

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 (NOL) 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 (NOL) Deduction” 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.

2. Decoupling Modifications. The Maryland decoupling modifications could affect the amount of the NOL that may be carried back or forward, or the amount of NOL 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.

3. Maryland Addition and Subtraction Modifications. To arrive at Maryland taxable income, federal taxable income is adjusted for the Decoupling Modifications in Tax-General Article § 10-310, and modified with additions and subtractions outlined in Tax-General Article §§ 10-305 through 10-309.

a. As a general rule, if the net Maryland addition and subtraction modifications under Tax-General Article §§ 10-305 through 10-309 in a Loss Year is negative (i.e., the subtractions exceeded the additions), the negative net Maryland modifications is *not* carried back or forward to offset another year’s income. However, there are limited exceptions:

b. In *Kraft General Foods, Inc. v. Comptroller of the Treasury* (June 8, 2001), the Maryland Tax Court held that while Maryland’s legislature had taken steps to allow companies to subtract foreign source dividends, Tax-General Article § 10-307(d), 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 a loss year when subtraction modifications exceeded addition modifications. Accordingly, when the benefit of subtracting foreign source dividends is lost in a negative net Maryland modifications, that foreign source dividend subtraction is now used (beginning June 8, 2011) 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.

4. Relationship between Maryland Addition and Subtraction 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 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 NAM and in the carryback or carryforward year to offset federal gross income on the federal return (thereby also in Maryland), is now precluded. Accordingly, it is necessary that a Loss Year NAM be recaptured, *i.e.* added back, in a carryback/carryforward year.

The Loss Year NAM remains associated with the Loss Year NOL. The Loss Year NAM recapture (or net operation loss modification recapture) pursuant to Tax-General Article § 10-306(a) invoking Tax-General Article § 10-205(e), is applied as an addition on 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. See Section II.B.2 for specific application and Section VI for examples.

B. Specific Application.

1. Net Operating Loss. 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.

a. Loss Year.

(1) 2011 and prior tax year returns. Maryland Form 500 reflects the federal NOL as a negative number on line 1, *taxable income based on attached federal return from the Taxable Income Worksheet.*

(2) 2012 and future tax year returns. Maryland Form 500 has changed. The federal NOL is reflected as a negative number on line 1c, *federal taxable income before net operating loss deduction*. In a loss year, there would be no net operation loss deduction.

b. Carryback/Carryforward Year.

(1) 2011 and prior tax year returns. The federal NOL Deduction taken is reflected on Form 500, line 1 for *federal taxable income based on attached federal return from the Taxable Income Worksheet*; see Taxable Income Worksheet, Form 500 Instructions. The result can never be less than zero. Any remaining NOL can be carried to another income year, as appropriate. This figure does not include the adjustment to the NOL amount by the Loss Year's decoupling modifications; such adjustment is computed on Form 500DM line 2, and reported on Form 500.¹ See Section 2 below.

(2) 2012 and future tax year returns. Instead of taking the federal NOL Deduction and the adjustments to the NOL Deduction separately, the combined *pro forma* NOL Deduction amount is reported on Form 500 line 5, *Federal NOL Carryforward available from previous years*. Form 500, line 1c, accordingly, is the federal taxable income *before* taking the federal NOL Deduction. See Section 2 below.

2. Decoupling Modifications.

a. Loss Year. The Maryland decoupling modifications in the Loss Year could affect the amount of the NOL that may be carried back or forward. For all tax year returns, the decoupling modifications are calculated on Maryland Form 500DM, and reported on Form 500 as a Maryland

net decoupling addition or subtraction modification. See Administrative Release No. 38.

A federal NOL schedule must be attached to the Loss Year return and carryforward/carryback year return(s).

b. Carryback/Carryforward Years. The Maryland decoupling modifications could affect the amount of the NOL Deduction that may be used in a carryback/carryforward year. The decoupling modifications (e.g. bonus depreciation) may increase or decrease the federal taxable income (*pro forma* or adjusted federal taxable income) and, correspondingly, increase or decrease the amount of the NOL Deduction that may be taken to offset the *pro forma* or adjusted federal taxable income amount. In turn, these decoupling modifications affect the amount of remaining NOL to carryover to another year.

The amount of the NOL Deduction that may be used in a carryback/carryforward year is also affected by the fact that 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.

(1) For 2011 and prior tax year returns, the decoupling effect on the NOL Deduction amount that is used in a carryback/carryforward year is calculated on Form 500DM along with the other decoupling modifications required for that year. The net decoupling adjustment is reported on Form 500 as a Maryland net decoupling addition or subtraction modification.

(2) For 2012 and future tax year returns, the decoupling effect on the NOL Deduction is no longer calculated on Form 500DM with the other decoupling modifications. Instead, a *pro forma* or adjusted federal taxable income is first computed to include the effect of the other decoupling modifications, and then the *pro forma* or adjusted federal NOL is applied to reduce the *pro forma* or adjusted federal taxable income, to no less than zero. In a carryforward year, this is applied on the line in Form 500 entitled *Federal NOL carryforward available from previous tax years (including FDSC carry forward)*. In a carryback year, it is reported on the line in Form 500X entitled *Adjusted Federal NOL carryback/carryforward*.

¹ For 2010 and 2011 tax years, if the corporation is required to complete Form 500A, do not include the NOL deduction on line 1 (i.e. do not include NOL deduction on line 4 of the Taxable Income Worksheet in the Instructions). The applicable NOL deduction will be utilized on Form 500A; and carried back to Form 500 on line 2g or 4e accordingly. See Forms 500 and 500A Instructions. The result can never be less than zero. Any remaining NOL can be carried to another income year, as appropriate. This figure does not include the adjustment to the NOL amount by the Loss Year's decoupling modifications; such adjustment is computed on Form 500DM line 2, and reported on Form 500.

3. Certain Maryland Addition and Subtraction Modification Adjustments.

The addition and subtraction modifications for Section 10-306.1 related party transactions and the Section 10-307 foreign dividend subtraction modification are not included in the NAM calculation, and are treated like a decoupling modification as follows.

a. **Foreign Dividend Subtractions.** In order to prevent the loss of the benefit of subtracting foreign source dividends when subtractions exceed additions, it may be necessary to adjust an NOL (or create a FDSC).²

(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). For 2011 and prior tax years, if the result is a NAM, that result shall be netted against the foreign source dividend subtraction, the Loss Year NOL, and any other decoupling modifications. For tax year 2012 and future tax years, the foreign dividends subtractions are a direct adjustment to federal taxable income, and will become part of the NOL after taking into consideration of the other modifications.

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 a NOL Deduction 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 subtraction modifications (excluding the foreign source dividend subtractions). If the result is positive, then that result shall be subtracted from the foreign source dividend subtraction. Any resulting FDSC is used to further reduce federal taxable income (but not below zero). Any unused FDSC is available for carryforward. *An FDSC may only be carried forward.*

² In tax year 2012 and future tax years, foreign dividends subtractions are a direct adjustment to federal taxable income, and will become part of the NOL as applicable.

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

(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 subtraction modifications (excluding the foreign source dividend subtraction). If the result is positive, then that result shall be subtracted from the foreign source dividend subtraction. The remainder is available for carryforward. *An FDSC created in a year without a NOL may only be carried forward.*

c. **Section 10-306.1 Modifications.** For tax years starting on or after January 1, 2010, 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 that may be carried back or forward, or the amount of the NOL used in carryback and carryforward years. Also, the Section 10-306.1 modification is not a part of the NAM computation. See Administrative Release 38 on decoupling modifications.

4. NOL Deduction Subject to Loss Year NAM Recapture.

If there is a Loss Year NAM, 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.

a. 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*.³ 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

³ For 2010 and 2011 tax year returns. If the corporation is required to complete Form 500A, the calculation for the NAM recapture is based on the amount of NOL utilized on Form 500A. See Forms 500 and 500a instructions.

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 examples provided in Section IV.)

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 or 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 in tax year 2 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, 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. 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.

IMPORTANT: *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 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 Loss Year NAM 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 Loss Year 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. Examples.

- A. Facts:** Loss Year is 1996, the loss is \$1,000,000
 NAM in the Loss Year is \$500,000

Taxable Year	Federal Taxable Income (as filed)	NOL Used	NOL Balance	NAM	NAM / NOL Recapture	NAM Balance	Maryland Taxable Income
1996	(\$1,000,000)		(\$1,000,000)	\$500,000	---	\$500,000	\$0
1997	\$150,000	(\$150,000)	(\$850,000)	\$0	---	\$500,000	\$0
1998	\$150,000	(\$150,000)	(\$700,000)	\$60,000	---	\$500,000	\$60,000
1999	\$150,000	(\$150,000)	(\$550,000)	\$0	---	\$500,000	\$0
2000	\$150,000	(\$150,000)	(\$400,000)	\$0	\$100,000	\$400,000	\$100,000
2001	\$200,000	(\$200,000)	(\$200,000)	\$0	\$200,000	\$200,000	\$200,000
2002	\$250,000	(\$200,000)	\$0	\$0	\$200,000	\$0	\$250,000

Illustration of TY00 NAM Recapture

Loss Yr NAM (TY96) subject to recapture	\$500,000
<i>Plus the cumulative</i>	
NOL (TY96) Deductions (TY97)	\$150,000
(TY98)	\$150,000
(TY99)	\$150,000
(TY00)	\$150,000

	\$1,100,000
Total NOL (TY96)	- \$1,000,000

Recapture (TY00) is lesser of	\$100,000

Exceed the

Illustration of TY02 NAM Recapture

Loss Yr NAM (TY96) subject to recapture	\$500,000
<i>Plus the cumulative</i>	
NOL (TY96) Deductions (TY97)	\$150,000
(TY98)	\$150,000
(TY99)	\$150,000
(TY00)	\$150,000
(TY01)	\$200,000
(TY02)	\$200,000

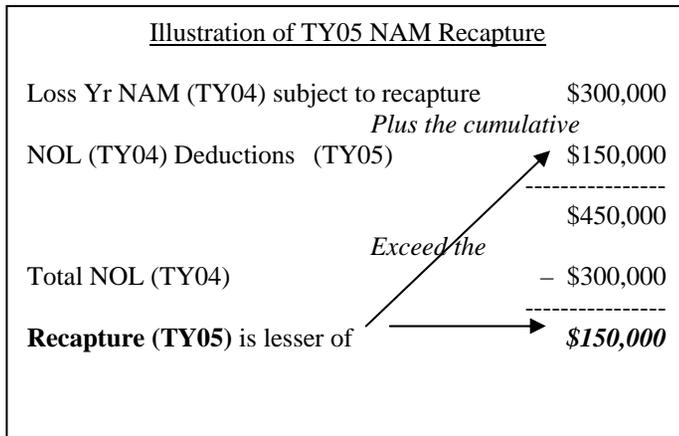
	\$1,500,000
Total NOL (TY96)	- \$1,000,000

Recapture (TY02) is lesser of	\$500,000

Exceed the

B. Facts: Loss Year 2004, the loss is \$300,000
 NAM for the Loss Year is \$500,000, \$300,000 of which offsets the NOL

Taxable Year	Federal Taxable Income (as filed)	NOL Used	NOL Balance	NAM	NAM / NOL Recapture	NAM Balance	Maryland Taxable Income
2004	(\$300,000)		(\$300,000)	\$500,000	---	\$300,000	\$200,000
2005	\$150,000	(\$150,000)	(\$150,000)	\$0	\$150,000	\$150,000	\$150,000
2006	\$150,000	(\$150,000)	\$0	\$65,000	\$150,000	\$0	\$215,000



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