NOL Sharing

For discussion by the MTC Uniformity Committee

August 2019

2006 Model

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  - Members treated as separate taxpayers
  - Jurisdiction determined on separate-entity basis
  - Tax attributes determined on separate-entity basis

Joyce

- Each member has its own share of the group in-state income & loss
- The share attributed to jurisdictionally-remote members is excluded
- Typical approach – separate-entity apportionment

Separate-Entity Apportionment

$$\text{Group Instate Income or Loss} \times \frac{\text{Member Numerator (In-State)}}{\text{Group Denominator (Everywhere)}}$$

Finnigan

- Two possible approaches:
  - Separate-entity apportionment, but don’t treat any members as jurisdictionally remote

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- Two possible approaches:
  - Separate-entity apportionment, but don’t treat any members as jurisdictionally remote
  - Use a single-entity (group) apportionment approach and assess group tax (e.g. jointly and severally)

Single-Entity Apportionment

Group Instate Income or Loss X $\frac{\text{Group Numerator (In-State)}}{\text{Group Denominator (Everywhere)}}$

Why allow an NOL deduction?

- NOLs represent operating (business) losses recognized in one year used to offset income in other years.

- Without NOLs, businesses whose incomes fluctuate for any reason would pay more tax (sometimes significantly more) than those whose incomes are stable.

Why *not* allow an NOL deduction?

- NOLs can cause significant fluctuations year-to-year in both personal and corporate income tax revenues.
- Another way to partially address this is to decouple from federal provisions that accelerate expensing (e.g. bonus depreciation).

Limits on NOLs generally –

- Expiration dates act as a limit
- At the state level, allocation and apportionment acts as a limit

These limits apply whether or not sharing is allowed.

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- Passthrough business losses can be offset against other business income in the hands of the owners
- Corporations that file a consolidated return compute a consolidated NOL

Why limits on NOL sharing?

- Possible duplications
- Incentive to traffic in NOLs
- Other abuse

“Sharing”

- Does NOT refer to offsetting group member income and loss in the year recognized—aka—combined filing.

- Does NOT mean unlimited use of NOLs—for example, when members join or leave the group.

"Sharing"

- Means – allowing the group to use an NOL generated by the group without limiting the NOL based on its attribution to a member of the group.

Limits on NOL *sharing* may include:

- No NOL can be brought into the group
- Loss can be brought into group but subject to the IRC § 382
- Loss can be brought into group but subject to SRLY type limit
- Loss can be brought into group but subject to both IRC § 382 and SRLY type limit
- Loss cannot be taken out of the group
- Loss must be taken out of the group
- Loss must be taken out of the group and further limited

Difference between two alternatives –

- Separate-entity apportionment – no sharing
    - *“No sharing approach”*
- Single-entity apportionment – with sharing
    - *“Sharing approach”*

Assume group remains the same – when will the approach used matter?

- If members' separate company income/loss change?
- If amount of intercompany transactions change?
- If the group's in-state apportionment factor changes?
- If group has nonapportionable loss?
- If members' relative proportions of the group's instate factor change?

Assume group remains the same – when the two approaches matter?

- ~~If members' separate company income/loss change?~~
- ~~If amount of intercompany transactions change?~~
- ~~If the group's in-state apportionment factor changes?~~
- ~~If group has nonapportionable loss?~~
- If members' relative proportions of the group's instate factor change?

Example of the difference between the two alternatives –

- Assume:
  - Single sales factor
  - Company X and Company Y are a unitary group and the group membership does not change

Assume Group XY

Combined Loss Year 1	($ 20M)
Company X in-state receipts	$ 20M
Company Y in-state receipts	$ 80M
Total in-state receipts	$100M
Total everywhere receipts	$200M
Company X separate-entity factor	10%
Company Y separate-entity factor	40%
Group single-entity factor	50%

Single-Entity Apportionment

- Company X
  - Separate-entity factor 10%
  - Group Loss ($20M)
  - Company X Loss ($2M)
- Company Y
  - Group Loss ($20M)
  - Separate-entity factor 40%
  - Company X Loss ($8M)

Separate-Entity Apportionment

- Group XY
  - Group Loss ($20M)
  - Single-entity factor 50%
  - Group Loss ($10M)

YEAR 1

In Year 2 – assume what changes is that the total instate factor goes down.

Would it make a difference if the NOL was computed on a separate-entity (no sharing) basis or a single-entity (group/sharing) basis?

Assume Group XY

Combined Income Year 2	$ 40M
Company X in-state receipts	$ 20M
Company Y in-state receipts	$ 80M
Total in-state receipts	$100M
Total everywhere receipts	$400M
Company X separate-entity factor	5%
Company Y separate-entity factor	20%
Group single-entity factor	25%

Single-Entity Apportionment

- Company X
  - Group Income $ 40M
  - Separate-entity factor 5%
  - Company X Income $ 2M
  - Company X NOL $ 2M
- Company Y
  - Group Income $ 40M
  - Separate-entity factor 20%
  - Company Y Income $ 8M
  - Company Y NOL $ 8M

Separate-Entity Apportionment

- Group XY
  - Group Income $ 40M
  - Single-entity factor 25%
  - Group Income $ 10M
  - Group NOL $ 10M

YEAR 2

Scenario 1

The loss from Year 1 is exactly the amount needed to offset income in Year 2—whether or not it is apportioned on a separate- or single-entity basis.

But what if the relative apportionment factors of Company X and Company Y do not remain the same?

Assume Group XY

Combined Income Year 2		$ 40M
Company X in-state receipts	$ 40M	
Company Y in-state receipts	$ 10M	
Total in-state receipts	$100M	
Total everywhere receipts		$200M
Company X separate-entity factor		40%
Company Y separate-entity factor		10%
Group single-entity factor	50%	

Single-Entity Apportionment

- Company X
  - Group Income $ 40M
  - Separate-entity factor 40%
  - Company X Income $ 16M
  - Company X NOL $ 2M
  - **Net Income after NOL $ 14M**

- Company Y
  - Group Income $ 40M
  - Separate-entity factor 10%
  - Company Y Income $ 4M
  - Company Y NOL $ 8M
  - **Net Income after NOL $ 0**

Separate-Entity Apportionment

- Group XY
  - Group Income $ 40M
  - Single-entity factor 20%
  - Group Income $ 10M
  - Group NOL $ 10M
  - **Net Income after NOL $ 0**

YEAR 2

Scenario 2

Will the amount of NOL that can be used under the separate-entity / no sharing alterative ever be *more* than the amount that can be used under the single-entity apportionment / sharing approach?

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No, only less.

Is it necessary to prohibit sharing in order to ensure that nonbusiness losses allocated outside the state are not used to offset income allocated or apportioned to the state?

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No, simply using a post-apportionment (allocated) carryover will work

Is it necessary to prohibit sharing in order to properly limit the use of NOLs to prevent duplication, trafficking of losses, or abuse?

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No, although tracking NOLs may be necessary

Is separate-entity apportionment / no sharing the only way of tracking NOLs?

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No, the IRC uses a different approach.

Is there a way to limit the use of NOLs to avoid duplication, trafficking, and abuse that does not require tracking?

Is there a way to limit the use of NOLs to avoid duplication, trafficking, and abuse that does not require tracking?

Maybe—by simply prohibiting a group member from bringing in or taking out any NOLs.

Essentials of tracking:

1. Net operating loss must be attributed to members in the year recognized.
2. Ordering rule for how member’s NOLs are used (shared) against group income.

Federal consolidated filing:

1. Determine separate company tax items
2. "Eliminate" intercompany items
3. Combine separate company income and loss
4. Compute the consolidated NOL
5. Carry forward consolidated NOL and use, subject to limitations.

Federal rules:

- Group loss is divided among members with separate company losses based on their share of the total amount of separate company losses
- Members losses are then used pro-rata, first-in, first-out

Federal NOL limitations:

- IRC § 382 – which limits the amount that can be used each year (equal to long-term tax-exempt interest rate times the value of the company) when any “ownership change” occurs.
- SRLY – which limits the amount that can be used each year to the separate company income of the entity that held the NOL at the time the limit is triggered.
- Other IRC provisions preventing abuse.

Other issues:

- Under TCJA federal NOLs no longer expire but are limited in use to 80% of net income before NOL deduction
- Most states have decoupled from IRC § 172 and have imposed some limit on the use of NOLs

Recommendations:

1. Federal-style limitations (current draft)
2. “Simple limitations” (no NOLs in or out of group)
3. No provisions in the draft but provide white paper

Recommendations:

1. Federal-style limitations (current draft)

- Pros:
  - Provides guidance to drafters wanting to use the single-entity approach but needing limitations
  - Federal rules are extensive and anticipate issues
  - Taxpayers may be more familiar
- Cons:
  - May need to be explicit about how the rules apply in certain state-specific circumstances
  - Rules may change.

Recommendations:

1. Federal-style limitations (current draft)

2. “Simple limitations” (no NOLs in or out of group)
   - Pros:
     - May provide sufficient limitations without need for tracking.
   - Cons:
     - Would allow the group to keep the NOL after, potentially, divesting itself of a particular line of business.

Recommendations:

1. Federal-style limitations (current draft)
2. “Simple limitations” (no NOLs in or out of group)
3. No provisions in the draft but provide white paper
   - Pros:
     - Potentially easiest to agree on
   - Cons:
     - Avoids addressing area where uniformity might be useful