Navigating the Complexities of State Net Operating Losses

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September 2023

Introduction

Companies generally do not like to report an operating loss to shareholders. But investors and executives also recognize that the ability to use Net Operating Losses (NOLs) to offset future taxable income can be an asset. At both the federal and state levels, NOLs can often be used to reduce taxable income in future (or sometimes past) years. And that is good news for companies that have recently incurred or acquired operating losses.

The way different states provide for NOLs is continuously changing though, which may create new risks and complexities for companies operating across multiple states. Using those NOLs effectively is not always straightforward.

In this article, we explore some of the recent trends in state NOL tax provisions, highlighting important areas of focus for corporate tax leaders. We explore how these changes might influence key business decisions, financial statements, and forecasting. And we offer some considerations and insights to help corporate tax leaders address the complexity and manage the value of their NOLs.

Why NOLs matter

NOLs happen when allowable expenses exceed taxable revenues for a specific tax year. What makes NOLs valuable is that they can be used at the federal and at the state level to essentially offset taxable income (thereby lowering the associated tax burden) in future years and – in some cases – in past years. As such, investors and analysts tend to see NOLs as a valuable asset.

The foundation shift

For decades, NOL treatment among the states has varied. However, most regimes were well-established and predictable. Many conformed with the federal tax code regarding NOLs (Internal Revenue Code § 172), which generally stated that an NOL could be carried forward to offset any taxable income from future periods up to twenty years or carried back up to two tax years to offset income from previous taxable years. After twenty years, any unused NOL carryforward would expire.

In 2017, the Tax Cuts and Jobs Act (TCJA)[1] introduced the first major changes to the federal treatment of NOLs in decades. The good news for taxpayers was that the carryforward period was no longer capped at twenty years – the NOL carryforward period would be indefinite.[2]

At the same time, however, TCJA also limited the amount of NOL carryforward that could be applied to 80% of taxable income.[3] But TCJA did not retroactively limit the use of NOL carryforwards generated prior to 2018, meaning that the federal NOL deduction might be different depending on the year in which the NOLs were incurred.

After the passage of TCJA, but before the federal limitation came into effect, U.S. Congress passed the Coronavirus Aid, Relief, and Economic Security Act (CARES Act). The CARES Act was an economic stimulus bill which, among other things, suspended the 80% limitation provided for under TCJA for tax

[1] Pub. L. No. 115-97, § 13302

[2] IRC § 172(b)(1)(A)(ii)(II)

[3] IRC § 172(a)(2)(B)(ii)

years ending before December 31, 2021.[4] Thus, the tax year ended December 31, 2021, was the first taxable year in which the limitation applied for a calendar year taxpayer.

Understanding the rules

As is often the way with state and local taxes in the U.S., what happens at the federal level generally has a related impact on what happens at the state level. Most states conform to the Internal Revenue Code to some degree, but they do not all do it in the same way or to the same degree. Some states have legislated NOLs through 'fixed conformity,' which essentially ties the state tax code to the federal tax code as of a certain date. Other states have adopted a 'rolling conformity,' which means that changes to the Internal Revenue Code are generally automatically adopted within the state taxing regime. Then there are those states that apply 'selective conformity,' under which their statutes broadly conform to the Internal Revenue Code as of a certain date but allows the state to decouple from specific provisions. Depending on the state, different approaches mean different treatments and calculations.

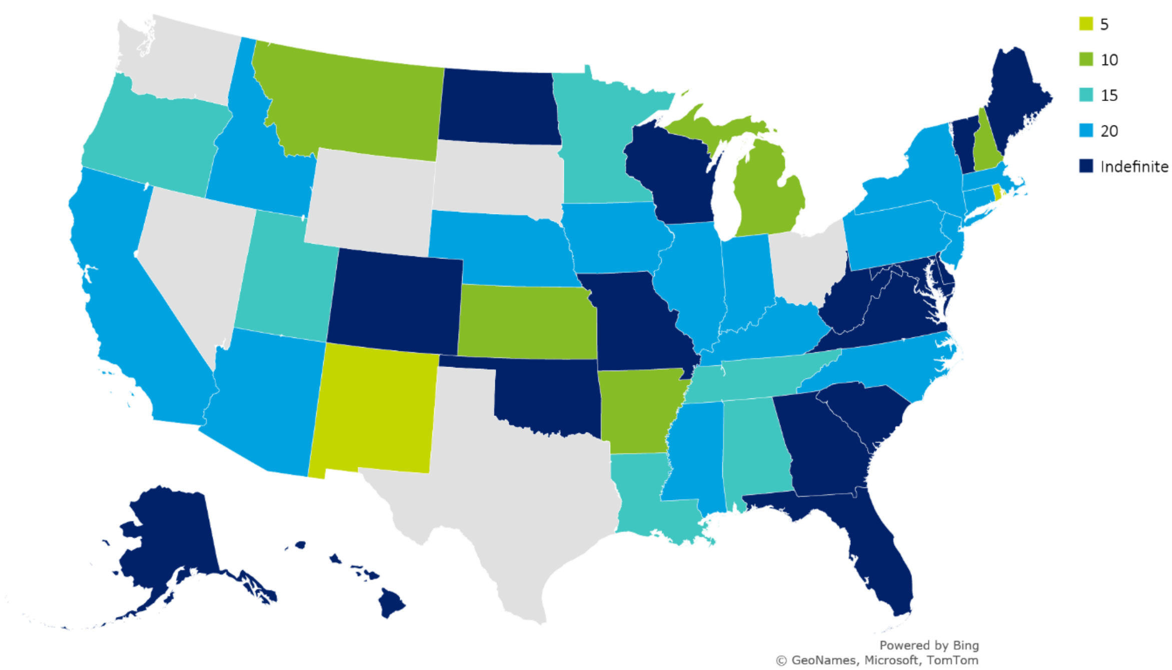
Similarly, the way that different states apportion income could have a significant impact on how NOLs are treated. Some states require your NOLs to be computed based upon and applied to your 'pre-apportioned' income (which is your Federal Taxable Income (FTI) before certain federal deductions) while others require it to be computed based upon and applied to the 'post-apportioned' income (pre-apportioned income multiplied by your apportionment factor in the state), which is generally a smaller number. This disparate treatment has an impact on the amount of tax paid and the value of the NOLs on your balance sheet.

[4] Pub. L. No. 116-136, § 2303

The landscape fractures

In response to the recent federal NOL rule changes, many states are revising the way they treat NOLs. In some states, legislators have adopted the federal carryback and carryforward rules, including the indefinite carryforward provision, while other states may restrict the carryback of NOLs and/or limit the carryforward period to five, ten, or twenty years. See **Chart A** for an overview of the current NOL carryforward landscape.

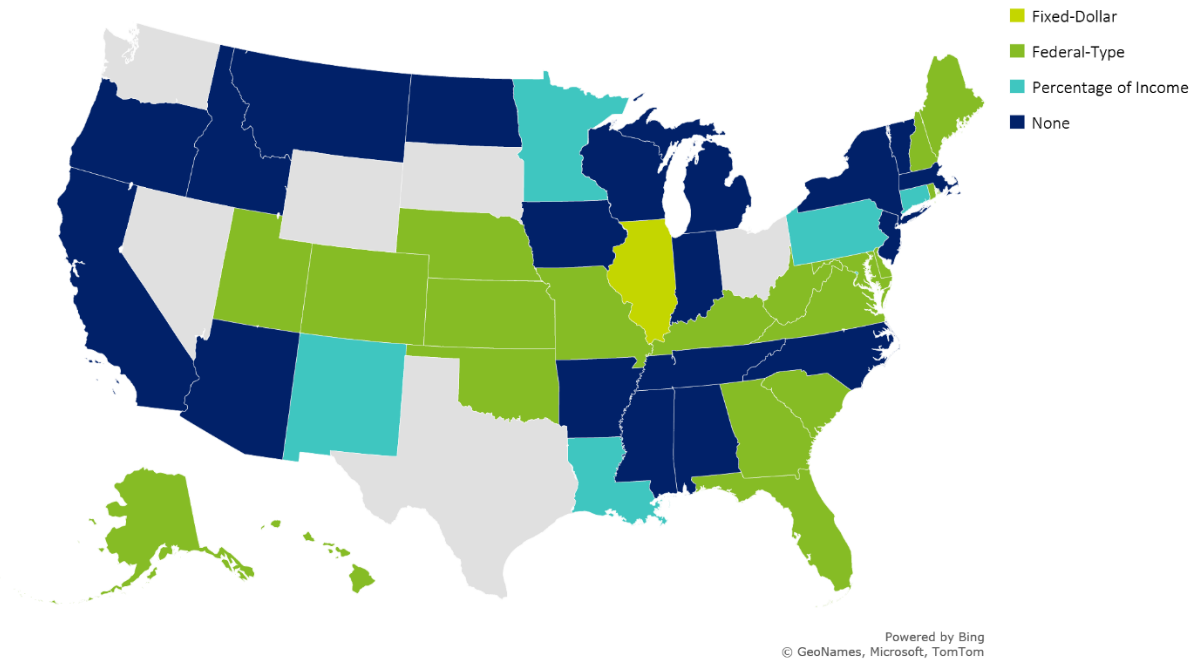
Chart A: General Corporation NOL Carryforward Period by State (TY 2022)



The same applies for the percentage limitation on taxable income that may be offset by NOLs – some are 80% like the federal NOL limitation and apply to the same taxable periods[5]; while some states have a modified adoption, such as the limits in Georgia or South Carolina where the states decouple from the application or timing of the federal limitation rule. See **Chart B** for an overview of the current NOL deduction limitations applied across the country.

[5]See Chart B-General Corporation NOL Carryforward Period by State (TY2022)

Chart B: General Corporation Statutory Limitations by State (TY 2022)



For example, Georgia applies the 80% limitation to Georgia taxable income[6] (as opposed to the taxable income after any pre-2018 NOL utilization, which would be consistent with the federal rule). South Carolina adopted an 80% limitation around the passage of TCJA but did not adopt the three-year suspension of the limit provided for in the CARES act.[7]

There are also other limitations or 'caps' on NOL deductions in certain states – several states have caps based on percentage of income limitations such as Louisiana,[8] Minnesota,[9] and Pennsylvania,[10] while others apply a fixed-dollar limit, such as Illinois, which limits the annual NOL deduction to $100,000 for tax years 2022-2024,[11] or West Virginia, which allowed for an NOL carryback, but capped the carryback deduction at $300,000.[12] Other states have instituted a temporary suspension of their NOL deduction and provided for an additional NOL carryover period to compensate the taxpayer for the lost NOL deduction in suspended years. For example, California had a rule to suspend the NOL deduction for taxpayers with apportioned and allocable income of over $1,000,000 for tax years 2020 and 2021.[13] In such cases, it is important for taxpayers to understand whether they have applied (or not applied) NOL deductions appropriately for the affected tax years. It is also prudent to validate whether carryforward periods have been properly adjusted to extend the life of the suspended NOLs. Those extra years can

6 Ga. Code Ann. § 48-7-21(b)(10.1)(A); *Income Tax Federal Tax Changes*, Ga. Dept. of Rev. (updated 5/20/2022).

7 S.C. Code Ann. §§ 12-6-580, 12-6-40(A)(1)(a), 12-6-50, 12-6-1130(4); *South Carolina's Guide to IRC Conformity from 2018-2020,* S.C. Dept. of Revenue September 2021).

8 La. Rev. Stat. Ann. §§ 47:287.73(B)(1), 47:287.86.

9 Minn. Stat. §§ 290.0133, subd. 5, 290.095, subd. 2(c).

10 72 P.S. §§ 7401(3)1(m), 7401(3)4(c)(1)(A)(VIII); 61 Pa. Code § 153.11.

11 35ILCS 5/207(a)(3)-(4), (d); Ill. Admin. Code tit. 86, § 100.2330(b)(1); Ill. Admin. Code tit. 86, § 100.2330(f)(5).

12 W. Va. Code § 11-24-6(d).

13 Cal. Rev. & Tax Code §§ 24416, 24416.21, 24416.22, 24416.23.

shift the projected utilization and expiration of NOL carryforwards, which may have a significant impact on the ability to utilize those NOLs in the future.

State legislators and tax authorities recognize the financial statement relationship state NOLs have for many publicly traded, multi-state organizations, and as such have often incorporated language into newly enacted provisions limiting the deduction of NOLs (and reducing the value of state NOLs and the associated DTA) that attempts to mitigate the associated negative financial statement impacts of these new provisions. For example, as certain states have enacted legislation to limit NOL utilization or completely eliminate a taxpayer's ability to deduct NOLs, consideration for the cash taxes paid and financial statement impacts of these provisions has been addressed through the provision of a related tax credit or deduction.[14] More recently, states have begun to provide similar relief for certain public companies in conjunction with law changes that indirectly effect the value of state DTAs (and deferred tax liabilities 'DTLs'). West Virginia, as an example, passed recent legislation that significantly impacted the apportionment factor calculation, moving from a three factor formula to a single sales factor, and replacing the cost-of-performance methodology with a market-based sourcing model.[15] Shortly after, the state passed House Bill 3286, which allows for a new deduction for certain publicly traded companies, providing an offset for the financial statement impact arising from the new apportionment regime. The bill describes the deduction as 'equal to one tenth of the amount necessary to offset the increase in the net deferred tax liability (DTL) or decrease in the net deferred tax asset (DTA), or the aggregate net change to both, as computed in accordance with generally accepted accounting principles (GAAP).'[16]

[14] Michigan, Texas, and New Jersey are examples of states that have enacted provisions intended to mitigate (sometimes only partially) the reduction or elimination of state NOL DTAs. See Mich. Comp. Laws § 208.1201(2)(i), Tex. Tax Code Ann. § 171.111, and N.J.S. § 54:10:A-4(k)(16), respectively.

[15] W. Va. H.B. 2026; W. Va. Code § 11-24-7

[16] W. Va. H.B. 3286; W. Va. Code § 11-24-6(c).

It is important to get this right

The implications of all this complexity and inconsistency are often significant for a company with operating losses doing business across multiple states. The impacts of getting it wrong may include over or under payment of tax, potential tax penalties and interest, and reputational risks. There are often some less obvious impacts, too.

Incorrect calculations may have a direct impact on the company's financial statements, forecasting, and cash flow assumptions. Companies reporting material NOL DTAs are tasked with recording the NOL balances across all jurisdictions and taxpayers and applying the appropriate tax rate. In addition to reporting the tax effected NOL balances on their financial statements, companies are also responsible for determining an associated NOL DTA valuation allowance (if any) – an account that adjusts (i.e., reduces) the DTA amount to an amount that is more-likely-than-not of being realized. If the historical NOL calculations are not accurately prepared, taxpayers may have a hard time computing the proper DTA amount, but it could also be very challenging to accurately account for the likelihood of realizing the benefit of those NOLs in future periods.

In light of the complexities involved with the NOL computation, some companies may attempt to shortcut their DTA calculation by adopting a 'blended rate' approach, where the weighted average of state tax rates in each filing jurisdiction is applied to the total state NOL balances. Or perhaps they may compute their state NOL DTA by measuring the NOLs based upon a total consolidated NOL amount as opposed to measuring on an entity-by-entity NOL amount basis. However, given the significant differences in state tax rates and calculations, the application of a 'blended rate' approach or computation on a consolidated group NOL basis may be materially different than a detailed entity-by-entity, state-by-state analysis.

Depending on the future income or loss expectations for each legal entity within the organization (on a jurisdictional basis), it is possible for state NOLs to be 'trapped' at an entity, particularly in states that do not provide for the sharing of NOLs across legal entities. In such situations, some companies may want to consider how their organization is structured with a view to enabling greater utilization of NOLs across the organization, which may lower the overall tax burden or increase the overall value of the NOLs on the organization's balance sheet. For example, rather than having two businesses operating in the same state with one generating losses while the other generates income, executives may consider how they might combine those entities to enable the losses from one business to offset the income of the other business. Such restructuring brings with it a host of additional considerations to think through, including but not limited to the various limitations that may affect the amount of NOLs available for use going forward (such as limitations on the carryover of losses following a merger, liquidation, or change of ownership). The federal approach to transferring and limiting the use of pre-change losses is prescribed in IRC section 381 and 382. While many states conform to these federal provisions, other states have deviated in whole or part from these provisions – making this another area that requires careful consideration on a state-by-state basis.

In certain jurisdictions allowing or requiring taxpayers to compute their state taxable income or loss and associated state tax liability on a consolidated or combined basis, taxpayers may be able to avail themselves of trapped NOLs without the additional complexities that come with an internal restructuring. Many of these combined or consolidated filing method states allow NOLs of any member of the combined or consolidated group to be applied against income earned by other members within the combined or consolidated group. Some states require members to have nexus, or a taxable presence, in the state in order to share in the generation and utilization of NOL. Other states, such as California, require group members to track their NOL separately such that NOLs may only be used against the future income attributed to the entity that generated the California loss(es). In states where the combined or consolidated return filing method is elective, there may be an opportunity to proactively enable greater utilization of NOLs in a manner that is less disruptive or involved than undergoing an internal reorganization.

Finding a better way to manage NOLs

Many tax departments find themselves challenged to deal with the complexity of managing NOLs across states in such a fluid environment. They may still be using manually prepared and maintained spreadsheets to track their NOLs for tax return compliance and tax provision purpose. Getting a view of the historic, current, and future NOL position on a state-by-state and entity-by-entity basis is often a time-consuming, burdensome task, filled with risks and challenges. Keeping up with the effects of changes in legislative, legal entity structure, and business operations often requires frequent re-computation of a company's state NOLs for financial statement purposes. Accordingly, some companies find it difficult to achieve a reliable and integrated view of their NOL position across all jurisdictions.

The good news is that there are a number of technology tools that can be used to reduce the effort, navigate the complexities, and reduce the risk of NOL management.

Effective tools are those that can combine data collection and management with dynamic tax rates and rule tracking to provide tax leaders and finance executives with a reliable and up-to-date view of their NOLs across states. Such tools should be robust enough to enable scenario analysis and forecasting of NOL utilization and expiration.

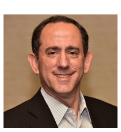
Deloitte's State NOL Insight tool, for example, offers tax leaders an intuitive, web-interfaced, database-powered solution that captures a taxpayer's state NOL-related data and uses that data flexibility for tax planning, compliance, and provision purposes. Tax rulesets are updated regularly for enacted legislation and maintained separately from computations, meaning that changes to state tax codes can quickly and easily be reflected in tax calculations and financial statements. The tool is supported by Deloitte's Multistate Tax team – one of the largest state and local tax practices in the United States.

Time for a new approach

The state NOL landscape will continue to change (we are currently tracking legislative proposals that could change the treatment of NOLs in various states within the next twelve months), and the complexity of managing state NOLs across multiple jurisdictions will likely continue to rise.

Staying informed of the proposed changes and adapting to them at pace can be a significant challenge. Technology and analytical tools can play an important role in helping corporate tax leaders navigate the complexity of NOLs and manage tax outcomes. We look forward to showing you how.

Get in touch



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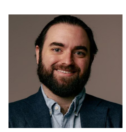

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