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PAUL J. HARTMAN
STATE AND LOCAL TAX FORUM

VANDERBILT UNIVERSITY LAW SCHOOL

The Ins and Outs of State NOL Deductions and Credits

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State NOL Issues - generally

- States often don’t follow federal NOL rules
- States differ on how to compute and use NOLs
- State NOL provisions frequently require tracking NOLs by entity
- Some states allow sharing of losses and some do not
- Most states require modifications, limitations, suspensions, or other adjustments to NOLs

Proper management of the NOL asset mitigates cash tax impacts and increases earnings per share

State NOLs and IRC 382 limitations

Federal 382 Principles - Limits the ability of a corporation to offset future income using (1) NOLs generated prior to a "change in ownership" and (2) certain built-in losses recognized post-change

Section 382 will be important if the transaction is a stock acquisition (with no 338 election if taxable) or a qualifying tax-free reorganization (Section 381 applies), or any transaction in which equity is issued and one or more parties is a loss corporation

Enacted to prevent "trafficking" in NOLs

State NOLs and IRC 382 limitations

The annual NOL deduction limitation on acquired NOLs = the value of the "loss corporation" on the date of the acquisition * the long-term tax-exempt interest rate defined in 26 U.S.C. § 382(f).

> The annual limitation accrues - if the amount of the NOL deduction limitation determined under 26 U.S.C. § 382 exceeds the corporate taxpayer's taxable income in a given taxable year, excess NOL limitation amounts are carried forward and added to the NOL deduction limitation amount for the succeeding taxable year. 26 U.S.C. § 382(b)(2).
>
> NUBIL - built-losses recognized during the five-year recognition period are treated as pre-change losses and subject to the Section 382 annual limitation
>
> NUBIG - built-in gains recognized during the five-year recognition period will increase the Section 382 limitation

Annual limitation may become zero if continuity of business enterprise is violated within 2 years of change

States’ Adoption of IRC 382 Varies

- Decouple from IRC 382
- Adopt IRC 382
  - Explicitly
  - Implicitly – most states fall in this category by adopting the IRC, and they do not provide explicit guidance on how to apply IRC 382

States' Adoption of IRC 382

Calculation of state 382 limitation

- Separate reporting states
  - Often, data isn't readily available to calculate 382 on a separate entity basis. May have to estimate based on relative value of entities in the acquired consolidated group or utilize valuation documents prepared in conjunction with the deal to determine.
- Apportionment
  - If apportioned, which apportionment factor to use? Year of acquisition v. year of utilization
  - Sinclair Broadcast(MN)
  - Verizon (FL)

Examples of States with Published Guidance

- South Carolina - SC REVENUE RULING #16-7:
  - SC IRC Sec. 382 limitation = the federal IRC Sec. 382 limitation x SC apportionment factor for the taxable year that the ownership change occurs
  - If taxpayer's RBILs are not subject to federal 382 limitations, then not subject to SC 382 limitations
  - If taxpayer's RBILs are subject to federal 382 limitation, then calculate SC NUBIL threshold and then SC NUBIL
- California - Technical Advice Memorandum: 2017 - 03
  - The limitation provided for in IRC section 382(b)(1) is applied on a pre-apportionment basis. "For California tax purposes, there is no statutory or case authority which would allow the IRC section 382 limitation to be applied on a post-apportioned basis."
  - The RBIGS and RBILS provided for in IRC section 382(h)(2) are determined on a post-apportionment basis.

  Note that California doesn't conform to 382 changes in FTJCA

Sinclair Broadcast Group, Inc. and Subsidiaries v. Commissioner of Revenue, No. 8919-R (Minn. Tax Ct. Aug. 11, 2017).

- Minn. Stat. Section 290.095, subd. 3(d): "the limitation amount determined under [IRC S]ection 382 shall be applied to net income, before apportionment, in each post change year to which the loss is carried."
- Commissioner argued:
  - the 382 limitation should be applied to net income, and also to taxable income. And since taxable income is post-apportionment, the 382 limitation should be apportioned.
  - Not applying an apportionment factor to federal 382 limitation allows the taxpayer to unfairly accelerate its use of its MN NOLs
  - The court should give deference to the DOR's long standing policy to apportion the federal 382 limitation
- Court found in favor of the taxpayer, stating that the statute clearly applies to pre-apportionment net income.

Verizon Communications Inc. & Affiliates vs State of Florida DOR
CASE NO.: 2018-CA-1543

- Florida Statute 220.13 states that a taxpayer utilizes its Florida net operating loss “in the same manner, and to the same extent” as for federal purposes.

  Fla. Admin. Code r. 12C-1.013(15)(j):"in computing the Florida corporate income tax, a deduction for the NOL carryover will be allowed to the extent of the amount allowed for federal purposes, provided that the deduction does not exceed the total amount of the Florida NOL carryover in such taxable year."
- The Department argued that the acquired state NOL should be utilized in the same % as the acquired federal NOL should be used:

  State NOL * federal 382 limitation/federal NOL = state NOL utilization
- Verizon argued that the statute and regulation do not allow for apportionment or other limitation to be applied to its federal 382 limitation in utilizing its acquired Florida NOL and thus, it could use its NOLs up to the amount of the federal 382 limitation.
- Verizon won at the trial court. The case is currently being appealed.

What are common reasons for a difference between the amount of federal loss carryforwards and state loss carryforwards?

A) Separate entity reporting.
B) Apportionment.
C) Statutory modifications to federal taxable income.
D) Differences in carryforward and carryback periods.
E) Conformity to federal utilization limitations (or lack thereof)
F) All of the above.

Federal planning – state attribute considerations

Pre-2020 – Loser Co has historically recognized substantial losses both for U.S. federal income tax and state income tax purposes.

Late 2020 – Loser Co is acquired by Buyer but does not meet the requirements to join Buyer's federal consolidated group. Loser Co files a federal consolidated return separate from Buyer and continues to file unitary returns based on the legacy unitary group.

Early 2021 – As a result of federal/international restructuring driven by Buyer, Loser Co generates a significant gain for U.S. federal income tax purposes. There are sufficient NOLs to offset the gain in its entirety for U.S. federal income tax purposes, and it was assumed sufficient state NOLs would similarly be available to offset any cash tax concerns.

Mid-2021 – Through additional federal/international structuring efforts, Loser Co. meets the requirements to join Buyer's federal consolidated group resulting in a short period federal consolidated return being filed by Loser Co for the first part of the 2021 tax year.

Upon preparation of the state extension calculation for the 2021 short period for Loser Co, it was discovered a significant state cash tax impact of the gain is being forecasted due to insufficient state NOL carryforwards. CRISIS!

Federal planning – state attribute considerations

Dooley, the bright young associate you just hired out of UGA's business school, has come to you with a fix to your problem. His suggestion is for Loser Co and Buyer to file as part of the same unitary group for the entire 2021 tax year. What should you do?

A) Rethink future recruiting efforts at UGA.

B) Give Dooley the bonus he deserves and cancel next week's interviews at Tennessee.

C) Sit tight, keep the UGA placement office number in your contacts, don't cancel the plane ticket to Knoxville, and ask Dooley to "crunch the numbers."

Accounting Method Changes Impacts / Opportunities

- Consider potential conflicting interests between federal and California (i.e., accounting method changes that may be considered for federal that may not be favorable for California purposes).

- With that said, businesses may wish to consider several options on their 2021 return as well as planning ahead for the 2022 return, where appropriate:

    - California separate elections (i.e., elections made for California purposes where a corresponding federal election is not required or opting out of elections made for federal purposes that are not favorable for California purposes).

    - California-only accounting method changes (i.e., consider affirmatively electing out of federal accounting method changes that may not be favorable for California purposes or consider an accounting method change for California only purposes regardless of whether a corresponding accounting method change is reported for federal purposes).

- More broadly than California, accounting method changes may also be leveraged as a mechanism to support utilization of state NOLs on behalf of entities that may not otherwise be projecting sufficient future income.

Statute of limitations pitfalls - carrybacks

- Loser Co, on a separate entity basis, has recognized positive taxable income for the preceding two years, and has recognized a current year loss.
- The current year loss was fully utilized in Loser Co's consolidated federal return.
- Although Loser Co's tax director realizes that the company would be entitled to refunds in several states as a result of an available carryback, the tax director does not have the time to file the amended returns and decides to simply claim the benefit of the loss as a carryforward on next year's return.

Assuming that Loser Co recognizes sufficient taxable income in the succeeding year to fully utilize the loss, are there risks with the tax director's decision?

Yes or No?

Statute of limitations pitfalls - carrybacks

Yes!

There are risks associated with simply assuming the losses can be carried forward. Certain states require that a loss must be carried back unless an affirmative election is made at the federal level to forego the carryback. Since the loss was fully applied in the federal consolidated return, no federal election to forego the carryback was made. As a result, it is possible that Loser Co was required to either: (1) amend the prior year returns to claim the benefit of the carryback, or (2) if available, make a separate state election to forego the carryback.

The risk that Loser Co runs is that all or a portion of the carryforward is disallowed and the statute of limitations on the carryback years is closed.

Statute of limitations pitfalls

Other Considerations

- Audit adjustments to attribute carryforwards
- Releasing reserves against the utilization of uncertain NOLs
- Claiming credit carryforwards in an open year related to otherwise closed years

Debt Placement (Holding Co vs Operating Co)

Common Driver of Trapped NOLs

As multinational or multistate companies continue to refine their capital structures, there has been a renewed focus on the location of interest deductions. Although many taxpayers are familiar with traditional "push-down" planning involving related party debt, fewer may be familiar with the potential to relocate interest expense on third party debt through co-obligor arrangements. This potential turns on the facts and circumstances of each case, carefully taking into account:

- The extent to which multiple entities may be viewed as co-obligors (as opposed to guarantors) due to joint and several liability
- Direct or indirect benefits of the financing to each of the co-obligors
- Avoiding characterization as a cost keeping arrangement
- Reasonable allocations of the liability between co-obligors
- Ensuring payment by co-obligors for their allocable share of the liability, while still allowing for flexible and / or varying payment amounts
- Contractual / equitable rights of contribution between co-obligors
- Unintended consequences arising from liability assumptions (deemed distributions and contributions)

The best time to raise these issues is when new or additional third-party debt is being considered or there is a plan to refinance existing debt.

Valuation Allowance Planning

Common Strategies for Utilizing Trapped NOLs

- Elective combination or consolidation of profitable and loss companies
- "Check the box" elections
- Selective mergers or conversions of profitable and loss companies
- Use of partnerships as a means to allocate income to a loss company
- Intercompany charges that result in recognition of income by a loss company
- Intercompany sales of appreciated depreciable or amortizable assets by a loss company
- Transfer of appreciated property to loss company in anticipation of future sale
- Contribution of profitable operations to loss company
- Review apportionment methodologies

Valuation Allowance Planning

Suggested Guidelines When Evaluating Options to use Trapped NOLs

- Match income that is already going to be taxed in the state against the NOLs.
- If you must create or apportion otherwise nontaxable income into a state in order to utilize the NOL, make sure that it enables you to get a benefit in another state.
- There is generally no downside to elective post-apportionment combination/consolidation. Pre-apportionment combination changes the state effective rate of all participating members, so the future must be considered.
- Elective pre-apportionment combination where the loss company has a lower apportionment percentage than the profitable entity is, more often than not, beneficial.
  - If the facts are reversed, it likely becomes a question of whether the cash tax savings and valuation allowance benefit outweigh the increase in current book tax expense.
  - Same holds true when evaluating mergers or conversions; however, unlike the elective filing method change which only changes apportionment in one state, mergers or conversions will impact effective rates of tax in multiple states.

Consolidated Filing Elections

Planning Ahead

If all the companies filing in a state have losses in the current year, it may not appear there is an advantage to making the election, but several additional points should be considered:

- If a combined return is filed, any filer in the group's losses will not be SRLY to the other filers, and thus if a filer has income in a later year that exceeds its cumulative losses, it will be able to use the other filer's prior year losses against its current year income.
- If a state, upon audit, asserts an entity with income has nexus in the years in which a combined return was filed, that entity will automatically be included in the combined return for those years, and the combined group's losses will reduce any tax, interest and penalty that would otherwise be due.

Consolidated Filing Elections

Financial Reporting Considerations

- The financial statement impact on deferred taxes and net operating loss valuation allowances in these states also needs to be considered.
- There generally should be no impact on deferred taxes as each entity will keep its own apportionment factors.
- However, if one entity with income has a deferred tax liability and another entity with losses has a deferred tax asset with an offsetting valuation allowance, it can recognize the deferred tax asset up to the amount of the deferred tax liability.
- More importantly, if an entity had a net operating loss with an offsetting valuation allowance, this could be affected as the losses may now be utilizable particularly in states that allow NOLs created in years before the election to be used to offset income of other group members.

SRLY Restrictions

2017 – Loser Co recognizes $10 million of state apportioned loss.

2018 – Loser Co is acquired by Buyer and joins Buyer's federal consolidated group. Loser recognizes $5 million of state apportioned loss post-acquisition.

2019 – Buyer begins filing a state combined/consolidated return with Loser Co. Loser Co recognizes $15 million state apportioned loss, $5 million of which is used by the combined/consolidated group.

2020 – Loser Co recognizes a nominal apportioned state loss and the combined/consolidated group recognizes the benefit of $15 million in post-apportioned Loser Co NOL carryforwards.

SRLY Restrictions

Loser Co's tax director gets a call from a state saying that they will be out the next day to examine the NOL deduction on the 2020 return. Without even looking at the return, the tax director pours a glass of scotch and relaxes because the tax director knows they have little to fear. The auditor must be from:

A) Virginia
B) Pennsylvania
C) Florida
D) Alabama

SRLY Restrictions

Answer is Florida since only NOLs that are actually SRLY restricted for federal income tax purposes will be SRLY in Florida. To date, Loser's state consolidated group has only deducted losses that arose subsequent to the time Loser joined in buyer's federal consolidated group.

- Loser may also be okay in Virginia, but would need to examine the return to confirm this since Virginia determines the amount of deductible loss on a pre-apportioned basis. Thus, the tax director cannot just assume that because Loser Co had $15 million of apportioned 2018 and 2019 losses, that sufficient losses existed in 2020 to support the deduction.

- Alabama would assert that the SRLY event was the election to file an Alabama consolidated return. Thus, Alabama would say that only the $10 million remaining 2019 loss would be deductible.

- If Loser Co is filing a combined/consolidated return in Pennsylvania, they probably have bigger problems than just the SRLY issue!

Strategic utilization opportunities

Other Considerations

- Attribute sharing (consider available opportunities to share credits in addition to NOLs)
- Ordering rules - must NOLs always be utilized prior to credits?
- Above vs below the line credit utilization opportunities
- TCJA vs CARES Act conformity NOL limitation determination opportunities

California: Reapportion NOLs

Problem

		2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	Total
	T.I.	($100)	($100)	($100)	($100)	($100)	($100)	$100	$100	$100	$100	$100	$100	**$0**
Apportionment	Prop	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	
	Payroll	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	
	Sales	10%	10%	10%	10%	10%	10%	10%	10%	10%	10%	10%	10%	
	Overall	5%	5%	5%	5%	10%	10%	10%	10%	10%	10%	10%	10%	
	Apport'd Inc. (Loss)	($5)	($5)	($5)	($5)	($10)	($10)	$10	$10	$10	$10	$10	$10	**$20**

California: Reapportion NOLs

Problem

		2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	Total
	T.I.	($100)	($100)	($100)	($100)	($100)	($100)	$100	$100	$100	$100	$100	$100	$0
Apportionment	Prop	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	
	Payroll	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	
	Sales	10%	10%	10%	10%	10%	10%	10%	10%	10%	10%	10%	10%	
	Overall	5%	5%	5%	5%	10%	10%	10%	10%	10%	10%	10%	10%	
	Apport'd Inc. (Loss)	($5)	($5)	($5)	($5)	($10)	($10)	$10	$10	$10	$10	$10	$10	$20

Solution

		2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	Total
	T.I.	($100)	($100)	($100)	($100)	($100)	($100)	$100	$100	$100	$100	$100	$100	$0
Apportionment	Prop	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	
	Payroll	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	
	Sales	10%	10%	10%	10%	10%	10%	10%	10%	10%	10%	10%	10%	
	Overall	10%	10%	10%	10%	10%	10%	10%	10%	10%	10%	10%	10%	
	Apport'd Inc. (Loss)	($10)	($10)	($10)	($10)	($10)	($10)	$10	$10	$10	$10	$10	$10	$0

California: NOL Carryover

- NOLs can be carried over and deducted at the unitary-group level rather than at a separate-company level
- Unitary business principle in California—*Edison Stores v. McColgan*, 30 Cal. 2d 472 (1947)
- NOL is a deduction from gross income—like other statutory deductions. Cal. Rev. & Tax §§ 24341, 24416.
- FTB's regulation (25106.5(e))?
- Application to you: avoid NOL "silos"

California: NOL Suspension

- Extend carryforward up to 7 more years AB-85 (eff. 6/29/20)
  - Cal. Rev. & Tax Code §17276.23
    - 3 years for losses carried into 2020
    - 2 years for losses generated in 2020
    - 1 year for losses generated in 2021
- Legal Ruling 2011-04
  - Ruling: 4-year extension requires income in suspension year
  - That requirement is not in the statute, so ignore
- No NOL silos
  - Carryover & deduct unitary group's NOLs on pre-intrastate apportionment basis
  - Deduct from group's combined CA income before divvying up among members

	Last Carryover Year		
Loss Year	Per FTB	Per Reed Smith	Rule
2000	2010	2016	10+2+4
2001	2011	2017	10+2+4
2002	2012	2017	10+1+4
2003	2013	2017	10+4
2004	2014	2018	10+4
2005	2015	2019	10+4
2006	2016	2023	10+4+3
2007	2017	2024	10+4+3
2008	2028	2034	20+3+3
2009	2029	2034	20+2+3
2010	2030	2034	20+1+3
2011	2031	2034	20+3

New Jersey: Enhanced NOL for Tech Companies

- General rule for NOL carryovers:
  - 7-year carryover for pre-2009 losses, 20-year carryover for 2009 forward
  - So NOL reflects losses only from 2009 forward
- Special 15-year carryover for certain taxpayers:
  - With qualified research in advanced computing, advanced materials, biotech, medical devices, electronic devices, or environmental technology
  - Research anywhere counts (not just NJ)
- **Solution: include 2004-2008 losses in NOL regardless of where research performed**

	Last Carryover Year			
Loss Year	Per Division	Per Suspension Rule	Per R&D Carryover Rule	Rule
2002	2009	2012	2017	7+3 or +15
2003	2010	2012	2018	7+2 or +15
2004	2011	2012	2019	7+1 or +15
2005	2012	2012	2020	+7 or +15
2006	2013	2013	2021	+7 or +15
2007	2014	2014	2022	+7 or +15
2008	2015	2015	2023	+7 or +15

New Jersey: MCI

- *MCI v. Division*, 2015 N.J. Tax Unpub. LEXIS 58 (2015)
- So, NJ follows consolidated return regulations
- Even for separate company years!
- So, go wayyyy back and …
  - Increase basis in subs under -32 for undistributed earnings (à la California)
  - Eliminate dividends (and enhance NOLs—going back to 2009)

New York: § 965 and NOLs

- Business loss = entire net income – (invest. inc. + other exempt inc.)

	Income Before 965	965 Income	Entire Net Income	Other Exempt Income	Business Loss
1	($100)	$0	($100)	$0	($100)

New York: § 965 and NOLs

- Business loss = entire net income – (invest. inc. + other exempt inc.)
- Other exempt income cannot exceed entire net income

	Income Before 965	965 Income	Entire Net Income	Other Exempt Income	Business Loss
1	($100)	$0	($100)	$0	($100)
2	($100)	$200	$100	$100	$0

New York: § 965 and NOLs

- Why is this a problem?
- Deduction for § 965 as “other exempt income”
- Deduction for “other exempt income” ≤ entire net income
- So deduction cannot ↑ NOL
- Bottom line: § 965 income can reduce NY NOL
- … *Kraft* problem: Undistributed *domestic* earnings would have no impact on NOL

New York: § 965 and NOLs

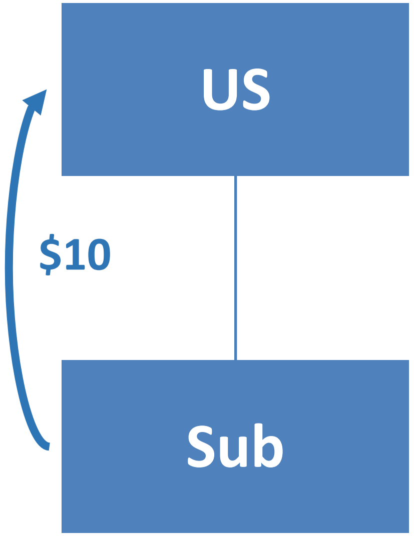
- Solution: allow full deduction for § 965

	Income Before 965	965 Income	Entire Net Income	Other Exempt Income	Business Loss
1	($100)	$0	($100)	$0	($100)
2	($100)	$200	$100	$100	$0
3	($100)	$200	$100	$200	($100)

Florida: NOL Problem

Problem: regulation says state subtraction cannot create/increase NOL

		Dividend from Domestic sub.	Dividend from Foreign sub.
Fed	Taxable income *(before DRD)*	$0	$0
	DRD *(domestic dividends)*	-$10	$0
	Taxable income	-$10	$0
State	Taxable income	-$10	$0
	Foreign dividend subtraction	$0	$0
	Net operating loss	-$10	$0



Solution: increase NOL by deducting dividend from foreign subsidiary

CPE Question: Why are state legislators so tough on NOLs?

A. Because they want to discourage investment
B. Because they want to discourage risk-taking
C. Because they don’t understand NOLs
D. Because it raises money short term, and short term matters most