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Chapter 12: Net Operating Losses

Schedule K – Loss Carryover

The *current year* net operating loss ("NOL") amount is shown on Schedule K - Determination of Loss Carryover Available, Line 6. This schedule reverses out certain deductions that were allowed on Schedules J1, J2, and J - in regards to dividends, nonbusiness earnings, earnings subject to self-employment taxes, and payments to a qualified pension or benefit plan.[1] These reversals (add-backs) should never turn an apportioned business loss (Schedule J, Line 29) into income. The current year loss amount shown on Schedule K, Line 6 is after apportionment, and taxpayers will report it on the subsequent year's Schedule U - Schedule of Loss Carryover.

A common error is mistaking the loss shown on Schedule J, Line 29 - Total Business Income (Loss) or Schedule J, Line 31 - Apportioned Business Income (Loss) as the *current year loss* amount that is available for carryover. However, the current year loss amount is the amount shown on the last line of Schedule K.

More specifically, the deductions made in calculating total business income on Line 29 that must be reversed in arriving at the current year loss available for carryover are:

- Dividends from corporations owned 80%-or-more deducted on Schedule J, Line 17;
- Nonbusiness earnings reported on Schedule J, Line 21 (and on Schedule M, Line 8);
- Earnings subject to self-employment tax deducted on Schedule J1, Line 6 and Schedule J2, Line 8; and
- Payments to a qualified pension or benefit plan deducted on Schedule J1, Line 7.

Schedule J and Sub-J audit work concerning the above expenses may be limited at the auditor's discretion when there is a current year loss and the amount will ultimately be reversed on Schedule K.

Schedule U – Loss Carryover

Any NOL incurred for a fiscal year ending on or after January 15, 1984, may be carried forward 15 years as a NOL carryover.[2] For example, a 2019 loss will expire in 2035, so any loss from 2019 that has not been used by the beginning of 2035 will be unavailable to offset Tennessee taxable income. Schedule U shows the losses earned, used, expired, and available for carryover by tax year.

> ⚠ **NOLs may <u>not</u> be carried back to offset net earnings subject to excise tax.**

Losses are always applied to the first available year of earnings and continue each year until the loss carryover is fully utilized. This means the losses are applied to the oldest period first.

At the beginning of an audit, carryover information that the taxpayer reported on Schedule U is compared with the state's computer schedule. Differences in the taxpayer's and the Department's loss carryover schedules are not unusual, but may go unnoticed by the taxpayer, resulting in a debit or credit memo.

The auditor should review not only the current year loss available for carryover but also the total loss carryover available to future periods. The Department's carryover schedule will show a 15-year history of loss carryovers earned and used, along with the current balance, for each tax period. Any differences discovered when this detailed information is compared to the taxpayer's Schedule U should be investigated. The taxpayer's failure to properly claim a loss on Schedule U does not prevent the Department from allowing the earned loss to offset future taxable income. Schedules J and K of the loss year establish the loss carryover amount for that year; so even if the taxpayer fails to include the loss on Schedule U, it would be reflected in the Department's computer system and included in the tax calculation. All increases to the loss carryover balance should come from Schedule K, Line 6.

Any discharge of indebtedness occurring on or after October 1, 2013, as the result of a Chapter 11 reorganization, must reduce net operating losses ("NOLs") by the amount that has been excluded from federal taxable income.[3] See Chapter 13 for further information.

Audit Adjustments to Carryover Schedules

The Department may assess tax in years within the statute of limitations ("SOL") based on changes made to the loss carryover amounts from tax years outside the SOL.

> ⚠ **The SOL bars the *assessment* of tax in years that are closed, but it *does not bar the adjustment* of carryover schedules.**

For example:

- Taxpayer files a return for the year ended December 31, 2008 and reports a current year loss amount of $1 million.
- Taxpayer reported the loss on Schedule U and carried it forward each year, unused, because Taxpayer continued to have losses.
- In 2020, Taxpayer reports a profit and deducts the 2008 loss carryover amount, resulting in very little excise tax paid.
- During an audit of the current year tax return, the auditor discovers that the $1 million loss reported on the 2008 return should have been a $1,000 loss.
- The auditor may correct the carryover schedule and assess additional current year excise tax even though the 2008 tax return is outside the SOL.

The excise tax liability for all tax years after the year in which a carryover schedule is changed needs to be sequentially recalculated, taking into account excise tax add-backs and deductions and the applicable apportionment ratios, to determine the loss carryover balance available to offset net income in tax years open under the SOL. The 15-year carryforward limitation would still apply. Only tax years open under the SOL would be assessed additional tax. For example:

- Auditor corrects the taxpayer's loss carryover schedule by decreasing a 2009 carryover amount by $10,000.
- There are no statute waivers.
- The excise tax for 2010 is recalculated, resulting in additional excise tax due of $325.
- However, there is no assessment, because 2010 is outside the SOL.
- The auditor would then recalculate the 2011 excise tax using the adjusted carryover schedule that reflects the 2010 tax recalculation.

Auditors should *not* perform detailed audits of tax years outside the SOL in order to verify a loss carryover amount; however, they *should* scan the schedule for obvious anomalies that are likely errors. The auditor should confirm the taxpayer agrees that an error was made in the carryover schedule of a year outside the SOL. If the taxpayer states that the carryover schedule is correct, the auditor should accept it and not request detailed records for this tax year.

However, in the event that a *taxpayer changes* the amount of a loss carryover on Schedule U for a tax year outside the SOL, the *auditor should request* detailed support for the adjustment before accepting the change.[4] If accepted, the excise tax liability for all tax years, starting with the year after the change, would be recalculated and the limitations on timing for refunds and assessments would apply.

⚠ **The same rules outlined above that apply to adjusting carryover schedules also apply to the job tax credit and industrial machinery credit carryover schedules.**

Survivability of NOLs

1. Successors and "Shell" Entities

Generally, each taxpayer is considered a separate entity for Tennessee franchise and excise tax purposes. When there is a merger, consolidation, or like transaction the successor entity *cannot* use loss carryovers generated by a predecessor entity. When two or more businesses merge, only losses of the survivor corporation will be allowed.[5] However, if a business merges into a shell entity, where the successor is essentially the same taxpayer as the predecessor, then the successor entity may take a deduction for the predecessor's loss carryover.[6]

⚠ **A shell entity is one that has no income, expenses, assets, liabilities, equity or net worth, or operations at the time of the restructuring.**

For example:

- **Step 1** – June 15, 2015: Company A formed the Taxpayer as a wholly-owned subsidiary under the laws of Delaware. At that time, the Taxpayer had no income, expenses, assets, liabilities, equity, or net worth.
- **Step 2** – August 30, 2015: Company A contributed all of Company B's stock to the Taxpayer.

- **Step 3** – August 31, 2015: Company B converted to a single-member LLC of the Taxpayer.
- Because the Taxpayer held Company B's stock prior to the conversion, it was not a shell company, and thus, cannot use Company B's previously generated losses.

2. Unitary Groups of Financial Institutions

A unitary group of financial institutions may take a loss carryforward generated by a group member that is a member of the group at the end of the group's tax year, provided the loss carryover was not taken by the member itself before it joined the group or by another unitary group of financial institutions of which the member had previously been a part.[7]

A unitary group of financial institutions may not use a loss carryover generated by a group member that dissolved, merged out of existence, or converted from a corporation to an SMLLC. Furthermore, if a unitary group member that generated losses is sold and becomes a unitary group member of another unitary group, the losses it generated *stay with the original group*.

3. Conversion from Corporation to SMLLC Owned by Non-Shell Parent Corporation

After a corporation converts to an SMLLC, even though the predecessor taxpayer is disregarded to the parent, the predecessor's losses cannot be used by the parent. This conversion is equivalent to a merger of a subsidiary corporation out of existence and into the parent corporation, with the taxpayer as the successor entity.

An NOL may only be taken by the entity that created it. Before the conversion, the taxable entity was the predecessor corporation, but after the conversion, it was the predecessor corporation *plus* the parent. Since the predecessor and successor taxable entities are different, the loss carryforward is not allowed.[8]

4. "F" Reorganization – U.S.C. §368(a)(1)(F)[9]

Generally, a taxpayer may not use the NOL carryforward of an affiliate that has been party to an "F" reorganization. However, the following circumstances are exceptions to this rule:

- The "F" reorganization is for the reincorporation of the operating company in another state. The reorganization is accomplished using a single operating company and a shell corporation. For example:

- Corporation X, planning to reincorporate in another state, forms Shell Corporation Y in the new state.

- Corporation X then merges into Corporation Y, with Corporation Y as the surviving entity.

- The successor taxpayer is a shell company. New Corporation Y may use Corporation X's NOL carryforward.

- If a company that is a member of a financial institution unitary group undergoes an "F" reorganization, the unitary group may continue to use the NOL carryforward generated by the company, provided that the company is in existence as a member of the unitary group at the end of the unitary group's tax year.

5. Dissolution of Affiliate

If a company makes a liquidating distribution of its assets to another company and then goes out of business (dissolves), its net operating losses do not survive the dissolution. The successor taxpayer may not use the dissolved affiliate's NOL carryforward.

6. Loss Generated by Taxpayer Making an Entity Election

An entity may change the way it is taxed for federal income tax purposes. For example, a corporation may elect to be taxed as an S-Corporation. Also, an eligible entity may use federal Form 8832 to elect[10] how it will be classified for federal tax purposes: a corporation, a partnership, or an entity disregarded as separate from its owner. These elections are not the same as a merger, a consolidation or like transaction, and therefore, the entity may continue to use its NOL carryforwards.

7. "338(h)(10)" Election Deemed Existence of Two Corporations

I.R.C. § 338(h)(10) is a joint election that allows a corporation that acquires the *stock* of another corporation to treat the acquisition as a purchase of *assets* instead of stock. The income or loss from such a transaction may be reflected on the consolidated federal return. At the federal level, the mechanics of this election involve a "deemed" asset sale and the "deemed" existence of two corporations. However, because Tennessee has not adopted the federal regulations under Section 338, there is no deemed existence of two corporations and no deemed liquidation. The corporation is the same corporation before and after the transaction that was the subject of the

Section 338(h)(10) election. Therefore, any loss carryforward is allowed in subsequent tax years for excise tax purposes.[11]

Audit Procedures – Loss Carryovers

The following are minimum suggested audit procedures. Modifications may be needed due to the particular facts and circumstances of a given audit and the auditor's judgment.

- Compare yearly details from the taxpayer's Schedules U with the state's computer loss carryforward screens.
  - Investigate differences and solicit the taxpayer's help in explaining how it arrived at its numbers.
- Look at the state's computer loss carryforward schedules to identify keying errors.
  - For example, an unusually large loss for a particular year may be recorded because the Schedule N apportionment schedule was not keyed into the Department's computer system, resulting in a 100% loss to generate instead of an apportioned amount. The erroneous 100% apportionment also could be due to taxpayer oversight in preparing the return.
- Consider whether a merger, consolidation, or like event has occurred in any prior year that would require an adjustment to the schedule.
- Consider whether the Department established or modified an account in error, based on incorrect information, which allowed the losses of one taxpayer to be available to another.

[1] TENN. COMP. R. & REGS. 1320-06-01-.21, Tenn. Code Ann. § 67-4-2006

[2] For certain taxpayers that incurred a loss for tax years ending prior to July 15, 1990, the loss carryforward is limited to seven years, per Tenn. Code Ann. § 67-4-2006(c)(1). Any NOL incurred by a member of the unitary group that has been apportioned to Tennessee in a year prior to filing a combined return may be carried forward seven years as a net operating loss carryover by the unitary group.

[3] Tenn. Code Ann. § 67-4-2006(c)(8)

[4] *See* Revenue Ruling 96-14

[5] Tenn. Code Ann. § 67-4-2006(c)(2)

[6] Tenn. Code Ann. § 67-4-2006(c)(3)

[7] Tenn. Code Ann. § 67-4-2006(c)(4)

[8] Revenue Ruling 07-14, Revenue Ruling 06-26, Revenue Ruling 06-20

[9] A Type F reorganization is a mere change in identity, form, or place of organization of one corporation. See Revenue Ruling 07-14, page 5.

[10] Commonly known as "Check the Box" classification.

[11] *See* Revenue Ruling 06-25