Parity for Main Street Employers

Net Operating Loss and Loss Limitation Rules in the CARES Act:
Supporting Individually and Family Owned Businesses When They Need It Most

What is a Net Operating Loss (NOL) Carryback? An NOL is the amount by which a company's expenses exceed its income. An NOL that is "carried back" may be deducted from income earned in previous years, resulting in a refund of tax payments a company made in the past. Similarly, an NOL that is "carried forward" may be deducted from income in future years.

For example, if a C corporation made $200,000 in profits every year for five years, but then suffered a $1,000,000 loss in the sixth year, a 5-year NOL carryback would allow that business to apply the loss against its prior earnings, generating a refund for the taxes paid in previous years.

Since the C corporation earned no income over a six-year period ($1,000,000 in income less $1,000,000 in losses), it makes sense that its net income tax liability should be zero. Good tax policy should level long-term tax burdens to reflect long-term income.

Deductions of current losses applied against past income are no longer available in the future. The $1,000,000 loss our example corporation carried back would have otherwise been carried forward. At its core, the policy is a timing shift that lowers taxes now and increases them in the future.

What did the CARES Act do? The CARES Act includes a 5-year carryback for losses incurred in 2018, 2019, and 2020. It also suspends the loss limitation rules for those years. Absent the loss limitation relief, pass-through businesses with large losses would have be unable to use the NOL relief in the example. One-hundred and twenty national business trade groups asked Congress for this provision, and it was included in every CARES Act draft leading up its adoption.

Is this a partisan policy? No. There is a longstanding history of bipartisan support for NOL relief during economic crisis. The "alternative" bill released by Speaker Nancy Pelosi on March 23rd includes the same policy -- a five-year carryback of net operating losses. Additional bipartisan bills that expanded NOLs include:

- *Worker, Homeownership, and Business Assistance Act of 2009*: Temporarily extended NOL carrybacks from 2 years to 5 years. Passed the House of Representatives by a vote of 403-12, and passed the Senate unanimously, 98-0.
- *The Gulf Opportunity Zone Act of 2005*: Temporarily extended NOL carrybacks from 2 years to 5 years for taxpayers affected by hurricanes Katrina, Rita, and Wilma. Passed the Senate by Unanimous Consent, and passed the House of Representatives by Unanimous Consent.
- *The Job Creation and Worker Assistance Act of 2002*: Temporarily extended NOL carrybacks from 2 years to 5 years. Passed the House of Representatives by a vote of 417-3, and passed the Senate by a vote of 85-9.

Opponents claim they were "unaware" this provision was included in the CARES Act. Were they also unaware when it was adopted in previous years? No. When the *Worker, Homeownership, and Business Assistance Act of 2009* passed (under Democratic control of the House, Senate, and White House), President Obama's White House press office said:

> *"The bill provides an expanded tax cut to tens of thousands of struggling businesses, providing them with the immediate cash they need to pursue an expansion or avoid contracting or furloughing their workers…Business*

losses incurred in 2008 or 2009 can now be used to recoup taxes paid in the prior five years. This provision is a fiscally responsible economic kick-start, putting $33 billion of tax cuts in the hands of businesses this year when they need it most, while enabling Treasury to recoup the majority of that funding in the coming years as these businesses regain their strength and resume paying taxes."

Speaker of the House Nancy Pelosi said:

"The bill also has the net operating loss carryback, which businesses tell us is necessary for them to succeed and to hire new people, and also to mitigate some of the damage that has been done to the economy from past policies."

Then Representative Chris Van Hollen said:

"This legislation will provide needed liquidity to cash-strapped businesses by giving companies a one-time opportunity to carry back their operating losses for five years in order to further support our economic recovery."

How did the 2017 Tax Cuts and Jobs Act affect NOL carrybacks for C-Corporations and Pass-Through businesses? The Tax Cuts and Jobs Act (TCJA) eliminated carrybacks of NOLs while capping the ability of pass-through business owners to offset active business losses against other forms of income. At the time, critics pointed out that these changes introduced a "pro-cyclical" bias back into the tax code that would harm taxpayers in the next recession. As Bill Gale and Yair Listokin wrote at the time:

Under prior law, firms losing money owed no income tax for the current year, and they could obtain cash refunds for taxes paid in the previous two years. Firms used this provision more in recessions than in booms, and it served as an automatic stabilizer. To stimulate the economy after the financial crisis, Congress temporarily expanded the carryback period for net operating losses to five years. The 2017 tax cuts, however, repealed carrybacks of losses for most businesses. As a result, as income turns down in a future recession, firms with losses will no longer be able to claim refunds for previous tax payments and therefore will face tighter cash constraints.

Why did the Joint Committee on Taxation (JCT) score the loss limitation relief as a large revenue loss? NOL carrybacks and loss limitation relief is simply a timing shift, allowing taxpayers to recoup their losses against taxes paid in the *past*, rather than carrying them *forward*. So over time, the revenue impact of the NOL carryback and loss-limitation provisions should be minimal. The only explanation for the high revenue estimate (subsequently revised downward, but still high) is the JCT believes the COVID-19 virus will result in massive losses and bankruptcies this year, so that tax benefits received today will not be repaid in future years. But that's an argument for more relief, not less.

Is this provision targeted at hedge funds and real estate investors? No, it applies to all corporations and pass-through business who are suffer losses and are able to meet the passive activity, at-risk and other tests ensuring the losses are from an active trade or business.

What's different now? Some commentators who have been raising concerns about this provision, such as Steve Rosenthal at the Tax Policy Center, previously said positive things about NOL carrybacks:

"By allowing businesses to deduct their current losses against past profits, the [pre-TCJA] rules provided economic help for struggling businesses via an immediate cash infusion, said Steven Rosenthal, a senior fellow at the Urban-Brookings Tax Policy Center. "That softens the blow to the direness of that [situation]," he said."

"The fact that it would reduce revenues right now would be a feature, not a bug," said William Gale, a senior fellow at the Brookings Institution, who has long worried about the country's long-term budget deficits. "The economy is more important than the budget, basically. And people's health is more important than the economy." Bill Gale, Brookings, *Wall Street Journal*