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NOLs - The most valuable state tax assets you only think you have

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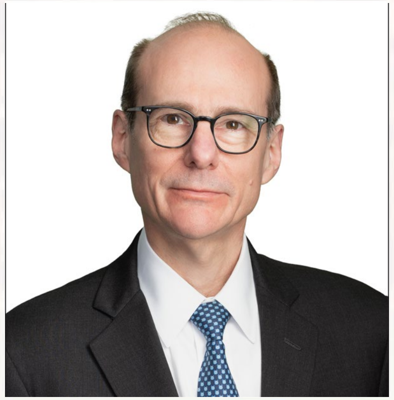

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Agenda

Overview of the NOL deduction

Recent federal tax law changes

Key state tax issues

Q&A (time permitting)

Overview of the NOL deduction

The NOL deduction works to…

"…ameliorate the unduly drastic consequences of taxing income strictly on an annual basis. They were designed to permit a taxpayer to set off its lean years against its lush years, and to strike something like an average taxable income computer over a period longer than one year."

Lisbon Shops, Inc. v. Koehler, 353 U.S. 382, 386 (1957)

IRC Section 172(a)

There shall be allowed as a deduction for the taxable year an amount equal to—

* * *

(A) the aggregate amount of net operating losses arising in taxable years beginning before January 1, 2018, carried to such taxable year, plus

(B) the lesser of—

(i) the aggregate amount of net operating losses arising in taxable years beginning after December 31, 2017, carried to such taxable year, or

(ii) 80 percent of the excess (if any) of—

(I) taxable income computed without regard to the deductions under this section and [IRC Sections] 199A and 250, over

(II) the amount determined under subparagraph (A).

Effect of corporate transfers

- Federal limitations on the NOL deduction aim at preventing a corporation from acquiring NOLs in order to reduce its taxable income.
  - These limitations generally address certain “tax-free” corporate reorganizations (i.e., nonrecognition transactions; see **IRC Section 381**), as well as transactions resulting in a change in ownership of the entity with NOL carryforwards (see **IRC Sections 382 and 384**).
  - Federal tax law imposes additional limitations, **separate-return-limitation-year (SRLY)** rules, applicable to members of federal consolidated return groups.

The state NOL deduction

- States generally offer an NOL deduction.
  - Though most states adopt federal taxable income as the starting point to the state corporate income tax computation, few states allow the federal NOL deduction without significant modification.
    - E.g., Missouri Department of Revenue instructions to Form MO-1120 (2021): "The only NOL subject to carry forward or carry back is the loss from the federal tax return. Missouri does not have provisions for a state NOL deduction." See also Mo. Rev. Stat. § 143.431(1) and (4)).
- State NOL statutes can vary from federal law as to:
  - The calculation of an NOL
  - The amount of or limitation on an NOL deduction
  - The timing of an NOL deduction

Recent federal tax law changes

Tax Cuts and Jobs Act (TCJA) (P.L. 115-97)

- The TCJA significantly modified the treatment of federal NOL deductions arising in tax years beginning after 2017 by:
  - Eliminating NOL carrybacks for most taxpayers
  - Allowing NOLs to be carried forward indefinitely for most taxpayers
  - Limiting usage of NOL carryforwards to 80% (rather than 100%) of the taxpayer's taxable income for the year (determined without regard to the NOL deduction)

Coronavirus Aid, Relief, and Economic Security (CARES) Act (P.L. 116-136)

- However, the CARES Act provided for the following incremental changes to the post-TCJA NOL deduction rules:
  - NOLs arising in a taxable year beginning after December 31, 2017, and before January 1, 2021, generally may be carried back 5 years.
    - Recall, the TCJA had repealed carryback provisions for most taxpayers.
  - The 80%-of-taxable-income limitation does not come into effect until tax years beginning after December 31, 2020.
    - Previously effective for tax years beginning after December 31, 2017.

Key state tax issues

Timing of state NOL deduction

- State-specific rules for carryforward periods vary:
  - Rhode Island offers only a 5-year carryforward for NOLs.
  - Several states, such as New York, provide a 20-year carryforward – reflective of pre-TCJA federal tax law.
- States often *require* that an NOL be carried back before it may be carried forward.
  - Failure to comply with such rules may result in loss of NOL. See, e.g., Mont. Code Ann. § 15-31-119; Montana Department of Revenue instructions to Form CIT (2021).
  - States offering a carryback may provide an election to forgo the carryback period (e.g., Mississippi), or may conform to a federal election.
- States may also specify the order in which NOLs from more than one loss year can be deducted.
  - In Louisiana, for tax years beginning on or after Jan. 1, 2020, NOLs are deducted based on the loss from the earliest year. La. Rev. Stat. Ann. § 47:287.86(C)(2) (2019 HB 263).

Amount of state NOL deduction

- While the amount of the state NOL deduction is generally based on state taxable net income, states may limit that deduction as follows:
  - Conformity to **federal** limitation (i.e., 80% of taxable income)
  - A **percentage** of taxable net income (e.g., Pennsylvania NOL deduction is limited to 40% of taxable income, applicable for taxable years beginning after December 31, 2018)
  - A **fixed-dollar** amount (e.g., Delaware NOL deduction is limited to $30,000 per year)
- State lawmakers occasionally enact suspensions of or limitations on NOL deductions in order to mitigate state tax revenue impacts of the deduction.
  - Recent examples include California (2020-2021) and Illinois (2022-2024).

Nexus

- A state may require that a corporation have **nexus in the loss year** for purposes of deducting NOL carried forward from subsequent year. For example:
  - Rhode Island statute provides that, "The deduction shall not include any [NOL] sustained during any taxable year in which the taxpayer was not subject to the tax imposed by this chapter." R.I. Gen. Laws § 44-11-11(b)(2).
  - Even if a state's statutes does not explicitly require nexus in the loss year, consider whether a state may use its discretionary authority (applying the tax benefit rule) to achieve the same result.

Apportionment

- A state NOL deduction is based on apportionment percentage in either the loss year (post-apportionment deduction) or the carryover year (pre-apportionment deduction).
  - In states that deduct NOLs on a **pre-apportionment** basis, a corporation's entire NOL from the loss year is offset by the corporation's total apportionable income from the carryover year before applying the taxpayer's apportionment percentage from the carryover year.
  - Other states deduct NOLs on a **post-apportionment** basis, meaning that an NOL is adjusted by the loss year's apportionment percentage, and the apportioned NOL is then offset against the corporation's apportioned income in the carryover year.
    - Note New Hampshire 2022 SB 435 (applicable to tax years ending on or after December 31, 2022) eliminating double apportionment of NOLs.

Allocation

- NOLs derived from non-apportionable (sometimes, “nonbusiness”) activities outside of a state might not be deductible against net taxable income from in-state business activities.
- On the other hand, state courts have held that a corporation may not carry over an NOL that is apportionable to the state but that, for federal income tax purposes, was offset by allocable nonbusiness income.
  - See, e.g., *Somerset Telephone Co. v. State Tax Assessor*, 259 A3d 97 (Me. 2021).

Interaction with nontaxable income

- State tax laws and agency guidance often provides that a state NOL may not be increased by the amount of income that is excluded or otherwise deducted as nontaxable income. For example:
  - In determining an Arkansas NOL, a corporation must add to gross income "all nontaxable income not required by law to be reported as gross income less any expenses properly and reasonably incurred in earning nontaxable income, which expenses would otherwise be nondeductible." Ark. Code Ann. § 26-51-427(2)(A).
    - See also Ark. Dept. of Fin. and Admin., No. 21-461 (July 31, 2021) (IRC Section 965 income excluded from Arkansas taxable income).
  - New Jersey NOLs must be used to reduce entire net income before applying the state's dividends received deduction. N.J. Rev. Stat. § 54:10A-4(k)(6)(c).

Net addition modifications and similar limitations

- Some states impose rules that prevent a single NOL deduction from creating multi-year tax benefits occurring:
  - First in the year the NOL offsets any state net addition modifications to federal taxable income; and
  - Second in the year the NOL is carried forward/backward and deducted.
- To avoid multiple uses of an NOL, these states add back or “recapture” an NOL deduction to the extent of any previous use.
  - Maryland imposes an addback in the carryover year in which the last dollar of the associated loss year NOL is applied to offset taxable income. Md. Code, Tax-Gen. §§ 10-306(b)(3) and 10-205(e).
- States may also impose rule limiting the amount of state NOL to the amount of a federal NOL for the year.
  - See, e.g., Colorado draft Rule 39-22-504-2(1)(d), issued Sept. 22, 2022.

Combined reporting

- Many states do not allow “sharing” of NOLs, even in a combined or consolidated report.
  - In these states, NOLs can only offset the income of the entity in the state combined or consolidated report that incurred the loss.
  - States that allow combined reporting typically follow SRLY or similar rules in limiting NOL deductions.
    - E.g., Arizona: NOLs incurred by a separate company may be carried forward and deducted against income reported on a combined return only to the extent that the combined income of the group is related to the entity that incurred the loss. Ariz. Admin. Code § 15-2D-302(B)(3)(a).

Change in corporation ownership

- States may conform to IRC Sections 381-384, which provide limitations for corporate carryovers of tax attributes, or may impose substantially similar rules.
  - Arizona employs a "continuity of business enterprise test." Arizona Dept. of Rev. CTR 91-2 (Apr. 2, 1991).
  - New Jersey regulations describe a "survivor rule" under which an NOL can only be carried over by the corporation that sustained the loss and is the surviving corporation. N.J. Admin. Code § 18:7-5.13(b).
- State conformity to the IRC Section 382 limitation, or similar state rules, raise questions as to whether that limitation:
  - Is applied to pre- or post-apportioned NOLs
  - Should, itself, be apportioned
  - Is determined on a separate company or combined group basis
    - See North Carolina 2022 HB 83, which clarified that federal regulations under IRC Sections 381 and 382 are applied on a separate entity basis for North Carolina purposes.

Other notable state tax issues

- Coordination of NOL deduction with other taxable income-limited deductions, including:
  - IRC Section 163(j) limitation on business interest expense
  - IRC Section 250 (GILTI, FDII)
  - Charitable contributions
- Statute of limitations
  - *R.O.P. Aviation, Inc. v. Dir., Div. of Tax'n*, 32 N.J. Tax 346 (N.J. Tax Court 2021)
  - Ark. Dept. of Fin. and Admin. Nos. 22-457, 22-699, 22-700 (Sept. 12, 2022)

Q&A

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Thanks for your participation