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Focus on third quarter provision: California FTB issues letter ruling on NOL carryovers, carrybacks, suspensions

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On September 23, the California Franchise Tax Board issued Legal Ruling 2011-04, providing guidance regarding the interaction of the state's net operating loss (NOL) deduction suspension provisions and the rules for carrying forward/back NOLs. The legal ruling could impact the third quarter provision for many California taxpayers. [Cal. Franchise Tax Bd., Legal Ruling 2011-04, 9/23/2011]

NOLs deducted in order of loss year; no extension unless loss "actually denied" by NOL suspension

The FTB cites federal Treas. Reg. 1.172-4(a)(3) for the rule that NOL carryovers and carrybacks are applied "in the order of the taxable years from which such losses are carried over or carried back, beginning with the loss for the earliest taxable year." Further, under Treas. Reg. 1.172-5, this process continues until all NOLs from the earliest years are absorbed. Under California law, NOL deductions are/were suspended for the 2002-2003 and 2008-2011 taxable years, with NOL carryover periods extended to correspondingly account for the periods for which the NOL deduction was denied due to the suspension. Applying the rules for application of multiyear NOL deductions to the California suspension period provisions, the FTB states that "even if an earlier year NOL is partially denied by operation of the suspension provisions, a subsequent year's NOL does not receive an additional



carryover period unless some portion of that year's NOL is *actually denied* by operation of the suspension provisions." (emphasis added)

For example, a taxpayer with a \$20 million NOL from the 2006 taxable year and a \$20 million NOL from the 2007 taxable year, with \$500,000 of income subject to tax in both 2008 and 2009 and no income or loss in 2010 or 2011 would have:

- \$500,000 of the 2006 NOL suspended for the 2008 taxable year and another \$500,000 of the 2006 NOL suspended for the 2009 taxable year. Because some portion of the 2006 NOL deduction is denied by operation of the NOL suspension provisions, the *entire amount* of the 2006 NOL deduction is extended by four years (to account for the 2008-2011 suspension period). Because the carryover period in 2006 was 10 years, the entire \$20 million of 2006 NOL will have an extended carryover expiration date of 2020 (10 years carryover plus the four year extension).
- none of the 2007 NOL suspended because, due to the ordering rule for NOL deductions, the earlier (2006) NOL deduction was deemed to be partially denied in 2008 and 2009. Because *no portion* of the 2007 NOL deduction is denied by operation of the NOL suspension provisions, *none* of the 2007 NOL deduction is eligible for extension. Because the carryover period for 2007 is also 10 years, the entire \$20 million of 2007 NOL will expire on the original expiration date for 2007 NOLs, *i.e.* in 2017.

Another example supplied in the legal ruling employs similar reasoning, in the situation of 2001 and 2003 NOLs subject to the 55% and 60% limitation in effect for those years, respectively.

NOL carrybacks addressed

Finally, the legal ruling provides an example that incorporates NOL carrybacks, first allowable in California for the 2013 taxable year (only 50% of a 2013 NOL may be carried back, while 75% of a 2014 NOL may be carried back, and 100% of NOLs may be carried back for 2015 and thereafter). The NOL carryback period in California is two years. In the example, the taxpayer has \$100,000 of income subject to tax in California in 2011 (it has \$300,000 of "preapportioned" income in 2011, thus exceeding the threshold for relief from the NOL suspension provisions for that year). The taxpayer has a \$100,000 NOL for each of the 2012 and 2013 taxable years, and \$75,000 of income subject to tax for the 2014 taxable year. The taxpayer does not elect to relinquish its 2013 California NOL carryback under I.R.C. section 172(b)(3). In this case:

- the 2012 NOL may not be carried back (since 2013 is the first carryback-eligible year in California). The 2012 NOL (\$100,000) is carried over and applied against the 2014 income subject to tax (\$75,000), leaving a remaining 2012 NOL carryover of \$25,000. The 2013 NOL may not be applied to 2014, because the ordering rule requiring the use of losses from the earliest taxable year mandates that the 2012 NOL carryover be used up first.
- 50% of the 2013 NOL must be carried back to 2011, and the taxpayer is allowed a deduction for 2011 regardless of the NOL suspension in effect for that year. Thus, \$50,000 of the 2013 NOL is carried back and applied as a deduction against its income subject to tax in 2011. The remaining \$50,000 of the 2013

NOL is available as a carryover and may be deducted once the 2012 carryover is extinguished.

PwC Observes

"There has always been a question as to the meaning of the statutory language allowing an extension of the NOL carryover period 'for any carryover of a net operating loss for which a deduction is denied'," observes Alan Bollinger, National Tax Services State and Local Tax Director with PwC in Sacramento. "This question arises in relation to the statutory provision that 'no net operating loss deduction shall be allowed for [the suspended period].' One common interpretation of these provisions is that if no NOL deduction is allowed for a taxable year, then all carryover NOL utilization has been suspended and the carryover periods for all the taxpayer's available NOLs are extended. Another, less common, interpretation is that the phrase 'no net operating loss deduction shall be allowed' is defined by the amount of the taxpayer's net income subject to tax in the suspension year, thus limiting the carryover extension to only those NOLs that would otherwise be used to offset such income. After twenty plus years of silence, the Franchise Tax Board has chosen the latter interpretation. There will likely be challenges to this interpretation, but in the interim California taxpayers should be alerted to the development as tax provision considerations may need to be addressed."

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