The Tax Treatment of Loses: Justifying Loss Offsets

Jacob Nussim

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It is commonly agreed that losses should be entitled to tax benefits, at least in most cases. The principal rationale for such tax benefits is avoiding the taxation of risk. Since business or investment risks involve potential losses, providing them no tax benefits decreases their after-tax yield excessively in comparison to less risky ventures, and hence further distorts economic activity.

There is more than a single way to provide tax benefits for periodic business losses. They can be refunded to losing taxpayers, received through an offset method, or paid in a loss transfer transaction. Although economists generally advocate a refundability mechanism for tax losses, income tax regimes around the world consistently adopt an offset method for losses. Campisano and Romano (1981) brought the issue of the socially preferable loss treatment mechanism to the fore of the legal scholarship by launching a normative attack on the loss offset regime and pushing forward a tax refundability mechanism on the threefold front of efficiency, equity, and complexity. Recently, Nussim and Tabbach (forthcoming, 2014), in a less ambitious study, analyze positively the three general mechanisms for the tax treatment of losses: loss offset, tax refundability, and loss transferability. They isolate the fundamental differentiating characteristics of these mechanisms, and show that the all three mechanisms can be redesigned equivalently. Loss treatment mechanisms are not normatively different, but diverge by their typical tax design, which implicitly represents certain normative choices. Thus, they claim, rather than comparing the advantages and disadvantaged of typical loss treatment mechanisms, we should make our socially desirable (normative) choices of treating losses for tax purposes, and then examine how they can be implemented by redesigning any tax treatment mechanism. Their analysis also uncovers the neglected choice of a tax rate schedule for losses. They claim it is most likely the central normative choice in the study of tax loss mechanisms.

This paper begins where Nussim and Tabbach's study ends, and examines the "appropriate" tax rate schedule for losses. Under a graduated income tax system, which tax rates should be applied to periodic business losses? I argue first that any tax rate schedule distorts risk taking. A second best optimal choice can be determined only through empirical examination, which is not only very complicated, but also varies over taxpayers (and time). On a similar basis, equity considerations are either indecisive or irrelevant. Therefore, I offer next a different argument for the "appropriate" tax rate schedule for losses that is based on the "income averaging" rationale. I show that although the typical design of a loss offset mechanism cannot be necessarily justified, a modified loss offset regime endogenously adopts an "appropriate" tax rate schedule.