

CALIFORNIA FRANCHISE TAX BOARD

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CH. 16 NET OPERATING LOSS

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16.1 INTRODUCTION

- a. Introduction**
- b. State And Federal Differences**
- c. FTB Form 3805Q**

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a. Introduction

For federal purposes, the entire amount of a net operating loss (NOL), the excess of allowable deductions over gross income, is generally allowed to be carried back two years and carried forward twenty years pursuant to the provisions of Internal Revenue Code (IRC) §172.

Effective January 1, 1987, California adopted the federal NOL provisions with some modification. The California general provisions of Revenue and Taxation Code (RTC) §24416 apply to taxpayers filing on either a worldwide or water's-edge basis. However, RTC §24416 contains special rules that only apply to taxpayers filing on a water's-edge basis. (RTC §24416(c).) RTC §24416 has been amended many times. This section was amended in 1989, 1991, 1992, 1993, 1994, 1996, 1997, 1998, 2000, 2001 and 2002. (Senate Bill 572, Stats. 1987, Chapter 1139; and Assembly Bill 2130, Stats. 1988, Chapter 11.)

California generally conforms to the federal NOL provisions. However, there are differences. In addition, California has unique provisions, such as the intrastate apportionment of the NOL for taxpayers filing on a combined basis, special rules when reorganizations occur, and an NOL recomputation that is needed when a taxpayer makes a water's-edge election. See MATM 8000 for a more detailed discussion of the NOL provisions. Also see California Code of Regulations §25106.5(e).

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b. State And Federal Differences

Although California generally conforms to the federal NOL provisions, there are numerous state and federal differences. The more important differences are:

1. Generally, California allows only 50% of an incurred NOL to be carried forward for taxable years beginning before January 1, 2000. For taxable years beginning on or after January 1, 2000, and before January 1, 2002, California will generally allow 55% of an incurred NOL to be carried forward. For taxable years beginning on or after January 1, 2002, and before January 1, 2004, California will generally allow 60% of an incurred NOL to be carried forward. For taxable years beginning on or after January 1, 2004, California allows 100% of an incurred NOL to be carried forward.

To summarize:

<u>Taxable Year</u>	<u>% Allowed</u>
Pre-1/1/2000	50%
On or after 1/1/2000 & before 1/1/2002	55%
On or after 1/1/2002 & before 1/1/2004	60%
After 1/1/2004	100%

2. California suspended the NOL deduction for 2002 and 2003. RTC §24416.3(a) provides that no NOL deduction shall be allowed for taxable years beginning on or after January 1, 2002, and before January 1, 2004. However, RTC §24416.3(b) provides that the carryover period will be extended for one additional year for losses incurred beginning on or after January 1, 2002, and before January 1, 2003. The carryover period will be extended for two additional years for losses incurred in taxable years beginning before January 1, 2002.
3. California did not allow a NOL deduction for taxable years beginning in the 1991 and 1992 calendar years (former RTC §24416.3(a)), except for a "qualified taxpayer", defined as a taxpayer who was engaged in the conduct of a business in a program area or an enterprise zone under RTC §24416.2. The carryover period was extended for two additional years for losses attributable to taxable years beginning in 1987 through 1990 and one additional year for losses attributable to taxable years beginning in 1991 as provided under former RTC §24416.3.

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4. In general, NOLs incurred for years beginning on or after January 1, 2000, can be carried forward for 10 years. For NOLs incurred in years beginning on or after January 1, 1987, and before January 1, 2000, California generally allows a 5-year carry forward. NOLs incurred in taxable years beginning on or after January 1, 1987, can be carried forward for 5 years.
5. California allows NOLs incurred in taxable years beginning in 1985 and 1986 to be carried forward 3 years, to the first year beginning in 1987 and the two subsequent years. Former RTC §24416(e)(2)-(3) also allowed a specified percentage (depending on the month in which the taxable year ended) of any NOLs incurred in taxable years ending during 1985 to be carried forward to the first year beginning in 1987 and the two subsequent years.
6. California does not allow an NOL to be carried back.
7. Special NOL rules apply for new businesses, eligible small businesses, and losses attributable to activities in certain economic incentive zones. (See RTC §§24416(b)(2), 24416(b)(3), 24416.2, 24416.4, 24416.5, 24416.6 and 24416.7.)
8. For corporations under the jurisdiction of the court under Title 11 or similar proceedings prior to January 1, 1994, or corporations receiving assets acquired in a transaction that qualifies as a tax-free reorganization under IRC §368(a)(1)(G), California allows a deduction for a NOL carry forward from taxable years beginning on or after January 1, 1987 and before January 1, 1994 for 10 taxable years following the year of the loss.

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c. FTB Form 3805Q

Corporations must complete and attach FTB form 3805Q, Net Operating Loss Computation and NOL and Disaster Loss Limitations-Corporations, to their California return. Water's-edge taxpayers should attach the FTB form 3805Q to their California water's-edge return, FTB form 100W.

16.2 GENERAL STATE CONSIDERATIONS

CONTENTS:

- a. Apportioning Corporations**
- b. Special Limitations**
- c. Alternative Minimum Tax NOL**
- d. Recomputing Prior Year NOL Carryovers**

a. Apportioning Corporations

Each corporation in a unitary group must separately compute its NOL carryover and its NOL deduction by using intrastate apportionment. The NOL deduction is subtracted from intrastate apportioned "net income for state purposes" to arrive at "net income for tax purposes." (RTC §25108.)

"Net income (loss) for state purposes" is the sum of a corporation's income or loss apportionable to California plus that corporation's nonbusiness income or loss allocable to California. (RTC §25108(c).) The NOL carryover of one unitary member of the group cannot be used to offset the intrastate apportioned income of another member of the unitary group. This differs from federal NOL treatment for consolidated returns. (Refer to the NOL section of the FTB Pub. 1061, Guidelines for Corporations Filing A Combined Report.)

Example:

Corporation A and Corporation B are unitary California taxpayers filing a water's-edge combined report. For the taxable year ended December 31, 1999, Corporation A has unitary business income of (\$6,000,000) and a California apportionment factor of 20%. Corporation B has unitary business income of \$1,500,000 and a California apportionment factor of 7%. A's intrastate apportioned net loss for state purposes is (\$900,000). [(\$6,000,000) - \$1,500,000 x 20%.] B's intrastate apportioned net loss for state purposes is (\$315,000). [(\$6,000,000) - \$1,500,000 x 7%.]

For taxable year ended December 31, 2000, Corporation A has unitary business income of \$6,500,000 and a California apportionment factor of 22%. Corporation B has unitary business loss of (\$1,250,000) and a California apportionment factor of 2%.

A's intrastate apportioned net income for state purposes for 2000 is \$1,155,000. [\$6,500,000 - (\$1,250,000) x 22%.] From this amount, A may deduct its NOL carryover deduction of (\$450,000), [(\$900,000) x 50% NOL limitation], resulting in taxable income of \$705,000.

B's intrastate apportioned net income for state purposes for 2000 is \$105,000. [\$6,500,000 - (\$1,250,000) x 2%.] From this amount, B may deduct its NOL carryover deduction of (\$157,500), [(\$315,000) x 50% NOL limitation], resulting in net income for tax purposes of zero. The unused NOL deduction of (\$52,500) may be carried over to the next year and be deducted from B's apportioned net

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income for state purposes. B's unused NOL may not reduce A's taxable income of \$705,000.

b. Special Limitations

There are special limitations for NOL carryovers when corporate acquisitions or reorganizations occur.

1. Limitation On NOL Carryovers Following Ownership Changes

California RTC §24451 conforms to IRC §382. (RTC §24592. Repealed by Ch.117, Stats. 1991, Section 87, effective July 7, 1991, effective for taxable years beginning on or after January 1, 1991.) Generally, NOLs incurred by a corporation before a change in its ownership will be limited in post-ownership change taxable years. The following formula is used to determine the federal limitation:

Value of corporation equity prior to the ownership change \times Federal long-term exempt rate = Limitation on pre-change loss to apply in post-change taxable years.

Under IRC §382(c), the loss limitation will generally be reduced to zero if the new loss corporation fails to continue the business enterprise of the old loss corporation during the two-year period beginning on the date of ownership change. See MATM 8060, which contains information concerning application of this rule.

2. Limitation On Pre-Acquisition Built-In Gains

RTC §24451 conforms to IRC §384. Loss corporations are restricted from offsetting their losses against built-in gains resulting from the disposition of property of an acquired corporation within five years of acquisition. This is effective for ownership changes that occur after December 15, 1987.

c. Alternative Minimum Tax NOL

For taxable years beginning on or after January 1, 1988, all taxpayers, including water's-edge taxpayers, may be subject to the Alternative Minimum Tax (AMT). A taxpayer that must compute its tax under the AMT system will be allowed an NOL deduction. The NOL deduction, however, must be computed under AMT rules and will be subject to certain limitations. When computing the AMT NOL, the following should be noted:

1. The AMT NOL deduction is limited to 90% of the alternative minimum taxable income (AMTI).

Example:

For taxable year ending December 31, 2000, Corporation A has AMTI of \$100,000. It also has an AMT NOL carryover from 1999 in the amount of \$150,000 (the 50% amount.) Under AMT, Corporation A will be allowed to offset only \$90,000 ($\$100,000 \times 90\%$) of the NOL carryover against its AMTI of \$100,000. The remaining unused NOL carryover of \$60,000 ($\$150,000 - \$90,000$) can be carried over and deducted against AMTI in subsequent years.

This is in contrast to the NOL rules under the regular tax system where Corporation A would be allowed to deduct all of the NOL carryover against its regular taxable income.

2. Each California taxpayer must apply its separately apportioned or allocated share of AMT NOL to its share of AMTI.

3. AMT NOL must be recomputed on the same basis as AMTI, that is, reduced and increased by adjustments and preference items.

See MATM 8500, which contains additional information concerning the application of the AMT rules.

d. Recomputing Prior Year NOL Carryovers

Income items may be examined and recomputed in years barred by the statute of limitations to determine the correct amount of NOL carryover to apply in a current year. Therefore, if the NOL carryover is material and a prior year loss has not been audited, the auditor should consider reviewing the returns for the loss year to see if there are significant issues that will affect the NOL carryover accuracy.

16.3 WATER'S-EDGE NET OPERATING LOSS

The NOL provisions in RTC §24416 are applicable to taxpayers in the water's-edge group. In addition, RTC §24416(c) specifically applies to water's-edge taxpayers. These rules provide:

"For any taxable year in which the taxpayer has in effect a water's-edge election under Section 25110, the deduction of a NOL carryover shall be denied to the extent that such NOL carryover was determined by taking into account the income and factors of an affiliated corporation in a combined report whose income and apportionment factors would not have been taken into account if a water's-edge election under Section 25110 had been in effect for the taxable year in which the loss was incurred."

Thus, to determine the amount of NOL carry forward deduction allowable in a water's-edge year, it is necessary to look back to the year the loss was incurred and determine what the amount of NOL would have been if a water's-edge election had been in effect. If the loss incurred would have been less if income had been determined on a water's-edge basis, the NOL is denied to that extent.

It is important to note that RTC §24416(c) only imposes a limitation on the NOL deduction. Under this section an NOL carryover may be decreased, but it cannot be increased. This section does not contain any provision that would allow a taxpayer to increase an NOL carryover.

In a water's-edge election year, the water's-edge group should not be deducting a NOL carryover that resulted from a loss incurred in a prior year by an affiliate not included in the water's-edge group. Further, as discussed in the previous section, intrastate apportionment is applied to determine the NOL of each corporation. The NOL carryover stays with each corporation and cannot be deducted in future years against income of other entities.

[FTB Legal Ruling 99-2](#), Net Operating Losses – “Eligible Small Business” and “New Business”, clarifies that a water's-edge election will not limit the computation of the asset test for purposes of the new business NOL, or the gross receipts test for purposes of the small business NOL.

Exhibit 16 demonstrates the application of these rules.

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16.4 POSSIBLE ISSUES AND SUGGESTED AUDIT PROCEDURES

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- a. Possible Issues**
- b. Suggested Audit Procedures**

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a. Possible Issues

1. If an NOL carryover is deducted on a water's-edge return, did any of the carryover result from losses incurred in non-water's-edge years? If so, is the NOL recomputed on a water's-edge basis, based on the year the loss was incurred?
2. If the NOL carryover is recomputed, is the NOL carryover greater than originally reported? The NOL cannot be increased by an RTC §24416(c) recomputation.
3. Was RTC §25108 applied to intrastate apportion the NOL?
4. If tax is computed under the AMT system, was the NOL carryover recalculated under the AMT rules?
5. Is the AMT NOL carryover offset more than 90% of the AMTI for the taxable year? Is the NOL under the AMT rules correct?

b. Suggested Audit Procedures

1. Review the tax return to determine the year the losses that generated the NOL carryover were incurred. If this information is not available in the return, request workpapers showing the calculation of the carryover.

2. * * * * *

3. Identify the entities that were included or were required to be included in the returns filed in the years the losses were incurred. This can be achieved by a review of the prior audit report and consolidated annual reports. If there are losses incurred in multiple years, this should be done for each year. An audit of a prior year may be performed to redetermine the allowable amount of a NOL carryover, even though the prior year may be closed by statute. This includes examining the method of filing to determine if the prior year filed return is correct. Financial information may need to be obtained for each entity.

4. Review returns under examination to determine if entities excluded from the water's-edge group were included in the years the losses were generated.

NOTE: ((* * *)) = Indicates confidential and/or proprietary information that has been deleted.