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INSIGHT

P.L. 115-97: Net Operating Losses

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Specialist in Economics

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The 2017 tax revision (P.L. 115-97) enacted on December 22, 2017, made significant changes to the federal tax system, including changes to the tax treatment of business net operating losses (NOLs). This Insight provides an overview of the tax treatment of NOLs that existed before the enactment of P.L. 115-97 and the treatment of losses going forward as a result of the 2017 revision.

What Is an NOL?

A business incurs an NOL when its deductions exceed its gross income, or, put differently, when a business's taxable income is negative. The year in which the NOL is realized is referred to as a "loss year." A business has no tax liability in a loss year. Additionally, an NOL may be used to reduce taxes in non-loss years.

2017 Law

Tax law in 2017 allowed businesses to use an NOL to obtain a refund for taxes paid in prior years or to reduce taxes owed in the future. Using an NOL to obtain a refund for past taxes paid is known as carrying back a loss, whereas using an NOL to reduce future taxes owed is known as carrying forward a loss. Specifically, 2017 tax law allowed for NOLs to be carried back for up to two years and carried forward for up to 20 years.

In 2017, tax law stipulated that a loss was to be first carried back to the two years preceding the loss year, beginning with the earliest year (subject to the waiver provision discussed below). If the carryback did not fully exhaust the NOL, the remaining portion was then carried forward. To carry back a loss, a taxpayer would file either an amended income tax return, or an application for a tentative refund. The taxpayer used the appropriate form to first recalculate tax liability for the earliest eligible carryback year. This calculation involved claiming the loss as part of that year's tax deductions. The taxpayer then received the difference between the actual taxes paid in the previous year and the new tax liability that resulted from

the NOL carryback as a refund. To carry a loss forward, a taxpayer would claim the loss as a deduction against future income on their tax return, thus reducing the tax owed.

Several exceptions existed to the general two-year carryback and 20-year carryforward treatment. For example, losses resulting from a casualty, theft, or a federally declared disaster were eligible to be carried back three years. Farming losses could be carried back five years. Losses resulting from a specified liability loss could be carried back 10 years. Real estate investment trusts (REITs) were not allowed to carry back an NOL, but were entitled to carry a loss forward for up to 20 years.

Modifications Made by P.L. 115-97

P.L. 115-97 modified the tax treatment of NOLs in three principal ways. First, carrybacks are no longer allowed. Second, losses may be carried forwarded indefinitely instead of 20 years. And third, the NOL deduction is limited to 80% of taxable income. The modifications made P.L. 115-97 apply to losses arising in tax years ending after December 31, 2017.

Considerations

In general, businesses prefer to carry back losses rather than carry them forward. Carrybacks produce an immediate and certain benefit whereas carryforwards reduce taxes at some uncertain time in the future. Disallowing carrybacks may diminish the ability of businesses to smooth out fluctuations in income and taxes, and address cash-flow problems over the business cycle, which could negatively impact some firms during periods of economic weakness. Carrybacks also help to minimize the distorting effects taxation has on risky investment decisions. Not allowing losses to be carried back could increase the tax burden on these investments, presumably resulting in less investment and innovation, which is often the result of businesses undertaking investments with a high degree of risk. However, it could be argued that in an extremely expansionary period investors are already making sufficiently risky investments and that adding further incentives to take on more risk could be unnecessary and economically inefficient.

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