Illinois’ Net Operating Loss Primer: Matching Taxation to the Business Cycle

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The Net Operating Loss (NOL) deduction is Illinois’ largest single corporate income tax expenditure. In FY 2012, the state forewent $217 million in corporate tax revenues through NOL deductions. The NOL becomes a tax expenditure because of the way Illinois modifies federal taxable income. The Illinois corporate income tax return (1) starts with Federal Taxable Income (FTI) (2) adds back the NOL included in computing FTI, and then (3) allows the apportioned Illinois NOL to be subtracted from apportioned income, and then (4) applies the tax rate. The past 10 years have seen lots of tinkering with the Illinois NOL deduction, all in the name of plugging state budget holes. Before 2004 Illinois followed the federal government in allowing companies to either carry back their NOL deduction two years or carry it forward up to 20 years. From 2003 to 2010, Illinois allowed companies to carry their deduction forward 12 years only. In 2011, Illinois suspended all NOL deductions, but in 2012 reinstated them with a $100,000 cap. Of course all this tinkering has only postponed use of NOLs, in effect borrowing against future revenues.
Introduction

As discussed above, NOL deductions are reported as tax expenditures in Illinois because companies are allowed to apply the deduction to future tax liabilities. In FY2012 the state forewent $217 million because of the NOL deduction.

What is a Net Operating Loss and what does it mean for business taxes?

In most cases, a company experiences a NOL when its expenses exceed its income. Consider a hypothetical record store, Rodríguez Records, in a hypothetical state with a fixed corporate income tax rate. The store generates approximately $100,000 per year in income and costs $85,000 per year to operate. Over any sufficiently long period of time it is likely that the Rodríquezes will have a “bad year” or two, during which its expenses exceed its income. Chart 1 shows the annual profits of this hypothetical record store over a 10-year period.

In Chart 1, the red area represents a net operating loss where the record store made negative profits. Over the entire decade, Rodríguez Records made $68,619 in profits (green plus red). But during the three years from 2008 to 2010, the store’s net income was $-10,926 (red area). Note that this is still a profitable company that generated profits, on average, of $6,861 per year.

How should Rodríguez Records’ NOL factor into its tax obligation? Here we illustrate some possible approaches. For this example we assumed that the tax rate on corporate profits was a constant 7 percent from 2004 to 2014.

Option 1: NOL only impact taxes for the years in which it occurs.

The first option is to simply let Rodríguez Records pay no corporate income taxes from 2008 to 2010, and then continue to tax its income at the normal rate after that. Under this option, the record store would pay $5,568 in income taxes from 2004 to 2014.
Option 2: NOL is allowed to impact taxes for years other than those in which it occurs

The second option is to recognize the ups and downs of the normal business cycle, and the fact that the 12-month tax year is an artificial time frame for evaluating (and taxing) a business. This can be achieved by subtracting the NOL either from past or future net income. If the NOL is subtracted from past income, or carried back, the taxpayer files an amended tax return for the earlier year, claims a refund for the difference between what they paid in taxes and what they would have paid with a lower net income. If the NOL is subtracted from future income, it is carried forward. (Illinois currently allows NOLs to be carried forward.) With the NOL carried forward, Rodríguez Records would only pay $4,803 in corporate income taxes from 2004 to 2014. Table 1 compares Rodríguez Records’ taxes with and without carry-forward.

Why might states allow companies to carry their NOLs forward?

NOL deductions serve the purpose of breaking the artificial tie between a corporation’s tax year and its profits, most strikingly with businesses whose profits are cyclical.

To see this, consider the total taxes Rodríguez Records’ would pay under each of the above options shown in Table 1.

The impact of ignoring the NOL is most striking when you look at the tax rate that Rodríguez pays. Notice that, even though the statutory tax rate used in this example is 7 percent, the total taxes Rodríguez Records’ pays as a percentage of its total profits is 8.11 percent if it is not allowed to carryover its NOL. Without carryover the average income tax rate faced by a company actually increases with the size of a company’s losses. To see this, consider the effect on average tax rate of increasing the NOL by $1,000, so that Rodríguez Records’ net income from 2008 to 2010 is -$11,926. Under this scenario Rodríguez Records’ average tax rate would be 8.23 percent rather than 8.11 percent. With carryover, the average tax rate a company faces is equal to the statutory rate of 7 percent.

Consider further a company whose annual profits are highly volatile as in Chart 2 on page 4.

This hypothetical company has profits of $38,768 from 2004 to 2014. If it were not allowed to carry its regular NOLs forward, it would pay $13,238 in corporate income taxes, or about 34 percent of its profits. Clearly this is well above the statutory corporate income tax rate. Such a tax regime would be unfair to this company since it would be simply a product of the volatility of its profits over time and not a product of a conscious policy choice on the part of lawmakers.

### TABLE 1. Rodriguez Records’ Profits and Taxes, 2004-2014

| Gross Profits | $79,545 |
| Gross Losses | -$10,926 |
| Net Profits | $68,619 |
| Taxes | |
| Without Carry-Forward | With Carry-Forward |
| Total Taxes | $5,568 | $4,803 |
| As % of Net Profits | 8.11% | 7.00% |
From these examples we can see that NOL deductions are necessary so that the *de jure* tax rate is equal to the *de facto* tax rate on corporate profits. If NOL deductions are not allowed the state ends up imposing a higher tax rate on net profits on industries that are more exposed to the business cycle. This is not a good policy; companies in these industries already face a less favorable business climate and the state tax code should not further exacerbate their difficulties. Furthermore, it is not fair to impose a higher tax rate on companies simply because they operate in volatile industries. The tax rate on corporate profits should be the same for industries whose profits are volatile and those whose profits are stable.

Additionally, allowing carryovers encourages businesses to maintain payrolls and other beneficial activity during recessions. For example, Rodríguez Records may be less likely to lay off or cut back the hours of its store clerks or other employees if it knows that its losses will reduce its future tax liabilities. And during recoveries companies with NOL deductions increase their payroll faster than those without NOL deductions. In this way, NOL deductions allow Illinois to better weather and recover from economic downturns.

**Conclusion**

Illinois’ corporate tax code should treat companies equally and fairly, and should encourage employment and income growth. NOL deductions help achieve these goals by equalizing corporate income tax rates across sectors of the economy, and by discouraging layoffs during recessionary periods and encouraging faster job growth during recoveries. As such, NOL deductions are an integral part of a fair and economically sound tax code.