

Maryland Income Tax
ADMINISTRATIVE **RELEASE**

Administrative Release No. 18

Subject: Net Operating Losses and Associated Maryland Addition and Subtraction Modifications

I. Definitions.

The following terms have the meanings indicated:

A. “Loss Year” means the initial taxable year in which there occurs a federal net operating loss deduction that can be carried back or carried forward in whole or in part to another taxable year.

B. “Decoupling Modification” means an addition or subtraction modification required to negate the effect of any federal provisions from which Maryland has decoupled.

C. “Net Addition Modification (NAM)” means, for any taxable year, the amount by which the sum of the addition modifications exceeds the sum of the subtraction modifications without considering the decoupling modifications that may apply.

D. “Net Operating Loss Deduction (NOL)” means a net operating loss deduction as defined under § 172 of the Internal Revenue Code.

E. “Foreign Dividend Subtraction Carryforward (FDSC)” means the amount of foreign source dividend subtractions that are allowed to be carried forward to ensure that the taxpayer receives full benefit of these subtractions as dictated by *Kraft General Foods, Inc. v. Comptroller of the Treasury* (June 8, 2001).

II. Corporations.

A. General.

1. NOL. The starting point for determining Maryland’s taxable income is federal taxable income determined under the Internal Revenue Code (as outlined in Tax-General Article § 10-304). Accordingly, Maryland recognizes a Federal NOL as the NOL for calculating Maryland taxable income. However, the Maryland decoupling modifications could affect the amount of the NOL or the amount used in carryback and carryforward years. Maryland follows the carryback and carryforward periods under federal law without

regard to an election under § 172(b)(1)(H) of the Internal Revenue Code for a carryback of up to 5 years. See Administrative Release No. 38 on decoupling modifications.

2. Maryland Addition and Subtraction Modifications. To arrive at Maryland taxable income, federal taxable income is modified with additions and subtractions outlined in Tax-General Article §§ 10-305 through 10-310.

3. Relationship between Maryland Addition and Subtraction Modifications and NOLs.

a. The Tax-General Article was amended in 1989 (Senate Bill 192, Chapter 110) to limit the effect on Maryland tax returns of federal NOL(s) (Tax-General Article § 10-306(a) invoking § 10-205(e)). A double use of the federal NOL, both in the Loss Year to offset Maryland addition modifications and in the carryback or carryforward year to offset federal gross income on the federal return (and thereby also in Maryland), is now precluded. Accordingly, it is necessary that a NAM developed in the Loss Year is added back in a carryback/carryforward year when the NAM had been offset by the federal NOL (i.e., nullified its taxability) in the Loss Year. This NAM remains associated with the Loss Year NOL and is applied as an addition (Maryland Form 500) in that carryback/carryforward year in which the last dollar of the associated Loss Year NOL is applied to offset taxable income.

b. Prior to the Maryland Tax Court decision in the case of *Kraft General Foods, Inc. v. Comptroller of the Treasury* (June 8, 2001), if a NAM in a loss year was negative (i.e., the subtractions exceeded the additions) there was no “additional” income to be taxed and the NAM was not carried with the associated NOL to be applied to an *Income Year*. The Kraft decision held that while Maryland’s legislature had taken steps to allow companies to subtract foreign source dividends and therefore give equal treatment to domestic and foreign source dividends as required by the Commerce Clause of the U.S. Constitution,

that equality was lost in an NOL year when subtraction modifications exceeded addition modifications. Accordingly, when the benefit of subtracting foreign source dividends is lost through a negative NAM calculation, that foreign source dividend subtraction is now used to adjust the Loss Year NOL (or create an FDSC) (see Section II.B.2.b. below).

c. Following court cases such as *Comptroller of the Treasury v. SYL, Inc.*, *Comptroller of the Treasury v. Crown Cork & Seal Company (Delaware) Inc.*, 375 Md. 78, 825 A.2d 399 (Md. 2003), Tax-General Article § 10-306.1 was added in 2004 (House Bill 297, Ch. 556) to prevent corporations from avoiding the Maryland corporate income tax by shifting income away from the State through the use of Delaware holding companies and other State tax avoidance techniques. Section 10-306.1 provides for the circumstances under which a corporation is required to add back to its federal taxable income any otherwise deductible interest expense or intangible expense paid directly or indirectly to one or more related members, in order to determine the corporation's Maryland taxable income. Section 10-306.1 also provides for a related member to subtract from the member's federal taxable income royalties, interest, or similar income from intangibles for which the corporation is required to add back in the same taxable year.

Section 10-306.1 is applied to restore a corporation's federal taxable income to what it should have been without the income shift. A Section 10-306.1 modification is accordingly treated like a Maryland decoupling modification, and may affect the amount of the NOL or the amount used in carryback and carryforward years.

B. Specific Application.

1. Net Operating Loss:

a. The federal NOL deduction is allowed for the Maryland filing on a separate company basis. An NOL generated when the company is not subject to Maryland income tax law may not be used by the company to offset its Maryland income.

The federal provisions for carryback and carryforward apply for purposes of the Maryland return. If an election is made to relinquish a carryback and instead, carryforward the NOL, a copy of the federal election must be included with

the Maryland return for the taxable year of the NOL. If the company has an NOL on a separate company (i.e., not consolidated filing) basis, and therefore did not have to make a federal election to forgo the carryback, then a *separate company* election must be filed with the Maryland return for the Loss Year.

In addition, if a liquidated or acquired corporation was not subject to Maryland income tax law when its NOLs were generated, then the acquiring corporation, which is subject to Maryland income tax law, cannot use the liquidated or acquired corporation's NOLs as deductions to offset its Maryland income.

Example: Corporation P is a Maryland company doing business in Maryland. Corporation P owns all of the stock of Corporation S, a State X company doing business in State X. Corporation S has NOLs. Corporation P liquidates Corporation S in a tax-free transaction under Federal income tax law. Corporation P may not use Corporation S's NOLs as deductions to offset its Maryland income.

Example: Corporation A is a Maryland company doing business in Maryland. Corporation T is a company formed in State X and is doing business in State X. Corporation T has NOLs. Corporation A acquires Corporation T in a tax-free transaction under Federal income tax law. Corporation A may not use Corporation T's NOLs as a deduction to offset its Maryland income.

b. For the Taxable Year in which the loss occurs (Loss Year), the Maryland Form 500 tax return shall reflect the federal NOL as a negative number on the line titled as *taxable income based on attached federal return*.

c. For a tax year that is a carryback or carryforward year, the *taxable income based on attached federal return* line shall reflect the federal income for that year less the NOL deduction taken. See Taxable Income Worksheet, Form 500 Instructions. This result can never be less than zero. Any remaining NOL can be carried to another income year, as appropriate.

d. An NOL schedule must be attached to the Loss Year return and carry-over return(s).

2. Net Addition Modification.

a. **For All Tax Returns.** If the total addition modifications exceed the total subtraction modifications in the Loss Year (or if there are only

addition modifications in the Loss Year), a modification to recapture the excess of additions over subtractions is required when applying the corresponding Loss Year NOL to a carryback/carryforward income year. If the additions do not exceed subtractions, no modification is required (exceptions apply if the modifications include foreign source dividends subtractions and Section 10-306.1 modifications, see Sections II.B.2.b and c below).

(1) Tax-General Article § 10-306(a) (invoking § 10-205(e)) details the calculation to determine the amount of a Loss Year NAM that shall be recaptured as an addition in an *Income Year* on MD Form 500, *Net Operating Loss Modification*. This line entry is strictly a modification and not the NOL.

(2) The Tax-General Article § 10-205(e) calculation seeks to ensure that when the NAM is recaptured in carryback/carryforward years, it is not offset again by its associated NOL. Recapture of the NAM begins when the NAM plus the cumulative associated NOL deductions already claimed for current and prior years exceed the total NOL. If the NAM is not totally used in the first recapture year, then the balance is carried to a subsequent year and applied. (See the example provided in IV.)

b. For Tax Returns with Foreign Dividend Subtractions. In order to prevent the loss of the benefit of subtracting foreign source dividends when subtractions exceed additions, it will be necessary to adjust an NOL (or create a FDSC).

(1) **Loss Year.** If subtraction modifications include foreign source dividends, the addition modifications shall be netted against the remaining subtraction modifications (excluding the foreign source dividend subtraction). If the result is a NAM, then that result shall be subtracted from the foreign source dividend subtraction and the result shall be added to the Loss Year NOL. The NOL schedule shall indicate by footnote that the NOL for that Loss Year has been adjusted to include the foreign source dividend subtraction.

(2) **Income Year with NOL.** When applying an NOL that does not reduce federal taxable income to zero, and foreign source dividend subtractions exist, then federal taxable income may be further reduced by foreign source dividends as

follows: the Maryland Form 500 addition modifications shall be netted against the remaining subtraction modifications (excluding the foreign source dividend subtractions). If the result is a NAM, then that result shall be subtracted from the FDSC and used to further reduce federal taxable income (but not below zero). Any unused FDSC is available for carryforward.

When an NOL does reduce federal taxable income to zero, and foreign source dividend subtractions exist, then the FDSC is available for carryforward.

When there is a FDSC carryforward, a completed Form 500A should be attached with Form 500 to reflect the computation of the FDSC carryforward (Form 500A, line 14). *An FDSC may only be carried forward.*

(3) **Income Year without NOL:** When foreign source dividend subtractions exceed federal taxable income, an FDSC may be created. The Maryland Form 500 addition modifications and the federal taxable income shall be netted against the remaining subtraction modifications (excluding the foreign source dividend subtraction). If the result is a NAM, then that result shall be subtracted from the foreign source dividend subtraction. The remainder is available for carryforward. (Attach Form 500A to reflect the computation of the FDSC carryforward on line 14; also attach this form when using the FDSC in a carryforward year). *An FDSC may only be carried forward.*

c. For Tax Returns with Section 10-306.1 Modifications. The addition and subtraction modifications for Section 10-306.1 related party transactions are treated like a decoupling modification, which may affect the amount of the NOL or the amount used in carryback and carryforward years, and is not part of the NAM computation. When there is a Section 10-306.1 modification, Form 500A should be completed and attached with Form 500. (See Administrative Release 38 on this and other decoupling modifications.)

III. Individuals and Fiduciaries.

A. General.

1. Net Operating Loss. Maryland recognizes the amount of a federal NOL used in a carryback or carryforward year as the NOL for calculating Maryland taxable income.

2. Relationship between Maryland Addition Modifications and NOLs.

The Tax-General Article was amended in 1989 (Senate Bill 192, Chapter 110) to limit the effect on Maryland tax returns of federal NOLs (Tax-General Article § 10-205(e)). A double use of the loss, both in the loss year to offset addition modifications and in the carryback or carryforward year to offset federal gross income on the federal return (and thereby also in Maryland), is now precluded. Accordingly, a NAM in a carryback/carryforward year is necessary when the federal NOL offsets a NAM (i.e., nullifies its taxability) in the Loss Year. This NAM remains associated with the Loss Year NOL and is applied as an addition in that carryback/carryforward year in which the last dollar of the associated Loss Year NOL is applied to offset taxable income.

B. Specific Application.

1. Net Operating Loss.

a. The federal NOL deduction that is *used* in a carryback or carryforward year is the amount by which the adjusted gross income for an individual or the taxable income of a fiduciary is reduced. If the NOL is not fully utilized in one carryback or carryforward year, this generally represents the “modified taxable income” as computed on Schedule B of federal Form 1045, Application for Tentative Refund.

Also, a NOL deduction generated when an individual or fiduciary is not subject to Maryland income tax law may not be used to offset Maryland income from an earlier year when that individual or fiduciary was subject to Maryland income tax law.

Example: In tax year 1, L, an individual, was solely engaged in business in Maryland. In tax year 2, L is solely engaged in business in State X. L may not use any NOL generated from doing business in State X as a deduction to offset L’s Maryland income in tax year 1.

In addition, the carryback or carryforward period shall generally be the same as that required or elected for federal purposes; however, for NOLs arising in tax years ending in 2001 and 2002, the federal carryback period was extended from 2 to 5 years. Maryland has decoupled from this extended carryback period. (See Administrative Release No. 38.) Where the taxpayer has elected the special 5-year NOL carryback period, addition or subtraction modifications may be required for all tax years

affected by the decoupling from federal depreciation and NOL carryback provisions.

b. For a tax year that is a carryback or carryforward year, the federal adjusted gross income shall be reduced by the amount of the NOL deduction as used for federal purposes. A fiduciary shall reduce the federal taxable income on Maryland Form 504 by the amount of the NOL deduction as used for federal purposes. Copies of the federal Form 1045, including Schedules A and B or equivalent schedules, shall be submitted with the return. A copy of the Loss Year federal return shall also be an attachment to the carryback or carryforward year.

2. Net Addition Modification (For all Tax Returns).

If the total of addition modifications exceeds the total subtraction modifications in the Loss Year (or if there are only addition modifications in the Loss Year), a modification to recapture the excess of additions over subtractions is required when applying the corresponding Loss Year NOL to a carryback/carryforward income year. If the additions do not exceed subtractions, no modification is required.

a. Tax-General Article § 10-205(e) details the calculation to determine the amount of a Loss Year NAM that shall be recaptured as an addition in an Income Year. This line entry is strictly a modification and not the NOL.

b. The Tax-General Article § 10-205(e) calculation seeks to ensure that when the NAM is recaptured in carryback/carryforward years, it is not offset again by its associated NOL. Recapture of the NAM begins when the NAM plus the cumulative associated NOL deductions already claimed for current and prior years exceed the total NOL. If the NAM is not totally used in the first recapture year, then the balance is carried to a subsequent year and applied. (See the example provided in Section IV below.)

IV. Example.

Facts

“Loss Year” is 1996: the loss is \$1,000,000
 NAM for loss year is \$500,000.
 Federal taxable income is \$400,000 for each carryforward year.

YEAR	FEDERAL INCOME		NOL USED		NOL BALANCE (RUNNING)		NAM		NAM BALANCE (RUNNING)	
	NOL	FEDERAL INCOME	NOL USED	NOL BALANCE (RUNNING)	NAM	Mod Line 2c	NAM BALANCE (RUNNING)			
1995				\$-						
1996	\$(1,000,000)			\$1,000,000	\$500,000		\$500,000			
1997		\$400,000	\$400,000	\$600,000			\$500,000			
1998		\$400,000	\$400,000	\$200,000		300,000	\$200,000			
1999		\$400,000	\$200,000	0		200,000	0			
2000				0	0		0			
2001				0	0		0			
2002				0	0		0			
TOTAL	\$(1,000,000)	\$1,200,000	\$1,000,000	\$1,000,000						

Illustration TY1998

NAM (TY96)	500,000
<i>Plus the cumulative</i>	
NOL (TY96) Deductions	1997 - 400,000
	1998 - 400,000
	1,300,000
<i>Exceed the</i>	
Total NOL (TY96)	1,000,000
Recapture	300,000

Begin to recapture the NAM when the NAM plus the cumulative associated NOL deductions already claimed for current and prior years exceed the total NOL.

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