



MULTISTATE TAX COMMISSION

MEMORANDUM

To: Combined Reporting Model – Finnigan Work Group
From: Helen Hecht – MTC General Counsel
Subject: Alternative Capital Gain/Loss Treatment
Date: November 18, 2019

BACKGROUND

NOTE: Documents referenced below are available on the work group project page here: <http://www.mtc.gov/Uniformity/Project-Teams/Model-Option-for-Combined-Filing>

The work group has been considering the treatment of capital gains and losses in the original and draft models. (See Comparison: Combined Filing Models – October 31, 2019, Section 3.C.(ii)(g)). The original model, which follows Joyce, adopts separate-entity treatment of capital gains and losses. The work group has generally been following a “single-entity” approach.

Previously, the work group was provided with the Massachusetts’ provisions on treatment of capital gains and losses. (See memorandum of October 14, 2019.) Massachusetts follows Finnigan to the extent that it includes all group members’ receipts in the receipts factor of the apportionment formula, whether or not the member is subject to tax on a separate entity basis. Massachusetts does not follow the “single-entity” approach.

Staff prepared two versions of the provisions for the draft Finnigan model. The first follows the original model’s separate-entity treatment closely. Each entity is allowed to offset its own capital gains and losses, including apportionable and nonapportionable gains and losses—on a post allocation and apportioned basis. But the entities in the group do not share capital losses, so if any of the members’ have unused capital losses, they must be carried over by the member and may only be used to offset capital gains of that member. This memo refers to this approach as the separate-entity approach without allocated loss restrictions.

The second proposed approach (which is currently in draft form), is based on informal comments in the work group meetings. It would allow entities in the group to share apportioned capital losses (to offset apportioned gains) on a combined basis, but would not allow any use of nonapportionable losses allocated to the state, except to offset gains that are from the same source and are allocated to the state in the same year. This memo refers to this approach as the single-entity approach with allocated loss restrictions. (See both approaches in the draft model set out in the Comparison: Combined Filing Models – October 31, 2019 – pages 12-13.)



At the Uniformity Committee meeting on November 6, staff presented information on these two approaches. (See Corporate Tax Treatment of Capital Gains and Losses in a Combined Return.) In comparing the separate-entity (without allocated loss restriction) approach and the single-entity (with allocated loss restriction), it appears that the second approach will often, if not always, be less favorable to taxpayers with nonapportionable losses allocated to the state. (In contrast, if the taxpayer has only apportionable gains and losses, the second approach will be more favorable.) As the presentation notes, since the rules for allocating nonapportionable losses often require sourcing to the state of commercial domicile, this second approach, therefore, may be less favorable to corporations domiciled in the state.

The committee agreed that the work group should also consider a strictly single-entity approach to the treatment of capital gains and losses—allowing the members of the group to share capital losses (whether apportionable or nonapportionable) on a post-allocated and apportioned basis—and to carry over, as a group, any unused capital loss subject to state and federal limitations. The committee also discussed the need for more information in order to give the work group any further guidance on the subject.

SUMMARY OF ISSUES

In order to facilitate further discussion by the work group – the following is a summary of the federal rules, the state differences, and the issues the group may want to consider.

FEDERAL RULES

Federal general income tax provisions, Subchapter C provisions, and consolidated filing rules provide the structure for the treatment of capital gains and losses for C corporations including:

1. Characterization rules. These rules determine whether an expenditure to acquire an asset (and any eventual gain or loss on the disposal of the asset) is ordinary or capital. If the asset is a capital asset, the expenditure may be required to be “capitalized” rather than expensed (although under current federal law, capital expenditures may be currently expensed in some cases). Any capitalized amount forms the beginning tax basis of the asset.
2. Depreciation. Federal provisions may allow periodic expense (depreciation or amortization) reducing the tax basis of a capital asset. Such expense (like any current expense allowed to be deducted when the asset is acquired) is typically treated as a business expense and will be considered in determining ordinary income or loss.
3. Recognition rules. These federal rules determine when a gain must be, and when a loss can be, recognized and taken into account for tax purposes.
4. Calculation of gain or loss. Federal provisions also determine the calculation of the gain or loss which typically allows a reduction in the proceeds equal to the tax basis of

the asset, subject to any recapture of depreciation expense, and may also provide for deduction of other expense. (Determining basis may be a fairly complicated process for some assets and one that the IRS tracks for the purpose of verifying gains and losses—see IRS Form 8494.)

5. Allowing offset of gains and losses. Federal provisions generally allow short-term and long-term capital gains and losses to be offset and determine the order in which those gains and losses will be netted. (See IRS Form 1120 Schedule D.)
6. Determine the rate of tax. Federal law imposes a lower rate of tax on capital gains for individuals, but the rate of tax for corporations is the same as for ordinary income.
7. Provide for consolidated treatment of capital gains and losses. The federal consolidated filing rules treat the capital gain/loss of a consolidated group as a consolidated tax attribute (a single-entity approach).
8. Provide for capital loss carryover. Under federal provisions, a capital loss carryover may be used against capital gains in other tax years, but not against ordinary income, and only to the extent that the deduction of the capital loss does not create an NOL.
9. Limit use of capital loss carryovers, built-in losses, and offset of built-in gains. The federal tax code and consolidated filing rules also impose strict limits on the use of capital loss carryovers (and built-in losses) of group members under IRC §§ 382 and 383 when there has been an ownership change and under the so-called SRLY rules, and also impose limits on the use of group capital losses to offset built-in capital gains in assets held by acquired companies under IRC §§ 384.

DIFFERENCES FOR STATE PURPOSES

1. Decoupling from depreciation. Some states have decoupled from the federal expense/depreciation rules or do not conform to recent changes in those rules. This affects tax basis determination and the computation of the gain or loss for state purposes.
2. Allocation and apportionment. States must apportion and allocate certain gains and losses (depending on whether they are related to the unitary business and are apportionable or nonapportionable).
3. Sales factor and allocation rules. States must determine whether to include proceeds from the sale of capital assets (or the net gains) in the sales factor of the apportionment formula, and how to apportion gains/losses from a separate business or allocate gains/losses from nonbusiness (nonapportionable) sources.
4. Separate or group tax attributes. States using combined or consolidated filing must determine whether they will treat the capital gains and losses as a combined or consolidated tax attributes (that is, whether they will take the separate-entity or single-entity approach).



5. Offsetting nonapportionable losses. States must determine whether they should allow offset of nonapportionable gains/losses allocated to the state against apportionable gains/losses apportioned to the state—or whether to allow offset of nonapportionable losses from one source allocated to the state against nonapportionable gains from another source.
6. Tax rates. States may impose different tax rates on capital gains and ordinary income.

CONSIDERATIONS FOR THE WORK GROUP

- It appears the first and most important consideration is whether to treat capital gains and losses as separate or group tax attributes. Given that the group is recommending a draft which treats NOLs as a combined tax attribute (subjecting that group NOL to federal limitations), would it be consistent to treat capital gains and losses similarly—or does that depend on whether the capital gains/losses are apportionable or nonapportionable? Note that the draft would currently allow ordinary expense/loss that might be nonapportionable to be treated as a group expense/loss through the use of a combined NOL.
- Also note that if the work group determines that capital gains and losses may be shared by the group and that the group may carry over a combined capital loss, it should be clear that limitations provided under federal law on the use of that loss (as well as the built-in gain/loss limitation rules under the IRC) would apply.