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In this article, Tran and Lee explore how the lack of uniformity in a net operating loss carryover state rule has created challenges for taxpayers and look at rules regarding sharing NOLs in a combined group and in merger and acquisition scenarios.

Net operating losses have been present in the tax code for well over a century and have taken many shapes and forms. In its most basic form, an NOL arises when a corporation's allowable deductions exceed its taxable income in a tax period. The concept of NOLs, carryforwards, and carrybacks was introduced in the Revenue Act of 1918 and permitted corporations to retain tax losses generated in a current year to offset taxable income in another tax period.[1] Under the 1918 act, the carryover period for NOLs was limited to one year forward and back. Rules were later enacted governing the succession, or lack thereof, of a target corporation's preexisting NOLs following a reorganization or acquisition of another corporation. Thus, similar provisions were adopted by state taxing authorities that either conformed to the Internal Revenue Code or deviated by enacting their own regulations.

However, unlike in the IRC, there is no uniform state rule for determining the carryforward and carryback periods, nor is there a uniform rule for determining the amount of an NOL carryover that is allowable as a deduction in a tax year. This lack of uniformity among the states creates challenges for taxpayers and is one of the many reasons why it is critical to be aware of state-specific rules and the corresponding effect potential IRC changes can have on states that automatically conform to the federal code.

Federal NOL — Brief History and Current Law

While the federal treatment of NOLs has undergone many changes since 1918, the general principle of providing companies with a deduction has remained constant, with one exception. The NOL carryback and carryforward provisions were eliminated under the Revenue Act of 1933, and NOLs continued to be disallowed as a deduction until the enactment of the Revenue Act of 1939, under which they could only be carried forward to the subsequent two years.

The main reason behind the longevity and continued support for the NOL deduction is fairness, and these provisions can help taxpayers "ameliorate the unduly drastic consequences of taxing income strictly on an annual basis. They were designed to permit a taxpayer to set off its lean years against its lush years, and to strike something like an average taxable income computed over a period longer than one year."[2] Permitting taxpayers to eliminate or offset their

[1] Revenue Act of 1918, section 204.

[2] *Libson Shops Inc. v. Koehler*, 353 U.S. 382, 386 (1957).

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profits by the losses they sustained in prior or future years can be especially helpful for new or growing companies.

The federal treatment of NOLs is codified in 26 U.S. Code section 172, which includes provisions for the carryover periods and limits on the amount of NOLs allowed as a deduction. The two most recent and significant modifications to the NOL rules were part of the Tax Cuts and Jobs Act[3] and the Coronavirus Aid, Relief, and Economic Security Act[4] of 2020.

Under the current rules, NOLs arising in tax years beginning after December 31, 2017, may no longer be carried back but can be carried forward indefinitely, with no expiration. Any post-TCJA NOLs (2018 and later for calendar-year filers) are only eligible to offset 80 percent of taxable income in a future period. Pre-TCJA NOL rules remain unchanged and are eligible to offset 100 percent of taxable income and generally must be carried back to the two preceding tax years with any excess carried forward for a period of 20 years before they expire if unused.

Unlike the Revenue Act of 1939, which did not reinstate the provision for NOL carryback, the CARES Act retroactively restored carryback by providing a five-year carryback of NOLs generated in tax years beginning after December 31, 2017, 2018, and 2019. The CARES Act temporarily delayed the imposition of the 80 percent limit until after December 31, 2020, for pre-TCJA NOLs.

State NOLs: Conformity to the IRC

Most states adopt the IRC concurrently, or at least portions of it, into their existing tax law. This is a result of these states using federal taxable income as the starting point for calculating a taxpayer's state taxable income.[5] However, states may have differing rules regarding how they choose to adopt IRC modifications. These rules, or state conformity statutes, generally fall into one of the following three categories:

1. Rolling conformity — a state automatically incorporates the most current IRC as amended on an ongoing basis.
2. Fixed date conformity — a state conforms to the IRC as enacted on a certain date. For example, a state may adopt the IRC as of December 31, 2017, but any subsequent changes made to the IRC are disregarded.
3. Selective conformity — a state chooses to incorporate or disregard some portions of the IRC to adopt into its state's tax law.

Despite these distinct state conformity policies, individual states may alter, or decouple altogether, from any IRC provision. As a result, states have responded differently to the modifications of the IRC under the TCJA and CARES Act as they relate to the treatment of NOLs under section 172. Below are some notable examples of state NOL carryforward limits.

Arkansas limits NOL carryforward to five years for losses incurred before January 1, 2020, eight years for losses incurred in tax years beginning on or after January 1, 2020, and for 10 years for losses incurred in tax years beginning on or after January 1, 2021.[6] Nontaxable income may not increase a taxpayer's NOL carryforward.[7] Nontaxable income, or income not subject to tax, includes nonbusiness income and dividends that are subject to the dividends received deduction. However, expenses for the nontaxable income may be in the NOL carryforward amount.

In Delaware, a corporate taxpayer that is also a member in a federal consolidated return may not claim an NOL carryover that exceeds its federal consolidated NOL even though the state requires separate company reporting.[8] This limitation has been a long-standing, non-statutory policy of the Division of Revenue, outlined in the division's audit manual. Because Delaware requires a corporation to pay income tax as a stand-alone entity, rather than on a consolidated basis, the Delaware Supreme Court concluded that the division's policy limiting a taxpayer's separate NOL deduction to the aggregate amount

[3] Tax Cuts and Jobs Act, P.L. 115-97 (2017) (codified in as amended at 26 U.S.C. section 172).

[4] CARES Act, P.L. 116-136 (2020) (codified as amended at 26 U.S.C. section 172).

[5] In general, states use either line 28 or line 30 of federal Form 1120 as the starting point.

[6] Ark. Code Ann. section 26-51-427(1)(B)-(C).

[7] Ark. Code Ann. section 26-51-427(2).

[8] Del. Code Ann. tit. 30, section 1903(a)(2)(i), as added by Del. H.B. 171 (2021), effective July 30, 2021.

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claimed by the taxpayer's consolidated group was inconsistent with Delaware law.[9] The division's policy was codified by legislation that became effective on July 30, 2021, but the statute did not clarify whether the new provisions would apply retroactively to any tax years.

Colorado is a rolling conformity state that uses line 30 of the federal Form 1120 as its starting point. As such, Colorado conforms to IRC section 172 and the 80 percent limitation on NOLs under the TCJA for losses incurred after December 31, 2017.[10] Although Colorado Department of Revenue Rule 39-22-103(5.3) decouples from the temporary delay allowed under the CARES Act, a recent decision by the Colorado Court of Appeals determined the rule to be invalid.[11] The 80 percent limitation on NOLs was unaffected by the court's decision despite its suspension under the CARES Act.[12]

Connecticut is also a rolling conformity state but does not follow section 172. Instead, Connecticut imposes a state-specific 50 percent limitation on the usage of NOL carryovers and does not allow NOLs to be carried back.[13]

Illinois and Pennsylvania are also rolling conformity states. However, the subtraction from adjusted and apportioned base income allowed for NOL carryforwards in Illinois is limited to $100,000 for tax years ending on or after December 31, 2021, and before December 31, 2024.[14] Pennsylvania does not follow section 172 as a result of its starting point (line 28 of federal Form 1120, taxable income before NOL and special deductions), limiting the taxpayer's state net loss deduction to 40 percent of taxable income for tax years beginning after 2018.[15]

Sharing NOLs Among Members of a Unitary Combined Group

The treatment of NOL carryovers is further complicated in states that permit or perhaps mandate group reporting on a combined or consolidated basis. Some states allow NOLs to be shared with the other group members, while others strictly prohibit sharing. In states where NOL sharing is not allowed, an NOL deduction may only be claimed by the component member that incurred the loss. In Arizona, for example, the NOLs of a corporation that is a member of a unitary combined business group may be used to offset the income of other group members if the NOLs were generated while the corporation was part of the combined group.[16]

In California, however, an NOL carryover for one member in a combined report may not be applied to another member in that report regardless of when it was generated and who was in the group at that time.[17] Corporate taxpayers that are members of a California unitary group must instead separately compute and track their NOL carryovers. If a member of the unitary group incurs a loss, its NOL carryover is calculated by applying its individual apportionment factors.[18] Each corporation in the combined report must complete a separate form when computing its separate California NOL carryover.[19] States such as California require NOL tracking on an entity-by-entity basis. This becomes helpful if a member leaves the group and may take its NOLs if it later joins a new group.

Mergers and Acquisitions

There are two federal provisions that govern the transfer of NOLs (section 381) from a corporation that is acquired by another corporation and potentially limit their use (section 382). Section 381 generally provides that a corporate acquirer assumes a predecessor's

[9] *Director of Revenue v. Verisign Inc.*, 267 A.3d 371 (Del. 2021) (taxpayer permitted to deduct the full amount of its NOL computed on a stand-alone basis for tax years 2015 and 2016 and was not limited by the aggregate NOL deducted on the federal consolidated return for those years).

[10] Colo. Rev. Stat. section 39-22-504(1)(b).

[11] *Anschutz v. Department of Revenue*, No. 2022COA132 (Colo. Ct. App. Nov. 17, 2022).

[12] *See also* Colo. DOR, "CARES Act Tax Law Changes & Colorado Impact" (rev. Apr. 2023).

[13] Conn. Gen. Stat. section 12-217(a)(4).

[14] 35 ILCS 5/207(d), Ill. Admin. Code, tit. 86, section 100.2330(f)(5).

[15] 72 Pa. Cons. Stat. section 7401(3)(4)(c)(1).

[16] Ariz. Admin. Code section 15-2D-302(B)(3). *See also* Ariz. DOR, Corporate Tax Ruling CTR 91-2 (Apr. 2, 1991); Ariz. DOR, Corporate Tax Ruling CTR 99-3 (May 22, 1999).

[17] *See* Instructions, FTB 3805Q Booklet, Net Operating Loss (NOL) Computation and NOL Disaster Loss Limitations-Corporation (undated).

[18] Cal. Code Reg. tit. 18, section 25106.5.

[19] *See* Form FTB 3805Q, Net Operating Loss (NOL) Computation and NOL Disaster Loss Limitations-Corporation.

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NOL carryforwards in some corporate acquisitions involving tax-free liquidations of subsidiaries or reorganizations. Section 382, generally intended to prevent "NOL trafficking," limits an acquiring corporation's ability to use NOLs from a target corporation when there is a change in control. For section 382 purposes, a change in control occurs when a shareholder, which owns at least 5 percent of the corporation's stock (by value), increases its ownership by more than 50 percent during the "testing period," which is generally three years. Further, under the separate return limitation year (SRLY) rules, if a corporation with NOL carryforwards joins a consolidated group and section 382 does not apply, the consolidated group is able to use the new member's NOLs only to the extent the new member contributes to its consolidated taxable income since joining the consolidated group.

Many states that conform to the federal NOL provision also incorporate the limitations in sections 381 and 382. There are always exceptions, such as Arizona, which disallows an NOL carryover "from a prior period if such loss was incurred by another corporation or group of corporations, prior to a merger, consolidation, or reorganization with the taxpayer, to the extent that Arizona adjusted income, earned after the merger, consolidation, or reorganization, is not attributable to the same entity that incurred the net operating loss."[20] The starting point for computing taxable income in Arizona is federal Form 1120, line 30, but Arizona law requires that the federal NOL deduction to be added back.

While many states have adopted sections 381 and 382, not all states adopt both sections, or a state may have its own set of rules for the succession of an NOL carryover in a corporate reorganization or liquidation. Illinois allows the NOL carryover of losses from a corporation that is acquired under a section 381 transaction;[21] however, the state does not follow the loss limitation or SRLY rules.[22] In Arkansas, an NOL carryover is allowed in an asset acquisition; however, an NOL deduction may only be claimed "when the ownership of both the acquired and acquiring corporations is substantially the same in that not less than eighty percent of the voting stock of each corporation is owned by the same person or, before the acquisition, the acquiring corporation owned at least eighty percent of the voting stock of the acquired corporation."[23]

Fortunately, identifying whether a particular state conforms to sections 381 and 382 is a straightforward analysis. The challenging aspect is how states *apply* the limitation. That is, most state NOLs are determined on a post-apportionment basis. The federal NOL limitation is determined on a pre-apportionment basis. Many states are silent as to whether the federal limit should be apportioned, and if so, from what year should the apportionment be used, the year of the transaction or the year of use?

Conclusion

There is no one-size-fits-all rule for the treatment of NOLs among the various state taxing jurisdictions. Instead, multistate corporate taxpayers need to consider many variables when losses are incurred, as each state's rules will likely result in different NOL carryover amounts that are subject to both federal rules under the IRC and the tax code of each state. Also, subsequent IRC updates or amendments can have significant ripple effects on many states' tax laws. This link between the IRC and state tax codes, which are both independent of, but also tied to, the IRC because of state conformity rules, produces a complex and diverse tax landscape among the states. ■

[20] Ariz. Admin. Code section 15-2D-302(B)(3).

[21] 35 Ill. Comp. Stat. Ann. 5/405(a).

[22] 35 Ill. Comp. Stat. Ann. 5/405(b-5).

[23] Ark. Code Ann. section 26-51-427(3); Ark. Code Ann. section 26-51-427(3)(D).

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