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It Is Time to Expand the Tax Loss Carryback

The coronavirus pandemic plunged the German economy into a severe recession. Following a recovery over the summer, growing numbers of infections give reason to fear that autumn will be difficult.

The German government has mobilized a lot of money to support the economy. In view of growing public debt, it is particularly important to target the economic stimulus packages well and ensure they do not strain the public purse more than is absolutely necessary. Given these requirements, the German government's reluctance to use one instrument, the tax loss carryback, is astonishing. Despite its rather technical appearance, this instrument is of considerable importance, especially in the current crisis. The restriction on loss offsetting currently in force is exacerbating the crisis, because it is a particular burden on companies that generated positive earnings before the crisis and are now suffering losses due to the crisis. The following example makes this clear.

Previous Use Too Hesitant

The loss carryback allows companies to offset losses incurred in 2020 against taxable profits in 2019. Before the crisis, the loss carryback was limited to EUR 1 million. Consider a corporation that made a profit of EUR 10 million in 2019 and suffers a loss of the same amount in 2020, i.e., it has earned nothing in both years taken together. Under the old rules, it could carry back losses of EUR 1 million from 2020, i.e., offset them against profits in 2019, but would still have to pay tax on the remaining EUR 9 million in profits. At a corporate tax rate of 15 percent, the company would therefore have to transfer EUR 1.35 million in corporation tax to the tax authorities. Since there is no loss carryback at all with the trade tax, which is set at about the same rate on average, an additional EUR 1.5 million in taxes are incurred here. In total, the company would therefore have to transfer EUR 2.85 million to the tax office, even though it didn't earn a cent taking both years together – and all this in the middle of a severe economic crisis. Legislators recognized this problem in principle and increased the loss carryback. But they were too hesitant. The upper limit for corporation tax was raised to a maximum of EUR 5 million, while for trade tax nothing changed. This reduces the tax payment due in our example by EUR 600,000 to EUR 2.25 million. That is still too much. A tax payment of this magnitude may be enough to drive the company into insolvency.

Targeted Relief through Expansion of Loss Carryback

There is much to recommend a significant expansion of the loss carryback. First, this would constitute a very targeted measure. Relief would go only to companies that had a functioning business model prior to the crisis and taxed their profits in Germany. Those already making losses beforehand cannot use the carryback. One of the peculiarities of the coronavirus crisis is that it affects different companies and sectors of the economy very differently. This is what makes it so important to precisely target the relief. Second, the measure does not cost the tax authorities much money. According to German government estimates, the limited expansion of the loss carryback granted so far will reduce tax revenues by EUR 4.2 billion in 2020, but more than 90 percent of this will flow back into the coffers in subsequent years. Since losses for 2020 that are not carried back reduce future taxable profits, the loss carryback will in most cases result in a tax deferral. Only in exceptional cases will the tax authorities suffer definitive tax shortfalls, for example if companies subsequently become insolvent. This means the effect of the carryback is similar to a temporary transfer of capital. Since the German state can currently borrow at negative interest rates, the public coffers are hardly burdened at all. For companies, however, the capital outflow thus prevented can avert insolvency through overindebtedness or illiquidity and thus save many jobs and the associated public revenue.

For example, compared to an expansion of the loss carryback, the temporary reduction in VAT is expensive and not very targeted. It costs the state EUR 20 billion and overwhelmingly benefits companies such as Amazon that generate high turnover and are winners in the crisis.

Loss Carryback Should Be Extended to Trade Tax

It is high time to raise the upper limit for loss offsetting significantly, for example to EUR 100 million, to make it meaningful for larger companies, too. Tax experts Philipp Lamprecht and Alfons Weichenrieder have also proposed extending the loss carryback to trade tax. One could counter that municipalities already face very high tax shortfalls. But this objection is not compelling. Without a carryback, today's losses will reduce future trade tax revenue. The currently expected tax shortfalls for municipalities are offset by the economic stimulus packages. Federal and state governments would surely be prepared to do more. It is therefore also in the urgent financial interest of the municipalities for the loss carryback to be extended to trade tax.

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Published under the title "Rettende Gutschrift", Handelsblatt, October 26, 2020, p. 48.