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INSIGHT

COVID-19: Potential Role of Net Operating Loss (NOL) Carrybacks in Addressing the Economic Effects

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A number of industries may suffer losses in 2020 as a result of the coronavirus disease 2019 (COVID-19) outbreak. The travel and tourism industry, and restaurant industry, appear particularly susceptible at the moment due to an uptick in canceled reservations and a reduction in bookings. Other industries are likely to be impacted as well by a drop-off in consumer spending and a resulting reduction in profits, with the impacts likely increasing if COVID-19 continues to spread.

Before 2018, businesses with losses could "carry back" net operating losses (NOL) and use them to receive a refund for past taxes paid. On several occasions, Congress temporarily extended or enhanced the carryback rules to assist businesses in times of general economic weakness, or in response to natural disasters. Recent changes enacted in the 2017 tax revision (P.L. 115-97), commonly referred to as the Tax Cuts and Jobs Act (TCJA), however, eliminated the ability to carry back losses. This Insight discusses how allowing NOL carrybacks could potentially assist businesses impacted by economic weakness associated with COVID-19.

Carrybacks and Carryfowards

When a business experiences a loss (or NOL, in tax jargon) it owes no tax in that year. Currently, a business may use a loss to reduce future taxes by claiming it as a deduction against income earned in some future year. This process is known as carrying forward a loss, and a business may carry a loss forward indefinitely. Prior to the TCJA, businesses were able to use losses to obtain a refund for taxes paid in the past two years, a process known as carrying back a loss. TCJA, however, eliminated the two-year carryback. Businesses generally prefer to carry losses back rather than carry them forward because carrybacks produce a benefit sooner and with certainty, whereas carryforwards reduce taxes at some uncertain time in the future.

An example may help demonstrate the mechanics of carrying back a loss. Suppose that a business earned profits of $100 last year and paid taxes of $21 (i.e., the tax rate was 21%). This year the business incurred a loss of $40 and thus owes nothing in taxes. If the business is allowed to carry back this $40 loss it can

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receive a partial refund for taxes paid last year. It does this by recalculating its tax liability last year, subtracting the $40 loss from its $100 in income and applying the 21% tax rate. The business would find its recalculated tax liability for last year to be $12.60 ($60 x 21%). It would then receive as a refund the difference between what it originally paid in taxes last year and its recalculated tax liability, or $8.40 ($21 - $12.60).

Expanded NOL Carrybacks: Past Experience

At various times, the NOL carryback period was modified to provide temporary or targeted tax relief. For example, during the Great Recession, the American Recovery and Reinvestment Act of 2009 (P.L. 111-5) and Worker, Homeownership, and Business Assistance Act of 2009 (P.L. 111-92) temporarily extended the two-year carryback period to up to five years. In response to the destruction caused by Hurricanes Katrina, Rita, and Wilma, Congress passed the Gulf Opportunity Zone Act of 2005 (P.L. 109-135), which extended the carryback period from two to five years for qualified losses occurring in the Gulf Opportunity Zone (or GO Zone). The Job Creation and Worker Assistance Act of 2002 (P.L. 107-147) temporarily extended the NOL carryback period from two to five years for losses incurred in 2001 and 2002 to assist in the economic recovery.

Stimulative Effect of Loss Carrybacks

One feature of effective fiscal stimulus is the speed with which it can impact the economy. Loss carrybacks suffer from one fundamental issue in this aspect: losses cannot be carried back until after the end of the tax year. The reason is that tax losses are computed over a tax year, and not over a month or a quarter. Additionally, some businesses suffering from short-term economic disruption may not benefit from a NOL carryback if they earn a profit over their full year. Businesses that are reasonably confident that they will be in a loss position at the end of the tax year, and that have (or have access to) technical tax accounting expertise, may be able to adjust required estimated tax payments to reflect an expected loss carryback and experience some relief. These will most likely be larger corporate taxpayers, and not smaller businesses.

Still, because it is notoriously difficult to predict the economy's performance, and because there is a great deal of uncertainty about COVID-19, providing the ability to carry back losses may help support businesses if economic weakness is prolonged. Businesses that ultimately incur losses at the end of the tax year would be able to amend previous years' tax returns and receive a partial refund. This could assist businesses that struggled to make payroll or cover operating expenses, as well as those that took loans that need to be repaid.

Another aspect of effective fiscal stimulus is the "bang for the buck" a given tax reduction or spending increase produces. Economists quantify this notion with the use of fiscal "multipliers." Fiscal policy multipliers measure the change in economic output in response to a dollar change in taxes or a dollar change in spending. Past estimates by the Congressional Budget Office (CBO) and Moody's Analytics suggest that the multiplier effects associated with NOL carrybacks are small when compared to other policy options. CRS Report R45780, *Fiscal Policy Considerations for the Next Recession*, contains the CBO's and Moody's estimates, and also reviews the potential effectiveness of a number of fiscal stimulus options that have been considered in response to recent economic slowdowns, including NOL carryback modifications.

Separate from the stimulative effects of NOL carrybacks is the issue of whether carrybacks should be part of the tax system's underlying structure. Many economists would argue that allowing businesses to carry back losses increases economic efficiency by reducing the distorting effect taxation has on investment.

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