IMPROVING ECONOMY MAKES STATE NOLS A TOP PRIORITY
A recent poll of Wall Street economists ranked the chance of a recession occurring in 2016 at 21%; up from a year ago, but still relatively low. Economy.com ranked the chances for a recession at an even lower rate of 17%. More importantly, many of the key measures of the U.S. economy, such as the the current 4.9% unemployment rate, are still considered good. With economic growth and corporate profitability going hand in hand, many corporate tax departments are now looking for ways to preserve cash flow and reduce tax liabilities. A key strategy is the use of net operating losses or NOLs.

To give a sense of the enormity of the opportunity, Bloomberg BNA analyzed the financial statements of the Fortune 1000 and estimated nearly $200 billion in NOLs sitting on their books. When corporations are profitable, NOLs tend to be an important focus for corporate tax departments. Relatively speaking, federal NOL rules are fairly straightforward making the calculation and use of NOLs on the federal level a manageable task. However, for those charged with the management of state NOLs, the ability to use them to easily offset state income tax liabilities is no easy feat.

State NOL rules are a complex tangled web that varies from state to state. This results in an especially painful process, particularly for companies with multiple entities that file in multiple states. Such companies are forced to deal with hundreds or even thousands of returns in a single year. Each entity may require its own NOL tracking schedule even in group filing states. Tracking NOL generation and utilization can frequently span upwards of a decade or more. In other words, managing state NOLs is a cumbersome, time-consuming task that requires countless hours managing spreadsheets to track, compute, and forecast state NOLs.

As companies can attest, spreadsheets are not only time consuming, but can also cause a myriad of issues. These range from risks of manual data entry mistakes, spreadsheet formula errors, and sudden unexpected cash tax increases to financial statement audit deficiency or material weakness in Sarbanes-Oxley controls.

Bloomberg BNA, a provider of expert software for tax and accounting professionals, wanted to understand the complexities and challenges of how corporate tax teams are currently managing state NOLs. They also wanted to understand key issues including state-specific rules regarding carrybacks/ carryovers, post-apportionment, pre-apportionment, group reporting, suspensions, and limitations.

This report is based on a survey of 100 finance executives at US-based C-corporations across a wide range of industries. The survey explored the effectiveness and satisfaction with current methods for managing NOLs.

**KEY FINDINGS:**

» With an improving economy, NOLs are an increasingly important focus for corporate tax teams. An overwhelming number of respondents (88%) expect to be moving into profitable years in the near future.

» When asked the various factors contributing to NOL management challenges, over one-third (39%) of respondents cited “state carryback/forward rules;” “keeping up with state NOL tax law changes” was a close second (33%); and “state limitations” (30%) was ranked the third biggest challenge.

» Manual processes rank as the top method for managing state NOLs. Despite being perceived as risky, when asked the various tools used to manage state NOLs, 68% of respondents use manual spreadsheets and one-third (33%) use databases, such as Access, to manage and track their state NOLs. Over half (52%) of respondents spend one to four weeks annually on spreadsheet and database maintenance.

» Automation strategies can address many of the top NOL concerns. Over one-third (37%) ranked “risk of last minute changes” as their top NOL concern, followed by “data integrity” and “business continuity” (tied at 32%). Plus, 29% cited “the inability to accurately forecast burn down rate of an NOL asset” as a key concern.
The economy is currently enjoying growth with an unemployment rate of 4.9% (as of June 2016). In line with this, an overwhelming number of survey respondents (88%) expect to move into profitable years in the near future, which means that NOLs will likely be an increasingly important focus for corporate tax teams moving forward.

88%
of respondents are expecting to be profitable in the near future

The majority of respondents (74%) have used losses to cover tax liabilities in the past. And almost half (46%) of respondents have 4-21+ years before all of their state NOLs expire or need to be fully utilized. This does not mean that after 21 years, the state NOL challenge goes away. On average, recessions occur every two to five years. In other words, economic downturns are a natural part of economic cycles, making NOLs a continual and natural part of the corporate tax function.

In fact, during an economic downturn, the need to organize, track, and report on losses, as well as apply strategies to maximize future NOL carryovers is just as important as actually applying losses during profitable years. While many companies may be tempted to focus solely on budget cuts during an economic depression, this is actually the ideal time to strategize ways to maximize NOL carryovers. With the right tools, tax teams can easily model out impacts of apportionment changes, elections, and state tax planning to increase the NOL carryover and better protect cash flow when the economy recovers and they once again experience profitable years.

HOW THE ECONOMY IMPACTS NOLS: THE CURRENT STATE OF NOLS

METHODOLOGY

In April 2016, Bloomberg BNA worked with an independent firm to survey 100 finance executives at US-based C-corporations across a wide range of industries. Participants were surveyed about their company’s state net operating losses (NOLs), including the effectiveness and their satisfaction with current methods for managing NOLs. The survey also explored the value of a dedicated NOL software solution as an alternative to spreadsheets and manual processes.
In its simplest form, NOL calculations are similar to a Schedule C in an individual tax return. But, whereas the Schedule C of the 1040 impacts only a single tax year, NOL schedules can go back and forward many years according to state rules. The foundation of any corporate state income tax return is the federal form 1120 tax return. Any change at the federal level, such as an IRS audit, tax notice, or taxpayer filing an amended return, impacts the state tax returns.

Once federal NOLs are calculated, states apply a multitude of modifications in order to arrive at their fair share – the state income or loss that will be subject to apportionment. For state corporate income tax purposes “apportionment” is the process used to assign to a particular state that portion of a multistate corporation’s income that the state may tax. Traditionally, apportionment has been based on three-factors: sales, property, and payroll. Many states are starting to move to a single-sales factor, but that can differ across industries, where industry-specific apportionment adds additional complexity to computing the loss and utilization of a loss.

States differ on rules around modifications and apportionment. Moreover, they have two sets of rules: one to control how the taxable income/loss is computed for a given year, and a second set of rules to control how any loss is computed and utilized. On top of this, states have specific rules regarding carrybacks/carryovers, post-apportionment, pre-apportionment, group reporting, suspensions, and limitations. With each state having such varying NOL rules and regulations, the management of NOLs at the state level quickly becomes a complex and unruly process.

**STATE NOL CHAOS: EACH STATE HAS DIFFERENT NOL RULES AND REGULATIONS**

NOTE THAT THIS IMAGE IS REPRESENTATIVE OF RULES IN GENERAL, OVER THE PAST DECADE.

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Most tax departments seem to agree that the management of state NOLs is no easy task. But what exactly makes it so difficult? When asked about the biggest challenges in managing state NOLs, over one-third of survey respondents (39%) cited state “carryback/forward rules” as their biggest challenge, with “keeping up with state NOL tax law changes” as a close second (32%). State limitations came in third (30%).

As for the states with the most complex NOL regulations – New York (19%) led the pack, with California (18%) a close second, and New Jersey trailing in at the third spot (10%).

**BIGGEST CHALLENGES IN MANAGING STATE NOLS**

1. **Carryback/forward rules**
2. **Keeping up with state NOL tax law changes**
3. **State limitations**

**MOST COMPLEX STATE NOLS**

- **New York**: 19%
- **California**: 18%
- **New Jersey**: 10%
RISKY MANUAL PROCESSES REMAIN TOP METHOD FOR MANAGING STATE NOLS

Despite the best efforts of corporate tax departments to effectively manage and track state NOLs, they continue to use risky manual processes, including spreadsheets (68%) and databases (33%) as their primary methods. Over half (52%) of respondents are spending one to four weeks annually on spreadsheet and database maintenance.

According to European Spreadsheet Risks Interest Group, half of the operational spreadsheet models used in large businesses have material defects. In other words, Excel mistakes are making their way onto financial statements.

Underscoring the perils associated with spreadsheet usage, over half (56%) of the survey respondents cited “manual data entry error,” followed by “missed tax rule or rate” (39%), and “a spreadsheet formula error” (38%) as the top risks associated with the use of spreadsheets and manually managed databases. Nearly one-third ranked “incorrect amount in tax provision (material misstatement in financials)” as a risk of spreadsheets.

These findings indicate the far reaching implications associated with decentralized state tax workpapers, in which tax teams have to create and maintain separate spreadsheets for provision, compliance, tax audits, and planning.

“Half of the operational spreadsheet models used in large businesses have material defects.
For many tax departments, tapping into valuable state NOLs to increase cash flow, and decrease tax liabilities is fraught with many obstacles and concerns – from the risk of last minute changes, to data integrity, to business continuity, to the inability to forecast burn-down rates of NOL assets.

The sheer volume of state-specific data – whether it be carrybacks/carryovers, post-apportionment, pre-apportionment, group reporting, suspensions, or limitations – appears to be the culprit of many of the key NOL concerns. Large volumes of data inherently put companies at risk for poor data integrity, lack of version control, risk of last minute changes, and the inability to accurately forecast the burn-down of NOL assets – which, according to the survey, also happen to be some of the top state NOL concerns. Not only is there no indication that state NOLs will become easier in the near future, there is every indication that NOLs will present tax departments with even more data to deal with. As an example, although federal and all state NOLs have traditionally been computed on a last in, first out (LIFO) basis, Louisiana recently passed legislation that state NOLs will now be computed on a first in, first out (FIFO) basis.

**WHEN IT COMES TO STATE NOLS, WHAT KEEPS TAX TEAMS UP AT NIGHT?**

- **01** Risk of last minute changes
- **02** Data integrity
- **03** Inability to accurately forecast burn-down of NOL asset
- **04** Transparency
- **05** Lack of version control
- **06** Business continuity
- **07** Poor Sarbanes-Oxley controls
CONCLUSION

So what is the solution to the state NOL conundrum? Bloomberg BNA asked tax departments this same question. The majority of respondents indicated that they would find value in the automation of state NOLs. Specifically, a solution that accurately computes allowable state NOL and utilization for compliance/provision, provides state NOL forecasting, and allows what-if analysis.

The reality is that the management of state NOLs by multistate corporations, with multiple entities is far too complex to navigate and manage manually. As state income tax and specific NOL laws continue to change and grow in complexity, so will the management of state NOLs. As a result, spreadsheets can no longer be the solution of choice as there is far too much at risk. Only by implementing best practices that automate the tracking, computation, and forecasting of state NOLs can companies know with certainty that they are leveraging their valuable state NOLs to the fullest extent.

ABOUT BNA STATE TAX™ ANALYZER

BNA State Tax Analyzer is the industry’s first multistate, multi-year, multi-scenario state tax analysis tool for corporate income tax, with support for NOLs from 1998 forward. Designed specifically for corporations that do business in multiple states, BNA State Tax Analyzer allows tax teams to:

» Create centralized state tax workpapers so it is no longer necessary to create and maintain separate spreadsheets for provision, compliance, tax audits, and planning.
» Do what-if planning, tax provision analysis, quarterly estimates, and tax audit responses for overall state income taxes and NOLs.
» Maintain a full audit trail with proper permission controls.
» Stay current with automatic tax code changes.
» Accurately model out various tax scenarios to optimize cash tax and make informed business decisions.

SOURCES:

5. "LEVERAGE SALT." http://www.leveragesalt.com/
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