MULTISTATE TAX COMMISSION

# MEMORANDUM

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| **To:** | Combined Reporting Model – Finnigan Work Group |
| **From:** | Helen Hecht – MTC General Counsel |
| **Subject:** | Preliminary Analysis - Sharing of NOLs |
| **Date:** | April 3, 2019 |

## BACKGROUND

The existing Model Statute for Combined Reporting, first adopted 2006, (2006 model) uses the so-called Joyce method for apportioning combined income. The work group is drafting an option for states that wish to use the Finnigan method instead.[1]

The work group, following the direction of the Uniformity Committee, is using a "single-entity" approach that would generally allow the sharing of net operating losses (NOLs). Questions have been raised as to whether sharing of NOLs should be permitted. This memo provides information that may be useful in addressing the NOL-sharing question.

Note – this analysis does not address the sharing of capital losses or sharing state tax credits. The original model allowed some sharing of capital losses.[2] Sharing credits, because of their nature, raise policy issues that are specific to the credit.[3]

## STATE NOL LIMITATIONS GENERALLY

NOLs can be limited in a number of different ways. For example, the 2006 model does not specify how states should conform to the federal tax rules. The model uses a generic, undefined term—"taxable income" when describing the computation of the allocated and apportioned income for each group member. Assuming the state decouples from any federal rules, particularly federal deductions, the state loss will differ and may be less than the federal loss. If the taxpayer had a state loss that was lower than a federal loss, the state would, presumably, "limit" the loss to the state amount.

[1] For information on the issues and the work group's discussions, see the project page on the MTC website, here: http://www.mtc.gov/getdoc/4570fde6-763b-450f-85bf-cbbb6e30dc94/Model-Option-for-Combined-Filing.aspx.

[2] See the Model Statute for Combined Reporting (2006 Model), Sec. 3.C.ii.(g), available here: http://www.mtc.gov/uploadedFiles/Multistate_Tax_Commission/Uniformity/Uniformity_Projects/A_-_Z/Combined%20Reporting%20-%20FINAL%20version.pdf.

[3] The 2006 model makes sharing of credits the exception to the rule. See 2006 Model, Sec. 3.A.ii.

Many states have also decoupled from the specific federal rules limiting the carryover period for the deduction of NOLs. Decoupling from federal rules may also allow states to limit the periods in which the deduction of an NOL can be taken to offset net income. But decoupling from the NOL carryover or other federal rules also serves to allow states to place additional or alternative restrictions on NOL carryovers and deductions. States can decouple from NOL rules either by adding back the federal NOL or adopting conformity to net income before the federal NOL deduction.

## CATEGORIES OF NOL LIMITATIONS

For our purposes, limitations on NOLs can generally be categorized as follows:

### Federal Carryover or NOL Deduction Limits

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

### Federal Limitations for Loss Company Acquisitions or Departures

The IRC provides limitations on the ability of a corporation to use the loss of an entity acquired and on the use of losses by members coming into or leaving the group. (These limitations are discussed further below.)

### State Specific Limitations

States typically apply three kinds limitations on the use of NOLs:

- Limitations Similar to Federal Limitations –

  States might impose their own separate carryover limitation. States may also impose separate limits on the use of NOLs of companies acquired by or companies leaving a combined group—while still allowing some sharing of losses among members of the group. Those limits may be more or less restrictive than federal limitations. (For example, a state could simply prohibit any use of an NOL of a company that comes into the group.)

- Allocation and Apportionment of Losses –

  All states allocate and apportion losses and most apply the apportionment factor of the loss year. This also serves as a kind of limitation on the NOL carryover and deduction.

  > Example 1: Company X operating in State A reports a federal net operating loss in year 1 of $100. Of that amount, $20 of loss is a non-business loss. Of the remaining $80 of business loss, $10 is apportioned to State A. Company X would have an NOL carryover in State A of $30.  In year 2, Company X reports

$200 of net income, $40 of which is apportioned to State A. State A may allow Company X to offset $30 of the post-allocation/ apportionment NOL against the $40 of post-apportionment net income.

Example 2: Assuming the states allows two separate unitary businesses to be included in a single combined return and the apportionable income of each is subject to separate apportionment, the state could require that the losses arising from each business be limited to use against the income of those separate unitary businesses.

- Complete Restriction on the Sharing of NOLs Between Group Members –

  States may also require that NOLs never be shared among members of the group, even if the group members do not change and the NOLs arise from losses created from the same unitary business.

As this memo discusses further below, completely restricting the sharing of NOLs between group members make limitations on the use of NOLs from members entering or leaving the group unnecessary. There is no indication, however, that complete restriction on the sharing of NOLs is *necessary* in order to have effective rules for that purpose. The federal rules are an example of how sharing may be permitted among group members, while also preventing the "purchasing" of losses or use of losses by corporations leaving the group.

Nor does completely restricting NOLs remove the need to compute the state-specific loss (with any adjustments required by state law), nor does it eliminate the need to allocate and apportion those losses at the state level and, if necessary, limit the use of the losses to the unitary business activity, or non-business activity, that created the loss. If the state wishes to limit the use of nonbusiness losses, for example, it would do so even when the corporation is filing as a separate entity.

Nor does completely restricting the use of NOLs serve to limit the carryover period or to impose other related restrictions. Therefore, it appears that both states that choose to allow the sharing of NOLs between group members, and states that do not, will need to consider whether other limits should be imposed for other purposes and will need rules to implement those other limitations.

## FEDERAL TREATMENT OF NOLS

Because the federal government provides rules for limiting the use of NOLs that can be adapted for state purposes, while still allowing the sharing of NOLs between members of the group, it is useful to briefly review the federal treatment of NOLs generally.

### NOLS GENERALLY

The annual reporting period for corporate income is entirely artificial. A business cycle (from the incurring of expenses to the generation of related revenue) may be shorter or longer than a year. Even mechanisms like accrual of income or depreciation and amortization of expense cannot exactly duplicate the actual business cycle. For this reason, the federal income tax (and the taxes of the states) have long granted businesses the ability to carry over net operating losses from one period to use in other periods. Nevertheless, a deduction for an NOL is generally been viewed as a matter of legislative grace, not a matter of right, by federal courts. See *S. F. H., Inc. v. Commissioner*, 444 F.2d 139, 142 (3d Cir. 1971).

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

## CONSOLIDATED FILING RULES

Federal tax rules allow corporations that are part of an affiliated group (as defined) to either file separate tax returns or to file a single return as a consolidated group. Consolidated filing rules govern the manner in which the tax is computed for the consolidated group. In general, these rules require deferral of the recognition of income and loss from intercompany transactions until there is a corresponding transaction with a person that is not a member of the group.

The process of converting the "separate taxable income" for each member of the group to the "consolidated taxable income" is governed by IRC § 1501-1564 and the regulations thereunder. Separate taxable income for each member of the group is computed after elimination of intercompany transactions. Then the consolidated net income or net operating loss for the group is computed by adding up receipts, income, gains, losses, and deductions of the separate members. (Gains and losses may be netted by category.).

Federal consolidated filing rules allow offsetting the group members' separate net operating losses against members' separate taxable income. See federal regulations §§ 1.1502-21 and 1.1502-12(h). Those federal rules also allow computation of a consolidated net operating loss (CNOL) carryover—which can be used by the group to offset net taxable income from any of the members. The losses making up the CNOL are also tracked on an entity basis so that if a member leaves the group, their separate portion the CNOL can be determined. The amount of a CNOL attributable to a member is calculated by apportioning the losses that are part of that CNOL in the year incurred. The loss of the group is allocated only to members of the group that had losses, after eliminations, multiplying the group loss by a fraction which is the loss of the member divided by the total loss for all members having separate losses (with some adjustments for particular circumstances).

The consolidated net operating loss (CNOL) carryover for the group is simply the sum of the unlimited NOL carryovers and carrybacks of the members of the group. So the CNOL carryover includes any losses the group may have generated (and that remain unused and unlimited) on a consolidated basis. But the CNOL also includes the NOLs of members arising in so-called "separate return years," to the extent not otherwise limited, less the NOLs of members who have left the group (tracked for that purpose).

The term "separate return year" refers to a year in which a member of the consolidated filing group did not file as a member of the group. Had that corporation filed separately, its NOL carryover would be calculated separately (or might otherwise be limited if part of another group). Separate return limitation year, or SRLY, rules are imposed under federal consolidated filing rules to limit the amount of loss that can be used by a group because of losses brought into, or members leaving, the group. Federal loss limitation rules can also be found in IRC §§ 381-384, as well as § 269.

IRC § 381 sets out the rules under which successor and surviving corporations may carry over and succeed to specific tax attributes following certain corporate reorganizations where IRC § 361 provides for non-recognition of gain. It allows NOLs to be carried over only if they are not otherwise limited by the provisions of IRC §§ 382, 383 and 384 and applicable regulations. Section 382 is generally thought of as the main restriction imposed on acquiring NOLs. Regulations implementing consolidated filing also impose restrictions on the use of losses by the consolidated group of members coming into or leaving the group. (The extensive regulations under IRC § 1502 are beyond the scope of this memo—but, suffice it to say, create a detailed framework for how the consolidated group may share losses when entities come into or leave the group.)

As noted above, it is possible for states to adopt and apply these same rules by reference, providing that they are to be applied as though the combined filing group were the consolidated group.

## STATES WITH COMPLETE RESTRICTIONS ON SHARING NOLS

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

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

Key:

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

| State | Combined? | Finnigan? | Sharing? | Consolidated? | Sharing? |
|---|---|---|---|---|---|
| Alabama | No | N/A | N/A | Yes | Yes |
| Alaska | Yes | Joyce | Yes | Yes | Yes |
| Arizona | Yes | Finnigan | Yes | Yes | Yes |
| Arkansas | No | N/A | N/A | Yes | Yes |
| California | Yes | Finnigan | No | No | N/A |
| Colorado | Yes | Joyce | Yes | Yes | Yes |
| Connecticut | Yes | Finnigan | Yes | No | N/A |
| Delaware | No | N/A | N/A | No | N/A |
| District of Columbia | Yes | Joyce | No | No | N/A |
| Florida | No | N/A | N/A | Yes | Yes |
| Georgia | No | N/A | N/A | Yes | Yes |
| Hawaii | Yes | Joyce | No | Yes | Yes |
| Idaho | Yes | Joyce | No | No | N/A |
| Illinois | Yes | Joyce | Yes | No | N/A |
| Indiana | Yes | Finnigan | Yes | Yes | Yes |
| Iowa | No | N/A | N/A | Yes | Yes |
| Kansas | Yes | Finnigan | Yes | Yes | Yes |
| Kentucky | Yes | ? | No | Yes | Yes |
| Louisiana | No | N/A | N/A | No | N/A |
| Maine | Yes | Finnigan | No | Yes | Yes |
| Maryland | No | N/A | N/A | No | N/A |
| Massachusetts | Yes | Finnigan | Yes | No | N/A |
| Michigan | Yes | Finnigan | Yes | No | N/A |
| Minnesota | Yes | Finnigan | Yes | No | N/A |
| Mississippi | Elective | Joyce | Yes | No | N/A |
| Missouri | No | N/A | N/A | Yes | Yes |
| Montana | Yes | Finnigan | No | Yes | No |
| Nebraska | Yes | Joyce | Yes | No | N/A |
| Nevada | N/A | N/A | N/A | N/A | N/A |
| New Hampshire | Yes | Joyce | Yes | No | N/A |
| New Jersey | Yes | Joyce | Yes | Yes | Yes |
| New Mexico | Elective | ? | Yes | Yes | Yes |
| New York | Yes | Finnigan | Yes | No | N/A |
| North Carolina | Yes | Finnigan | Yes | No | N/A |
| North Dakota | Yes | Joyce | No | Yes | No |
| Ohio | Yes | ? | No | Yes | No |
| Oklahoma | No | N/A | N/A | Yes | No |
| Oregon | Yes | Finnigan | Yes | No | N/A |
| Pennsylvania | No | N/A | N/A | No | N/A |
| Rhode Island | Yes | Finnigan | Yes | No | N/A |
| South Carolina | No | N/A | N/A | Yes | Yes |
| South Dakota | N/A | N/A | N/A | N/A | N/A |

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|---|---|---|---|---|---|
| Tennessee | Yes | ? | Yes | Yes | Yes |
| Texas | Yes | Joyce | Yes | No | N/A |
| Utah | Yes | Finnigan | Yes | No | N/A |
| Vermont | Yes | Joyce | Yes | No | N/A |
| Virginia | Elective | Joyce | No | Yes | No |
| Washington | N/A | N/A | N/A | N/A | N/A |
| West Virginia | Yes | Joyce | No | No | N/A |
| Wisconsin | Yes | Finnigan | No | No | N/A |
| Wyoming | N/A | N/A | N/A | N/A | N/A |

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

## Consideration of Sharing Losses in Adoption of 2006 Model

The issue of sharing NOLs and credits was raised and discussed in the public hearing for the 2006 model. In the initial report, the hearing officer noted the following rationale for the treatment of NOLs in the 2006 model:

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

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

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

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

UDITPA or unitary theory requires a credit earned by one taxpayer to be allowed against the separate tax liabilities of the other taxpayer members of a combined group.

. . .

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

## PRELIMINARY RECOMMENDATIONS FOR FURTHER DISCUSSION

Based on this preliminary analysis, staff believes that the model should provide for the tracking of NOLs on a separate company basis, using an approach similar to the federal rules (which allocates the group loss to the members that have separate losses, after eliminations). As discussed above, something like this is necessary if there are to be appropriate limits on the NOLs that companies may bring into or leave the group with.

The work group should also discuss and decide whether it believes, as this preliminary analysis suggests, that sufficient limitations can be imposed on the use of NOLs without the need to completely limit the sharing of NOLs between members of the group. If so, it should consider and recommend how those limits—for example, by reference to federal consolidated limits—might be achieved. If the work group concludes it is not possible to impose sufficient limitations for this purpose without completely restricting the sharing of NOLs, it should ask the Uniformity Committee to reconsider its instruction to adopt a "single-entity" approach to sharing NOLs.

Of course, the work group may also consider whether there is any other reason to recommend to the Committee that it reconsider the "single-entity" approach, and instead retain complete restrictions on the sharing of NOLs under the Finnigan option.

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