

POLICY BRIEF



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Net Operating Loss in Arizona

Taxing Business Profits on a Multi-Year Basis

Prepared by Grant Hanna

NOL carryovers “ameliorate the unduly drastic consequences of taxing income strictly on an annual basis. They were designed to permit a taxpayer to set off its lean years against its lush years, and to strike something like an average taxable income computed over a period longer than one year.”

--Harold Burton, U.S. Supreme Court Justice, 1957

Key Points

The federal government and 26 states have adopted a 20 year carryforward policy.

The aim of allowing losses to be deducted against past and future profits is to measure profitability over a period that more closely corresponds to a business's investment horizon.

Conforming Arizona's NOL tax policy to the federal system will improve the state's business tax climate and allow small businesses, new ventures, high-tech businesses and manufacturers' additional time for investment and employment growth.

Introduction

The primary goal of business tax policy is to fairly tax business profitability. Because the vast majority of businesses see profits generated over multi-year periods, annual taxation fails to accurately capture the true economic performance of a business. Recognizing the need for a multi-year perspective, the federal government first provided a net operating carryover in the Revenue Act of 1918. Since the Act, both the federal government and a majority of states have utilized net operating loss carryovers to adapt the annual tax cycle to the multi-year economic cycle faced by businesses.

What is a NOL Carryback and Carryforward?

A business has a net operating loss (NOL) when its tax-deductible expenses exceed taxable revenues during the fiscal year.¹ The annual accounting method causes an unbalanced tax burden by not allowing businesses to benefit from the excess deductions generated in an NOL year. The federal government and most states mitigate this unbalance by allowing businesses to carryback and carryforward an NOL. A business filing a NOL carryback applies the excess deductions to past profitable years and receives a refund for taxes paid during those periods. A business filing an NOL carryforward applies current losses to future years' profits. If a business generates a loss of \$100,000 in year one and nets \$300,000 of taxable income in year five, application of an NOL carryforward reduces its year five taxable income to \$200,000. By offsetting income and expenses over longer periods of time, both types of NOL carryovers remedy the inequity of applying the annual accounting principle to business taxpayers with fluctuating income.

NOL Carryback and Carryforward in Federal Taxation

Computation of a net operating loss deduction at the federal level follows a three-step statutory scheme outlined in 26 U.S.C.A. § 172.

1. First, the business computes the NOL by determining the excess of allowed deductions over the gross income for a year with certain modifications.² The computations are made under the law applicable to the taxable year in which the loss is sustained.

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2. Second, the NOL for a loss year is carried back to each of the two preceding years allowing refunds of taxes paid (businesses with less than a \$15 million yearly average of gross receipts are allowed NOL carrybacks of five years under the The Worker, Homeownership and Business Assistance Act of 2009).³ Any portion of the NOL remaining after deduction of the carrybacks is then carried forward to each of the 20 taxable years following the loss year. The NOL is deducted in chronological order until it is fully consumed. A taxpayer may elect to waive the carryback of an NOL for a loss year and instead carry the NOL forward only.
3. Third, the business tallies the “net operating loss deduction” for a taxable year (the sum of the NOL carryovers and NOL carrybacks deducted in that year).²

State Computation of NOL

One can divide the states’ approaches to the NOL deduction into three categories. First, some states literally adopt the amount of the federal NOL deduction allowed for the taxable year. This amount is subtracted from the federal tax base before any state modifications are made to that base. Second, many states provide for a state NOL deduction “in the same manner” as the NOL deduction provided under the federal system. This concept of conformity contemplates a separate state NOL deduction that is different from the federal NOL deduction, although it is determined by the application of rules at the state level similar to rules applied at the federal level. Third, several states, while not literally incorporating the amount of the federal deduction into the state calculation, nevertheless tie the permitted state NOL deduction to the actual federal tax treatment of the taxpayer by using the existence

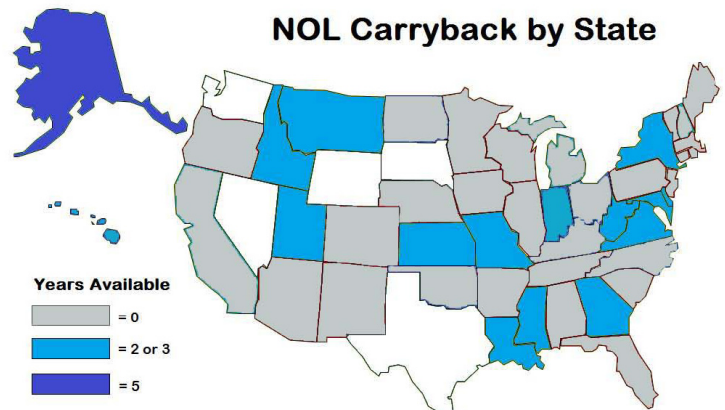
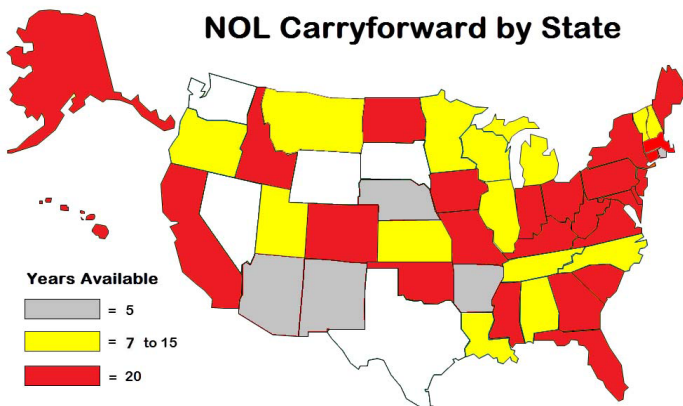
and amount of the federal NOL as the starting point for, or limitation upon, the amount of the state NOL subject to carryover. The state loss, thus determined, may then be carried over by rules resembling the federal rules. The third approach may be viewed as a hybrid of the first and second approaches. Under Arizona Revised Statutes § 43-1123, a taxpayer computes an NOL “within the meaning section 172(c) of the internal revenue code” less deductions outlined in § 43-1122.⁴ This constitutes a hybrid form of NOL computation.

State Availability and Length of NOL Carryovers

Arizona has no NOL carryback and a five year NOL carryforward. Forty of the 45 states with a corporate income tax have a longer carryforward period than Arizona with 26 states conforming to the 20 federal standard. Of the 16 states states with an NOL carryback, 11 allow two year, 4 allow three year and one allows five year. (See Appendix 1) In terms of opportunity to claim an NOL deduction, Arizona resides in the bottom 15% of states that collect a corporate income tax. As evidenced by recent action in New Jersey, Indiana and California, the modern trend is to increase the opportunity for NOL deduction.

Rationale for NOL deduction

Businesses generally operate with the goal of making a profit over the life of a 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 sub-



**Nevada, South Dakota, Texas, Washington & Wyoming do not impose corporate income tax.*

stantial personnel and other costs before the new line of business or branch becomes profitable. In some circumstances, these additional costs might cause the entire company to experience many years of loss. Profitable businesses may also experience unprofitable years periodically due to downturns in the overall economy or factors that affect their particular industry.

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's investment horizon than would a strictly annual accounting of profits.⁵ 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. Writing for a seven member majority of the U.S. Supreme Court, Justice Burton held that NOL carryovers "ameliorate the unduly drastic consequences of taxing income strictly on an annual basis. They were designed to permit a taxpayer to set off its lean years against its lush years, and to strike something like an average taxable income computed over a period longer than one year."⁶ Without income averaging, for example, a business that experienced losses of \$1,000 per year for five years followed by profits of \$1,000 per year for five 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.⁷ Of course, neither business actually earned a profit over the 10 year period taken as a whole. Thus, it would be inequitable for the first business alone to have positive income tax liability merely because of the timing of its losses and profits.

NOL Carryover Reform in Arizona

Conforming Arizona's NOL tax policy to the federal system of a two-year carryback and 20 year carryforward will improve the state's comparative business tax climate and allow small businesses, new ventures, high-tech businesses and manufacturers' additional time for investment and employment growth. These industries are prone to generate NOLs in early years of operation and are disadvantaged by the current limitations in Arizona's business tax policy. Lengthening the opportunity for NOL deduction could aid in the promotion of entrepreneurship within Arizona and the attraction of businesses from outside the state.

Conclusion

Since the Revenue Act of 1918, federal and state governments have recognized the need to remedy the unbalanced tax burden on businesses forced to adhere to annual accounting principles. By reforming its business tax policy to correspond more accurately with business cycles through the adoption of a two-year NOL carryback and 20 year carryforward policy, Arizona would improve its competitive position among the states. This is a simple tax policy change that lawmakers can enact to ensure that Arizona remains an economically viable climate to start and cultivate a business until it becomes profitable.

Notes

¹ “Net operating loss” and its carry-back and carry-over as a deduction under Internal Revenue Code. M.L. Cross. June 1998

²Internal Revenue Service. <http://www.irs.gov/taxtopics/tc409.htm>

³“New Law Extends Net Operating Loss Carryback for Small Businesses.” Accessed at: <http://www.irs.gov/newsroom/article/0,,id=205329,00.html> (March, 2009).

⁴Arizona Revised Statutes § 43-1121-24

⁵Utilization of Net Losses in Taxable Years Other Than That of Occurrence. Laura Hunter Dietz, J.D., and Jane E. Lehman, J.D. August 2011

⁶*Libson Shops, Inc v. Koehler*, 353 U.S. 382, 386 (U.S. 1957).

⁷Partial Loss Refundability: How Are Corporate Tax Losses Used? Michael Cooper & Matthew Knittel, National Tax. September 2006.

Appendix 1

State NOL Carryback and Carryforward

	Carryforward	Carryback	Notes/Max		Carryforward	Carryback	Notes/Max
Alabama	15	0		Mississippi	20	2	
Alaska	20	5		Missouri	20	2	
Arizona	5	0		Montana	7	3	
Arkansas	5	0		Nebraska	5	0	
California**	20	0		New Hampshire	10	0	\$1,000,000
Colorado	20	0	\$250,000	New Jersey	20	0	
Connecticut	20	0		New Mexico	5	0	
Delaware	20	2	\$30,000	New York	20	2	\$10,000
Florida	20	0		North Carolina	15	0	
Georgia	20	2		North Dakota	20	0	
Hawaii	20	2		Ohio	20	0	
Idaho	20	2	\$100,000	Oklahoma	20	0	
Illinois**	12	0	N/A 2011-2014	Oregon	15	0	
Indiana	20	2		Pennsylvania	20	0	
Iowa	20	0		Rhode Island	5	0	
Kansas	10	3		South Carolina	20	0	
Kentucky	20	0		Tennessee	15	0	
Louisiana	15	3		Utah	15	3	
Maine	20	0	\$100,000	Vermont	10	0	
Maryland	20	2		Virginia	20	2	
Massachusetts	20	0		West Virginia	20	2	\$300,000
Michigan	10	0		Wisconsin	15	0	
Minnesota	15	0		U.S.	20	2	

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** Both California and Illinois have currently suspended the NOL carryover deduction. In California the NOL carryover deduction is suspended for taxpayers with at least \$300,000 of preapportioned income (\$500,000 for 2008-2009). In Illinois, the NOL carryover deduction is not allowed for any taxable year ending after December 31, 2010 and prior to December 31, 2014.