX/ST$ of its funds to the risky asset, whereas under the tax-without-recoupment the firm's $a = SM_{NO}/ST < SX/ST$. According to the lump-sum tax criterion, the income tax without recoupment violates the principle of tax neutrality, by decreasing the amount of risk that a firm is willing to accept.

indifference curve meeting $S''_{NO}T''_{NO}$ (here, $H$) cannot be tangent to $S''_{NO}T''_{NO}$. Rather, it will intersect $S''_{NO}T''_{NO}$ at a point where $H$ has a steeper slope than $S''_{NO}T''_{NO}$—that is, it will intersect "from above."

All the vectors of the lump-sum tax are parallel and of equal magnitude. Further, $S''_{NO}T''_{NO}$ is parallel to $ST$. Therefore, the relative positions of points $M'_{NO}$ and $X'$ on $S''_{NO}T''_{NO}$ correspond to those of points $M_{NO}$ and $X$ on $ST$.

As point $X$ is to the right of point $M_{NO}$, $SM_{NO} < ST$, and so $SM_{NO}/ST < SX/ST$.

Cf. Stiglitz, supra note 42, at 271 (concluding that the demand for the risky asset, $a$, is always less with no or partial loss offsets than with full loss offsets). The amount invested in the risky asset will be less under a tax with no loss offsets than under a tax-with-recoupment, R. Musgrave & P. Musgrave, supra note 22, at 674-76; Stiglitz, supra note 42, at 277, unless the tax
The analysis demonstrates that a tax with less than a full loss offset provision—a tax other than one based on the principle of recoupment—decreases risk taking. By producing a post-tax budget constraint with a slope steeper than that of the corresponding lump-sum tax, the nonrecoupment-tax places the investor on a lower indifference curve. In contrast, a tax-with-recoupment, creating a post-tax budget constraint which coincides with that of the lump-sum tax, does not alter risk taking. Further, a parallel post-tax budget constraint implies that the relative prices of assets are not affected by the tax, a condition necessary for the efficient allocation of production factors.

Our conclusion of greater efficiency under the tax-with-recoupment is not, however, unambiguous. The analysis that we have employed, a partial equilibrium solution, is subject to criticism from a general equilibrium perspective, for involving what is known as the problem of the “second best.” In the real world, the optimal or “first best” solution may be unattainable, and the theory of the second best demonstrates that under such circumstances the effect of a move toward optimal efficiency in one market may be to create inefficiencies in other parts of the economy. More specifically, while the net operating loss deduction may be inefficient or distortive, it may also be a second best solution in the form of an offset to other inefficiencies in private markets, or other inducements to risk taking within the tax laws. Thus, although our analysis has refined the intuitive argument concerning the effects of recoupment on risk taking, it does not provide a definitive solution. This is not surprising, since the use of economics in analyzing tax policy should not be understood to offer unassailable policy recommendations, but rather to provide insights for evaluating the

without offsets has a lower tax rate than the tax with offsets, A. ATKINSON & J. STIGLITZ, supra note 22, at 113-14.

When compared to no tax, the decrease in risk-taking from no loss offsets depends on the wealth elasticity of demand, that is, on the wealth effect of the tax. But for sufficiently high tax rates, the decrease is unambiguous. See A. ATKINSON & J. STIGLITZ, supra note 22, at 112.


For example, in an imperfect capital market, the shape of $ST$ for a particular investor may not reflect the tradeoff between additional returns in state $S_1$ and those in state $S_2$, available to the economy as a whole. If the investor's $ST$ curve is too flat, he will invest more in the risky asset than he would in an efficient market where he has access to all investment opportunities, and in that case the nonneutral incomplete loss offset would move his investment decision back in the direction of greater efficiency. However, there is no basis for assuming that constellation of effects. Moreover, under those circumstances, recoupment may have favorable distributional consequences, even if it is not more efficient, since full offsets would shift the tax burden away from investors with less access to investment opportunities toward those whom the capital market serves efficiently. In an interesting paper, Michael Woodford has analyzed such an effect and demonstrates the likelihood that the second best effects will be small. Woodford, Loss Offsets and Optimal Taxation (Manuscript, October 1981). He also considers the efficiency of full loss offsets using general equilibrium analysis and determines the conditions under which the results of the partial equilibrium analysis employed in this Article hold.
array of alternative tax proposals, or, as Atkinson and Stiglitz have succinctly put it, “to explore the ‘grammar of arguments.’” 64

Administrative Convenience of the Recoupment System

A final advantage of the recoupment system derives from its greater administrative simplicity and convenience, compared with that of the current averaging regime. The current provisions for loss carryovers encourage corporate mergers. The opportunity afforded by section 172 to carry losses back three years is of no value to a firm with no past profits; similarly, the opportunity to carry losses forward fifteen years is of little value to a firm whose future prospects are dim. Since the past losses of one firm can offset the current and future profits of another if the two firms merge in compliance with sections 381 and 382, profitable firms often seek to acquire loss corporations to shelter income.65 By the same token, loss firms will be unusually willing partners to merger because that course may represent the only means by which they can realize the value of otherwise nondeductible and non-transferable losses.66 The configuration of temporal restrictions and potential transferability provides an incentive for mergers with little or no economic justification other than the acquisition of the net operating loss deduction. To minimize such efforts at income sheltering by mergers with loss companies, the current Code has developed an elaborate enforcement scheme, through sections 269, 381, and 382, which limits transferability of losses.67

In a recoupment system, however, the need for the general policing mechanism for corporate acquisitions, section 269, is reduced, and the complicated and detailed provisions that explain and restrict the transfer of losses in the corporate reorganization context, sections 381 and 382, are no longer necessary. The recoupment system virtually

64 A. Atkinson & J. Stiglitz, supra note 22, at 456.
67 These provisions were adopted to curtail the abuse of trafficking in losses. I.R.C. § 269 deals with acquisitions made to evade or avoid income tax; I.R.C. § 381 deals with carryovers of tax attributes in certain corporate acquisitions; and I.R.C. § 382 deals with special limitations on net operating loss carryovers. See B. Bittker & J. Eustice, supra note 7, §§ 16.35-36, 16.43, 16.65 (section 269 enacted to curb trafficking in losses; section 382 added to remedy presumed weaknesses in operation of section 269); D. Kahn & P. Gann, supra note 16, at 849 (sections 269, 381-383 part of statutory pattern to prevent trafficking in losses for tax avoidance purposes); Staff of Joint Comm. on Taxation, 94th Cong., 2d Sess., General Explanation of Tax Reform Act of 1976, 191-93 (1976), 1976-3 C.B. (vol. 2) 203-05 (1976 revisions in section 382 to correct defects and close loopholes that failed to cover transactions where trafficking in losses could still occur).
guarantees that loss company reorganizations will occur for \textit{bona fide} business purposes and not solely for purposes of tax evasion. The loss company receives in direct payment from the Treasury a refund for its net operating loss in the year of the loss and can never lose that tax benefit. Thus it need not search for a corporate partner to preserve the tax value of its loss. In other words, the entity sustaining a loss will recover the full tax value of that loss without having to acquire an offsetting positive income stream. The incentive for loss companies to offer profitable firms the tax advantage of an income offset by merger or acquisition is thereby eliminated.

If the only purpose for a reorganization is to enable a profit company to acquire a net operating loss deduction, the mutual benefit from the transaction to the parties is nullified by recoupment; for in a proportional tax system like the corporate income tax, the loss refund matches the tax savings of a deduction against another income stream, so the parties will not gain from seeing a reorganization go through if its sole reason is the tax advantage from income offsetting. Consequently, mergers without any other reason besides tax avoidance would most likely be abandoned. As we have noted, the progressivity of the tax rates on the first $100,000 of corporate income alters this equivalence by at most $19,250.\footnote{See notes 16-18 and accompanying text \textit{supra}.} But because recoupment replaces the system of loss offsetting, the effect of possible discrepancies in the tax rates resulting in the variability of the tax value of losses is virtually negligible. Furthermore, the transaction costs of such a merger would more than likely exceed any gain from the differential in the rates between receiving a deduction or a refund.

Recoupment would thereby eliminate the extensive litigation under section 269 over subjective states of mind of taxpayers engaging in corporate acquisitions involving net operating losses.\footnote{Compare Zanesville Inv. Co. v. Comm'r, 335 F.2d 507, 512-14 (6th Cir. 1964) (allowing deduction of post-acquisition losses; assets declined in value after sale) \textit{with} R.P. Collins & Co. v. United States, 303 F.2d 142, 145-47 (1st Cir. 1962) (denying post-acquisition losses on ground of taint of tax avoidance in purchasing company with built-in losses). See B. BITTKER \& J. EUSTICE, \textit{supra} note 7, \S\ 16.21 (discussing use of I.R.C. \S\ 269).} Similarly, it would call off the elaborate change in ownership calculations called for by section 382,\footnote{See B. BITTKER \& J. EUSTICE, \textit{supra} note 7, \S\ 16.22-23 (discussing problems of section 382 ownership test); \textit{ALI DRAFT}, \textit{supra} note 40, at 21-23 (same). For examples of the problems arising under this section, see Commonwealth Container Corp. v. Comm'r, 393 F.2d 269 (3d Cir. 1968) (problem of contingent stock acquisitions; court ignored later issue of stock to old shareholders in applying section 382 test based on “own immediately after” language of statute); Maxwell Hardware Co. v. Comm'r, 343 F.2d 713 (9th Cir. 1965) (carefully tailored technical compliance with section 382 because only 30 percent increase in value of new ownership and nonvoting preferred stock used, while voting trust shifted control from old shareholders to third party). See also B. BITTKER \& J. EUSTICE, \textit{supra} note 7, \S\ 16.24 (amended section 382(b) involving reorganizations will cause more trouble than predecessor).} and the unpredictable and often impractical applica-
tion of the old change-in-business test of section 382, which is still in force. Finally, it would render obsolete the manipulation of transaction forms, undertaken to comply with section 381, as well as the undue emphasis on tax planning to avoid losing a loss deduction because of section 381's formalistic distinctions among types of acquisitions. The loss corporation receives its refund when the loss is incurred, regardless of transaction form, and irrespective of what happens to it in the future, or what happened to it in the past. The certainty of recoupment means that the loss company will not have to sell its loss at a discount to a profit company; rather, it will receive the full tax value of the loss for its own shareholders, who sustained the loss. Furthermore, this matching of losses with ownership fulfills the underlying purpose of the change in ownership rules of section 382. In sum, by removing the incentive created for loss trafficking by the restricted availability of loss carryovers in the present system, recoupment simplifies the complex task of administering the net operating loss deduction under sections 269, 381 and 382.

ANSWERING OBJECTIONS TO A RECOUPMENT SYSTEM

Several arguments have been advanced in opposition to proposals for loss recoupment: that it will subsidize inefficient managers; that it constitutes a negative income tax for big business; and that it encourage taxpayers to contrive artificial business losses. These objections, however, are either flawed or without merit. In addition, proposals other than recoupment have been offered to replace the current loss deduction provisions, including permitting losses to be freely

71 See ALI DRAFT, supra note 40, at 19-21 (discussing problems of change-of-business test). Compare Comm'r v. Barclay Jewelry, Inc., 367 F.2d 193, 195-96 (1st Cir. 1966) (denying deduction; voluntary suspension is change of business) with Clarksdale Rubber Co. v. Comm'r, 45 T.C. 234, 245-47 (1965) (two-year suspension in business activity following purchase of stock did not constitute "change of business"). See also note 7 supra (discussion of probability that changes in section 382 will become effective).

72 For example, the problem raised in complying with section 381 in Aetna Cas. & Sur. Co. v. United States, 568 F.2d 811, 821-23 (2d Cir. 1976), by the fact that a reverse triangular merger ostensibly did not meet the survivorship requirements to carry back post-affiliation losses, is irrelevant under a recoupment system. The new Aetna subsidiary would receive a refund for its own, newly incurred losses and the case's complicating fact that the prior income necessary for a loss carryback under the Code belonged to the old subsidiary, which had ceased to exist, would no longer matter.

73 See 1958 INCOME TAX PROJECT, supra note 8, at 41 (practitioners observe loss positions acquired for 10 to 15 cents on the dollar, or less); Eldridge, supra note 25, at 73 (same).

74 Another incidental benefit of recoupment would be greater accuracy in capital budgeting. A common calculation method discounts the tax benefits from depreciation by the riskless rate of interest, assuming that losses can always be recovered under the Code. See H. LEVY & M. SARNAT, supra note 51, at 78. But under the Code that assumption is not always correct; hence the accuracy of such a model for a decision rule is diminished. Under recoupment the opportunity to receive the tax benefit of the loss is certain.
transferred in the marketplace, and deducting losses transferred in the corporate acquisition context in proportionate shares according to a joint venture concept.\textsuperscript{75} These alternatives, however, fail to satisfy the goals of taxpayer equity, neutrality, and administrative simplicity as adequately as recoupment does.

\textit{Encouraging Inefficiency}

It might be objected that a recoupment system would encourage inefficient managers and businesses, by “subsidizing” their fruitless enterprises. But this objection is easily rebutted. In the first place, the objection ignores the practical business position of a firm “enjoying” recoupment of losses: Such a firm is still losing money. Consequently, a recoupment regime would leave inefficient businesses and managers facing the same market mechanisms that they encounter today. Insolvency or management replacement might be, at most, delayed somewhat by the loss mitigating provisions of the recoupment system,\textsuperscript{76} but inefficient businesses and managers would still fail.

But apart from the obvious, common sense explanation that people are not in business to lose money, the objection that recoupment encourages inefficiency is conceptually flawed: It adopts an impermissible time perspective. By arguing that recoupment would encourage inefficiency, the objection plainly takes an \textit{ex post facto} view of the provision’s effect. Such a view is improper. \textit{After} the fact of investment success or failure, it is easy to distinguish efficient enterprises from inefficient ones. Yet in order to affect investment decisions, tax provisions must be laid down \textit{in advance} of the investment, and it is only from this \textit{ex ante} perspective that their efficacy can be properly judged. From this perspective, it is clear that investment affecting tax provisions operate in an inherently risky and uncertain environment. In such an environment, according to the principle of tax neutrality, the recoupment proposal is less distortive than the current Code provisions on investment behavior, all other things being equal. From the proper, \textit{ex ante} perspective, then, recoupment represents the more desirable tax policy. The objection that loss refunds will sometimes be paid to inefficient businesses is no more than the tax law equivalent of Monday morning quarterbacking.

In addition to these practical and theoretical flaws, the objection of inefficiency also errs by looking at only one side of the ledger. It stresses the drain on the Treasury that would be caused by recoupment refunds paid to failing firms. But at the same time, it ignores the social

\textsuperscript{75} See ALI DRAFT, note 40 \textit{supra}.

\textsuperscript{76} Even this is doubtful, however, because sources of finance capital and boards of directors would probably take into account the availability of recoupment of losses in evaluating business and managerial performance.
benefits that would be derived from the success of risky business enterprises that would not have been undertaken in the absence of a recoupment system. For all of these reasons, the objection that recoupment will encourage inefficiency has little merit.

Subsidizing Business with a Negative Income Tax

Critics of the recoupment proposal may characterize it as a negative income tax that benefits business. Thus, the argument goes, the system operates to provide an unearned subsidy for business interests. This perception of the proposal, however, is based upon a flawed analogy. The conceptual underpinnings, function, and operations of the two tax proposals can quickly be shown to be entirely distinct. Recoupment is not a subsidy device but a means of achieving equity among taxpayers and investment neutrality.

The negative income tax was conceived as an explicit welfare device, an “approach to income maintenance,” which would relieve the poverty of individuals. Its underlying theory postulates a specified income level needed to obtain the basic necessities of life. If an individual fails to reach that minimum level, the government should enable him to achieve it by refunding the differential amount. Thus, under a negative income tax system, families receive cash payments in inverse relation to their incomes, until they reach a basic allowance “breakeven” level. The essential features of a negative income tax program consequently involve the negative income tax amount, which is determined by income, size, and composition of the family unit, and a single test of eligibility consisting of a comparison between the family’s

77 If necessary, the corporate income tax rate could be raised to maintain a constant level of federal revenue, and recoupment would represent a transfer of income from profit firms to loss firms. But any adjustment in the rates would most likely be small: in the aggregate, businesses prosper substantially more than they lose money, and even under the present system profit firms buy net operating losses and use them to reduce their own taxes. Further, new sources of taxable income will arise from the risky ventures that succeed and would not have been undertaken without recoupment, and from the reduction in the nonproductive use of resources on tax avoidance devices related to recovery of losses and the litigation surrounding them under the current system, such as mergers to acquire net operating loss deductions.

78 Cf. Bravenec & Fraser, supra note 2, at 363 (concept of refundable credit has met with resistance as in the case of negative income tax); Eldridge, supra note 25, at 88-89.


80 Crumbley, Behavioral Implications of Taxation, 48 Accounting Rev. 759, 760 (1973); Tobin, Pechman, & Mieszkowski, supra note 79, at 2.
income and the income breakeven level.\textsuperscript{81} The income of the family unit is subject to an offsetting tax, substantially less than one hundred percent (but greater than low bracket rates of the regular income tax).\textsuperscript{82}

The recoupment proposal has nothing in common with these features or premises of a negative income tax. The business entity receiving a refund is recovering a fraction of the excess of its business expenses over its income. It is thus not receiving a grant by which it can attain a minimal income level regardless of its own production efforts, but is matching expenditures against revenues. The refund is proportional to its (negative) income flow and not pegged to an outside minimum income standard. Moreover, the refund is determined solely by the size of the loss and the corresponding tax rate on business income; it does not vary with the nature or characteristics of the recipient entity. There is no independent eligibility test comparing income and set minimum levels; only the existence of a business operating loss triggers recoupment. Consequently, the refund is neither intended to support, nor capable of supporting, the unsuccessful business, in contrast to the family's net benefit received from the negative income tax.

\begin{figure}
\centering
\includegraphics[width=\textwidth]{figure4}
\caption{Negative Income Tax}
\end{figure}

\textsuperscript{81} Pechman, \textit{supra} note 79, at 587-88.
\textsuperscript{82} \textit{Id}; Tobin, Pechman, & Mieszkowski, \textit{supra} note 79, at 3.
Because recoupment merely perfects the treatment of business losses, ensuring that only net income is taxed, as do other deduction and exemption provisions of the Code, the fundamental distinction between the negative income tax and recoupment system can be readily demonstrated by a simple graph. While the recoupment proposal discontinues refunds at the zero income level, with no offsetting rates in the positive income zone, the negative income tax operates in the positive income range to provide a subsidy.

Figure 4 represents the effect on a family unit’s income of a negative income tax. Line OBDC represents the taxpayer’s income subject to a regular income tax, while line ADC represents the shift in disposable income produced by substitution of a negative income tax, where $D$ represents the tax breakeven point and $A$ is the basic minimum allowance level for a no-income family. The shaded portion OAD represents the incremental subsidy accruing to poor family units under the negative income tax, an amount related to the government’s establishment of a minimum income level and not the family’s pre-tax income producing efforts. No such differential support level exists in the recoupment system, which is depicted in Figure 5. In the upper right quadrant, the income line OC maintains its continuous linear shape and constant slope. The effect of the refund is limited to the lower left quadrant, where one can compare the slopes of the recoupment tax line OL and the nonrecoupment tax line ON. As the graph shows, the nonrecoupment line declines more steeply than the recoupment line, whose slope remains the same as that of OC. The shaded area LON represents the offset’s mitigation of the negative income flow, but as shown, the amount is related proportionally to income producing activities and does not work as a subsidy or support level for positive receipts like the shaded portion OAD of the negative income tax. Thus, while a negative income tax operates as a subsidy at nonnegative income levels, recoupment simply introduces a symmetry in tax treatment between negative and positive levels of income.

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83 See generally B. BITTKER & L. STONE, FEDERAL INCOME, ESTATE, AND GIFT TAXATION 181, 184, 231 (deductions necessary to arrive at taxable income; cost of earning a living, unlike cost of living, is ordinarily fully deductible—if deductibility of business expenses had been narrowly drawn by Congress, tax imposed would have been sales, value added, or gross receipts tax and not income tax); M. CHIRELSTEIN, supra note 27, at 86-87 (deductions necessary to maintain system of income tax as opposed to sales or excise tax); McNulty, Tax Policy and Tuition Credit Legislation: Federal Income Tax Allowances for Personal Cost of Higher Education, 61 CALIF. L. REV. 1, 16-18, 27-28 (1973) (discussing use of deduction to perfect definition of income in considering tax proposal providing allowances for costs of higher education).

84 Figure 4 is simplified compared to some negative income tax proposals, to the extent that it does not show the area of overlap between the negative and positive income tax systems that will result because of the positive tax’s system of reductions in the personal exemption and standard deduction calculation for the family’s income. See Pechman, supra note 79, at 592-93.
A final objection that might be lodged against the proposed recoupment system is that its institution would encourage business taxpayers to contrive artificial business losses that would enable such taxpayers to claim refunds from the Treasury. Of course, these problems already exist in similar form under the current Code. The proposed recoupment system probably would increase to some extent the existing pressure on the distinctions between capital expenditures and current deductions and between stock and debt characterizations of a firm's capital structure, as taxpayers seek to accumulate more aggregate deductions to receive a loss refund. However, because behavior designed to evade taxes already exists, the current Code contains mechanisms to deal with such problems.

In the first place, the problem of determining "requisite seriousness about making money" arises under the current Code in the context of "hobby losses." Because under section 165, an individual's losses in one line of business can be used to offset his income in another line, individual taxpayers sometimes attempt to deduct as business losses the
losses they incur in their hobbies.\textsuperscript{85} The Internal Revenue Service and the courts have developed a “business purpose” test to apply to such attempts on a case-by-case basis.\textsuperscript{86} Such a test can never be wholly satisfactory, turning as it must on objective indications of subjective intent.\textsuperscript{87} But for present purposes, it suffices to observe that the problem of “requisite seriousness”\textsuperscript{3} already arises, and is already dealt with, under the present Code. In other words, the objection being levied against recoupment of losses is a familiar refrain. The real problem is not one of permitting recoupment of losses but of adequately distinguishing between production and consumption activities,\textsuperscript{88} a problem which raises the rather speculative question whether recoupment will increase monitoring costs by inducing taxpayers to contrive losses more than it will reduce the current high costs of mergers and efforts to avoid the limited life of a carryover and the restricted transferability of losses, and the concomitant costs of monitoring these efforts.

Similarly, the problem of taxpayers’ attempts to generate losses by providing for excessive salaries and excessive debt also arises under the present Code.\textsuperscript{89} To meet this problem, section 162(a)(1) imposes a “reasonable” limit on the amount of salaries that can be deducted, and section 385 authorizes the Internal Revenue Service to adopt regulations defining whether a particular investment is to be classified as debt or equity.\textsuperscript{90}

The problem of evasive behavior as it would exist under a recoupment regime thus does not differ in kind from the present problem: The motives behind the understatement of income are essentially identical to those behind the claim of a net operating loss, and the means of effecting each, while numerous,\textsuperscript{91} are the same. Indeed, given the present provision for loss carrybacks, the very problem feared by critics of recoupment already exists with respect to any business enterprise that has shown a profit in the last three years. The fact that the loss carryback provision has not been notably abused suggests that a recoupment system would be treated in similar fashion. Moreover, for the

\textsuperscript{85} See, e.g., Smith v. Comm’r, 9 T.C. 1150 (1947) (business executive owned farm, deducted its “uninterrupted losses” from his business income).

\textsuperscript{86} Id. at 1150, 1154-56; B. Bittker & L. Stone, supra note 83, at 234-36 (citing cases).

\textsuperscript{87} See M. Chirelstein, supra note 27, at 88-89, 89 n.1.

\textsuperscript{88} See A. Atkinson & J. Stiglitz, supra note 22, at 115.

\textsuperscript{89} See, e.g., Tomlinson v. 1661 Corp., 377 F.2d 291 (6th Cir. 1967) (excessive debt); Patton v. Comm’r, 168 F.2d 28 (6th Cir. 1948) (excessive salary); Edwards v. Comm’r, 50 T.C. 220 (1968), rev’d, 415 F.2d 578 (10th Cir. 1969) (excessive salary); M. Chirelstein, supra note 27, at 116-21 (observing Internal Revenue Service practice of disallowing excessive salary deductions).

\textsuperscript{90} The Internal Revenue Service has recently promulgated regulations under section 385. See Treas. Reg. § 1.385-1 to -10, 45 Fed. Reg. 86,438 (1980).

refund to be channeled into the hands of shareholders, the bulk of the loss would have to be derived from excessive salary or interest payments to shareholders who wear two hats, as employee-owners or creditor-owners. But the taxpayer-shareholders receiving the excessive salaries or excessive interest payments will have to pay taxes on that income. The opportunity to profit from contriving artificial losses while paying individual income taxes would thus arise only in a small number of cases—those where the corporate loss is over $100,000 so the 46 percent recoupment rate would apply, and the personal rates of the shareholders, whose incomes have been increased by the corporate balance sheet manipulations, are less than 46 percent.

On the other hand, one could be concerned not with contrived losses redirected into shareholders' pockets but with losses of the "paper" variety, such as extensive deductions from revenues under the Code's allowance of accelerated depreciation methods. Apart from the simple answer that the Code affirmatively permits corporate taxpayers to shield income through such techniques, a ready solution can be adopted to restrict any excessive temptation to generate losses by depreciation expenditures. We can require firms to use straight line depreciation for computation of a net operating loss; separate books for tax purposes are not foreign to the Code or corporate practice. Such a requirement would make it impossible for firms to contrive massive losses by using accelerated depreciation deductions.

In one sense, then, the artificial-losses objection proves too much, because it applies as well to the provisions of the current Code. But in another sense, this objection may carry less weight with respect to recoupment than it does with respect to the present provisions. For example, from the standpoint of publicly owned corporations, the temptation to claim fictitious losses might be less than the temptation to understate income: News of outright losses could have a greater adverse impact on share prices than would news of unexpectedly low profits. Even for close corporations, partnerships, and sole proprietorships, which are not as concerned with market evaluation, another consideration suggests the same practical outcome. A firm that adroitly understates its income may not distinguish in any particular way its tax return from millions of others filed annually. By contrast, a firm claiming a net operating loss refund would know that its return would thereby stand out and could easily be made the object of special scru-
Finally, the recoupment system provides a more equitable and neutral tax treatment of businesses than does the present system. These strong arguments in favor of its adoption outweigh whatever slight concerns might exist with respect to the possibility that recoupment may increase existing pressures on the various distinctions made between \textit{bona fide} business operating deductions and those claimed for tax evasive purposes. There is no reason to assume that any increased enforcement costs from the heightened pressure will not be offset by the decreases in administrative costs from the greater simplicity of the recoupment system and the reduced incentive for mergers solely to attain the tax attribute of the net operating loss deduction.

\textit{Comparison with Alternative Proposals}

A final question remains concerning the reason for selecting recoupment over other possible means of revising the current tax treatment of net operating losses. We discuss, in turn, two major alternatives that have been proposed: free transferability of losses,\footnote{See H. BALTER, \textit{supra} note 91, ¶ 3.01-02 (enumerating features of a taxpayer's return or circumstances that prompt particular Internal Revenue Service attention). To reinforce this fear of special scrutiny, the IRS could announce a policy of auditing all (or a high percentage of) returns that claim a net operating loss refund.} whereby tax losses could be sold on the open market; and a “joint venture” approach to net operating losses in corporate acquisitions, as recently proposed by the American Law Institute.\footnote{See, \textit{eg.}, Brock, \textit{Past, Present, and Future of Net Operating Loss Carryovers in Corporate Acquisitions}, 43 \textit{Taxes} 586, 596-97 (1965).} A brief comparison with these proposals will show that recoupment is the most satisfactory approach for resolving the various problems arising from the net operating loss deduction provisions.

\textbf{Free Transferability}.—Under a system of free transferability of losses, the current restrictions on the availability of loss deductions would be lifted; the tax attribute of the loss deduction could be purchased and used by any profit firm to offset its own, unrelated income.\footnote{ALI \textsc{Draft}, note 40 \textit{supra}.} Like recoupment, transferability eliminates inequitable tax

\footnote{A qualified form of the free transferability system was recently enacted as part of the Reagan administration's tax reform legislation in the form of relaxed leverage leasing provisions. See Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 201(f)(8), 95 Stat. 172 (1981) (leasing arrangements for investment tax credits and depreciation allowances). See also Wall St. J., Aug. 27, 1981, at 1, col. 6. To the extent that these reforms effect a system of free transferability, this legislation is subject to the criticisms appearing in the accompanying text. Moreover, the reforms will not always permit the full recovery of the losses; the profit company is purchasing only the investment tax credit, which equals 10 percent of the purchase price of certain capital equipment, and the depreciation allowances for such equipment, which may constitute only a part of the value of a company's net operating loss. And, there is a further objection that can be raised against the}
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treatment caused by the expiration of unused net operating losses, because no loss need ever expire. The loss can simply be sold to a profitable firm for use as an offset. The inevitable question, then, is why recoupment should be preferred to free transferability, or to put it more directly, why the Treasury should be burdened with paying out cash refunds when a similar result could be achieved by allowing private persons to buy losses in the marketplace just like any other commodity.

Apart from aesthetic choices preferring to give refunds directly to the taxpayer who incurred the loss rather than to allow firms to bid for disembodied tax attributes with the explicitly sanctioned purpose of shielding income, several factors support favoring recoupment. In the case of a massive loss company, as, for example, instanced by the recent history of financial difficulties in the automotive industry, a free market solution would be inadequate. With millions of dollars of losses, no one firm would be able to (or necessarily desire to) purchase the loss asset, and several purchasers would be necessary. This would correspondingly increase the transaction costs of structuring the purchase, such as having to find the buyers, negotiating with numerous parties, and the like. There would also be greater administrative costs, as the loss attribute would have to be divided up among several taxpayers and traced along several returns. The increased costs to the purchasers would undoubtedly result in a corresponding reduction in the offered price, and consequently, the loss firm would most probably not receive the full tax value of its loss. In these circumstances, free transferability would be a more unwieldy, complicated solution, compared to the straightforward government refund program of recoupment.

Proponents of free transferability might further argue that a marketplace solution would serve an important private auditing function, which is more efficiently performed by profit firms than the Internal Revenue Service because of the investigative incentives of prospective purchasers. But while the purchaser has a clear incentive to audit the loss firm to ensure that he is buying a bona fide deduction at its "true" value, this would not relieve the IRS from responsibility to review the loss transfer, if only to keep the private auditors honest. Rather than cost savings from more efficient auditing of losses, one could as easily anticipate duplications of auditing effort by the government to police the already audited purchase transactions.

system of free transferability of losses effected by the new legislation. By relying on liberalized leasing and investment tax credit provisions as the means by which loss firms can transfer the tax value of their losses to other firms, the new legislation arbitrarily differentiates between loss firms that can make use of those provisions and loss firms that cannot. This differentiation—like the policy of providing investment tax credits—must be justified by the principle of promoting economic growth, and cannot be justified by the principles of tax equity and neutrality that support recoupment. See text accompanying notes 22-64 supra.
Since free transferability does not guarantee that the market will not discount the loss even in the absence of unusually large transaction costs, the loss firm may not receive the full tax value of its loss under such a measure. While there is no risk of challenge to the overall transaction as there is in the present system, the IRS could recompute the actual amount of the loss; while undoubtedly the same risk may be present whether the loss is being transferred or refunded, the purchaser will discount its payment price accordingly, and there will be that much less received by the loss firm, regardless of the IRS audit outcome. Moreover, there must be some marginal difference between the tax value and the purchase price for the transaction to be profitable from the standpoint of the profit firm. Thus, a recoupment approach would be more desirable than a system of free transferability.

**Joint Venture Approach.**—The American Law Institute Tax Advisory Group has put forth its own proposal to revise the current provisions for net operating losses in the context of corporate acquisitions. Rejecting both recoupment and free transferability, the ALI has developed a series of complex rules to limit the carryover of losses in acquisitive transactions, based on the principle that losses should be deducted against subsequent earnings only to the extent allocable to the capital that had been invested in the loss firm. The proposal resembles the perspective on losses of section 382, which concentrates on continued stock ownership percentages, to ensure some fixed numerical relationship between the amount of the loss to the firm and the offset available to the new entity to minimize the sheltering of unrelated business income.

The major disadvantage of the ALI proposal is its very narrow focus: It does nothing to alter the basic inequity between taxpayers with varying economic histories, which is an undesired result of the present provisions. This is in part a function of the ALI's more limited perception of its role; the drafters viewed their task as working within the structure of the current system. Consequently, their proposal does not confront the central dilemma of the current system, that the treatment of net operating losses departs from the Haig-Simons definition of income. Temporal limitations are retained, as are the very real

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98 In addition, free transferability of individual taxpayer losses might result in a situation similar to that of the municipal bond exemption of I.R.C. § 103, where, because there are not enough high bracket taxpayers to purchase all the bonds, the market price of bonds for all purchasers is lowered to attract those in lower brackets. See M. Chirelstein, supra note 27, at 327-28. In the case of losses, this would mean that the seller would not receive the full tax value of the loss. But in the context of the corporate taxpayer, given the small spread in corporate tax rates and the fact that the vast majority of corporate income is taxed at the highest 46 percent rate, any lowering of the purchase price below the 46 percent value, with a consequent loss to sellers, would be unlikely.

99 ALI DRAFT, supra note 40, at 72-73.
differences in value between carrybacks and carryforwards. In addition, the ALI's contention that the profitable party will enter the transaction with the loss firm under the joint venture rule without a decision "distorted" by the prospect of a carryover\textsuperscript{100} is not necessarily correct. Clearly, the loss firm has something to gain from entering into the venture—mainly, the use of its loss deduction—and the added value of the deduction must enter into the terms of the transaction and the allocation of interests between the two entities in the new enterprise. In other words, the value of the anticipated deduction will be taken into account in the purchase price. As long as one party gains from the transaction because it can use otherwise unusable net operating losses, there is bound to be some distortion in the investment choice of that party; while the profit firm cannot use the loss, the loss firm is given an incentive to merge under the ALI proposal because it is given an avenue to ensure some use of offsets by entering into an acquisitive transaction. Consequently, the investment decision is still "distorted" in that the tax consideration of using loss offsets is essential to that decision, from the point of view of the loss firm.

Moreover, the ALI approach is in marked contrast to the recoupment system, which has the virtue of administrative simplicity. As the ALI drafters recognized, tracing the loss firm's capital in various transactional contexts requires complex rules due to the innumerable forms of corporate acquisitions. While both proposals protect the loss firm's capital, recoupment does so directly, without cumbersome calculations, by reimbursing the loss firm regardless of its future permutations and not due to its reembodiment in another corporate form.

Lastly, recoupment directly confronts the theoretical difficulty the ALI proposal disregards: what to do about losses that cannot be offset for lack of later profits, in order to maintain the integrity of the tax as one on net income. The ALI proposal does not purport to restructure the current disparities among taxpayers in the treatment of net operating loss deductions, but simply attempts, in piecemeal fashion, to tinker with the existing system at one of its more problematic points, the exultation of form over substance in the transferring of tax attributes like losses in corporate acquisitions. In sum, the ALI proposal, when compared to recoupment, fares little better than the current system from the perspectives of equity, neutrality, and administrative convenience.

**CONCLUSION**

The recoupment system receives powerful justification from the principles of equity between taxpayers, economic efficiency, and administrative convenience. In the face of these considerations, the objections usually advanced against recoupment—the promotion of

\textsuperscript{100} *Id.* at 73-74.
inefficiency, subsidization of business, and encouragement of contrived losses—have little merit. Consequently, rather than expending further energy on the elaboration and complication of the present loss deduction regime, tax reformers should instead focus their efforts on replacing it with a system of recoupment of losses.