

Client Alert.

September 27, 2011

Franchise Tax Board Issues Legal Ruling Regarding Calculation of Net Operating Loss Carryover Periods

By Timothy A. Gustafson and Carley A. Roberts

California generally conforms to the federal provisions regarding net operating loss (“NOL”) deductions.¹ However, California’s seemingly endless battle with budget deficits has resulted in periodic suspensions of California taxpayers’ ability – both personal and corporate – to take NOL deductions. For example, California suspended NOL deductions for the 2002 and 2003 taxable years.² More recently, California generally suspended NOL deductions for the 2008 through 2011 taxable years.³

Such suspensions are typically accompanied by extensions of the carryover period for NOL deductions denied in a given year, in whole or in part, because of the application of the suspension provisions to that year’s NOL. Corresponding with the most recent suspension, California extended the carryover period – set at 20 years for NOLs incurred in 2008 and later⁴ – as follows: one year for losses incurred on or after January 1, 2010 (and before January 1, 2011);⁵ two years for losses incurred on or after January 1, 2009 (and before January 1, 2010);⁶ three years for losses incurred on or after January 1, 2008 (and before January 1, 2009);⁷ and four years for losses incurred before January 1, 2008.⁸

Further, California has implemented limited NOL carryback provisions for NOLs attributable to taxable years beginning on or after January 1, 2013.⁹ The NOL carryback provisions allow for a two-year carryback period¹⁰ and apply even where a

¹ Cal. Rev. & Tax. Code §§ 17201, 17276.20, 24416.20.

² Cal. Rev. & Tax. Code §§ 17276.3, 24416.3.

³ Cal. Rev. & Tax. Code §§ 17276.21, 24416.21; see also Assembly Bill 1452 (Laws 2008); Senate Bill 858 (Laws 2010). NOLs incurred in tax years beginning on or after January 1, 2008, and before January 1, 2010, are not suspended for individuals with net business income of less than \$500,000 or corporations with income subject to tax of less than \$500,000. Cal. Rev. & Tax. Code §§ 17276.21(d)(1), 24416.21(d). NOLs incurred in tax years beginning on or after January 1, 2010, and before January 1, 2012, are not suspended for taxpayers with modified adjusted gross income of less than \$300,000 or preapportioned income of less than \$300,000. Cal. Rev. & Tax. Code §§ 17276.21(d)(2), 24416.21(e)(1).

⁴ Cal. Rev. & Tax. Code §§ 17276.22, 24416.22.

⁵ Cal. Rev. & Tax. Code §§ 17276.21(b)(1), 24416.21(b)(1).

⁶ Cal. Rev. & Tax. Code §§ 17276.21(b)(2), 24416.21(b)(2).

⁷ Cal. Rev. & Tax. Code §§ 17276.21(b)(3), 24416.21(b)(3).

⁸ Cal. Rev. & Tax. Code §§ 17276.21(b)(4), 24416.21(b)(4).

⁹ Cal. Rev. & Tax. Code §§ 17276.20(c)(2), 24416.20(d)(2).

¹⁰ *Id.* The carryback provisions limit the amount of a taxpayer’s NOL eligible to be carried back. Namely, only 50% of the NOLs generated in the 2013 taxable year are eligible to be carried back and only 75% of the NOLs generated in the 2014 taxable year are eligible to be carried back. Cal. Rev. & Tax. Code §§ 17276.20(c)(2)(A) & (B), 24416.20(d)(2)(A) & (B). No such limitations exist for NOLs generated in the 2015 taxable year. Cal. Rev. & Tax. Code §§ 17276.20(c)(2)(C), 24416.20(d)(2)(C).

Client Alert.

NOL deduction is suspended under California law.¹¹

Accordingly, this constant give and take has raised questions as to the calculation of a taxpayer's remaining NOL carryover period when the NOL deduction is suspended under California Law.

California Franchise Tax Board ("FTB") Legal Ruling 2011-04¹² attempts to answer these questions by setting forth how the NOL suspension provisions operate on the remaining carryover periods in such situations. Presenting three situations, the FTB walks through multiple calculations in Legal Ruling 2011-04 which arise from the interaction between California's NOL suspension, carryover and carryback provisions and sets forth a framework for determining when a taxpayer's NOL deduction is suspended and in what order such deductions must be used when only some NOL deductions of a taxpayer have been suspended.

FTB's scenarios highlight a number of factors important to the calculations, including how a taxpayer will not receive the benefit of an extended NOL carryover period if no portion of the taxpayer's NOL deduction was denied by operation of the suspension provisions for a given taxable year.¹³ Moreover, the rules governing the ordering of NOL carryover and carryback periods prevent a subsequent year's NOL from receiving an additional carryover period simply as a result of the partial denial of an earlier year NOL deduction by operation of the suspension provisions.¹⁴ Further, a taxpayer who fails to relinquish an applicable NOL carryback period under Internal Revenue Code section 172(b)(3) must carryback an eligible NOL each year in the relevant carryback period before carrying the NOL forward.¹⁵

If you have any questions or would like further information on these developments, please contact:

Eric J. Coffill
(916) 325-1324
ecoffill@mofo.com

Carley A. Roberts
(916) 325-1316
croberts@mofo.com

Timothy A. Gustafson
(916) 325-1312
tgustafson@mofo.com

Jenny Choi
(916) 325-1336
jennychoi@mofo.com

About Morrison & Foerster:

We are Morrison & Foerster—a global firm of exceptional credentials in many areas. Our clients include some of the largest financial institutions, investment banks, Fortune 100, technology and life science companies. We've been included on *The American Lawyer's* A-List for seven straight years, and *Fortune* named us one of the "100 Best Companies to Work For." Our lawyers are committed to achieving innovative and business-minded results for our clients, while preserving the differences that make us stronger. This is MoFo. Visit us at www.mofo.com.

Because of the generality of this update, the information provided herein may not be applicable in all situations and should not be acted upon without specific legal advice based on particular situations.

¹¹ Cal. Rev. & Tax. Code §§ 17276.21(c), 24416.21(c).

¹² FTB Legal Ruling 2011-04, Sept. 23, 2011, available at http://www.ftb.ca.gov/law/rulings/active/lr11_04.pdf.

¹³ See Cal. Rev. & Tax. Code §§ 17276.21(b), 24416.21(b).

¹⁴ Cal. Rev. & Tax. Code §§ 17201, 17276.20, 24416.20; see also Treas. Reg. §§ 1.172-4(a)(3), 1.172-5.

¹⁵ See *Miller v. Comm'r* (1996) 99 F.3d 1042.