MULTISTATE TAX COMMISSION

MEMORANDUM

To:	Combined Reporting Model – Finnigan Work Group
From:	Helen Hecht – MTC General Counsel
Subject:	Staff Analysis – NOL Sharing (Updating the April 3, 2019 Memo) **For Discussion Purposes Only**
Date:	May 27, 2019

STATUS UPDATE

The Model Statute for Combined Reporting adopted in 2006 (the 2006 model) follows the Joyce rule. That model does not permit the sharing of NOLs among members of the combined group. In 2018, the Uniformity Committee created a work group to draft alternative provisions for the 2006 model following the Finnigan rule. The committee instructed the work group to draft those provisions using Utah's single-entity approach. That approach allows the sharing of NOLs among group members.

Sharing of NOLs necessarily requires specific limitations on that sharing in order to avoid abuse. The work group produced draft alternative Finnigan provisions for consideration by the Uniformity Committee, providing for NOL sharing and imposing specific limitations.

Phil Skinner, work group chair, presented the draft alternative Finnigan provisions to the Uniformity Committee at its April 25, 2019 meeting. Michael Fatale, Massachusetts, submitted written comments concerning the draft NOL provisions. (See Michael's letter in the appendix to this memo.) Additional questions and comments were raised by the committee members and members of the public. The Uniformity Committee has instructed the work group and Commission staff to consider these questions and comments and report back at the next committee meeting on August 6, 2019.

This memo updates and supplements the memo of April 3, 2019. It was prepared by staff for discussion purposes only, is meant to raise additional issues and provide information, and does not represent the views of the Commission or its members.

This memo also does not provide exhaustive analysis of some of the substantive issues raised. Staff is seeking additional guidance from the work group before undertaking additional analysis.

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DRAFT NOL SHARING/LIMITATION PROVISIONS

The work group's draft provisions addressing NOLs allow sharing and provide limitations on the sharing and use of NOLs as follows:

(1) The combined group must attribute losses apportioned or allocated to this state in any tax year to the members of the group as follows:

(a) To each member of the group that had a loss under Subsections A(1) or (2), the portion of the group loss determined by multiplying that loss by a fraction, the numerator of which is the member's loss, and the denominator of which is the total loss of all the members that had losses; plus

(b) To each member of the group that had a nonapportionable loss allocated to this state, but only to the extent that such loss contributed to the total combined group loss reported to the state in that year.

In no case shall members be attributed total losses under this Paragraph (1) in excess of the loss reported to this state by the combined group in the tax year.

(2) The combined group available net operating loss carryover in any tax year is:

(a) The total net operating losses of the combined group allocated or apportioned to the state in past years to the extent such losses have not been used to offset income of the group or are not otherwise limited by state law; plus

(b) The net operating losses of a member of the group created before that member became a part of the group, but only to the extent such losses:

(i) 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;

(ii) were properly allocated or apportioned to this state in the year created;

(iii) were properly attributed to the member under Paragraph (1) if the member was part of a separate combined group when the losses were created;

(iv) have not been used to offset income of any taxpayer; and

(v) are not otherwise limited by state law; minus

(c) The net operating losses of a member of the combined group attributed to that member under Paragraph (1) or brought into the group under Subparagraph (b) above that have not been used to offset income and are not otherwise limited by state law, as of the date that member is no longer part of the combined group.

For purposes of this Paragraph (2), the losses of combined group members are deemed to have been used to offset income through the deduction allowed in Paragraph (3) by applying a pro-rata reduction to the losses of all combined group members in each year, starting with the earliest year.

(3) The combined group may take a net operating loss deduction against income allocated or apportioned to this state in a tax year under this Subsection 3 to offset such income, in whole or in part, to the extent the group has an available net operating loss carryover in that year.

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QUESTIONS/COMMENTS RAISED CONCERNING DRAFT PROVISIONS

Below is a summary of the comments and questions about NOL sharing/limitations raised, organized by general category. These will be addressed in a later section of this memo:

- Necessity of Addressing NOL Sharing/Limitations:
  - Does the logic behind the Finnigan rule require changes to the NOL provisions of the 2006 draft?
  - Are there other reasons to address NOL sharing/limitations as part of the model alternative Finnigan provisions?
  - If NOLs should be addressed, should this be done through a white paper or through model or alternative model provisions?
    - Comments concerning a white paper versus draft model (or alternative model) provisions:
      - There may be too many options (including existing laws) to create one model set of provisions for NOL sharing/limits.
      - Drafting a model set of NOL provisions might take more time and effort—beyond the general scope of the Finnigan project.
      - An MTC model allowing NOL sharing might signal disapproval of states that do not allow any sharing of NOLs.
      - Combined filing states currently take different approaches to NOLs and may not want to adopt uniform provisions.
      - States that wish to adopt NOL sharing/limitations may want a model that establishes workable rules.
      - State that wish to adopt combined filing may find that they need NOL sharing/limitation provisions.
      - The work group could produce alternatives—for not sharing NOLs and for sharing and limiting sharing and use of NOLs.
- Other Substantive Issues/Comments:
  - The work group should consider how these rules relate to the existing rules being used in the various states.
  - The work group should consider a rule that excludes sharing of an NOL created by an entity before it was a member of the group.
  - The work group should consider a rule that excludes sharing an NOL created by an entity before it became a member of the unitary business.

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BACKGROUND

This section contains general information that may assist the group in considering the issues and questions that have been raised.

TERMINOLOGY

Note: This memo uses some important terms in a particular way:

- *Tax attribute* – refers to an element of the income tax computation that a taxpayer (entity or group) carries into a tax year, e.g. tax basis in particular assets, NOL carryovers, credit balances, etc.
- *Net operating loss* – the term "net operating loss" is used here to describe the operating loss resulting in a particular tax year on a separate company or group basis.
- *NOL carryover* or *NOL* – the terms NOL carryover or, simply, NOL refer to the tax attribute that is created by losses resulting in other tax years and available for use to offset income.
- *Separate company* (income, loss, attributes, etc.) – describes the income, loss, attributes, etc. of a particular legal entity, determined under applicable federal and state tax rules as if the entity filed on a stand-alone basis. Separate company income or loss may also be computed with or without intercompany eliminations.
- *Separate-entity apportionment approach* – refers to having each combined group member apportion the group's combined income/loss using a separate apportionment factor (calculated by dividing the member's numerator by the combined group's denominator).
- *Single-entity apportionment approach* – refers to apportioning the combined group income/loss on a combined basis, using the group's combined apportionment factor (computed by dividing the group's numerator by the group's denominator).

TRACKING NOLS BY ENTITY

In the state combined filing context, NOL carryovers can arise from two main sources[1]--net operating losses associated with apportionable income/loss of the unitary business and nonapportionable (nonbusiness) losses, which are typically recognized by particular group members. This memo focusses on apportionable losses since they raise more complex issues of attributing and tracking the NOL by entity.

Whether or not a state allows NOLs to be shared between entities in a group, the NOL will have to be attributed to, and its use will have to be tracked by, each entity within the group. Therefore, as background to considering NOL sharing/limitation, it is useful to consider how NOLs are attributed to individual group members.

[1] Federal NOL limitations make further distinctions including passive losses and capital losses, among others.

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JOYCE RULE SEPARATE-ENTITY APPORTIONMENT APPROACH

The 2006 model follows the Joyce rule, so named after a California Franchise Tax Board decision.[2] Under the Joyce rule of combined filing, separate entity members of the unitary group are regarded as separate taxpayers for purposes of determining whether they are subject to tax under state and federal law. So, under Joyce, a group member may not be subject to tax in the state even though the unitary business is. This requires a state following the Joyce rule to determine taxable income or loss on a separate entity basis, while using the group's income or loss to do this. The method generally used is the separate-entity apportionment approach (as described above and in the example below).

Under Joyce, if a member is not subject to tax in the state, the member's receipts will be included in the group denominator of the receipts factor used by all the members, but any receipts sourced to the state will be excluded from that entity's numerator. So the entity will report no portion of the group income to the state.[3]

Example of the Joyce Rule and the separate-entity apportionment method

Companies 1, 2 and 3 are part of a unitary business operating in State X, which has a single sales factor. Company 1 is protected by P.L. 86-272. The following table shows the separate company amounts of net operating income or loss after eliminations. The results of the Joyce separate-entity apportionment method are also shown.

	Income/Loss	Receipts in X	Everywhere	Factor	X Income/Loss
Co. 1	$1 million	$2 million	$20 million	N/A	$0
Co. 2	($1 million)	$3 million	$30 million	3%	$300,000
Co. 3	$10 million	$5 million	$50 million	5%	$500,000
Group	$10 million		$100 million		
Total Sep.					$800,000

Note that whether a group member will have an apportioned loss in a state (giving rise to a potential NOL) depends on whether the *group* has a loss, not whether the member *itself* has income or loss on a separate company basis.

2 When the 2006 model was adopted, California, which participated substantially in the drafting of the model, still followed the Joyce rule. California and a number of other states that once followed Joyce now follow Finnigan. For more background information on the Joyce/Finnigan issue and the work group's discussions see the project page on the MTC website, here: http://www.mtc.gov/getdoc/4570fde6-763b-450f-85bf-cbbb6e30dc94/Model-Option-for-Combined-Filing.aspx.

3 On the other hand, if the member sells from a state that follows Joyce into states where it would not be subject to tax under Joyce, those sales/receipts may be thrown back (assuming the origin state has a throw-back rule).

FINNIGAN RULE SEPARATE- AND SINGLE-ENTITY APPORTIONMENT APPROACHES

Under the Finnigan rule, also named after a California Franchise Tax Board decision, if the unitary group is subject to tax in the state, then each member of the group is subject to tax. But even under Finnigan, states may require the members of the group to use a separate-entity approach to apportioning the combined income or loss. Alternatively, the income or loss may be apportioned using a single-entity apportionment approach. States that use a single-entity approach may consider the members of the group to be jointly and severally liable for the total tax owed, or alternatively, a portion of that total tax may be attributed back to each member of the group.

Example of Finnigan separate- and single-entity apportionment approaches

This example uses the same facts as the Joyce example above. Again, Companies 1, 2 and 3 are part of a unitary business operating in State X. But here, Company 1 would not be considered protected by P.L. 86-272. The results here are different than under the Joyce rule, therefore. But those results are the same regardless of whether the separate-entity or single-entity apportionment approach is used.

	Income/Loss	Receipts in X	Everywhere	Factor	X Income/Loss
Co. 1	$1 million	$2 million	$20 million	2%	$200,000
Co. 2	($1 million)	$3 million	$30 million	3%	$300,000
Co. 3	$10 million	$5 million	$50 million	5%	$500,000
Separate-Entity	$10 million		$100 million		$1 million
Single-Entity	$10 million	$10 million	$100 million	10%	$1 million

Again, as the example following the Joyce rule above also shows, here, all the group members will either have some apportioned income, or some apportioned loss, depending on the group income or loss. The fact that a group member might have income or loss on a separate company basis does not matter.

NOL SHARING/LIMITATION IMPLICATIONS

All of the combined filing approaches discussed above, whether following the Joyce or Finnigan rule, allow operating income and operating losses between group members to be offset in computing apportionable income or loss. This is, of course, the essence of combined filing. (Again, because nonapportionable income or loss is often associated directly with a particular group member, that issue is ignored for purposes of this discussion.)

States may or may not allow sharing of NOLs between group members. Any of the general approaches discussed above, including the Finnigan single-entity apportionment approach, can be made to either permit or exclude NOL sharing. Whether or not states follow the Joyce rule or the Finnigan rule, therefore, does not dictate whether the state might allow NOL sharing—as the appendix to this memo shows.

Also, regardless of whether NOLs are allowed to be shared or not, there will be a need for tracking NOLs by entity. Even when NOL sharing is allowed, as it is under federal consolidated rules, there must be limits on that sharing. In addition to other specific limitations, the work group's draft NOL provisions explicitly follow federal rules for limiting NOLs in particular situations. This explicit provision, in the draft itself, is important because as one commentator on the draft has noted, if a state merely conforms to federal rules by conforming to net taxable income generally, the way in which those rules apply in the state combined filing context may not be clear.

ANALYSIS OF QUESTIONS/COMMENTS AND SUBSTANTIVE ISSUES

NECESSITY OF ADDRESSING NOL SHARING/LIMITS

Does the logic behind the Finnigan rule require changes to the NOL provisions of the 2006 draft?

During the public hearing of the 2006 draft, members of the public questioned whether it was consistent with the unitary business principle to prohibit the sharing of NOLs attributed to members of the combined group under the Joyce rule. The hearing officer's initial report responded with the following rationale for prohibiting the sharing of NOLs (and credits):

> "As mentioned above, the combined report required under the proposed model statute does not disregard the separate identities of the taxpayer members of the combined group. The model is quite consistent in its treatment of the combined group as a set of individual entities rather than a single taxpayer: business income subject to apportionment is calculated as the sum of all members' individually determined net business income or loss; as a general rule, deductions and credits are taken only by the specific taxpayers that earned them; and, the amount of total combined business income apportioned to a state is calculated as a function of each taxpayer's own factors in that state (the Joyce method), as opposed to the factors for the entire group as a whole in that state (the Finnigan method)."[4]

The hearing officer's supplemental report, referencing this same issue, also notes:

> "3. Treatment of Credits and Net Operating Loss
> . . .
> This issue was also addressed in the original Hearing Officer's Report of April 25. (See pp. 19-22, esp. pp. 20-21) In the opinion of the Hearing Officer, while combined reporting should reflect the principles of UDITPA and unitary theory, nothing in either UDITPA or unitary theory requires a credit earned by one taxpayer to be allowed

[4] Report of the Hearing Officer Regarding the Proposed Model Statute for Combined Reporting, Sec. IV.B,1, p. 19-21, available here: http://www.mtc.gov/uploadedFiles/Multistate_Tax_Commission/Uniformity/Uniformity_Projects/A_-_Z/CR%20HO%20Report.pdf,

> against the separate tax liabilities of the other taxpayer members of a combined group.
> . . .
> If the proposed model were to treat the entire group as a single taxpayer with a single tax liability, then it might make some sense for credits to be applied against that single tax liability. (And in such case it would also make sense that nexus for any part of that unitary business would provide nexus for the entire unitary business.)"[5]

(While this section of the supplemental report references only credits, it appears the rationale was intended to address the public comments with respect to both NOLs and credits.)

So, to summarize, the hearing officer determined that sharing of NOLs was inconsistent with the Joyce rule. To the extent the Joyce rule is seen as a requirement that each member of the group be treated as a separate taxpayer with its own tax attributes, then it would not be consistent with this requirement to allow sharing of NOLs attributed to the members. There is no reason to question this determination.

The Finnigan rule does not treat members of the combined group as separate entities for purposes of determining whether those entities are subject to tax in the state. But this does not mean that following the Finnigan rule *requires* the sharing of NOLs or other tax attributes. A state may determine that it should treat members of the group as separate taxpayers, or as having separate tax attributes, for other purposes—so that the rationale of the hearing officer's reports would still apply. Furthermore, as the April 3, 2019 memo discusses, the allowance of an NOL carryover (like a tax credit) is entirely a matter of legislative grace and the use of an NOL may be allowed or limited for a whole host of reasons.

That said, those who believe in the unitary business principle must also be skeptical of any method of assigning a portion of a unitary group's operating income or loss to the group's members. The unitary business principle is founded on the idea that it is exceedingly difficult to accurately divide up group income or loss between group members. Yet, this is a task that must be done, especially if a state wishes to prohibit sharing of NOLs entirely (although it is also necessary for applying certain limitations on that sharing).

As discussed above, the most common way in which operating income or loss is attributed to members of the combined filing group is by using the single-entity apportionment approach—which not only determines the group income or loss apportioned to the state, but also the amounts apportioned to each group member.

For example, assume a unitary group includes Company X. In Year 1, X suffers a disruption in its operations, causing it to recognize a substantial separate company operating loss, after

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[5] Supplemental Report of the Hearing Officer Regarding the proposed Model Statute for Combined Reporting, Sec. II,A,3., available here: http://www.mtc.gov/uploadedFiles/Multistate_Tax_Commission/Uniformity/Uniformity_Projects/A_-_Z/CR%20HO%20Report%20-%20Supplemental%20Amended%206-21-05.pdf.

eliminations. The unitary group also has a loss, after offsetting the operating income of other group members. Under the separate-entity apportionment approach, all group members will be attributed some portion of that group loss to carry forward as an NOL. In Years 2-5, assume that X has small losses related to the change in its operations, but the group, after offsetting operating income of other members, has net income in those years. X will be attributed some portion of that income in Years 2-5 and may take some part of the NOL that was attributed to it in Year 1 against that income. The other group members will also have some portion of the original loss to use against their portion of the group income in Years 2-5.

While formulary apportionment of income between *jurisdictions* is presumed constitutional unless it leads to a result "'out of all appropriate proportions to the business transacted . . . in [a] State,'"[6] it should not be assumed that the use of formulary apportionment to divide up income between group *members* renders a result that is necessarily "accurate" or consistent. Assuming, as we must, that any method of assigning group income or loss to the members of the group will be somewhat inexact, using that method only to track NOLs by entity in order to limit their use in particular circumstances also minimizes any arbitrary effects. And as will be discussed further below, the federal rules for tracking NOLs by entity used to apply limits to the sharing of NOLs differ somewhat.

Also, because it is the group member's apportionment factors that are used to attribute the group income and loss to those members, if the member's relative proportions of state apportionment factors remain fairly stable, it will make little difference whether NOLs are shared or not. For example, assume Company 1 and Company 2 are a unitary group. If for each year over a 10-year period, Co. 1 has a 10% factor in state X and Co. 2 has a 20% factor, then at the end of the 10 years, the same amount of any NOL generated will have been used, whether or not state X allows sharing.

But when relative state factors of group members change, a state that does not allow sharing may allow less NOL to be used (at least during a particular period), even if the group's total state factor remains the same. Take the following very simple example:

Year 1	Income/Loss	Receipts in X	Total Receipts	Factor	X Income/Loss
Parent	$100,000	-	$ 1,000,000	0.0%	-
Sub 1	($1,200,000)	$1,000,000	$ 89,000,000	1.0%	($10,000)
Sub 2	$100,000	$ 500,000	$ 10,000,000	0.5%	($5,000)
Total	($1,000,000)	$1,500,000	$100,000,000	1.5%	($15,000)
Year 2					
Parent	$100,000	-	$1,000,000	0.0%	-
Sub 1	$ 500,000	$ 500,000	$89,000,000	0.5%	$5,000
Sub 2	$ 400,000	$1,000,000	$10,000,000	1.0%	$10,000
Total	$1,000,000	$1,500,000	$100,000,000	1.5%	$15,000

[6] *Container Corp. of America v. Franchise Tax Bd.*, 463 U.S. 159, 170 (quoting *Hans Rees' Sons*, 283 U. S. 123, 135 (1931)

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As this example demonstrates, while the unitary business would apportion $15,000 of operating loss in Year 1 and $15,000 of operating income in Year 2 to state X, attributing the loss to each of the subsidiaries combined with the change in their relative apportionment factors means that only $10,000 of the NOL will be used in Year 2 ($5,000 by Sub 1 and $5,000 by Sub 2).

Nevertheless, it remains true that some method of tracking NOLs by entity (both when losses are generated and when NOLs are used) is also necessary in order to effectively limit the sharing of NOLs. Therefore, allowing the sharing of NOLs may not significantly simplify the reporting and administration of NOL use unless there are no changes in the make-up of the group over time. Furthermore, as noted previously, this discussion does not address what states may choose to do with nonapportionable losses generated by members of the group. Those losses must be tracked if their use is to be limited—and limitations may apply to these losses for different reasons.

In short, while these kinds of issues ought to be considered, it does not appear that the logic of Finnigan requires a different approach to NOLs than the one adopted in the 2006 model. The best that can be said is that, unlike the Joyce approach, there is no inconsistency between the Finnigan approach and the sharing of NOLs.

Are there other reasons to address NOL sharing/limitations as part of the model alternative Finnigan provisions?

As information in the appendix to this memo shows, a majority of the states that require or allow some form of combined or consolidated filing also allow sharing of NOLs to some degree. It is reasonable to expect that those states will continue to allow sharing and that other states may move to allowing the sharing of NOLs—particularly separate filing states that move to combined filing. States that decide to allow sharing of NOLs must impose some limits on that sharing—and the design of these limits is important. Therefore, the reason to address the sharing of NOLs would be to address what might serve as appropriate *limits* on NOL sharing.

If NOLs should be addressed, should this be done through a white paper or through model or alternative model provisions?

Given that the policy choice to allow NOL sharing is not dictated by the unitary business principle, per se, or by the method of combined filing used, and given that there are alternative methods for limiting NOL sharing, it would be appropriate to address the issue through a white paper. This would also allow aspects of the alternative methods to be considered. But there is also no reason for the work group to avoid setting out examples of the language of limitation provisions that might be adopted. Having such examples can help states that are seeking to ensure that they have effective limits on the sharing of NOLs.

OTHER SUBSTANTIVE ISSUES

As summarized above, the discussions at the Uniformity Committee meeting also raised other substantive issues. But the committee generally deferred discussion of potential substantive issues to the work group. This section, therefore, provides general information meant to help the work group identify important substantive issues that may require further analysis.

NOLs Generally

Income tax systems typically provide for NOL deductions because the typical annual reporting period may be shorter than the business cycle—so that a loss incurred in one period is to produce income in a later period. Nevertheless, as noted above, a deduction for an NOL is, like all deductions, generally been viewed as a matter of legislative grace, not a matter of right, by federal courts. See *S. F. H., Inc. v. Commissioner*, 444 F.2d 139, 142 (3d Cir. 1971).

Under IRC §172, NOLs are generally carried over (after 2017, only to future years) and used to offset income in the order that those losses were incurred. Federal consolidated filing rules impose a tracking regime on NOLs so that they can be attributed to members of the group. To the extent the loss is the loss of the consolidated group, it will be apportioned to the members, as will the use of any NOL deduction, for tracking purposes. See federal regulation §1.1502-21(b). Under the changes adopted by the Tax Cuts and Jobs Act, loss carryovers are now unlimited in terms of time, but are limited to 80% of net income.

Interaction of Federal and State NOL Limitations Generally

Use of NOLs can be limited in a number of different ways for a number of different reasons. The 2006 model does not specify how states should conform to the federal NOL rules generally. The model uses a generic, undefined term—"taxable income" when describing the computation of the allocated and apportioned income for each group member. Assuming the state decouples from any federal rules, particularly federal deductions, the state loss will differ and may be less than the federal loss. This acts as a "limit" on the loss, as does apportionment (discussed below). Many states have decoupled from the federal NOLs carryover period. Decoupling from the federal NOL rules allows states to place additional or alternative restrictions on NOL carryovers and deductions. States that conform to the computation of the federal NOL generally may also conform to the new 80% limitation. States can decouple from NOL rules either by adding back the federal NOL or adopting conformity to net income before the federal NOL deduction.

Specific limitations relevant to NOL sharing are discussed further below.

Allocation and apportionment of losses

An important limitation on the use of NOLs generally is the requirement to allocate or apportion losses those losses to the state. The draft model provisions (provided on page 2 above) use the amount of allocated and apportioned losses to the state as an upper limit on any NOL that may be used in that state. Those provisions state that: "The combined group must attribute losses apportioned or allocated to this state in any tax year to the members of the group as follows . . ..” The provisions also state that: “In no case shall members be attributed total losses under this Paragraph (1) in excess of the loss reported to this state by the combined group in the tax year.” The draft provisions do not limit the use of nonapportionable NOLs to offset nonapportionable income. So, if a nonapportionable loss is allocated to the state, it will be available for use to offset apportionable or nonapportionable income, subject to other limitations.

Tracking NOLs by member

Some method of tracking NOLs by group member is needed regardless of whether a state allows NOL sharing. States that do not allow NOL sharing restrict the use of the NOL in each tax year to the entity to which it has been attributed. States that do allow NOL sharing must impose limits and those limits generally require tracking NOLs by entity as well. The method most states use to track NOLs by group member is described in the previous section. That method takes the operating income or loss of the group and apportions it using the separate-entity approach.

The federal method of tracking NOLs by member in consolidated groups is different. That method, which is used to assign NOLs for the purpose of limiting them in certain situations, generally assigns the group operating loss to the individual members that had separate company net operating losses, on the basis of each entity’s share of the total loss. This is the method adopted under the draft NOL provisions, which state that a member of the group will be assigned “the portion of the group loss determined by multiplying that loss by a fraction, the numerator of which is the member’s loss, and the denominator of which is the total loss of all the members that had losses.” (See above, page 2.)

Limiting NOLs when members enter or leave a group

Both the federal government and the states that allow NOL sharing impose limits when entities enter or leave a group. The limit may be as simple as saying that an entity joining or leaving a group may not carry over any amount of NOL into or out of the group.

It should be noted that an entity’s tax attributes are often related. For example, a taxpayer is entitled to depreciation of assets acquired at the beginning of a business cycle, before the income from those assets is realized, some years later. Assume at the beginning of Year 1, the taxpayer acquired $1 million of capital assets. In that year, the taxpayer had $0 income before depreciation, and $100,000 of depreciation expense, leading to a $100,000 operating loss. At the beginning of Year 2, the taxpayer would have a $100,000 NOL carryover. But the taxpayer would also have a reduced tax basis in the capital assets of $900,000. If this taxpayer joins a unitary group in Year 2, its NOL may be excluded, but its tax basis in the assets will carry over. So if it were to sell those assets for $1 million, it would recognize a $100,000 gain.

Specific federal limitations on NOLs when an entity enters or leaves the group (and in other situations) are discussed in the following section.

FEDERAL TREATMENT OF NOLS

Federal consolidated filing rules allow offsetting of operating income and losses of members of the consolidated group and the use of a consolidated NOL (CNOL). But when members come into or leave the group, there are a number of detailed rules that impose significant limitations on the use of any NOLs those members may bring into the group, as well as how much of any NOL is left with the group when the member leaves. Those rules are found mainly in IRS regulations under the consolidated filing provisions of the IRC (mainly IRC 1502), or under IRC §§ 381-384. Other sections of the IRC may also effectively limit the use of NOLs.

One benefit of the federal rules is that they are very detailed—anticipating a number of situations that may come up when separate legal entities are filing together in a single return. For example, they detail how the rules apply to passive losses, basis in the stock of subsidiaries, and in different types of corporate reorganizations. The federal tax code has long recognized that taxpayers might be incented to create losses or seek to acquire them and so have imposed significant limits as well as anti-abuse provisions.

As noted above, the pre-2018 federal law limited periods in which an NOL deduction could be claimed, creating so-called carry-back and carry-forward periods. Under TCJA, an unused federal NOL can be carried forward indefinitely but there are other limits on the amount of the NOL deduction allowed each year, the most significant of which is that it may not exceed 80% of net income.

SOURCES OF FEDERAL NOL LIMITATIONS

As noted, the two main sources of federal NOL limitations are the consolidated filing regulations which set out so-called SRLY limitations and also IRC §§ 381-384, primarily § 382 (as well as § 269). The consolidated filing rules allow computation of a consolidated net operating loss (CNOL) carryover—which can be used by the group to offset net taxable income from any of the members. The losses making up the CNOL are also tracked on an entity basis so that sharing of the CNOL can be limited, e.g. if a member leaves the group.

The amount of a CNOL attributable to a member is calculated by apportioning the losses that are part of that CNOL in the year incurred. The loss of the group is allocated only to members of the group that had losses, after eliminations, on a separate company basis, multiplying the group loss by a fraction which is the loss of the member divided by the total loss for all members having separate losses (with some adjustments for particular circumstances).

SRLY LIMITATIONS GENERALLY

The limits on use of NOLs under the federal consolidated regulations are based in the idea of the affiliated group and membership in that group in each tax year. This gives rise to something referred to as a "separate return year" (SRY) and "separate return limitation year" or "SRLY." The definition of "separate return year" relates to any return of a member (or predecessor), other than a consolidated return of the instant group. It is a term of art, and applies regardless of whether the member filed an actual separate return or as part of another group's consolidated return. There are also limited exceptions to the definition of a SRY. A loss created by a current member in a SRY will be subject to SRLY limitations when it comes to including any unused portion of that loss in the CNOL carryforward.

Current SRLY Rules

As with many federal issues, NOL limitations have evolved over time—generally becoming more specific and more limiting. The SRLY rules now overlap with specific statutory limitations and the treatment of that overlap is discussed below.

The main body of SRLY regulations were first issued in 1966, and were later revised substantially in 1996. The fundamental idea underlying both sets of regulations is that an NOL generated in a separate return year can only be used by a group to the extent it could have been used by the loss member had that member filed separately. So, a SRLY loss cannot be used to offset consolidated taxable income attributable to other members of the group.

The amount of the SRLY losses that could be used was the difference between (i) the consolidated taxable income of the group for the carryover or carryback year and (ii) the consolidated taxable income of the group for such year recomputed by excluding the income and deductions of the loss member (that is, the member coming into the group).

In 1996, the IRS substantially broadened the focus of the SRLY rules. The two primary objectives of the 1996 SRLY rules were to impose SRLY limitations on subgroups, rather than individual members, when appropriate, and to compute the limitation using the loss member's cumulative contribution to consolidated taxable income over the period after the loss member joined the group. SRLY rules are designed to have specific application under different types of corporate reorganizations.

In general, the SRLY limitation can be expressed as follows: The aggregate NOL carryover of a member from losses arising in separate return years that may be included in the group's CNOL and used in a particular year by the group cannot exceed the aggregate separate company operating income (net of any operating losses) of the loss member over the period when that loss member was part of the group.

Overlap Rules

The SRLY rules overlap with the limitations under IRC § 382 which impose very strict limits, discussed below. The IRS has, therefore, adopted rules to prevent overlapping limitations and to indicate which limitation applies. In general, in any overlap situation, § 382 rules will apply. Section 382 is designed to prevent trafficking in NOLs. It imposes strict limits where there has been a change in ownership, as defined, of the loss entity. In rare cases, it may be possible for a subsidiary to go from less than 80% ownership to more than 80% ownership, so as to be included in the consolidated return, but not be subject to §. 382, in which case the SRLY limitations will apply. Otherwise, § 382's limitations will generally apply.

IRC SEC. 382 AND SEC. 383 LIMITATIONS

Under §382, when a corporation has an ownership change, its NOL carryover is subject to limitation. This limitation applies regardless of whether the corporation is joining a consolidated group. The limitation is an amount calculated by multiplying the value of the loss corporation (or group) by the long-term tax exempt rate (currently about 1.9%). So, for example, a corporation valued at $100 million would have a federal NOL limitation of about $1.9 million, regardless of the amount of its NOL at the time of the change in ownership. As with all aspects of the federal NOL limitation rules, the rules concerning the calculation of value are detailed and take into account all manner of circumstances that may affect the proper valuation of the stock of the corporation.

The §382 limitation also applies to limit the use of certain built-in losses that might be recognized by the corporation after an ownership change. Section 383 similarly provides that if an ownership change occurs with respect to a loss corporation, the §382 limitation for any post-change year also limits the amount of capital gain or regular tax liability that may be offset by capital losses and excess credits of a loss corporation arising before the ownership change.

Sec. 382 applies to a "loss corporation." A "loss corporation" is one that has an NOL carryover, a capital loss carryover, or certain tax credit carryforwards, or has a net unrealized built-in loss. Under TCJA, a "loss corporation" also includes any corporation entitled to use a carryforward of disallowed business interest.

In general, an ownership change involves an increase of more than 50 percentage points in common stock ownership by any 5% shareholder during the testing period (usually a three-year period). So, for example, if a 10% owner becomes a 15% owner during a three-year period, the Sec. 382 loss limitation is triggered.

In addition, for any NOL to survive a change in ownership under Sec. 382, there must be a continuity of the business for at least two years. This is an additional protection against the trafficking in NOLs.

Application of § 382 to consolidated filers

The consolidated return regulations apply the § 382 limitation to a consolidated group's NOLs—including limiting the losses of a consolidated group that is acquired. This so-called single-entity approach seeks to treat change of ownership situations the same regardless of whether the predecessor and successor taxpayers are entities or groups of entities. The § 382 limitation following an ownership change of a loss group generally is computed by treating the loss group as a single entity. Thus, for any post-change year, the consolidated § 382 limitation is an amount equal to the value of the loss group multiplied by the long-term tax-exempt rate that applies with respect to the ownership change. The value of a loss group is computed taking the value of the stock of each member excluding stock owned directly or indirectly by another member. Single-entity treatment also applies for purposes of determining whether a loss group or loss subgroup satisfies the continuity of business enterprise requirement.

Corporations Leaving a Consolidated Group

Section 382 generally applies to a corporation when it leaves the consolidated group. The amount of NOL attributed to that corporation under the consolidated filing rules which provide for tracking of NOLs by entity is the NOL to which the Sec. 382 limitation would apply. In addition, under the consolidated filing regulations, the group CNOL would exclude the NOL of the departing corporation.

Appendix

States with Complete Restrictions on Sharing NOLs

States are not uniform in whether they allow any sharing of NOLs, although a number of states appear to allow sharing to a substantial degree whether under combined reporting, in some cases, through an election to file on a consolidated basis.

Note – The table on the following page shows only whether sharing is permitted to any degree. It does not show the other limits that may be imposed on NOLs (allocation and apportionment, § 328 or SRLY type limitations, etc.). To the extent that these other limitations are applied, the state may require that losses be tracked by entity, even though sharing is otherwise permitted, at least to some degree.

Key:

- States shaded blue have complete restriction on the sharing of NOLs.
- States shaded green allow sharing in the context of a federal-style consolidated filing election.
- States shaded grey either have no corporate tax or do not allow any kind of combined or consolidated filing.
- The remainder of the states allow sharing.

State	Combined?	Finnigan?	Sharing?	Consolidated?	Sharing?
Alabama	No	N/A	N/A	Yes	Yes
Alaska	Yes	Joyce	Yes	Yes	Yes
Arizona	Yes	Finnigan	Yes	Yes	Yes
Arkansas	No	N/A	N/A	Yes	Yes
California	Yes	Finnigan	No	No	N/A
Colorado	Yes	Joyce	Yes	Yes	Yes
Connecticut	Yes	Finnigan	Yes	No	N/A
Delaware	No	N/A	N/A	No	N/A
District of Columbia	Yes	Joyce	No	No	N/A
Florida	No	N/A	N/A	Yes	Yes
Georgia	No	N/A	N/A	Yes	Yes
Hawaii	Yes	Joyce	No	Yes	Yes
Idaho	Yes	Joyce	No	No	N/A
Illinois	Yes	Joyce	Yes	No	N/A
Indiana	Yes	Finnigan	Yes	Yes	Yes
Iowa	No	N/A	N/A	Yes	Yes
Kansas	Yes	Finnigan	Yes	Yes	Yes
Kentucky	Yes	?	No	Yes	Yes
Louisiana	No	N/A	N/A	No	N/A
Maine	Yes	Finnigan	No	Yes	Yes
Maryland	No	N/A	N/A	No	N/A
Massachusetts	Yes	Finnigan	Yes	No	N/A

Michigan	Yes	Finnigan	Yes	No	N/A
Minnesota	Yes	Finnigan	Yes	No	N/A
Mississippi	Elective	Joyce	Yes	No	N/A
Missouri	No	N/A	N/A	Yes	Yes
Montana	Yes	Finnigan	No	Yes	No
Nebraska	Yes	Joyce	Yes	No	N/A
Nevada	N/A	N/A	N/A	N/A	N/A
New Hampshire	Yes	Joyce	Yes	No	N/A
New Jersey	Yes	Joyce	Yes	Yes	Yes
New Mexico	Elective	?	Yes	Yes	Yes
New York	Yes	Finnigan	Yes	No	N/A
North Carolina	Yes	Finnigan	Yes	No	N/A
North Dakota	Yes	Joyce	No	Yes	No
Ohio	Yes	?	No	Yes	No
Oklahoma	No	N/A	N/A	Yes	No
Oregon	Yes	Finnigan	Yes	No	N/A
Pennsylvania	No	N/A	N/A	No	N/A
Rhode Island	Yes	Finnigan	Yes	No	N/A
South Carolina	No	N/A	N/A	Yes	Yes
South Dakota	N/A	N/A	N/A	N/A	N/A
Tennessee	Yes	?	Yes	Yes	Yes
Texas	Yes	Joyce	Yes	No	N/A
Utah	Yes	Finnigan	Yes	No	N/A
Vermont	Yes	Joyce	Yes	No	N/A
Virginia	Elective	Joyce	No	Yes	No
Washington	N/A	N/A	N/A	N/A	N/A
West Virginia	Yes	Joyce	No	No	N/A
Wisconsin	Yes	Finnigan	No	No	N/A
Wyoming	N/A	N/A	N/A	N/A	N/A

Note that of the states that do not allow any sharing, some follow the Joyce method of computing apportioned income for the members of the group and some follow Finnigan (or use a single-entity approach). The same thing is true of the states that do allow sharing—some follow Finnigan and some follow Joyce.

MULTISTATE TAX COMMISSION

April 19, 2019

To the MTC Uniformity Committee:

With respect, I would like to offer the following comments to the uniformity committee for consideration in connection with the "Finnigan Model Draft 4-11-19." In some part, I offer these comments from the vantage point of a state that – like several other states – relied upon the Model as existent when previously adopting combined reporting (which my state did for tax year 2009). At the same time, I note that regrettably I have not been able to be an active participant in this workgroup and so perhaps in these comments I am missing some important point.

First, I offer a technical suggestion. I think the proposed definitional change that would define a combined report as being a tax return should be backed out as I think that change is inconsistent with the terminology in most combined reporting states and more importantly conflicts with Section 3.D.4 of the Model, which infers that a combined report is not a tax return and that "[t]he [state] *combined report* of the combined group must be attached to the [state] *corporate income tax return*."

Second and more substantively, I raise the question whether changes to the Model to effectuate the Finnigan sourcing principle necessarily require wholesale changes to the Model allowing for the sharing of NOL carry forwards and credits. My view is that the former change does not require the latter changes and I believe that this point is exemplified by the law in some states. So, I would suggest that if persons believe that the sharing of NOL carry forwards and credits *should be considered* by a state that adopts combined reporting when such reporting methodology includes the Finnigan principle, that the changes to the model merely note the logic that supports this conclusion (i.e., and not offer specific loss/credit sharing rules). One possibility would be that the group could capsulize the concepts embodied in the proposed provision in a white paper that states the basic principles that a state should consider. If it is determined that specific NOL carry forward and credit sharing rules do not need to be placed within the model, then my third comment below becomes moot.

Third, and related to my second point, if a determination is made that the changes to the model should be accompanied by specific NOL carry forward and credit sharing provisions, then I think it might be helpful to spend additional time considering those provisions. I say this not because the proposed rules strike me as wrong but because there are myriad ways in which NOL carry forwards and credits can and arguably should-be shared and numerous potentially-complex issues that I think could benefit from further consideration – including questions about how the rules relate to the pre-existing rules being used in the various states. Consideration of these points would be an exercise that I think might be different in kind from the prior charge of the work group to consider the addition of Finnigan to the Model, and could serve to attract state persons that are expert on these rules.

As an example with respect to the NOL carry forward rules, no specific rule is provided to the effect, as in other states, that NOL carry forwards can only be shared with corporations that were members of the combined group when the loss was incurred. Also, the draft rules suggest that a member's loss carry forward that pertains to a period prior to that member being brought into the combined group may be shared by group members – with no specific consideration as to whether that loss was derived from the unitary business.   Similarly, the credit-sharing rule states that a credit belonging to one member of the group for a period prior to that member becoming part of the group can be shared with other members of the group (again without any unitary business restriction). Again, I don't think any of these provisions are necessarily "wrong," I just think there is a fair question as to whether these are the right provisions to now be enshrined in the model.

Thank you for your consideration.

Michael T. Fatale
Massachusetts Department of Revenue