Imperfect State Conformity to Section 382: Georgia’s Unorthodox Approach

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On December 2, 2005, the Georgia Department of Revenue adopted regulations 560-7-3-.13 and 560-7-3-.06, which include, among other things, detailed rules regarding Georgia’s application of section 382 in the context of consolidated returns.

In general, section 382 provides that when a corporation experiences an ownership change, the corporation’s ability to use prechange losses, including net operating loss carryovers and certain built-in losses, to offset postchange taxable income is restricted. The amount of the restriction (the section 382 limitation) is generally equal to the value of the loss corporation’s stock immediately before the ownership change, multiplied by the long-term tax-exempt rate.

In most cases, Georgia follows the federal rules under section 382. In particular, the new Georgia regulations provide that “a determination that an ownership change has occurred for federal income tax filing purposes and pursuant to Internal Revenue Service regulations (including those regulations relating to how to apply Internal Revenue Code section 382 to consolidated returns) shall apply for Georgia purposes.” The regulations provide that when a corporation has an ownership change, the corporation’s use of its prechange losses in a postchange tax year will be subject to a section 382 limitation. The amount of the Georgia section 382 limitation for a postchange year is generally equal to the federal section 382 limitation, multiplied by the corporation’s Georgia apportionment percentage in that year.

As otherwise provided in this regulation, the Internal Revenue Code section 382 limitation shall be applied in the same manner as applied in the Internal Revenue Code and related regulations.

Ga. reg. section 560-7-3-.13(k)(2). It should be noted that this provision — when read in conjunction with Ga. reg. section 560-7-3-.13(k)(k)(1) — leaves open the possibility that an ownership change could technically apply for Georgia purposes but not for federal purposes. Ga. reg. section 560-7-3-.13(k)(k)(1) provides that “except as otherwise provided in this regulation, the Internal Revenue Service Regulations regarding how to apply Internal Revenue Code section 382 when a consolidated return is filed ... shall not apply for Georgia purposes” (emphasis added). Thus, if there has been no federal ownership change for a consolidated group, then Ga. reg. section 560-7-3-.13(k)(2) would not apply; however, one could take the position that under Ga. reg. section 560-7-3-.13(k)(k)(1), each member of the consolidated group must still be separately tested to determine if an ownership change has occurred for Georgia tax purposes. That is a fairly technical reading of the Georgia regulations and thus may have been unintended. However, if the Georgia regulations had intended there to be an ownership change for Georgia tax purposes only if there was an ownership change for federal tax purposes, the regulations could simply have so provided.

This apportionment requirement is generally consistent with state tax principles. However, it is notable that Georgia applies the apportionment percentage of each postchange year rather than the apportionment percentage of the prechange year. As a result, the Georgia section 382 limitation — unlike the federal section 382 limitation — will need to be recalculated for each postchange year. It is not clear that applying the apportionment percentage of each

(Footnote continued on next column.)
However, Georgia departs from the federal rules by requiring the section 382 limitation to be computed on a separate-entity basis, even when a Georgia consolidated return is filed. 7 Perhaps to reinforce Georgia's separate entity principle, Georgia also rejects the federal overlap rule. Thus, Georgia applies the separate return limitation year (SRLY) rules even in situations in which there has been a change of ownership triggering the application of section 382 limitations, and the section 382 limitations and the SRLY rules overlap. Significantly, Georgia appears to be the only state that has declined to follow the federal rules in those respects. 8

This article discusses whether Georgia's new rules regarding the application of section 382 to consolidated groups are justifiable in light of the objectives of section 382 and consolidation, the overarching goals of tax simplification and neutrality, and the general principles of state taxation. 9

I. Computation of Consolidated Section 382 Limitation

A. Federal Single-Entity Approach

In the federal context, when a consolidated group (a loss group) has an ownership change, the amount of consolidated taxable income for any postchange year that can be offset by prechange consolidated NOLs can't exceed the consolidated section 382 limitation for that year. 10 In other words, the section 382 limitation applies to the consolidated group itself, rather than separately to each individual member of the group.

In general, the consolidated section 382 limitation for a postchange year is equal to the value of the loss group multiplied by the long-term tax-exempt rate that applies for the ownership change. 11 The value of the loss group is generally equal to the value of the stock of each member of the group immediately before the ownership change, other than stock that is owned directly or indirectly by another member of the group. 12

Example. Individual A owns 100 percent of the stock of X corporation, and the total value of the stock of X corporation is $10,000. X corporation owns 90 percent of the stock of X1 corporation, and the other 10 percent of X corporation is owned by Individual B. The total value of the stock of X1 corporation is $5,000 (so the value held by Individual B is $500). Suppose the long-term tax-exempt rate is 5 percent. If A sells all of the stock of X to Individual C, then the amount of the consolidated section 382 limitation is equal to ($10,000 + $500) x 5 percent, or $525.

The federal rules for calculating a consolidated section 382 limitation are based on the single-entity approach to the taxation of federal consolidated groups. Under that approach, the members of a consolidated group are generally treated as divisions of a single taxpayer, with the common parent as the sole representative for each member of the group.

The single-entity approach also applies to loss subgroups within consolidated groups. 13 A loss subgroup generally consists of two or more corporations that were previously affiliated with each other in another group, where at least one of the corporations carries over an NOL that did not arise in a SRLY for the former group. 14 Thus, the single-entity approach under the regulations can apply, for example, to a consolidated group's acquisition of another consolidated group or a subset of that group.

When the Treasury Department first issued regulations in 1991 adopting the use of the single-entity approach for purposes of calculating the section 382 limitation for consolidated groups, it justified this approach as follows:

The single-entity approach to section 382 reflects the ability of corporations filing consolidated returns to use each other's losses as well as the principle that the tax laws should operate in a neutral manner with respect to changes in ownership. Under the neutrality principle, losses that arise while two or more corporations are members of one group and that are therefore available to be used among the members should remain so available following an ownership change, subject only to...
the restrictions that would be imposed on a single entity in similar circumstances.\textsuperscript{15}

In other words, the single-entity approach is consistent with the tax neutrality principle because it permits members of a consolidated group to use losses of other members of the group to the same extent as would be allowed if all of the members were a single entity.

B. Georgia Separate-Entity Approach

Georgia has declined to adopt the single-entity approach for purposes of calculating the section 382 limitation. Rather, for Georgia tax purposes, the section 382 limitation “shall be computed on a separate entity basis even when a consolidated federal income tax return is filed.”\textsuperscript{16} Accordingly, under that approach, a separate section 382 limitation must be computed for each member of the loss group.\textsuperscript{17}

**Georgia departs from the federal rules by requiring the section 382 limitation to be computed on a separate-entity basis, even when a Georgia consolidated return is filed.**

The Georgia DOR has informally stated that the separate-entity approach for computing the section 382 limitation is consistent with Georgia’s general treatment of consolidated groups because the income of a member of a consolidated group is calculated on a postapportionment basis. What that means is that each member of a Georgia consolidated group is first required to separately compute its Georgia taxable income or loss. In computing that income or loss, a member uses its own apportionment factors, deducts any Georgia SRLY losses it might have, and applies any applicable section 382 limitation.\textsuperscript{18} The separate company income or loss of the members of the group then are consoli-
dated and any Georgia consolidated NOLs are deducted to arrive at the consolidated taxable income or loss of the group.\textsuperscript{19}

Thus, because income or loss is first calculated for each separate entity based on that entity’s particular tax attributes (such as its apportionment factors), the Georgia DOR apparently reasons that the section 382 limitation — as just another tax attribute — should also be applied at the entity level. Admittedly, Georgia’s approach has a certain intuitive appeal. After all, because Georgia separately tracks NOLs of each member of a consolidated group, shouldn’t it also separately limit those NOLs?

**Georgia restricts loss utilization at the separate-entity level rather than at the group level. Georgia’s approach appears to be inconsistent with its general treatment of consolidated NOLs.**

However, Georgia — as in the federal context — generally permits a member of a consolidated group to offset its income with losses generated by other members of the consolidated group, as long as those losses were not incurred in a separate return year.\textsuperscript{20} In other words, Georgia basically treats members of a consolidated group as a single entity for the use of losses. Yet, by computing the section 382 limitation separately for each member of the group, Georgia restricts loss utilization at the separate-entity level rather than at the group level. Georgia’s approach thus appears to be inconsistent with its general treatment of consolidated NOLs.\textsuperscript{21} To put it another way, although Georgia’s method of determining the amount of any consolidated losses is based (at least in part) on separate-entity principles, its method of using those losses is based on single-entity principles. Because the section 382 limitation is relevant to the use — rather than the determination — of consolidated losses, the single-entity approach under section 382 would seem to be more consistent with Georgia’s consolidated return rules.

Moreover, if the section 382 limitation is viewed as an attribute of the consolidated group rather than as an attribute of a particular member of the group, and to prevent the avoidance of taxes regarding those transactions, Ga. reg. section 560-7-3-13(5)(f).

Footnote continued in next column.)
the use of a single-entity approach would also be consistent with Georgia’s taxation of consolidated groups on a postapportionment basis. Indeed, in the federal context, members of a consolidated group are treated as separate entities for certain purposes, yet this does not preclude — or even mitigate against — the adoption of the single-entity approach under section 382. Accordingly, the use of the separate entity approach in Georgia should not be necessitated simply because income is calculated on a postapportionment basis.

More importantly, perhaps, is the possibility that the separate-entity approach is contrary to the overall purpose of section 382. In general, section 382 was designed to prevent loss trafficking, and the rules of section 382 are based on the idea that the rate of loss utilization following a change in ownership of a loss corporation should be based on the expected income generated if all of the assets of the corporation were converted to tax-exempt debt instruments. Thus, in the consolidated return context, section 382 permits a fixed amount of income to be used each year to absorb a loss, regardless of the actual income contribution of the member of the group that incurred the loss. The use of the separate-entity approach, which permits the available loss to be used only against the actual income of the loss member, would therefore appear to be inconsistent with that overall scheme.

By adopting the separate-entity approach, Georgia adds considerable complexity to an already highly intricate set of tax rules, thereby substantially increasing both taxpayer compliance burdens and administrative costs.

Furthermore, by adopting a separate-entity approach, Georgia violates the neutrality principle (at least in some cases) by preventing consolidated NOLs from being used by a member of the consolidated group in a postchange year, when such NOLs would have been available if the members of the group were treated as a single entity for that purpose. The result is illustrated by the example below.

Example. Suppose X and X1 had a consolidated NOL in 2006 equal to $1 million. Suppose further that there is an ownership change of the group in the beginning of 2007 that results in a federal consolidated section 382 limitation of $200,000 and a Georgia section 382 limitation equal to $100,000 for each of X and X1. In 2007, X generates taxable income of $10,000 and X1 generates taxable income of $200,000. For federal income tax purposes, the consolidated taxable income would be equal to $210,000 and the group would be entitled to offset that income with $200,000 of NOLs from the prior year. However, for Georgia income tax purposes, X1 would be entitled to offset $100,000 of its taxable income, and X would be entitled to offset $10,000 of its taxable income in 2007, resulting in a total offset of only $110,000.

Finally, by adopting the separate-entity approach, Georgia adds considerable complexity to an already highly intricate set of tax rules, thereby substantially increasing both taxpayer compliance burdens and administrative costs.

23Under Ga. reg. section 560-7-3-.13(8)(k)(6), to the extent that there is any unused section 382 limitation in a postchange year, the unused amount will generally carry over to the subsequent year (for up to 20 years). See also O.C.G.A. section 48-7-21(b)(10)(B). That rule is generally analogous to the federal rules under sections 382(b)(2) and 172.
24For simplicity, this example assumes that the Georgia apportionment percentage for the postchange year of each of X and X1 is 100 percent.
25Notably, Georgia’s adoption of the separate entity approach doesn’t apply for all section 382 purposes. In particular, as noted above, Georgia follows the federal single-entity approach for determining whether an ownership change has occurred. Ga. reg. section 560-7-3-.13(8)(k)(2). In addition, the Georgia regulations generally conform to any adjustments to the value of a loss corporation that are required for federal income tax purposes to prevent duplication of value, including adjustments applicable to controlled groups and consolidated groups. Ga. reg. section 560-7-3-.13(8)(k)(3). For a controlled group (generally, an affiliated group of corporations with 50 percent or more common ownership), the value of the stock of each member of the group is generally reduced by the value of the stock of any other member of the group directly owned by such member. That adjustment is intended to prevent members of a controlled group that don’t file a consolidated return from duplicating value in computing an individual member’s section 382 limitation. For federal income tax purposes, a member of a controlled group may elect to restore all or a portion of the value back to its parent corporation. Treas. reg. section 1.382-8(c)(2). Georgia doesn’t permit that value to be
II. Overlap Rule

A. Federal Overlap Rule

In most cases, when a corporation becomes a member of a consolidated group, the corporation also has an ownership change triggering the application of section 382. Accordingly, the corporation could potentially be subject to two separate limitations regarding its loss carryovers: the section 382 limitation and the SRLY limitation.

In general, the SRLY rules limit the amount of the consolidated group’s taxable income that may be offset by NOL carryovers that a member generated before the time that it became a member of the consolidated group (such losses are referred to as SRLY losses).26 The amount of the SRLY limitation is generally equal to the amount of income generated by the new corporation after it became a member of the consolidated group.27 Thus, the SRLY limitation is based on the member’s actual contribution to consolidated taxable income rather than to the anticipated income to be generated by the member (as in the case of section 382).

On June 25, 1999, the Treasury Department issued Treas. reg. sections 1.1502-21, -22, and -15, which included rules governing the situation in which both a SRLY limitation and a section 382 limitation may apply to a loss corporation. Those regs generally provide that the SRLY limitation does not apply when a corporation becomes a member of a consolidated group and has an ownership change under section 382 simultaneously with, or within six months of, joining the group.28 The rule is referred to in the regulations as the overlap rule.29

Before the adoption of the overlap rule, if both a SRLY limitation and a section 382 limitation applied to a loss corporation — for example, because the corporation became a member of a consolidated group and had an ownership change at the same time — the corporation’s losses were subject to the lesser of (that is, the more restrictive of) those limitations.

B. Georgia Overlap Rule

Georgia has adopted SRLY rules for Georgia consolidated groups generally analogous to the federal SRLY rules.30 However, Georgia has declined to adopt the federal overlap rule, providing instead that if the section 382 limitation and the Georgia SRLY limitation both apply to an NOL, the NOL is subject to both the Georgia SRLY limitation and the section 382 limitation.31 Accordingly, Georgia subjects the corporation’s losses to the more restrictive of those two limitations.

The question thus arises whether both limitations are necessary or desirable to achieve the primary objective of the section 382/SRLY rules of deterring loss trafficking. The Treasury Department and the Internal Revenue Service conducted a study of that issue when determining whether to adopt the federal overlap rule and concluded that, on balance, “the simultaneous or proximate imposition of a section 382 limitation reasonably approximates a corresponding SRLY limitation.”32 In other words, a separate SRLY limitation was generally determined to be unnecessary when a section 382 limitation would otherwise apply.33 Therefore, in most cases, the section 382 limitation standing alone should provide sufficient protection against loss trafficking transactions.

Of course, despite that general rule, there will clearly be situations in which a SRLY limitation would present a greater restriction than the applicable section 382 limitation, and therefore may also have some additional deterrent effect.34 However, in such cases, commentators have argued that “requiring a taxpayer to run the SRLY gauntlet in addition to the section 382 gauntlet is unwarranted because any additional revenue that might be gained from retaining a dual limitation is outweighed by the added complexity of the SRLY rules.”35 To put it another way, the incidental benefit that may be

30See Ga. reg. section 560-7-3-.13(8)(e). (“Net operating losses carried to a consolidated return year from a Georgia separate return limitation year (GSRLY) may be used to reduce the group’s income only to the extent of the income contributed by the GSRLY member.”)
31Ga. reg. section 560-7-3-.13(8)(k)(7).
33However, when section 382 is inapplicable (for example, loss trafficking through carryback transactions), the SRLY rules are more likely to provide a deterrent to loss trafficking transactions.
34For example, if a corporation joining a consolidated group doesn’t immediately generate income once it becomes a member of the group, the SRLY limitation will be zero.
generated by applying the SRLY limitation in addition to the section 382 limitation is likely overshadowed by the additional burden inflicted upon taxpayers of having to comply with two separate limitations. Thus, because of the high importance placed on tax simplification in general, and without a clear (and significant) benefit to applying both limitations simultaneously, only one such limitation should apply.

Assuming therefore that only one limitation is desirable, the issue becomes which limitation to impose. As noted above, the SRLY rules are based on a different underlying principle than section 382: They restrict loss utilization depending on the actual income generated by the SRLY member rather than on the anticipated income of the member if its assets were converted to tax-exempt bonds. Some have contended that the method used by section 382 provides “greater precision and predictability about the consequences of a transfer of tax losses, and that section 382 promotes neutrality between a buyer and seller of tax benefits in a more efficient and more equitable way than do the SRLY rules.”

Indeed, this conclusion is generally consistent with the adoption by the Treasury of the single-entity approach under section 382, as discussed above.

Accordingly, the federal overlap rule recognizes that both the section 382 limitation and the SRLY limitation are unnecessary in most cases to adequately deter loss trafficking, particularly in light of the additional complexity created by having two separate limitations, and that the section 382 limitation, by promoting tax neutrality, is probably a more appropriate option.

By contrast, the Georgia overlap rule imposes significant taxpayer burdens by requiring the computation of two separate limitations without providing a clear offsetting benefit. Furthermore, Georgia’s rule seems to be even less defensible when, as in this case, the section 382 limitation is computed on a separate-entity basis because the section 382 limitation would provide even greater restrictions — and, presumably, greater deterrent effect — than in the federal tax context.37

III. Conclusion

The Treasury and the IRS adopted the overlap rule and the single-entity approach for calculating section 382 limitations for members of consolidated groups for compelling reasons. Those reasons include the preservation of tax neutrality, simplification of the tax rules and consistency with the underlying objectives of section 382, and the consolidated rules applicable to the use of tax losses.

The fact that every state other than Georgia apparently follows the federal rules further suggests that no adequate justification for Georgia’s approach exists.

By comparison, Georgia’s novel rejection of those rules violates general principles of tax neutrality, substantially increases complexity in the tax code (and, correspondingly, taxpayer compliance burdens and administrative costs), and is also fundamentally inconsistent with the overall purpose and scheme underlying section 382. More importantly, there appears to be no clear benefit created by the new Georgia rules, other than perhaps a slight increase in tax revenue. Because that incidental benefit was obviously not a sufficient basis to justify either the adoption of the separate-entity approach or the rejection of the overlap rule in the federal context, it’s difficult to see why it would be satisfactory at the state level. Indeed, the fact that every state other than Georgia apparently follows the federal rules further suggests that no adequate justification for Georgia’s approach exists.

36Id.

37Notably, most other states have adopted the federal overlap rule by generally incorporating the provisions of the Internal Revenue Code and the Treasury regulations promulgated thereunder. However, at least one state — Alabama (which, like Georgia, is a separate-entity state) — has expressly adopted provisions that “mirror” the federal overlap rule, thereby suggesting a specific intent to follow this rule. See Ala. Admin. Code r. 810-3-35.1-03. (The SRLY limitation “does not apply to net operating loss carryovers when the application of...this section results in an overlap with the application of 26 U.S.C. section 382...An overlap of section 382 with respect to a net operating loss occurs if a corporation becomes a member of a consolidated group (the SRLY event) within six months of the change date of an ownership change giving rise to a section 382 limitation with respect to that carryover (the section 382 event).”)