Further Discussions on I.R.C. Section 382: Should Section 382's Limitation Be Apportioned for State Income Tax Purposes?

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I.R.C. Conformity

Of the states that have conformed to I.R.C. §382, some have required that the limitation imposed on taxpayer losses following an ownership change be apportioned in determining the amount of state net operating losses that can be used in a given tax year. In this article Brian Sullivan and Meredith Morgan, of Deloitte Tax LLP's Multistate Tax Transaction Advisory Services, discuss how the resolution of apportionment issues with respect to net operating losses can depend on the express rule-making authority granted to state taxing agencies related to the state's conformity to I.R.C. §382.

Further Discussions on I.R.C. Section 382: Should Section 382's Limitation Be Apportioned for State Income Tax Purposes?

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Introduction

As a general rule, many states appear to conform to the provisions of Internal Revenue Code Section ("I.R.C. §")[1] 382, which limits the use of net operating loss carryforwards ("NOLs") and certain built-in losses following an ownership change.[2] States' application of I.R.C. §382 can have a significant impact on the calculation of deferred assets and future cash tax liabilities. Furthermore, the calculation of state tax attributes, including NOLs, is a key component in any merger and acquisition tax due diligence.

Many states conform to I.R.C. §382 by either directly referencing the section through statute or regulation (commonly referred to as "specific conformity") or by incorporating the I.R.C. generally through a specific date or using federal taxable income as the starting point for the state income tax computation (commonly

[1] Unless otherwise specified, all "I.R.C. §" references are to the Internal Revenue Code of 1986 (the "Code") and all "Treas. Reg." references are to the Treasury regulations promulgated thereunder, both as amended through the date of this article.

[2] An ownership change occurs whenever a corporation's five percent shareholders have increased their aggregate ownership interest in the stock of the corporation by more than 50 percentage points within a rolling three-year period. *See* I.R.C. §382(g).

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referred to as ''general conformity''). A minority of states do not conform to I.R.C. §382; therefore, state NOLs may not be limited in the same manner as the limitation of federal NOLs after an I.R.C. §382 ownership change. However, taxpayers should continue to be aware of specific state limitations that may operate in lieu of I.R.C. §382.[3]

Once it is determined that a state conforms to I.R.C. §382, many secondary, but equally important, questions arise regarding how a taxpayer should apply federal rules in harmony with other differences found in state taxing regimes. Among these questions is the issue of whether the I.R.C. §382 limitation should be apportioned in states that apply NOLs to post-apportioned taxable income. And, if the limitation is apportioned, what is the appropriate apportionment factor (or factors) to use? This article addresses how states have differed in their approach to the issue of apportioning I.R.C. §382 limitations, how apportioned limitations may differ among those states and how the regulatory or administrative guidance provided by some states may not be precedential.

Apportionment of the I.R.C. §382 Limitation

Apportionment and allocation are concepts in state taxation designed to fairly attribute the income of a multistate corporation to the multiple jurisdictions in which it operates. There is no equivalent concept in federal corporate income taxation. The Uniform Division of Income for Tax Purposes Act (''UDITPA'') was drafted by the National Conference of Commissioners on Uniform State Laws in 1957 to promote uniformity by providing a model tax act that divides the income of a multistate taxpayer equally among the states in which it does business. The basic UDITPA apportionment formula was a ratio of payroll, property and sales within a state over the payroll, property and sales everywhere.[4] This formula is meant to represent the connection between a taxpayer and the taxpayer's assets within the state which are used to produce income. There are many variations among the states regarding the apportionment formula, including the recent trend towards increased weighting of the sales factor, but the basic concept remains the same. Although some states apply NOLs prior to apportionment, most states apply NOLs to the post-apportioned income and carryover any unused NOLs on a post-apportioned basis.

While adoption of the UDITPA apportionment provisions may not be entirely uniform, every state adopts the concept of apportionment in imposing a net income tax on income earned by taxpayers operating a multistate business.[5] As noted above, only a minority of states has specifically conformed to I.R.C. §382, and among those, only a few have provided a requirement that the I.R.C. §382 limitation is apportioned in determining the amount of state NOLs that can be utilized in a given tax year.

[3] The analysis of which states adopt I.R.C. §382 and which do not is outside the scope of this article.

[4] UDITPA §9.

[5] *See Mobil Oil Corp. v. Vermont Comr. of Taxes*, 445 U.S. 425, 439 (1980), where the U.S. Supreme Court held that ''[T]he linchpin of apportionability in the field of state income taxation is the unitary-business principle.''

Minnesota Tax Court Case – A Source of Guidance

On January 18, 2013, the Minnesota Supreme Court dismissed a petition filed by the Minnesota Department of Revenue (''the Commissioner'') against Express Scripts Inc. (''Appellant''), a Delaware-incorporated pharmaceutical company.[6] The petition was a request to reexamine the Minnesota Tax Court's holding on the following issues: 1) the existence of a unity relationship between Appellant and its subsidiary and 2) the requirement that Appellant apportion the federal I.R.C. §382 limitation for Minnesota income tax purposes as it related to Appellant's acquisition of a subsidiary.[7]

In determining Minnesota corporate net income, Minn. Stat. §290.095, subd.3.(c) provides that post-apportioned taxable income may be reduced by the amount of Minnesota NOL carryovers to the extent that the NOL is apportioned by the apportionment ratio from each loss year. In subdivision (d) of that same statute, Minnesota provides that I.R.C. §382 will ''apply to carryovers in certain corporate acquisitions and special limitations on net operating loss carryovers. The limitation amount determined under Section 382 shall be applied to net income, *before apportionment* (emphasis added), in each post change year to which a loss is carried.''[8] The Minnesota Department of Revenue has interpreted this statute in its long-standing Revenue Notice 99-07 by stating that the federal limitation should be ''multiplied by the post-change year's apportionment to determine the limited amount of (apportioned) taxable net income that is eligible for a net operating loss deduction.''[9]

Appellant in the Express case stated that ''before apportionment'' should be interpreted to mean that no Minnesota apportionment ratio should be applied against the federal I.R.C. §382 limitation and that if the legislature had intended for the I.R.C. §382 limitation to be apportioned the statute would have specified the correct apportionment ratio to be used.[10] The Commissioner, citing Revenue Notice 99-07, claimed that the apportionment ratio in the year of NOL utilization should be used to apportion the Appellant's federal limitation. The Tax Court, in rejecting the Commissioner's argument, cited Minn. Stat. §270C.07, subd. 1-2, and noted that Revenue Notice 99-07 is based on language that the legislature failed to include in the statute and is a statement of department policy which does not carry the force of the law and has no precedential effect.[11] Accordingly, the Tax Court held that the Commissioner exceeded the authority granted by the legislature by requiring the Appellant to apportion its I.R.C.

[6] The Minnesota Supreme Court dismissed the petition for review because the Department failed to file the petition within the required period of time. The Minnesota Supreme Court did not address the merits of the case.

[7] For purposes of this article, the analysis of unity will not be discussed. For a full analysis, *see Express Scripts Inc. v. Minnesota Comr. of Rev.*, Minn. No. A12-1966 (Jan. 18, 2013) and *Express Scripts Inc. v. Minnesota Comr. of Rev.*, Minn. Tax Ct., No. 8272 R (Aug. 20, 2012).

[8] Minn. Stat. §290.095, subd.3.(d).

[9] Minn. Dept. of Rev., Revenue Notice 99-07, Aug. 9, 1999

[10] *Express Scripts Inc. v. Minnesota Comr. of Rev.*, Minn. Tax Ct., No. 8272 R (Aug. 20, 2012).

[11] *Id.*

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§382 limitation for Minnesota income tax purposes. As such, the Tax Court looked to the language presented in the statute, not the Revenue Notice, to determine if Minnesota requires the federal limitation to be apportioned.

Because the legislature specified the correct apportionment ratio to use in subsection 3(c), omitted any similar directive in subsection 3(d), and used the term ''before apportionment'' in subsection 3(d), the Tax Court held that the legislature did not intend for the I.R.C. §382 limitation to be apportioned. Furthermore, subsection 3(d) specifically references the federal I.R.C. §382 limitation, which is a fixed, unchanging limitation that is determined at the time of the ownership change.[12] The Tax Court further noted that the Commissioner's position did not align with Congress' intent to fix the annual I.R.C. §382 limitation based on the value of the loss corporation as of the date of the ownership change. If, as the Commissioner argued, the amount of Minnesota NOL limitation were to be redetermined on an annual basis using different apportionment percentages each year, it would be impossible to value the NOLs of the loss corporation for Minnesota purposes at the time of the ownership change because the future apportionment ratios would be uncertain.

It should be noted, however, that the holdings from the Minnesota Tax Court are not binding on the Minnesota Supreme Court and may not provide support to avoid penalties assessed by the Department of Revenue. However, as discussed below, Minnesota is not the only state with an ambiguous statute adopting I.R.C. §382, requiring a judicial interpretation to determine whether or not to apportion the I.R.C. §382 limitation.

Alabama Administrative Law Court - Requires Regulatory Guidance

In the 2009 case of *AT&T Corp. v. Alabama Dept. of Rev.*, the Alabama Department of Revenue assessed tax against AT&T for applying the entire pre-apportioned I.R.C. §382 limitation against its post-apportioned Alabama NOLs.[13] The Alabama Department of Revenue argued that apportionment of the NOL limitations would be required because the application of the full federal amount to the apportioned Alabama losses would allow for excessive state NOLs. While the administrative law judge (''ALJ'') agreed with the Alabama Department of Revenue's analysis and cited Ala. Code §40-18-1.1, which provides that principles of the federal I.R.C. sections that are incorporated by Alabama shall be applied to the amounts as computed under Alabama law – thus contemplating apportionment, the ALJ ultimately held that the possibility of multiple interpretations or differing methods of computation made it such that regulations were necessary, and ''without duly promulgated guidelines specifying how the §382 limitation should be apportioned and otherwise applied for Alabama purposes, the federal limitations amount must be allowed.''[14]

Subsequent to this case, the Alabama Department of Revenue issued regulation 810-3-1.1-.01(4)(b)1 which provides that ''when a loss corporation experiences an ownership change and the provisions of I.R.C. §382 apply, the Alabama apportionment factor of the loss corporation for the reporting period including the ownership change must be used to compute the I.R.C. section 382 limitation application to Alabama multi-state taxpayers.''[15] It should also be noted that unlike the Minnesota law discussed above, the Alabama law provides express statutory authority authorizing the Department to promulgate regulations as they relate to applying Alabama's adoption of federal tax law and principles.[16] Because the legislature provided express authority to the Alabama Department of Revenue to promulgate regulations interpreting Alabama's conformity to the I.R.C., including I.R.C. §382, the regulation carries the power of law. One of the lessons of the Alabama and Minnesota developments is that consideration should be given to whether appropriate rule-making authority has been delegated to the taxing agencies by the state legislatures.

Multistate Application of I.R.C. §382

As discussed above in the *Express* case, the Minnesota Department of Revenue's reliance on the Minnesota regulation as support for its position raises an interesting question as to the purpose of state regulations and their application. As a general rule, a state tax agency promulgates regulations, notices, informational bulletins, *etc.*, in an attempt to provide further explanation of a statute through its interpretation and understanding of legislative intent, often by expanding ambiguous statutory terms or language. All of this is done in an attempt to increase uniformity among taxpayers in the application of the law. These interpretations by the executive branch of government generally only carry the weight of law if the state legislature has expressly granted the respective state taxing authorities the power to promulgate rules necessary to administer the statute. Without such authority, the taxing authority's directives may not be precedential. The latter was the case when the Commissioner of Minnesota attempted to enforce Revenue Notice 99-07 in the *Express* case.

Because so few states address apportionment of the I.R.C. §382 limitation in their statutes, the issue becomes whether the legislature has specifically given the state taxing agency the power to promulgate additional guidance. State taxing agencies may be prohibited from requiring the application of a more restrictive limitation on the utilization of state NOLs, which is the result of applying an apportionment factor, if express authority is not provided and the state merely conforms to I.R.C. §382 by generally adopting the I.R.C. Further, even when a state legislature adopts I.R.C. §382 through specific conformity, an analysis should include whether or not the legislature has extended rule-making authority to the state taxing agency when apportionment of the I.R.C. §382 is not addressed in the statute. For example, similar to Alabama, Georgia specifically conforms to I.R.C. §382 but the requirement to apportion the I.R.C. §382 limitation is only detailed in a regulation.[17] How-

[12] *Id.*

[13] *AT&T Corp. v. Alabama Dept. of Rev.*, Ala. Dept. of Rev., Admin. Law Div. No. 05-403 (June 30, 2006).

[14] Id.

[15] Ala. Admin. Code r. 810-3-1.1-.01(4)(b)1. The regulation became effective Sept. 24, 2009.

[16] Ala. Code §40-18-1.1(c).

[17] *See* Ga. Code Ann. §48-7-21(b)(10.1)(D) and Ga. Comp. R. & Regs. r. 560-7-3-.06(5)(e)4.

ever, Georgia's requirement to apportion the limitation appears to carry the force of law because the specific conformity statute provides that ''[t]he Commissioner shall by regulation provide the method of determining how such sections apply'' and grants ''authority to promulgate regulations regarding net operating losses with respect to this paragraph and with respect to consolidated return net operating losses.''[18]

Therefore, a prudent taxpayer should consider whether the state taxing agency that has actually provided guidance requiring the apportionment of the federal I.R.C. §382 limitation has the underlying statutory authority from the legislature to interpret its adoption of I.R.C. §382.

Conclusion

Although sometimes overlooked by taxpayers and tax professionals, the state tax consequences of an I.R.C. §382 ownership change, including whether any particular state requires apportionment of the I.R.C. §382 limitation, can materially impact the utilization of state tax NOLs. In many cases, the guidance provided by state taxing agencies related to the application of I.R.C. §382 may be lacking, unclear, or even overreaching. It is important for taxpayers to analyze whether the regulatory requirement or state taxing authority's interpretation of the statute carries the force of law and would survive judicial scrutiny.

[18] *See* Ga. Code Ann. §48-7-21(b)(10.1)(D) and (F).

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