MULTISTATE TAX COMMISSION

MEMORANDUM

To:	Combined Reporting Model – Finnigan Work Group
From:	Helen Hecht – MTC General Counsel
Subject:	Comprehensive Analysis – Capital Gain/Loss Treatment FOR DISCUSSION PURPOSES ONLY
Date:	December 3, 2019

BACKGROUND

On its last call, the work group discussed the November 18, 2019 staff memo which summarized the uniformity committee's instructions to further consider capital gain and loss treatment, including a Utah-style single-entity approach. The memo also summarized two alternative draft provisions— the separate-entity approach without allocated loss restrictions and the single-entity approach with allocated loss restrictions. In addition, the memo set out the general federal and state rules governing capital gain and loss treatment for corporate taxpayers.

The work group asked staff to:

> (1) analyze whether differences in the state tax treatment, including nonconformity to federal provisions, might affect the ability to use the single-entity approach; and
>
> (2) provide draft language to implement a Utah-style single-entity approach.

The November 18, 2019 memo, along with other documents on this project, is available on the work group project page here: http://www.mtc.gov/Uniformity/Project-Teams/Model-Option-for-Combined-Filing

TREATMENT OF CAPITAL GAINS AND LOSSES - GENERALLY

This section restates November 18, 2019 memo's summary of federal and state capital gain/loss provisions in the form of an outline of the general steps for reporting state tax on capital gains and losses.

STEP ONE: Characterization.

The first step in determining tax treatment of capital gains and losses is the characterization of the gain or loss as capital versus ordinary. Federal rules which generally require capitalization of expenditures made to acquire certain assets. Capitalized amounts form the beginning tax basis of the capital asset. The gain or loss from disposal of such assets will be treated as capital gains or losses. States largely follow these federal characterization rules. The main exception is those states that do not (yet) conform to TCJA amendments to IRC § 1221. Those amendments exclude from capital assets any patents, inventions, models or designs, and secret formulas.

STEP TWO: Depreciation and adjusted tax basis.

Some, but not all, capital assets are subject to depreciation—allowing a portion of the asset's basis to be charged as a deductible expense against ordinary income each year. Depreciation directly affects a capital asset's adjusted tax basis as well as any potential gain or loss on disposal of the asset. (See Step Four below.) A number of states do not conform to federal depreciation rules, especially the bonus depreciation rules (including amendments under TCJA allowing 100% expensing in some cases). These nonconforming states require taxpayers to add-back federal depreciation and compute a separate deduction for state-adjusted depreciation. These nonconforming states would also compute a separate state-adjusted tax basis in the related assets. This, in turn, will affect the amount of capital gains and losses that may ultimately be recognized.

STEP THREE: Recognition rules.

Federal rules determine the tax year in which a gain must be, and a loss can be, recognized and taken into account for tax purposes. Gains and losses are typically not recognized until some transaction, transfer, or other event occurs that allows the gain or loss to be reliably calculated. States generally conform to federal recognition rules—so that the event that requires recognition of a federal capital gain or loss will also require recognition of a state gain or loss—even if the amount of the gain or loss is different for state purposes (e.g. due to nonconformity to depreciation rules).

STEP FOUR: Calculation of gain or loss.

Federal provisions also determine the calculation of the gain or loss on transfer or disposal of capital assets. Generally, federal rules allow a reduction in the proceeds (if any) for an amount equal to the adjusted tax basis of the asset, subject to any recapture of depreciation expense (which is treated as ordinary income instead), and may also provide for deduction of other expenses. (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.)

In general, states follow the federal approach to calculating the capital gain or loss—allowing deductions for the adjusted tax basis (calculated, if necessary, separately for state purposes) and other allowable expenses. States that do not conform to federal depreciation, so that the state adjusted tax basis for certain capital assets is different than the federal adjusted tax basis in those same assets, typically require that federal net capital gains be subtracted from federal net income and do not allow any federal net loss carryover deduction. Instead, these states provide for a separate state-level calculation of the related capital gains or losses, and any net capital gain or loss, as well as any state level loss carryover that may be allowed.

STEP FIVE: Apportionment or allocation of gains and losses

For state purpose, capital gains and losses, as separately calculated under state rules if necessary, must either be apportioned or allocated to determine any state-sourced amounts. State adjusted capital gains and losses that are apportionable in nature are typically netted and any apportionable net capital gain is included in net income and apportioned together with that income. (The MTC has model rules for when amounts related to a capital asset transaction are included in the receipts factor and where those amounts are sourced for apportionment factor purposes.)

Under UDITPA, state adjusted gains and losses that are nonapportionable (nonbusiness) in nature and that result from disposal of tangible or real property are allocated to the situs of that property. Nonapportionable capital gains and losses from intangible property (including stock) are allocated to the taxpayer's commercial domicile. Nonapportionable capital gains and losses allocated to another state are simply excluded from the taxing state's state-sourced income calculation. Nonapportionable capital gains and losses allocated to the taxing state are included—but there may be differences in how nonapportionable capital losses are allowed to be used. (See Step Six below.)

STEP SIX: Netting based on separate- or single-entity treatment.

Federal provisions generally allow short-term and long-term capital gains and losses to be offset and specify the order in which those gains and losses will be netted. (See IRS Form 1120 Schedule D.) Under federal rules, a net capital loss (after offsetting all capital gains) cannot be taken against ordinary income. Instead, that loss is subject to a limited carryback and carryforward period. (See Step Seven below.)

States also generally allow capital gains and losses (adjusted for state purposes as necessary) to be offset following general federal rules. But there are two issues that affect the result at the state level:

- The first is whether members of a filing group are allowed to share (offset) capital losses against each other's capital gains. The federal consolidated filing rules treat the capital gain or loss of a consolidated group as a consolidated tax attribute (the single-entity approach) allowing offsetting among the members. The MTC Joyce combined filing model does not allow offsetting of capital gains and losses between members of the combined group. Instead, each member that has a net capital loss may have a state loss carryover which may be used (depending on state law) against capital gains of that member recognized in other tax years (the separate-entity approach).
- The second issue that affects the result at the state level is whether the state allows apportionable capital gains and losses to be offset against nonapportionable capital gains and losses. Generally, this issue arises only when some amount of nonapportionable gain or loss is allocated to the taxing state. Otherwise, the gain or loss (not allocated to the state) would simply be excluded from the state's calculation of taxable net income.

STEP SEVEN: Capital loss carryover.

Under federal provisions, a net capital loss (after offsetting capital gains) cannot be used to offset ordinary income but may be carried forward or back, subject to limitations, for use against capital gains in other years. Most states appear to follow this same treatment. A few states allow (or require) the capital loss to be taken in the year it is recognized against ordinary income—and some appear to allow the capital loss to create or increase a net operating loss.

STEP EIGHT: Limitations on use of capital loss carryovers.

The federal tax code and consolidated filing rules also impose strict limits on the use of capital loss carryovers of group members under IRC §§ 382 and 383 when there has been an ownership change and under the so-called SRLY rules (under the IRS's consolidated filing regulations), 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. Most states appear to conform to IRC §§ 382-384 but may not conform to the SRLY rules.

STEP NINE: 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. A few states provide lower rates for certain capital gains for corporations.

PROPOSED SINGLE-ENTITY PROVISIONS

In order to follow a single-entity approach in the treatment of capital gains and losses, several different provisions in the current draft must be altered as follows:

Section 3. Determination of taxable income or loss for a combined group.

A. Components of income subject to tax in this state; application of tax credits and post-apportionment deductions.

i. The combined group shall calculate and pay tax based on the combined group taxable income or loss apportioned or allocated to this state, which includes:

(a) the group's apportionable income apportioned to this State, determined under this Section 3., [DRAFTER'S NOTE: If the combined group's apportionable income might be subject to more than one apportionment method, e.g. when different methods are applied to different types of businesses, the state needs to provide language indicating that the group's apportionable income may need to be divided between these businesses. Also, if the state provides that apportionment does not apply to a taxpayer (including a group) that does business entirely within the state, then the state may wish to reference that provision here.]

(b) the group's income sourced to this state ~~from the sale or exchange of capital assets and from involuntary conversions,~~ as determined under Section 3.C.ii.(g), below,

NOTE: The sections of the original model refer to gains and losses in various ways that are not always consistent. This draft would simplify the way in which those gains and losses are referred to. Here it is only necessary to refer to subparagraph (g).

(c) the group's nonapportionable income or loss allocable to this State, other than income or loss included in income as determined under Section 3.C.ii.(g), determined under [provisions for allocation of nonapportionable income];

> NOTE: This is necessary in order to not double-count nonapportionable gains sourced to the state which will be included in the income under subparagraph (g).

. . .

C. Determination of the apportionable income and other tax items of the combined group.

The apportionable income of a combined group is determined as follows:

i. From the total income of the combined group, determined under Section 3.C.ii., subtract income, and add expense or loss, other than the apportionable income, expense or loss of the combined group not otherwise required to be subtracted under paragraph (g) of subsection (ii) below.

ii. Except as otherwise provided, the total income of the combined group is the sum of the income of each member of the combined group determined under federal income tax laws, as adjusted for state purposes, as if the member were not consolidated for federal purposes. ~~The income of each member of the combined group is determined as follows~~ The following subparagraphs provide for the manner of computing the members' or the combined groups' income and other tax items:

> NOTE: These provisions are necessary because the sections that follow do a combination of things—they determine the members income and they also determine group tax items.

. . .

(g) Any net gain resulting from application of Subchapter P of the Internal Revenue Code is subtracted from the total net income of the members of the combined group. [DRAFTER'S NOTE: If the state decouples from federal treatment of depreciation and tax basis and requires taxpayers to compute separate state amounts for capital gains, losses and/or loss carryovers, then insert language here referring to the section that instructs taxpayers how to report state-adjusted capital gains and losses.] The combined group then computes the net gain or loss for the state for the tax year on a group basis, and includes the net gain as part of income subject to tax in the state under Section 3.A.i.(b) or carries over the net loss subject to [state law allowing for a capital loss carryover] as follows:

(1) Each separate gain or loss for the members of the group is determined [following Subchapter P of the Internal Revenue Code or state provisions requiring the computation of state-adjusted capital gains and losses].

(2) Each separate apportionable gain or loss is then apportioned using the combined group's apportionment factor determined under Section 3.B., and each separate nonapportion-

able gain or loss is allocated under [reference to UDITPA rules for allocating gains or losses or other state law rules].

(3) Each separate amount of apportionable gain or loss apportioned to this state and each separate amount of nonapportionable gain or loss allocated to this state is classified pursuant to [Subchapter P of the Internal Revenue Code or state provisions if different].

(4) The state-sourced amounts of gains or losses within each class are netted for the combined group (without netting between such classes).

(5) The net state-sourced amounts of gain or loss for all classes are then netted following the general rules under Subchapter P of the Internal Revenue Code.

(6) If the amount determined in subparagraph (5) is a net gain, that gain is added to net income subject to tax as computed under Section 3.A.i.

(7) If the amount determined in subparagraph (5) is a net loss, that loss may not be deducted from net income but may be carried over subject to [state law providing for a net capital loss carryover] and used against state sourced capital gains for the group, provided that such loss would not be subject to limitations applicable to those losses under any provision of the Internal Revenue Code or applicable federal regulations if the member were joining a federal consolidated filing group;