Eakinomics: No U-turns on Pandemic Tax Policy

The COVID-19 pandemic generated an economy-wide cash-flow crisis and recession. It has put a premium on Congress finding ways to rapidly infuse cash into businesses so they can keep their doors open and employees’ paychecks flowing. Broadly speaking, the entire bipartisan Coronavirus Aid, Relief, and Economic Security (CARES) Act represents the pursuit of this strategy.

In addition to unemployment insurance, checks for households, and the Paycheck Protection Program, CARES included “Five-Year Carryback of Operating Losses.” In addition to the catchy moniker, it has the additional virtues of incentivizing retaining employees and not increasing the long-term deficit. Unfortunately, the same House of Representatives that helped enact the provision in March voted last month to repeal it.

Presumably, this is some sort of reflexive big-corporations-are-bad instinct. But looking past that to the substance of the policy shows that repealing the five-year carryback would be a mistake. The provision simply allows a business with losses in 2020 to carry those losses back for five years, providing it a refund for some of the taxes it paid in past years when it was profitable. This refund provides a struggling business with cash when it most needs it and gives an incentive to retain its employees, since the wages it pays its workers this year will result in a refund of taxes paid in previous years.

In the absence of a carryback, the business would be required to carry any losses forward – resulting in an equivalent tax reduction, but in the future. Getting liquidity and saving jobs today, however, is much more valuable to the business and its employees than giving the business the same refund in the future.

Loss carrybacks and carryforwards are not gimmicks invented in this crisis; they are longstanding features of the tax system. When businesses have losses in some years and profits in other years, they would be overtaxed if they were not permitted to reduce their income with those losses. This was recognized by the Supreme Court in 1957: “Those provisions were enacted to 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.”

In addition to being firmly grounded in the principles of income taxation, the five-year carryback of operating losses is a tried-and-true remedy for mitigating the impact of an economic downturn. Congress enacted this provision with bipartisan support in 2002 after the attacks of 9/11, in 2009 to fight against the last recession, and, as noted earlier, in the CARES Act.

In voting for repeal, the House of Representatives opted to only allow a loss incurred in 2020 to be carried back for at most two years and a loss incurred in 2019 for at most one year. But many companies experiencing significant losses would not have sufficient income in this short period to absorb all of their losses. They would
be eligible for less liquidity relief now, forced instead to carry their excess losses forward and to wait to receive a less valuable tax refund in the future.

Some have justified the House provision on the grounds that losses should not be carried back to a time when the corporate tax rate was higher. But given the urgency of the moment, it is the wrong time to invent a new theory to limit the use of tax losses and short-circuit a tried-and-true approach to supporting businesses’ ability to retain their employees.