CORPORATE TAX TREATMENT OF CAPITAL GAINS AND LOSSES IN A COMBINED RETURN

FOR THE MTC FINNIGAN WORK GROUP AND UNIFORMITY COMMITTEE –

PREPARED BY MTC STAFF – NOVEMBER 2019 - **UPDATED JANUARY 2020**

For discussion purposes only.

NOTE:

- This analysis uses the terms "apportionable" and "nonapportionable." States may use the terms "business" and "nonbusiness" (or "allocable") to refer to the same concepts.

FEDERAL TREATMENT - GENERALLY

- "Capital" gains and losses and other similar gains and losses – treated separately from "ordinary" income or loss
- "Capital" – generally means a capital asset is involved
- Capital gains and losses are subject to IRS provisions (§§1202-1298) determining their calculation (e.g. whether or not related basis and expense are deductible)
- Proceeds – (Basis + Expense) = Positive Number = Capital Gain
- Proceeds – (Basis + Expense) = Negative Number = Capital Loss

FEDERAL REPORTING OF CAPITAL GAINS/LOSSES

- Recognition, calculation, and reporting of individual gain/loss
  - Form 8949 – Sales/dispositions of capital assets
    - Broken down by short-term and long-term capital gains/losses
    - Short-term capital gains and losses are netted
    - Long-term capital gains and losses are netted
  - Form 4797 - Sales of business property
    - Broken down by §1231 property (certain business property treated as capital), §1245 gains and similar property, and recapture.
    - Determines whether gains/losses are capital or ordinary
  - Form 6252 – Sales where installment method is used
  - Schedule K-1 – distributive share of capital gains/losses from passthroughs
  - Other reported capital gains/losses

FEDERAL REPORTING OF CAPITAL GAINS/LOSSES

- Netting of capital gains and losses
  - Schedule 1120 D
    - Divided into short-term and long-term gains and losses from all sources
    - Nets short-term gains and losses
    - If there is a net gain, deducts any available capital loss carryover
    - Nets long-term gains and losses
  - Any net capital gain is included in income
  - A capital loss must be carried over and can be used as to offset capital gains in the carryover years provided it does not create/increase an NOL
  - Use of the loss carryover may be limited when companies change ownership or enter or leave the consolidated group

FEDERAL CONSOLIDATED FILING

Capital gains and losses are treated as consolidated items on the federal tax return

Therefore – limitations also apply

IRC § 383(b) – change of ownership and IRC § 384 – built-in gains.	Consolidated filing rules track losses and limit use if an entity enters or leaves the group

MTC COMBINED FILING (JOYCE) MODEL

- Each member uses separate-entity (Joyce) apportionment to determine that member's share of the group (net) apportionable gain/loss.
- Each member determines the source of its separate nonapportionable gains and losses.
- Each member may offset its state-sourced apportionable and nonapportionable gains and losses.
- Because each member reports its own share of the group income, there is no offsetting of one member's net loss against another member's net gain.
- Each member may carryover its unused capital loss (whether apportioned or allocated to the state) subject to state limitations.

MTC COMBINED FILING (JOYCE) MODEL

- EXAMPLE:
- XY Group:
- State has single sales factor apportionment
  - Sales factor:
    - XY total everywhere sales = $1000
    - Member X instate sales = $100 . . . Sales Factor = 10%
    - Member Y instate sales = $200 . . . Sales Factor = 20%
  - Federal capital gains/losses:
    - Member X - apportionable capital gain = $200
    - Member Y - apportionable capital loss = <u>($100)</u>
    - Net group apportionable capital gain/loss = <u>$100</u>
    - Member Y - nonapportionable capital loss sourced to state = ($50)

MTC COMBINED FILING (JOYCE) MODEL

- State results:
  - Member X:
    - Has apportionable group capital gain of \$100 X 10% = \$10
    - That gain is added to Member X's other apportioned and allocated state income
  - Member Y:
    - Has apportioned group capital gain of \$100 X 20% = \$20
    - Has nonapportionable state-sourced capital loss = (\$50)
    - Y's nonapportioned capital loss can be offset against Y's apportioned capital gain so \$0 gain is added to Y's other apportioned and allocated state income and Y has a carryover loss of \$30

ALTERNATIVE FINNIGAN APPROACH NO. 1
(SEPARATE-ENTITY APPROACH – FOLLOWING FINNIGAN)

Maintain	Maintain the separate-entity apportionment treatment of group's apportionable capital gains & losses - but use Finnigan.
Continue	Continue to allow individual members to offset their share of the group's apportionable gain/loss against their state-sourced non-apportionable gain/loss.
Include	Include in the group's income the net gain of any individual member (without offsetting other member's net losses).
Limit	Limit carryover of a member's net capital loss to use only on a separate-entity basis.

ALTERNATIVE FINNIGAN APPROACH NO. 2
(SINGLE-ENTITY APPROACH – WITH ALLOCATED LOSS LIMITATION)

Separate & Share	Separate group's capital gains and losses into two categories - apportionable and nonapportionable and allow sharing (offsetting) of apportionable gains and losses.
Allocate/ Apportion	Allocate *each* nonapportionable gain and loss and apportion the group's *net* apportionable gain/loss using the group's apportionment factor (single-entity approach).
Include	Include any apportioned net capital gain and each non-apportionable state-sourced gain in group income. Allow carryover of any net *apportioned* capital loss.
Limit	Limit use of *nonapportionable* state-source losses to offset nonapportionable gains from the same source and year; limit use of any apportioned loss carryover similar to federal.

ALTERNATIVE FINNIGAN APPROACH NO. 3
(SINGLE-ENTITY APPROACH - NO ALLOCATED LOSS LIMITATION)

Separate & Share	Separate group's capital gains and losses into two categories - apportionable and nonapportionable and allow sharing (offsetting) of apportionable gains and losses.
Allocate/ Apportion	Allocate *each* nonapportionable gain and loss and apportion the group's *net* apportionable gain/loss using the group's apportionment factor (single-entity approach).
Net & Include	Net nonapportionable gains and losses sourced to the state against the group's apportioned net capital gain/loss. If result is a gain – include in income. Allow group to carryover loss.
Limit	Limit use of apportionable net capital loss similar to federal.

SIMPLE COMPARISON EXAMPLE

ASSUME THE STATE USES SINGLE SALES FACTOR APPORTIONMENT

Sales Factor:				
Year 1	**X**	**Y**	**Z**	**XY**
In-state	$ 100	$ 200	$100	$ 300
Everywhere	$ 500	$ 500	$500	$ 1,000
Single Entity	10%	20%	20%	
Group				30%
Year 2	**X**	**Y**	**Z**	**XZ**
In-state	$ 100	$ 200	$100	$ 200
Everywhere	$ 500	$ 500	$500	$ 1,000
Single Entity	10%	40%	10%	
Group				20%

At the end of Year 1, Y leaves the group and Z joins.

SIMPLE COMPARISON EXAMPLE

- Year 1:
  - Member X – apportionable gain = $1,000
  - Member Y – apportionable loss = ($200)
  - Member Y – nonapportionable state-source loss = $300
  - XY net apportionable gain = $800
- Year 2:
  - Member X – nonapportionable state-source gain = $100
  - Member Z – apportionable gain = $1,000
  - XZ net apportionable gain = $1,000
  - Ex-Member Y – apportionable gain = $200

ALTERNATIVE FINNIGAN APPROACH NO. 1
(SEPARATE-ENTITY APPROACH – FOLLOWING FINNIGAN)

- Year 1 –
  - Member X's apportioned gain = $800 X 10% = $80
  - Member Y's apportioned gain = $800 X 20% = $160
  - Member Y's nonapportionable state-source loss = ($300)
  - Result –
    - XY's income will include $80 gain from X and $0 gain from Y
    - Y will carry over $140 of loss to use on a separate-entity basis

ALTERNATIVE FINNIGAN APPROACH NO. 1
(SEPARATE-ENTITY APPROACH – FOLLOWING FINNIGAN)

- Year 2 –
  - Member X's apportioned gain = $1,000 X 10% = $100
  - Member X's nonapportionable state-source gain = $100
  - Member Z's apportioned gain = $1,000 X 10% = $100
  - Ex-member Y's apportionable gain = $200
  - Result –
    - XZ income will include $200 gain from X and $100 gain from Z
    - XZ will not be able to use Y's carryover loss from Year 1
    - Y can use its $140 carryover (nonapportionable) loss against its $200 apportionable gain for a net gain of $60

ALTERNATIVE FINNIGAN APPROACH NO. 2
(SINGLE-ENTITY APPROACH – WITH ALLOCATED LOSS LIMITATION)

- Year I –
  - Group XY apportionable gain $800 X 30% = $240
  - Nonapportionable state-source loss = ($300)
  - Result –
    - XY's income will include $240 gain
    - The nonapportionable state-source loss will not offset the gain and will not carry over

ALTERNATIVE FINNIGAN APPROACH NO. 2
(SINGLE-ENTITY APPROACH – WITH ALLOCATED LOSS LIMITATION)

- Year 2 –
  - Group XZ apportionable gain $1,000 X 20% = $200
  - Nonapportionable state-source gain = $100
  - Ex-member Y apportionable gain = $200
  - Result –
    - XZ's income will include $300 gain
    - XZ will not be able to offset any of the nonapportionable loss from Year 1
    - Ex-member Y's income will include $200 gain, also without offset of the Year 1 nonapportionable loss

ALTERNATIVE FINNIGAN APPROACH NO. 3
(SINGLE-ENTITY – NO ALLOCATED LOSS LIMITATION)

- Year I –
  - Group XY apportionable gain $800 X 30% = $240
  - Nonapportionable state-source loss = ($300)
  - Result –
    - XY will be able to offset the entire apportioned gain and will have a group loss carryover of $60

ALTERNATIVE FINNIGAN APPROACH NO. 3
(SINGLE-ENTITY – NO ALLOCATED LOSS LIMITATION)

- Year 2 –
  - Group XZ apportionable gain $1,000 X 20% = $200
  - Nonapportionable state-source gain = $100
  - Ex-member Y apportionable gain = $200
  - Result –
    - XZ's income will include $300 gain
    - Y's income will include $200 gain
    - Whether Y will be able to use any part of the $60 (nonapportionable) loss carryover will depend upon application of the federal limitations

SUMMARY OF FEDERAL CAPITAL LOSS LIMITATIONS

- IRC §383(b) – provides that the limitations under §382 (change in ownership) shall apply to limit the use of a capital loss after an ownership change.
- IRC §384 – limits the use of pre-acquisition losses against built-in gains of the acquired corporation for five years after the acquisition.
- SRLY (consolidated regulations) – limit the use of capital losses (where other limits do not) using separate-entity tracking. (See Reg. §1.1502-22 and 22A.)

OBSERVATIONS

- Unlike ordinary losses (which the draft allows to be shared between members), it is somewhat more likely that capital gains and losses may be nonapportionable (nonbusiness) losses.
- There is a theoretical basis for limiting the use of nonapportionable nonbusiness losses to offset apportionable business gains.
- The idea of limiting the use of nonapportionable losses to gains from the same source may be difficult to implement—since the definition of the "same source" may be open to various interpretations.
- Limiting the use of nonapportionable losses will generally result in treatment less favorable to the taxpayer.
- Nonapportionable (nonbusiness) gains and losses are often allocable to the state of commercial domicile. To the extent Alternative 2 is less favorable, it will be more likely to affect companies domiciled in the state.
- Federal limits may limit use of carryovers under Alternative 3 to a greater extent than the separate-entity approach in Alternative 1.