

 **Special Series | Dealing with Deficits: How States Can Respond**

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## MINORITY OF STATES STILL GRANTING NET OPERATING LOSS “CARRYBACK” DEDUCTIONS SHOULD ELIMINATE THEM NOW

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### Summary

As a result of the current recession, nearly all states are experiencing the most serious fiscal crisis of at least the last 25 years. Many are already being forced to cut vital services, lay off employees, increase taxes and college tuitions, and tap reserves. In this context, they can ill-afford maintaining any policies that worsen their financial problems.

Yet 19 states (see the box at right) are at risk of compounding their fiscal difficulties because of a somewhat obscure feature of their income tax codes known as the net operating loss (NOL) “carryback” deduction.<sup>1</sup> This provision allows businesses to file amended income tax returns for past years in which they were profitable, use current year business losses to offset those profits, and receive refunds of taxes paid in past years. During recessions, when tax payments by businesses tend to fall in any case, refunding business taxes paid in *prior* years can make revenue shortfalls even larger.

These 19 states could avoid some loss of personal and/or corporate income tax revenue during the current fiscal crisis — and future recessions — if they act now to

### KEY FINDINGS

- Nineteen states could avoid unnecessarily compounding their fiscal problems during the current economic downturn by repealing deductions from their personal and/or corporate income taxes for “net operating loss carrybacks.” The states are:

Alaska	Mississippi
Delaware	Missouri
Georgia	Montana
Hawaii	New York
Idaho	Ohio
Indiana	Oklahoma
Iowa	Utah
Louisiana	Virginia
Maryland	West Virginia
Michigan	

- These states allow businesses to use current losses to offset past profits and receive refunds of prior-year taxes paid — at exactly the time that *current*-year tax collections are falling.
- The majority of states don’t grant NOL carryback deductions.
- All states already provide almost the same tax benefit to businesses by allowing them to use current losses to offset *future* profits — a policy that is not nearly as disruptive to state fiscal management.
- 7 of these 19 states could be especially hard-hit if they don’t repeal their carrybacks because of direct links between their carryback laws and the federal tax code; legislation has been introduced to grant bigger NOL carrybacks to corporations.

disallow NOL carrybacks. (Personal income tax revenues would be affected because businesses organized as sole proprietorships and partnerships are also permitted to carry back NOLs.)<sup>2</sup> Three states — Kentucky, Illinois, and North Dakota — repealed their NOL carryback deductions during the years of tight state finances that followed the 2001 recession.

The underlying objective of permitting an NOL carryback deduction is reasonable from the standpoint of tax policy.<sup>3</sup> The provision allows a business to calculate taxable profit by averaging its income — including negative income — over several years. Allowing businesses to average profitable years and loss years recognizes both that start-up businesses often incur losses for several years before they become profitable and that many businesses experience temporary losses in the course of an economic downturn.

This income-averaging policy can be substantially achieved, however, by permitting “loss carryforwards” — allowing businesses to deduct any losses they suffer against *future* profits. The tax savings provided by carrybacks and carryforwards is essentially the same, with the principal difference being a matter of timing. Given that the objective of loss carrybacks can largely be achieved by allowing losses to be carried forward, it is ill-advised for states to compound their fiscal difficulties by issuing refunds for previously-paid taxes at a time when their current-year personal and corporate income tax collections are being affected adversely by an economic slowdown or recession. Loss carrybacks conflict with state balanced budget requirements, which force states to balance current year budgets even when the economy is weak, revenues are flagging, and service needs are rising.

A majority of states already apparently recognize the advantages of limiting income averaging by businesses to prospective deductions; 26 states and the District of Columbia permit losses to be carried forward to reduce future tax liabilities but bar loss carrybacks.<sup>4</sup> Policymakers who wish to avoid an unnecessary revenue loss in their states’ 2010 and 2011 fiscal years could do so by amending their tax laws to disallow the carryback of calendar 2009 operating losses experienced by businesses to earlier tax years.

If states act quickly, it is even possible to disallow the carryback of 2008 losses incurred by corporations. Such action would still be timely; the vast majority of corporations did not file their income tax returns prior to April 15th but rather will do so toward the end of this summer or even later. Disallowing the carryback of 2008 operating losses would significantly reduce the amount of refunds states will have to issue during their 2010 fiscal years as a result of the NOL carryback provision. Quick action is important because corporate profits were still high in 2006 and 2007 and most states that permit carrybacks allow a two-year carryback period.

Quick action may be especially important for Alaska, Delaware, Michigan, Missouri, New York, Ohio, and Oklahoma. These seven states tie the amount of NOL carrybacks they grant to corporations and/or individuals to the federal income tax carryback rules. Legislation has recently been introduced in the U.S. Senate to lengthen the NOL carryback period from two years to five years. Were this legislation to be enacted, it would significantly increase the amount of tax revenue these seven states would have to refund if they fail to repeal their carryback provisions.

## How Loss Carrybacks Work

In most cases, states allow NOL carrybacks because the federal Internal Revenue Code (IRC) allows carrybacks, even though only about a third of the carryback states are specifically linked to the federal provisions. At present, the IRC generally allows a business experiencing an operating loss in the most recent tax year to file amended tax returns for the two prior years and deduct that loss against any profits earned in those two years. Any unused losses that remain after being carried back can be deducted against profits earned in any of the next 20 years.

Take, for example, a corporation that earned \$1,000 in profit in both 2005 and 2006 and then experienced a loss of \$3,000 in 2007. The federal loss carryback provision allows this corporation to file amended tax returns for 2005 and 2006 and use \$2,000 of the 2007 loss to offset the \$1,000 profit earned in each of those two years.<sup>5</sup> In this circumstance, the corporation would receive a refund of all taxes paid in 2005 and 2006, since the NOL carryback deduction would bring taxable profit in both years down to zero. The unused \$1,000 of 2007 loss not carried back to 2005 or 2006 could be deducted against any profits earned in tax years 2008 through 2027.

Most states that allow loss carrybacks allow them for the same two-year period provided for in the IRC.<sup>6</sup> While all states with personal and/or corporate income taxes allow losses to be carried forward, a number of them limit carryforwards to shorter periods than the 20 year period allowed for federal tax purposes (for example, limiting the carryforward period to five or ten years). Five states — Delaware, Idaho, New York, Utah, and West Virginia — cap the dollar amount of losses that can be carried back.<sup>7</sup>

## The Rationale for Allowing Losses to Be Carried Forward and Back

The basic rationale for allowing losses to be carried forward and back flows from a recognition that businesses generally are established with the goal of making a profit over the life of the business rather than in any particular year. Many new businesses that ultimately prove to be successful and profitable lose money for a number of years before they cross over into profitability. The same long-term profitability goal applies to activities a business initiates subsequent to its initial formation. If the company is entering a new line of business or expanding into a new geographic area, it might experience substantial personnel and other costs before the new line of business or branch even begins operating, and still more costs before it becomes profitable. In some circumstances, these additional costs might cause the entire company to experience one or more years of loss. Finally, of course, profitable businesses may experience unprofitable years periodically due to downturns in the overall economy or factors that affect their particular industry (for example, a temporary spike in energy costs).

The aim of allowing losses to be deducted against past and future profits is to measure profitability for tax purposes over a time period that more closely corresponds to a business' investment horizon than would a strictly annual accounting of profits. Without this form of income averaging, a business that was never truly profitable in an economic sense could be subject to tax on its "profit" merely because of the timing of its receipts and expenses. Without income averaging, for example, a business that experienced losses for 5 years of \$1,000 per year followed by profits of \$1,000 per year for 5 years would pay income taxes in the latter period. In contrast, a business that exactly broke even in each of those 10 years (experiencing neither losses nor profits) would have no income tax liability in any of those years. Of course, neither business actually earned a profit over

the 10-year period taken as a whole. Thus, it arguably would be inequitable for the first business alone to have positive income tax liability merely because of the timing of its losses and profits. (That is not to say, however, that only profitable businesses should pay state taxes; see the text box on p. 8.)

### **Even If Averaging Business Income over Time Can Be Justified, Allowing Loss Carrybacks for State Income Tax Purposes Cannot Be**

Business profits are highly volatile over the course of the business cycle. Profits are often a fairly narrow “wedge” between a business’ receipts and its expenses. Because many of those expenses cannot be cut back quickly or easily when a business notices its sales slowing, a relatively small decline in a business’ sales due to an economic downturn or slowdown often leads to a much larger proportionate drop in profits. For example, between the fourth quarter of 1999 (when pre-tax corporate profits peaked prior to the 2001 recession) and the third quarter of 2001 (when corporate profits hit bottom) corporate profits fell by 17.8 percent. Over that same period, nominal Gross Domestic Product actually posted a 6.5 percent gain.

If business profits decline sharply during economic downturns, state taxes on business profits are likely to decline sharply as well. That was the states’ experience during the last recession in 2001. According to a recent study by the Rockefeller Institute of Government, in the three fiscal years in which state revenues were most adversely affected by the 2001 recession, the median revenue shortfall for state corporate income taxes was 35.4 percent — twice as large as the 17.5 percent shortfall in state personal income taxes and more than six times larger than the 5.3 percent shortfall in state sales tax receipts.<sup>8</sup>

Falling corporate tax revenues have worsened state fiscal problems during most previous recessions. Such revenue declines occur at a time when the need for state services and programs financed by business taxes not only does not recede, but, in fact, often increases. For example, workers who lose jobs and the income and benefits that come with them often need state-financed medical care, income supplements, housing assistance, and job training. These services are financed in most states by the General Fund, into which state personal and corporate income tax receipts usually flow.

Given the need to maintain or increase spending during economic recessions, it is surprising that some 19 states compound the fiscal problems that arise at such times from declining business tax receipts by permitting businesses to file for refunds of previously-paid taxes.

- There is little justification for such a self-inflicted fiscal wound; states can provide substantially the same tax savings to businesses by allowing them to carry their net operating losses forward and deduct them against future profits.

### Repealing the NOL Carryback Deduction: Mechanics

How a state would need to amend its tax law in order to disallow NOL carrybacks depends upon how that law links to the Internal Revenue Code. In some states allowing NOL carrybacks, state law defines state taxable income as federal taxable income before the deduction of net operating losses (often line 28 on the federal corporate income tax return), and then explicitly authorizes a further deduction for net operating loss carryforwards and carrybacks. In such a state, it is generally only necessary to strike the language referring to loss carrybacks. In North Dakota (which repealed NOL carrybacks in 2003), it was only necessary to strike eight words that referred to carrybacks.\* 2003 legislation to disallow NOL carrybacks in Illinois (S.B. 1634) achieved a similar result by adding five words clarifying that the provision for NOL carrybacks was not available for tax years that terminated on or after December 31, 2003.

In states that define state taxable income for corporations as federal taxable income after NOL deductions (line 30 of the federal corporate tax return), it generally would be necessary to add somewhat lengthier language providing for the adding back of NOL carrybacks deducted on the federal return. Arizona's statute, for example, provides for an add-back of all net operating loss deductions (Section 43-1121), and then allows a subtraction of just loss carryforwards (Section 43-1123). Addback language will also generally be necessary to remove NOL carrybacks from state personal income tax codes. Net operating losses experienced by small business owners are deducted in calculating both federal "adjusted gross income" and federal "taxable income." One or the other of these measures is used as the starting point for the state personal income tax calculation in almost every state.

Losses that have already been carried back for federal tax purposes will never appear on the federal return as carryforwards. Some states' laws may provide that the amount of losses to be carried forward for state purposes is the amount deducted on the federal return. In such states, it may be necessary to add language clarifying that losses disallowed as carrybacks on the state return can still be carried forward notwithstanding the fact that they have not been deducted as carryforwards on the federal return.

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\*H.B. 1471, Section 3, signed by the Governor on April 6, 2003. The law struck two additional words and added seven to clarify the effective date of the disallowance.

- While it is true that business cash flow would be improved by obtaining refunds of state income taxes paid in the past, a business that needed the cash for investment purposes likely would be able to borrow it on the capital market. Interest rates tend to be favorable during recessions, precisely the time when most net operating loss carrybacks would be claimed.
- Because of their balanced budget requirements, however, states generally would be unable to borrow money to offset the revenue they lose by allowing businesses to claim loss carrybacks.

Faced with a choice between improving business cash flow and avoiding further impairment of their ability to maintain services during recessions, a majority of states have appropriately chosen to limit businesses to claiming NOL carryforwards. The text box above discusses the mechanics of disallowing carrybacks.

## Repealing the NOL Carryback Deduction: Timing

If states amend their tax laws to disallow carrybacks of net operating losses experienced by businesses in the 2009 tax year now underway, it would prevent businesses in most states from obtaining refunds of some or all of their tax year 2007 and 2008 tax payments.<sup>9</sup> Most of these refunds would not actually be issued until some time in the states' 2011 fiscal years, however. States generally follow federal rules that would require the 2009 tax return to be filed before the prior-year refunds could be claimed. Most corporations would not be expected to file their 2009 tax returns until after July 1, 2010, when FY11 begins in most states. It generally takes corporations a number of months to close out their books and prepare their tax returns, which are often quite complex. (Like individuals, corporations can obtain an automatic six-month extension of the filing deadline if they make a timely request.) Accordingly, most of the revenue losses that states would avoid by disallowing the carrying-back of losses incurred in the current, 2009 tax year, would be Fiscal Year 2011 revenue losses.<sup>10</sup>

Given the evident seriousness of current economic conditions, it is unlikely that many states will be out of the woods financially by FY11; during the last recession, most states were in deep fiscal distress for at least two fiscal years after the recession ended. Thus, avoiding an unnecessary FY11 revenue loss by repealing NOL carrybacks effective with the current 2009 tax year is likely to be quite helpful to state finances in that year.

Moreover, almost every state is already predicting a shortfall in its Fiscal Year *2010* budget and will struggle to close it in the next few months.<sup>11</sup> Accordingly, states may also wish to consider acting quickly to disallow the ability of corporations to carry back their *2008* losses to obtain refunds of taxes paid in tax years 2006 and 2007. Few if any large corporations have filed their 2008 tax returns; most will not do so until September or October of this year. Although it would require states to devote some resources to preparing educational materials and distributing them to corporate tax managers making clear that 2008 losses could not be carried back, this should not be very difficult; state revenue departments have well-developed channels for informing tax practitioners about changes in tax laws, regulations, and policies.

Delaying the ability of a corporation to obtain an anticipated tax refund only a few months before the refund was to be paid may appear to be a somewhat extreme, disruptive measure. Many families and individuals, however, face even more serious disruptions of their financial circumstances as a result of the state fiscal crisis. For example, at least 19 states have enacted or implemented cuts that will affect low-income families' eligibility for health insurance or reduce their access to health care. State university students in several states will likely face much greater-than-anticipated increases in tuition and cuts in financial aid in the fall 2009 semester; more than half the states have already reduced aid to public colleges and universities. Disallowing the carrying-back of 2008 NOLs could enable states to avoid subjecting some additional number of families and persons to financial and perhaps physical harm. Given that corporations would still be able to reap the tax saving from 2008 losses in future years, policymakers could reasonably choose to act quickly and disallow carrybacks of 2008 corporation losses. States disallowing carrybacks could extend the carryforward period to allow businesses a longer period of time in which to utilize their losses.

## Cost of Some States' NOL Carrybacks Could Increase Due to Federal Expansion

It may be especially important that some of the states allowing NOL carrybacks move quickly to repeal them, because the cost of those provisions in forgone revenue could rise sharply in the coming months. A bill has recently been introduced in the Senate to extend the federal NOL carryback period from two years to five years for tax years 2008 and 2009.<sup>12</sup> This would allow corporations suffering deep losses as a result of the recession to deduct them against profits earned in three additional pre-recession years — increasing the likelihood that all of the losses could be used and that the revenue refunded would be greater.

Were this extension to be enacted, seven states — Alaska, Delaware, Michigan, Missouri, New York, Ohio, and Oklahoma — would automatically extend their NOL carryback periods to five years as well because their NOL provisions are tied to the federal rules. Unless they deliberately took action to “decouple” from the extension, these states — like the federal government— would experience an additional revenue loss.

These seven states could choose to decouple only from the extension, retaining the current two-year carryback period. That is what Missouri did in 2002, when the federal government enacted a temporary extension of the carryback period from two to five years as part of that year’s economic stimulus legislation. However, given that the retention of *any* carryback provision is fiscally imprudent, it would be preferable that these states view the threat of an increased revenue loss as an incentive to eliminate the provision in its entirety.

Five additional states — Georgia, Hawaii, Indiana, Virginia, and West Virginia — also tie their NOL carryback provisions to federal law but would not be automatically affected by a federal extension because they are tied to the Internal Revenue Code as it exists on a specified date. However, these states routinely pass laws to roll that date forward and would pick up the extension if they “reconnected” to the Code as of a date that occurred after the NOL extension had gone into effect. Indeed, Georgia, Indiana, and West Virginia all did that back in 2002, and their revenues were adversely affected. At the very least, when they roll their reconnect dates forward these three states should decouple specifically from any extension of the carryback period — as Hawaii and Virginia did the last time. Again, for all the reasons discussed in this report, the wise course of action from the standpoint of fiscal stability would be to eliminate NOL carrybacks entirely while retaining loss carryforwards.

### **Unprofitable Corporations Benefit from State Services And Therefore Can Be Expected to Pay *Some* State Taxes**

One basic rationale for imposing income taxes on businesses is the “benefits received principle” — the notion that some taxes can be viewed as payment for services rendered by government to the taxpayer. The owners of businesses benefit from state programs and activities that make possible or facilitate the operation of the business. These services include public education (which helps provide the business with a productive workforce), the maintenance of a legal and regulatory system that enforces business contracts and discourages commercial fraud, and the provision of public transportation networks that enable businesses to obtain inputs and get their products to market. The benefits received principle holds that business owners can be expected to pay state taxes to compensate the state for services like these that are provided to the business. While in theory these taxes could be imposed on business owners directly (and in some instances are), the practical difficulties of taxing out-of-state owners of corporations has led most states to impose taxes on the corporations directly rather than seek to tax non-resident stockholders.

Taxing profits is only one possible approach to taxing businesses for the state services they — or their owners — receive. Because businesses benefit from state services like education and roads whether they are profitable or not, it is entirely reasonable for states to impose some type of general business tax that does not depend upon business profitability. Some 11 states, for example, impose a corporate minimum tax that is a fixed amount — ranging from \$10 in Oregon to \$2000 in New Jersey. At least five states go further, and require businesses to pay the higher of a tax calculated as a percentage of profit (which of course is zero when the business has no profit) and a tax calculated on some other basis. (In New York that alternative base is the business’ capital stock, in New Hampshire it is “value-added” within the business, and in Kentucky, Michigan, and New Jersey it is the business’ gross receipts minus some purchases from independent firms.) Still other states impose both a corporate profits tax and a non-profits-based tax. All three of these categories of taxes serve as a form of “alternative minimum tax” that ensures that all businesses pay something to support the public services from which they benefit, even if they are not profitable in a particular year.

Allowing businesses to average taxable profits and losses over a number of years arguably is reasonable *income* tax policy. Such a policy ensures that businesses that are not truly profitable over an extended period of time are not liable for income taxes merely because they have a profitable year or two. Accepting such a policy does not mean, however, that unprofitable businesses should have no state tax obligations. Again, the “benefits received principle” applies to profitable and unprofitable businesses alike.

## Notes

<sup>1</sup> John C. Healy and Michael S. Schade Wald, *2009 Multistate Corporate Tax Guide on CD-ROM*, CCH, validated with selective review of state corporate income tax statutes.

<sup>2</sup> In Michigan and Ohio, the operating loss carryback provision applies only to individual income taxes.

<sup>3</sup> That is not to say, however, that granting carrybacks or lengthening the carryback period is justified as a means of stimulating state or federal economic growth. At the state level, the loss of revenue from granting or extending carrybacks requires offsetting cuts in state spending or tax increases that reduce economic demand to the same extent, providing no net boost to economic growth. At the federal level, refunding additional income to corporations during a recession is unlikely to boost their investment significantly since the major roadblock to such investment is likely to be insufficient demand for their products. See: Aviva Aron-Dine, "Net Operating Loss Measure Under Consideration in Senate Has Low Bang-for-the-Buck as Stimulus: No Justification for Waiving PAYGO for the Provision," Center on Budget and Policy Priorities, February 26, 2008.

<sup>4</sup> Five states do not have corporate or personal income taxes for which NOL carrybacks are relevant. They are Nevada, South Dakota, Texas, Washington, and Wyoming.

<sup>5</sup> NOL carrybacks can also be claimed for federal tax purposes on forms specially designed for that purpose; it generally is not necessary to file a full-blown amended return.

<sup>6</sup> Louisiana, Montana, and Utah allow a three-year carryback under state-specific provisions.

<sup>7</sup> The annual cap amounts are as follows:

Delaware	\$30,000
Idaho	\$100,000 (over two-year carryback period)
New York	\$10,000 (applicable to corporations only; no cap for individuals)
Utah	\$1,000,000
West Virginia	\$300,000

<sup>8</sup> Donald J. Boyd and Lucy Dadayan, "What Will Happen to State Government Finances in a Recession?" Rockefeller Institute of Government, State University of New York, January 30, 2008, Table 6, p. 16. Available at [www.rockinst.org/WorkArea/showcontent.aspx?id=13894](http://www.rockinst.org/WorkArea/showcontent.aspx?id=13894).

<sup>9</sup> As noted above, Louisiana, Montana, and Utah allow a three year carryback, so 2009 losses could be carried back to 2006 as well in those states.

<sup>10</sup> Some of the avoided revenue losses likely would be FY10 revenue losses. Small business owners eligible for refunds from NOL carrybacks would find it in their interest to file their 2009 tax returns as early as possible, and many likely would do so before June 30, 2010, when most states' 2010 fiscal years end.

<sup>11</sup> See: Elizabeth McNichol and Iris J. Lav, "State Budget Troubles Worsen," Center on Budget and Policy Priorities, Updated March 13, 2009; available at [www.cbpp.org/9-8-08sfp.htm](http://www.cbpp.org/9-8-08sfp.htm).

<sup>12</sup> The lead sponsor of the bill is Senate Finance Committee Chairman Max Baucus.

The federal economic stimulus bill enacted in February 2009 also contained an extension of the NOL carryback period from two years to five years, but the revenue impact was limited by restricting eligibility to businesses with gross income less than \$15 million. The states that automatically conform to the federal carryback period will lose revenue from this extension, but it is effectively too late to decouple from it.