

CALIFORNIA FRANCHISE TAX BOARD

Legal Ruling No. 280

November 2, 1964

STATUTORY PROVISIONS: APPLICATION OF SPECIFIED PERSONAL INCOME TAX LAW SECTIONS

Syllabus:

(1) Section 18451 does not cover a change or correction made by the Internal Revenue Service for a year for which an assessment by them is barred notwithstanding that the change or correction is made in order to recompute the net operating loss deduction for a later open year?

(2) Under the same facts as (1) above the State may not make an assessment for any of the years barred for Federal purposes, even though the State statute was open as to the date of the Revenue Agent's Report.

(3) If deductions are disallowed on the Federal return but "taxable income" is not changed because the disallowance is offset by an increased net operating loss deduction, the taxpayer is not required to make a report pursuant to Section 18451?

The Operations Division has requested advice on the application of Sections 18451, 18586.2 and 18586.3 of the Personal Income Tax Law and their counterparts in the Bank and Corporation Tax Law, Sections 25432, 25673, and 25674, respectively. The questions will be discussed herein in terms of the Personal Income Tax Law sections.

(1) The Operations Division has received Federal Revenue Agent's Reports on the examination of California taxpayers. In addition to examining and adjusting years open to assessment by the United States, the report disallowed expenses in earlier years that were barred to assessment by the federal statute of limitation. The examination of these earlier years, even though barred, was necessary for federal purposes to determine the correct amount of the net operating loss that could be carried over to the open years under examination. The California statutes do not provide for a net operating loss deduction.

The Operations Division also points out additionally that as of the date of the Revenue Agent's Report a year that was closed to federal assessment but was examined for purposes of the net operating loss carryover was still open under the 4-year California statute of limitations. However, as of the date the State received the information, an assessment would otherwise be barred for such year by the State statute.

(2) For a year that is open and under examination by a federal agent, the taxpayer's return would have shown a net income before the net operating loss deduction was taken, but the taxable income was, in fact, zero after such deduction. Adjustments were made in the report disallowing certain expense deductions, but the increased net income was offset by an equivalent increase in the net operating loss deduction, so that taxable income remained unchanged at zero. However, because of differences in the computation of Federal and California taxable income, the taxpayer did have net income for California purposes and the disallowance of the expense would result in additional California tax liability. At the time the information was received by the State, the 4-year statutory period for making an assessment had expired. Although the disallowances of expenses contained in the Revenue Agent's Reports would result in additional taxes owing the State, the State is barred by the 4-year statute of limitations from making an assessment, unless the taxpayer comes under Section 18451 in which case the State may issue assessments within the period provided by Sections 18586.2 or 18586.3, which ever is applicable.

(1) The general purpose in enacting Section 18451 was to permit the State the opportunity to avail itself of a federal examination of a California taxpayer resulting in a change or correction in the amount of net income or taxable income returned to the United States. Section 18586.2 was enacted at the same time to extend the period within which the State could issue a notice of proposed assessment if the taxpayer failed to report to the State the change or correction. Section 18586.3 was enacted thereafter to also extend the period where the taxpayer did report the change or correction.

The literal language of Section 18451 states that if the amount of taxable income "for any year" is changed or corrected by a federal examination the taxpayer shall make a report to the State within 90 days after "the final determination of such change or correction." The use of the phrase "for any year" by itself might make the section applicable to any year in which a change in taxable income was made by a federal examination, whether or not the year was open to assessment by the United States. However, the term "any year" must be read in context with the remainder of the sentence, which refers to the "final determination" of such change or correction for the year. A "final determination" is defined in Reg. 18581-18601(c), subdivision (6), as "an irrevocable determination or adjustment of a taxpayer's federal tax liability from which there exists no further right of appeal either administrative or judicial." It is concluded that, construing the sentence as a whole, the term "any year" is limited by the requirement of a "final determination", and therefore is limited to any year for which the federal tax liability can be finally determined or adjusted. This includes only a year which is open to a federal assessment; and does not apply to any year which is barred to the federal government at the time of its examination, and not otherwise open to the State.

It is clear that the net income of a barred year may be recomputed to the

extent that it affects the net operating loss deduction for an open year, as was done in the instant cases. Phoenix Coal Co., Inc. v. Commissioner, 231 Fed. 2d 420; Rev. Rule. 56-285, Cum. Bull. 1956-1, p. 134. But the liability for the earlier years is not kept alive for all purposes beyond the original period of limitation. Edward G. Leuthesser, 18 T.C. 1112, 1125. The barred years can be reviewed and income changed to the extent it may affect an open year, but only because the year against which the deficiency is asserted is still open.

(2) The 4-year statute of limitations (Sections 18586 and 25663) require that the notice of proposed assessment must be mailed within the 4-year period. The fact that an adjustment was indicated with respect to a particular taxpayer on a Revenue Agent's Report dated prior to the expiration of the 4-year period cannot conceivably affect the operation of the sections. The law is clear that the notice must be mailed within the limitation period. Knowledge, alone, of the deficiency does not keep the period of assessment open; the required action must be taken.

(3) Section 18451 requires that the taxpayer make a report to the State "if the amount of taxable income . . . as returned to the United States Treasury Department is changed or corrected . . ." The term "taxable income" used in the section must mean "taxable income" as shown on the federal return, as defined in Section 63(a) of the 1954 Internal Revenue Code for purposes of the federal income tax. It is defined as "gross income, minus the deductions allowed by this chapter . . ." Among the deductions allowed on the federal return, in computing taxable income, is the net operating loss deduction. (Section 172.) This deduction consists of net operating loss carryovers and carrybacks from other years. The net operating loss deduction for any year is not an independently determined amount but, rather, is the amount necessary (if sufficient carryover and carryback losses are available) to decrease taxable income, computed without the net operating loss deduction, to zero. After allowing the net operating loss deduction, the taxable income as defined in the statute is zero.

In the case here under consideration, the federal examination of an open year resulted in the disallowance of certain business expense deductions claimed by the taxpayer. The taxable income as originally returned to the federal government was zero after claiming the net operating loss deduction. Upon the disallowance of the expense deductions pursuant to the examination, the net operating loss carryover from the preceding year was increased, so that after allowing the net operating loss deduction in the greater amount taxable income remained at zero. Although the changes would have increased the taxpayer's California tax liability, there has been no change in the "amount of taxable income" returned to the United States Treasury Department. It remains unchanged at zero. It is concluded that the condition specified in Section 18451 has not been fulfilled, and, accordingly, the section cannot be applied.

Although this result may not have been intended in drafting the statute, I am

of the opinion that it is required by the express language, and that the unambiguous language does not permit any different construction. I would conclude that Section 18451 would have to refer specifically to changes in "items of gross income or deductions", rather than to changes in the "amount of taxable income", in order for the section to apply in this situation.

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