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Massachusetts - Certain NOLs generated by QSubs prior to their treatment as disregarded entities may be carried forward and used by the parent S corporation

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In brief

On June 27, 2012, the Massachusetts Department of Revenue finalized a directive setting forth how, for taxable years beginning on or after January 1, 2009, an S corporation determining its entity-level excise tax on net income is to calculate and apply NOL carryforwards generated in prior years by its QSubs.

The Directive also explains the related consequences of recent apportionment changes regarding the taxation of S corporations and their QSubs. [Massachusetts Department of Revenue, [Corporate Excise/Income Tax Directive 12-3](#) (June 27, 2012)]

In detail

Statutory background

Since 2003, Massachusetts has changed how its subjects S corporations and their QSubs to the income and non-income measures of the corporate excise:



- Prior to March 5, 2003, QSubs were treated as separate taxable entities only with respect to the non-income measure of the corporate excise and minimum excise tax. For purposes of the income measure of the corporate excise under G.L. c. 63 § 32D, the tax was imposed at the S corporation level and the tax base combined the net income of the S corporation and the QSub.
- Between March 5, 2003 and the 2008 tax year, QSubs were treated as separate taxable entities subject to both the income and the non-income measure of the corporate excise.
 - Under § 32D, a QSub was subject to tax measured by its net income only if it had total receipts of \$6 million or more.
- Effective for tax years beginning on or after January 1, 2009, S corporations and their QSubs are no longer treated as separate taxable entities; rather, they are treated as a single taxpayer for both income and non-income measure purposes. Accordingly, the income, loss, deduction, and credits of a QSub are taken into account by the S corporation parent when the parent files its corporate excise tax return.

The issue

For taxable years beginning on or after January 1, 2009, how does an S corporation calculate and apply NOL carryforwards generated by its QSubs in prior years?

Calculating the carryforward

Generally, an S corporation may use a QSub's NOL carryforward generated in a tax year before 2009 if the loss was generated by the QSubs in a taxable year in which it was a QSub of the same S corporation, subject to the following adjustment to be made in all intervening taxable years:

- For an intervening year where the QSub was subject to the §32D(a)(ii) tax on net income (because it had total receipts of \$6 million or more), then the amount included in the carryforward calculation is the actual Massachusetts net income amount before apportionment
- For an intervening year where the QSub was not subject to the §32D tax(a)(ii) on net income, the entity must perform a pro forma calculation of its income or loss for that year as if it had been subject to the income measure of the excise.

The calculation must be performed for the QSub for each year until: (1) the QSub is no longer treated as a separate entity (before the 2009 tax year); or (2) until the carryforward is depleted.

Pre-apportionment and Post-apportionment calculations

Generally, for tax years beginning before January 1, 2010, corporations could carry forward NOLs on a pre-apportionment basis. However, if a corporation - including an S corporation - was a member of a combined group for a taxable year beginning on or after January 1, 2009, then such corporation was required to use a NOL carryforward on a post-apportionment basis.

For the 2010 tax year and going forward, all corporations determine NOL carryforwards on a post-apportionment basis. In making this calculation, a QSub must determine its loss or income for a given taxable year and multiply the relevant amount by the apportionment percentage of the QSub for each such taxable year.

Proportionate use of NOL carryforwards

When an S corporation seeks to apply NOL carryforwards that derive from losses incurred by itself and one or more of its QSubs, and where the NOL deduction to be taken is less than the total NOL carryforward, the S corporation applies a proportioned NOL carryforward. The amount of the S corporation's loss carryforward that is attributable to the individual entities for such prior year is determined in proportion to the amount of each entity's carryforward loss available from that prior year, subject to the relevant pre-apportionment or post-apportionment rules noted above.

Reporting concerns

An S corporation must separately calculate losses attributable to its individual QSubs, breaking out such losses by year and applying the apportionment percentage of each QSub for that year. Current state forms (especially Form 355S, Schedule E-2) do not provide a place to break out these calculations for individual QSubs. An S corporation must make the individual calculations and report them as blended figures on its tax return (in particular, Schedule E-2).

Actions to think about

Given the recent changes in both the tax treatment of QSubs for purposes of the section 32D tax on net income and the carryforward treatment of NOLs, this guidance is necessary for the proper calculation and tracking of QSub NOLs -- especially because the state tax forms do not provide a place to break out the calculations. Interestingly, if a QSub is sold or ceases to qualify as a QSub in a taxable year beginning on or after January 1, 2009, any NOL carryforward it had generated will continue as a tax attribute of its former S corporation parent. This policy position differs from the general Massachusetts rule that tax attributes belong to the corporate entity that generated them, but is consistent with the fiction that the QSub is a disregarded entity.

Let's talk

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