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Net Operating Loss Policies in the OECD

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Key Findings

- Net operating loss (NOL) deductions (carryforwards and carrybacks) help ensure that businesses are taxed on their average profitability, which makes the tax code more neutral across businesses and over time.

- Ideally, countries should allow their businesses to carry their losses forward and back without any limits. However, no OECD country with a standard corporate income tax system allows unlimited NOL deductions.

- During the COVID-19 pandemic, several OECD countries temporarily expanded their NOL carrybacks and carryforwards to provide relief to illiquid but otherwise solvent businesses. These policies should be made permanent and, where necessary, expanded.

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Introduction

During the COVID-19 pandemic, many countries around the world swiftly adopted various corporate tax measures to provide relief to their businesses. For instance, corporate income tax payments were deferred, capital allowances were expanded, and—the topic of this paper—tax treatment of business losses was adjusted.[1]

Many businesses run losses at different points in time, particularly at times of economic crisis—such as the COVID-19 pandemic—or during a business' start-up phase. During a loss-making year, businesses generally do not pay corporate income tax. If there are excess losses, they can either be

- carried forward and offset against the next available future profits to reduce corporate tax liability ("NOL carryforwards"); or, in some countries,
- carried back to offset profits earned in preceding year(s) and thus generate a refund of corporate tax previously paid ("NOL carrybacks").

NOL carryovers help ensure that businesses are taxed on their average profitability over time. This not only levels the playing field between stable and more volatile industries and businesses but also removes distortions against more risky investment projects that incur losses before becoming profitable. Thus, a corporate income tax system should ideally allow for unlimited NOL carryforwards and carrybacks and make an inflation-adjustment to carryforwards to account for the time value of money.

However, no OECD country with a standard corporate income tax system allows for unlimited carryforwards and carrybacks. Instead, NOL deductions are often restricted by limiting either the number of years for which losses can be carried over or the share of taxable income that can be offset by losses.

Many OECD countries improved their tax treatment of losses during the COVID-19 pandemic to support the survival of illiquid but otherwise solvent businesses. However, most of those provisions were temporary and limited to the tax year 2020 (and, in some cases, 2021). Ideally, these measures should be made permanent and, if necessary, further expanded.

This paper explains how NOL deductions work and the impact NOL restrictions have, outlines the ideal design of NOL policies from an economic perspective, surveys the current state of NOL policies in the OECD, and shows how countries have adapted their NOL policies during COVID-19 to help struggling businesses.

1 For a list of tax policy measures implemented in various countries around the world during the COVID-19 pandemic, see OECD, "Country Tax Measures in Response to COVID-19 Pandemic," https://www.oecd.org/tax/covid-19-tax-policy-and-other-measures.xlsm.

How Net Operating Loss (NOL) Deductions Work

The standard corporate income tax system intends to tax a firm's net income, ideally in a consistent manner over time. However, some businesses and industries may have more volatile profitability than others. Without NOL deductions, this may lead to inconsistent tax treatment over time.

For example, imagine a firm in a volatile industry that has a $50,000 loss in Year 1 and makes $100,000 in profits in Year 2. A second firm makes $25,000 in profits in Year 1 and in Year 2. Thus, both firms have the same combined net income over those two years, $50,000.

However, without an NOL deduction, Firm 1 pays a higher effective tax rate than Firm 2 over the two-year period.

While Firm 1 does not pay corporate tax in its loss-making Year 1, it is subject to tax on the full $100,000 in profits in Year 2. Firm 2, on the other hand, pays tax on its $25,000 in profits in each of the two years.

Without NOL deductions, this results in an effective tax rate of 40 percent for Firm 1 and 20 percent for Firm 2, despite both firms having the same net income of $50,000 over the two-year period. In other words, Firm 1 is penalized for having more volatile profits than Firm 2 (see Table 1).

TABLE 1.

Effective Tax Rate for Two Firms without a Net Operating Loss Deduction (20 Percent Statutory Corporate Tax Rate)

	Firm 1	Firm 2
Year 1		
Net Income	($50,000)	$25,000
Tax Liability (Positive Net Income x 20%)	$0	$5,000
Year 2		
Net Income	$100,000	$25,000
Tax Liability (Positive Net Income x 20%)	$20,000	$5,000
Combined: Year 1 + Year 2		
Total Income	$50,000	$50,000
Total Tax Liability	$20,000	$10,000
Combined Effective Tax Rate (Total Tax Liability/Total Income)	**40%**	**20%**

Source: Tax Foundation calculations.

When Firm 1 takes an NOL deduction, this equalizes the effective tax rate on net income over both years with Firm 2. To do so, Firm 1 "carries over" the loss from Year 1 ($50,000) and deducts it from its net income in Year 2 ($100,000 – $50,000) when calculating tax liability for the second year (see Table 2).

TABLE 2.

Effective Tax Rate for Two Firms with a Net Operating Loss Deduction (20 Percent Statutory Corporate Tax Rate)

	Firm 1	Firm 2
Year 1		
Net Income	($50,000)	$25,000
Tax Liability (Positive Net Income x 20%)	$0	$5,000
Year 2		
Net Income	$100,000	$25,000
Tax Liability (Positive Net Income after NOL Deduction x 20%)	$10,000 [($100,000–$50,000) * 20%]	$5,000
Combined: Year 1 + Year 2		
Total Income	$50,000	$50,000
Total Tax Liability	$10,000	$10,000
Combined Effective Tax Rate (Total Tax Liability/Total Income)	**20%**	**20%**

Source: Tax Foundation calculations.

This example shows that NOL deductions play a critical role in taxing businesses on their average profitability over time. Without the NOL deduction, businesses with volatile income are taxed more over time on the same income than businesses that have consistent income.

The Impact of Limiting NOL Deductions

Most countries put limits on their NOL deductions. These limits generally take two forms:

- Limiting the number of years for which losses can be carried forward or carried back.
- Limiting the amount of taxable income that can be offset by NOL deductions in a given year.

However, placing such limits on NOL deductions can significantly increase the tax burden on businesses that have more volatile income streams.

For example, assume that in an eight-year period a business starts out with annual profits of $100,000. However, in Year 2, it incurs a loss of $500,000 due to a sharp economic downturn before it breaks even in Year 3, makes a lower profit of $50,000 in Year 4, and returns to its pre-crisis profit of $100,000 starting in Year 5 (see Table 3).

The country the business operates in has a five-year limit on NOL carryforwards, and NOL carrybacks are not allowed. The corporate tax rate is 20 percent.

Due to this five-year limit, the business can only offset $350,000 of the $500,000 in losses it incurred in Year 2.[2] As a result, the business pays $40,000 in corporate income taxes on a net profit of $50,000 during the observed eight-year period.[3]

TABLE 3.

Impact of a 5-Year Limit on NOL Deductions (20 Percent Statutory Corporate Tax Rate)

Year	Taxable Profit (Loss)	Loss Adjustment (nominal)	Profit after Loss Adjustment	Tax Liability after Loss Adjustment	NPV* of Loss Adjustment (in Year 2 real terms)
1	$100,000	$0	$100,000	$20,000	$0
2	($500,000)	$0	$0	$0	$0
3	$0	$0	$0	$0	$0
4	$50,000	$50,000	$0	$0	$43,267
5	$100,000	$100,000	$0	$0	$80,496
6	$100,000	$100,000	$0	$0	$74,880
7	$100,000	$100,000	$0	$0	$69,656
8	$100,000	$0	$100,000	$20,000	$0
Total	**$50,000**	**$350,000**	**$200,000**	**$40,000**	**$268,299**

Note: * The net present value (NPV) calculation assumes a 7.5% discount rate (2% inflation plus 5.5% real rate of return).
Source: Tax Foundation calculations.

In addition, due to the time value of money, a deduction in later years is not as valuable in real terms as today's deduction. For example, assuming a 7.5 percent discount rate, the nominal $50,000 loss deduction in Year 4 has a value of $43,267 in real terms (from the perspective of the loss-making Year 2). In other words, in real terms the value of NOL deductions decreases over time.[4,5]

Design Considerations for NOL Policies

Ideally, a corporate income tax system should provide unlimited NOL carrybacks and carryforwards. In addition, any amount carried forward should be augmented by an adjustment to compensate for the time value of money. If designed this way, corporate taxation would be symmetric, which means it would act both as a stabilizer for more volatile industries/businesses and remove distortions against more risky projects that may incur losses during certain periods.[6]

2 The share of losses that the business can offset against future profits would be further reduced if the business does not return to profitability for a longer period of time.

3 This translates to an effective tax rate of 80 percent. However, this effective tax rate would gradually decrease if the number of observed years was extended and the business continued to be profitable.

4 OECD countries' NOL rules generally do not account for the fact that over time NOL deductions lose value in real terms. Mexico appears to be the only OECD country that has inflationary adjustment rules that allow taxpayers to apply tax losses based on their inflation-adjusted value.

5 The same applies to capital allowances, as capital allowance deductions taken in future years are worth less than deductions taken today. See Elke Asen, "Capital Cost Recovery across the OECD," Tax Foundation, March 31, 2021, https://www.taxfoundation.org/publications/capital-cost-recovery-across-the-oecd/. In addition, there is an interaction between NOL deductions and accelerated depreciation. Since capital allowances are often carried forward as part of tax losses, NOL limits can lower the amount of capital allowances a business ultimately gets to deduct.

6 A detailed discussion of these effects can be found in Tibor Hanappi, "Loss carryover provisions: Measuring effects on tax symmetry and automatic stabilisation," OECD Taxation Working Papers No. 35, Feb. 22, 2018, https://www.oecd-ilibrary.org/taxation/loss-carryover-provisions_bfbcd0db-en; and Michael P. Devereux and Clemens Fuest, "Is the Corporation Tax an Effective Automatic Stabilizer?" *National Tax Journal* 62:3 (September 2009): 429-437, http://www.ntanet.org/NTJ/62/3/ntj-v62n03p429-37-corporation-tax-effective-automatic.html.

For businesses, tax certainty is an important component of investment decisions and can have significant impacts on economic growth. To promote tax certainty, it is thus preferable to implement permanent rather than temporary policies. This is particularly relevant in the context of the COVID-19 pandemic, as many tax measures were implemented on a temporary basis. While this may have been the right approach for certain measures, improvements to the tax code—such as enhanced NOL provisions—should be made permanent. This would not only provide businesses and tax administrations with tax certainty and help ensure the taxation of average profitability but also mean that a liquidity-enhancing tax measure is already in place in case of a future economic crisis.

The tax revenue costs of NOL carrybacks tend to be relatively low and largely a function of timing. An NOL carryback allows a business to use its current losses now to get a refund for past taxes paid, rather than wait until it can carry the losses forward to a period in which it is profitable again. With NOL carrybacks governments forgo tax revenues when businesses are making losses, but keeping otherwise healthy businesses afloat will lead to future tax revenues. In addition, losses used for carrybacks now cannot be used for future carryforwards, which further reduces the impact on government revenues.

Survey of NOL Policies in the OECD

A survey of NOL policies in OECD countries shows that there is significant variation in how businesses can offset their losses—with almost all countries placing restrictions on carrybacks and/or carryforwards.

Estonia and Latvia are currently the only OECD countries that have moved from a standard corporate income tax system to a cash flow-based corporate tax system. This means that their businesses only pay corporate income tax on profits paid out to shareholders, and thus there is no need for NOL provisions. However, in effect, the treatment of losses under a cash flow-based tax system is equivalent to a standard corporate tax system with unlimited carrybacks and carryforwards.

In 20 of the 37 OECD countries, corporations can carry forward losses indefinitely in 2021, though 11 of these limit the amount of taxable income that can be offset by previous-year losses. Of the 17 countries with time limits, the average loss carryforward period is 9.4 years.

Countries tend to be significantly more restrictive with loss carryback provisions than with carryforward provisions. In 2021, only the Estonian and Latvian systems effectively allow, by design, unlimited carrybacks of losses. Of the nine countries that allow time-limited carrybacks, the average period is 1.4 years.

TABLE 4.

Net Operating Loss (NOL) Deductions in the OECD, as of May 2021

Country	Loss Carryback (Number of Years)	Loss Carryforward (Number of Years)	COVID-19 NOL Policies	Additional Comments
Australia	0	No limit	Temporary carryback rule: Companies with an aggregated turnover below AUD 5 billion in a relevant loss year can carry back losses for the 2019-20, 2020-21, or 2021-22 income years to offset against an income tax liability for the 2018-19, 2019-20, or 2020-21 income years.	Capital losses can only be utilized to offset capital gains.
Austria	0	No limit, capped at 75% of taxable income	Losses that cannot be offset in 2020 can, upon request, be carried back into 2019 up to an amount of EUR 5 million. If the loss carryback cannot be used in full in 2019, a further carryback into 2018 (up to EUR 2 million) is possible.	-
Belgium	0	No limit, capped at 70% of taxable income exceeding EUR 1 million	One-time possibility for loss carryback: An exemption can be applied during the financial year closing between March 13, 2019 and July 31, 2020 for the estimated loss incurred in the subsequent year (i.e., the COVID-19 year). Limits apply.	-
Canada	3	20	-	Capital losses are calculated separately from business/ property losses.
Chile	0	No limit	-	-
Colombia	0	12	-	Capital losses cannot be offset.
Czech Republic	2, limited to CZK 30 million	5	Permanent 2-year carryback provision was introduced as part of a COVID-19 relief package (went into effect on June 30, 2020).	-
Denmark	0	No limit, capped at 60% of taxable income exceeding DKK 8,767,500 for 2021	-	-
Estonia	No limit (cash-flow tax)	No limit (cash-flow tax)	-	-
Finland	0	10	-	-
France	1, limited to EUR 1 million	No limit, capped at 50% of taxable income exceeding EUR 1 million	Accelerated refunds for loss-carryback receivables: Taxpayer can request immediate reimbursement of unused carryback receivables for the financial year ending December 31, 2020.	-
Germany	1, limited to EUR 10 million	No limit, capped at 60% of taxable income exceeding EUR 1 million	Loss carryback amount was increased from EUR 1 million to EUR 10 million for the fiscal years 2020 and 2021.	-
Greece	0	5	-	-
Hungary	0	5, capped at 50% of taxable income	-	-
Iceland	0	10	-	-
Ireland	1	No limit	Accelerated refunds for loss-carrybacks: Companies can estimate their trading losses in an accounting period which includes some or all of the period from March 1, 2020 to December 31, 2020 and carry back up to 50 percent of those losses on an accelerated basis. Such an "interim claim" for the relief can be made as early as four months after the beginning of the accounting period.	Non-trading losses are calculated separately from trading losses.
Israel	0	No limit	-	Carryforward rules vary by loss category (business losses, passive losses, or capital losses).

TABLE 4, CONTINUED.

Net Operating Loss (NOL) Deductions in the OECD, as of May 2021

Country	Loss Carryback (Number of Years)	Loss Carryforward (Number of Years)	COVID-19 NOL Policies	Additional Comments
Italy	0	No limit, capped at 80% of taxable income	Certain companies that increased their capital between May 20, 2020 and December 31, 2020 can benefit from a tax credit equal to 50% of any operating losses exceeding 10% of the net equity (up to 30% of the capital increase).	Losses arising in the first three years of activity of a new business can be offset with 100% of taxable income. For IRAP purposes (regional tax on productivity), tax losses may not be carried forward.
Japan	0	10, capped at 50% of taxable income	A corporation whose paid-in capital is JPY 1 billion or less can carry back net operating losses generated in fiscal years ending from February 1, 2020 to January 31, 2022. For these businesses, the 50% cap on carryforwards also does not apply.	SMEs (companies with paid-in capital of JPY 100 million or less) can carry losses back for one year for national corporate tax purposes. SMEs and newly established companies can use NOLs to fully offset their taxable income (50% cap does not apply).
Korea	1, limited to small and medium-sized enterprises	15, capped at 60% of taxable income for companies other than small and medium-sized enterprises	-	-
Latvia	No limit (cash-flow tax)	No limit (cash-flow tax)	-	-
Lithuania	0	No limit, capped at 70% of taxable income	-	Operating losses and capital losses are separated and treated differently for corporate income tax purposes. 70% cap on carryforwards does not apply to small businesses.
Luxembourg	0	17	-	-
Mexico	0	10	-	-
Netherlands	1	6	Accelerated refunds for loss-carrybacks: Rather than having to wait until after the filing of the 2020 tax return to gain the benefit of the carryback, a company may instead estimate the coronavirus-related loss for 2020 and include all or part of it in a reserve when determining its 2019 taxable profit. The corona reserve can be set off immediately against the company's 2019 taxable profit, but must not exceed it.	-
New Zealand	0	No limit	Companies can carry back all or part of an actual or anticipated 2019-20 net loss against 2018-19 taxable income (through an amended tax return); or an actual or anticipated 2020-21 net loss against 2019-20 taxable income (by reestimating provisional taxes paid).	-
Norway	0	No limit	2020 losses of up to NOK 30 million can be carried back and offset against 2018 and 2019 tax surpluses.	-
Poland	0	5, capped at 50% of total loss per year	Taxpayers whose profits are at least 50 percent lower in 2020 than in 2019 due to the pandemic may carry a tax loss incurred in 2020 back and deduct it from their 2019 income for tax purposes. The deduction is capped at PLN 5 million.	-
Portugal	0	12, capped at 80% of taxable income	Tax losses incurred in 2020 or 2021 can be carried forward for 12 years and offset against up to 80 percent of taxable profits. (The permanent policy is as follows: Loss carryforwards are limited to 5 years and capped at 70% of taxable income.)	Certain small and medium-sized enterprises can carry forward losses for 12 years.
Slovak Republic	0	5, capped at 50% of taxable income	Taxpayers may deduct unused tax losses for accounting periods ending in the years 2015 to 2018, in a total amount of EUR 1 million, from the income tax base for the accounting period for which the deadline for submitting an income tax return occurs in the year 2020.	50% cap does not apply to micro-taxpayers (total income or revenues up to the amount of EUR 100,000).

TABLE 4, CONTINUED.

Net Operating Loss (NOL) Deductions in the OECD, as of May 2021

Country	Loss Carryback (Number of Years)	Loss Carryforward (Number of Years)	COVID-19 NOL Policies	Additional Comments
Slovenia	0	No limit, capped at 63% of taxable income	-	-
Spain	0	No limit, capped at 70% of taxable income exceeding EUR 1 million (additional revenue-based restrictions apply)	-	-
Sweden	1.5 (tax allocation reserve)	No limit	-	-
Switzerland	0	7	-	-
Turkey	0	5	-	Capital losses are separate from operating losses.
United Kingdom	1	No limit, capped at 50% of taxable income exceeding GBP 5 million	The proposed UK Finance Bill 2021 contains provisions allowing losses to be carried back for 3 years if they are incurred in accounting periods ending from April 1, 2020 through March 31, 2022. While the amount that can be carried back to the immediately preceding year is unlimited, the carryback of any unused loss to the two earlier years will be subject to a cap of GBP 2 million for each of the accounting periods. In addition, there is the option of accelerated loss relief.	Operating ("trading") losses are calculated separately from capital losses.
United States	0	No limit, capped at 80% of taxable income	Implemented as part of March 2020's CARES Act, losses accrued in the 2018, 2019, and 2020 tax years could be carried back up to five years. In addition, the 80% cap was suspended for the years 2018, 2019, and 2020.	-

Sources: Bloomberg Tax, "Country Guides," https://www.bloomberglaw.com/product/tax/toc/source/511920/147664382; PwC, "Worldwide Tax Summaries," https://www.pwc.com/gx/en/services/tax/worldwide-tax-summaries.html; and individual government websites.

OECD Countries with the Least and Most Restrictive NOL Policies

Although it would be ideal from an economic standpoint, no OECD country with a standard corporate tax system provides unlimited NOL carrybacks and carryforwards. However, there is significant variation in the extent to which NOL carryovers are limited across the OECD.

Canada's NOL policies are among the best permanent ones in the OECD. While carryforwards are limited to 20 years, they are not subject to taxable income limits. In addition, Canada is the only country that has a permanent NOL carryback policy of three years (without taxable income limits).[7]

Mexico is the only OECD country that allows taxpayers to apply tax losses based on their inflation-adjusted value, and thus compensates its businesses for the time value of money.

7 Many OECD countries introduced temporary NOL carrybacks as a response to the COVID-19 pandemic. However, almost none of these policies has so far been made permanent (see column "COVID-19 NOL Policies" in Table 4).

Hungary and Slovakia have the most restrictive permanent NOL provisions in the OECD: Carrybacks are not allowed, and carryforwards are not only limited to five years but also capped at 50 percent of taxable income.

Poland is the only OECD country that limits the share of losses that can be carried forward, rather than the share of taxable income that can be offset. More specifically, Poland limits its five-year loss carryforwards to 50 percent of total loss per year, meaning that a loss must be carried forward for at least two years.

NOL Deductions and COVID-19

The sudden shutdown of economies due to the COVID-19 pandemic led to an immediate concern about business liquidity. To keep illiquid but otherwise solvent businesses afloat, a variety of tax-related measures were introduced, including the expansion of NOL deductions.

NOL Carryforwards

As shown in Table 2, NOL carryforwards can help ensure the taxation of average profitability over time as today's losses can offset future profits. While NOL carryforwards constitute an important element of the corporate tax code in the medium to long term, their use for instant relief is limited, as struggling businesses will only get the liquidity benefit when they are profitable again and liable to tax. Losses from previous years can be carried forward to the current accounting period but this would not free up any liquidity unless the business is making a profit.

However, a few OECD countries did expand their NOL carryforward provisions during the pandemic. For example, Japan lifted its 50 percent taxable income limit on carryforwards for companies that qualify for a special carryback provision. Portugal expanded its carryforwards for tax losses incurred in 2020 or 2021 from five to 12 years and increased the taxable income limit from 70 percent to 80 percent. The United States suspended its 80 percent taxable income limit on carryforwards for the years 2018, 2019, and 2020.

NOL Carrybacks

As an immediate relief measure, NOL carrybacks are much more valuable to businesses affected by the crisis because they result in a refund of taxes paid in previous tax years and thus provide additional liquidity. For example, a business with a $100,000 profit in 2019 and a $200,000 loss in 2020 can offset half of the losses incurred in 2020 against the profits made in 2019 and thus receives a full refund for the corporate taxes paid in 2019.[8]

8 This example also shows how carrybacks disproportionally help businesses that have been profitable in the past. If the business had $200,000 in profits in 2019, it could offset all its 2020 losses. On the other hand, if the business was incurring losses even prior to COVID-19, it would not have any previous-year profits it could offset—and thus would not benefit from a carryback provision.

Almost half of all OECD countries implemented or expanded NOL carryback provisions. In addition, to provide business relief as quickly as possible, several OECD countries accelerated the process of issuing refunds for past taxes paid. For example, Ireland allows its businesses to estimate their trading losses in an accounting period which includes some or all of the period from March to December of 2020 and to carry back up to 50 percent of those losses on an accelerated basis. An "interim claim" for the relief can be made as early as four months after the beginning of the accounting period, which can significantly ease some businesses' liquidity constraints.

In May 2021, the European Commission (EC) recommended that as a response to the COVID-19 pandemic EU member states should allow NOL carrybacks to at least the previous fiscal year, i.e. until 2019, and may extend it up to the previous three years, i.e. until 2017.[9] As most EU countries do not have permanent carryback provisions, and not all have already implemented temporary ones as a response to COVID-19, this would be a valuable relief measure for businesses across Europe. However, the EC recommendation also suggests a limit of €3 million per loss-making fiscal year. While this would limit the effect on corporate tax revenues, it would also create size-based distortions.

Conclusion

NOL provisions are an important element of each standard corporate income tax system. Ideally, countries should provide unlimited NOL carrybacks and carryforwards and add an inflation-adjustment to carryforwards. This would help ensure that businesses are taxed on their average profitability over time, which would level the playing field between more and less volatile businesses/industries and remove distortions against more risky investment projects. In addition, particularly NOL carrybacks can act as a liquidity-enhancing instrument, which can be essential during economic shocks.

Many OECD countries expanded their NOL policies during the COVID-19 pandemic to help ensure the survival of illiquid but otherwise solvent businesses. However, most of those provisions are temporary. Policymakers should make them permanent and, where appropriate, expand them. This would ensure businesses are taxed on their average profitability going forward, and that a liquidity-enhancing tax measure is already in place in case of a future economic crisis.

9 European Commission, "Commission Recommendation of 18.5.2021 on the tax treatment of losses during the COVID-19 crisis," May 18, 2021, https://ec.europa.eu/taxation_customs/sites/default/files/1_en_act_part1_v2_0.pdf.