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NOL Strategies for Federal and State Tax Reporting by Multi-State Companies
Mastering FederalRegs and Restrictions, Differing State NOL Matches, Carryback and Carryforward Elections

TUESDAY, SEPTEMBER 24, 2013
1pm Eastern    |    12pm Central   |   11am Mountain    |    10am Pacific

Today’s faculty features:

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NOL Strategies for Federal and State Tax Reporting by Multi-State Companies

Sept. 24, 2013

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Today’s Program

Section 382
[Robert Liquerman and Amy Chapman]

Corporate Equity Reduction Transactions (CERT)
[Robert Liquerman, Rebecca Holtje]

State Net Operating Loss Issues and Opportunities
[John Harper]
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SECTION 382

Robert Liquerman, KPMG
Amy Champman, KPMG
Section 382 provides that if a *Loss Corporation* experiences an *Ownership Change*, then the amount of the Loss Corporation’s taxable income for any postchange year (or period) that can be offset by its prechange losses cannot exceed the *Section 382 Limitation* for that year.
Section 382 – Ownership Change

A Loss Corporation is any corporation having an NOL carryover, capital loss carryover, net unrealized built-in loss, general business credit carryover, AMT carryover, foreign tax credit carryover.

A Loss Corporation has an Ownership Change if, on a testing date, the percentage by value of stock of the Loss Corporation owned by one or more 5 percent shareholders has increased by more than 50 percentage points over the lowest ownership percentage of such shareholders at any time during the testing period.

A testing date is any date on which the percentage ownership of a 5 percent shareholder changes or on which an equity structure shift, such as a merger, occurs. (See exceptions in Notices 2008-76 and 2008-84.)

The testing period is generally a rolling three-year period ending on the testing date.
## 5-percent Shareholders

<table>
<thead>
<tr>
<th>Type</th>
<th>If ownership % &gt; 5%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Individuals</td>
<td>5% shareholder</td>
</tr>
<tr>
<td>Corporations</td>
<td>Attribute ownership to s/h</td>
</tr>
<tr>
<td>Partnerships</td>
<td>Attribute ownership to partners</td>
</tr>
<tr>
<td>Trusts</td>
<td>Attribute ownership to trustee/beneficiary</td>
</tr>
<tr>
<td>ESOPs</td>
<td>5% shareholder (some exceptions)</td>
</tr>
<tr>
<td>Governments</td>
<td>5% shareholder (some exceptions)</td>
</tr>
<tr>
<td>Investment advisors</td>
<td>Treatment depends on “economic owner”</td>
</tr>
</tbody>
</table>
Coordinated Acquisitions

A group of persons who have a formal or informal understanding among themselves to make a coordinated acquisition of stock are treated as an entity;

A principal element in determining if such an understanding exists is whether the investment decision of each member of a group is based on the investment decision of one or more other members.
Segregation

Segregation rules treats certain groups of shareholders as a new public group, separate from any pre-existing public group.

These typically include:

- Issuances by Loss Corp to public
- Redemptions by Loss Corp from public
- Acquisitions/dispositions of Loss Corp stock by 5-percent shareholders from or to public
- Reorganizations qualifying as equity structure shifts
- First or higher-tier transactions
Segregation Rules – Exceptions

These exceptions may allow a Loss Corp to issue shares with no or a reduced corresponding increase in cumulative owner shift

Small issuance exception – Reg. 1.382-3(j)(2)
- Generally treats small issuances by Loss Corp as issued to existing direct public groups on a pro-rata basis

Cash issuance exception – Reg. 1.382-3(j)(3)
- Generally treats a portion of shares issued by Loss Corp “solely for cash” as issued to existing direct public groups
IRS invites comments relating to potential modifications to the treatment of “Small Shareholders” (i.e., shareholders who are not 5-percent shareholders) for section 382 purposes.

Notice 2010-49 sets forth two approaches to the proper treatment of Small Shareholders, both of which recognize that one of the primary abuses Section 382 seeks to prevent is the acquisition of loss corporation stock, followed by contribution of income-producing assets or diversion of income-producing opportunities.
Notice 2010-49 Two Approaches

The Ownership Tracking Approach

Approach primarily taken by the current regulations

It is generally of no significance whether the shareholders who increase their ownership (to count towards the 50% threshold) are Small Shareholders or 5-percent shareholders (aside from public trading)

For example, if a 5-percent shareholder sells stock to Small Shareholders, such Small Shareholders are segregated into a separate public group, resulting in a shift in ownership counted towards the 50% threshold
Purposive Approach

Seeks to identify more specifically the circumstances in which abuses of Section 382’s underlying purpose are likely to arise.

Reflects the view that it is unnecessary to take into account all acquisitions of stock by Small Shareholders, because Small Shareholders are generally not in a position to abuse Section 382 by acquiring loss corporation stock and then contributing income-producing assets (or diverting income-producing opportunities), typically would result in fewer owner shifts, because many shifts are not abusive.
Generally adopts “Purposive Approach” described in Notice 2010-49

1. “Secondary transfer” exception to segregation rules for sales by 5-percent shareholders to public

2. “Small redemption” exception to segregation rules (similar to current small issuance exception)

3. Small holder first tier and higher tier entity exception from segregation rules

4. Modifies segregation rules applicable to transactions involving tiered entities

**Effective Date**

For testing dates occurring on or after the date published as final regulations
Notice 2010-50: Background

Section 382(l)(3)(C): “Except as provided in regulations, any change in proportionate ownership which is attributable solely to fluctuations in the relative [FMV] of different classes of stock shall not be taken into account.”
Notice 2010-50: Example

Date 1

LossCo

A

50 common shares
Value=$300

B

100 voting preferred
shares
Value=$100

Day before Date 2

LossCo

A

50 common shares
Value declines to
$25

B

100 voting preferred
shares
Value=$100

Notice 2010-50: Example
**Notice 2010-50: Example (Cont.)**

Date 2

- 3 common shares
- 50 common shares Value=$23.50
- 100 voting preferred shares Value=$100

Date 1:
- 75%
- 25%

Immediately before Date 2:
- 20%
- 80%

Date 2:
- 19%
- 80%
- 1%
Provides guidance for loss corporations with more than one class of stock

Gives significant flexibility in applying section 382(l)(3)(C)

Discusses acceptable methodologies for taking or not taking into account fluctuations in value among the classes of stock

Identifies one inappropriate methodology

Requests comments to assist in the development of future guidance
Full Value Methodology

% of stock owned by shareholder = FMV of stock owned / Total FMV of stock outstanding

Hold Constant Principle

Value of a share, relative to the value of all other stock of the corporation, is established on the date that share is acquired by a particular shareholder. On subsequent testing dates, the % interest represented by that “tested share” is then determined by factoring out fluctuations in the relative values of classes that have occurred since the acquisition date of the tested share.
Between 2008 and 2010, the Service issued a number of Notices, including Notice 2010-2 to address certain federal income tax implications of the issuance of instruments by loss corporations to Treasury under the Emergency Economic Stabilization Act of 2008 (“EESA”).

Notice 2010-2 provides guidance to corporate issuers with respect to the treatment of stock issued to Treasury (either directly or upon the exercise of a warrant) pursuant to specified EESA programs (“TARP Stock”).
Notice 2010-2: The Rules

TARP Stock (other than Section 1504(a)(4) Stock) issued to Treasury is not considered to cause Treasury’s ownership in the issuing corporation to have increased over the lowest percentage that it owned on any earlier date.

TARP Stock is considered to be outstanding for purposes of computing the percentage of stock owned by other 5-percent shareholders on any testing date.

TARP Stock that is redeemed will be treated as if it had never been outstanding.
If Treasury sells TARP Stock (other than Section 1504(a)(4) Stock) and the sale creates a segregated public group (a “TARP Public Group”), the TARP Public Group’s ownership in the issuing corporation will not be considered to have increased solely as a result of such a sale.

The TARP Public Group’s ownership is treated as having increased to the extent the TARP Public Group increases its ownership pursuant to any transaction other than a sale of stock by Treasury, including an increase attributable to the Small Issuance Exception or the Cash Issuance Exception.
CORPORATE EQUITY REDUCTION TRANSACTIONS (CERT)
Rules Applicable To Corporate Equity Reduction Transactions (CERTs)

- Sect. 172(b)(1)(A) allows an NOL incurred by a taxpayer to be carried back or carried forward to taxable years of that taxpayer.
  - Carrybacks are limited to the two years prior to the year of the NOL, and
  - Carry forwards are limited to the 20 years after the year of the NOL.

- Sect. 172(b)(1)(E) prohibits an applicable corporation from carrying back a portion of an NOL (the CERIL) incurred in any loss limitation year (an LLY) to those taxable years that precede the taxable year in which a CERT occurs.

- The purpose of the CERT limitation is to prevent taxpayers from claiming a refund of a prior-year tax payment for the purpose of funding the cost of post-CERT year interest expense “allocable” to certain corporate acquisitions and distributions. See H.R. Rep. No. 101-247 (1989)
What Is A CERT (Corporate Equity Reduction Transaction)?

- As provided in 172(h)(3) a CERT is defined as either a “major stock acquisition” or an “excess distribution.”
  - **Major stock acquisition (MSA):**
    - An acquisition by a corporation of 50% or more (by vote or value) of the stock in another corporation
    - A stock acquisition for which a 338 election is made is not an MSA.
  - **Excess distribution (ED):**
    - A current-year corporate distribution (including redemptions, regardless of whether they are dividend equivalents), provided the amount exceeds the greater of:
      - 150% of the average of such distributions during the three taxable years immediately preceding the taxable year of the potential ED, or
      - 10% of the fair market value of the stock of such distributing corporation, measured at the beginning of such current year
    - Adjustments are made for certain stock issuances and certain contributions for, distributions on, and redemptions of plain vanilla preferred stock.
Examples Of A CERT

172(h)(3)

Note: Distribution must exceed both the 150% (three-year lookback) and 10% (fair market value) thresholds in 172(h)(3)(C), to constitute an ED.
What Is An Applicable Corporation?

- An applicable corporation is:
  - An acquiring C corporation in an MSA
  - A target C corporation in an MSA
  - The C corporation making the distribution in an ED
  - A successor to an applicable corporation
Identifying Applicable Corporation In A CERT

172(b)(1)(E)(iii) = Applicable corporation
What Taxable Years Are The LLYs (Loss Limitation Years)?

- The LLYs are the tax years in which the CERT occurred and, generally, each of the two following tax years.

  Corporation T engages in a CERT during its taxable year ending Dec. 31, Year 4.

  T’s LLYs are Year 4, Year 5 and Year 6.

172(b)(1)(E)(ii)
How Is The CERIL Computed?

- The applicable corporation’s CERIL (corporate equity reduction interest loss) is the difference between its NOL for the taxable year and the NOL for the taxable year reduced by its allocable interest deduction (AID).

- The applicable corporation’s AID is the portion of its NOL that is generated by interest deductions “allocable” to a CERT.

- Interest deductions are “allocable” to a CERT based on the UNICAP model (Treas. Reg. 1.263A-9), but subject to certain limitations:
  - AID cannot exceed the “three-year base period amount,” and
  - AID under $1 million is disregarded under a *de minimis* rule.
  - Sect. 172(h)(2)(B) prohibits direct allocation of interest expense to non-CERT activity.
Proposed CERT Rules

- On Sept. 13, 2012, the IRS and Treasury issued proposed regulations addressing CERTs.
  - The proposed regulations are prospective only.
  - The proposed regulations address:
    - General CERT rules:
      - Identification of CERT costs
      - Application to tax-free transactions
      - Interaction of EDs and MSAs
      - Calculation of lookback period items
      - Successor rules
Proposed CERT Rules (Cont’d)

- Consolidated CERT rules:
  - Guidance on single vs. separate entity
  - Treatment of intercompany transactions
  - CERT status
  - Allocation of CERT “attributes”

- Carryback waivers:
  - Avoidance of CERT taint

- On Sept. 9, 2013, the New York State Bar Association, Tax Section, commented on the Proposed CERT Rules. See 2013 TNT 175-17.
STATE NET OPERATING LOSS ISSUES AND OPPORTUNITIES

John Harper, KPMG
State Conformity to Federal NOL Provisions

● Three methodologies
  - Start with Line 30, no addition modification for federal NOL
    ▪ E.g., DE, ME, MD, MO, VA
    ▪ Generally carryforward NOLs pre-apportionment
  - Start with Line 30, require add-back of federal NOL and provide for separate state NOL
    ▪ E.g., FL, GA, IL, MI, SC
    ▪ Generally carryforward NOLs post-apportionment
  - Start with Line 28 and provide for separate state NOL
    ▪ E.g., CA, IN, MA, NC, PA
    ▪ Generally carryforward NOLs post-apportionment

● State NOL deduction may differ from federal because of state modifications, application of apportionment factors, and segregation of business and nonbusiness income, among other items
Carryback/CARRYFORWARD NONCONFORMITY

- Many states do not conform with federal carryback and carryforward periods
- Many states disallow NOL carrybacks (e.g., CT, FL, MN)
- Most states do not automatically conform to extended federal NOL carryback
- Some states temporarily suspend the NOL deduction
  - Fairly common tactic when states experience budgetary problems
  - CA suspended NOL deductions for tax years beginning on or after January 1, 2008 and before January 1, 2012
  - IL suspended NOL deductions for tax years ending after December 31, 2010, and prior to December 31, 2012
NOL Deduction Limitations

- Some states limit, either by dollar amount or percentage, the amount of NOL that may be deducted
  - For taxable years beginning after December 31, 2013, taxpayers can deduct net losses equal to the greater of 25 percent of taxable income or $4 million
    - Cap increases again in 2015
- Many states do not permit an NOL deduction for a loss incurred while a taxpayer was not doing business (i.e., not subject to tax) in the state
  - E.g., CO, MD, SC
- Other states do not impose such a requirement:
  - Instructions to 2011 Delaware Form 1100, p.7:
    - “It is not relevant to determine if the net operating loss occurred while the corporation was doing business in Delaware.”
Other NOL Limitations (Cont.)

- In some states, an NOL carryback/carryforward may not: (1) reduce federal taxable income below zero and/or (2) be used to offset net state addition modifications
  - Examples:
    - **Missouri** – FTI cannot be less than zero. *Brown Group Inc. v. Admin. Hearing Comm’n*, 649 S.W.2d 874 (Mo. 1983)
Apportionment Issues

- Some states require the NOL to be carried forward from the loss year after allocation and apportionment
  - This permits only the loss attributable to that state to be carried over against income from that state
  - Most states use the apportionment factor in the year the loss is generated (e.g., Illinois, Indiana)

- Other states allow the NOL computation to be made before apportionment and permit the deduction to be applied in the carryforward year before apportionment
  - This effectively results in the loss carryover being apportioned using the current year’s factors (e.g., Missouri)
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NOL Use by Affiliated Members

- Many combined reporting require NOLs to be tracked on a separate company basis (i.e., losses carried forward separately by one member do not offset combined income attributed to another member)
  - E.g., California

- Some states allow losses of one member to offset income of another
  - E.g., Illinois

- Kentucky only allows one member’s NOL to offset of 50% of the income of non-loss members of a consolidated group
State Conformity to Federal Consolidated Return NOL Regulations

● Most, if not all, separate return states do not conform to federal consolidated return regulations

● A number of combined return states do not conform as well including California

● Key Differences:
  − Federal NOL computed and carried forward on consolidated group basis
    ▪ Unless entity enters or leaves group and SRLY rules apply
    ▪ Then consolidated NOL allocated to members based on relative NOL
  − CA NOL determined on combined reporting group basis
    ▪ NOL then apportioned to CA
    ▪ NOL then allocated to members based on relative CA apportionment and separately carried forward
Net Operating Losses after Corporate Transactions (State Conformity with IRC 381)

- In some states an NOL of a non-survivor may be limited or eliminated following a merger
  - Massachusetts—pre-merger NOLs of non-surviving member are eliminated
  - New Jersey—Only losses of surviving entity allowed; Director can disallow if primary motive of acquiring a company appears to be use of NOLs
  - North Carolina—pre-merger losses allowed only to extent the assets that operated at a loss are operated at a profit post-merger

- Proper planning may reduce loss of state NOLs
Net Operating Losses after Corporate Transactions (State Conformity with IRC 382)

• Do states not allowing federal NOL deduction follow IRC 382?
  - Do they specifically adopt IRC 382?
  - Do they specifically mention IRC 172 and the limitations imposed therein?

• Is limitation pre- or post-apportionment?
  - Assumption pre-apportionment unless specific provisions otherwise based on rationale in these cases:
    - *AT&T Corp. v. Alabama* (Ala. ALJ 2006) (subsequently regulatorily “overturned” by Ala. Admin. Code 810-3-1.1-.0(4)(b))
    - *Express Scripts, Inc. v. Commissioner* (Minn. Tax Ct. 2012) (court ignored Minnesota Department of Revenue guidance in so holding)
      • Overturned by statute: “The limitation amount determined under section 382 shall be applied to net income, before apportionment, in each post change year to which a loss is carried.” Minn. Stat. 290.095, Subd. 3.(d).
CERT Limitations of IRC 172(h)

- Limitation on ability of corporations to carryback NOLs attributable to the interest expense incurred on certain debt financed acquisitions
- Follow similar rationale as for determining how IRC 382 limitation is to be applied for state
  - Does state adopt federal NOL (without requiring it to be added back and separate state NOL subtracted)?
  - Does state refer to IRC 172?
  - If not, CERT limitation may not apply
State Separate Return Limitations

- Some states limit losses when a new member joins a combined return
- Similar rules apply at a Federal consolidated return level
- Examples:
  - The portion of any combined net operating loss which is related to a separate corporation which is determined to not be includible in the unitary group may be carried forward against income of that [new] corporation computed on a separate basis. Arizona Regulation, R 15-2D-302(B)(3)(b)
  - The net operating loss carryforward deduction shall not exceed the apportionable income of the unitary group times a fraction, the numerator of which is the Nebraska gross receipts of such [new] corporation and the denominator is the gross receipts of the unitary group. Neb. Admin. R. & Regs. 24-060.05
State Separate Return Limitations (Cont.)

- How do states that recently adopted combined reporting treat NOLs from separate return years?

- **DC:** “SRLY provisions of 172 and 1502 apply”
  - D.C. Mun. Regs. 109.30(f)

- **MA:** Pre-combination losses may only be utilized on a post-apportioned, separate-company basis by the generating entity.

- **WI:** A SRLY rule applies to net losses incurred in tax years beginning before Jan. 1, 2009 that are carried forward into the unitary return.
  - Wis. Admin. Code Tax 2.61(9)(e)

- **WV:** SRLY rules in Reg. 1.1502 apply
  - Form CNT-139
Net Operating Losses
North Carolina’s Net Economic Loss Provisions

- NC has a net economic loss (NEL) concept, which differs from the federal NOL. Items of income excluded from taxable income (e.g., muni-bond interest and dividends) reduce the NEL
  - In Dayco Corp. v. Clayton, 153 S.E.2d 28 (N.C. 1967), a NC loss carryback was reduced in the year of the carryback by all corporate income for the year, even nontaxable dividends and gain derived from the sale of stocks of a non-subsidiary corporation allocable to states other than NC.
  - NC recently issued guidance explaining application of this concept

- DOR changed its policy regarding the calculation of NELs in the year of creation
  - Previously, income items that could not be taxed by NC were netted against any allowable deductions to determine if there was a NEL to be carried over
  - Under the DOR’s revised position, nontaxable items of income cannot reduce a taxpayer’s loss in the year of creation that is available for carryover.

- However, such items can reduce the amount of NEL that can be deducted in a carryover year as per the Dayco decision. Important Guidance: Computation of Net Economic Loss (Aug. 17, 2012).
NOL Related Planning Opportunities

● Accelerate income to avoid NOL expiration
● Increase apportionment in year of loss
● For states that limit carryovers in mergers, propose that the entity with the more significant NOLs in that state be the survivor
● Challenge state conformity to IRC 382
● Specific state planning:
  − Massachusetts allows election to claim increased NOL in certain cases where combined group MA property and payroll have increased since the loss year
Remedies for Past Computational Errors

- Are taxpayers allowed to adjust income for year NOL generated to increase the amount of NOL carryforward if that year is otherwise closed under state’s statute of limitations?

- Two methods to accomplish:
  - Must file amended state return or other document for year of loss to establish revised amount of NOL
    - E.g., AL, CT, IL, MA, NJ
  - May adjust return for current year or year loss utilized to reflect revised NOL carryforward
    - E.g., AZ, CA (see FTB Release, Aug. 1, 2006), FL
  - In other states it is recommended to file amended return even if not explicitly required (e.g., MD, OR)