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Managing State NOLs: Tracking Carryovers and Limitations Under Section 381 and Section 382 and Planning Opportunities to Maximize Utilization

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Managing State NOLs: Tracking Carryovers and Limitations Under Section 381 and Section 382 and Planning Opportunities to Maximize Utilization

August 21, 2019

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STRAFFORD WEBINAR

MANAGING STATE NOLS: TRACKING CARRYOVERS AND LIMITATIONS UNDER SEC. 381 AND SEC. 382 AND PLANNING OPPORTUNITIES TO MAXIMIZE STATE NOL UTILIZATION

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AUGUST 21, 2019

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EXPERIENCE

Mariano Sori is a partner in BDO's State & Local Tax services practice and National Leader for State Income & Franchise Tax services. He has more than 30 years of state tax consulting experience within a public accounting environment and concentrates on income and franchise tax issues such as nexus, state tax base modifications, apportionment of income, business/non-business income, unitary taxation, gross receipt taxes, allocation of partnership items, and state filing options.

Mariano focuses on performing state tax diagnostic reviews designed to provide businesses with an assessment of their state tax position, including the identification of refund and prospective filing opportunities and the reduction of exposure in multiple jurisdictions. In addition, Mariano assists businesses in designing and implementing structural enhancements in order to generate long-term state tax reductions.

Mariano consults on all aspects of state income tax, including participating in mergers and acquisition transactions, due diligence reviews, representation on state tax controversy matters, and assisting companies with state tax compliance and state tax accrual reviews. He has worked with Fortune 1000 and mid-size companies in industries such as manufacturing, retail, consumer services, financial services, real estate, technology, and transportation.

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EXPERIENCE

Katie is a Senior Manager in BDO Chicago's State and Local Tax Practice with over 9 years in public accounting. Katie specializes in on multi-state organizations, including complex multi-tiered partnerships, ensuring our clients meet all compliance requirements and deadlines. Most of her clientele are corporate entities with heavy state and international presence.

Specific experience includes:

- Overlooking and managing the tax compliance function of multiple types of clients.
- Working directly with clients to provide quality results from a variety of tax arenas.
- Handling tax controversies with the state authorities.
- Understanding special issues and getting tax specialists involved when it will benefit the client.

PROFESSIONAL AFFILIATIONS

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Agenda

- State Treatment of NOLs
- State Treatment of NOLs after Tax Reform
- Valuation of State NOLs for Financial Reporting Purposes
- Section 381 Carryover of State NOL Attributes
- Section 382 Limitations on Use of State NOLs
- Strategies to Maximize State NOL Utilization

STATE TREATMENT OF NET OPERATING LOSSES

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Federal Net Operating Losses

Starting Point-- Federal NOL

Starting point for the tax base determines whether a state will conform to federal NOL computations.

- Line 28 Starting Point. Federal taxable income *before the NOL and special deductions*
  - Line 28 Starting Point. Taxpayers begin their tax computation with line 28 of federal Form 1120, which is federal taxable income *before the NOL* and special deductions. Taxpayers must apply specific state NOL computation provisions to determine the state NOL deduction.
    - 25 states starting point is federal taxable income before NOL

- Line 30 Starting Point. Federal taxable income *before the NOL and special deductions*
  - Line 30 Starting Point. Taxpayers begin their tax computation with line 30 of federal Form 1120, which is federal taxable income *after the NOL* and special deductions.
    - 16 states require the federal NOL deduction to be added back

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Carryforward and Carryback Periods

- For federal purposes NOLs generated ***before*** December 31, 2017 are carried back to the two preceding taxable years. If an NOL deduction still remains, it is carried forward 20 years until fully utilized.
  - Taxpayers can make an irrevocable election to waive the carryback and carry the entire NOL forward.

- States vary on carryforward and carryback periods and limits
  - Some states conform to federal carryback and carryover periods
  - Some states have carryback and carryover periods that are different from federal periods.
  - Some states do not allow NOL carrybacks and provide a shorter carryover period.
  - Many states do not allow NOL carrybacks and only allow NOL carryforwards
    - Some states that allow a carryback will allow a taxpayer to elect to forego the carryback, carrying the NOL forward to subsequent years only.

Carryforward and Carryback Periods

Carryback

- 29 States do not allow NOL carrybacks
- 3 States allow NOLs to be carried back 3 years
- 13 States allow NOL carrybacks to same extent as federal law or allow NOLs to be carried back 2 years

Carryforward

- Approximately 26 States allow NOLs to be carried forward 15 or 20 years
- 3 States allow NOLs to be carried forward 5 or 7 years
- 5 States allow NOLs to be carried forward 10 or 12 years
- 11 States allow NOLs to be carried forward to same extent as federal law

State Treatment of NOLs

Post-Apportioned NOLs

- NOL deduction taken after allocation and apportionment
- Apportionment % is important in the year the NOL is generated.
- Majority of states (36 plus DC) calculate state NOL based on apportionment percentage in year NOL incurred

Apportionment Decreased from 2017 to 2018		
Year	**2017**	**2018**
Income/(Loss)	(1,000,000)	1,200,000
Apportionment	75%	50%
Apportioned Income	(750,000)	600,000
Post Apportioned NOL		(600,000)
Taxable Income		-
Tax Rate		6%
Tax		-

Apportionment Increased from 2017 to 2018		
Year	**2017**	**2018**
Income/(Loss)	(1,000,000)	1,200,000
Apportionment	50%	75%
Apportioned Income	(500,000)	900,000
Post Apportioned NOL		(500,000)
Taxable Income		400,000
Tax Rate		6%
Tax		**24,000**

State Treatment of NOLs

Pre-Apportioned NOLs

- NOL deduction taken before allocation and apportionment
- Apportionment % is important in the year the NOL is utilized.
- A minority of states calculate state NOL based on apportionment percentage in year NOL used
  - Maryland
  - Missouri
  - Virginia

Apportionment Decreased from 2017 to 2018		
Year	**2017**	**2018**
Income/(Loss)	(1,000,000)	1,200,000
Pre Apportioned NOL		(1,000,000)
Income Subject to Apportionment		200,000
Apportionment	75%	50%
Apportioned Income	(750,000)	100,000
Tax Rate		6%
Tax		**6,000**

Apportionment Increased from 2017 to 2018		
Year	**2017**	**2018**
Income/(Loss)	(1,000,000)	1,200,000
Pre Apportioned NOL		(1,000,000)
Income Subject to Apportionment		200,000
Apportionment	50%	75%
Apportioned Income	(500,000)	150,000
Tax Rate		6%
Tax		**9,000**

Nexus Standards and Importing NOLs

Nexus

- Most states require a taxpayer to have nexus with a state in the year a loss is generated, in order to carry over that loss to a subsequent year. For post-apportionment states, this requirement is implicit, because a loss cannot be apportioned to a state unless the taxpayer has nexus with that state.

No Nexus

- Some states do not have their own NOL provisions (they rely on the federal NOL provisions) and have no nexus requirements for claiming an NOL.
- Accordingly, taxpayers in those states can "import" NOLs from years when the taxpayer did not have nexus with the state.

Incorporating State Modifications into the NOL Calculation

- Federal NOL with State Modifications
  - Maryland (with potential modification)
    - Requires NOL recapture of excess of additions over subtractions from year NOL incurred when NOL is claimed
  - Missouri (modifications may be required)
    - Requires modification to NOL through state additions or subtractions
  - Virginia (requires adjustments)
    - Requires adjustments for state additions and subtractions from year NOL incurred

Maryland NAM Recapture

Maryland Pre-Apportioned NOL – NAM Recapture Example

- If state addition modifications exceed state subtraction modifications ("Net Addition Modification") in the taxable year of the federal NOL, the federal NOL in that year is used to offset the state addition modification.
- To prevent a double benefit, the taxpayer must recapture the amount of the net addition modification in the year in which the net addition modification plus the cumulative associated NOLs taken for current and prior years exceed the total federal NOL.

A. Facts: Loss Year is 1996, the loss is $1,000,000
NAM in the Loss Year is $500,000

Taxable Year	Federal Taxable Income (as filed)	NOL Used	NOL Balance	NAM	NAM / NOL Recapture	NAM Balance	Maryland Taxable Income
1996	**($1,000,000)**		($1,000,000)	$500,000	---	$500,000	$0
1997	$150,000	($150,000)	($850,000)	$0	---	$500,000	$0
1998	$150,000	($150,000)	($700,000)	$60,000	---	$500,000	$60,000
1999	$150,000	($150,000)	($550,000)	$0	---	$500,000	$0
2000	$150,000	($150,000)	($400,000)	$0	***$100,000***	$400,000	$100,000
2001	$200,000	($200,000)	($200,000)	$0	$200,000	$200,000	$200,000
2002	$250,000	($200,000)	$0	$0	***$200,000***	$0	$250,000

Incorporating State Modifications into the NOL Calculation

Indiana Department of State Revenue v. Caterpillar, Inc., [No. 49S10-1402-TA-79 (Ind. Sup. Ct., Aug. 25, 2014)]

- Taxpayer, in computing its federal taxable income, included its foreign source dividends (FSDs). Taxpayer then took the Indiana FSD deduction which increased its Indiana NOLs.
- The Department disallowed the NOLs, arguing that taxpayer could not deduct the FSD in computing its NOL because the Indiana NOL statute does not incorporate or reference the Indiana FSD statute.
- Indiana Supreme Court ruled that the taxpayer could not increase its Indiana NOL carryover by the amount of its foreign source dividend (FSD) deducted in computing Indiana adjusted gross income.
  - Taxpayers compute the NOL by modifying their federal NOLs using a three-step process. None of the steps reference the FSD deduction, which is codified separately from the NOL statute.
  - The court reasoned that if the Legislature had intended taxpayers to include every adjustment to adjusted gross income in the NOL calculation, it would have said so. The taxpayer also failed to show that disallowing the FSD deduction unconstitutionally discriminated against the foreign commerce. Consequently, the FSD deduction is not permissible in computing the NOL.

Incorporating State Modifications into the NOL Calculation

Many other states do not allow foreign dividend deductions to create an NOL.

- Example: Minnesota
  - The NOL deduction is applied on line 6 ***before*** the dividends received deduction on line 8.

5 Taxable net income *(add lines 3 and 4)* 5				
6 Net operating loss deduction *(from NOL)* 6				
7 Subtract line 6 from line 5 7				
8 Deduction for dividends received				
a Amount from DIV, line 15 . . . . . . 8a				
b Multiply line 8a by line 2 above for each column 8b				

Combined Reporting

Current Year Losses

- States generally allow current year losses to be shared among group members without limitation

Carrybacks and Carryforwards

- NOL computation at the unitary group level
  - 15 states allow sharing among group members that were part of the original loss year return
  - Illinois follows the group theory and calculates the NOL for the entire group as if it where one taxpayer
  - Recommend tracking by entity in case new entities enter the group or existing entities leave the group

- NOL computation at the member level
  - 11 states plus District of Columbia do not allow sharing; only allow NOL carryback or carryforward to be claimed by member that incurred the NOL
  - California follows the separate company theory and requires the computation of NOLs on an entity by entity level basis.
  - This method leads to trapped NOLs if apportionment fluctuates for each group member from year to year

California Example

Year 1

A, B and C are part of a combined group

- Taxable income (loss) as follows:
  - A: (100)
  - B: 100
  - C: (50)
  - Total loss (50)
- Apportionment % as follows:
  - A: 0%
  - B: 100%
  - C: 0%
- B is apportioned the (50) loss for Year 1

Year 2

A, B and C are part of a combined group

- Taxable income (loss) as follows:
  - A: (100)
  - B: (100)
  - C: 300
  - Total income $100
- Apportionment % as follows:
  - A: 0%
  - B: 0%
  - C: 100%
- C is apportioned the income of $100 for Year 2
- C cannot use the (50) NOL from Year 1 because it was apportioned to B.
- The (50) loss from Year 1 is trapped with B

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Sharing vs No Sharing

Prior Year Losses

- Generally when states switch from separate reporting to combined reporting they do not allow losses to be shared among group members

- Example:
  - Wisconsin switched from separate reporting to combined reporting in 2009 and limits sharing of pre-2009 NOL carryforwards among group members
    - Tax years before 2012:
      - No sharing of pre-2009 NOL carryforwards with group
    - Tax years after 2011:
      - Apply the NOL carryforward to member's own income, then apply 5% of NOL the carryforward to other members

Suspended or Limited State NOLs

- At times, states will suspend or limit the use of state NOLs
- Usually done if state has budget shortfall issues
- Example of state with NOL limitation:
  - Pennsylvania:
    - Utilization limited to:
    - 40% of taxable income after 2018
    - 35% of taxable income after 2017
    - 30% of taxable income for 2017
- Example of states that have suspended their NOLs in the past is California
  - Suspended years generally do not count as a taxable year for purposes of the carryover period

STATE NOLS AFTER TAX REFORM

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Federal Net Operating Losses After Tax Reform

- Net operating losses arising in tax years *beginning* after 2017 will be limited to 80% of taxable income
- NOLs available for carryover that arose in years prior to 2018 will not have limitation on utilization
- NOLs arising in years *ending* after December 31, 2017 will no longer be available to carryback two years
- Carryforward period is now indefinite (rather than 20 years)
- State Impact
  - Only a handful of states are conforming to the TCJA's amendments to IRC Section 172
  - For most states, you will still need to calculate and track individual state NOLs with their own limitations and carryforward periods.

State Impact of Amendments to Federal NOL

State Reactions and Impact

- Georgia (H.B. 918) – adopts amended IRC Section 172 NOL limitation.
- Indiana (S.B. 1316) – decouples from amended IRC Section 172 NOL limitation; applies own NOL calculation (including 20 year carryforward).
- Utah (H.B. 2003) – adopts amended IRC Section 172 NOL limitation, effective for tax years beginning on or after 1/1/2019.
- State impact/reactions may be minimal as most already modify IRC Section 172, provide their own NOL deduction, or use their own NOL limitation.
  - States with carryback periods could be encouraged to eliminate.
  - States without NOL limitations could be encouraged to adopt.
  - Will states adopt an indefinite carryforward period? Decoupling will add to federal/state complexity.

Incorporating State Modifications into the NOL Calculation

- New Jersey starts with line 28, Taxable income before net operating losses
- New Jersey Allows a deduction for IRC 250(a). However, these deductions are only allowed to the taxpayer that included the GILTI and FDII income on it's federal return and actually took the deduction for federal purposes. TB-85(R)
  - P.L. 2018, c. 131, enacted a provision allowing the federal deductions under IRC §250(a) for New Jersey CBT purposes; however, such deductions are allowed only to the specific taxpayer that included the respective GILTI and FDII income on its federal and New Jersey CBT returns, and that actually took the deductions for federal tax purposes. If taxpayers 2 Rev. 12/2018 were not allowed the IRC §250(a) deduction for federal tax purposes, they will not be allowed the deduction for New Jersey CBT purposes
- Under federal law, if a taxpayer is at a loss before the 250(a) deduction or they utilize NOLs, they are not allowed to take the 250(a) deduction.
- New Jersey NOL carryovers can be used to offset net GILTI and FDII Income on a pre-apportioned basis
- Companies with large GILTI inclusions will utilize NOLs at a much faster rate

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New Jersey Example

- For federal purposes they utilized an NOL. Thus, the 250(a) deduction was disallowed at the federal level.
- No 250(a) deduction at the federal level = No New Jersey deduction.
- NOL applied to gross GILTI and FDII amounts
- NOL utilized for NJ purposes was 20M

Line	Description	Line No.	Amount
28.	Taxable income before net operating loss deductions and special deductions – Subtract line 27 from line 11 (Must agree with line 28, page 1 of the Unconsolidated federal Form 1120, or appropriate line from forms 1120-IC-DISC, 1120-FSC, or 1120-A, whichever is applicable) (See instructions 8(b) and 16(c))........	28.	20,000,000.00
	NEW JERSEY ADJUSTMENT – LINES 29-38 MUST BE COMPLETED ON THIS FORM		
29.	Interest on federal, state, municipal, and other obligations not included on line 5 above (see instruction 16(d))	29.	
30.	Related interest addback (from Schedule G, Part I)	30.	
31.	New Jersey State and other states taxes deducted above (see instruction 16(f))	31.	
32.	Depreciation and other adjustments (from Schedule S) (see instruction 42)........	32.	
33.	(a) Deduct IRC Section 78 Gross-up not deducted at line 37a below (do not incl. dividends)	33a.	
	(b) Other deductions and additions. Explain on separate rider (see instruction 16(h))	33b.	
	(c) Elimination of nonoperational activity (from Schedule O, Part I)........	33c.	
	(d) Interest and intangible expenses and costs addback (from Schedule G, Part II) (see instr. 16h)	33d.	
	(e) Add back IRC Section 965 deductions and exemptions........	33e.	
	(f) Deduct IRC §250(a) amount allowed federally (See inst. 17 for limitations)	33f.	
	(g) Add back any other federally exempt income not reported elsewhere on Schedule A (see instruction 16h)	33g.	
34.	Entire net income before net operating loss deduction and dividend exclusion – Total lines 28 through 33 inclusive	34.	20,000,000.00
35.	Net Operating Loss Deduction (from Form 500, line 9)	35.	20,000,000.00

New Jersey Example

- No NOL utilized at the federal level which means they where allowed the 250(a) deduction.
- 250(a) deduction at the federal level = New Jersey deduction.
- NOL applied to net GILTI and FDII amounts
- NOL utilized for NJ purposes was 15.6M

28.	Taxable income before net operating loss deductions and special deductions – Subtract line 27 from line 11 (Must agree with line 28, page 1 of the Unconsolidated federal Form 1120, or appropriate line from forms 1120-IC-DISC, 1120-FSC, or 1120-A, whichever is applicable) (See instructions 8(b) and 16(c))	28.	20,000,000.00
	NEW JERSEY ADJUSTMENT – LINES 29-38 MUST BE COMPLETED ON THIS FORM		
29.	Interest on federal, state, municipal, and other obligations not included on line 5 above (see instruction 16(d))	29.	
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32.	Depreciation and other adjustments (from Schedule S) (see instruction 42)	32.	
33.	(a) Deduct IRC Section 78 Gross-up not deducted at line 37a below (do not incl. dividends)	33a.	
	(b) Other deductions and additions. Explain on separate rider (see instruction 16(h))	33b.	
	(c) Elimination of nonoperational activity (from Schedule O, Part I)	33c.	
	(d) Interest and intangible expenses and costs addback (from Schedule G, Part II) (see instr. 16h)	33d.	
	(e) Add back IRC Section 965 deductions and exemptions	33e.	
	(f) Deduct IRC §250(a) amount allowed federally (See inst. 17 for limitations)	33f.	4,375,000.00
	(g) Add back any other federally exempt income not reported elsewhere on Schedule A (see instruction 16h)	33g.	
34.	Entire net income before net operating loss deduction and dividend exclusion – Total lines 28 through 33 inclusive	34.	15,625,000.00
35.	Net Operating Loss Deduction (from Form 500, line 9)	35.	15,625,000.00
36.	Entire Net Income before the dividend exclusion – Subtract line 35 from line 34	36.	

VALUATION OF STATE NOLS

Accounting for State NOLs

With the reduction in the federal rate it has made accounting for state taxes much more important.

NOLs give rise to deferred tax assets (“DTA”)

- NOLs should be tracked on an entity by entity basis.
- Post-apportioned NOLs are not revalued from period to period.
- Pre-apportioned NOLs should be revalued each period.
- Carryforward periods should be analyzed.
- Evaluate if a Valuation Allowance is required.

Valuation Allowance – General Concept

- Valuation allowance must be recognized to the extent that it is "more likely than not" that some or all of the deferred tax asset will not be realized
  - ASC 740 -"Reduce deferred tax assets by a valuation allowance if, based on the weight of available evidence, it is more likely than not (a likelihood of more than 50 percent) that some portion or all of the deferred tax assets will not be realized."
- Recognition or non-recognition of valuation allowance is <u>not</u> optional
- Adjustment to valuation allowance is <u>required</u> as circumstances change

Valuation Allowance

- "More Likely Than Not" Criterion

  Types of Evidence to Evaluate

Examples of Negative Evidence	Examples of Positive Evidence
• Cumulative losses in recent years • History of expired carryforwards • Short carryforward /carryback periods • General industry trends • Going concern issues • No taxable income expected in future years	• Positive earnings history • No history of expired carryforwards • Long or unlimited carryforward periods • Sales backlog • Appreciated net asset values

- All available positive and negative evidence must be considered
- Evidence will include both objective and subjective information
- Weight given to evidence should be commensurate with the extent to which it can be objectively verified

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Valuation Allowances

Valuation Allowances May be Required When You Have the Following:

- Limited carryforward periods
  - NOLs with unlimited carryforward periods may still require a VA
- Trapped NOLs – some states allow for sharing of losses others do not
- Negative evidence of cumulative losses in recent years
- History of expiring losses
- Projecting losses in future years

Valuation of State NOLs

Mergers and Acquisitions

- IRC 381 Conformity
  - Do tax attributes carryover?
- IRC 382 Conformity and Application
  - Limits on NOLs
  - Is 382 applied on a pre apportioned or post apportioned bases
- Separate Filing vs. Combined Filing
  - Are NOLs allowed to be shared among group members

State tax attributes should be analyzed to calculate the potential impact on the purchase price.

SECTION 381 CARRYOVER OF STATE NOL ATTRIBUTES

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State NOL Planning in M&A Transactions

- Prior to the pursuing any M&A transactions, it is important to determine whether state NOL carryovers can be used subsequent to that M&A transaction.
- It is important to understand the state specific NOL carryover rules relating to M&A transactions during the planning stages of M&A transaction and plan accordingly.

IRC Section 381

- Section 381 provides that an acquiring corporation succeeds to the NOL carryovers in connection with tax free liquidations and certain qualifying reorganizations.
- How is this applied at the state level?

IRC Section 381

State Conformity:

- Many states have explicitly adopted Sec. 381 or implicitly adopted it because they have not explicitly decoupled from this provision.
  - Some states expressly adopt IRC Sec 381 since they reference IRC Sec 381 in their state statutes and regulations
    - Some Examples: California, Florida, Georgia, Iowa, Michigan, Minnesota, and Pennsylvania
  - Other states implicitly adopt IRC Sec 381 in their statutes by their adoption of the IRC or their adoption of IRC Sec 172 which references IRC Sec 381

- Decouple: Some states expressly disallow the carryover of NOLs for various reasons.
  - Continuity of Business Enterprise Requirement (NC)
  - NOL Deduction Restricted to Corporation that Incurred the Loss (MA, MS, MT, NJ, TN)

- Some states which do not adopt IRC Sec. 381 will however allow the utilization of pre-acquisition NOLs to the extent there is continuity of business.

  - Arizona, Arkansas, Connecticut and Utah are examples of states that utilize this approach.
    - Arizona, Arkansas and Utah have issued regulations that describe how to compute the limit on acquired companies state NOLs: refer to Ariz. Comp. Admin. R. & Regs. §15-2D-302.B.3; Ark. Reg. § 1.26-51-427(3)(C); and Utah Code Sec. 59-7-110(6).

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Restrictions on State NOL Deductions

North Carolina:

- In *BellSouth Telecommunications, Inc. v. Department of Revenue* (No. COA96-558 [N.C. Ct. App., June 3, 1997]), the North Carolina Court of Appeals ruled that a corporation could not deduct a pre-merger net economic loss of a former subsidiary, because the continuity of business enterprise requirement was not satisfied. NOLs carry over only if the acquiring corporation continues the business enterprise of the loss corporation.

New Jersey:

- In *Richard's Auto City, Inc. v. Division of Taxation* (No. A-54 [N.J. Sup. Ct. June 21, 1995]), the New Jersey Supreme Court held that the Division of Taxation regulation limiting post-merger NOL carryovers to the same corporation that originally incurred the loss was valid. Thus, a corporate survivor of a merger could not deduct NOLs incurred by the merged corporation.

Restrictions on State NOL Deductions

Tennessee:

- In *Little Six Corp. v. Johnson* (No. 01-A-01-9806-CH-00285 [Tenn. Ct. App., May 28, 1999]), the Tennessee Court of Appeals held that the surviving corporation in a statutory merger may not deduct NOLs incurred by the merged corporation because the use of such deductions was specifically prohibited by regulation, and an analysis of the applicable statute demonstrated the legislature's intent that the corporation claiming the benefit of an NOL must be the same corporation that incurred the loss.
  - However, a Tennessee statue indicates that NOL carryovers do survive if that taxpayer merges into a shell entity with no income, expense, assets, liabilities, or net worth (Tenn. Code §67-4-2006(c)(3))

Combined Reporting – Sec. 381

- Some states that require combined reporting and adopt IRC Sec. 381 only allow NOL carryovers to offset income attributable to:
  - The taxpayer that generated the NOL carryover or,
  - The acquiring corporation of the taxpayer that generated the NOL

- Combined states that use the "intrastate" approach can lead to "trapped" NOLs
  - Example:
    - California assigns income to a taxpayer within a combined group based on the relative proportion of that taxpayers sales over the combined group's total sales. If the entity that generated the NOL does not have an apportionment factor in California they will not be able to utilize those NOLs even if they survived to them under IRC Sec. 381. These NOLs will "trapped" until this entity has state income apportioned to it.

SECTION 382 LIMITATIONS ON STATE NOLS

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IRC Section 382

- Section 382 does not disallow an NOL deduction, but rather limits the amount of the deduction to the amount of future profits generated by the loss corporation's business capital.

- For transactions in which the acquiring corporation succeeds to the NOL carryovers the ability to utilize them could be limited by 382.

- States that adopt IRC Sec. 381 typically also adopt IRC Sec. 382
  - Illinois is an exception. 35ILCS 5/405(a) indicates tat a taxpayer succeeds to the NOLs in the case of an acquisition of assets described in IRC Sec. 381(a) but 35 ILCS 5/405(b-5) indicates no limitation under IRC Sec. 382 shall apply to a NOL carryover.

IRC Section 382

Should an IRC Sec. 382 limitation be apportioned in states which utilize an apportioned NOL deduction?

- Some states require the apportionment of this limitation, either by use of the apportionment ratio in the year ownership change occurs or the apportionment ratio in the year the NOL is utilized.
  - Alabama, Georgia, Minnesota, Oregon, and Pennsylvania are examples of states that expressly require the apportionment of an IRC Sec. 382 limitation.
- Example:
  - Ga. Code Ann. §48-7-21(b)(10.1)(D). Whenever an ownership change occurs, an IRC §382 limitation will apply to all GA pre-change losses that are carried over to a post-change year. Pre-change years end on or before the date of an ownership change, while post-change years end after the date of an ownership change. In a post-change year, the limitation on the use of any pre-change year GA NOLs shall be determined by applying that post-change year's apportionment percentage to the IRC §382 limitation for that post-change year. Ga. Comp. R. & Regs. §560-7-3-.06(5)(e)4.

IRC Section 382

- Some states which utilize an apportioned NOL are silent relating to whether the IRC Sec. 382 limitation should be apportioned.
  - Taxpayers have been successful in asserting that state auditors cannot unilaterally decide to apportion the IRC Sec. 382 limitation on audit.
  - See AT&T Corporation v. Alabama Department of Revenue., Docket No. Corp. 05-403 (Jun. 30, 2006) & Express Scripts, Inc. v. Minnesota Department of Revenue, Minnesota Tax Court No 8272 R (Aug. 20, 2012).
    - Subsequent to the AT&T decision Alabama issued a regulation requiring the apportionment of IRC Sec. 382 limitations. See AL Reg. Sec. 810-3-1.1-.01(4)(b)

Modified 382 Limitations

California

- Technical Advice Memorandum 2017-03 addresses the complicated application of sections 382 through 385 for California purposes
  - Section 382 is applied on a *pre-apportionment* basis
  - The recognized built-in gains and losses (RBIGS and RBILS) provided for in section 382(h)(2) are determined on a *post-apportionment* basis
  - The net unrealized built-in gains and losses (NUBIGs and NUBILS) provided for in section 382(h)(3) are determined on a *post-apportionment* basis
  - The limitation of the use of excess credits provided for in section 383(a)(1), which references the limitation provided for in section 382, is applied on a *pre-apportionment* basis
  - California applies the examples found in Reg. section 1.383-1(f), but the federal rates in those examples must be substituted for the applicable state rates

IRC Sec. 381 and 382 Takeaways

Before any merger or acquisition it is important to structure the transaction in a way where the acquiring corporation under IRC Sec. 381 is a taxpayer that is expected to meet the following criteria after the acquisition/reorganization:

- Have taxable income on a separate company basis and apportionment factors sourced to the separate company states where the taxpayer will file.
  - This will ensure that taxpayer will be able to use those NOLs in separate company states
- Have sales sourced to combined reporting states where the taxpayer will file.
  - This will ensure that taxpayer will be able to use those NOLs in the combined reporting states that only allow NOL carryovers to be utilized to offset state taxable income attributable to either:
    1. the taxpayer that generated the state NOL carryover; or
    2. the acquiring corporation under IRC Sec. 381 of the taxpayer that generated the NOL carryover.

IRC Sec. 381 and 382 Takeaways

Before any merger or acquisition it is important to determine the following:

- Whether state NOLs of the acquired/reorganized companies survive?
  - This should be determined so the proper deferred tax assets can be recorded for financial purposes related to NOL carryovers.
  - Quantify impact on purchase price.

- Will those NOL carryovers be limited and if so will enough income be generated to utilize them?
  - Detailed modeling may be necessary
  - This should be determined so appropriate Valuation Allowances can be established if necessary.
  - Quantify impact on purchase price

STRATEGIES TO MAXIMIZE STATE NOL UTILIZATION

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Analysis of State NOL Utilization Strategies

When analyzing state NOL utilization strategies it is imperative to have a thorough understanding of the following:

- State NOL mechanics
- State NOL carryforward rules
- State group reporting (sharing vs. no sharing, etc.)
- Federal NOL rules
- IRC 381/382/172
- State SRLY rules

Effects of State Filing Methodology

- Majority of states that default to separate return filings allow for an election to file a consolidated return.
  - Elections are usually binding
  - Some require pre-approval
  - Restrictions on includable entities
    - Federal Consolidated v. Nexus Consolidated
    - Could be restrictions on utilization of tax attributes
- Consolidated returns can be advantageous if the group has both income and loss companies.
  - However, the rules should be analyzed before making an election as most elections are binding.

Consolidated Return Example - Georgia

Separate Georgia Returns			
	Parent Co.	Sub A	Sub B
State Tax Base	4,000,000	(600,000)	(5,000,000)
GA Apportionment	60.000%	10.000%	50.000%
GA Taxable Income	2,400,000	(60,000)	(2,500,000)
Tax Rate	6.00%	6.00%	6.00%
Total Tax	**144,000**	-	-

- Georgia defaults to separate filing
- Total Tax Liability $144,000 on an entity level basis

Consolidated Georgia Return				
	Parent Co.	Sub A	Sub B	Total
State Tax Base	4,000,000	(600,000)	(5,000,000)	
GA Apportionment	60.000%	10.000%	50.000%	
GA Taxable Income	2,400,000	(60,000)	(2,500,000)	(160,000)
Tax Rate				6.00%
Total Tax				-

- Georgia provides for a consolidated election (Request Required)
- Each entity calculates and apportions income on a separate entity basis. These amounts are then added together.
- NOLs generated when an entity was part of a consolidated GA return can be shared (GA does have SRLY rules).
- Tax Savings of $144,000

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Effects of State Filing Methodology

Coca-Cola Enterprises Inc. v. Ala. Dep’t of Revenue, No. Corp. 09-641 (Ala. Dep’t of Rev. Feb.14, 2013)

- Alabama ALJ held that an affiliated group can deduct NOLs from years when the group did not file an Alabama consolidated return. However, the corporation that incurred the loss must have been a member of the group at the time the loss arose.
- Group must meet definition of “affiliated group” at the time the loss arose
- Thus, an affiliated group can exist before it elects to file an Alabama consolidated return

Planning Strategies

Convert Profitable Corporation into a Single-Member LLC ("SMLLC")

- Example:
  - Company A operates at a loss and has generated substantial NOL carryforwards.
  - Company B generates income and pays tax annually.
  - Convert Company B into a SMLLC with Company A being the soul owner
  - Almost all states conform to the federal treatment of SMLLC's. Therefore, Company A will be able to offset the income from Company B by utilizing it's NOL carryforwards. This will also allow Company A to utilize any "trapped" NOLs in states such as California

Planning Strategies

Company A and Company B are Separate Corporations

	Company A	Company B
State Tax Base or (Loss)	(6,000,000)	5,000,000
Pennsylvania Sales	800,000	3,900,000
Everywhere Sales	2,000,000	4,000,000
Apportionment %	40.00%	97.50%
Taxable Income	(2,400,000)	4,875,000
Tax Rate	9.99%	9.99%
Tax Liability		**487,013**

Company A is a Corporation and Company B is a SMLLC owned by Company A

	Company A Stand Alone	SMLLC - B	Total Company A
State Tax Base or (Loss)	(6,000,000)	5,000,000	(1,000,000)
Pennsylvania Sales	800,000	3,900,000	4,700,000
Everywhere Sales	2,000,000	4,000,000	6,000,000
Apportionment %	40.00%	97.50%	78.33%
Taxable Income	(2,400,000)	4,875,000	(783,333)
Tax Rate			9.99%
Tax Liability			

Tax Savings of $487,013

NOL Utilization Strategies

What can be done to stop generating state NOLs that can't be utilized?

- Things to consider:
  - Unallocated Expenses
  - Uncharged Services
  - Mobile income streams (i.e. intangibles, vendor rebates, etc.)
  - Intercompany transactions
    - Transfer pricing should be considered
  - Debt Issues
    - Is 3rd party debt at the right entity?
    - Pushing down debt

- Keep in mind: Any strategy pursued needs to have business purpose and economic substance

State NOL Utilization Strategies

- Tripping unrealized built in gains to use NOLs
- Moving appreciated assets into loss corporation before selling them
- Creating or tripping deferred intercompany transactions
  - Separate entity reporting states: Distribution of appreciated property to the corporate parent.
- Mergers or liquidates of loss company into a profitable company
  - Analyze 381 rules in the state
- Tax Accounting Method Changes
  - Accelerating income
  - Deferring deductions

Key Takeaways

- Tracking state NOLs has become increasingly more difficult.
- It is essential for tax compliance, tax provision preparation and the compilation of a Company's financial statements that state NOLs are tracked effectively.
- It's important to continue monitoring legislation to ensure state NOLs are tracked correctly.
- Maximizing both cash and tax benefits related to state NOLs can be a complex task.
- There are planning strategies; however, it's important to understand the state rules and analyze and model out the impacts to avoid common pit falls.

Questions?

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