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

For discussion purposes only.

FEDERAL TREATMENT - GENERALLY

- "Capital" gains and losses and other similar gains and losses – treated separately from "ordinary" income or loss
- "Capital" –means a capital asset is involved
- Capital gains and losses are subject to general IRS provisions 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

LIMITATIONS ON CAPITAL LOSSES

General federal approach to treatment of capital gains and losses subject to limitations (see Schedule D to the 1120)

- Determine each short-term capital gain and loss by category (IRC section)
- Determine each separate long-term capital gain and loss by category
- Offset short-term capital gains and losses
- Offset long-term capital gains and losses
- Offset short-term capital gains against long-term capital losses or vise-versa
- Include net capital gain income in taxable income
- Carryover net capital loss for use in future years as short-term capital loss

Bottom line – capital losses cannot create NOLs

FEDERAL CONSOLIDATED FILING

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

Therefore – the following limitations also apply

IRC § 383(b) imposes 382-type limits the amount of loss that can be used after a substantial change in ownership

Consolidated filing rules track losses and limit use if an entity enters or leaves the group

MTC COMBINED FILING (JOYCE) MODEL

- Takes a separate entity approach but allows combination of group apportionable capital gains and losses to determine each member’s share of those apportionable capital gains and losses.

MTC COMBINED FILING (JOYCE) MODEL

- EXAMPLE:
  - Member X has an apportionable capital gain of $100
  - Member Y has an apportionable capital loss of $50
  - The net apportionable capital gain of $50 is separately apportioned to X and to Y using their separate-entity apportionment factor. (This is the same factor used to apportion ordinary income or loss.)

MTC COMBINED FILING (JOYCE) MODEL

- Maintains the separate-entity treatment of nonapportionable capital gains and losses.
- A member’s nonapportionable capital gains and losses that are allocated to the state can be netted against the entity’s share of apportionable capital gains and losses.

MTC COMBINED FILING (JOYCE) MODEL

- EXAMPLE:
  - Assume X has $1,000 of in-state receipts and the group has $10,000 everywhere receipts.
  - X would apportion 10%, or $5 of the $50 combined gain.
  - Assume X has $10 of nonapportionable loss allocated to the state. X would have a net capital loss of $5 which it could carry forward.

MTC COMBINED FILING (JOYCE) MODEL

- Each member carries over any unused net capital loss (assuming state law allows for a carryover of such losses) to be used by that member.

FINNIGAN APPROACH

- We will need to clarify the treatment of capital gains and losses under the Finnigan approach, since the separate entities will not be reporting taxable income on a separate (Joyce) basis but under the single-entity approach.

ALTERNATIVE APPROACH NO. 1

Maintain	Maintain the separate-entity treatment of capital gains and losses including the separate-entity apportionment of apportionable capital gains and losses
Continue	Continue to allow offsetting of separate entity apportionable and nonapportionable (state-sourced) gains and losses
Include	Include in combined group income the separate-entity net capital gains of the members (but do not allow offsetting of capital losses among the members)
Limit	Limit carryover of the separate-entity net capital losses to use only on a separate-entity basis

ALTERNATIVE APPROACH NO. 2

Combine	Combine members' capital gains and losses (netted by category) into two groups – apportionable and nonapportionable.
Apportion	Apportion the apportionable gain or loss (after offsetting categories) using the group apportionment factor (single-entity approach).
Include	Include in income the apportioned capital gain along with any nonapportionable state-sourced gains (netted by category).
Limit	Limit use of nonapportionable state-source losses (netted by category) to offset nonapportionable net gains from the same source and year; allow carryover of apportionable capital loss subject to federal limitations.

SIMPLE COMPARISON EXAMPLE

- Members X and Y each have a 25% separate-entity state apportionment factor and the group XY has a 50% state apportionment factor.
- Member X has the following (federal):
  - Short-term apportionable capital gain - $100
  - Long-term apportionable capital loss - ($100)
  - Long-term nonapportionable capital loss - ($200)
- Member Y has the following (federal):
  - Long-term apportionable capital gain - $200
  - Short-term nonapportionable capital gain - $100
- Long-term nonapportionable gain and loss are allocated to the state but they are not derived from the same source.

SIMPLE COMPARISON EXAMPLE – ALTERNATIVE 1

Combined apportionable capital gain/loss =	$200		
X's apportioned capital gain (25% of $200)		$50	
X's separate nonapportionable loss		($200)	
X's net loss		($150)	
Y's apportioned capital gain (25% of $200)		$50	
Y's separate nonapportionable gain		$100	
Y's net gain		$150	
Amount of gain to be included in the income of XY =			$150
Amount of capital loss carryover that X may use =			($150)

SIMPLE COMPARISON EXAMPLE – ALTERNATIVE 2

Combined apportionable capital gain/loss =	$200	
Combined apportioned capital gain (50% of $200)		$100
Member Y’s nonapportionable capital gain		$100
Total capital gain included in XY income =		$200
Capital loss limited (“trapped”) =	$200	

OBSERVATIONS

- These are not the only 2 ways in which capital gains and losses might be treated.
- 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.