Lost in Translation

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INTRODUCTION

From its inception, the tax code has limited taxpayers’ ability to deduct certain losses.¹ Over the years, whether as true tax reform or packaged as reform, tax authorities have added a wide variety of loss-limiting provisions, serving a range of purposes. Some, like the recently enacted 461(l), are nothing more than hidden tax increases; however, the vast majority are designed to prevent taxpayers from manipulating the tax rules to their advantage. These provisions can be broken into different families or groupings based on the problem(s) they seek to address. Some are designed to prevent taxpayers from shifting losses to other taxpayers. Others are designed to protect the realization requirement by preventing taxpayers from triggering built-in losses in property while functionally retaining it. Still others are designed to ensure that taxpayers’ tax results match their economic reality. Taken as a whole, these provisions significantly complicate the tax code and distort taxpayer behavior, leading many to wonder whether something important has been lost in translation from idea to practice.

Most articles considering loss limiting provisions focus on only one or two provisions.² This Article takes a more comprehensive approach, considering the variety of loss-limiting provisions found in the code and regulations. The first goal is simply to categorize the different provisions. These provisions differ not only in their goals, but also in their causes, that is, the feature(s) of the tax code that create the conditions that taxpayers might exploit and which necessitate the prohibitions. They also differ in the techniques and mechanisms they employ to achieve their ends. The second goal is to consider potential changes to the law to address the myriad issues these provisions raise.

The loss-limiting provisions touch upon virtually every aspect of the tax code, including the realization requirement, annual accounting period, and the appropriate taxable unit, among others. They also rely on a host of different mechanisms to achieve their goals, including non-recognition, disallowance, and manipulation of basis. Given the variety of problems addressed, their causes, and the mechanisms used to limit losses, finding a unified field theory for loss limiters may not be possible. Nonetheless, it may be feasible to enact a number of reforms to harmonize and rationalize these provisions, including eliminating ...

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² See, e.g., Cummings, Discontinuities in Corporate Recognition of Loss, 44 Tax Lawyer 39 (Fall 1990); Douglas Kahn & Jeffrey Kahn, Prevention of Double Deductions of a Single Loss: Solutions in Search of a Problem, 26 VA. TAX REV. 1 (2006) (discussing the limitations imposed by Section 336(d) and the limitations imposed by Section 362(e)).
I. Basic Features of the Income Tax

Before turning to specific loss limiters, it may help to review the basic features of the income tax in which these provisions operate. Many of these features create the conditions that arguably make the loss-limiters necessary. They may also factor into any efforts to reform or harmonize these provisions.

The tax code does not formally incorporate any specific ideal income definition, but most scholars evaluate its provisions using the Schanz-Haig-Simons formulation, which posits that an individual’s income equals his consumption plus change in wealth over an accounting period, typically a year. The real-world income tax deviates from this ideal in a number of important ways, primarily because the income tax did not derive from Haig Simons but rather from financial accounting as it existed in the early 1900s. A number of deviations address administrative concerns, and these deviations often create the conditions necessitating the loss limiters discussed here. The most important deviation for our purposes is the realization requirement, which postpones taxes on certain changes in wealth—specifically gains or losses on property—until the property has been sold or otherwise disposed of. This feature permits gains and losses on property to build up over time and for taxpayers to selectively realize losses while delaying gains into the future. A second feature of the income tax that contributes to the need for loss limitation rules is that it employs graduated tax rates and affords preferential rates for capital gain income.

A third feature of the income tax is that not all losses are equal; for example, expenses and losses deemed personal are not deductible, while those incurred in pursuit of a trade or business or in a profit-seeking activity are. A fourth feature is that the tax code generally treats each individual and corporation as a separate taxpayer, even when they share economic interests, which could allow taxpayers to claim realized losses even if they do not reflect actual losses. A fifth feature is that taxpayers may include debt in basis, including non-recourse debt that they may never be required to repay. A sixth feature is that the code generally uses a global approach, where income and deductions from different activities are aggregated to determine taxable income, creating the possibility that losses from one activity could be used to offset income from another. A seventh feature is the general rules that taxpayers do not recognize gain or loss when they contribute property to a corporation or partnership. Finally, the code uses an annual accounting period, which creates the potential for mismeasurement of income and over-taxation, and is the most important contribution of financial accounting to the income tax.
As described more fully below, these features, either alone or in combination with others, create the conditions that taxpayers have attempted to exploit to lower their taxes and which motivated tax authorities to respond with loss limiters.

II. A Taxonomy of Loss Limiters

The first step in any effort to consider loss limiters broadly is to categorize them. One option would be to focus on the features of the tax code that make them purportedly necessary. Another would be to group them based on the mechanism they use to prevent and sometimes preserve losses. However, the best way to approach these provisions is to look at the different purposes these provisions serve. Some loss limiters appear to be hidden tax increases, but the vast majority prevent taxpayers from “cheating” the system. Such cheating include transferring losses from one taxpayer to another, deducting personal losses by converting loss property from personal to business use, triggering losses while functionally retaining property, taking advantage of the time value of money by harvesting losses while postponing gains, converting ordinary income into lower-taxed capital gains, and claiming tax losses that do not correspond to a taxpayer’s economic losses.

A. Preventing Loss Transfers

The first family of loss limiting provisions is aimed at preventing taxpayers from transferring losses from one taxpayer to another. In a system with graduated tax brackets and entirely different tax regimes for different sorts of taxpayers, taxpayers have an incentive to shift gains to those in lower tax brackets and losses to those in higher tax brackets. Even absent graduated rates, taxpayers may reduce taxes by directing gains or losses to others with corresponding losses or gains. While those who transfer losses generally reduce the tax liability of others, they can share the tax savings, whether through contract or because the taxpayers are closely related and view themselves as an economic unit.

Some anti-transfer rules are targeted at both gains and losses, while others are aimed solely at losses. Interestingly, the anti-income assignment rules have largely been developed by the courts,7 while most of the loss transfer limitations are statutory or developed in the regulations.8 Both kinds of transfers are disfavored, but transferring losses appears to be the greater sin. As discussed below, anti-loss transfer provisions can be found in a variety of contexts, including gift giving, net operating losses, and in the partnership contribution rules.

1. Section 1015 and the Shifting Basis Rule

One of the first anti-loss transfer rules is found in section 1015, which sets forth the basis rules for gifts and prevents the transfer of a loss in a carryover basis regime. Gifts are not considered a “sale or other

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7 See, e.g., Lucas v. Earl, 281 U.S. 111, 115 (1930) (holding that tax could not be avoided by the use of contracts assigning the income to another); See also Comm’r v. Giannini, 129 F.2d 638 (1942) (holding that there was no deficiency in taxpayer’s income tax because the taxpayer did not receive money and did not direct its disposition).

8 See, e.g., I.R.C. §§ 267, 1015.
disposition” for purposes of section 1001(a) and therefore are not a realization event for the donor. Among other things, there is no amount realized for purposes of determining gain or loss. Because there is no sale, questions also arise as to the basis the donee should have in the acquired item. Under normal circumstances, basis is cost, what the taxpayer paid for an asset.9 Options for determining the basis a donee should take include (1) giving the donee a basis equal to the fair market value of the gift at the time of the gift, (2) giving the donee no basis, because his cost is $0 or (3) transferring the basis from the donor to the donee. Option 1 seems unthinkable to a modern tax lawyer, but it is in fact the rule early tax authorities adopted.10 Relying on trust accounting, they reasoned that the donee’s starting point was the value received, much as a trust started with the value contributed, and therefore they set the donee’s basis at the fair market value on receipt.11 Not surprisingly, taxpayers soon figured out that they could avoid the income tax on appreciated property by transferring property as a gift and having the donee sell it.12 If the donor and donee were close, as was usually the case, the donee could use the proceeds for the benefit of the donor or simply transfer them back to the donor by gift. Such transfers were exempt from tax.13

A simple example illustrates this point. Imagine A purchases an asset for $10 and the asset increases in value to $25. Gift giving is not a realization event. Thus, A can give the property to B without paying any tax on the $15 gain. If B’s basis is the fair market value at the time of the gift, B’s basis is $25. Thus, if B sells the asset, B pays no tax, and the $15 of economic gain goes untaxed, a tax result at odds with economic reality.

Congress could have addressed this problem in a number of ways. First, it could have set B’s basis to $0, B’s actual cost. However, B would then pay tax on $25 of gain, even though the asset has appreciated only $15. While the government wins with this approach, the tax result deviates from economic reality no less than it did with the original rule. Second, Congress could have determined that gift giving counts as an “other disposition” for purposes of section 1001(1) and therefore constitutes a realization event. Were this the case, A would have to pay tax on the $15 of gain at the time of the gift, using the fair market value as the amount realized, while B could receive a fair market value basis. The tax result would match economic reality, but such a rule would raise the valuation and liquidity problems the realization requirement was designed to avoid.

A third option, and the one Congress chose in 1921, was continue to exclude gifts from the definition of “other disposition” but to transfer A’s basis in the asset to B, effectively treating A and B as one economic unit with regard to the gift.14 In the example above, when A transfers the property to B, A pays no tax, B takes a $10 basis in the asset, and B must report the $15 gain when he sells it for $25

9 I.R.C. § 1012(a).
12 See H.R. REP. NO. 67-350 (1921); See also S. REP. NO. 67-275, at 10 (1921).
13 See I.R.C. § 102.
even though B alone has experienced no gain. The Supreme Court blessed this approach in Taft v. Bowers, noting that the investment was a single event and that Congress had the power to make the donee step into the donor’s shoes for tax purposes. This rule ensured that the overall tax result matched economic reality.

By adopting the transferred basis approach, Congress opened the door for taxpayers to transfer income to one another. In the example above, B is forced to pay the gain that accrued in A’s hands. This could be quite advantageous if B is in a lower tax bracket or has losses he can use to offset the gains. This rule also opened the door to loss shifting. If A had purchased the asset for $25 and the asset had dropped to $10, under the pure transferred basis rule, he could give it to B and have B sell it and claim the $15 loss. Taxpayers were quick to exploit this possibility, and Congress responded to such efforts in 1934 by introducing the “shifting-basis” rule that continues to this day.

For property with a built-in loss given as a gift, the taxpayer must use the lower fair market value as the basis for purposes of calculating a loss, while continuing to use the donor’s basis for calculating gains. This prevents the donee from deducting any losses that occurred while the donor held the property, while permitting them to deduct losses that occur after the transfer.

Again, an example may help. If A acquires the property for $25 and gives it to B when it is worth $10, and then B sells it when it is worth $5, B determines his loss by using $10 as his basis, instead of A’s $25 basis. He would thus deduct a $5 loss, which matches the loss that occurred while he owned the property. Neither he nor A may claim the $15 loss that occurred in A’s hands. Admittedly, the shifting basis rule causes the tax results to deviate from economic reality. The asset has dropped in value from $25 to $5, reflecting a $20 loss. However, A and B together get to deduct only $5, causing $15 of loss to go unclaimed.

While matching tax results to economic reality is an important goal, here Congress decided that preventing taxpayers from transferring losses is more important.

15 278 U.S. 470 (1929).

16 This ability to transfer gains is subject to some limitations. For instance, where A has appreciated property, negotiates the sale and then permits B to consummate it, courts have used the step transaction doctrine or some variation thereof, to rule that the gain is truly A’s gain. Salvatore v. Commissioner, 434 F.2d 600 (2nd Cir. 1970) (holding Mrs. Salvatore alone was the seller of a gas station because children were only conduits used to pass title and distribute the proceeds of the sale, and the transfer of title to children was simply a step towards that end); See also Davant v. Commissioner, 366 F.2d 874 (5th Cir. 1966) (holding that when a corporate liquidation was a pretext to an immediate reincorporation, the law treated the liquidation and reincorporation as a reorganization and the income as dividends rather than capital gains).


18 Interestingly, if B sells the property for a price between the original basis and the fair market value at the time of the gift, say $15, B will report no gain or loss. As a matter of economic reality, A will have suffered a $15 loss, while B will have experienced a $5 gain, for a net $10 loss. However, the loss occurred while A owned the property, and B is not allowed to claim it.
2. Net Operating Losses

The tax treatment of net operating losses (NOLs) also reflects concerns regarding loss transfers.\textsuperscript{20} Tax does not have negative numbers, and thus taxpayers do not receive a refund they experience a business loss. Rather, when a business has more expenses than revenues during the accounting period, it reports no income. The expenses in excess of revenue are termed net operating losses, and they would be lost forever absent some rule to the contrary. Indeed, this was the original rule when the tax code was first enacted. However, restricting losses to the year in which they occurred runs the risk over overstating a taxpayer’s income, at least as viewed from a longer perspective, and pressure arose early on to permit taxpayers to transfer losses between years as a way to average income over time.\textsuperscript{21}

The effects of the annual accounting period on income measurement can be seen with a simple example. Imagine a flat rate tax of 20% and two companies, one with $50,000 of income each year for two years, and the other with a $50,000 loss in year one and a $150,000 gain in year two. Both companies have earned $100,000 over the two-year period, but the first company would be taxed on $100,000, resulting in $20,000 in taxes, while the second would be taxed on $150,000, resulting in $30,000 in taxes. The problem is exaggerated with graduated rates. If the rates were 20% for the first $50,000 and 40% for all amounts thereafter, the first company would owe $20,000 in taxes, while the second would owe $50,000.

Congress first permitted taxpayers to transfer losses between tax years in 1919.\textsuperscript{22} The initial rule permitted taxpayers to carry losses back one year, and then, if any losses still remained, to carry the same forward to the next. The stated purpose of this rule was to soften the consequences of the annual accounting period.\textsuperscript{23} Over the years, Congress has tinkered with the carryback and carryforward periods, with the most recent changes coming in the 2017 Tax Cut and Job Creation Act, which


\textsuperscript{21} This is distinct from transfers between taxpayers, as was the case with gifts.

\textsuperscript{22} See Revenue Act of 1918, Pub. L. No. 65-254, § 204(b), 40 Stat. 1057, 1061 (1918). The rules have changed significantly over the years and are now contained in I.R.C. § 172.

\textsuperscript{23} A number of income averaging proposals have been made over the years, and indeed some have been enacted for brief periods. See \textit{Tax Rules of Yore: Tax Breaks You Can’t Use Now But...}, J.K. Lasser (Jun. 24, 2014, 8:80 AM), \url{https://www.jklasser.com/articles/tax-rules-of-yore-tax-breaks-you-cant-use-now-but/} (discussing how a general four year income averaging rule had expired in 1986). The chief advocate for income averaging was William Vickrey, see William Vickrey, \textit{Agenda for Progressive Taxation} 164-97 (1947). though many others have followed. \textit{See, e.g.}, Daniel Shaviro, \textit{Beyond the Pro-Consumption Tax Consensus}, 60 Stan. L. Rev. 745 (2007).
eliminated the ability to carry NOLs back, while allowing unlimited carryforwards.\textsuperscript{24} The new law also limited allowable NOLs to the lesser of the NOLs or 80% of the taxpayer’s taxable income.\textsuperscript{25}

Implicit in the averaging justification for allowing taxpayers to transfer NOLs between years is the notion that NOLs should only be available to the taxpayer who generated them. This is fairly straightforward where individuals involved. It gets far more complicated when dealing with corporations, which are taxing entities themselves. Should the limitation apply solely to the corporation, or should it extend the shareholders, who are the real parties in interest? What happens if there is a change of control or a change in the business? The first court to consider whether NOLs could be transferred did so in the context of a reincorporation, where the owners of the new corporation remained the same. It held that the new corporation could not use the old corporation’s NOLs.\textsuperscript{26} Consistent with this corporate level view of NOLs, corporations were allowed to retain their NOLs even after their stock was sold to a new owner.\textsuperscript{27}

The ability of NOLs to survive a change or ownership created significant incentives for companies with profits to acquire those with NOLs so that they could use the NOLs to offset their income, whether through the consolidated reporting rules or by combining a profitable business with one with NOLs. In 1943, Congress enacted section 129, the predecessor to section 269, permitting the Treasury Secretary to block an acquiring company from using acquired tax attributes if the principle purpose of the acquisition was to evade or avoid tax, consistent with the idea that NOL carryovers were part of an income averaging regime and therefore specific to the taxpayer who created them.\textsuperscript{28}

Congress first began to move away from the income averaging justification for NOL carryovers in the corporate context in 1954 by permitting NOLs to carry over to new corporations in some subsidiary liquidation and reorganization scenarios.\textsuperscript{29} However, to qualify under the new Section 381, there

\textsuperscript{24} See Updated Details and Analysis of the 2017 House Tax Cuts and Jobs Act, TAX FOUNDATION (Nov. 3, 2017), https://taxfoundation.org/2017-tax-cuts-jobs-act-analysis/ (discussing how the Act allows for NOLs to be carried forward indefinitely and eliminates NOL carrybacks).

\textsuperscript{25} This limitation appears to be modeled on the AMT rules, which allowed 90% of NOLs and might be considered a hidden tax increase, as it does not appear to have a normative basis. The JCT estimates that the new provision will raise $210 billion over a ten-year window. See Tax Reform: KPMG Report on New Tax Law at 41 (Feb. 6, 2018), https://home.kpmg.com/content/dam/kpmg/us/pdf/2018/02/tnf-new-law-book-feb6-2018.pdf. The recent changes raise questions regarding the treatment of pre and post-2017 NOLs, which are beyond the scope of this article.

\textsuperscript{26} New Colonial Ice Co. v. Helvering, 292 U.S 435, 437-38 (1934) (denying the carryover of NOLs to a corporation that reincorporated under a new charter); See also Libson Shops, Inc. v. Koehler, 353 U.S 382 (1957) (denying NOL carryovers in the merger situation).

\textsuperscript{27} See, e.g., Alprosa Watch Corp. v. Comm’r, 11 T.C. 240 (1948) (permitting NOLs to be used after the stock of a company was sold because the taxpayer remained the same).

\textsuperscript{28} See Simmons, supra note 20, at 1058-61 (describing how NOLs were valued by buyers and sellers).

\textsuperscript{29} I.R.C. § 381 (1954).
needed to be a continuity of interest, reflecting a switch from the entity level approach to a shareholder approach to NOLs. By insisting on a continuity of interest, the rule reflected the idea that the people (in this case shareholders) who generated the losses were benefiting from them, thereby averaging their income over time. Section 382 required large shareholder continuity where the old business was abandoned but not when the new company continued the business, reflecting both the corporate and shareholder approaches to NOLs. The result was increased complexity and an opportunity to manipulate the rules to transfer NOLs to new taxpayers, contrary to the original intent.30

Despite the loosening of the rules to permit NOL transfers in reorganizations and some changes of corporate control, the Treasury Department restricted the transfer of NOLs in 1966 by adopting consolidated return regulations that limited the use of NOLs.31 As with the other rules, these changes were consistent with the notion that those who generated the NOLs should profit from them. Another way to think of NOLs is as simply another corporate asset. Most economists believe that disallowing NOLs creates an improper asymmetry between gains and losses that discourages taxpayer risk-taking.32 Under this view, taxpayers should be allowed current refunds for NOLs. To date, permitting refunds is off the table. However, allowing NOL transfers could be viewed as an indirect way to provide refunds, much like the way that Congress funds a variety of activities through transferrable tax credits.33 Rather than provide refunds directly to shareholders, allowing a market in NOLs would permit shareholders to monetize them. The government indirectly pays by recovering lower tax revenues from the acquiring company. However, despite academic support for tax refunds or alternately a market in NOLs, Congress has steadfastly acted to limit NOL transfers.

As part of the 1986 tax overhaul, Congress added a new feature to its anti-NOL transfer regime, responding to the insight that the market for NOLs was driven by the different values buyers and sellers placed upon them. The new Section 382 attempted to undermine that market by limiting the NOLs that an acquiring company could use to the value NOLs had in the hands of the selling company multiplied by the long-term tax-exempt rate.34 In so doing, it eliminated the incentive for both parties to the transaction to transfer NOLs, such that deals would be driven by other, non-tax related factors. The

30 Congress attempted to fix some of the shortcomings with the old Section 382 in 1976, but those attempts were flawed, and the effective date for the new legislation was postponed until the statute was superseded by the 1986 reform and a completely new section 382. See Simmons, supra note 20, at 1065-67.

31 Id.

32 See Huaqun Li, A Quick Overview of the Asymmetric Taxation of Business Gains and Losses, TAX FOUNDATION (May 31, 2017), https://taxfoundation.org/taxation-business-gains-losses-nol/ (“Tax asymmetry is especially disadvantageous to risky business investment due to the high uncertainty associated with the investment’s streams of return for the upcoming years. When choosing between two projects with equal expected pretax rates of return, the risky one is less likely to be selected because of the penalization caused by partial loss offsets, should they occur, compared to the less risky one.”).


34 I.R.C. § 382(b).
revised statute retained the requirement that the new company continue the old company’s business (for two years) for any carryover NOLs to be allowed and the complicated rules to determine when an ownership change had occurred that might trigger the limitations.

3. IRC 704(c) and Partnership Loss Transfers Rules

Still another anti-loss transfer rule can be found in Section 704(c), which provides that any pre-contribution gain or loss on property contributed to a partnership must be allocated back to the person who contributed it. Section 721 provides for non-recognition of gains and losses when partners contribute property to a partnership. Section 723 carries over the basis in the contributed property. Thus, any pre-contribution gain or loss is preserved within the partnership to be triggered when the partnership disposes of the property. Unlike corporations, which generally must distribute gains and losses on a pro rata basis, allowing a limited transfer of pre-contribution gains or losses, partnership rules give partners significant leeway to allocate gains and losses. Absent 704(c), partners could allocate the gains and losses on contributed property entirely to non-contributing partners, effecting an assignment of income or transfer of loss.

As with section 1015’s gift basis regime, it took Congress some time to address this concern. Congress first attempted a comprehensive partnership tax regime in the 1954 code. The original version of 704(c)(1) treated contributed property as if it had been purchased by the partnership for purposes of loss and gain allocation. As a result, any gains or losses on such property were allocated to all partners according to the partnership agreement, creating distortions in book and tax accounting and permitting partners to shift pre-contribution gains and losses to other partners. Any transferred gain or loss was temporary because it would be accounted for when a partner left the partnership or the partnership dissolved, but even temporary distortions could be problematic. Partners who wanted to avoid these problems were permitted to allocate the gain or loss back to the contributing partner under section 704(c)(2).

35 I.R.C. § 382(c).
36 I.R.C. § 382(g).
37 In this regard, it differs from the corporate tax rules found in IRC 351, which do not require that gain or loss on contributed property be allocated back to the contributing shareholder, even for corporations that have chosen to be taxed as pass-through entities under Subchapter S. See I.R.C. § 351.
In 1984, in response to significant taxpayer manipulation of the original section 704(c), Congress amended the section, effectively making section 704(c)(2)’s elective allocation mandatory.\textsuperscript{42} Doing so ensured that the party who experienced the gain or loss was taxed and addressed the book/tax disparity created whenever gain or loss property was contributed to a partnership.

However, partners could easily avoid 704(c)’s loss chargeback rule by distributing loss property to another partner instead of selling it. As with contributions, distributions of property are tax-free to the partnership, and the partnership’s basis of distributed property carries over to the recipient,\textsuperscript{43} who could then sell the property and report the loss. Congress significantly limited this gambit in 1992 when it added section 737 to the code.\textsuperscript{44} Under this provision, if a partnership distributes property with pre-contribution gain or loss within 7 years of contribution, the property is deemed sold at its fair market value, and any pre-contribution gain or loss is then allocated back to the contributing partner.

Additional complications arise when contributed property sells for less loss or gain than existed on contribution. In the loss context, this means an asset sells for more than it was worth on contribution, generating a book gain from the partnership’s perspective, but less than its basis, generating a tax loss. The non-contributing partners have an economic gain, while the contributing partner has a smaller than expected loss.\textsuperscript{45} Under the so-called ceiling rule, taxpayers cannot allocate more tax gain or loss than the partnership actually experienced. This continues the book/tax disparity that arose at contribution and leads to a temporary shifting of loss to the non-contributing partner until the partnership dissolved.

In 1992, the Treasury Department proposed new regulations under the new section 704(c) to address this problem. In addition to the traditional method, which permitted gains and losses to be shifted, the new regulations permitted taxpayers to choose between two additional methods, the curative and remedial, to address the problems created by the ceiling rule.\textsuperscript{46} The rules permit taxpayers to elect different methods for different assets, thus permitting taxpayers to pick the most favorable method for each piece of contributed property the partnership owns. Not surprisingly, partners choose the option that will minimize taxes whenever possible.

\textsuperscript{42} I.R.C. § 704(c)(2).

\textsuperscript{43} I.R.C. §§ 731(b), 732(a)(1). Special basis rules limit the basis of distributed property to the partner’s basis in his partnership interest, which prevents partners from getting more credit for basis than they contributed. I.R.C. § 732(a)(2).


\textsuperscript{45} In some regards this is similar to the gift scenario where property with a built-in loss is transferred and later sold at a price between the lower fair market value at the time of the gift and its basis. The donor experienced a loss, while the donee experienced a gain, but tax considerations lead to no gain or loss being declared.

\textsuperscript{46} The curative permits partners to allocate existing gains and losses in the partnership to address the book tax disparities. If insufficient gains or losses exist, the problem will not be fully addressed. The remedial permits partners to create notional gains and losses and thus address the problem in its entirety.
In 2004, Congress enacted section 704(c)(1)(C) to address loss-shifting transactions. Under this provision, the partnership must use the fair market value of contributed property at the time it was contributed as the basis for determining the tax results for non-contributing partners. When the property has gain in value since contribution, the contributing partner reports a book gain and a tax loss, which will bring his accounts closer together but not synchronize them completely. The non-contributing partners report both a book gain and a tax gain, such that their tax results match their economic results and their book and tax accounts remain in sync. As a result, the contributing partners cannot transfer any of the loss he should bear to the non-contributing partners.

B. Preventing Personal Loss Deductions

Yet another family of loss limitation provisions is designed to prevent taxpayers from deducting personal expenses or losses, which is prohibited in sections 262 and 165(c). Taxpayers have engaged in two distinct efforts to avoid those restrictions. First, taxpayers may be tempted to convert property from personal to business or profit-seeking use. Second, taxpayers may attempt to classify hobbies and other activities as engaged in as a trade or business or as a for-profit venture. In both cases, they seek to bring themselves within the ambit of sections 162, 212 or 165(c). Tax authorities have developed rules to prevent this.

1. Converting Property from Personal to Profit-Seeking Use

The gift rules involve efforts to transfer losses on property between two distinct taxpayers. The anti-conversion rules are designed to prevent taxpayers from transferring losses incurred by taxpayer qua personal owners to the same taxpayer acting as profit-seekers. Not surprisingly, the rules limiting losses in this context mirror those found in the gift context, but adjusted to account for the differences between inter and intra-personal transfers.

Again, an example will help illustrate the issue and the rules designed to prevent abuse. Imagine that C purchased a house for $500,000 and has lived in the house for several years. Unfortunately, the house has gone down in value to $400,000. Were C to sell the house, she would have a $100,000 non-deductible personal loss. In contrast, if C had acquired the house as part of a business or for investment purposes, she could sell the house and deduct the $100,000 loss. What happens if C converts her home from personal to business use and then sells it? If she is allowed to take the loss she suffered when the property was held for personal use, section 165(c)’s prohibition against personal losses is easy to avoid. The statute is silent regarding conversions, but the Treasury Department has stepped into the breach.

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48 For a more complete analysis of section 704(c)(1)(C), see Monroe, supra note 41 (arguing that I.R.C. § 704(c) has been unworkably complicated and that it prevents those contributing loss property from electing either the curative or remedial methods to counteract the effects of the ceiling rule).
The first question to be decided, and one beyond the scope of this article, is whether a taxpayer has actually converted the use of a house such that losses should be deductible.\textsuperscript{49} Assuming the taxpayer has properly done so, the second question is how much loss taxpayers may deduct with regard to converted property when it is sold. The Treasury Department issued T.R. § 1.165-9 in 1960, which essentially adopts the shifting-basis rule used in the gift in the personal residence context. The regulation first disallows losses on personal residences.\textsuperscript{50} It then allows losses on converted residences.\textsuperscript{51} However, it contains special basis rules for such residences, stating that the basis for determining loss is the lesser of the fair market value or basis at the time of conversion.\textsuperscript{52} Applying this rule to the example above, C would have to use the $400,000 fair market value at the time of conversion, as opposed to the $500,000 cost, as her basis for determining loss, effectively preventing her from deducting the $100,000 loss that happened when the house was being used as a residence, but permitting her to deduct any losses that arose after the property was converted to profit-seeking use.\textsuperscript{53}

While this regulation specifically applies to converted residences, the logic applies to any property converted from personal to business use. Thus, taxpayers will not be allowed to convert a personal car to business use and thereby deduct a loss on the car that occurred while they used it as a personal car.

2. The Hobby Loss Rules

The hobby loss rule prevents taxpayers from creating deductible losses from certain types of activities.\textsuperscript{54} The ban on deducting personal expenses creates significant pressure for taxpayers to classify their expenses as incurred as part of a trade or business or in pursuit of profits. For many activities, such as bird watching, there is no question that the activity is a personal hobby, and the expenses associated with it are not deductible. But what about activities that have the possibility of generating revenues, such as participating in competitive dog shows or horse breeding and racing? Under what circumstances should these activities be considered a trade or business or a profit-seeking activity such that the associated expenses should be deductible against income?

\textsuperscript{49} In \textit{Horrmann v. Commissioner}, the tax court determined that, where a taxpayer has used a property as a residence, he must do more than just “abandon the property and list it for sale or rent.” 17 T.C. *903, *909 (1951), in contrast, where taxpayers inherit property and immediately evince an intent to sell, the property will be deemed to have been converted from personal use.

\textsuperscript{50} Treas.Reg. § 1.165-9(a) (1960).

\textsuperscript{51} Treas.Reg. § 1.165-9(b)(1) (1960).

\textsuperscript{52} Treas.Reg. § 1.165-9(b)(2) (1960).

\textsuperscript{53} Similar rules exist with regard to depreciation on converted property. If taxpayers were allowed to depreciate the entire basis of property that they converted when in a loss position, they would effectively be allowed to deduct value lost while the residence was used for personal purposes. Accordingly, the treasury regulations require taxpayers to use the fair market value of such property for depreciation calculations when basis is greater than fair market value at the time of conversion. See Treas.Reg. § 1.167(g)(1). (as amended in 1964).

Despite using the term “trade or business” throughout the Code, Congress has not seen fit to define it. Nor do the regulations contain a comprehensive definition. Rather, it has been left largely to the courts to give the term meaning. And yet, despite precedent stretching back almost to the beginning of the tax code, a clear definition remains elusive. In contrast, tax authorities have provided clear guidance regarding the line between profit-seeking activities and hobbies or other personal activities. Section 183 creates a taxpayer-friendly presumption that an activity is profit-seeking if it has turned a profit in 3 out of 5 years. The regulations indicate that the determination is one based on facts and circumstances and provides a number of relevant factors, including the manner in which the activity is conducted, taxpayer and advisor expertise, time and effort expended on the activity, taxpayer success or lack thereof, and the amount of personal pleasure or recreation involved. The line matters because expenses incurred in pursuit of profits may be deducted even if they exceed income from the activity. In other words, such expenses avoid the strictures of section 262 and 165(c) and can be used to offset unrelated income.

Although sections 262 and 165(c) prevent the deduction of personal expenses and losses, section 183 actually permits such deductions where taxpayers have earned income from not-for-profit activities. However, it limits the deductions to the income the activity produces, effectively zeroing out that income. Expenses in excess of income are not allowed and may not be carried forward to future years. Allowing taxpayers to deduct personal expenses appears to deviate from the ideal income definition described above. In fact, it is consistent with such a rule because it ensures that individuals are taxed only on their actual economic gains.

Section 61 includes all income, from whatever source derived, including income from not-for-profit activities, such as a $50 cash prize for the best pie at the county fair. If personal expenses associated with baking the pie, the lucky prize winner might actually owe tax on $50 when she, in fact, has lost money. The baker who spends $200 on supplies and wins a $50 prize has experienced a $150 decline in wealth. Taxing her on a $50 gain would be at odds with economic reality. Congress added section 183

55 See, e.g., I.R.C. §§ 162, 195.
57 I.R.C. § 183(d). For horse activities, the presumption applies if the taxpayer has turned a profit 2 out of 7 years.
58 Treas.Reg. § 1.183-2(a) – (b) (1972).
59 Examples of hobbies range from recreational softball, which offers little chance of profit, to horse breeding, where a small but real possibility exists. The Tax Cuts and Jobs Act of 2017 added section 67(g) to the code, which suspends the ability to take itemized deductions, including those under section 183 through January 1, 2026. I.R.C. § 67(g). Accordingly, this deduction is not currently available, but it could well become so again, whether because Congress recasts it as an above-the-line deduction, deductible for purposes of determining adjusted gross income under section 62, I.R.C. § 62, or if the provision expires.
to the tax code in 1969 to address this problem by allowing taxpayers to deduct expenses from not-for-profit activities to the extent of gains from such activities.\textsuperscript{60}

Although section 183 can be defended on normative grounds, it deviates from the normal “global” approach taken in the U.S. tax system in which all income and expenses are pooled together to determine taxable income.\textsuperscript{61} This approach contrasts with that used by a number of countries, including the United Kingdom and Germany, that employ a schedular system, in which income and expenses from different activities are determined separately. Under this approach, deductions from one activity cannot be used to offset income from another activity, permitting tax authorities to impose different tax rates on different types of income without fear that taxpayers will allocate their deductions to the highest taxed income.

Section 183 effectively adopts a schedular approach to hobby profits and expenses, allowing taxpayers to deduct such expenses only against gains from the same activity. Indeed, Congress has resorted to this approach in a number of cases that involve loss limitations. For instance, it permits taxpayers to deduct gambling losses only to the extent of gambling winnings, effectively treating gambling as a personal activity, despite its obvious profit-seeking motive.\textsuperscript{62} As discussed more fully below, the passive activity loss rules and the limitations on capital losses provide other examples of Congress resorting to a schedular approach to limit losses.\textsuperscript{63}

C. Preventing Losses when Property is Functionally Retained

Another family of loss prevention rules is designed to prevent taxpayers from triggering losses on property while functionally retaining it. The realization requirement permits gains and losses in property to build up over time. It also gives significant discretion to taxpayers to time their gains and losses to gain the greatest advantage. Typically, because of the time value of money, taxpayers have incentives to accelerate losses by engaging in a realization event while deferring gains. However, realization comes at a price. Taxpayers must typically divest themselves of the property in question. Not surprisingly, taxpayers quickly developed a number of techniques to trigger losses while functionally retaining their property. Tax authorities have responded with a number of different rules to prevent this, including sections 1091 (wash sales), 267 (related-party losses), and 1041 (transactions between spouses), as well as the part gift/part sale regulations.

\textsuperscript{60} In essence, the rule treats $150 of the expenses as non-deductible personal consumption, which offsets the $150 decrease in wealth.


\textsuperscript{62} I.R.C. § 165(d).

\textsuperscript{63} See I.R.C. §§ 469. 1211, 1212.
1. Section 1091 and the Wash Sale Rules

Shortly after the modern income tax came into being, taxpayers figured out that they could manipulate the realization rule to defer gains while harvesting losses. One such technique was the “wash sale,” in which taxpayers sold loss property and then immediately repurchased similar property. Congress responded quickly to this by enacting section 214(a)(5) as part of the Revenue Act of 1921. This provision “prevents the evasion of tax” by disallowing losses on sales of stock and securities sold and purchased within a 60-day window. As Congress explained as part of a later amendment, one who sells and then reacquires his property has not really changed his economic position in that he “has not terminated his investment in the loss property.” Initially, these disallowed losses were gone forever, but in 1924, Congress added a provision that adjusted the basis of the new stock to preserve the disallowed loss. Congress renumbered the provisions in 1928 and eventually combined them into section 1091 in 1954.

Again, an example may help. Imagine that A owns 100 shares Google stock that he bought for $10,000 and which is now worth $7,000. Absent section 1091, A could sell the stock, trigger the $3000 loss, and repurchase 100 shares the next day for $7,000, ending up with a $7,000 basis in the new stock. Section 1091(a) disallows A’s loss because he reacquired the stock within the prohibited window. Section 1091(d) provides that the basis in the new 100 shares is the basis of the original 100 ($10,000), adjusted by the difference in price between the original sale and the new acquisition, in this case $0. As a result,


66 This provision does not prevent taxpayers from selling stock and securities to trigger gains and then repurchasing the same or similar property. Many of the same justifications for banning loss wash sales apply to gain wash sales, and it is not clear why gains are treated more favorably than losses. In most cases, taxpayers will not wish to trigger gains and are unlikely to engage in such transactions. However, if taxpayers have expiring losses or if tax rates are set to rise, they may wish to do so. For an argument that wash gain sales transactions may be improper even absent a specific code provision, see see Stanley Veliotis, Do Tax Motivated Wash Gain Sails Pass Economic Substance Muster?, 71 TAX LAW. 391 (2018). In some cases, taxpayers may seek to obtain the financial benefits of a sale without formally selling the property, thus avoiding gains. Section 1259 treats certain transactions as constructive sales, even where the taxpayer retains the property, thus protecting the realization requirement from abuse from the gain side. I.R.C. § 1259


the new stock preserves the $3,000 loss that was not recognized, and the tax result remains consistent with economic reality.

2. Sections 267 and 707(b)(1) and the Related Party Sales Rules

Wash sales were not the only way taxpayers devised to harvest losses while functionally retaining property. As noted above, gift giving is not a realization event, and therefore taxpayers cannot trigger a loss on property simply by giving it away. But what if they sell the property to a related party? Such a transaction would constitute a realization event, triggering a loss, but it would violate the notion that taxpayers must terminate their investment in an asset before being allowed to claim a loss for tax purposes. Congress enacted section 24(a)(6), the predecessor to section 267, in 1934 to address this loss harvesting technique.\footnote{See Revenue Act of 1934, ch. 277, § 24(a)(6), 48 Stat. 680, 691 (1934). One concern that arises in the related-party area that is absent for wash sales that rely on the market is whether the sale price reflects fair market value. In other words, related taxpayers might artificially deflate the price of an asset to create or increase a tax loss that can be used to offset other income. Any forgone value as a result of an artificially low price remains in the hands of the related party and so is not truly lost.}

Before 1934, tax authorities considering related-party transactions focused on whether the sales in question were bona fide. If they were, the intent to reduce taxes was not deemed relevant. Section 267 obviated the need for such an inquiry by adopting a bright-line approach, disallowing losses when taxpayers had proscribed relationships. Over time, Congress has expanded the list of proscribed relationships,\footnote{See, e.g., Revenue Act of 1937, Pub. L. No. 75-377, § 301(a), 50 Stat. 813, 827 (1937) (expanding the reach of the previous 24(a)(6) to cover related corporations). The 1954 reform renumber the section 267 and further expanded the covered parties.} adding section 707(1) in 1954 to address similar concerns in the partnership area.\footnote{See Internal Revenue Code of 1954, Pub. L. No. 83-591, § 707(b)(1), 68 Stat. 730, 68A Stat. 3, 243 (1954).}

Disallowing the loss on a sale to a related party causes the seller’s tax results to differ from his economic reality. Imagine that D acquires property for $25 and later sells it to his son, E, when it is worth $10. D has a realized economic loss of $15. However, section 267 disallows the deduction because D and E are related.\footnote{I.R.C. § 267(a). Congress might have suspended D’s loss until the property was sold to an unrelated party, but that would have introduced significant complexity to the code.} If the property declines further in value and then E sells it, D’s loss is gone forever. E’s basis is $10, what he paid for the asset.\footnote{See I.R.C. §§ 1011, 1012.} If E sells the property when it is worth $6, he reports a $4 loss, that is, the loss that accrued while he owned the property. In this regard, it functions like section 1015’s anti-loss transfer rule relating to gifts in that E is not allowed to take D’s loss.

 Had A sold the old stock for $7,000 and later purchased the new stock for $8,000, the basis in the new stock would be $10,000 + $1,000, for a total of $11,000, again preserving the $3,000 disallowed loss.
But what happens if E sells the property for more than he paid for it? As originally drafted, E got not credit for D’s disallowed loss. Thus, if he were to sell the asset for $45, he would have to report a $35 gain ($45 AR - $10 basis), which is the gain he experienced. The difficulty is that the asset started at $25 and ultimately sold for $45, representing an overall economic gain of only $20. While the divergence of tax and economic results was deemed acceptable in the loss setting because of the ban on loss transfers, it is less acceptable when contemplating gains. Thus, Congress added section 267(d) to the code in 1954 to ameliorate this problem. As a result, section 267 now produces the same results as section 1015, but using different mechanisms. Rather than rely on the shifting basis rule to achieve these results, section 267(d) provides that E should recognize only so much gain as exceeds the previously disallowed loss with respect to the property. In the example above, D’s disallowed loss was $15. E’s realized gain was $35. Under section 267(d), E recognizes only $20 of gain, the amount of economic gain when D and E are considered together.

3. Part Gift/Part Sale Transactions

While taxpayers may not transfer losses by making a gift and may not trigger losses by selling to a related party, they can trigger losses by selling at fair market value to a sympathetic but statutorily unrelated party, e.g., a godson. Taxpayers who have access to such people might be tempted to increase their losses by selling property to them at an intentionally below market rate. Unfortunately for such a taxpayer, tax authorities addressed this possibility in 1957 in the part sale/part gift regulations. Not surprisingly, these provisions borrow from both the related party and gift rules aimed at preventing improper losses.

Again, an example may help the discussion. Imagine that F purchases land for $100,000, which drops in value to $70,000. If he gives it to his son, he cannot take the loss, and the shifting basis rule will prevent his son from taking the loss. If he sells it to his son, the loss would be disallowed under section 267. But what if he sold the property to his godson? Section 267 would not apply, and he could declare a $30,000 loss, while his godson would own the property with a $70,000 basis. However, assume instead that F really could use a $60,000 loss to offset his income and decides to sell the property to G for $40,000, despite its $70,000 fair market value. Should he be allowed to take a $60,000 loss? What should happen when G attempted to sell the property?


77 See I.R.C. § 267(d).

78 The similarities between sections 267 and 1015 continue when considering a sale for more than the original sales price and the seller’s basis. If E were to sell the asset for $20, he would have a $10 realized gain. However, section 267(d) requires him to recognize gain only to the extent it exceeds the seller’s disallowed loss, in this case $15. Thus, E reports no gain. In the gift context, section 1015 requires the donee to use the fair market value at the time of gift for determining loss and the donor’s basis for determining gain. When property sells at a price between the fair market value at the time of gift and the donor’s basis, no gain or loss is realized. In both cases, the result deviates from economic reality. However, any other result would the buyer/donee to deduct some of the loss that arose when the seller/donor owned the property.
Given the intent to sell below market, this transaction qualifies as a part sale/part gift. The regulations state that no losses is sustained where the amount realized is less than the basis.\textsuperscript{79} Under traditional basis rules, the buyer would take a cost basis. However, this would lead to a tax result inconsistent with economic reality, as the artificially low basis would lead to a significant gain unrelated to the true economic result with respect to the property. For instance, if the buyer sold the property for $120,000, he would report an $80,000 gain, even though the property had only appreciated $20,000. The regulations require the buyer to use the greater of the amount paid or the seller’s basis, in effect giving the buyer credit for the seller’s basis, as is done with gifts.\textsuperscript{80} Thus, if G were to sell the property for $120,000, he would report a $20,000 gain, consistent with the economic gain experienced when F and G are considered together.

However, if G were allowed to use F’s basis in all cases, he could effectively deduct some or all of the $30,000 loss that happened when the property was in F’s hands. The regulations prevent this by providing that, for purposes of calculating loss, the basis in the hands of the buyer cannot exceed the fair market value at the time of the transaction.\textsuperscript{81} This condition is only triggered when the property has a built-in loss at the time of the transaction and the seller intentionally sells below the fair market price. In the example above, although F paid $100,000 and G paid $40,000, any losses would be measured from $70,000, the fair market value at the time of the sale. As a result, G would declare a $10,000 loss of he sold the property for $60,000, even though he had a $20,000 gain relative to what he paid. When added to the $30,000 loss that happened when the property was in F’s hands, the total tax loss is $40,000, equal to the economic result.

4. Section 1041 and Married Couples

In 1984, Congress added Section 1041 to the code to address transactions between current and former spouses.\textsuperscript{82} This provision covers both sales and gifts between spouses, and Congress amended sections 267 and 1015 to make clear that section 1041 governed in case of overlap.\textsuperscript{83} The provision applies to both gains and losses, and it is not clear whether a concern regarding one or the other dominated. Like Section 267, section 1041 prohibits losses on sales between spouses, but it relies on non-recognition to do it. Regardless of the mechanism, it prevents taxpayers from selling assets to a related party to trigger a loss, while functionally retaining the property. However, rather than give the purchasing spouse a cost basis, as is the case with section 267, the provision transfers the selling spouse’s basis to buyer. As a result, the buying spouse can actually take the loss that occurred in the seller’s hands, assuming he sells it for the same price, contrary to the results under section 267. The buying spouse must also report any gain that accrued in the hands of the selling spouse that was not recognized. Similarly, with regard to gifts, the provision simply transfers the seller’s basis to the buyer, without employing the shifting basis

\textsuperscript{79} See Treas. Reg. § 1.1001-1(e) (as amended in 2017).
\textsuperscript{80} See Treas. Reg. § 1.1015-4 (as amended in 1972).
\textsuperscript{81} Id.
\textsuperscript{83} I.R.C. §§ 267(g), 1015(e).
rule found in section 1015. Thus, spouses may transfer losses by selling property or making gifts to one another in ways that others cannot, reflecting the notion that they are a taxable unit.

D. Preventing Timing Games and Tax Alchemy with Capital Losses

Even when taxpayers fully dispose of property, thus satisfying the requirement that they terminate their investment in property, the realization requirement gives taxpayers significant opportunities to manipulate their tax results. Most rational taxpayers will trigger losses currently and push gains out into the future. In some cases, taxpayers can lower their absolute taxes. In others, triggering losses currently will only lead to increased future income that offsets current savings. However, even in those circumstances, taxpayers may reduce taxes in present value terms by operation of the time value of money. Thus, Congress has determined that the ability to harvest losses yields too great a tax advantage and has stepped in to stop it, even when property is sold or otherwise transferred to a third party.

Except for a few brief periods, capital gains have been taxed more lightly than ordinary income, whether by excluding some capital gains from income or by applying a lower tax rate to such gains.84 The capital loss limitation, first introduced in 1924, is designed to prevent taxpayers from manipulating the realization requirement and deducting low-taxed capital losses against high-taxed ordinary gains. The rules have changed several times over the years. Currently, corporate taxpayers may deduct capital losses to the extent of their capital gains, and individual taxpayers may deduct an additional $3,000, which can be used to offset ordinary income.85 Thus, these rules deviate from the regular global approach and treat gains and losses separately from other types of income, operating similarly to sections 183 and 165(d).

The legislative history from the Revenue Act of 1924 notes that “the injustice to the Government is too obvious to require much comment,”86 but in case it is not quite that obvious, a brief explanation might help. First, as a result of the realization requirement, taxpayers control the timing of capital gains and losses. Absent loss limitations, taxpayers could trigger losses currently and delay gains until some future date, reducing their taxes on a present value basis. Thus, even absent preferred rates for capital gains, giving taxpayers unfettered opportunities to deduct capital losses against ordinary income would give taxpayers significant opportunities to defer income and lower their taxes.

Second, if taxpayers are eligible for preferential rates on their capital gains, they can time their sales of capital assets and effectively convert ordinary gains into capital gains, a form of tax alchemy. Imagine a taxpayer with $100,000 of ordinary income and two capital assets, one with a built-in $100,000 gain and another with a built-in $100,000 loss. If the taxpayer holds the properties, he reports $100,000 of ordinary income and pays $40,000 in taxes at ordinary rates. If he is allowed to offset ordinary income with capital losses, he could sell both pieces of property, allocate the $100,000 of losses to the ordinary

85 See I.R.C. § 1211. Excess losses are suspended and may be carried back and then forward in the case of corporations and forward only in the case of all other taxpayers.
income, and report only $100,000 of capital gains, paying only $20,000 in taxes at capital gains rates. At a minimum, the code should require taxpayers to use their capital losses to offset their capital income first before applying capital losses to ordinary income, in which case, our taxpayer would once again report $100,000 of ordinary income. However, a savvy taxpayer could easily avoid this rule by selling the loss property in the year he earns $100,000 of ordinary income and waiting until the next tax year to sell the gain property, in which case he would report no income in year one and $100,000 of capital gain in year two. The actual rule, limiting the capital loss deduction to the amount of capital gains, prevents the taxpayer from deducting the $100,000 capital loss against the $100,000 ordinary gain in year one, forcing the taxpayer to pay tax on $100,000 of ordinary income in year one. The disallowed loss is then carried forward and may be offset against the $100,000 capital gain in year two, resulting in no income and no tax that year.87

E. Preventing Non-Economic Losses

As noted above, one of the core tax principles is that tax results should match economic results. However, it is a little more complicated than that. For instance, the realization requirement delays taxation on economic gains or the deduction of losses until an asset has been sold. When losses are allowed, they are limited to the loss of after-tax dollars, as can be seen in the basic loss formula, which posits that losses are the excess of basis over the amount realized.88 Allowing taxpayers to deduct pre-tax dollars would create an asymmetry where unrealized gains escape tax, but the loss of such untaxed gains could lead to tax savings.89

The rule tying the deductibility of losses to basis also applies to deductions associated with business or profit seeking activities. During the 1960s and 1970s, taxpayers participated in a wide range of tax shelters that were economically unsound but which made sense because of the tax benefits they provided.90 The hallmark of these shelters was the use of borrowed money to purchase assets. Early on, tax authorities determined that taxpayers should be given credit in basis for borrowed funds,91

87 See I.R.C. § 1211.

88 I.R.C. § 1001(a). The casualty loss rules limit losses to the adjusted basis of the property damaged, as opposed to the fair market value destroyed. Treas. Reg. § 1.165-7(b) (as amended in 1977). This rule can also be found in the provision that limits a charitable deduction in most cases to a taxpayer’s basis in property, as opposed to its fair market value. IRC 170(e). The main exceptions favor the wealthy and include appreciated stock and property used by the donee for purposes related to the donee’s charitable purpose, such as paintings donated to a museum. I.R.C. § 170(e)(1)(B)(i) and (e)(5).

89 Imagine an asset that rises in value from $15 to $100. The $90 gain is not taxed absent a realization event. If the asset falls in value to $25, the taxpayer has lost $75 as an economic matter, but he is not entitled to a tax loss because the $75 he lost was never taxed. Indeed, he has realized a $10 gain that he must include in income. If the property had dropped to $5 in value, he would be entitled to a $10 loss, reflecting the fact that he invested $15 of after-tax dollars and only recovered $5 on the sale.

90 See Bittker et al., supra note 61, at 675-79.

91 See, e.g., Crane v. Comm’r, 331 U.S. 1 (1947).
presumably on the theory that those amounts would eventually be paid back with after-tax dollars. When tax preferences for depreciation (calculated using an asset’s basis) combined with other tax rules, such as the deductibility of interest, investments could generate significant losses that could be used to offset other income. In some cases, taxpayers would ultimately bear the losses as loans were repaid, but that could be years in the future, permitting taxpayers to benefit from the time value of money. In other cases, taxpayers avoided the losses altogether.

Many tax shelters were simply fraudulent; taxpayers overvalued property and issued notes that they never intended to repay. While tax authorities could challenge such shelters on an ad hoc basis, this placed a significant enforcement burden on the IRS, and further, even the “legitimate” tax shelters were delivering results that deviated from economic reality. Thus, the problem of shelters required a more systematic approach to ensure that taxpayers were only deducting amounts for which they had basis and which represented actual economic losses they suffered or would suffer as loans were repaid. Over the years, Congress enacted a number of loss limiting provisions to address these concerns, including sections 704(b), 704(d) and 1336(d), limiting partnership and S corporation losses to an owner’s basis in such entities, the at-risk rules found in section 465, and the passive activity loss rules of section 469.

1. Section 704(b) and Substantial Economic Effect

The partnership rules for allocating gains and losses in the first place can be viewed as a loss limitation provision designed to match tax results with economic reality. Section 704(a) affords partners significant leeway in allocating gains and losses. Unchecked, this would permit partners to manipulate their tax results in ways that were disconnected from their actual gains and losses. To prevent taxpayers from disassociating tax and economic results, the rules require that allocations have “substantial economic effect.” A full analysis of the substantial economic effect rules is far beyond the scope of this article, but a simple description illustrates how these rules ensure that tax allocations match each partner’s economic reality. The basic test for economic effect requires that (1) partnerships keep capital accounts, (2) liquidations occur according to the capital accounts, and (3) partners be required to make up deficits in their capital accounts. The net effect of these requirements is that the allocations and corresponding changes to the capital accounts actually reflect the money the partners will receive or be

92 In theory, these early losses could be made up later or might be offset when the shelter failed and COD income were generated for the shelter to be allocated out to the investors. However, few shelters actually succeeded, and many investors failed to report any COD income. Even if they had, they would have been able to reduce their taxes by virtue of the time value of money.

93 This issue does not arise in the corporate context, even with pass-through corporations because allocations are typically pro rata, significantly limiting the ability to direct gains and losses to specific owners.


forced to contribute if the partnership liquidates. If the allocations are also substantial, the IRS will respect the allocation of gains and losses because they reflect the partner’s economic reality.

2. Section 704(d)’s and 1336(d)’s Loss Limitations

The tax code has two pass-through regimes, one for partnerships and the other for corporations that elect pass-through status under Subchapter S. Under both regimes, the business entity is not subject to tax but rather allocates its income and loss to the owners each year. However, section 704(d), in the partnership context, and 1336(d), in the corporate context, limit the owners’ ability to take losses to the extent of their basis in their ownership interests in the respective business entities. As explained below, these rules ensure that the tax losses owners claim reflect actual losses of after-tax money that they have suffered or will suffer in the future as they repay loans with after-tax dollars.

Taxpayers who contribute property to a partnership in return for a partnership interest need not recognize any gain or loss on their contributions. As a result, they receive a basis in their partnership interests equal to the basis of the property they contribute. This “outside” basis is adjusted up for income allocated to them from the partnership and decreased by their share of partnership losses. The basis is also adjusted up for any debt the partnership incurs under complicated rules that allocate debt to partners based on their obligations to repay such debt. Section 704(d) prevents partners from taking losses allocated to them by a partnership if those losses exceed that partner’s outside basis. Disallowed losses are held in suspense until the partner’s outside basis increases, thereby ensuring that partners only deduct losses on amounts for which they have previously been taxed. As noted above, outside basis increases when the partnership allocates income to the partner or when the partnership incurs debt that is allocated to the partner. As a result, taking on debt has become an important tool in generating basis so that taxpayers may take full advantage of partnership losses. Working together, these rules ensure that partners are allowed deduct only amounts that reflect the real-world loss of after-tax dollars.

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96 The substantiality rules are designed to ensure that taxpayers do not allocate income in ways that reduce taxes. This might occur where different types of income are allocated to different partners, but the overall levels in the capital accounts remain the same as they would have been absent a special allocation or where allocations are transitory. See Treas.Reg. § 1.704-1(b)(2)(iii)(b)-(c). Exploring these rules is far beyond the scope of this article.

97 I.R.C. § 721(a).

98 I.R.C. § 722. Those who purchase their partnership interests from others receive a cost basis. I.R.C. § 742.

99 I.R.C. § 705(a).

100 I.R.C. § 752. While taxpayers have not paid taxes on borrowed money, the presumption is that they will repay the loans with previously-taxed dollars. Thus, taxpayers are given credit up-front for borrowed money. For recourse loans, where lenders can seek repayment from the partnership, and for general partnerships, where lenders can seek repayment from partners, these rules make sense. Where loans are non-recourse, or where partner liability is limited, the justification for allocating basis for such loans to partners for purposes of determining outside basis becomes both more questionable and more complicated. These complexities are beyond the scope of this article.
S corporation shareholders also avoid recognition on the contribution of property, so long as they meet the requirements of section 351. They also receive a basis equal to the basis of property they contribute.\footnote{I.R.C. § 358.} As with partnerships, shareholder basis is adjusted up and down for gains and losses allocated.\footnote{I.R.C. § 1367.} Unlike with partnerships, where partnership debt is allocated to the partners for purposes of determining basis, corporations are treated as separate tax entities, and corporate debt is not allocated to the shareholders. As a result, S corporation shareholders engage in different financing arrangements aimed at creating basis.\footnote{\textit{S} Corporation shareholder lend money to their corporations to generate basis rather than have the corporation take out loans from third parties.} Section 1366(d) limits losses for S corporation shareholders to their basis in the stock of the corporation. As with Section 704(d), the purpose is to ensure that the amounts deducted as losses reflect after-tax dollars that have been lost or for which they are ultimately on the hook.

3. Section 465 and the At Risk Limitations

In 1976, Congress added Section 465 to the code to address the problems that arise when taxpayers borrow money on a non-recourse basis and then generate losses by depreciating assets acquired with the loan proceeds. The section did not rescind taxpayer ability to deduct losses with respect to non-recourse debt. Rather, it allowed all such deductions against income generated by the activities for which the debt was taken out. However, any excess deductions were allowed against other income only to the extent the taxpayer was at risk for the debt. Put differently, it deviated from the global approach to income and deductions and adopted a schedular approach for activities that involved non-recourse debt, permitting full deductions related to such debt within the activity’s schedule and prohibiting such deductions outside of it.

Initially, the provision identified a limited number of covered activities that traditionally generated losses. In 1978, Congress expanded the provision cover activities carried on in other trades and businesses.\footnote{I.R.C. § 465(c)(3).} Notably, real estate activities are largely exempt from these rules. The section defined at risk to include money and the basis of property contributed to an activity as well as borrowed amounts for which the taxpayer was personally liable or for which he has pledged property not in use in the activity. By limiting deductions in this way, the rule ensured that deductions used to offset income from other activities represented economic losses of after-tax money that the taxpayer had already suffered or that he would have to suffer when he repaid the loans associated with a given activity.\footnote{See Bittker et al., \textit{supra} note 61 at 689.}
4. Section 469 and the Passive Activity Loss Limitations

Despite the at-risk rules, taxpayers continued to find ways to deduct non-economic losses. Thus, as part of the complete overhaul of the tax code in 1986, Congress enacted section 469, which limited losses from passive activities. Congress reasoned that most shelters involved passive investors, and therefore it limited a taxpayer’s ability to claim losses based on whether taxpayers actively participated in the activity that generated the losses. Unlike section 465, taxpayers could aggregate passive activities, such that losses from one passive activity could offset gains from others. As with section 465, disallowed losses were carried over to future years.\textsuperscript{106} However, when a taxpayer entirely disposed of a passive activity, the suspended losses could be used to offset active income.\textsuperscript{107} Presumably, once the activity ends, it is possible to determine the actual economic losses experienced, as opposed to temporary distortions caused by a variety of tax rules.\textsuperscript{108}

Section 469 raises a host of questions, including what constitutes active participation in a trade or business, and what counts as a passive activity the income of which can be offset by passive losses.\textsuperscript{109} The intricacies of these rules is well beyond the scope of this article, but suffice it to say that they add significant complexity to the code.

F. Corporate Loss Limiting Provisions

The corporate tax provisions contain a number of loss limiting provisions.\textsuperscript{110} Some apply at formation, others when property is distributed in the ordinary course of business, while still others apply during corporate dissolutions. These rules appear to serve a number of different goals, though it is not at all clear how well they do so.

1. Section 351 and Corporate Formation

To encourage taxpayers to contribute assets to a corporation, and in recognition of the fact that contribution of property in return for control of a corporation reflects little more than a change in the form of ownership, Section 351 provides that built-in gains and losses will not be recognized on contributions of property in return for controlling interests in the corporation.\textsuperscript{111} However, section 351(b) requires taxpayers to recognize gain to the extent of the fair market value of the boot received, while precluding taxpayers from recognizing losses. Given the control requirements of section 368(c),

\begin{footnotes}
\item[106]\textit{\textsuperscript{\textsuperscript{I.R.C. § 469(b).}}}
\item[107]\textit{\textsuperscript{\textsuperscript{I.R.C. § 469(g). In light of the concerns about sales to related parties and whether such sales count as true dispositions, selling a passive activity to a related party does not count as a disposition. I.R.C. § 469(g)(1)(B).}}}
\item[108]\textit{\textsuperscript{\textsuperscript{See Bittker et al., supra note 61, at 724.}}}
\item[109]\textit{\textsuperscript{\textsuperscript{Id. at 699-724.}}}
\item[110]\textit{\textsuperscript{\textsuperscript{See Cummings, supra note 2.}}}
\item[111]\textit{\textsuperscript{\textsuperscript{For a definition of control, see I.R.C. § 368(c).}}}
\end{footnotes}
this rule appears to be aimed at preventing taxpayers from triggering losses while functionally retaining the property, albeit in the hands of the corporation.

2. Section 311 and Corporate Property Distributions

Section 301 governs corporate distributions, which can be classified as either dividends (distribution of profits) or a return of capital. When corporations distribute property, section 301(d) provides that the basis of property the shareholder receives is its fair market value at the time of distribution. In other words, the recipient takes the property with no built-in gain or loss. Section 311(a) provides that the corporation recognizes no gain or loss when it distributes property, consistent with the rule in General Utilities. However, section 311(b) undoes this rule with regard to gains, requiring corporations to recognize gains on the distribution of property under section 301. No exception exists for losses. Thus, when a corporation distributes loss property, the loss is gone forever, creating a significant disincentive to distribute loss property. Corporations remain free to sell such property to third parties and distribute the proceeds, triggering the loss at the corporate level.

Two potential justifications for the rule exist. First, it may be designed to prevent taxpayers from harvesting losses. If losses were recognized, corporations would likely choose to distribute only loss property, thus triggering losses and deferring gains. If losses were simply not recognized with a carryover basis, losses could be transferred from corporations to shareholders. Second, the rules may be aimed at preventing losses between related parties. Even if shareholders and the corporations they own are not formally related under section 267, moving property from corporations to shareholders could be seen as little more than a change in the form of ownership, in which case allowing the corporation to claim a loss would be improper.

3. Section 336(d) and Corporate Liquidations

Corporate liquidations also involve distributing corporate property and therefore raise loss issues. Under the General Utilities doctrine that existed until the 1986 tax reform, liquidating corporations were entitled to distribute their assets without triggering a corporate level tax. Congress repealed this doctrine in 1986, requiring corporations to recognize gains in liquidations. Under current law, liquidations are treated as an exchange of corporate assets for stock, triggering both a corporate and shareholder tax. Thus, it differs from section 311(a), which disallows losses for distributions under section 301. However, Congress was worried that taxpayers might find ways to abuse the new rules, in

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112 See 296 U.S. 200 (1935).
113 If corporations were to sell property to a related party, including a controlling shareholder, the loss would be disallowed under section 267. However, the loss would not be gone forever, as was is the case with sections 301 and 311, because section 267 uses the non-recognition rules to reduce the gain on a subsequent sale.
115 I.R.C. § 336(a).
116 I.R.C. §§ 331, 336(a)
particular with regard to losses. Accordingly, it added sections 336(d)(1) and (2) to the code to limit losses in two specific situations. 117

First, under section (d)(1), if the shareholder who receives property is related to the corporation (as defined in section 267), the loss will be disallowed if it is not distributed pro rata or if it is disqualified property. Presumably, the related party/non-pro rata requirement reflects the concern that the transfer is little more than a change in the form of ownership and that taxpayers should not be allowed to trigger losses while retaining the property in question. In contrast, disqualified property is defined as property acquired within 5 years of the distribution in a section 351 transaction. Notably, disqualified property need not have been contributed with a built-in loss. Moreover, post-contribution loss is disallowed. Thus, the abuse targeted in this second part of (d)(1) is unclear. 118

Second, (d)(2) bans losses on property contributed in a section 351 transaction as part of a plan to liquidate the corporation and trigger the loss. In such cases, the basis of the loss property is reduced to eliminate the pre-contribution loss, while still allowing post-contribution losses. This “anti-stuffing” provision appears to be aimed those seeking to double a loss on property by contributing it to a corporation and then disposing of the property. If both (d)(1) and d(2) apply to a liquidation, (d)(1) takes precedence, thus depriving corporations of both pre- and post-contribution losses.

4. Section 362(e) and the Basis of Contributed Property

Congress drafted section 336(d) in part to stop taxpayers from doubling losses by contributing loss-property to a corporation and then triggering the loss through a liquidation. In the wake of the Enron scandal, Congress came to understand that taxpayers could play such games outside the liquidation context, despite section 311(a)’s ban on taking losses on distributed property. Accordingly, in 2004, Congress enacted section 362(e) to restrict taxpayers’ ability to use the corporate form to double losses, ending almost 100 years of parity, a pedigree longer than the General Utilities doctrine at its death.

Section 362 governs the basis of property contributed to a corporation. Consistent with most non-recognition provisions, basis transfers from the donor to the corporation. Before section 362(e), a taxpayer who owned an asset with a $50 basis and a $30 value could double the loss by contributing the asset to a corporation. The corporation would own the asset with a $50 basis and a $30 value, and the shareholder would own stock with a $50 basis and a $30 value. Section 362(e) requires the taxpayer to reduce the property’s basis to fair market value at the time of contribution, such that the loss will exist

117 Neither the House nor Senate version of the bill contained these provisions. Rather, they were added during the conference with little explanation. See Kahn et al., supra note 2, at 6; See also H.R. Rep. No. 99-841, pt. 2, at II-200 (1986) (Conf. Rep.), as reprinted in 1986 U.S.C.C.A.N. 4075, 4286.

118 There is some suggestion in the record that one of the concerns was that corporations would undervalue property to generate greater losses. However, it is not clear that these concerns justify the rule. See Kahn et al., supra note 2, at 14–18.
only in the stock received.119 Alternately, taxpayers may choose to reduce the basis of their stock, leaving the loss in the corporation.120 The statute and regulations contain detailed rules that apply when taxpayers contribute multiple properties, some of which have built-in gains and others with built-in losses. Basis reduction is only required when the taxpayer contributes net built-in loss, and the reductions are allocated according to each property’s relative contribution to the total loss.121 As a result, some property retains losses even after the basis reduction required under section 362(e). Exploring the intricacies of these rules is beyond the scope of this article.

5. Consolidated Statement Rules and the Ilfeld Doctrine

Finally, the consolidated return regulations, backstopped by the Ilfeld doctrine, prevent corporations from claiming a double deduction for a single economic loss.122 The intricacies of the consolidated return regulations are beyond the scope of this article, but the regulations generally prevent corporations from selling stock in a subsidiary at a loss and then also selling the underlying assets at a loss. While the regulations are extremely detailed and presumably supersede the older Ilfeld doctrine, the Third Circuit recently invoked the doctrine to deny a deduction to a corporation that had technically complied with the rules.123 The existence of non-statutory anti-abuse rules, like the Ilfeld doctrine or the step-transaction doctrine further complicate tax planning because it is not clear when the IRS will invoke the doctrine or when a court will concur.

G. Hidden Tax Increases

Finally, a number of loss limiters appear to be little more than hidden tax increases. Raising tax rates is anathema to many in Congress, but legislators quickly discovered that they could raise taxes without touching the rates. For instance, in 1991, Congressman Donald Pease introduced a provision that limits itemized deductions for taxpayers with incomes over a certain level.124 By limiting the deductions, the provision effectively increased taxable income, leading to greater taxes, without adjusting the rates. Section 461(1), recently enacted as part of the 2017 Tax Cuts and Jobs Act takes this approach to a new level.

Section 461(l) displaces section 461(j), which limited losses that non-corporate farmers could take. Before 2008, farmers who actively participated could deduct all their farm losses against other income.

119 The corporation will own an asset with a $30 basis and value, while the shareholder will own stock with a $50 basis and $30 value.

120 If the taxpayer elects to reduce the basis in the stock, the corporation will own an asset with a $50 basis and $30 value, while the shareholder will own stock with a $30 basis and value.


124 I.R.C. § 68.
Those who did not materially participate were limited by the passive activity loss rules of section 469. In 2008, Congress determined that farmers who received government subsidies should not be allowed to use losses incurred in those subsidized businesses to offset other income even if they were actively involved in running the business. Accordingly, section 461(j) prohibits farmers who received subsidies from taking “excess farm losses,” with disallowed losses carried forward to future years.

As part of the Tax Cuts and Jobs Act of 2017, Congress “expanded” the limitation on excess farm losses to cover excess business losses of all non-corporate taxpayers. This new section applies in lieu of section 461(j) from 2018 to 2025. Excess losses were defined as those in excess of $250,000 ($500,000 for joint returns). Disallowed losses are treated as NOLs and are deductible as such under the rules set forth in section 172. While framed as an “expansion” of section 461(j), section 461(l) omits the key provision of 461(j) that purportedly justifies it. Section 461(j) applied only to farms that received government subsidies. Section 461(l) applies to all businesses. Lacking a justification or problem it seeks to address, it operates much in the way the Pease amendment does-as a hidden tax increase. Indeed, it is estimated to produce almost $150 billion in additional revenues over a ten-year window.

H. Conclusion

The various loss limitations described above serve a number of different purposes and are triggered by a number of different features of the tax code, whether acting alone or in concert with others. They also use a variety of different techniques to limit losses, including simple disallowance, non-recognition, adjustments to basis, and resort to a schedular approach to taxation. Given these different goals, causes, and techniques, it is not possible to develop a unifying theory that ties all the different provisions together, except perhaps to note that most are aimed at preventing taxpayers from taking advantage of various features of the income tax to lower their tax liability in ways of which Congress disapproves. These provisions add significant complexity to the code, increasing planning and compliance costs and creating traps for the unwary. Thus, even absent a unifying theory, the loss limitation provisions seem ripe for reform. The question, addressed below, is how best to do so.

125 See Joint Comm. on Taxation, 111th Cong., General Explanation of Tax Legislation Enacted in the 110th Congress 141 (Mar. 2009).
126 Farmer were allowed to take the greater of $300,000 or the net farm income over the prior 5 taxable years. I.R.C. § 461(j)(4).
127 I.R.C. § 461(j)(2).
128 See Joint Comm. on Taxation, Description of the Chairman’s Mark of the “Tax Cuts and Jobs Act” 19 (Nov. 2017).
129 I.R.C. § 461(l)(1).
130 I.R.C. § 461(l)(3).
131 I.R.C. § 461(l)(2).
III. Analysis

Tax authorities should consider three approaches to reforming the loss limitation provisions. First, they might consider giving up on the goals, that is, permit the activity the limits target. Second, they might address the root causes, that is, the features of the tax code that make the provisions necessary in the first place. Finally, they could focus on improving individual provisions and harmonizing them. In some cases, several provisions, added at different times, appear to be aimed at the same problem. Coordinating and streamlining those provisions may yield significant benefits. In other cases, provision seem poorly designed to achieve their purported goals and could be fine-tuned to avoid being under-inclusive or overbroad. Finally, different provisions use different terminology to accomplish the same ends. Using consistent language and techniques would simplify the code and reduce compliance costs.

A. Give up on the Goals

One solution to the problems created by the loss limitation rules is simply to give up. For instance, one could determine that transferring losses is not a cardinal sin or that the realization rule need not be protected by requiring true alienation of property to a third party. Except perhaps in a few circumstances identified below, giving up on the goals seems ill-advised.

1. Loss Transfers

If taxpayers are allowed to transfer losses, the government stands to lose significant revenue. In a system with progressive rates, losses are more valuable to high income taxpayers than low income taxpayers. Thus, taxpayers have incentives to transfer losses and thereby reduce government revenues. Even absent progressive rates, incentives exist to transfer losses. Losses are generally not valuable to taxpayers with little or no income. If they can be transferred to other taxpayers, those taxpayers can reduce their own taxes without a concomitant increase in the transferor’s taxes. Thus, Congress should retain the shifting basis rule of section 1015 and the part gift/part sale regulations to prevent taxpayers from transferring loss property to others by gift or part gift and permit them thereby to lower their taxes. Similarly, section 704(c)’s ban on taxpayers transferring losses (and gains) to others by contributing property to a partnership and then using the permissive allocation rules to direct losses associated with such property to a partnership and then using the permissive allocation rules to direct losses associated with such property to other partners should be retained.

The same logic applies to the limitation imposed on a taxpayer’s ability to transfer net operating losses under section 382. However, an argument could be made that the transfer of NOLs should be allowed. As noted above, economists take the view that losses of previously taxed money should lead to tax refunds. Allowing taxpayers to carry losses backward and forwards effectively permits them to get that refund. NOLs that are carried back lead to actual refunds. NOLs that are carried forward reduce future taxable income and therefore future taxes, operating akin to a refund. However, companies that have NOLs and little opportunity to earn future income will likely never be in a position to receive a refund. Allowing companies to transfer NOLs to others, whether in the context of an acquisition or standing alone, would be an indirect way of providing refunds for NOLs. The money would come not from the government directly but from the company acquiring the NOLs. The government’s contribution would be the reduction in tax revenues from the company acquiring the NOLs.
The government has employed this indirect financing approach in a number of other scenarios. For instance, the government has financed hospitals and low-income housing by providing those engaged in such activities with transferrable tax credits. Those who receive the credits sell them to others, thus raising capital for their projects. The government’s contribution is the reduced tax revenues it collects from those who use the acquired tax credits to reduce their tax liability. Allowing taxpayers to sell NOLs could operate in a similar manner, though the precise amount of the government’s contribution would not be known in advance.

Allowing taxpayer to sell NOLs would raise a number of issues that might lead to complications. For instance, one could allow the sale of NOLs in all cases, regardless of the taxpayer’s financial situation. Alternately, taxpayers could be allowed to transfer NOLs only if they have little likelihood of using them to offset other income. Determining likelihood of future income would be quite difficult, and some proxy might be appropriate. One possibility would be to allow transfers only where the taxpayer generating the NOLs was acquired. Companies with a bright earnings future are arguably less likely to sell themselves than ones facing a difficult future. Thus, acquisition could serve as a proxy for situations where a company may not be able to use its NOLs, thus warranting a deviation from the anti-loss transfer norm. Under this approach, the 1986 changes to section 382 designed to limit the value of NOLs should be repealed.

2. Personal Loss Deductions

Preventing taxpayers from deducting personal losses is not something tax authorities should give up on. Otherwise, well-advised and well-situated taxpayers will be able to deduct amounts other taxpayers cannot.

3. Related Party Sales/Protecting the Realization Requirement

The related party transaction rules are aimed at two concerns. The first is that we cannot trust the sales price when the buyer and seller are related, and the parties may collude to increase losses. The second is that allowing parties to trigger losses without fully disposing of property permits taxpayers to evade the realization requirement. Concern about collusion seems like a worthy goal and not one Congress should abandon. However, tax authorities could address this concern by requiring independent appraisals rather than disallow losses, much as they do in the charitable donation context. Admittedly, appraisers have significant flexibility when valuing property, and this may not be workable, but it at least deserves some consideration.

Given taxpayer ability to determine which assets to sell and the likelihood that they will trigger losses and defer gains, protecting the realization requirement appears to be a worthy goal. Given up on this goal would permit taxpayers to engage in a range of transactions that have no real-world impact other than lowering their taxes. For instance, a father could give $15,000 to his minor son, who then uses the money to purchase a loss asset from the father. Absent a rule to the contrary, the father reports the loss and retains control of the asset, though titled in the name of his son. Disallowing losses in this

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133 See Giegerich, supra note 33, at 640–709 (discussing the monetization of certain federal tax credits).

context appears to be the only way to prevent this. It may be possible to fine-tune the rules to get at truly abusive transactions, but the goal itself seems worth keeping.

4. Timing and Tax Alchemy

Even assuming sales only to third parties, the realization requirement gives taxpayers significant opportunities to affect their tax results by timing their sales of property. The capital loss limitations are designed to prevent taxpayers from accelerating losses and deferring income and from using capital losses to offset ordinary income, which would effect a kind of tax alchemy. Allowing taxpayers functionally to convert ordinary income into capital income undermines the justifications for taxing capital income at lower rates. Similarly, defending against taxpayer efforts to lower their tax liability in present value terms by taking advantage of timing has been one of the great advances in tax law.135 Admittedly, interest rates are so low now that the impact of timing games is much less than hit has been, but that does not mean we should abandon these rules, especially insofar as interest rates will certainly rise again. Again, these goals seem worth keeping.

5. Preventing Non-Economic Losses

Improving the match between tax and economic results is an important goal of tax law. Abandoning this goal is a non-starter. That said, as discussed more fully below, the rules designed to advance this goal are among the most complex in the code and are ripe for reform. Potential changes to these rules are discussed below.

6. Doubling Losses in the Corporate Context

The natural consequence of the non-recognition rules for corporate formations along with treating corporations as a separate taxpayer is that taxpayers might be able to double losses by contributing loss property to corporations and trigger losses by transferring property from corporations to shareholders. Preventing taxpayers from taking advantage of these opportunities seems an appropriate goal. Having said that, the current rules are somewhat incoherent and desperately in need of reform, as discussed more fully below.

B. Address the Causes

Assuming that the goals are inviolate, another approach to reforming the loss provisions is to address the root causes of the problems they were designed to address. As described below, wholesale changes to fundamental or longstanding features of the tax code seem unlikely.

1. The Realization Requirement

The realization requirement is one of the most criticized features of the income tax and perhaps the greatest source of its complexity. Delaying gains and losses until taxpayers sell or otherwise dispose of

property permits those gains and losses to build up, which creates the possibility of transferring significant losses to others, the temptation to trigger losses while still holding onto property, and the ability to manipulate one’s tax result by harvesting losses, necessitating the anti-abuse rules described above. In addition, taxpayers have engaged in a number of transactions to allow them to cash out of investments without triggering a gain for tax purposes.\textsuperscript{136} Congress has had to enact a number of provisions to prevent such behavior as well.\textsuperscript{137}

The main justifications for the requirement are that it avoids the need to value property every year and addresses liquidity issues that would arise if taxpayers owed taxes on the appreciation, but not sale, of their assets.\textsuperscript{138} Nonetheless, a number of scholars have called for moving to a mark-to-market regime, at least for publicly traded assets,\textsuperscript{139} and others have advocated for adopting a looser standard for determining when a realization event has occurred.\textsuperscript{140} One commentator has described the realization requirement as the income tax’s Achilles heel,\textsuperscript{141} and many have argued that the problems are so severe that we would be better off with a consumption tax, which eschews a tax on changes in wealth.\textsuperscript{142}

Despite the critiques, and perhaps some minor tweaks, it seems highly unlikely that Congress will eliminate the realization requirement or that the tweaks will obviate the need for the loss limiting rules.\textsuperscript{143} Still less likely is a switch to a consumption tax, despite both academic and political support. Thus, eliminating the realization requirement is not a viable option for addressing the loss limitation rules.

2. Preferential Rates for Capital gains

Preferential rates for capital gains also create incentives for taxpayers that have caused Congress to enact loss limiting rules. Proponents raise a host of justifications for the preference, including the

\textsuperscript{136} For instance, taxpayers may attempt to enter into straddles, where they acquire offsetting positions and then trigger the loss side while deferring the offsetting gain, or constructive sales, in which taxpayers short property they already own to eliminate the risk of owning the property, while yielding cash without triggering a gain.

\textsuperscript{137} See, e.g., I.R.C. §§ 1092, 1259.


\textsuperscript{139} See Elkins, supra note 138; see also Clarissa Potter, Mark-to-Market Taxation as the Way to Save the Income Tax—A Former Administrator’s View, 33 VAL. U. L. REV. 879 (1999).


\textsuperscript{143} See Schenk, supra note 138 (explaining why the realization rule is so persistent despite its flaws).
bunching up of gains because of the realization requirement,\textsuperscript{144} while detractors note that they raise serious equitable questions and contribute to the tax code’s complexity.\textsuperscript{145} Like the realization requirement, the preference is sticky. However, even if the preference were eliminated, taxpayers would still have an incentive to trigger losses and delay gains to take advantage of the time value of money. Accordingly, addressing preferential rates will not eliminate the need for loss limiting provisions aimed at capital gains.

3. Annual Accounting Period and Income Averaging

The annual accounting period creates incentives for taxpayers to transfer losses, resulting in loss limitation provisions. While some accounting period is necessary, scholars have suggested income averaging as a remedy for the problems that arise when income in broken into one-year segments,\textsuperscript{146} and indeed Congress has experimented with a more limited averaging regime during the 1980s.\textsuperscript{147} There may be good reasons to allow income averaging and perhaps even refunds in years where taxpayers have excess losses. However, avoiding the complications of the loss limitation rules is not one of them because, while doing so would make losses more valuable to individual taxpayers who anticipated future income, it would not address loss transfers between taxpayers in the mergers and acquisitions context.\textsuperscript{148}

4. Taxpayer Unit

The related-party rules are necessary because each individual is typically treated as a taxpayer. One could reduce the need for such rules by expanding the concept of taxpayer unit. Transactions within a unit would simply not count, as is currently the case with spouses and former spouses under section 1041. However, creating a broader concept of the taxpayer would simply move the difficult questions and complications created by section 267 to a different section of the code. Accordingly, expanding the


\textsuperscript{145} One solution that has been floated repeatedly is to index basis to account for inflation. \textit{See, e.g.,} Alec Fornwalt, \textit{Capital Gains Taxes Should be Indexed to Inflation}, TAX FOUNDATION (Jul. 23, 2018), https://taxfoundation.org/capital-gains-taxes-indexed-inflation/ (discussing why Congress should consider indexing capital gains tax basis to ensure investors are taxed on actual gain). However, doing so would introduce another form of complexity to the code, especially it comes to accounting for debt. \textit{See e.g.,} Deborah A. Geier, \textit{Indexing Basis for Inflation: The Intractable Problem of Debt}, 156 TAX NOTES 507 (2017)

\textsuperscript{146} See Vickery, \textit{supra} note 23; Shaviro, \textit{supra} note 23.

\textsuperscript{147} See the U.S. income averaging rules from 1964, which were codified at I.R.C. §§ 1301-05 (2000) and repealed by the Tax Reform Act of 1986, Pub. L. No. 99-514, §§ 141(a), 151(a), 100 Stat. 2085.

\textsuperscript{148} \textit{See Tax Rules of Yore: Tax Breaks You Can’t Use Now But…, supra} note 21 (discussing how a general four-year income averaging rule had expired in 1986).
concept of the taxable unit beyond the individual would do little to address the problems the related party rules create.

5. Economic Losses

The loss limiters focused on ensuring tax losses equal economic losses are necessitated in large part by the rule that borrowed funds are included in basis. The at-risk rules backstop the rules that limit losses to basis by ensuring that taxpayers do not get basis in cases where they are unlikely to suffer economic losses. The passive activity loss rules limit losses in situations where basis from debt is most likely to cause tax results to diverge from economic reality. Eliminating basis for borrowed funds would address many of these concerns, but it would create a host of other problems, not the least of which being that basis would change with every repayment of principle. Disallowing basis for debt is likely a non-starter.

6. The Classical Corporate Tax System

The loss limiters found in the corporate tax rules are necessitated in large part because of the classical system, in which both corporations and their shareholders owe tax, allowing for the doubling of losses. Although various attempts and suggestions have been made to eliminate this doubling of gains and losses through pass-through or credit regimes, or by reducing the taxes on dividends, the classical system appears here to stay, at least so long as we have an income tax. Significant support exists both within academia and in the Republican party for a switch to consumption taxation, and the expansion of tax-deferred savings options and other changes to the tax code such as expensing have moved the income tax code closer to a consumption tax in operation, a wholesale shift to a consumption tax seems unlikely to give the high costs of changing the tax system in such a dramatic way. In any event, were Congress to introduce a true consumption tax, many, if not all, of the loss issues would be resolved.

C. Improve and Harmonize the Rules

Given that Congress seems unlikely to give up on the goals underlying most loss limiting provisions and will be unwilling to change many of the fundamental features of the tax code that create or exacerbate the problems that the loss limiters are designed to prevent, the best we can hope for is to reform the provisions we do have to aim them more directly at the problems they are supposed to address and to make them easier to understand and apply.

1. Repeal Section 461(l)

The first reform should be to revoke section 461(l). It replaces section 461(j), which limited farm losses in cases where farmers received government subsidies. The new section is not limited to farm losses and is not conditioned on the receipt of government benefits. It also applies after (1) sections 704(d) or 1336(d), which limit losses to basis for partnerships and S corporations, (2) section 465, limiting losses to


at risk investment, and (3) section 469, preventing losses from passive activities. Each of these provisions is designed to ensure that tax losses match economic losses. Section 461(l) appears to have no purpose other than to raise revenues.

The government certainly needs revenues. However, generating them through complicated provisions that serve no other purpose seems ill-advised. Taxpayers are unlikely to respond rationally to hidden tax increases because they are unlikely to understand how the rules will interact. Both Democrats and Republicans routinely call for tax simplification. Eliminating this provision would be a good first step in that direction.

2. Harmonize and Fine Tune the Corporate Tax Rules

The corporate loss limiters are a confused mess. Several different rules appear aimed at the same harm, and many of those rules do not actually address the harms at which they are aimed. For instance, the first part of section 336(d)(1) disallows losses in a liquidation when property is distributed to a related party on a non-pro rata basis. It is not clear what malfeasance this provision is supposed to prevent. The second part of 336(d)(1) disallowed losses related to disqualified property, i.e., property contributed to corporations under section 351, but only when distributed to related parties. It is not at all clear why losses on such property should be disallowed only when distributed to related parties. Moreover, the provision applies to all losses, even post-contribution losses, which do not implicate taxpayer manipulation. Section 336(d)(2) is aimed directly at abusive transactions and is arguably all that is necessary. However, even that provision may be unnecessary given section 362(e), which reduces basis on contributions of net losses precisely to prevent the improper doubling of losses.

3. Adopt Similar Phrasing for Basis Shifting Rules

Tax authorities shift basis in a number of different scenarios to prevent taxpayers from either shifting losses from one taxpayer to another or deduct personal losses after property has been converted to business of for-profit use. However, the code and regulations use very different language to do so. For instance, section 1015 states that, if basis exceeds fair market value at the time of a gift, taxpayers should use the fair market value at the time of the gift as the basis for determining loss. In contrast, T.R. §1.1015.4 instructs that a taxpayer’s basis in a part gift/part sale scenario is the greater of the seller’s basis or what the buyer paid. However, for purposes of determining loss, the basis may not be greater than the property’s fair market value at the time of the transaction. The only circumstance under which this provision comes into play is if the property was worth less than the basis at the time of the transaction. In contrast, the regulations for converted property provide that the basis for determining loss for such property is the lesser of the property’s basis or its fair market value at the time of conversion. Again, the fair market value only of such property or comes into play is if the property was worth less than the basis at the time of conversion.

Although this would not be a major reform, tax authorities should strive to spell out clearly the circumstances in which the rules apply and to use consistent phrasing whenever possible. The code and

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151 I.R.C. § 1015.
regulations were drafted over many years with many different authors using different language for similar rules.

4. Consolidate the Related Party Rules

Another reform that could reduce complexity would be to adopt a uniform definition of related party, much as Congress adopted a uniform definition of child as part of the Working Families Tax Relief Act of 2004.\textsuperscript{152} At present, the code contains three different related party provisions, sections 267, 318, and 707(b). In addition, section 482 permits the IRS to reallocate income and deductions between two organizations “owned or controlled directly or indirectly by the same interests.” Section 351 applies only when shareholders with a controlling interest contribute property in return for equity.\textsuperscript{153} Section 267 includes siblings, ancestors, spouse and descendants as related parties, while section 318 includes only spouses, children, grandchildren, and parents. Some provisions use 50\% ownership as the marker of control,\textsuperscript{154} while others use 80\%.\textsuperscript{155} A number of provisions incorporate these provisions, but with modifications.\textsuperscript{156}

Simply put, it makes little sense to have multiple related-party definitions for different parts of the code. These rules treat multiple parties as one taxpayer for certain purposes. It is not at all clear why we should have different rules for losses on sales, partnerships, corporations, or for specific transactions. There should be one default rule that applies in all cases, with a very high burden imposed before deviating from that default.

CONCLUSION

The loss limitation rules found in the tax code create significant complexity, require careful planning, and may trap the unwary. However, meaningful reform may be quite difficult. The provisions are aimed at a variety of taxpayer behaviors and caused by a number of different and long-standing features of the tax code. It seems highly unlikely that Congress will give up on the goals motivating these provisions or make fundamental changes to the income tax to eliminate their need. Nonetheless, some reforms are possible. In some cases, multiple provisions appear to be aimed at the same problem. In others, it is not clear what the harm is or how the provision prevents it. The time is ripe for tax authorities to take a step back and review all of the loss provisions to determine whether they are still necessary, and, if so, whether they can be fine-tuned to better address the harms they are designed to prevent.

\textsuperscript{153} I.R.C. § 351.
\textsuperscript{154} See, e.g., I.R.C. §§ 267(b)(10), 707(b)(1).
\textsuperscript{155} See, e.g., I.R.C. § 368(c).
\textsuperscript{156} For instance, section 179 excludes from the definition of purchase sales between related parties, using section 276’s related party definition. However, it excludes siblings from section 267(c)(4)’s definition of related party. See I.R.C. § 179(d)(2).