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In this article, Sullivan discusses common income tax issues encountered by corporate taxpayers in bankruptcy and out-of-court restructuring transactions, in which the blanket adoption of the IRC at the state level creates additional complexity and uncertainty within state income tax regimes.

In the spirit of consistency and ease of administration, most states that impose corporate income taxes begin their computation of taxable income with federal taxable income. One method commonly adopted by many states to accomplish that objective is to require a corporation to use the amount reported on its federal tax return as the starting point for the state tax calculation. Most states, however, have enacted legislation to conform to the Internal Revenue Code[1] in some respect, either through rolling conformity or static conformity.[2] Other states may not adopt the IRC but rather use the amount reported on Line 28 or Line 30 of the federal Form 1120 as their starting point for determining the amount of state taxable income. It has also been quite common recently for states to opt out of some federal tax provisions that states may view as either unfavorable or inconsistent with their income tax policies (for example, bonus depreciation (IRC section 168(k)), the expensing of depreciable business assets (IRC section 179), the domestic production activities deduction (IRC section 199), and the deferral of some cancellation of debt income (CODI) provided by IRC section 108(i)). Nevertheless, it is possible that the general conformity to the IRC provisions may have other unintended consequences, especially for corporate taxpayers experiencing a bankruptcy or debt restructuring transaction.

Presumably, the goal of general IRC conformity is to make the administration of a state income tax easier by using federal taxable income as a starting point and making only some state modifications that effectuate state tax policies. However, general conformity to the IRC may create situations in which a technical reading of the law produces potentially unintended results not contemplated by state tax policymakers. This article discusses some of the common income tax issues encountered by corporate taxpayers in bankruptcy and out-of-court restructuring transactions, where the blanket adoption of the IRC at the state level creates additional complexity and uncertainty within state income tax regimes.

I. State Conformity to IRC Section 1502

The consolidated return regulations, promulgated under the authority delegated to Treasury under IRC section 1502, are a system of rules for determining the tax liability of a group of corporations filing a consolidated federal income tax return. The filing of a consolidated U.S. federal income tax return can be elected by the affiliates of a common parent (if the requirements are met).[3] To allow taxpayers to offset income of some entities with the losses of other entities, most affiliated corporations that are eligible will elect to file a consolidated U.S. federal income tax return.

[1]Statutory and regulatory references to the code or IRC section are to the Internal Revenue Code of 1986, as amended, and all regulation section references are to the Treasury regulations thereunder.

[2]Rolling (or moving date) conformity refers to a state conformity statute that automatically adopts any changes to the federal law, while static (or fixed-date) conformity refers to a state conformity statute that adopts the federal law on a certain date (for example, January 1, 2011) and does not include any federal law changes enacted after that date.

[3]Reg. section 1.1502-75(a)(1).

However, the default filing method in many states is separate legal entity reporting, with no ability for affiliated taxpayers to elect to file on a consolidated basis. In a separate entity context, the federal consolidated return regulations generally do not apply.

In states that do allow filing on a combined or consolidated basis, many do not follow the consolidated return regulations. The consolidated return regulations provide rules often applicable in restructuring transactions (for example, IRC sections 108 and 1017 to a consolidated group in reg. section 1.1502-28[4] and for IRC section 382 in reg. sections 1.1502-91 through 1.1502-96[5]).

Likewise, in determining tax basis for subsidiary stock, the investment adjustment rules found in the federal consolidated return regulations are applied for taxpayers in a federal consolidated income tax return. The federal consolidated return investment adjustment system is a comprehensive set of rules for adjusting the basis of the stock of a subsidiary held by a member of a consolidated group. The regulations provide rules for the investment adjustment system, which include reg. section 1.1502-32 (investment adjustments), reg. section 1.1502-33 (earnings and profits), reg. section 1.1502-19 (excess loss accounts), reg. section 1.1502-36 (loss disallowance rules), and reg. section 1.1502-11 (circular basis adjustments).

As discussed above, in states that require corporate taxpayers to file separate returns, federal taxable income is generally the starting point for the determination of taxable income for state purposes; however, federal taxable income is computed on a pro forma basis without any adjustments provided by the federal consolidated return regulations. In that context, the stock basis adjustments of reg. section 1.1502-32 are not made and the basis of the subsidiary stock should generally be calculated as follows:

Cost

Plus: Capital contributions

Less: (Return of capital)

Stock basis without reg. section 1.1502-32 adjustments

That basis disconformity can also exist in states that require consolidated or combined reporting on a unitary basis. As discussed below, differences in stock basis as well as the application of other federal consolidated return regulations are examples of when blanket conformity to some federal laws but not others could have a significant impact on the application of those federal rules to a corporate taxpayer in a bankruptcy or other restructuring transaction. That disconformity creates uncertainty and inconsistency in determining the proper treatment of the federal bankruptcy rules for states that simply adopt the IRC generally, specifically in reducing tax attributes and applying IRC section 382 for state income tax purposes.

II. State Tax Provisions in the Bankruptcy Code

Section 346(j)(1) of the federal Bankruptcy Code provides:

> For purposes of any State or local law imposing a tax on or measured by income, income is not realized by the estate, the debtor, or a successor to the debtor by reason of discharge of indebtedness in a case under this title, except to the extent, if any, that such income is subject to tax under the Internal Revenue Code of 1986.

The Bankruptcy Code clearly prohibits a state from including in state taxable income any CODI realized in a federal bankruptcy proceeding that is excluded from federal taxable income under IRC section 108(a). Therefore, it would appear that regardless of whether a state actually adopts IRC section 108(a) or otherwise conforms to the IRC is not relevant because federal law prohibits a state from imposing income tax on CODI recognized by a debtor in a title 11 case.[6]

While the Bankruptcy Code appears to provide uniformity among the states regarding income taxes, the federal prohibition on taxing CODI may not be as clear for states that impose taxes not measured by income. For example, neither the Ohio commercial activity tax statutes nor the Washington business and occupation tax statutes specifically exclude from the tax base any CODI realized in a bankruptcy.

The requirement to apply attribute reduction can also be found in Bankruptcy Code section 346(j)(2), which provides:

> Whenever the Internal Revenue Code of 1986 provides that the amount excluded from gross income in respect of the discharge of indebtedness in a case under this title shall be applied to reduce the tax attributes of the debtor or the estate, *a similar reduction shall be made under any state or local law imposing a tax on or measured by income to the extent such state or local law recognizes such attributes*. Such state or local

[4]Covering the exclusion of CODI from gross income and the associated attribute reduction rules.

[5]Covering rules regarding the limitations on the use of net operating losses and other tax attributes to a consolidated group.

[6]While the author acknowledges that there has been considerable debate for many years on how the federal government's power to enact laws governing bankruptcy grants jurisdiction to the bankruptcy court and may ostensibly nullify states' rights to impose their jurisdiction to tax under their sovereign immunity granted by the U.S. Constitution's 11th Amendment, it appears that imposing an income tax on a debtor's CODI in a title 11 case would undermine the basic goals and general premise of providing debtors with a "fresh start" and the opportunity to reorganize with bankruptcy protection. *See Collier on Bankruptcy*, at para. TX12.02 (2012).

law may also provide for the reduction of other attributes to the extent that the full amount of income from the discharge of indebtedness has not been applied. [Emphasis added.]

As a result, the federal Bankruptcy Code suggests that states should reduce state NOLs and other state tax attributes by the amount of excluded CODI — essentially providing that states should adopt the method of IRC sections 108(b) and 1017.

It appears that each state would, under its own statutes, exclude CODI recognized in a federal bankruptcy case in the determination of state taxable income. However, in the event of any uncertainty regarding a state's position on that issue, section 346(j)(1) of the Bankruptcy Code provides additional support for excluding CODI from state taxable income.

For non-title 11 case transactions, the determination of whether CODI is taxable for state income tax purposes will generally default to each state's conformity to the IRC or any state-specific rules addressing CODI.

III. State Conformity to IRC section 108

IRC section 108(a) provides that gross income does not include CODI if the discharge of the indebtedness is made by a taxpayer in a title 11 bankruptcy case or if the taxpayer is insolvent.[7] That exclusion does not come without a tax cost because the amount of CODI excluded is applied to reduce a taxpayer's tax attributes beginning with NOL carryforwards, followed by the reduction of general business and minimum tax credits, capital loss carryovers, basis of property, passive activity losses and credit carryovers, and foreign tax credit carryovers.[8] The rules for reduction of tax basis are found in IRC section 1017. A taxpayer may also elect under IRC section 108(b)(5) to first reduce the basis of depreciable property.

It appears that most states adopt the bankruptcy and insolvency exclusions for CODI and the attribute reduction provisions of IRC sections 108 and 1017 through their general adoption of the IRC.

A. Reg. Section 1.1502-28 Conformity/Nonconformity

For taxpayers that have elected to file a consolidated return for federal income tax purposes (which is most U.S. companies that are eligible to make that kind of election), reg. section 1.1502-28 provides guidance regarding how to apply the attribute reduction rules of IRC section 108 for members of the federal consolidated return. Under that framework, each member's CODI is first applied to reduce the separate entity's tax attributes under the ordering rules of IRC section 108(b).[9] Then, any reduction in the stock basis of a subsidiary is pushed down to the tax attributes of that subsidiary, becoming deemed CODI of that subsidiary.[10] Finally, the consolidated tax attributes of all members are reduced.[11]

In states that adopt IRC section 1502 and the regulations thereunder, it appears that absent any specific guidance for the application of IRC section 108, those states would also apply reg. section 1.1502-28, including the "pushdown" rule outlined in reg. section 1.1502-28(a)(3). For the states that do not follow the consolidated return regulations, it appears that the pushdown of subsidiary stock reduction would not be required. Similarly, that concept of "pushdown" or "deemed" CODI would not apply to the separate entity states unless explicitly adopted.[12]

The concept of not applying the federal consolidated regulations in states that require separate entity income tax return filings seems intuitive but yet creates additional compliance and uncertainty in the context of bankruptcy transactions. Because the federal consolidated regulations are generally intended to treat the consolidated group as a single taxpayer, application of IRC section 108 for a separate entity can result in CODI being applied differently in the reduction of tax attributes at the entity level than the corresponding reduction using consolidated return principles. As such, the goal of conforming to federal law becomes quite different in determining the taxable income for an entity filing on a separate basis for state income tax purposes. As the corporate taxpayer files state income tax returns in future years, the amount of federal taxable income used as a starting point could not only be different from the federal taxable income determined for purposes of the federal return but also different among each state where that entity files separately because of the varying degrees of attribute reduction applied to NOLs, credits, capital losses, and tax basis in assets as discussed below.

B. Reduction of NOLs

Through their general conformity to the IRC, most states appear to require the reduction of NOLs under IRC section 108(b) for CODI that is excluded from income under IRC section 108(a). However, the application of the federal rules is not without uncertainty in many states as only a few states have provided specific guidance indicating a requirement to reduce state tax attributes or method applicable to state NOLs. A few states, including New Jersey and Tennessee, have not historically required the reduction of NOLs but have recently enacted legislation that attempts to provide the necessary statutory requirements for taxpayers to reduce NOLs.

[7]IRC section 108(a)(1).

[8]IRC section 108(b).

[9]Reg. section 1.1502-28(a)(2).

[10]Reg. section 1.1502-28(a)(3).

[11]Reg. section 1.1502-28(a)(4).

[12]Georgia is a separate return jurisdiction that has specifically adopted reg. section 1.1502-28(a)(3). *See* Ga. Comp. R. & Regs. r. 560-7-3-.06(5)(c)(2).

New Jersey amended N.J.S.A. 54:10A-4(k)(6)(F) of its Corporation Business Tax Act on June 30, 2014, to require that a corporation's NOL be reduced by the amount excluded from federal taxable income under subparagraph (A), (B), or (C) of IRC section 108(a)(1) for the privilege period of the discharge. Before that legislation, many taxpayers relied on guidance found in a 1996 departmental newsletter in which the New Jersey Division of Taxation stated that it did not require the reduction of NOLs regarding a corporation that is insolvent when debt was discharged.[13]

On May 13, 2013, Tennessee enacted legislation that requires an adjustment to a taxpayer's Tennessee NOL carryforward for any discharge of debt occurring on or after October 1, 2013.[14] The adjustment is equal to the amount of discharge excluded from federal taxable income under subparagraph (A), (B), or (C) of IRC section 108(a)(1) allocable or apportionable to Tennessee in the year of the discharge.[15] For CODI recognized in a transaction before October 1, 2013, Tennessee has ruled that it did not require the reduction of NOLs under IRC section 108(b).[16]

Other states simply may not have the requisite attributes subject to reduction under their tax regimes. For example, Texas does not provide for NOLs. For purposes of computing taxable margin, total revenue is determined by adding income from lines 1c and 4 through 10 of the federal Form 1120.[17] After determining total revenue, a taxpayer generally may deduct (1) 30 percent of total revenue, (2) total compensation, or (3) costs of goods sold.[18] Because the excluded CODI is not included on those lines of Form 1120, Texas should not include the excluded CODI in its computation of total revenue. Furthermore, Texas does not provide any specific statutory guidance requiring attribute reduction similar to the provisions of IRC section 108(b).

Because Bankruptcy Code section 346(j)(2) requires "a similar reduction" of state tax attributes for excluded CODI, any attribute reduction that affects asset basis that is ultimately reported as a gain or loss on lines 1c and 4 through 10 of the federal Form 1120 could affect total revenue in Texas. Therefore, a simple approach would be to use the same attribute reduction amounts that applied to federal attributes affecting the computation of federal taxable income on the federal Form 1120. The inconsistency of that approach to simply follow federal rules occurs whenever the federal consolidated return regulations are applied in the reduction of federal tax attributes. In a combined return, the revenue amounts for Texas purposes are determined for each member "as if the member were an individual taxable entity."[19] That requires a pro forma approach without regard to the federal consolidated return regulations. Therefore, it appears reasonable to use the federal amount of basis reduction, but not apply the consolidated return regulations, specifically reg. section 1.1502-28.

Illinois provides specific statutory and regulatory guidance on how IRC section 108(b) is applied to Illinois tax attributes. To ascertain the impact of attribute reduction, Illinois provides the following formula to determine the amount of Illinois NOL reduction: the federal reduction of NOL is multiplied by a fraction in which the numerator is the amount of CODI excluded from gross income that would have been allocated and apportioned to Illinois in the year of the discharge, and the denominator is the amount of CODI excluded for federal purposes.[20] However, Illinois's regulations do not specify whether the Illinois NOL reduction is applied on a combined or separate entity basis to match the amount of federal NOL reduced by members of a federal consolidated group.

Georgia's regulations similarly provide that the amount of Georgia NOL to be reduced is determined by applying the Georgia apportionment percentage for the year of the discharge to the amount of the federal IRC section 108 reduction.[21] In both Georgia and Illinois, the state NOL reduction is based on the amount of actual federal NOL reduction and not the amount of CODI excluded from state taxable income under IRC section 108(a). Therefore, it is possible that a taxpayer may not reduce all its state NOLs under those methods even if the entire federal NOL is reduced and CODI is applied to other tax attributes. Neither Illinois nor Georgia provides specific guidance on the reduction of other tax attributes when CODI exceeds NOLs. Therefore, one presumption would be that any tax basis reduction is the same for federal and state purposes.

In contrast, Oregon's rules determine the amount of Oregon NOL reduction based on the amount of CODI that was excluded from Oregon taxable income. By statute, Oregon provides that a taxpayer that excludes CODI from federal gross income under IRC section 108(a)(1)(A) shall exclude that amount of CODI that is apportioned to Oregon.[22] Oregon's regulations further provide that the Oregon tax attributes of a multistate taxpayer shall be reduced until all the excluded income is absorbed.[23] Subsection (a) of the regulation provides that Oregon NOLs are reduced first and proportionally, using the Oregon apportionment for the year of debt forgiveness.

In the few states, such as Georgia, Illinois, and Oregon, that have provided some statutory or regulatory guidance on

[13]N.J. Div. of Taxation, "New Jersey State Tax News" (Winter 1996).

[14]*See* Chapter 321 (HB 175) of Tenn. Public Acts 2013.

[15]Tenn. Code Ann. section 67-4-2006(c)(8)(ii).

[16]Tenn. Letter Ruling #11-44, Tenn. Dept. of Rev. (2011).

[17]Tex. Tax Code Ann. section 171.1011(c).

[18]Tex. Tax Code Ann. section 171.101(a)(1).

[19]Tex. Admin. Code section 3.590(d)(1).

[20]35 Ill. Comp. Stat 5/207(c).

[21]Ga. Comp. R. & Regs. r. 560-7-3-.06(5)(c)(1).

[22]Or. Rev. Stat. section 314.306(1).

[23]Or. Admin. R. 150-314.306(3).

the application of IRC section 108 to state NOLs, the economics of state apportionment are always addressed to avoid the reduction of apportioned NOLs by pre-apportionment CODI. In an unpublished decision, the California State Board of Equalization ruled that a taxpayer's California NOLs should be reduced by the CODI apportioned to California and not by a pre-apportioned amount of CODI.[24]

In other states that track NOLs on a post-apportioned basis, it seems reasonable to apply apportionment to either the CODI or federal NOL reduction to determine the amount of state NOL reduction. However, to the extent there are large swings in apportionment from the years when the NOLs were created as compared with the year of the debt discharge, the actual attribute reduction may vary significantly from the federal results. For example, if the taxpayer's apportionment in State A has historically been 25 percent but because of dispositions of some business operations during the bankruptcy the taxpayer's State A apportionment increases to 50 percent in the year of the discharge, the economics of its reduction to State A NOLs will be twice as much as the impact to its federal attributes.

Also, while reasonable and relatively simple from a practical perspective, an apportionment method using the apportionment factor from the year of the discharge of CODI might not fall squarely within the rules provided by federal bankruptcy law. As discussed above, section 346(j)(2) of the Bankruptcy Code provides that "a similar reduction shall be made." And, in examples when the state apportionment was significantly lower in prior years, that kind of reduction of state attributes using a higher apportionment factor to post-apportion the CODI, as pointed out in the previous example, may appear egregious.

An alternative, but potentially arduous, approach would be to determine the amount of state NOL reduction by converting a post-apportioned state NOL carryover to a pre-apportionment value and then reducing that pre-apportioned value by the amount of CODI. That kind of approach would require a taxpayer to review its losses and apportionment in each prior year and would appear to be consistent with Bankruptcy Code section 346(j)(2).

However, despite the potential differences in economic results, states such as Georgia, Illinois, and Oregon simply use a single-year apportionment factor method, presumably for ease of administration. As such, a rule applying apportionment to CODI or NOL reduction is helpful for corporate taxpayers and the state tax agencies in reconciling the federal rules with specific state differences in NOL carryforwards, but state guidance often stops short of discussing other tax attributes that may be subject to reduction at the federal level.

C. Reduction of Credits

For federal income tax purposes, after the reduction of NOLs, general business credits allowable under IRC section 38 and the minimum tax credits available under IRC section 53(b) are reduced (every $3 of CODI reduces $1 of credit).[25] California provides its own rules regarding the reduction of state credits. To the extent there is CODI in excess of NOL, California requires credits to be reduced pro rata at a rate of 11.1 cents per dollar of excluded CODI.[26] Most other states provide no specific guidance on whether credits can or should be reduced. Because states may offer many different types of income tax credits, including jobs and investment tax credits, it would seem that only credits that are similar to the federal general business and minimum tax credits would be subject to reduction in states that generally conform to the IRC without specific legislation such as that enacted by California to extend IRC section 108 to other state tax credits.

As discussed above, neither Georgia nor Illinois provide any guidance regarding the reduction of tax attributes other than NOLs. As such, it would appear that without affirmative and specific authority, the amount of CODI applied to reduce federal credits does not reduce state tax credits in Georgia and Illinois. However, uncertainty may result for some corporate taxpayers that have reduced federal credits under IRC section 108(b)(2)(B) and (C) without a corresponding state tax credit reduction. Does the CODI that was applied to federal credits apply to reduce other state attributes under the ordering rules of IRC section 108? If the answer is yes, then that is another area of potential complexity in reconciling state conformity to the IRC in future tax years.

For example, if a corporate taxpayer has $100 of CODI that reduces $50 of its federal general business credit carryforward under IRC section 108(b)(2)(B), then the remaining $50 of CODI will reduce other federal tax attributes. For purposes of this example, let's assume that the $50 reduction is applied to the tax basis of a depreciable asset. For federal tax purposes, future depreciation deductions are affected because of the $50 reduction to the asset's adjusted tax basis. Therefore, the corporate taxpayer's taxable income is expected to be $50 higher in the aggregate in future tax years as a result of IRC section 108(b) once the asset is fully depreciated.

If, for state income tax purposes, the lack of state credits to offset the $100 of CODI results in $100 of reduction to the same depreciable asset, the corresponding aggregate income to the federal taxable income that is used as the

[24] *See Appeal of Wilshire Restaurant*, No. 166408 (Cal. State Bd. of Equal., Jan. 9, 2003). Because this is an unpublished decision, it may not be cited as precedent; however, it may provide some guidance on how the BOE may address that issue when presented with similar facts.

[25] IRC section 108(b)(2)(B)-(C), (b)(3)(B).

[26] Cal. Rev. & Tax. Code section 24307(b), (d).

starting point for determining state taxable income before apportionment should be $100 higher as a result of applying IRC section 108(b) and lost depreciation deductions, which is $50 higher than the federal taxable income reported by the corporate taxpayer. The irony in the application of this interpretation under state law is that conformity to IRC section 108(b) principles results in nonconformity to adjusted basis and federal taxable income determined under the IRC. Further, while state income tax returns provide mechanisms via statutory modifications to federal taxable income in other areas where the state legislature chose to decouple from the IRC for purposes of intended depreciation differences, there is generally no specific statutory modification or even a line on the state tax returns indicating specific differences related to the application of IRC section 108.

The other view may be that the reduction of federal tax credits without a corresponding state tax credit does not result in more CODI applied to other attributes because application of IRC section 108 should be the same as federal for states that generally conform to the IRC. Under that theory, depreciable basis applied for federal and state purposes should be the same in order to maintain consistency in depreciation deducted by the corporate taxpayer in future years after the bankruptcy. However, while that approach to federal conformity may sound straightforward, it may also create the potential for additional uncertainties, as discussed below.

D. Reduction of Capital Losses

For federal income tax purposes, CODI in excess of NOLs and enumerated credits then reduces capital loss carryforwards. Some states, such as Massachusetts and Tennessee, have decoupled from allowing a capital loss carryforward in their income tax regimes.[27] In California, similar to NOLs, capital loss carryovers are tracked on a post-apportioned separate entity basis using intracompany California apportionment.[28] Therefore, only corporations that were in the combined return and had California factors in the year that the capital loss was recognized will have a California-apportioned capital loss carryover to use against future capital gains. In Florida the federal capital loss carryover is apportioned to Florida in the year the loss is incurred.[29] The loss is then carried forward, not back, and treated in the same manner as a federal capital loss under IRC section 1212.[30] The loss is then applied to the apportioned capital gain in the year of such gain.[31]

However, most states do not provide a mechanism in their income tax regimes for tracking capital losses for state purposes. In those states, the amount of capital loss carryforward is essentially a pro forma capital loss for state purposes that is applied without regard for the federal consolidated return regulations and may not be used to offset capital gains of affiliated corporations. Tracking capital losses on a pro forma basis increases the possibility that the amount of capital loss available to offset CODI for purposes of state attribute reduction will differ from the federal results.

For example, if a corporate taxpayer generates a capital loss in a prior year but offsets all of that capital loss in its federal consolidated return with a capital gain from another member of the consolidated group, that taxpayer may have a capital loss carryforward for state purposes only that is available to offset a future capital gain of its own. Assuming the same facts in the previous example, the taxpayer with $100 of CODI and no credit reduction for state purposes may be able to apply the $100 in reduction of its pro forma capital loss, and no CODI would be applied to adjusted tax basis for state purposes. In this example, the opposite result is reached from that above in that the corporate taxpayer would have $50 more of depreciation deduction available to offset taxable income used for state purposes resulting in less taxable income than for federal purposes. However, the lack of a statutory modification regarding IRC section 108 as well as the state tax return not providing a line for a different depreciation deduction creates confusion, uncertainty, and, most of all, less ease of administration than contemplated by the states' general conformity to the IRC.

E. Reduction of Tax Basis

To the extent any CODI remains after being applied against capital loss carryforwards, IRC section 108(b)(2)(E) provides that the basis of the corporate taxpayer's assets are reduced, with a cross-reference to IRC section 1017. IRC section 1017(b)(2) sets forth limitations (the liability floor) that provide that the reduction in asset basis is limited to the excess of the debtor's aggregate asset basis over the amount of its debt as of the date of the discharge. However, to the extent IRC section 1017(b)(2) is applied to determine the liability floor for state purposes, the tax basis of assets used in the computation should be adjusted to reflect any differences between federal tax basis and state tax basis in the assets. A few potential and common adjustments to consider would include the differences in depreciable asset basis because of bonus depreciation adjustments for states that decoupled, and subsidiary stock basis adjustments because of the investment adjustments required by reg. section 1.1502-32. Further, to the extent any intercompany liabilities are eliminated in consolidation for purposes of a federal liability floor computation, those intercompany balances should be respected by most states for purposes of determining the liability floor.

[27] *See* Mass. Gen. L. ch. 63 section 30(4) and Tenn. Code Ann. section 67-4-2006(b)(2)(E).

[28] Cal. Code Reg. tit. 18, section 25106.5-2(a)-(g).

[29] Fla. Admin. Code Ann. r. 12C-1.013(16)(b)(1).

[30] Fla. Admin. Code Ann. r. 12C-1.013(16)(a).

[31] Fla. Admin. Code Ann. r. 12C-1.013(16)(c).

If the liability floor doesn't apply, CODI is applied to reduce the adjusted tax basis of assets on a dollar-for-dollar basis for assets in the following classes in the order prescribed by reg. section 1.1017-1. If the remaining CODI is less than the aggregate adjusted basis of any particular class, then reduction is performed on a pro rata basis for that class.

- class 1: real property used in business, other than real property held as inventory, that secured the discharged debt;[32]
- class 2: personal property used in a trade or business, other than inventory, accounts receivable, and notes receivable, that secured the discharge of debt;[33]
- class 3: assets used in a trade or business, other than inventory, accounts receivable, notes receivable, and IRC section 1221 real property;[34]
- class 4: inventory, accounts receivable, notes receivable, and IRC section 1221 real property are reduced;[35] and
- class 5: property not used in the business nor held for investment.[36]

Similar to the computation of the liability floor, common adjustments to consider for state income tax purposes would be the differences in depreciable asset basis because of bonus depreciation adjustments and subsidiary stock basis adjustments required by reg. section 1.1502-32.

One additional key difference and critical area of nonconformity to the federal consolidated regulations in applying attribute reduction relates to the reduction of subsidiary stock basis. As discussed above, the amount of subsidiary stock basis is likely different in many states because of nonconformity with reg. section 1.1502-32; however, the complication of applying IRC section 108(b) and IRC section 1017 to reduce tax basis in assets is exacerbated when the recapture provisions of IRC section 1245 must also be considered and tracked for state income tax purposes because reg. section 1.1502-28 does not apply.

F. Intercompany Debt

When an obligation of a debtor is canceled, there are income tax implications for both the debtor and the creditor. For the debtor, the cancellation will result in taxable CODI unless an exception applies.[37] In a bankruptcy or insolvency, IRC section 108 generally applies to exclude CODI from gross income and require attribute reduction. IRC section 166(a) generally provides that the creditor can receive a deduction for debts that become worthless during the tax year.[38]

However, the federal consolidated return regulations provide different rules when the intercompany debt is between members that participate in a consolidated federal return. Under the general framework of the federal consolidated return regulations, members of an affiliated group do not recognize items of income or loss on the extinguishment of intercompany debt unless a triggering transaction occurs.[39] Generally, a triggering transaction occurs when a member realizes an amount, directly or indirectly, from the assignment or extinguishment of all or part of its remaining rights or obligations under an intercompany obligation.[40]

When a triggering transaction occurs, the indebtedness is treated as having been satisfied by the debtor for cash in an amount equal to its fair market value, and then as having been reissued as a new obligation for the same amount of cash, immediately before the triggering transaction.[41] In a deemed satisfaction and reissuance when the fair market value of the debt is less than the adjusted issue price of the obligation, the debtor member realizes CODI. Similarly, the creditor will realize a loss if the fair market value of the obligation is less than the creditor's basis in the obligation. The result is that the debtor's CODI and the creditor's loss will typically offset in consolidation, and the exclusion from income under IRC section 108(a) and the subsequent reduction to attribute under IRC section 1017 do not apply.[42]

For separate company purposes, the federal treatment does not generally apply because the parties file separate returns and the federal consolidated return regulations do not apply. Therefore, it appears that the creditor corporation may deduct the bad debt while the debtor corporation must apply IRC section 108. Further, combined and consolidated filing states vary on conformity to reg. section 1.1502-13(g) so the application may similarly follow a separate entity approach requiring attribute reduction for the debtor corporation. The results of that federal conformity/nonconformity is generally that the CODI applied to reduce tax attributes is higher for state income tax purposes when intercompany debt is extinguished in a bankruptcy transaction, creating potential permanent differences that corporate taxpayers will need to track and consider for years to come.

IV. Section 382

It is common that taxpayers emerging from bankruptcy experience an ownership change triggering the IRC section 382 limitations on NOL carryforwards and built-in losses. Only a few states, such as Illinois, Tennessee, and Arizona, have explicitly stated that IRC section 382 does not apply to their state income tax regimes.

[32]Reg. section 1.1017-1(a)(1).
[33]Reg. section 1.1017-1(a)(2).
[34]Reg. section 1.1017-1(a)(3).
[35]Reg. section 1.1017-1(a)(4).
[36]Reg. section 1.1017-1(a)(5).
[37]IRC section 61(a)(12).
[38]IRC section 166(a)(2).

[39]Reg. section 1.1502-13.
[40]Reg. section 1.1502-13(g)(3)(i)(A)(1).
[41]Reg. section 1.1502-13(g)(3)(ii)(A).
[42]Reg. section 1.1502-13(g)(4)(i)(C).

Illinois appears to have explicitly decoupled via statute and regulation. Illinois expressly provides that no limitation under IRC section 382 shall apply to Illinois NOL deductions or some Illinois credits.[43] In a private letter ruling, Tennessee ruled that NOLs are not limited for a "mere change in stock ownership," and instead the state applies its own rules.[44] A 2010 Arizona Tax Court case held that Arizona does not apply IRC section 382 to limit the utilization of NOLs.[45]

Arizona starts its income tax computation with federal taxable income computed under the IRC, subject to specific state modifications.[46] Among the modifications is a requirement to add back the federal NOL as computed under IRC section 172.[47] Arizona then permits a subtraction for NOLs computed under state provisions.[48] The Arizona NOL is the amount computed under IRC section 172, increased or decreased by Arizona modifications and apportioned to Arizona.[49] Also, Arizona only provides for a five-year carryover as opposed to the 20 years allowed under the IRC.[50]

In the tax court decision cited above, the court held that because the federal NOL is added back and replaced with a separately computed Arizona NOL, "the statutory language necessitates the conclusion that the legislature intended for the state to write its own rules governing net operating losses."[51] As a result, Arizona NOLs would appear not to be restricted by IRC section 382 but by the state's judicial history. The tax court decision is not precedent but relies on the position laid out in the landmark case *Oliver's Laundry*.[52] Both *Oliver's Laundry* and *Libson Shops* were decided before Congress's enactment of IRC section 382 in 1986. Under *Libson Shops*, a successor corporation in a merger was not able to deduct pre-merger losses against post-merger income when the business generating the loss was not substantially the same as the business generating the post-merger income. While *Libson Shops* has been essentially repealed for federal income tax purposes by IRC section 382, it appears that Arizona continues to follow its pre-1986 rules regarding NOL limitations based on the holding of *Oliver's Laundry*. Arizona has laid out a specific formula for that computation in Arizona Corporate Tax Ruling 94-11.[53]

While most states appear to follow the general provisions of IRC section 382 for corporate income tax purposes, only a minority of states have provided specific guidance or methods for applying IRC section 382 to their unique state regimes.[54]

A. State Conformity to IRC Section 382

Naturally, the first issue to address when analyzing the application of IRC section 382 in a state context is whether the state follows IRC section 382. While the question itself seems relatively straightforward, it may be surprising to discover that only a handful of states address whether they have adopted IRC section 382.

Only a small number of states specifically reference IRC section 382 in their statutes. Those states either incorporate IRC section 382 in its entirety or refer only to its application regarding NOLs. Examples of states with specific reference to IRC section 382 include Georgia, Oregon, and Pennsylvania.[55] There are also states that do not specifically adopt by statute but reference IRC section 382 in their regulations, such as Colorado, Florida, and Massachusetts.[56] Colorado's regulation, however, provides an interpretation of IRC section 382 conformity that appears to be narrower than the federal income tax rules by adopting IRC section 382 for NOLs incurred by a corporation taxed under subchapter C of the code only when it is acquired by another subchapter C corporation. The regulation, however, does not discuss either conformity or nonconformity to IRC section 382 in other types of transactions that create an ownership change. It is unclear whether this restricts the IRC section 382

[43] 35 Ill. Comp. Stat. 5/405(b-5).

[44] Tenn. Letter Ruling No. 11-44, Tenn. Dept. of Rev. (Sept. 7, 2011).

[45] *Wells Fargo & Co. v. Arizona Dept. of Revenue*, Ariz. Tax Ct., No. TX 2007-000496 (May 21, 2010).

[46] Ariz. Rev. Stat. section 43-1101(1), (2), (4).

[47] Ariz. Rev. Stat. section 43-1121(7).

[48] *Id.*

[49] Ariz. Rev. Stat. section 43-1123(A); Ariz. Admin. Code 15-2D-302(E)(1).

[50] Ariz. Rev. Stat. section 43-1123(B).

[51] *Wells Fargo & Co.*, No. TX 2007-000496.

[52] *State Tax Commission v. Oliver's Laundry & Dry Cleaning Co.*, 508 P.2d 107 (Ariz. 1973), citing *Libson Shops Inc. v. Koehler*, 353 U.S. 382 (1957).

[53] Ariz. Corp. Tax Ruling CTR 94-11, Ariz. Dept. of Rev. (Aug. 7, 1994).

[54] For purposes of determining whether there has been a change in ownership of a corporation, IRC section 382(l)(3) incorporates constructive ownership rules. As a result of those rules, transfers of stock ownership within a controlled group of corporations typically do not result in an ownership change and an ownership change is most often triggered by the acquisition of subsidiary stock by a third party or a shift in the ownership of stock in the ultimate parent of the controlled corporate group. As a consequence, an ownership change for federal income tax purposes is usually an ownership change for state income tax purposes, and it is unusual to have an ownership change for state purposes that is not also an ownership change for federal purposes, regardless of whether the state requires separate, consolidated, or unitary combined returns. Thus, the state issues arising under IRC section 382 and the issues addressed in this article relate to the determination of the limitations on the use of state NOLs and other tax attributes following an ownership change and not on whether an ownership change has occurred.

[55] *See* Ga. Code Ann. section 48-7-21(b)(10.1)(D); Or. Rev. Stat. section 317.478(4); and Pa. Cons. Stat. 7401(3)4(g).

[56] *See* Colo. Code Regs. section 39-22-504(2)(2); Fla. Admin. Code Ann. r. 12C-1.0511(1)(f); and Mass Regs. Code tit. 830, section 63.30.2(11)(b).

limitation or if IRC section 382 may apply in other situations through Colorado's use of federal taxable income as the starting point in the computation of Colorado taxable income.[57]

A few states, such as Indiana and New York, also express their adoption of IRC section 382 in the form of administrative guidance.[58] Indiana has ruled that IRC section 382 applies to its NOL regime through its references to IRC section 172. The Indiana income tax calculation begins with adjusted gross income derived from sources within Indiana.[59] Adjusted gross income is defined as taxable income under section 63 with some adjustments, including an adjustment to eliminate federal NOLs.[60] Indiana then allows for its own NOLs as calculated under IRC section 172, which are subject to Indiana's statutory modifications and are then apportioned to Indiana.[61] For tax year 2013, Indiana adopted the code as of January 1, 2013.[62] Further, under Indiana law, when a section of the code is specifically adopted for Indiana purposes, any other section of the code referenced in the adopted section also applies for Indiana tax purposes.[63] Therefore, because IRC section 382 is referenced by IRC section 172(k)(2), the Indiana Department of Revenue has ruled that IRC section 382 has been generally adopted for Indiana purposes.[64]

In most states, however, it appears that conformity is implied through either using federal taxable income as the starting point for state taxable income or through adoption of the IRC in general. However, corporate taxpayers should consider whether any additional state-specific limitation on NOLs provided by states whose NOL rules decouple from the federal rules may operate in lieu of IRC section 382.

B. Effect of Apportionment on the Operation of IRC Section 382

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 income taxation. At a high level, allocation typically refers to the direct assignment of income from a particular transaction or activity to a particular state. That allocation method generally applies to nonbusiness income arising from activities that are not integral to the business of the taxpayer (that is, not unitary). By contrast, apportionment refers to the assignment of income to the individual tax jurisdiction based on the measure of the taxpayer's relative activity in the state regardless of how the income was generated. That apportionment method was accomplished through the application of property, payroll, and sales factors, which are intended to measure the taxpayer's relative use in the state of capital, labor, and the state's marketplace.[65] The result is an apportionment percentage that is applied to state taxable income (that is, federal taxable income after state adjustments).

Some jurisdictions, such as New York and Virginia, determine the NOL before apportionment. That makes the issue of apportionment of the section 382 limitation moot because the NOL and the IRC section 382 limitation are both unapportioned (similar to the federal treatment).

The majority of states, however, apportion the NOL based on the apportionment factors applicable in the year of the loss. In those states, complications often arise in determining whether a corporation should use its federal IRC section 382 limitation for purposes of applying IRC section 382 in limiting state NOL utilization, or whether the corporation must also apply an apportionment factor to determine a state-specific, post-apportioned IRC section 382 limitation. Because most states are silent on that issue, the challenging question for many corporate taxpayers is whether a state's general conformity to the IRC implies use of the federal IRC section 382 limitation to limit state NOLs or if a taxpayer is required to make the leap to interpret that the IRC section 382 limitation should be apportioned by breaking away from general conformity without any specific statutory or regulatory guidance to do so. If the limitation is required to be apportioned for state purposes, questions naturally arise as to how that apportionment percentage is determined.

In the 2009 case of *AT&T Corp. v. Alabama Dept. of Rev.*, the Alabama DOR assessed tax against AT&T for applying the entire pre-apportioned IRC section 382 limitation against its post-apportioned Alabama NOLs.[66] The DOR 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. The administrative law judge agreed with the DOR's analysis and cited Ala. Code section 40-18-1.1, which provides that principles of the federal IRC sections that are incorporated by Alabama shall be applied to the amounts as computed under Alabama law — thus contemplating apportionment. However, the ALJ ultimately held that the possibility of multiple interpretations or differing methods of computation made regulations necessary, and "without duly promulgated guidelines specifying how the section 382 limitation should be apportioned and

[57]Colo. Rev. Stat. section 39-22-304(1).

[58]*See* Letter of Findings No. 98-0501, Ind. Dept. of Rev. (Mar. 1, 2001); and TSB-A-07(2)C, N.Y. Comm'r of Tax. and Fin. (Mar. 19, 2007).

[59]Ind. Code section 6-3-2-1(b).

[60]Ind. Code section 6-3-1-3.5(b), (b)(6).

[61]Ind. Code section 6-3-2-2.6(a)-(c).

[62]Ind. Code section 6-3-1-11(a).

[63]Ind. Code section 6-3-1-11(b).

[64]Ind. Letter of Findings No. 08-0246 (May 27, 2009).

[65]The trend is that many states have replaced the traditional three-factor formula with a single-sales-factor formula.

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

otherwise applied for Alabama purposes, the federal limitations amount must be allowed."[67]

C. Effect of Filing Methods on State Application of IRC Section 382

When the taxpayer that experiences an ownership change does not have any subsidiaries or does not file a consolidated federal return, the state methods for applying IRC section 382 should generally follow the federal computations. However, in today's corporate environment, almost all taxpayers that are members of an affiliated group generally elect to file on a consolidated basis for federal income tax purposes. For those consolidated groups, the federal consolidated return regulations regarding IRC section 382 (reg. sections 1.1502-91 through 1.1502-99) generally provide that the IRC section 382 limitation is determined regarding the attributes of the consolidated group on a single entity basis and not for its members separately. As such, the fair market value of the loss group (measured by the parent company's value) is multiplied by the long-term tax-exempt rate to determine a single consolidated annual IRC section 382 limitation.[68]

For state corporate income tax purposes, using a consolidated approach to computing the IRC section 382 limitation has limited applicability. The default filing method is separate reporting in many states and the consolidated return regulations are not adopted in many unitary jurisdictions. In those instances, consideration should be given to the potential application of the controlled group rules because a member of a federal consolidated group would generally also be a member of a controlled group. Generally, the controlled group rules determine the value of the stock of any corporation for purposes of determining the base annual IRC section 382 limitation by subtracting the stock values of its subsidiaries.[69]

In practice, determining stock value at the subsidiary level can often be a challenging exercise. For federal income tax purposes, a consolidated group would be required to determine the fair market value of the stock of the common parent, as well as any interests in subsidiary stock held by nonmembers. There is typically no federal income tax reason for purposes of applying IRC section 382 to determine the stock value of a subsidiary on a separate company basis for federal income tax purposes.

Subsidiaries in a consolidated group are not typically publicly traded, and determining separate company stock values is not as straightforward as it would be otherwise. In theory, an appraisal by legal entity would be good evidence of the separate company values. However, in practice, those appraisals can be expensive and impractical if not warranted by other nontax purposes. In the absence of an appraisal, other methods may exist for determining separate company stock value, depending on a taxpayer's specific facts and circumstances and taking into consideration that the methods may ultimately be audited by state tax authorities.

Additional complications may exist in determining the value of subsidiary stock. For example, there may be uncertainty whether intercompany debt (which can include intercompany notes and receivables, as well as cash sweep accounts) is debt or equity for state tax purposes.

Even in a combined filing for unitary groups, there may be differences from the federal income tax determination of loss corporation value using the federal consolidated return regulations because of the differences in state rules regarding ownership percentages, water's-edge reporting, and so forth. Further, many states that require combined returns to be filed by unitary groups do not follow the federal consolidated return regulations. Therefore, even if the federal and state groups are identical, the federal income tax application of IRC section 382 may not apply in those states. If the federal consolidated return rules do not apply to the unitary group, then there is uncertainty in many states as to how and when to apply the rules on a unitary basis.

With varying levels of uncertainty among the states, taxpayers are left to struggle with the proper application of IRC section 382 for both tax return compliance and financial reporting purposes. Differences between federal and state calculations may arise because of nonconformity to IRC section 382, the application of state apportionment factors, and disparate filing methods or consolidated group composition.

V. Conclusion

Despite the goal of making administration of the income tax easier, other traps can result from the ambiguity and even potential conflict of law created by general state conformity to the IRC. That is especially true when a corporate taxpayer experiences a once-in-a-lifetime event, such as a bankruptcy or other out-of-court restructuring transaction. For many states, simply following the federal rules in a bankruptcy without specific guidance as to how to reconcile that conformity to state concepts not found in the IRC often creates more uncertainty and a complexity in administration of state income taxation that becomes inconsistent and seldom easy. ☆

[67] *Id.*
[68] Reg. section 1.1502-93(a)(1).
[69] Reg. section 1.382-8(c).