MULTISTATE TAX COMMISSION

NOL White Paper

Prepared by the Staff of the Multistate Tax Commission for the Finnigan-Combined Filing Project Work Group and the Uniformity Committee. Submitted to the Uniformity Committee for its meeting of August 6, 2019.

NOTE: This white paper is prepared for discussion purposes only. The analysis and recommendations in this white paper do not necessarily represent the position of the Multistate Tax Commission or its member states. Thank you to everyone who provided input for and review of this white paper.

Contents

NOL White Paper

Purpose

The MTC's Model Statute for Combined Reporting, adopted in 2006 (the 2006 model), follows the Joyce rule.[1] Last year, the MTC Uniformity Committee (committee) undertook a project to draft an alternative model following the Finnigan rule (the Finnigan model). The committee created a work group for that purpose.[2] This white paper resulted from that project.

Uniform approach to NOL sharing

This white paper is tended to serve two purposes. It first seeks to help the committee determine whether the Finnigan model should set out particular uniform provisions for allowing group use of NOL deductions and limiting that use. If the committee determines that particular NOL provisions should not be included in the Finnigan model, the committee may decide to recommend this white paper (or some version of it) as a resource for states to help them better understand the policy choices in providing for and limiting the use of NOLs in a combined group return.

Focus on NOL sharing and limits on sharing

Net operating losses generally, as well as the use of NOL carryovers in the context of a group return, and the types of limits on "sharing" or use of NOLs by the group, can raise dozens of specific issues. The results of applying any one set of limits or rules will also differ depending on the particular facts and circumstances.

Given the purpose of this white paper, it does not attempt an exhaustive analysis of every possible issue or alternative approach. Rather, it sets out a summary of the most common methods used by states and the federal government to provide for NOL deductions in the context of group returns, including limits on the use of NOLs by members of corporate filing groups. It also analyzes some of the more significant pros and cons of those common methods.

But note—there are many kinds of NOL limitations—all of which may have different purposes. For example, only certain types of business-related expenses may be taken into account in calculating NOLs. There may be time limits (carryover periods) on the use of NOLs. Also, for federal purposes and most states, NOLs may not transfer from an unincorporated business when it incorporates or from an incorporated business that is reorganized into a passthrough form.

Similarly, federal tax rules and the rules of some states distinguish operating or business losses from nonbusiness, investment, or capital losses (depending on the type of taxpayer). Capital losses, in particular, have a separate set of limitations that apply. (The draft Finnigan model does not seek to alter the treatment of capital losses adopted in the 2006 model.)

The NOL limitations with which this white paper is primarily concerned are limitations on the use of a group NOL or on the "sharing" of NOLs among group members. These limitations typically include limitations on bringing an NOL into, or taking it out of a group, or using an NOL that may have been acquired. It is, nevertheless, worth noting that other types of limitations are assumed to apply to, and may impose much more significant limitations on, the use of group NOLs.

NOTE – Some analysis of these issues has already been done for the project in the form of a Briefing Book and staff memos that are available on the project page:

http://www.mtc.gov/getdoc/4570fde6-763b-450f-85bf-cbbb6e30dc94/Model-Option-for-Combined-Filing.aspx.

Introduction – Background

As noted, the committee has undertaken the project to draft an alternative combined filing model statute following the Finnigan rule. Therefore, a brief discussion of the difference between the Joyce rule and the Finnigan rule is in order.

[1] The 2006 model is available here: http://www.mtc.gov/uploadedFiles/Multistate_Tax_Commission/Uniformity/Uniformity_Projects/A_-_Z/Combined%20Reporting%20-%20FINAL%20version.pdf. Note that the model was amended in 2011 but those amendments do not affect the use of the Joyce rule.

[2] For an explanation of the Joyce and Finnigan rules, see the Project Briefing Book on the project web page here: http://www.mtc.gov/getdoc/4570fde6-763b-450f-85bf-cbbb6e30dc94/Model-Option-for-Combined-Filing.aspx.

Joyce versus Finnigan and combined filing

Joyce reflects the theory that a corporate member of the unitary group might lack nexus with a state, or be protected from state taxation under P.L. 86-272, even though the unitary business itself has activities subjecting its income to tax in a state. The Joyce rule effectively treats each combined group member as a separate taxpayer, at least for this jurisdictional purpose, while still using group income or loss as part of the measurement of the income or loss for those members that are subject to tax.

Under Joyce, states often require each of the group's corporate members to calculate their own share of the group's income and tax liability. To do this, each entity's apportionment factor is calculated separately using that entity's numerators over the total group's denominators. This is referred to in this white paper as the *separate-entity apportionment approach.*

Following this approach, if a corporate member lacks nexus or is protected by P.L. 86-272 in a particular state, its factors are included in the group's denominator, but it would have zero-numerators in its own apportionment factor for that state, even though it might have in-state receipts.[3] Under the Joyce rule and the separate-entity apportionment approach, a unitary business may apportion less total income or loss to a state than it would if the state treated all of the group's members as being subject to tax.[4]

The 2006 model adopted the Joyce rule and the separate-entity apportionment approach. The Hearing Officer's Report on the 2006 model[5] determined it would be inconsistent with the Joyce rule's separate-taxpayer treatment to allow sharing by the group members of certain tax attributes, including NOLs and credits.[6] Nothing in this white paper alters that conclusion.

But this logic does not necessarily apply, at least to NOLs, when states follow the Finnigan rule. Under Finnigan, the amount of income or loss apportionable to the state will be the same amount that would be apportioned as if the unitary group were treated as a single taxpayer—that is, with one amount of income or loss and a single combined apportionment factor.

Some Finnigan states use this very approach—referred to in this white paper as the *single-entity apportionment approach.* Under the single-entity apportionment approach, group members may be jointly and severally liable for the group tax,[7] or one entity may agree to be primarily liable for that tax.

Other Finnigan states may compute tax and impose liability on each corporate member of the group and, for this purpose, may employ the separate-entity apportionment approach, but without excluding any member's numerators. Alternatively, a Finnigan state may use single-entity apportionment, but then attribute the group apportioned income or loss to group members using some other method.

But to be clear, even though some Finnigan states may use a separate-entity apportionment approach (or a method of attribution) to determine the group members' taxable income or separate tax liability, those states will apportion the same total amount of group income or loss as Finnigan states that use the single-entity approach (that is, as if the group were a single taxpayer).

The work group, following the Uniformity Committee's direction, drafted the Finnigan model following the single-entity apportionment approach. Under that approach, each tax year the group income or loss is apportioned using the group factor and there is no attempt to apportion or assign that annual in-come or loss to the group members. A group NOL is computed and can be used against group income—or "shared." Tracking of the NOL by member is provided for, however, so that the NOL can be effectively limited, as discussed further in this white paper.

[3] Some states attribute all of the apportioned income or loss to group members that are subject to tax, thus skirting this effect of the Joyce rule.

[4] An example of this effect is included in the Briefing Book, see supra note 2.

[5] See Supplemental Report of the Hearing Officer, June 5, 2005, 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.

[6] See the staff memo – "Staff Analysis – NOL Sharing (Updating the April 3, 2019 Memo)" of May 27, 2019; and the staff memo – "Staff Analysis – NOL Sharing" of April 3, 2019, available on the project page here: http://www.mtc.gov/getdoc/4570fde6-763b-450f-85bf-cbbb6e30dc94/Model-Option-for-Combined-Filing.aspx.

[7] This is the same method use for assessing tax under the federal consolidated filing rules. See federal Reg. § 1.1502-6.

But to be clear—following the Joyce rule does not require a state to prohibit any sharing of NOLs and following the Finnigan rule does not require a state to compute a group NOL (so as to effectively permit sharing). There are Joyce states that allow sharing of NOLs, as well as Finnigan states that provide for a separate-entity, rather than a group, NOL deduction.

Limitations on use of a group NOL

This white paper uses the term "share an NOL" to mean either of the following: (1) corporations filing a group return calculate a group net operating loss that may be carried forward and deducted against group income, with some limitation, or (2) the state provides for the separate calculation of group members' net operating losses but allows NOL carryovers to be offset (deducted) against income of other members generally, again, with limitations.

As this white paper sets out in more detail, the federal government and the majority of states now allow related corporations to compute a group NOL or otherwise share NOLs when those corporations are required to file, or elect to file, combined or consolidated returns.

The fact that sharing is generally permitted should not be taken to mean that sharing is *unlimited*. When group NOLs are provided for, or sharing of NOL carryovers is allowed, limits must also be imposed to avoid duplicating of NOL deductions when corporations enter or leave the group, to avoid potential trafficking of NOLs, and to prevent other abuse. t

Limits on sharing for these purposes include not allowing an NOL to be brought into or taken out of a group when a member enters or leaves, requiring that NOLs brought into the group only be used to offset that member's income, and restrictions on the use of corporate NOLs after any change in ownership. The federal tax code imposes such limits and the states may or may not conform to those limits and may also impose other limits on NOL sharing.

Draft Finnigan model's NOL provisions

The draft Finnigan model allocates and apportions the group income or loss using the single-entity approach (discussed further in this report). Under this approach, the group apportionment factor is used to apportion the group income or loss each year. This approach allows for the calculation of a group NOL carryover and a group NOL deduction.

But the draft model also includes NOL provisions imposing limitations on the sharing of group NOLs that rely, to an extent, on federal NOL provisions (also discussed further in this report). Those draft provisions can be found in the latest draft model on the project website and in the May 27, 2019 Staff Analysis – NOL Sharing Memo (see links on prior page), and are also set out on the next page, with comments.

Draft NOL provisions:

C. The combined group is allowed a net operating loss deduction from the amount of income apportioned or allocated to this State . . .

(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.

This allows for the tracking of NOLs by entity and for applying limitations described

This generally follows the method of attri-buting losses used for federal purposes.

This makes clear that nonapportionable losses allocated to the state are included but only to the extent they contributed to the combined group loss.

Members joining the group are allowed to bring in an NOL but only to the extent it would not be limited by federal rules, discussed further in this white paper.

The NOL of a member joining the group is also limited to the amount that was properly allocated and apportioned to the state in the year created and properly attributed to that

This requires that the group reduce its NOL when a member leaves the group, following the same attribution rules.

This provision allows the group to use the NOL, calculated above, to offset group income.

Policy behind NOL deductions -

The decision to provide any kind of deduction for an NOL carryover is a matter of legislative grace.[8] But while there is no requirement for such a deduction, it is supported by certain policy considerations.

First, and most importantly, allowing NOL carryovers mitigates the effects of imposing an artificial annual reporting period for determining taxable profits.[9] If no NOL carryover deduction were allowed, businesses whose incomes fluctuate—including start-ups that are less profitable in the early years, companies with a longer business cycles, and companies making significant long-term investments—would pay more tax than those businesses whose incomes are stable. In some cases, the difference in tax liability can be substantial.

For example: Companies X and Y are in similar businesses. They can choose to maintain current operations or make a large investment over a period of two years that will pay off in Year 3. Company X chooses to make the investment, but Company Y does not. Also assume an effective tax rate of 20%.

The companies' annual net income/loss and tax are:

Income/Loss	Year 1	Year 2	Year 3
Company X	($ 1M)	($ 1M)	$ 2M
Total 3-Year Income			$ 0M
Tax – no NOL	$ 0	$ 0	$400K
Total 3-Year Tax			$400K
Company Y	$ .5M	$ .5M	$ .5M
Total 3-Year Income			$1.5M
Tax – no NOL	$ 100K	$ 100K	$100K
Total 3-Year Tax			$300K

Without an NOL deduction, Company X will pay $100K more in tax than Company Y, even though, over the course of the three years, it earned no profit compared to the $1.5M in profit earned by Company Y. To avoid this effect, IRC § 172 provides that all businesses, whether conducted by individuals, passthroughs, or C corporations can effectively use losses in one year to offset income in another year.

The second policy reason for allowing an NOL carryover is to counter the effects of an economic downturn.[10] Companies may experience losses during such periods and allowing an NOL carryover deduction reduces tax owed, which may spur recovery. This policy consideration is much more important at the federal level, since federal effective tax rates are much higher than at state rates, so that NOL deductions provide greater economic benefit.

In addition, the policy behind the treatment of NOLs in the context of combined corporate filing may be influenced by how NOLs are treated in other contexts. In particular, this paper considers the treatment of NOLs when states allow federal-style consolidated filing (which 22 states now do).

Similarly, the policy behind the treatment of corporate NOLs may be influenced by how NOLs of passthrough entities are treated. More business income is now reported by passthrough entities than by C corporations.[11] And in that context, the NOLs generated are used by individual owners (or corporate) owners, rather than the entities themselves. While different limitations apply to losses reported by individuals (including basis, at-risk, and passive activity limitations) sharing of business NOLs, generally—that is, offsetting the operating income of one business with an NOL deduction generated from another business—is not prohibited. Indeed, for individual taxpayers, the income and deductions from multiple businesses may be aggregated to determine the proper amount of operating loss and NOL carryover for the individual taxpayer.[12]

[8] See supra note 6.

[9] See *Lisbon Shops, Inc. v. Koehler*, 353 U.S. 382, 386 (1957). See also, "The Tax Treatment of Net Operating Losses: In Brief," the Congressional Research Service, Oct. 4, 2017, p. 3, available here: https://www.everycrsre0port.com/files/20171004_R44976_198ab4bf7386cb256f3c1e0923b91359df415fc4.pdf.

[10] See supra note 9, p. 2.

[11] See The Tax Policy Center Briefing Book - Key Elements of the U.S. Tax System – Business Taxes – available here: https://www.taxpolicycenter.org/briefing-book/what-are-pass-through-businesses.

[12] See IRS Publication 536, Net Operating Losses (NOLs) for Individuals, Estates, and Trusts, available here: https://www.irs.gov/pub/irs-pdf/p536.pdf.

Finally, however, NOLs are typically significant enough to greatly increase variability of corporate income tax revenue over time, especially after an economic downturn.[13] This effect can be particularly problematic for states which must generally have balanced budgets. Also, carryback provisions complicate the tracking and computation of income and loss and many states therefore do not allow carryback of NOL deductions and impose limitations on how long an NOL can be carried forward. These types of limitations (deductibility limitations) are not addressed in this white paper.

Calculation of the NOL - generally

To the extent states conform or partially conform to federal tax law, those federal provisions will affect the computation of net operating losses and NOL carryovers. This section focuses on the basics of the federal calculation of the NOL. (Later sections address federal consolidated filing and federal limitations on the sharing of NOLs.)

Computation of the net operating loss

Under the Internal Revenue Code (IRC), when business expenses exceed operating revenues (with certain modifications), the business recognizes a net operating loss.[14] If a state decouples from any federal provisions for determining business expenses or revenue, therefore, businesses will have a different amount of net taxable income or loss for state purposes, and a different NOL.

For example: Assume Company X, which operates entirely in State A, invests in new plant and equipment in Year 1. State A has decoupled from current federal depreciation rules. For federal tax purposes, Company X reports $40M of receipts, $20M of operating expense, and $30M of depreciation expense. But for state purposes, it has only $10M of depreciation expense. In Year 1, Company X will have a federal net operating loss of $10M, but will have $10M in operating income in State A.

This type of above-the-line difference may be a timing difference, as in this example, or a permanent difference. Above-the-line differences will affect the amount of state NOL (or whether a business has a state NOL) regardless of what method of filing—separate, combined, or consolidated—the state may impose. Such differences are typically handled as in state statutes as add-backs or subtractions from the federal base and do not generally affect sharing of NOLs in a group return or limits on that sharing.

Net operating loss deduction - generally

In the past, federal NOLs would eventually expire if unused. Under the Tax Cuts and Jobs Act of 2017 (TCJA), an NOL will not expire, but the deduction in each future year is capped at 80% of net income for that year.[15] A state that decouples from these IRC § 172 rules, adopting different rules instead, will potentially allow a different amount of NOL carryover deduction each year, even if it recognizes the same amount of NOL in the loss year.

For example: Assume State A has decoupled from IRC § 172 and provides, instead, that corporations are only entitled to a 5-year NOL carryforward.

- In Year 0, Company X, operating entirely in State A, has a $10M net operating loss for both federal and state purposes.
- In the next 10 years (Years 1-10) Company X then has $1M in net income before NOL deductions.

In each of Years 1-10, Company X will have federal taxable income after NOL deductions of $200K, for a total of $2M. (It will also have $200 in NOL carryover at the end of Year 10.)

In each of Years 1-5, Company X will have $0 state taxable income after NOL deductions and then Company X's remaining NOL carryover of $5M will expire. In each of Years 6-10, Company X will have $1M in taxable income, for a total of $5M.

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[13] See Treasury Inspector General for Tax Administration, "The Internal Revenue Service Administered Corporate Net Operating Losses Efficiently and Effectively; However, Financial Reporting Could Be Improved;" Oct. 13, 2015; Reference Number: 2016-IE-R002, pp. 1-6, available here: https://www.treasury.gov/tigta/iereports/2016reports/2016IER002fr.pdf.

[14] IRC § 172(c)-(d).

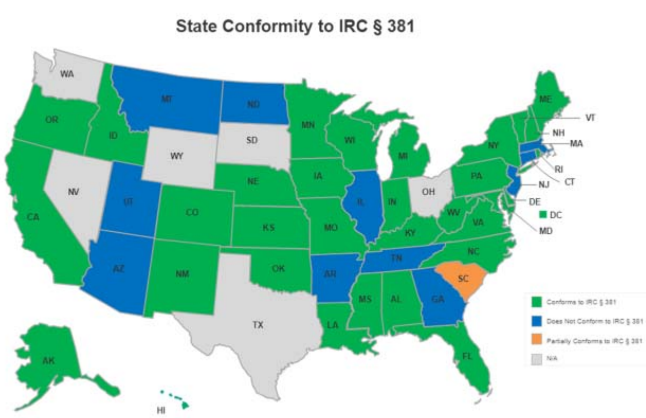
[15] IRC § 172(a)(2) and (b).

This type of difference between state and federal NOL treatment, like the previously discussed above-the-line difference, may arise in states that have decoupled from IRC § 172 provisions, regardless of the filing method used in that state. Unlike the above-the-line difference, however, a shortened state NOL carryover period may combine with a prohibition on sharing to limit the ability of group members to use their separate NOLs, as discussed in a later section of this white paper.

Succession to NOLs under IRC § 381

Under IRC § 381, a corporation that acquires the assets of another corporation in a tax-free reorganization succeeds to certain tax attributes of that corporation, including NOLs. In addition to succeeding to the transferor's NOL, the new owner may succeed to the transferor's earnings and profits, capital loss carryover, inventory valuations, and the transferor's depreciation methods for the pre-acquisition basis in the assets transferred as well as certain other accounting methods.

Some states have decoupled from IRC § 381. (See the following map as well as data in the appendix to this report.) In that case, the transferee's state NOL would have to be reduced by the amount of any federal NOL obtained from the transferee. This would presumably be true even if the transferor and transferee filed a state combined return and even if the state otherwise allowed sharing of NOLs.



Federal Consolidated Filing

Since the federal limitations on NOLs, discussed later in this report, relate, in substantial part, to the federal consolidated filing election, this section briefly summarizes how federal consolidated filing works, particularly in terms of computing the federal consolidated NOL carryover that may be used by the filing group. Note that the consolidated filing rules not only govern the determination of annual income and any group NOL, but also affect the related calculation of things like tax basis, including basis in subsidiary stock.

Consolidation and elimination

When a group of affiliated corporations elects to file a federal consolidated return, most—but not all—tax items are first computed on a separate entity basis. The NOL deduction, as discussed below, is one of the items that is, instead, determined on a consolidated basis.

The IRS rules for computing separate entity tax items and treating intercompany transactions between the consolidated group members are set out in Treasury Regulations under IRC § 1502 of the consolidated filing provisions. These regulations are very detailed. Regulation § 1.1502-13 provides rules for taking into account items of income, gain, deduction, and loss of members from intercompany transactions. The purpose of these rules is to clearly reflect the taxable income (and tax liability) of the group as a whole by preventing intercompany transactions from creating, accelerating, avoiding, or deferring consolidated taxable income (or consolidated tax liability).

The process of determining separate company tax amounts, and the consolidated group tax items based on those amounts, is sometimes referred to as "consolidation" or "elimination" of intercompany items. Recognition of the tax effects of intercompany transactions is typically deferred until some transaction involving a third party (or an event that would be a taxable event if the consolidated entities were operating as divisions of a single entity).

As part of the schedules to the consolidated return, therefore, the consolidated group members will set out their items of gross income and deductions, after eliminations determined following these regulations. These separate company amounts will then be used to calculate the consolidated tax items and group's net operating income or loss. These con-solidated schedules will be different from a separate company tax return that might be filed by the entities (discussed further in the following section).

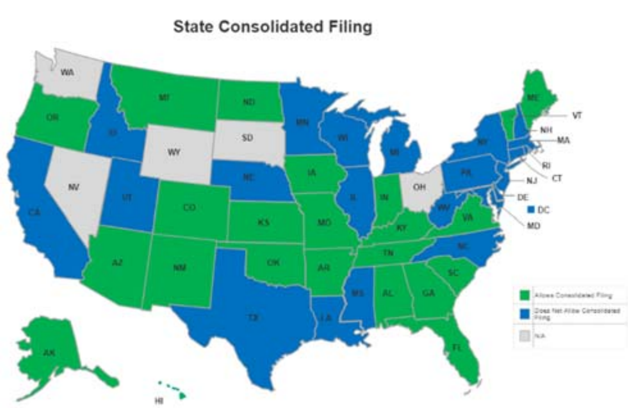
Computation of CNOLs

Some of the consolidated group's tax attributes are determined on a group basis. Consolidated net operating losses (CNOLs) are determined at this point. Regulation 1.1502-21 governs the computation of CNOLs. Consolidated filing regulations that limit the use of the CNOL are discussed in later sections.

The federal consolidated group net income or loss, before the CNOL deduction, is determined by combining the group members' separate company income and loss. Therefore, any net operating loss of the group is necessarily computed on a consolidated basis. Federal regulations also provide for tracking of NOL carryovers by entity so that limits may be applied. Those limits, discussed in later sections, apply when there is an ownership change including when an entity enters or leaves a group.

State consolidated filing elections

Some states offer an election for corporations to file as a federal-style affiliated group, generally following federal consolidated filing rules—as the map below (and data in the appendix to this report) shows.



Of course, states cannot simply require consolidated filing because such a requirement may not comply with the unitary business principle.

Separate vs. Combined Filing

This section briefly summarizes key state corporate income tax return filing concepts that may have some bearing on the use of NOLs, including use by corporations filing a group return.

Separate filing and transfer pricing

Historically, most states imposed corporate income tax on a separate company basis. Rather than deferring recognition of intercompany transactions (or eliminating them), separate entity reporting requires that each corporation recognize and report results of any intercompany transactions as though they were with unrelated parties. If the state follows IRC § 482, then the price used to value these intercompany transactions must clearly reflect income. But the proper transfer price is often a matter of vigorous debate.

While each corporation reporting on a separate company basis must recognize the effects of intercompany transactions, the intercompany revenue, expense, income, and loss of the related corporations will typically offset—that is, net to zero.

For example: Assume Company X owns Company Y. Company X charges Company Y a management fee. The following are the amounts of income and expense that Companies X and Y would report if filing on a separate company versus a combined (or consolidated) basis:

	Separate	Combined
Company X		
Receipts	$ 100M	$ 100M
Mgt. Fee Rev.	10M	
Expenses	90M	90M
Income/Loss	$ 20M	
Company Y		
Receipts	$ 100M	$ 100M
Expenses	120M	120M
Mgt. Fee Exp.	10M	
Income/Loss	($ 30M)	
Total Income/Loss	($ 10M)	($ 10M)

The fact that total net income or loss of the related corporations is the same, whether the separate company amounts are netted, or the companies file a combined return, however, does not mean the state-*apportioned* income or loss will be the same on a separate company basis. The difference can, and often is, substantial.

For example: Take Company X and Company Y above. Assume Company X operates entirely in State A and Company Y operates entirely in State B. If States A and B impose separate corporate filing, State A will have taxable income of $20M from Company X and State B will have an NOL of $30M from Company Y. Assuming that the apportionment factors for Company X and Company Y are relatively equal, if X and Y filed combined returns in both states, half of the $10M combined loss would be apportioned to each state.

Unitary business principle - combined filing

It is exceedingly difficult to accurately assign income and expense between related corporations that engage in a unitary business. Separate company tax filing typically requires the recognition of intercompany transactions that may look like or take the place of transactions that would occur between unrelated parties, as well as the use of complex transfer-pricing rules to properly value those transactions. Corporate structures and intercompany transactions, however, can be created solely for the purpose of income shifting or apportionment factor dilution, as part of strategies to lower state taxes.

But even if intercompany transactions could be properly recognized and valued, there are also important inter-company flows of value that occur in a unitary business which cannot be captured or reflected under general federal tax recognition rules. For example, a subsidiary of a profitable parent may engage in greater risks, with greater payoff, than a similarly sized company operating on its own because the subsidiary's parent can provide support for such risk-taking.

The unitary business principle allows states to effectively ignore the often artificial corporate structures that make up a single integrated enterprise, and any intercompany transactions or flows of value, and instead compute net income or loss for the business as a whole. It thus avoids both the artificial nature of separate entity reporting and the problems of transfer pricing and potential abuse.

It is for these reasons that the MTC has long recommended to states that they adopt combined filing under the unitary business principle as a more accurate method of determining income of an integrated business which may be conducted by related entities. Under the unitary business principle, the income or loss of unitary entities is determined as if those entities were a single corporation.

Both Joyce and Finnigan combined filing states start with the combined group income or loss and then allocate and apportion that income or loss. The differences between Joyce and Finnigan states and the apportionment methods typically used are discussed further below.

Allocation & Apportionment

States must allocate and apportion income of multistate businesses. Like the principles underlying combined filing, the approach to allocation and apportionment of income has important implications for the treatment of NOL carryovers. This section briefly summarizes the approaches to allocation and apportionment that are relevant to our analysis.

Joyce versus Finnigan

As noted in the introduction, in apportioning income or loss of a unitary business, states typically follow one of two general rules—Joyce or Finnigan. The Briefing Book prepared for the project describes the difference between the Joyce and Finnigan rules in detail.[16] There are differences between states, even if they follow the same rule. But for our purposes, it is sufficient to note that, while both methods start with the income and loss of the unitary business, that income or loss may be apportioned differently under each rule.

[16] See supra note 2.

To comply with Joyce, a state typically uses what this paper refers to as separate-entity apportionment to apportion group income or loss. Under Finnigan, states can, and some do, use a single-entity (combined) apportionment approach. The difference between the separate-entity and single-entity apportionment approaches, as they pertain to treatment of NOLs, is discussed in a later part of this section.

Apportionable / nonapportionable income

In determining how much of a unitary business's income or loss a state may tax, items of income, gain, expense, or loss may be treated differently depending on whether or not those items are generated as part of the unitary business.

Under the MTC uniform recommendations, adopted in 2014, which amend Compact, Art. IV (UDITPA), apportionable income is defined, in part, as follows:

> "all income that is apportionable under the Constitution of the United States and is not allocated under the laws of this state . . . and any income that would be allocable to this state under the Constitution of the United States, but that is apportioned rather than allocated pursuant to the laws of this state."[17]

Nonapportionable income is, simply, all other income.

Timing of allocation and apportionment

Rules under Art. IV (UDITPA) address how nonapportionable income (or loss) will be attributed or "sourced" to a state. Nonapportionable income is typically a discrete item of income, gain, loss, and/or deduction, and is deemed to be nonapportionable because of its character and the nature of its source. The sourcing of that income is, therefore, generally fixed and unlikely to vary, regardless of the timing of its recognition for tax purposes.

But this is not true for apportionable income. The amount of apportionable income or loss attributed to a state is determined by applying the apportionment formula to the total amount of that income or loss in the year that the income or loss is recognized. What is important for our purposes is that apportionment factors can change over time. The apportionment factors in years other than the year of recognition, however, do not matter, even though events occurring in these other years may have an important bearing on the resulting income or loss.

Example 1: Assume Company X spends two years developing a new product at its facility in State A, where it has significant property and payroll. In Years 1 and 2, Company X has net operating losses, reflecting the investment in product development. In Year 3, before production of the product begins, Company X decides to shift all its property and payroll from State A to its production facilities in State B. In Year 3, production begins in State B and sales are made throughout the country, resulting in a significant profit (exceeding the NOLs). Company X may apportion much of its losses in Years 1 and 2 to State A, but very little of its income in Year 3.

Pre- versus post-apportioned NOL carryover

Recognizing that a business's apportionment factors in a state may vary year-to-year, the question naturally arises as to how the available amount of an NOL carryover should be calculated. Should that NOL carryover reflect the apportionment factors in the year in which the loss was generated, or the year in which the loss is used?

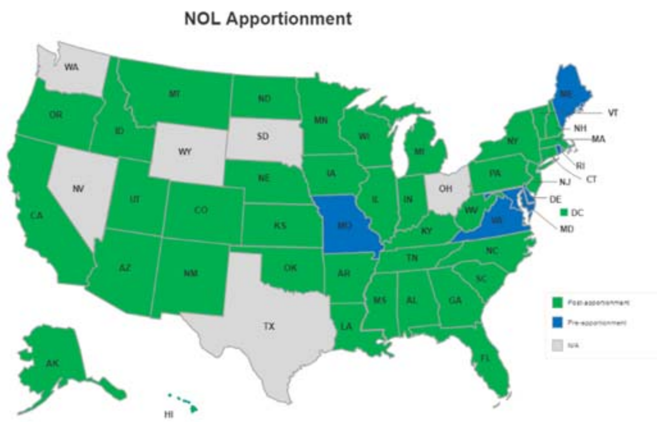
For example: Take the example discussed above. State A might calculate the NOL carryover available by simply adding the post-apportionment losses from Years 1 and 2. But State A could also calculate the available NOL on what is referred to as a pre-apportionment basis. One way to do this is by simply apportioning net income after the NOL deduction, effectively subjecting the NOL to apportionment in the year it is used.

In this example, State A would tax a greater share of Company X's income using a pre-apportionment approach, since Company X had relatively higher factors in its loss years. But the result could just as easily go the other way (if Company X had done its

[17] See Article IV Amendments Approved by the Multistate Tax Commission, July 30, 2014, available here: http://www.mtc.gov/getattachment/Uniformity/Project-Teams/Section-1-Model-Definition-of-Receipts%E2%80%9D-Regulation/ARTICLE-IV-AMENDMENTS-July-2014-Clean.pdf.aspx.

product-development at facilities outside State A, in the loss years, and had then moved those resources to production facilities in State A in the income year).

The map below (and data in the appendix) reflect whether states use a pre- or post- apportionment approach to calculating state NOL carryovers.



Note that the majority of states now use post-apportionment. This method has the advantage of automatically excluding nonapportinable losses not allocated to the state (discussed further below). Therefore, the remainder of this paper generally assumes that states follow the post-apportionment method of determining the amount of NOL carryover available for use. The draft Finnigan model also follows the post-apportionment approach.

Treatment of nonapportionable losses

In order to tax nonapportionable or nonbusiness income (as defined by the MTC model amendments to Compact, Art. IV, summarized above), consistent with the Constitution, states must have some connection with the source of that income. But states are not constitutionally prohibited from giving a deduction, if they choose to, for nonapportionable losses that may be part of an NOL carryover, even if those losses were allocated to another state.

The tracking of the use of nonapportionable losses is, therefore, also a consideration in calculating the NOL available for use in a particular state. But it is important to note that nonapportionable losses are seldom ordinary losses. Instead, they are generally capital losses. If the loss is a capital loss, its use would be treated differently, and would be subject to different limitations, under federal rules and by states that conform to those rules. (The 2006 model and the draft Finnigan model also treat such losses separately from the NOL.)

Nevertheless, it has been suggested that because some portion of NOLs may be nonapportionable operating losses, states should not allow sharing of NOLs. There are two problems with this argument, even assuming that some portion of the NOL is derived from a nonapportionable (ordinary) loss rather than a capital loss.

First, assuming the state uses the post-apportionment approach to calculate the NOL carryover for that state, then the NOL carryover for that state will include only the amount of the nonapportionable loss that was allocated to that state in the year the loss was recognized. In other words, a post-apportionment approach automatically excludes any nonapportionable loss if that loss was allocated to another state in the year recognized.

The second problem with the argument that sharing of NOLs should not be allowed in order to prevent the sharing of nonapportionable NOLs is that neither the definition of nonapportionable income (loss), nor in the sourcing rules, depend on whether the nonapportionable loss was generated in a single corporation or a group. Nonapportionable income or loss is simply, by definition, income or loss that does not result from the unitary business, regardless of whether that income or loss was generated by the same entity that recognized the business income or by a related entity.

While there appears to be no basis for the concern that sharing of NOLs generally will lead to inappropriate sharing of nonapportionable losses, there is an argument to be made that any nonapportionable loss that is included in an NOL and allocated to the state should be limited in its use to offsetting income that is derived from the same nonbusiness source. But the logic behind such a limitation would apply whether the state allows or requires separate company or combined filing and regardless of whether it allows sharing of NOLs under combined filing.

Separate- vs. Single-Entity Apportionment

As discussed briefly above, combined filing states may apportion combined income either on a single-entity or separate-entity basis. Joyce states often use some form of separate-entity apportionment in order to determine the income or loss by entity. The 2006 model, which follows Joyce, also uses separate-entity apportionment. Some Finnigan states use a form of separate-entity apportionment (or attribution) as well, whereas others use single-entity apportionment. This section looks at differences between separate-entity and single-entity apportionment methods.

Apportionment method does not dictate sharing or limits on sharing

Just as Joyce states may allow sharing of NOLs and Finnigan states may attribute group NOLs to particular members and restrict sharing, the use of separate- versus single-entity apportionment, alone, does not dictate whether NOL carryovers may be shared between group members. More importantly, allowing the use of a group NOL or the sharing of NOLs does not prevent states from imposing limits when group membership changes, or for other important reasons.

But what may be needed for this purpose is a means of tracking group NOLs by member. States can use separate-entity apportionment for tracking purposes, while also allowing sharing. But there are other means of tracking group NOLs by member. As discussed in later sections, the federal rules take a different approach to this tracking and attribute consolidated NOLs to individual corporations within the group based on their separate corporate losses.

Furthermore, the use of single-entity apportionment, without NOL sharing, by itself, does not impose the same limit on the use of NOLs found under federal law. In particular, under IRC § 382, discussed further below, the use of an NOL of a company that has a change in ownership is subject to a fairly significant limitation.

The use of single-entity apportionment, without NOL sharing, however, does impose another inherent but not-so-obvious limit on the use of NOLs when the relative apportionment factors of group members change. This is inherent limit is illustrated in the following section.

Inherent limit imposed by single-entity apportionment, without NOL sharing

As discussed above, apportionment factors for a business may change over time for a host of reasons. This is important for understanding the inherent limit imposed by the use of the separate-entity apportionment approach, without NOL sharing (what this section will abbreviate as *separate-entity/no sharing*). Variation in apportionment factors over time will also cause variations in the members' relative proportion of the group's instate apportionment factor.

Take the traditional integrated production business —Manufacturer, Wholesaler, Retailer. Assume that while much of the sales of Manufacturer are inter-company, it also has a small number of very large third-party customers that may buy its products directly. If one of these larger customers is in a particular state, fluctuations in the orders from that customer, year-to-year, will cause a variation in the relative proportions of the instate receipts factors for Manufacturer, Wholesaler, and Retailer. In essence, when one member's factors change, for any reason, the members' relative proportions of the group's instate factor will also change.

When group members' relative proportions of the group in-state apportionment factor remain the same (regardless of whether the group in-state factor itself goes up or down) there will be no difference in NOL use between separate-entity /no sharing and single-entity apportionment with sharing of NOLs. But when the members' relative proportions of the group in-state apportionment factor change, separate-entity /no sharing may limit the NOL that can be used. This limit appears to be fairly arbitrary as the comprehensive example below illustrates.

Comprehensive example -

Assume Company X and Company Y are a unitary group operating partly in State A, which uses a single receipts factor apportionment formula.

Year 1 Income and Loss – Separate Company

Company X

Receipts	$ 100M
Intercompany Charges	20M
Expenses	(100M)
Nonapportionable Loss	(10M)
Net Income	$ 10M

Company Y

Receipts	$ 100M
Expenses	(120M)
Intercompany Charges	(20M)
Net operating loss	$ (40M)

Non-Intercompany Receipts in State A

Company X in-state receipts	$ 20M
Company Y in-state receipts	$ 80M
Total in-state receipts	$100M
Total everywhere receipts	$200M

State A Receipts Factor

Company X =	$20M/$200M = 10%
Company Y =	$80M/$200M = 40%
Total XY Factor =	$100M/$200M = 50%

Note that the Company X's proportional share of the group in-state factor is 20% and Company Y's proportional share is 80%.

The combined apportionable net operating loss of Group XY in Year 1, after eliminations and excluding X's nonapportionable loss, would be $20M. The separate-entity apportionment of that group loss is calculated below.

Separate-Entity Apportionment of Group Loss

Company X =	($20M)
	X 10%
	= ($2M)
Company Y =	($20M)
	X 40%
	= ($8M)
Total Apportioned Loss	($10M)

If single-entity apportionment is used to apportion this loss the result is as follows:

Single-Entity Apportionment of Group Loss

Group XY =	($ 20M)
	X 50%
	=($10M)

Note also that if State A required Company X and Company Y to filed separate company tax returns (instead of on a combined basis) the intercompany transactions would be recognized and, X would report net apportionable *income* of $20M and Y would report a net *loss* of $40M. After apportionment, State A would have $4M of apportioned income from Company X and $32M of loss from Company Y.

But combined reporting, even when using separate-entity apportionment, results in both entities recognizing some portion of the *group loss*. This is would be true even if the companies had no intercompany charges. It would also be true regardless of whether State A allows sharing of NOL carryovers. This is a fundamental difference between separate company filing and separate-entity apportionment of group income or loss.

Also, the total resulting apportioned income or loss under separate-entity / no sharing and single-entity apportionment with sharing will be the same in the tax year in which any loss is recognized. The difference between the two methods comes into play when NOLs are carried forward and used.

To illustrate that difference, consider two alternative scenarios for Year 2 – below.

Year 2 – Scenario 1

Assume that in Year 2, the companies have combined apportionable income of $40M, which exceeds the total apportionable loss in Year 1 by $20M.

But assume that in Year 2, while the companies still have $200M of combined everywhere receipts, their in-state receipts go down from Year 1, as follows:

Year 2 - Non-Intercompany Receipts in State A

Company X in-state receipts	$ 10M
Company Y in-state receipts	$ 40M
Total in-state receipts	$ 50M
Total everywhere receipts	$200M

Note that while both companies in-state receipts have gone down, as has the group's in-state receipts, their relative proportions of the group in-state receipts factor remain the same.

Year 2 - State A Receipts Factor

Company X =	$10M/$200M = 5%
Company Y =	$40M/$200M = 20%
Total XY Factor =	$50M/$200M = 25%

What is important here is that, as in Year 1, Company X's proportional share of the group factor is 20% and Company Y's proportional share is 80%.

The result of apportioning the $40M of combined income in Year 2 on a separate-entity basis, and then providing for a post-apportionment NOL deduction, without NOL sharing, is that the NOL carryover for both entities is used up in offsetting Year 2 income:

Year 2 - Scenario 1 – NOL Deduction & Carryover

Company X:

Year 2 Income	5% X $40M =	$ 2M
NOL Carryover/Deduction		(2M)
Income after NOL Deduction		$ 0

Company Y:

Year 2 Income	20% X $40M =	$ 8M
NOL Carryover/Deduction		(8M)
Income after NOL Deduction		$ 0
Total Income after NOL Ded.		$ 0

The result of apportioning the Year 2 income on a single-entity basis, effectively allowing the sharing of the Year 1 NOL, is the same:

Group XY:

Year 2 Income	25% X $40M =	$ 10M
NOL Deduction		(10M)
Income after NOL Deduction		$ 0

Year 2 – Scenario 2

But unlike Scenario 1, the result of using single-entity /no sharing and using separate-entity apportionment with sharing may not be the same if the group members' relative proportions of the group in-state apportionment factor changes from Year 1 to Year 2. This is the not-so-obvious limit that may be imposed by separate-entity apportionment, when no NOL sharing is allowed.

Assume that in Year 2, the apportionable income is the same - $40M. But also assume that while the companies' total everywhere receipts are the same as Year 1 (and Scenario 1), the separate company in-state receipts and receipts factors from Year 1 are simply switched.

Company X in-state receipts	$ 40M
Company Y in-state receipts	$ 10M
Total in-state receipts	$ 50M
Total everywhere receipts	$200M

Now, Company X's share of the group factor is 80% (instead of 20% as in Year 1) and Company Y's share is 20% (instead of 80% as in Year 1).

If State A used single-entity apportionment, then, again, the NOL is effectively shared, and it will be entirely used up against income.

Year 2 - Scenario 2 – Single-Entity Result

Group XY:

Year 2 Income	50% X $40M =	$ 20M
NOL Deduction		(10M)
Income after NOL Deduction		$ 10M
Remaining NOL Carryover		$ 0

But apportioning the $40M of combined income in Year 2 using the separate-entity approach is now:

Company X = 40% X $40M = $ 16M
Company Y = 10% X $40M = $ 4M

This, in turn, effects the use of the NOL from Year 1.

Year 2 - Scenario 2 – Separate-Entity /No Sharing

Company X:

Year 2 income	$ 16M
Year 1 NOL	(2M)
Income after NOL deduction	$ 14M

Company Y:

Year 2 income	$ 4M
Year 1 NOL	(8M)
Income after NOL deduction	$0

Total income after NOL deduction	$ 14M
Remaining NOL carryover (Company Y)	$ 4M

In contrast to Scenario 1, where the member's relative proportions of the group in-state factor were unchanged, allowing both to use up the NOL, here, the available NOL carryover for Company Y in Scenario 2 exceeds the separate-entity apportioned income in the later year—effectively limiting use of the NOL.

Not only is the result in Scenario 2 not due to any change in the unitary business's in-state apportionment factor, it is also not attributable to entities coming into or leaving the group. Further, if the loss in Year 1 were smaller, or the income in Year 2 larger, or the change in the member's relative proportions of the in-state factor less substantial, the NOL might still have been deductible in total by both companies, even without sharing. The limit that results from separate-entity /no sharing is essentially arbitrary.

Also note that using the separate-entity /no sharing approach means that when there are variations in the member's relative proportions of the group in-state factor, the NOL deduction allowed may be less, but never more, compared with the single-entity apportionment / sharing approach. This is because NOL deductions are always limited by the amount of income in the year used.

Moreover, as noted above, some states have shortened NOL carryover periods. To the extent NOLs may expire, applying the single-entity /no sharing approach may also result in more income being subjected to tax over time. The actual results, however, will vary greatly depending upon the specific circumstances.

Can necessary limits on NOLs be imposed without this effect?

The advantage of using the separate-entity apportionment/ no sharing approach, is that the group NOL carryover amounts are automatically tracked group member, year-to-year, which can facilitate determining what portion of an NOL is attributed to an entity in the event that it enters or leaves a group. The disadvantage of using this approach, as the preceding section demonstrates, is that it can result in a fairly arbitrary limit even when the group members remain the same.

It is not necessary to prohibit any sharing of NOLs in order to effectively track the NOL carryover by entity. Nor does imposing such tracking increase the compliance burden (although it does not lessen that burden, either). The following section discusses the need for tracking of NOLs by group member.

On the next pages are a table and a map showing which states follow the Finnigan or Joyce approach, and whether the state allows sharing of NOLs under either consolidated or combined filing.

Note – This table shows only whether sharing is permitted to any degree (following most current law). It does not show limits that may be imposed on sharing. Even states that allow sharing may require that NOLs be tracked by entity for the purpose of applying limitations.

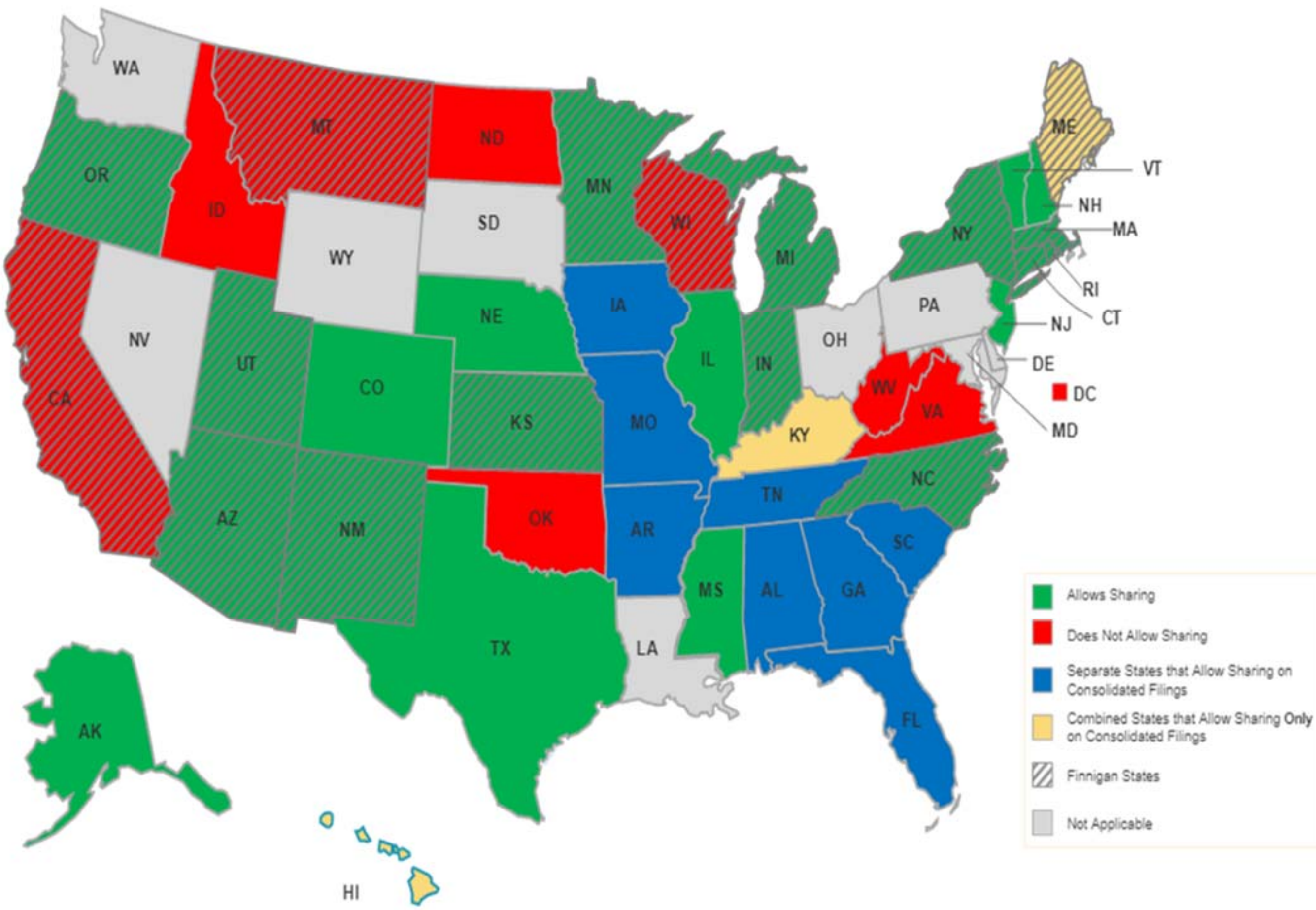
Key:

- 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	Yes	Finnigan	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	N/A	N/A	N/A	N/A	N/A
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

The map below illustrates this data:



Tracking of NOLs for the Purpose of Limiting Sharing

If sharing is allowed, but limitations are to be imposed in order to avoid duplicate deductions, trafficking in losses, or potential abuse, then NOLs will still have to be tracked by group member. There are two general methods for tracking losses.

The first, as discussed in detail in the prior section, is the single-entity apportionment method. When this method is used solely for tracking NOLs, it will not impose the inherent limit discussed above when members of the group do not change, but their relative apportionment factors do. It will, however, provide a separate-entity amount of NOL carryover that may be used in applying other necessary limits on NOL use.

The second method of tracking losses is by attribution based on separate company amounts, typically after eliminations. This is the method generally used for federal purposes.[18]

Comprehensive Example

Assume the following:

Year 1 –

Company X income/loss	($ 20M)
Company Y income/loss	($ 80M)
Group income/loss	($100M)

In-state factors:	
Company X	10%
Company Y	40%
Group	50%

Year 2 –

Company X income/loss	$ 10M
Company Y income/loss	$ 70M
Group income/loss	$ 80M

In-state factors:	
Company X	40%
Company Y	10%
Group	50%

Separate-entity apportionment method of tracking:

Year 1 in-state NOL by entity is computed:

Company X = ($100M) X 10% =	($10M)
Company Y = ($100M) X 40% =	($40M)
Total NOL	($50M)

Year 2 in-state income by entity is computed:

Company X = $80M X 40% =	$ 32M
Company Y = $80M X 10% =	$ 8M
Total Income	$ 40M

Year 2 Income after NOL deduction before sharing:

Company X income	$ 32M
Company X NOL	$ 10M
Income after NOL deduction	$ 22M

Company Y income	$ 8M
Company Y NOL	$ 40M
Income after NOL deduction	$ 0
NOL remaining	$ 32M

Year 2 Income with sharing:

Company X income remaining	$ 22M
Company Y NOL remaining	$ 32M
Group income	$ 0
Company Y NOL carryover	$ 10M

[18] See Reg. §1.1502-21(b)(2)(iv).

Attribution – based on separate income/loss

Instead of using separate-entity apportionment to track the loss, the group's apportionable loss, and its use, may be attributed to those group members on the basis of separate company amounts of apportionable income and loss, after eliminations.

Assuming the same facts as above, in Year 1, the in-state apportioned group NOL of $50M would be attributed to Company X and Company Y as follows:

Company X's share of the total NOL

Company X's loss	$ 20M
Total loss	$100M
Pro-rata share	20%
Share of $50 group state NOL	$ 10M

Company Y's share of the total NOL

Company Y's loss	$ 80M
Total loss	$100M
Pro-rata share	80%
Share of $50 group state NOL	$ 40M

In Year 2, these losses would also be deemed to be used against income on a pro-rata basis, as follows:

Year 2 group in-state income	$ 40M
Company X's pro-rata share	$ 8M
Company Y's pro-rata share	$ 32M

Therefore, at the end of Year 2 the companies would have the following NOL carryovers:

Company X Year 1 NOL	$ 10M
Company X's use in Year 2	$ 8M
Company X NOL carryover	$ 2M
Company Y Year 1 NOL	$ 40M
Company Y's use in Year 2	$ 32M
Company Y's NOL carryover	$ 8M

Total NOL carryover in Year 2 would be the same under both tracking methods - $10M, but would be attributed to the entities differently.

Also note that in a more complex set of facts, involving multiple entities with multiple losses over multiple years, the ordering rules for tracking of loss creation and use by group members would also come into play. Under various IRC provisions, the ordering is generally assumed to be first-created, first-used. If multiple group members have losses created in the same year, used in later years, they are deemed to be used on a pro-rata basis. Also, NOLs subject to limitation are deemed to be used first.[19]

NOL tracking methods

The results of the two tracking methods are not only different from each other, but the result of the separate-entity apportionment method might also be different depending on whether, and to what extent, the members' relative proportions of the group's instate apportionment factor change year-to-year. In contrast, the result of the attribution method (based on separate income/loss) would not change depending upon any shift in the relative apportionment factors among the group members.

Impact of tracking method on different types of NOL limits

There are multiple ways in which sharing of NOLs may be limited. Depending on the type of limits, how NOLs are tracked may or may not matter. Consider three different (among many) limitation regimes:

Limitation Regime No. 1: State A never allows sharing of NOLs by separate corporations, but it imposes no other limitation on the use of an NOL even if the corporation's ownership or group membership changes. In that event, rather than tracking the NOL by member, State A will not compute a group NOL or allow use of that NOL against group income. Instead, it will likely use the separate-entity apportionment/ no sharing approach described in the prior section of this white paper.

But note, while this regime may address potential duplication of NOLs, it may not provide sufficient safeguards against trafficking of NOLs. Consider a company with a large instate NOL. If it is acquired by

[19] See IRC §§ 172 and 382 and related regulations as well as various consolidated filing regulations including Reg. §1.1502-15(a) and §1.1502-21(c)(1)(ii).

a group with significant income, also apportioned to the state, it will be apportioned some of that group income and will be able to use its NOL against that income without any other limits.

Limitation Regime No. 2: State A allows sharing among group members, but if a corporation joins or leaves a group, it cannot bring in or take out any amount of NOL. Under this regime, it would not be necessary to track the group NOL by separate entity or attribute any of that NOL's use to particular entities. This regime would address both duplication and trafficking. However, it would not be possible to apply the IRC § 382 limitation under this regime (since that limitation looks to the NOL of the company that has had an ownership change).

Limitation Regime No. 3: State A allows sharing, but imposes limitations similar to federal limitations discussed further below. This regime would require tracking of NOLs by entity using some method. Using a method similar to the federal method would likely create fewer potential conflicts in the application of the federal limitations.

Federal NOL Limitations

The draft Finnigan model provisions addressing NOLs (set out on page 6 of this white paper) impose limitations on the use and sharing of NOLs that rely, in part, on the federal limitations imposed on NOL sharing.

As discussed above, the federal consolidated filing rules allow computation of a consolidated net operating loss (CNOL) carryover—which can be used by the consolidated filing group to offset consolidated net income. The losses making up the CNOL are also tracked on an entity basis (using the attribution method described above) so that sharing of the CNOL can be limited (e.g. if a member leaves the group).

The federal limitations on the sharing of NOL deductions were summarized in the staff memos prepared as part of the project.[20] The following sections describe these federal limitations in somewhat more detail. First, however, the general rationale for adopting these provisions as part of the draft Finnigan model is summarized.

Use of federal limitations as part of the draft model NOL provisions

The rationale for adopting federal-style limitations is four-fold. First, the federal rules are extremely detailed and anticipate a host of situations in which corporate acquisition, merger, or restructuring could lead to questions concerning the availability of NOL carryovers or limitations on their use or sharing. The rules also coordinate, to the extent necessary, other IRC provisions and the treatment of other related tax attributes such as basis in assets and built-in losses, capital loss carryovers, basis in subsidiary stock, etc.

Second, while these rules are fairly complex, and while the SRLY rules specifically apply in the context of the federal consolidated filing regime, these federal rules can also be applied at the state level in the context of the combined filing group. In many cases, the analysis required by the federal rules (e.g. to determine if there is an ownership change under IRC § 382) will have to be done for federal tax filing purposes—so that the additional analysis needed for state purposes may not significantly increase the compliance burden.

Third, as with federal conformity generally, states may be able to rely on IRS audits or other review procedures to enforce state tax requirements. So if it is determined, for example, that SRLY limitations apply to the federal NOL, that same analysis may support applying the limitation for state purposes.

Fourth, as noted previously in this white paper, states that allow federal-style consolidated filing typically follow federal consolidated filing rules for sharing of NOLs and would also need to apply federal limitations on that sharing. For these states, applying significantly different NOL sharing limitations in the context of combined filing might tend to affect the choice of filing method and might create further complications when corporations leave or join groups or when groups change their filing method election.

[20] See supra note 3.

Nevertheless, there are drawbacks to relying on federal limitations. First, such limitations can change. Second, the application of the methods in the context of state tax regimes may raise issues that lack clear answers. Third, there are simpler methods of limiting the use of NOLs when groups change—including simply providing that no state NOL can be brought into or taken out of the group.

Federal limitations - generally

The three main sources of federal NOL limitations are federal provisions designed to prevent trafficking in losses, primarily § 382, the consolidated filing regulations which set out so-called SRLY limitations, and provisions that are intended to prevent abuse, primarily IRC § 269 (not covered here).

The SRLY rules overlap with the limitations under IRC § 382 which impose very strict limits, discussed below. The IRS has, therefore, adopted rules to address this overlap that indicate which limitation applies first (discussed further below). In general, in any overlap situation, IRC § 382 rules, which are designed to prevent trafficking in NOLs, will apply.[21]

Sec. 382 limitations - generally

The provisions limiting the ability to use a loss carryover after an ownership change are set out in IRC § 382 and the regulations under that section. These rules are exceptionally detailed, and as noted above, serve to coordinate the limitations with other related federal tax provisions, including limitations on the use of built-in losses and the treatment of built-in gains. The limitations also now apply to the TCJA's creation of an interest expense carryover related to IRC § 163(j)'s annual limitation on interest expense deductions.

Sec. 382 applies to a "loss corporation." A "loss corporation" may also be a group of related entities. A loss corporation (or group) is one that has an NOL carryover, a capital loss carryover, or certain tax credit carry-forwards, 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 under IRC 163(j).

The IRC § 382 limitation not only applies to the use of NOL carryovers, but also to the use of certain built-in losses that might be recognized by the corporation after an ownership change. IRC § 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.

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 general, if an ownership change occurs, the amount of the loss corporation's NOL carryover will not change but it will be limited in its use to an amount that equals the value of the corporation times the long-term tax-exempt interest rate. Currently that rate is about 1.9%.

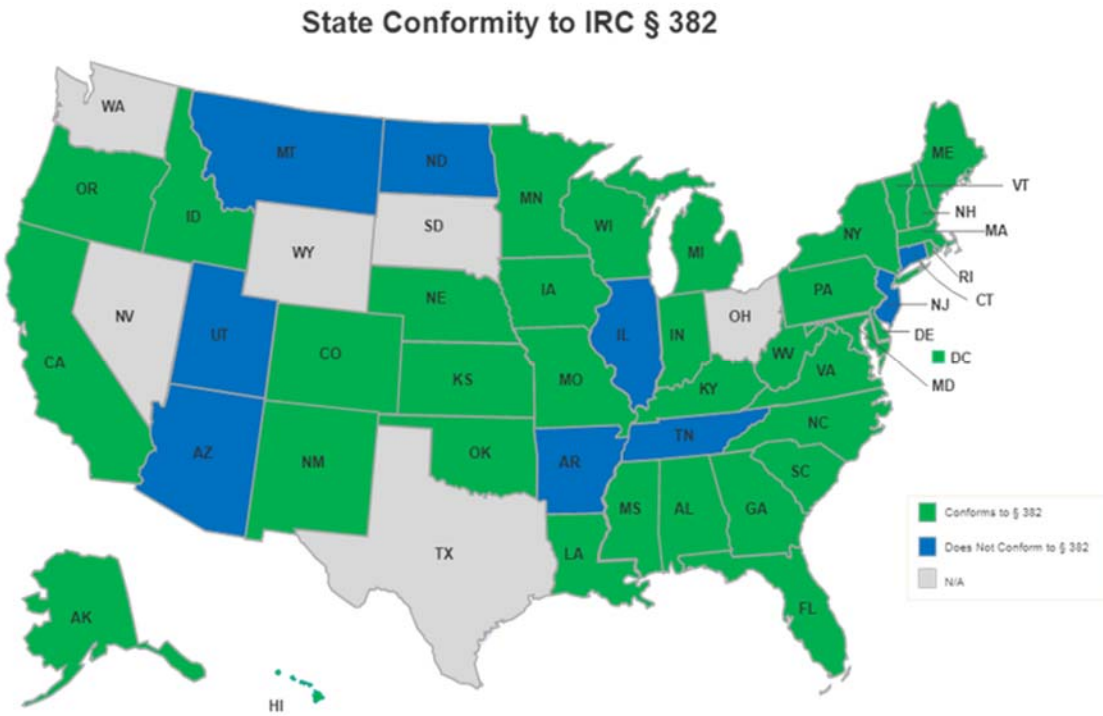
For example: Assume a corporation has an NOL of $10 million when the § 382 limitation is triggered. Also assume the corporation is valued at $100 million. It would not be able to use more than $1.9 million of NOL in any particular post-change year, regardless of how much taxable income it might have in that year.

As with all aspects of the federal NOL limitation rules, the rules concerning the calculation of the loss corporation's value are detailed and they take into account all manner of circumstances that may affect the proper valuation of that corporation's stock.

In addition, for any portion of the NOL carryover 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.

[21] See Regulation 1.1502-94.

The map below (and the data in the appendix) shows states that conform to IRC § 382. Note that these states may also impose additional limitations on the carryover of NOLs into a combined group:



On the following pages, excerpts of IRC § 382 are set out with highlights and comments. The purpose here is not to provide an in-depth analysis of all the provisions of § 382 but to focus on the general framework of the rules.

IRC 382

(a) General Rule — The amount of the taxable income of any new loss corporation for any post-change year which may be offset by pre-change losses shall not exceed the section 382 limitation for such year.

(b) Section 382 Limitation — For purposes of this section—

(1)In General — Except as otherwise provided in this section, the section 382 limitation for any post-change year is an amount equal to—

(A) — the value of the old loss corporation, multiplied by

(B) — the long-term tax-exempt rate.

(2) Carryforward of Unused Limitation — If the section 382 limitation for any post-change year exceeds the taxable income of the new loss corporation for such year which was offset by pre-change losses, the section 382 limitation for the next post-change year shall be increased by the amount of such excess.

(3) Special Rule for Post-Change Year Which Includes Change Date —

. . .

(c) Carryforwards Disallowed if Continuity of Business Requirements Not Met

(1) In General — Except as provided in paragraph (2), if the new loss corporation does not continue the business enterprise of the old loss corporation at all times during the 2-year period beginning on the change date, the section 382 limitation for any post-change year shall be zero.

(2) Exception for Certain Gains — The section 382 limitation for any post-change year shall not be less than the sum of—

(A) — any increase in such limitation under—

(i) — subsection (h)(1)(A) for recognized built-in gains for such year, and

(ii) — subsection (h)(1)(C) for gain recognized by reason of an election under section 338, plus

(B) — any increase in such limitation under subsection (b)(2) for amounts described in subparagraph (A) which are carried forward to such year.

(d) Pre-Change Loss and Post-Change Year — For purposes of this section—

(1) Pre-Change Loss — The term "pre-change loss" means—

(A) — any net operating loss carryforward of the old loss corporation to the taxable year ending with the ownership change or in which the change date occurs, and

(B) — the net operating loss of the old loss corporation for the taxable year in which the ownership change occurs to the extent such loss is allocable to the period in such year on or before the change date.

. . .

(2) Post-Change Year — The term "post-change year" means any taxable year ending after the change date.

(3) Application to Carryforward of Disallowed Interest — The term "pre-change loss" shall include any carryover of disallowed interest described in section 163(j)(2) under rules similar to the rules of paragraph (1).

(e) Value of Old Loss Corporation — For purposes of this section—

(1) In General — Except as otherwise provided in this subsection, the value of the old loss corporation is the value of the stock of such corporation (including any stock described in section 1504(a)(4)) immediately before the owner-ship change.

(2) Special Rule in the Case of Redemption or Other Corporate Contraction —

. . .

(f) Long-Term Tax-Exempt Rate — For purposes of this section—

(1) In General — The long-term tax-exempt rate shall be the highest of the adjusted Federal long-term rates in effect for any month in the 3-calendar-month period ending with the calendar month in which the change date occurs.

. . .

The limitation imposed by § 382 does not reduce the NOL carryforward but, instead, limits the amount that can be used following a change in

The long-term tax-exempt rate fluctuates but is generally around 2-3%.

In addition to the limit above, this requirement also ensures that a loss company is not acquired simply for its loss.

(g) Ownership Change — For purposes of this section—

(1) In General — There is an ownership change if, immediately after any owner shift involving a 5-percent shareholder or any equity structure shift--

(A) — the percentage of the stock of the loss corporation owned by 1 or more 5-percent shareholders has increased by more than 50 percentage points, over

(B) — the lowest percentage of stock of the loss corporation (or any predecessor corporation) owned by such shareholders at any time during the testing period.

An ownership change need not be a 100% change in the corporation's owner but merely a substantial change in the ownership of any 5% shareholder.

(2) Owner Shift Involving 5-Percent Shareholder — There is an owner shift involving a 5-percent shareholder if—

(A) — there is any change in the respective ownership of stock of a corporation, and

(B) — such change affects the percentage of stock of such corp-oration owned by any person who is a 5-percent shareholder before or after such change.

(3) Equity Structure Shift Defined

(A) In General — The term "equity structure shift" means any reorganization (within the meaning of section 368). Such term shall not include—

(i) — any reorganization described in subparagraph (D) or (G) of section 368(a)(1) unless the requirements of section 354(b)(1) are met, and

(ii) — any reorganization described in subparagraph (F) of section 368(a)(1).

(B) Taxable Reorganization-Type Transactions, Etc. — To the extent provided in regulations, the term "equity structure shift" includes taxable reorganization-type transactions, public offerings, and similar transactions.

(4) Special Rules for Application of Subsection

. . .

(h) Special Rules for Built-In Gains and Losses and Section 338 Gains — For purposes of this section—

. . .

(i) Testing Period — For purposes of this section—

(1) 3-Year Period — Except as otherwise provided in this section, the testing period is the 3-year period ending on the day of any owner shift involving a 5-percent shareholder or equity structure shift.

(2) Shorter Period Where There Has Been Recent Ownership Change — If there has been an ownership change under this section, the testing period for determining whether a 2nd ownership change has occurred shall not begin before the 1st day following the change date for such earlier ownership change.

(3) Shorter Period Where All Losses Arise After 3-Year Period Begins —

. . .

(j) Change Date — For purposes of this section, the change date is—

. . .

(k) Definitions and Special Rules — For purposes of this section—

(1) Loss Corporation — The term "loss corporation" means a corporation entitled to use a net operating loss carryover or having a net operating loss for the taxable year in which the ownership change occurs. Such term shall include any corporation entitled to use a carryforward of disallowed interest described in section 381(c)(20). Except to the extent provided in regulations, such term includes any corporation with a net unrealized built-in loss.

(2) Old Loss Corporation — The term "old loss corporation" means any corporation—

(A) — with respect to which there is an ownership change, and

(B) — which (before the ownership change) was a loss corporation.

(3) New Loss Corporation — The term "new loss corporation" means a corporation which (after an ownership change) is a loss corporation. Nothing in this section shall be treated as implying that the same corporation may not be both the old loss corporation and the new loss corporation.

(4) Taxable Income — Taxable income shall be computed with the modifications set forth in section 172(d).

(5) Value — The term "value" means fair market value.

(6) Rules Relating to Stock

. . .

(7) 5-Percent Shareholder — The term "5-percent shareholder" means any person holding 5 percent or more of the stock of the corporation at any time during the testing period.

(l) Certain Additional Operating Rules —

. . .

(2) Ordering Rules for Application of Section

(A) Coordination With Section 172(b) Carryover Rules — In the case of any pre-change loss for any taxable year (hereinafter in this sub-paragraph referred to as the "loss year") subject to limitation under this section, for purposes of determining under the 2nd sentence of section 172(b)(2) the amount of such loss which may be carried to any taxable year, taxable income for any taxable year shall be treated as not greater than—

(i) — the section 382 limitation for such taxable year, reduced by

(ii) — the unused pre-change losses for taxable years preceding the loss year.

(B) Ordering Rule for Losses Carried from Same Taxable Year — In any case in which—

(i) — a pre-change loss of a loss corporation for any taxable year is subject to a section 382 limitation, and

(ii) — a net operating loss of such corporation from such taxable year is not subject to such limitation, taxable income shall be treated as having been offset first by the loss subject to such limitation.

. . .

As noted previously in this white paper, the federal NOL limitations also provide for ordering rules governing how different NOLs may be used when they are deducted.

Application of § 382 to consolidated filers

The limitations under IRC § 382 also apply to corporations that are part of a commonly owned group and federal consolidated filing regulations generally determine how the § 382 limitation applies in that case.[22] In general, the § 382 limitation following an ownership change of a loss group is computed by treating the loss group as a single entity. 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.

Thus, for any post-change year, the consolidated IRC § 382 limitation that applies after a group ownership change is an amount equal to the loss group's value multiplied by the long-term tax-exempt rate that applies with respect to the owner-ship change. Single-entity treatment also applies for purposes of determining whether a loss group or loss subgroup satisfies the continuity of business enterprise requirement.

§ 382 limitation on departing member NOL

Section 382 generally applies to a corporation when it leaves the consolidated group. The group NOL is reduced by the amount of NOL attributed to that corporation under the consolidated filing rules, which provide for tracking of NOLs by entity using the separate company attribution method discussed in the prior section. This is also the amount of NOL to which the Sec. 382 limitation would apply, limiting the NOL's use in the post-change years. Note that in the draft Finnigan model's NOL provisions, a separate provision requires the reduction of the group's NOL by the amount attributed to a departing member.

SRLY limitations, generally

The limits on use of NOLs under the federal consolidated regulations are based in the idea of the affiliated group and the consolidated NOL (CNOL). The CNOL includes losses generated by any group member of the group in the year the loss is recognized. But under SRLY rules, when a corporation joins a group, any NOL carryover that corporation may have will have been recognized as part of a tax return other than the consolidated group's return (either a separate company return for the corporation joining the group, or another consolidated return in which the corporation was a member). The NOL in that case is referred to as a "separate return limitation year" or "SRLY" NOL.

Once an NOL is a SRLY NOL, its use by the group is limited—generally to the separate company income that is generated by the separate corporation (or group of corporations)—so that it cannot be shared by any group the corporation has joined.

The SRLY limitations are found in IRS regulations under the federal consolidated filing rules, mainly Reg. 1.1502-21. The main body of SRLY regulations were first issued in 1966, and were later revised substantially 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.

It is important to note that IRS regulations resolve the overlap between IRC § 382 and the SRLY rules in favor of the strict limitation in § 382.[23] There are situations at the federal level in which the SRLY rules will, nevertheless, apply. For state tax purposes, the SRLY limitations could also apply where § 382 does not apply (if imposed as if the combined group were the consolidated filing group). For example, if a subsidiary of a unitary group is not included in the group in Year 1, but is included in the group in Year 2, any NOL it might bring into the group could be subject to SRLY limitations.

As data in the appendix show, a number of states apply SRLY rules, both in consolidated filing (if an election is provided) and in combined filing contexts.

[22] See Regulation 1.1502-91.

[23] See Regulation 1.1502-21(g).

Other Considerations

Before summarizing conclusions below, there are two other general considerations that should be noted.

NOLs and State Jurisdiction

The genesis of this white paper was the decision by the Uniformity Committee to consider adopting an alternative Finnigan-based combined filing model. As noted in this white paper, the fundamental difference between Joyce and Finnigan states is their view of whose activities count, from a jurisdictional standpoint—those of the individual group members (Joyce) or those of the group itself (Finnigan). This matters because another reason a Joyce state might choose to limit the use of NOLs to the individual group member to which that NOL is assigned is because any member of the unitary business, in any particular year, might claim to be jurisdictionally remote. States following the Finnigan rule do not have this concern.

But it also matters to the Joyce states what standard of jurisdiction applies for tax purposes. To the extent that standard is lower, the difference between the result under the Joyce and Finnigan rules is reduced. After the Supreme Court's decision in *Wayfair,*[24] no state need limit its state tax jurisdiction to businesses that have a physical presence in the state. And, to the extent that modern electronic commerce and Internet technologies enable non-physically present busi-nesses to easily engage in activities in the state that exceed the protections of P.L. 86-272, those pro-tections are also less likely to apply, even when a state follows the Joyce rule.

Transition Rules

The purpose of this white paper is to assist the Uniformity Committee in determining whether to recommend particular uniform NOL provisions for states that adopt combined filing following the Finnigan rule. This recommendation would, presumably, apply to any separate-filing state that is considering adopting a Finnigan combined filing approach, any Joyce state considering adopting a Finnigan approach, and states that have adopted a Finnigan combined filing approach but that currently have different NOL provisions. The recommendations would also, presumably, apply to states that have in place an election for consolidated filing.

This raises questions of what NOL transition rules states might need in order to adopt any model uniform rules. The kinds of transition issues that would need to be addressed include:

- Whether and to what extent separate company NOLs would be grandfathered for use by a combined filing group;
- How to transition from existing NOL rules (whether under the Joyce or Finnigan approach) that might be different from the model uniform rules;
- What to do with NOLs from prior periods that applied different NOL provisions if the state amends its law to adopt uniform NOL provisions; and
- Assuming companies might elect into or out of consolidated or combined filing, how NOLs are treated in that case, especially when group membership changes under the different filing options.

The current draft Finnigan model does not contain any transition rules and because state rules currently vary to such an extent that the transition rules would likely have to be determined by each state.

Conclusions

State NOL Rules Vary

State NOL provisions that determine the computation of the loss, the NOL carryover, and NOL deduction differ in a number of ways, some of which were covered above. Those differences include (but are not limited to) differences caused by:

- Decoupling from federal tax provisions that are used to compute the net operating loss (e.g. depreciation rules);

[24] South Dakota v. Wayfair, Inc., 585 U.S. ___ (2018).

- The extent to which the NOL carryover can be used to offset income generally—including any time limits on the use of the NOL;
- Calculation of the NOL carryover on a pre- versus post-apportionment basis;
- Adoption of the Joyce or Finnigan rule;
- Use of separate-entity versus single-entity apportionment and whether NOLs are confined to use by the entity to which they are assigned or attributed;
- If the state assigns or attributes NOLs to particular entities, the way in which this is done;
- Whether the state conforms to IRC § 381 NOL succession rules;
- The basis for tracking NOLs for the purpose of limiting the use of those NOLs;
- Whether the state allows any portion of a company or group NOL to be brought into or taken out of the group;
- Whether the state permits sharing of NOLs among group members to any extent;
- Whether the state conforms to IRC § 382 limitations; and
- Whether the state conforms to SRLY rules (federal consolidated filing rules limiting the use of losses).

Limited Principles Govern NOL Rules

The following limited principles can be derived from the analysis of state NOL provisions:

- As this white paper noted at the outset, the provision of an NOL deduction is a matter of legislative grace. Some amount of NOL, however, is necessary so that businesses that have variable profits over the course of several years are not taxed more than those that have profits that vary less.
- States following Joyce may reasonably choose to limit the use of NOLs to particular combined group members, given that under the Joyce rule, these corporations are treated as the taxpayer for important purposes, including jurisdiction.
- In general, however, whether a state follows Joyce or Finnigan need not determine whether it may choose to allow the group to share NOLs;
- Even if a state allows sharing of NOLs among group members, it will need to impose limits in order to avoid duplication, trafficking, and abuse.
- A post-apportionment approach has the advantage of using the apportionment factor in the year the loss is created, which may be a better indication of the source of the loss, and also allows a state to exclude nonapportionable losses that are not sourced to the state;
- If a state applies the separate entity apportionment /no sharing approach to the use of NOLs, it may result in an arbitrary limitation on that use where the group member's relative apportionment factors change between the year the NOL is generated and the year it is used;
- A state that allows sharing but imposes limitations may need to use some methodology to track NOLs by entity in order to impose those limits; the exception being a state that simply prohibits corporation from bringing a loss into or taking a loss out of a group (and does not follow IRC § 382); and
- States may apply federal NOL limitations, primarily IRC § 382, in addition to any other limitations, regardless of the method of filing used.

General Policy Considerations

The policy considerations that influence the adoption of NOL provisions by states may include:

- The benefits/detriments of federal conformity;
- The complexity versus effectiveness of different approaches;
- The effect of allowing NOLs on the variability of corporate income tax revenue;
- Consistent treatment of NOLs of similarly situated businesses (e.g. pass-throughs and corporations);

- Consistent treatment of NOLs regardless of the method of filing (e.g. combined versus federal-style consolidation);
- Ease of compliance, administration, and enforcement versus effectiveness at avoiding duplication, trafficking, and potential abuse.

Staff Recommendations

Based on analysis set out in this white paper and discussions of the Uniformity Committee and Finnigan-Combined Filing work group, staff recommends consideration of the following options:

1. Adopt the draft alternative Finnigan model, with any necessary revisions, incorporating the NOL provisions set out in that draft;

2. Adopt a simpler regime prohibiting a corporation from bringing any NOL into the combined group or taking any NOL out of the group; or

3. Leave the NOL provisions to be determined by the state that adopts the model.