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First, Do No Harm: States Can Preserve Revenue by Decoupling From CARES Act Tax Breaks for Business Losses

By Michael Mazerov

The Coronavirus Aid, Relief, and Economic Security (CARES) Act, enacted in March 2020, included several costly federal tax breaks for businesses that will also reduce many states' personal and corporate income tax revenues because their tax codes are tied to the federal code. Several of these tax breaks allow businesses to get refunds of taxes they owed for the 2018 and 2019 tax years, before the pandemic hit. Five states — Colorado, Georgia, Hawaii, New York, and North Carolina — have already "decoupled" their tax laws from these provisions to avoid having to give back revenue they have already collected; other states should do the same.[1]

Some of these tax breaks have questionable merit at the federal level and make even less sense for states, which must balance their budgets each year — an extremely challenging task given their sharp revenue declines since the pandemic hit. States will need to *increase* tax revenues during the next several years to minimize cuts in education, health care, child care, infrastructure, and other critical services, which would disproportionately harm low-income people and people of color. Their immediate priority must be to preserve existing revenue sources by avoiding unnecessary and unwarranted tax cuts.

About half the states have probably lost some revenue already because their tax codes are linked to current provisions of the Internal Revenue Code (IRC). These "rolling conformity" states need to decouple from the CARES Act provisions as early as possible in their 2021 legislative sessions to prevent additional revenue losses and minimize the number of taxpayers that will have to file amended tax returns and pay taxes that were previously refunded.

The remaining states' tax codes are linked to the IRC as it existed on a specific date before the CARES Act changes took effect. Ordinarily, such "static conformity" states could wait to decouple from CARES Act tax breaks when they next update their laws to conform to the IRC as of a later

[1] See Colorado HB20-1420, https://leg.colorado.gov/sites/default/files/2020a_1420_signed.pdf ; Georgia HB 846, http://www.legis.ga.gov/Legislation/20192020/195259.pdf; Hawaii SB 2920, https://www.capitol.hawaii.gov/session2020/bills/SB2920_HD1_.pdf; New York A. 9508B/S. 7508B (Part WWW), https://nyassembly.gov/leg/?default_fld=&leg_video=&bn=A09508&term=2019&Summary=Y&Text=Y; North Carolina HB 1080, https://www.ncleg.gov/Sessions/2019/Bills/House/PDF/H1080v7.pdf.

date. But because the CARES Act changed these provisions *retroactively* for tax years 2018 and 2019, even states conforming to the IRC as it existed at the beginning of 2018 or 2019 could face imminent revenue losses if they fail to act in early 2021.

While there are numerous tax provisions in the CARES Act from which states should consider decoupling, three require the most urgent attention because they will likely result in the most significant near-term revenue reductions. All three suspended restrictions that the 2017 Tax Cuts and Jobs Act (TCJA) had placed on businesses' (and business owners') ability to use business losses to reduce their tax liability. The CARES provisions:

- **Allowed owners of "pass-through" businesses to deduct an unlimited amount of business losses to offset their non-business income.** Under the TCJA, owners of businesses legally structured as pass-throughs — sole proprietorships, partnerships, S corporations, and limited liability companies — could only deduct up to $500,000 in business losses per couple ($250,000 for an individual) from their non-business income (such as capital gains) in the tax year in which the losses were incurred.[2] Losses above that amount — deemed "excess business losses" — could be deducted from *future* income. The CARES Act suspended that limit, retroactively for tax years 2018 and 2019 and also for 2020.

  This suspension is a far cry from a carefully targeted strategy to assist businesses that have suffered true economic losses resulting from the recession. It only benefits very high-income taxpayers; as Figure 1 shows, more than 80 percent of the federal tax benefits go to just 43,000 taxpayers with incomes over $1 million, who will save $1.6 million apiece, on average, the congressional Joint Committee on Taxation (JCT) estimated. Several tax experts have identified real estate and hedge fund investors as those likely to benefit the most, and in many cases the "losses" they are deducting are only on paper, occurring when taxpayers concentrate certain expenses in particular tax years rather than spread them out over the period in which they will actually generate income. Moreover, many of the newly deductible losses occurred in 2018 and 2019, before the pandemic hit, which means the government is subsidizing businesses that lost money during a strong economy. Finally, some of the losses will be those of out-of-state businesses; in other words, states will be forgoing revenue to cut taxes for businesses that are not creating or preserving jobs for their residents.

  A substantial majority of states are apparently coupled to this CARES Act provision. They should decouple and retain the TCJA limit.

- **Allowed corporations and pass-through businesses to use current-year losses to offset past-year profits.** Prior to TCJA, such businesses could "carry back" any losses in the current year (called "net operating losses" or NOLs) to past years in which they were profitable, file amended tax returns for those years, and receive refunds of some of or all the taxes they had paid on those profits. TCJA eliminated NOL carrybacks, while retaining longstanding provisions that allow current-year losses to be subtracted from future profits, called NOL "carryforwards." The CARES Act not only reinstated NOL carrybacks but did so retroactively for the 2018 and 2019 tax years and allowed losses to be used to get refunds of taxes paid as far back as 2013. (Previously, carrybacks had generally been limited to the two prior years.)

[2] Pass-throughs are so named because their profits are exempt from the corporate income tax and instead are directly passed through to the owners' personal income tax returns.

Although carrybacks can be justifiable in principle as an element of *federal tax policy,* they are ill-advised from the standpoint of *state fiscal policy* because states must balance their budgets. Allowing carrybacks during a recession, when states are already losing corporate and individual income tax revenues because many businesses are less profitable or even losing money, compounds state revenue shortfalls by compelling them to refund taxes already collected. For this reason, a large majority of states have eliminated carrybacks in their corporate income tax.

Nonetheless, at least a few states are coupled to federal NOL carryback provisions for corporate taxes, and even more still allow carrybacks for pass-through businesses taxable under their personal income taxes. Such conformity could lead to substantial tax refunds this year and next. State policymakers should determine if their corporate and/or personal income taxes are coupled to federal loss carryback provisions and, if they are, decouple from them once and for all. (States, however, should retain NOL carryforward deductions.)

- **Enabled corporations and pass-through businesses to *zero-out* their tax liability in years in which they are profitable by deducting prior-year losses.** Under TCJA, NOL carryforwards could offset no more than 80 percent of current-year profits. The CARES Act removed this limit, once again for the pre-pandemic tax years of 2018 and 2019 as well as 2020.

  As a result, a business that experienced a loss in 2018 can deduct 100 percent of that loss against profits realized in 2019 and 2020, and a business with a loss in 2019 can deduct 100 percent of that loss when it files its 2020 tax return next year. In other words, this CARES Act provision can benefit businesses that lost money *before* the pandemic but manage to be profitable this year in spite of it — hardly those most in need of tax reduction. Moreover, as with the CARES Act's excess business loss provision described above, some of these losses will only be on paper, not true economic losses. Accordingly, states should decouple from this CARES Act provision as well.

The CARES Act changes are particularly harmful to already hard-hit state treasuries because they were retroactive to the 2018 and 2019 tax years. Although only a handful of states have estimated the adverse impact of conforming to these changes, those estimates should raise alarms for other states. Maryland, for example, estimated that conforming to these three provisions would reduce revenue by $272 million over the two fiscal years ending June 30, 2021, while Michigan estimated a $420 million loss and Oregon a $180 million loss over the same two fiscal years. (See Table 1; Michigan's fiscal year ends on September 30.)

A further argument for decoupling from the CARES tax breaks is that it would only affect *when* business losses can be deducted, not *if* they can be. All the losses affected by decoupling can still be carried forward as deductions against the business's future profits. This is likely why decoupling legislation already enacted in Colorado, Georgia, Hawaii, New York, and North Carolina generated little controversy or debate. And, of course, businesses will continue to get substantial *federal* tax breaks even if states choose not to layer-on tax breaks of their own.

Decoupling from the three CARES provisions should be a high priority for 2021 legislative sessions. To better protect their tax bases in the future, rolling-conformity states should seriously consider switching to fixed-date conformity, and all states should amend their laws to ensure that retroactive federal changes to tax years already ended have no impact on their taxes.

TABLE 1

Estimated Revenue Loss From Conformity to CARES Act's Suspension of Three TCJA Business Loss Provisions

	FY20	FY21	FY22
Colorado		$78 million	$18 million
Maryland	$46 million	$226 million	$8 million
Michigan	$238 million	$182 million	
Montana		$91 million	$46 million
Nebraska		$96 million	$61 million
Oregon	$180 million		

Sources: Colorado Legislative Council, Final Fiscal Note on HB20-1420 (decoupling bill), July 28, 2020, http://leg.colorado.gov/sites/default/files/documents/2020A/bills/fn/2020a_hb1420_f1.pdf; Maryland Comptroller Peter Franchot, "60-day report" letter to Governor Larry Hogan, Senate President William C. Ferguson IV, and Speaker of the House Adrienne A. Jones, June 12, 2020, https://www.marylandtaxes.gov/reports/static-files/revenue/federalimpact/CARES_Act_60_Day_Report_Final_2020.pdf; Michigan Dept. of Treasury, Office of Revenue and Tax Analysis, "Estimated Revenue Impact of the CARES Act," unpublished table (available from the author), April 24, 2020; Montana State Legislature, Legislative Fiscal Division, "Revenue Outlook 2023 and Beyond," September 2020, https://leg.mt.gov/content/Committees/Interim/2019-2020/Revenue/Meetings/September-2020/LFD-Sept-update.pdf; Nebraska Dept. of Revenue, "Estimates of GF Revenue Impact of CARES Act," unpublished, undated table; see https://twitter.com/fredmknapp/status/1272907799530475522 (Twitter post of Fred Knapp, reporter for Nebraska Public Radio and Television, June 16, 2020); Oregon Legislative Revenue Office, "Coronavirus Aid, Relief, and Economic Security (CARES) Act (H.R. 748), Tax and Revenue Related Provisions," May 2020, https://olis.leg.state.or.us/liz/2019I1/Downloads/CommitteeMeetingDocument/222068.

Background on State Income Tax "Conformity"

In most states, the calculation of state taxable income starts with the federal "adjusted gross income" (AGI) reported by individuals and "taxable income" reported by corporations. This linkage between federal and state tax calculations is referred to as Internal Revenue Code (IRC) "conformity." In conforming states, any changes in federal tax law affecting AGI and/or corporate taxable income affect the calculation of state tax liability unless the state amends its tax laws to "decouple" from those changes.[3] States routinely decouple from changes in federal tax law, especially those that would cause significant revenue losses.[4]

Conforming states differ in how and when IRC changes begin affecting their tax calculations and revenues. About half of the states have "rolling conformity," meaning that any IRC changes *automatically* affect their tax calculations in the same tax year in which the federal changes take effect unless the state enacts legislation decoupling from that change for that year. For example, the CARES Act included a provision allowing individuals who do not itemize their deductions to nonetheless deduct up to $300 in charitable contributions from their gross income in arriving at AGI. Congress made the provision retroactive to the beginning of the 2020 tax year, which was then already underway. Thus, rolling-conformity states will also automatically allow that deduction for tax year 2020 unless they decouple from it.

[3] Many other IRC provisions affect tax calculations further down the tax return than the AGI and corporate taxable income lines, such as the calculation of tax credits; changes in these "below the line" calculations tend not to flow through to state tax returns. Likewise, because the multiplication of taxable income by applicable tax rates occurs below the AGI and taxable income lines, changes in federal tax *rates* do not affect state tax liability.

[4] For example, most states are already decoupled from federal NOL carryback provisions for corporations, as opposed to pass-through business owners.

The other half of states have "static" or "fixed-date" conformity. Their income tax codes are linked to the IRC as it existed on a specific date — most often December 31, 2018 at present.[5] Fixed-date conformity states do not incorporate IRC changes occurring after the conformity date into their own tax laws until they change their laws to move that date forward to (or after) the effective date of those changes. Some states move the conformity date forward exactly one year in every annual legislative session; others may wait several years before doing so.

Because fixed-date conformity states must take action to move the conformity date forward, they have more of an opportunity to consider whether they should decouple from any recent federal tax changes. As discussed below, however, the fact that three CARES Act provisions discussed in this report are retroactive to 2018 and 2019 puts even some fixed-date conformity states at risk of automatic, immediate revenue losses.

CARES Act Suspends Three TCJA Limits on Business Loss Deductions

Enacted in December 2017, TCJA included large net federal income tax cuts for corporations and pass-through entities.[6] Largely to mitigate the revenue loss from these tax cuts, TCJA included some base-broadening provisions. Among them were three restrictions on the ability of pass-through business owners and both corporations and pass-through businesses themselves to deduct business losses to reduce their taxes:

- **Excess business losses.** TCJA limited the ability of managing owners[7] of pass-throughs to use operating losses (the amount by which expenses exceed income) in those businesses to offset the owner's other income. Under the provision, a maximum of $500,000 of current-year business losses could be subtracted from current-year non-business income in calculating taxable income for a married couple filing a joint return ($250,000 for single filers).[8] Any business losses above those limits, deemed "excess business losses," could be "carried forward" and subtracted from the taxpayer's future income from the business.
- **NOL carrybacks.** TCJA permanently repealed NOL carrybacks, a longstanding feature of federal tax law that allowed corporations and pass-through businesses to use current-year operating losses to offset *prior*-year profits. Previously, businesses could file amended tax returns for previous years in which they were profitable (up to two prior years for most businesses when TCJA was enacted), subtract their current-year losses from those profits to lower their taxable income, and receive refunds of income taxes they had paid. If a business's current-year losses exceeded its combined profit in the two prior years, the excess could be

[5] The Federation of [state] Tax Administrators publishes an annual table detailing each state's relation to the IRC and the federal tax base used as a starting point to calculate state taxable income. See: https://www.taxadmin.org/assets/docs/Research/Rates/corp_stg_pts.pdf and https://www.taxadmin.org/assets/docs/Research/Rates/stg_pts.pdf.

[6] Among other things, TCJA reduced the top federal corporate income tax rate from 35 percent to 21 percent and granted many pass-through business owners a 20 percent deduction on the business's profits.

[7] Limits on the ability of *passive* investors in pass-through businesses (as opposed to managing owners) to use losses to offset other income predated TCJA and remain in effect.

[8] Both limits are annually adjusted for inflation.

carried forward and subtracted from profits realized in future years; TCJA retained this carryforward option.

- **NOL carryforwards.** Though TCJA retained the deduction for NOL carryforwards, it newly prevented them from being used to wholly eliminate corporate or pass-through business tax liability in any year by limiting them to 80 percent of the business's taxable income.

The CARES Act suspended all three of these limits retroactively:

- **Excess business losses.** CARES suspended TCJA's $500,000/$250,000 caps on deductions for pass-through business losses for tax years 2018, 2019, and 2020, allowing owner-managers to deduct their entire share[9] of the business's losses in each of those years from any non-business income (wages, salaries,[10] investments, etc.) that they and their spouses have. Taxpayers whose pass-through business losses were subject to the caps in 2018 can file amended returns and receive refunds. The CARES Act was passed early enough in 2020 that most taxpayers who would have faced the caps for tax year 2019 would not yet have filed their tax returns. Likewise, the IRS tax returns and instructions for tax year 2020 will not include the caps.
- **NOL carrybacks.** CARES reinstated NOL carrybacks for both corporations and pass-through businesses for tax years 2018, 2019, and 2020 and extended the carryback period from two years to five. In other words, a corporation can deduct losses that occurred in 2018 from profits earned as far back as tax year 2013.
- **NOL carryforwards.** CARES eliminated the 80 percent cap on NOL carryforwards for tax years 2018, 2019, and 2020.

Decoupling From Excess Business Loss Tax Break

Nearly all states whose personal income tax calculations start with federal AGI presumably gained personal income tax revenue when TCJA limited the deductibility of pass-through business losses and now risk losing revenue due to the CARES Act's suspension of the limit.[11] State policymakers should confirm that this assumption is valid with respect to their states; if it is, they should enact legislation at the earliest opportunity to decouple from the CARES provision and restore the TCJA limit. Decoupling is justified for the following reasons:

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[9] Many businesses organized as pass-throughs have multiple owners who — depending on the type of entity — may be referred to as stockholders, partners, or members. The legal documents forming the entities set forth the shares of profits and losses that are allocated to owners each year.

[10] In developing tax returns for tax year 2018, the Internal Revenue Service interpreted this provision as capping at $500,000 the amount of pass-through losses that could be deducted from investment income (rents, dividends, interest, and capital gains) but not capping the amount that could be deducted against wages and salaries. JCT disputed that interpretation, as did numerous outside experts. JCT appears to have accurately reflected Congress's intent, because Congress included in the CARES Act language clarifying that for tax years after 2020, pass-through business losses can offset up to $500,000 of wage/salary and investment income combined. Nonetheless, due to the CARES suspension of the TCJA provision, for tax years 2018-2020 there is no limit on the deductibility of passthrough losses from wage/salary income.

[11] Some states linked to federal AGI may have enacted *state-specific* limits, but there is no evidence to suggest they are common.

Decoupling would preserve significant state revenue. The CARES Act's excess business loss tax break is its second-most-expensive tax provision, after the $1,200 tax rebate to individual taxpayers. It was expected to reduce federal personal income tax revenue by $74 billion in federal fiscal year 2020 and $64 billion in 2021.[12] Only a handful of states have estimated the revenue impact of conforming to this provision, but as Table 2 indicates, the losses are significant at a time when cost increases and sharp revenue declines due to the pandemic and recession are squeezing state budgets severely. Maryland, for example, estimated that it would lose $136 million in state fiscal years 2020-21 combined; Michigan estimates a $387 million loss over that period. Other states could lose far more: Illinois, for example, had 42,000 taxpayers with partnership or S-corporation income who reported more than $500,000 in 2018 AGI, compared to Maryland's 19,000 and Michigan's 22,000.[13] Every state that links to federal AGI risks significant losses.

For rolling-conformity states, the biggest revenue losses will likely occur in the current 2021 fiscal year, since that is when amended returns for tax year 2018 will likely be filed and when original returns for tax year 2019 claiming the tax break *were* filed. But both rolling and fixed-date conformity states that do not decouple will suffer additional revenue losses in fiscal year 2022, since the tax break is also allowed in tax year 2020 and most pass-through owners will likely file their returns after July 1, 2021, when fiscal year 2022 begins in most states.

TABLE 2

Estimated Revenue Loss From Conformity to CARES Act's Suspension of TCJA Excess Business Loss Provision

	FY20	FY21	FY22
Colorado		$73 million	$18 million
Maryland	$21 million	$115 million	$4 million
Michigan	$208 million	$179 million	
Montana		$47 million	$41 million
Nebraska		$83 million	$54 million
Oregon		$98 million	

Sources: Colorado Legislative Council, Final Fiscal Note on HB20-1420 (decoupling bill), July 28, 2020, http://leg.colorado.gov/sites/default/files/documents/2020A/bills/fn/2020a_hb1420_f1.pdf; Maryland Comptroller Peter Franchot, "60-day report" letter to Governor Larry Hogan, Senate President William C. Ferguson IV, and Speaker of the House Adrienne A. Jones, June 12, 2020, https://www.marylandtaxes.gov/reports/static-files/revenue/federalimpact/CARES_Act_60_Day_Report_Final_2020.pdf; Michigan Dept. of Treasury, Office of Revenue and Tax Analysis, "Estimated Revenue Impact of the CARES Act," unpublished table (available from the author), April 24, 2020; Montana State Legislature, Legislative Fiscal Division, "Revenue Outlook 2023 and Beyond," September 2020, https://leg.mt.gov/content/Committees/Interim/2019-2020/Revenue/Meetings/September-2020/LFD-Sept-update.pdf; Nebraska Dept. of Revenue, "Estimates of GF Revenue Impact of CARES Act," unpublished, undated table; see https://twitter.com/fredmknapp/status/1272907799530475522 (Twitter post of Fred Knapp, reporter for Nebraska Public Radio and Television, June 16, 2020); Oregon Legislative Revenue Office, "Coronavirus Aid, Relief, and Economic Security (CARES) Act (H.R. 748), Tax and Revenue Related Provisions," May 2020, https://olis.leg.state.or.us/liz/2019I1/Downloads/CommitteeMeetingDocument/222068.

[12] JCT, "Description of the Tax Provisions of Public Law 116-136, The Coronavirus Aid, Relief, and Economic Security ("CARES") Act," April 23, 2020, p. 108. Those revenue losses would slowly be recouped as the pass-through business loss deductions made possible in those two tax years would be unavailable in future years, but the JCT nonetheless estimated that the provision would have a net cost of $135 billion in federal fiscal years 2020-30.

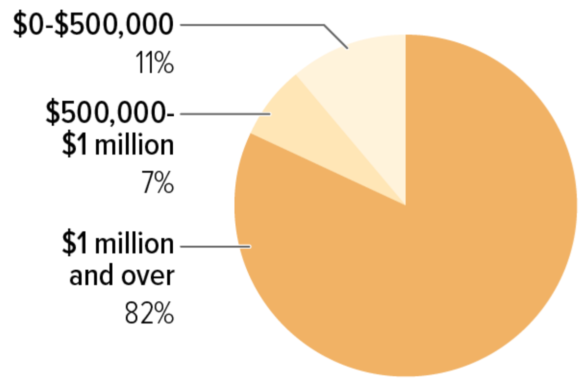
[13] IRS, Statistics of Income Division, state personal income tax statistics, https://www.irs.gov/statistics/soi-tax-stats-historic-table-2.

Decoupling would avoid an enormous state tax giveaway to the rich. The benefits of the CARES Act's excess business loss tax break, which will produce $135 billion in federal tax savings, will flow overwhelmingly to the richest taxpayers. The tax break *only* goes to single taxpayers with more than $250,000 in combined wage/salary and other investment income and married taxpayers with more than $500,000 in such income. It is therefore unsurprising that more than 80 percent of the federal tax benefits will go to just 43,000 taxpayers with incomes over $1 million, whose taxes will fall by an average of $1.6 million apiece, according to JCT.[14] (See Figure 1.) Real estate and hedge fund managing investors are likely to be the biggest winners, according to tax experts.[15]

FIGURE 1

CARES Act "Excess Business Loss" Tax Break Mostly Benefits Millionaires

Share of tax break for taxpayers, by income, 2020



Note: The tax break lets owners of "pass-through" businesses (such as S corporations and partnerships) deduct an unlimited amount of business losses to offset their non-business income.

Source: Letter from Joint Tax Committee Chief of Staff Thomas A. Barthold to Senator Sheldon Whitehouse and Rep. Lloyd Doggett, April 9, 2020

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Many of the deductible business "losses" are not true economic losses. Rather, they often are only paper losses due to overly generous deductions for real estate and other investments. As University of South Carolina tax law professor Clint Wallace explains:

> In many circumstances, a tax loss can occur without any out-of-pocket expenditure. For example, say that in 2017 a real estate investor purchased $50 million of property that is financed in part from money contributed by the investor and in part from bank loans. . . . . The real property might generate $2 million or more in depreciation deductions each year [annual write-offs of a portion of the initial cost of the building], and these deductions are available even if the depreciable assets are, in fact, appreciating in value, as buildings often do. The tax rules [also] allow the investor to deduct the interest expense now, even though it is not paid until later. [16]

The CARES Act provision not only applies to tax years prior to the pandemic and recession, but is not targeted to pass-throughs actually hurt by these events. Two of the three years it covers are the pre-pandemic years of 2018 and 2019. Also, as Wallace notes, the tax break is

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[14] Letter from JCT Chief of Staff Thomas A. Barthold to Senator Sheldon Whitehouse and Representative Lloyd Doggett, April 9, 2020.

[15] See, for example: Jesse Drucker, "Bonanza for Rich Real Estate Investors, Tucked into Stimulus Package," *New York Times*, March 26, 2020; Steven Hadjilogiou *et al.,* "CARES Act Provides Significant Benefits to Real Estate Industry," McDermott, Will & Emery client alert, April 2, 2020; Steven M. Rosenthal and Aravind Boddupalli, "Heads I Win, Tails I Win Too: Winners From the Tax Relief for Losses in the CARES Act," Tax Policy Center, April 20, 2020.

[16] Clint Wallace, "The Troubling Case of the Unlimited Pass-Through Deduction: Section 2304 of the CARES Act," forthcoming in *University of Chicago Law Review Online,* draft June 29, 2020, pp. 5-6, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3583074. Citations omitted.

"not conditioned on taking any future actions or using the funds received in a way that might have positive spillover effects for the broader economy or for populations that are particularly vulnerable to the negative economic consequences of COVID-19. Thus, the unlimited pass-through deduction cannot be justified as a targeted response to circumstances created by the spread of COVID-19."[17]

At most, only a small amount of the tax savings will likely be reinvested in pass-through businesses in the state losing revenue. The tax break seems unlikely to provide much economic benefit to states that stay coupled. First, there is no requirement that businesses reinvest any of the tax savings in the business. The tax savings directly benefit the business's owners, not the business itself, and many pass-through businesses have multiple owners who would have to agree among themselves to reinvest their savings from the tax break in the business. Reaching such an agreement would be difficult if the tax savings differ significantly among a business's owners, as they likely often will.

Second, the businesses may well be located in states other than those in which some (or even all) of their owner-managers reside. So even if those owners did plow their tax savings back into the business to keep workers on the job or expand employment, the states losing the revenue may receive little or no direct economic benefit.

The tax break creates winners and losers by favoring one form of business over another. Unlike owner-managers of a pass-through business, owner-managers of a taxable "C" corporation cannot use business losses to offset their non-business income; the losses remain within the business and can only be used to offset the profits of the business itself. Thus, owners of businesses formed as pass-throughs will receive a tax break denied to owners of businesses organized as taxable corporations.

Decoupling From NOL Carryback Tax Break

The Internal Revenue Code long allowed taxable corporations and pass-through businesses alike to deduct tax losses experienced in the current tax year from profits in *previous* years. Taxpayers filed amended tax returns for the previous year(s) and used these net operating loss carryback deductions to obtain refunds of taxes they had previously paid.[18] Similarly, the IRC provided for loss *carryforwards.* Thus, for example, a corporation that had profits of $400,000 each in 2015 and 2016 but lost $1 million in 2017 could carry back $400,000 of that loss for each of those prior years — resulting in a full refund of its tax liability — and carry forward the remaining $200,000 to deduct against profits earned in 2018 and beyond.

TCJA repealed NOL carrybacks but preserved NOL carryforwards and eliminated a 20-year limit on their use. However, the CARES Act reinstated NOL carrybacks for tax years 2018 and 2019 (retroactively) and 2020. In addition, CARES extended the carryback period from two years to five.

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[17] Wallace, *op. cit.,* p. 2.

[18] Congress has frequently changed the number of years to which current operating losses could be carried back; at the time of TCJA's enactment, that period was two years. Thus, for example, a corporation that lost $1 million in 2017 but had profits of $500,000 in both 2015 and 2016 could file amended returns for both years and receive a refund of all the corporate income tax it had paid. Different rules applied to "capital losses," that is, losses associated with the sale of specific assets.

For example, a corporation that had an operating loss in tax year 2018 can file an amended return for as far back as tax year 2013 and receive a refund of taxes paid that year.

NOL carrybacks and carryforwards can be justifiable from the standpoint of federal tax policy. Businesses make long-term investments in plant and equipment, research and development, brand identity, and other assets with the aim of earning a profit over the life of those investments; this may entail multiple years in which expenses exceed revenue (and not necessarily just during the start-up period). NOL carrybacks and carryforwards are a way to measure and tax the profitability of the company over multiple years. Otherwise, two businesses earning the same profit over the life of an identical investment could face significantly different tax bills, depending upon when they earned that profit.[19]

However, granting NOL carrybacks is problematic for states from the standpoint of budget management — particularly when, as now, an economic downturn has sharply reduced both the personal income taxes that pass-through business owners pay and corporate income taxes. Allowing NOL carrybacks can drastically compound the revenue loss by enabling businesses to use their losses to obtain refunds of taxes paid well before the recession.

This additional revenue loss is less worrisome for the federal government, which can and should run deficits during a recession to stimulate the economy. But it is a significant problem for states whose constitutions mandate that they balance their budgets. This explains why only 12 of the 45 states with corporate income taxes allow any NOL carryback deductions, and three of them cap the deductions at very low amounts.[20] However, because most states start their personal income tax calculations at federal AGI, and pass-through business income or loss is reported above the AGI line on the tax return, many if not most states likely *are* allowing NOLs to be carried back for *personal* income tax purposes.[21]

State policymakers should ask their legislative counsels' offices or state revenue department's legal divisions whether they are again granting NOL carrybacks for corporate and/or personal income tax purposes because of the CARES Act — or, indeed, for any reason. If they are, they should amend their laws to permanently disallow carrybacks, regardless of any future changes in federal tax treatment. (States that disallow carrybacks should continue their policy of allowing any losses that were carried back for federal tax purposes to be carried *forward* for *state* tax purposes.)

On top of the inevitable fiscal problems NOL carrybacks create for states during recessions, additional reasons specific to the current situation further justify permanently disallowing them:

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19 Without NOL carryforwards, for example, a corporation that lost $3 million one year and then earned profits of $3 million in each of the next two years would owe tax on $6 million in profit, while a competitor that made the same initial investment, experienced no annual losses, but earned $1 million in each of the three years would owe tax on only $3 million.

20 According to attorneys with the Council On State Taxation, Alaska, Georgia, Hawaii, Mississippi, Missouri, New York, Oklahoma, Virginia, and West Virginia allow an unlimited amount of losses to be carried back to a prior tax year, while Delaware, Idaho, and Montana cap those amounts. Karl A. Frieden and Stephanie T. Do, "State Tax Conformity to Key Taxpayer-Favorable Provisions in the CARES Act," *State Tax Notes*, April 20, 2020, p. 308.

21 Again, some states may have specifically disallowed NOL carrybacks, but a state-by-state examination of state statutes to determine this is beyond the scope of this report.

- **The specifics of the CARES Act NOL carryback provision will likely harm state finances even more than usual.** Extending the carryback period to five years in combination with retroactively reinstating carrybacks for 2018 and 2019 could concentrate massive tax refunds in just one or two state fiscal years. A corporation that had large operating losses in 2018 (due, for example, to significant long-term investments made that year) and moderate profits in years before that could get a refund of all state income taxes it paid from 2013 through 2017. Those refunds are likely to be issued during the current 2021 state fiscal year (assuming they have not been already). Moreover, if that corporation was profitable in 2019 but has a loss in 2020, it can file an amended return for 2019 by next June 30 carrying back that loss as well. Under this scenario, in other words, a state might have to refund six years' worth of tax payments to corporations in a single budget cycle.
- **The CARES provision is not targeted to businesses hurt by the pandemic**. There is no justification for reinstating NOL carrybacks for losses incurred in 2018 and 2019 — years of healthy economic growth. Granting NOL carrybacks retroactively simply distributes cash indiscriminately to businesses in the hope they will use it to preserve jobs, purchase from local suppliers, or invest in equipment, without *requiring* them to do any of these things. States should not compound Congress's error with their own. If state policymakers believe they can afford to devote revenue to assisting businesses harmed by the pandemic, they have much more targeted and cost-effective methods — for example, providing direct financial assistance to businesses that have been particularly hard hit, like restaurants.
- **Expanding NOL carryback deductions has little "bang for the buck" as economic stimulus**. Because they are required to balance their budgets, states cannot inject net purchasing power into their economies by cutting taxes; every dollar of tax reduction must be matched by a dollar of tax increase or a dollar cut in someone's income (for example, in the salary of a state university professor or a payment to a state road maintenance contractor). But even if states could stimulate growth this way, making NOL carrybacks more generous would be a particularly ineffective method. Economists Alan Blinder and Mark Zandi have estimated that of 15 different potential ways that taxes can be cut to stimulate the national economy during recessions, expanding NOL carrybacks ranks dead last in the amount of new economic output created per dollar of forgone tax revenue.[22] The Congressional Budget Office has also concluded that tax cuts structured to increase short-term corporate tax flows — which is what NOL carrybacks do — have little bang for the buck.[23]

Decoupling From NOL Carryforward Tax Break

TCJA prevented pass-through businesses and corporations from using NOL carryforward deductions to zero-out their income tax liability in any year. Under the law, NOL carryforwards

[22] Alan S. Blinder and Mark Zandi, "The Financial Crisis: Lessons for the Next One," Center on Budget and Policy Priorities, October 15, 2015, Table 5, https://www.cbpp.org/sites/default/files/atoms/files/10-15-15pf.pdf.

[23] Charles J. Whalen and Felix Reichling, "The Fiscal Multiplier and Economic Policy Analysis in the United States," Congressional Budget Office Working Paper, February 2015, Table 1, https://www.cbo.gov/sites/default/files/114th-congress-2015-2016/workingpaper/49925-FiscalMultiplier_1.pdf.

could only offset 80 percent of taxable income reported in a year, though the remaining 20 percent could be carried forward to future years.[24]

The CARES Act suspended this provision retroactively for 2018 and 2019 losses. This means that a business that lost money in 2018 can carry 100 percent of the loss forward to 2019 and then to 2020 if needed to use it up; a business that lost money in 2019 can carry 100 percent of the loss forward to 2020. However, a business that loses money in 2020 — likely the year in which operating losses will be most prevalent — will be subject to the 80 percent limit in 2021.

States should decouple from this CARES Act provision. Businesses that lost money during 2018 and 2019 but manage to be profitable in 2020 have little claim to a reduction in their taxes. Moreover, as discussed above, many businesses' 2018 and 2019 losses are paper losses, not true economic losses.

In addition, many businesses experiencing true cash-flow deficits this year have received significant financial assistance through the CARES Act's Paycheck Protection Program, and large corporations have ready access to cash in the capital markets. Most states, in contrast, are experiencing severe financial difficulties, while their constitutions bar them from borrowing to cover operating deficits and federal assistance to date has been grossly inadequate. Accordingly, states must prioritize preserving their revenues, and maintaining a modest limit on businesses' ability to use losses to reduce their taxes during the 2021 and 2022 fiscal years seems an entirely reasonable mechanism.[25] Indeed, during previous recessions some states enacted much more stringent limits on the use of loss carryforwards to preserve revenue.[26]

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[24] For example, if a corporation lost $1 million in 2018 and had $500,000 of profit in 2019, it could only use $400,000 of that 2018 loss to offset its 2019 profit; tax would still be due on the remaining $100,000 of 2019 profit.

[25] If state policymakers are concerned about the ability of small businesses with true economic losses to access the capital markets and wish to provide them with some tax relief, they could suspend the 80 percent limit for the carrying over of 2020 losses into the 2021 tax year only for businesses with receipts below a certain threshold. However, as discussed above, there is no justification for suspending the limit for (pre-pandemic) 2018 or 2019 for any businesses.

[26] During the 2008-2010 recession, California and Maine suspended NOL carryforwards entirely for several years, and Colorado capped them at $250,000. National Conference of State Legislatures, "State Tax Actions 2008" and "State Tax Actions 2009"; Rachel A. Wilson and Mace Gunter, "2010 Legislation Limiting Use of Net Operating Losses and Tax Credits to Close Operating Deficits," Jones Day *State Tax Return*, March 2010.

TABLE 3

Estimated Revenue Losses From Conformity to CARES Suspension of Limits on Net Operating Loss Carrybacks and Carryforwards

	FY20	FY21	FY22
Colorado		$5 million	
Maryland	$25 million	$111 million	$4 million
Michigan	$30 million	$3 million	
Montana		$44 million	$5 million
Nebraska		$13 million	$7 million
Oregon		$91 million	

Note: The Colorado Department of Revenue had previously determined that CARES Act changes would not apply retroactively to 2018 or 2019 tax years.

Sources: Colorado Legislative Council, Final Fiscal Note on HB20-1420 (decoupling bill), July 28, 2020, http://leg.colorado.gov/sites/default/files/documents/2020A/bills/fn/2020a_hb1420_f1.pdf; Maryland Comptroller Peter Franchot, "60-day report" letter to Governor Larry Hogan, Senate President William C. Ferguson IV, and Speaker of the House Adrienne A. Jones, June 12, 2020, https://www.marylandtaxes.gov/reports/static-files/revenue/federalimpact/CARES_Act_60_Day_Report_Final_2020.pdf; Michigan Dept. of Treasury, Office of Revenue and Tax Analysis, "Estimated Revenue Impact of the CARES Act," unpublished table (available from the author), April 24, 2020; Montana State Legislature, Legislative Fiscal Division, "Revenue Outlook 2023 and Beyond," September 2020, https://leg.mt.gov/content/Committees/Interim/2019-2020/Revenue/Meetings/September-2020/LFD-Sept-update.pdf; Nebraska Dept. of Revenue, "Estimates of GF Revenue Impact of CARES Act," unpublished, undated table; see https://twitter.com/fredmknapp/status/1272907799530475522 (Twitter post of Fred Knapp, reporter for Nebraska Public Radio and Television, June 16, 2020); Oregon Legislative Revenue Office, "Coronavirus Aid, Relief, and Economic Security (CARES) Act (H.R. 748), Tax and Revenue Related Provisions," May 2020, https://olis.leg.state.or.us/liz/2019I1/Downloads/CommitteeMeetingDocument/222068.

Failing to Decouple Will Cause Additional Revenue Losses

As discussed above, most states have permanently disallowed NOL carrybacks for taxable corporations, and some may have also done so for pass-through businesses. This is one reason why states' estimated revenue losses from remaining coupled to the CARES Act's carryback and carryforward provisions (see Table 3) are not as great as those from remaining coupled to the excess business loss provision (see Table 2). Nonetheless, the losses can be significant, as the three-year, $140 million revenue impact for Maryland indicates. (Note that Table 3 combines the revenue impact of the carryback and carryforward provisions, since only Nebraska has estimated them separately.) Policymakers should seek estimates from their state revenue department of how much revenue is at risk. However, every dollar of existing revenue is precious at present, and the policy arguments for permanently disallowing carrybacks and retaining the 80 percent cap on carryforwards are compelling.

States Should Decouple ASAP

It is especially urgent that rolling-conformity states decouple from the three business loss tax breaks in the CARES Act as soon as possible. However, even some fixed-date conformity states may risk substantial revenue losses if they do not decouple quickly.

Rolling-Conformity States

Congress frequently enacts tax-law changes that are made retroactive to the beginning of the tax year already underway (which for individual taxpayers and many businesses is January 1). Even if a rolling-conformity state's legislature has already recessed when Congress enacts such a change, that state can protect itself from any resulting revenue loss if it acts to decouple early in the following year's session. This is because relatively few individual taxpayers file their returns by the end of February, and people with pass-through business income and a large majority of corporations usually file much later than that. (They frequently apply for extensions to October 15, which are automatically granted.) To be sure, waiting until the year after the IRC change to decouple usually has the disadvantage of requiring the state revenue department to prepare and publish revised instructions and tax forms. Nonetheless, even a rolling-conformity state can normally protect itself from a significant revenue loss in the face of a federal tax cut.

It is, however, virtually unprecedented for Congress to enact a revenue-losing tax law change applicable to a tax year *before* the one during which it is enacted. In suspending all three of the TCJA loss restrictions discussed in this report retroactively for the 2018 and 2019 tax years, Congress created an enormous problem for states that want to protect themselves from revenue losses.

Many of the individual pass-through business owners and corporations that could file amended returns for tax year 2018 to claim higher deductions under the three CARES Act provisions have already done so.[27] So have many pass-through owners and corporations that can claim higher deductions for tax year 2019, the returns for which were due October 15, 2020.[28] So by the time legislatures begin meeting in January 2021, much of the potential tax savings from rolling states' conformity to the CARES Act provisions for those two years will already have been claimed. If a state decoupled at that point, it would have to require many taxpayers to file a *second* amended return for 2018 and a first amended return for 2019 and pay the higher taxes that would result.

That is unfortunate, but it should not deter states from decoupling. The near-term need for revenue is simply too great, as are the tax and fiscal policy merits of decoupling discussed above. It will be inconvenient for some taxpayers to have to file a second amended 2018 tax return, but it should be noted that they were willing to take the effort to file the first one to claim retroactive tax benefits. More broadly, it is not uncommon for taxpayers to discover after they have filed a tax return that they failed to claim deductions and other tax breaks for which they were eligible, and they are entitled to file amended returns to claim them. If they (and other taxpayers) may file amended returns when doing so benefits them, states may reasonably impose an obligation to file a new return to protect revenue in a fiscal crisis not of their making.

Since some taxpayers might already have committed or spent the tax savings they claimed retroactively, decoupling legislation should allow for a reasonable repayment plan (say, three years), just as states often permit taxpayers assessed an unanticipated additional liability following an audit

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27 Recent evidence suggests, however, that many corporations did *not* file amended returns in 2020 for tax year 2018 to claim loss carrybacks but may instead be waiting until next year to do so (or claimed carrybacks on their 2019 returns instead). If that is the case, it suggests that if states decouple early in 2021, they may be able to avoid having to issue large refunds and to impose an additional filing requirement on many corporations. See Brian Thaler, "Corporate Tax Mystery: Why So Few 'Quickie' Refunds?" Politico Pro, October 27, 2020.

28 Some states waived penalties for businesses that filed later, which likely will incentivize some to do so.

to make payments in installments. And because the additional liability results from retroactive state action, the repayments should not be subject to interest.[29]

Fixed-Date Conformity States

Nearly all fixed-date conformity states are currently linked to the IRC on a date earlier than the CARES Act's March 27, 2020 enactment and should not lose any revenues from the three CARES Act provisions for tax year 2020 until they move that linkage date forward. However, some could lose revenues for tax years 2018 and 2019, depending on the wording of their IRC conformity statutes.

South Carolina and Vermont are two examples of fixed-date conformity states whose tax laws are ambiguous as to whether those CARES provisions will apply for tax year 2018. South Carolina's law defines the applicable version of the IRC as follows:

> SECTION 12-6-40. Application of federal Internal Revenue Code to State tax laws.
>
> (A)(1)(a) Except as otherwise provided, "Internal Revenue Code" means the Internal Revenue Code of 1986, as amended through December 31, 2018, and includes the effective date provisions contained in it.

And Vermont's law states:

> Section 5824. Adoption of federal income tax laws
>
> The statutes of the United States relating to the federal income tax, as in effect on December 31, 2018 . . . are hereby adopted for the purpose of computing the tax liability under this chapter.

As a result of the CARES Act, the TCJA limits on loss deductions are no longer "in effect" as of December 31, 2018. Accordingly, taxpayers in both states could file amended returns for tax year 2018 deducting NOL carrybacks and 100 percent of pass-through business losses, and litigate with some potential for success if either state challenged the deductions. A Google search of the two states' revenue department websites turned up no guidance on whether these CARES Act changes would apply retroactively to 2018.

Policymakers in fixed-date conformity states who want to maintain the TCJA limits would therefore be well advised to ascertain their revenue department's interpretation of existing IRC conformity law on this question and, if the department believes there is any ambiguity, enact new statutory language clarifying that the CARES Act does *not* apply to the state's tax laws for 2018, 2019, or 2020. West Virginia provides a good example of how explicit the language should be:

> Any reference in this article to the laws of the United States means the provisions of the Internal Revenue Code of 1986, as amended. . . . All amendments made to the laws of the

[29] In the case of 2018 amended and 2019 original tax returns that have not been processed by the time decoupling legislation is enacted, the state tax agency can simply inform the taxpayer that part of the deduction has been denied, recalculate the tax liability, and either issue a smaller refund or an assessment for additional tax — just as it would for any taxpayer who accidentally claimed a deduction for which they were ineligible.

> United States after December 31, 2018 but prior to January 1, 2020, shall be given effect in determining the taxes imposed by this article to the same extent those changes are allowed for federal income tax purposes, whether the changes are retroactive or prospective, but *no amendment to the laws of the United States made on or after January 1, 2020, may be given any effect.*[30]

Decoupling for Tax Year 2020

Regardless of whether a state wishes to recoup revenue losses caused by conformity to the three CARES Act tax breaks for the 2018 and/or 2019 tax years, it should do so for 2020, for two main reasons. First, the tax- and fiscal-policy arguments supporting decoupling for 2018 and 2019 largely apply to 2020 as well:

- The tax savings from suspending the TCJA excess business loss provision are heavily skewed to the very richest taxpayers, do not always represent true economic losses, do not necessarily benefit the business itself, are not conditioned on the business preserving or increasing jobs or investment, and may benefit businesses with no significant employment in the state.
- A state that allows the carrying-back of losses experienced in tax year 2020 might have to refund as much as five years' worth of a business's tax liability during fiscal year 2022 (which starts July 1, 2021 in most states), when the state likely will only be gradually recovering financially from the pandemic and recession.

Second, if a state decoupled for tax year 2020 early in 2021, it is highly unlikely that any taxpayers would have to file amended returns. Not only are most business returns filed well past the regular April 15 deadline, but a large majority of returns that could claim any of the three tax breaks will be prepared by tax professionals. If decoupling legislation is introduced early in the session, they will likely advise their employers or clients to delay filing until it is clear whether the legislation is going to be enacted — which may well not be until the very end of the session. The only practical problem created by decoupling for 2020 would be the need for state revenue departments to revise instructions and forms to reflect the law changes; this is a price well worth paying to avoid an unwarranted revenue loss.

Conclusion

Numerous, compelling tax policy- and fiscal management-related considerations argue in favor of decoupling from the CARES Act tax breaks for business losses. Decoupling is fundamentally a means by which states can prioritize their cash flow needs during this fiscal year and next; all the deductions limited by decoupling will be available for deduction in future years.

Looking ahead, Congress's decision to make these tax breaks *retroactive,* despite the financial damage and logistical problems it inflicted on states, should be a wake-up call for rolling-conformity states. They should seriously consider switching to fixed-date conformity. And fixed-date conformity states should amend their laws to make clear than no retroactive federal changes to tax years beginning before their conformity dates will ever apply in the future. States should take action to ensure that they never again automatically lose revenue when a future Congress cuts taxes.

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[30] Section 11-21-9 of the West Virginia statutes; emphasis added.