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2011 Legislation Limiting Use of State Net Operating Losses and Tax Credits to Close Budget Deficits

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Last year we saw a number of state legislatures propose bills to suspend or eliminate net operating loss ("NOL") carryforwards, NOL carrybacks, and tax credits in an effort to close the gap between state budgets and revenue. This year we are seeing not only many of the same revenue-raising measures proposed, but also competing legislation that, if passed, would expand the use of NOL carryforward and carryback deductions. For example, in Montana, bills with competing NOL provisions are currently under consideration by the state legislature, and it is not currently clear which bill, if any, will make it out of committee. The long-term consequences of eliminating, limiting, or expanding NOL provisions and other income tax credits remain to be seen.

Limitations on Use of Net Operating Losses

For federal tax purposes, NOLs generally may be carried back (currently two years) or forward (currently 20 years) pursuant to I.R.C. § 172. Federal NOLs survive corporate acquisitions (*e.g.*, reorganizations) under the circumstances specified in I.R.C. § 381 and are subject to limitations on the use following an "ownership change" (generally 50 percent) per I.R.C. § 382. Many states have NOL rules that differ from the federal tax NOL rules. The differences are becoming more prevalent as states take action to limit NOL carrybacks and carryforwards.

The following is a summary of certain state bills limiting the use of state NOLs that have been enacted or introduced in the 2011 legislative session:

Illinois SB 2505, Public Act 096-1496 – Enacted

On January 13, 2011, Governor Pat Quinn signed into law Senate Bill 2505, the "Taxpayer Accountability and Budget Stabilization Act," which went into effect immediately. The Act provides for several changes to the state's Income Tax Act as a direct result of its looming budget crisis and is projected to raise an estimated $6.8 billion on an annual basis. The relevant provision suspends the NOL carryover deduction for corporations other than S corporations for any taxable year ending after December 31, 2010, and before December 31, 2014. The current carryover provisions (12 years for losses incurred on or after December 31, 2003) will be extended by the number of years affected by the suspension.

Hawaii SB 1532 – Senate Ways & Means Committee

If passed, this bill would repeal the NOL deduction from state income tax in addition to repealing many other income tax exemptions, such as: (i) the exclusion for income not subject to taxation by the state under the Constitution and laws of the United States; (ii) the deduction of dividends received by any corporation upon the shares of stock of a national banking association, qualifying dividends received by members of an affiliated group, or dividends received by a small business investment company; and (iii) the exemption for royalties derived from patents, copyrights, or trade secrets received by an individual or a qualified high-technology business. The bill would also repeal many income (and general excise) tax credits, as discussed below.

Indiana SB 545 – Reading in Senate Committee on Tax and Fiscal Policy

Indiana SB 545, currently reading in the Senate Committee on Tax and Fiscal Policy, states, "A taxpayer is not entitled to carryback any net operating losses after December 31, 2011." If passed, this bill would eliminate the carryback of NOLs under the state income tax law. A provision identical to SB 545 eliminating NOL carrybacks is included in SB 589.

Montana SB 70 – Tabled in House Committee

If passed, Montana SB 70 would eliminate NOL carryback provisions for losses sustained after December 31, 2010. Existing law allows deductions for NOLs incurred in years beginning on or after January 1, 2011, to be carried back three years.

Colorado Reg. 39-22-504(2) – Recent Amendment to Regulation

The Colorado Department of Revenue has amended a corporate income tax regulation related to NOLs. The regulation states that for tax years beginning on or after January 1, 2011, but before January 1, 2014, the amount of NOLs used by a C corporation cannot exceed $250,000 in any tax year. If the $250,000 limitation prevents a corporation from using any part of its NOL carryforward in a tax year, then all NOLs carried forward to such tax year may be carried forward one additional year for each tax year the restriction applies. Any portion of an NOL carryforward that cannot be used solely because of the $250,000 limitation shall be increased by 3.25 percent for that tax year. Also, for any short tax year, the 3.25 percent rate will be prorated by the number of months in the tax year divided by 12. This amendment is effective March 2, 2011.

Expansion of Use of Net Operating Losses

On the other end of the spectrum lie state bill proposals that would expand the use of NOLs by: (i) removing the cap on NOL deductions in a given tax year, (ii) increasing the amount of NOL generated in a tax year that may be carried forward, or (iii) increasing the number of years of a carryback or carryforward period. The following is a summary of state bills expanding the use of state NOLs that have been introduced in the 2011 legislative session:

Arizona SB 1199 – Reading in Senate

If passed, this bill would amend the calculation of NOLs by extending the NOL carryforward period from five to 20 succeeding taxable years, beginning December 31, 2010. This amendment would revise the Arizona tax law by conforming it to the federal carryforward provision.

Colorado SB 11-073 – Senate Committee on State, Veterans & Military Affairs

Colorado SB 11-073 would repeal a $250,000 cap on the amount of NOLs that a corporation may subtract from federal taxable income when calculating Colorado taxable income. The cap is currently in effect for income tax years commencing prior to January 1, 2014. The bill does not seem to have any traction at this point, having been "postponed indefinitely" in committee.

Maine HP 123 – House Committee on Taxation

Current Maine law puts a three-year moratorium on the carrying forward of NOLs for 2009, 2010, and 2011, requiring that the NOLs subtracted for federal tax purposes be added back in for Maine income tax purposes for those years. The bill, if passed, would eliminate the requirement that NOLs be added back into Maine income tax for years beginning in 2011.

Montana HB 598 – House Committee on Taxation

If passed, Montana HB 598 would conform Montana law to the I.R.C. rule on NOLs. Current law provides a three-year carryback period and a seven-year carryover period for NOLs. Further, in the case of a merger or consolidation of corporations, an NOL deduction would be granted to the acquiring or parent corporation for its NOLs sustained prior to the merger or consolidation.

Nebraska LB 483 – Revenue Committee

If passed, Nebraska LB 483 would allow an NOL carryover deduction for each of the 10 taxable years succeeding the year of the loss for NOLs incurred in taxable years beginning on or after January 1, 2010. The carryover period under current Nebraska law is five taxable years succeeding the year of the loss.

New Hampshire SB 126 – Senate Ways & Means Committee

New Hampshire SB 126, and its companion bill HB 242, would increase the amount of NOL generated in a tax year that may be carried forward from $1 million to $10 million for purposes of the business profits tax, beginning July 1, 2011. The Department of Revenue Administration predicts that this bill will decrease state revenue by an indeterminable amount in fiscal year 2012 and each year thereafter.

Elimination or Limitation of Tax Credits

The following are summaries of some of the proposed legislation seeking to eliminate or limit tax credits.

Arizona HB 2597 – House Second Reading

If passed, this bill would repeal Title 43, Chapter 11, Article 6 of the Arizona Revised Statutes, which lists all of the state's corporate income tax credits. The bill would become effective for tax years beginning in 2012.

Hawaii SB 1532 – Senate Ways & Means Committee

If passed, this bill would repeal many income (and general excise) tax credits, including income tax credits for renewable energy, high-technology investment and infrastructure, motion pictures, low-income housing, and agriculture. As discussed above in the NOL limitation section, the bill would also repeal many exclusions and deductions from income. The sheer scope of the bill makes its passage seem unlikely, but if the bill does pass, expect an uproar.

Idaho SB 1039 – Reading in Senate

Idaho SB 1039 provides an automatic expiration date for all income tax "deductions and credits," unless extended by statute. If the bill is passed, a new Idaho Code § 63-3089 would provide that

> [n]otwithstanding any other provision of law to the contrary, all deductions and credits to the taxes imposed by this chapter shall automatically expire on January 1, 2013, unless a specific section is extended by statute. Extended sections in this chapter granting a deduction or credit to the tax imposed by this chapter shall expire five (5) years from the date of being extended by statute unless further extended by statute for a period of not more than five (5) years after its effective date, unless extended by statute. Any new deduction or credit enacted after July 1, 2011, shall expire five (5) years after its effective date, unless extended by statute.

While not discussed above, this bill could presumably impact the NOL deduction if the NOL provisions were not specifically extended.

Maryland HB 918 – House Ways & Means Committee

Maryland HB 918, if passed, would repeal certain tax credits that are currently allowed against public-service franchise tax and state income tax for purchase of coal mined in Maryland. Current law allows a public-service company to claim a credit against the public-service-company franchise tax in the amount of $3 for each ton of Maryland-mined coal that the public-service company purchased in the calendar year.

Missouri SB 185 – Senate Ways & Means Committee

If passed, this bill would automatically sunset all tax credit programs that are not currently subject to the Missouri Sunset Act. It would become effective January 1, 2013, and would not limit in any way a recipient's ability to redeem tax credits authorized prior to that date.

Oregon HB 2567 – House Revenue Committee

If passed, HB 2567 would delay the allowance of any income tax credits between January 1, 2011, and January 1, 2014, until the state legislature finds that certain economic conditions have been met. The Oregon legislature is also considering numerous bills that would extend the sunset on various tax credits, such as the qualified research-activities credit (HB 3174 and SB 315).

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