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LEGAL RULING 2011-04

Subject: Suspension of Net Operating Loss Deductions – Extension of Carryover Periods

BACKGROUND

Questions have been raised as to the calculation of the remaining carryover periods when the deduction of a net operating loss (NOL) is suspended under California law. This ruling sets forth how the suspension rules operate in those situations on the remaining carryover periods.

ISSUES

- (1) When is a taxpayer's deduction of a NOL "suspended"?
- (2) What is the order in which NOLs must be used where only some NOL deductions of a taxpayer have been suspended, resulting in an extended carryover period for those suspended NOL deductions?

SITUATION 1

W Corporation has a \$20,000,000 NOL from the 2006 taxable year and a \$20,000,000 NOL from the 2007 taxable year. W has \$500,000 of "income subject to tax"¹ in 2008, and \$500,000 of income subject to tax in 2009. W does not have any income or loss in either the 2010 or 2011 taxable years. Which NOLs will be denied a deduction in the 2008 and 2009 taxable years by operation of the suspension provisions of Revenue and Taxation Code (RTC) section 24416.21, subdivision (a)? As of the first day of W's 2012 taxable year, what are the remaining carryover periods for W's 2006 and 2007 NOLs?

SITUATION 2

X Corporation has a \$2,727,272.73 NOL from the 2001 taxable year, \$500,000 of income subject to tax in 2002, and a \$1,666,666.67 NOL from 2003. X does not have any income or

¹ For purposes of this ruling, the phrase "income subject to tax" is intended to mean the amount of taxable income immediately before any NOL deduction is allowed or suspended, in addition to its ordinary meaning in RTC section 24416.21, subdivision (d). As a result, for apportioning taxpayers this phrase would have the same meaning as "net income for state purposes" under RTC section 25108, subdivision (c). For non-apportioning taxpayers, this phrase would have the same meaning as gross income computed under Article 1 (commencing with RTC section 24271) of Chapter 6 of Part 11, less the deductions allowed under Article 1 (commencing with RTC section 24341) of Chapter 7 of Part 11, less the deductions allowed under Article 2 (commencing with RTC section 24401) of Chapter 7 of Part 11, **but prior** to the calculation of the NOL deduction under RTC section 24416.20.

In the case of taxpayers subject to the Personal Income Tax Law, the principles set forth in this ruling should be applied in a manner consistent with the rules found under Article 6 (commencing with RTC section 17201) of Chapter 3 of Part 10.

loss from 2004 through 2007. X has \$500,000 of income subject to tax in 2008. X does not have any income or loss from 2009 through 2012. In 2013, X has \$1,000,000 of income subject to tax. As of the first day of X's 2014 taxable year, what is the remaining carryover amount and carryover period for X's 2001 and 2003 NOLs?

SITUATION 3

Y Corporation has \$300,000 of pre-apportionment income and \$100,000 of income subject to tax in California for the 2011 taxable year. Y has a \$100,000 NOL for each of the 2012 and 2013 taxable years, and has no NOL carryovers from any prior taxable years. Y then has \$75,000 of income subject to tax for the 2014 taxable year. Y does not elect to relinquish its 2013 California NOL carryback under Internal Revenue Code (IRC) section 172(b)(3). As of the first day of Y's 2015 taxable year, what are the carryover amounts and carryover periods of Y's 2012 and 2013 NOLs?

LAW & ANALYSIS

Federal law, under Internal Revenue Code (IRC) section 172(c), defines a "Net Operating Loss" as the excess of the deductions allowed by Chapter 1 of the IRC over gross income, subject to modifications in IRC section 172(d). Under Treasury Regulation (Treas. Reg.) section 1.172-1(e)(1), each individual NOL is determined under the law applicable to the year that loss is sustained. Treas. Reg. section 1.172-4(a)(3) provides that a NOL carryback or carryover is either the full or partial amount of a NOL that has not been absorbed. Treas. Reg. section 1.172-1(a) generally provides a "NOL deduction" is the aggregate of (1) the NOL carryovers to such year, plus (2) the NOL carrybacks to such year, which can be used to offset taxable income in a taxable year.

Under RTC sections 17201 and 17276.20 (former RTC section 17276), and RTC section 24416.20 (former RTC section 24416), California generally conforms to IRC section 172, with exceptions not relevant to this ruling.

California has periodically suspended the ability of personal and corporate taxpayers to take a NOL deduction. NOL deductions were suspended for the 2002 and 2003 taxable years, and again for the 2008 through 2011 taxable years.² However, the 2008/2009 suspension provisions do not apply and the taxpayer can take a NOL deduction for the 2008 and 2009 taxable years if a personal income taxpayer has less than \$500,000 of net business income, or a corporate taxpayer has less than \$500,000 income subject to tax.³ The 2010/2011 suspension provisions do not apply and the taxpayer can take a NOL deduction for the 2010 and 2011 taxable years if a personal income taxpayer has less than \$300,000 of modified adjusted gross income, or a corporate taxpayer has less than \$300,000 of pre-apportioned income.⁴

Under the California NOL suspension provisions, the carryover period for each year's NOL is extended only where a NOL deduction is denied, in whole or in part, because of the application

² RTC §§ 17276.3, subd. (a), 17276.21, subd. (a), 24416.3, subd. (a), & 24416.21, subd. (a).

³ RTC §§ 17276.21, subd. (d)(1), & 24416.21, subd. (d).

⁴ RTC §§ 17276.21, subd. (d)(2), & 24416.21, subd. (e)(1).

of the suspension provisions to that year's NOL.⁵ Accordingly, a NOL or NOL carryover will not have an extended carryover period if no portion of the NOL deduction was denied by operation of the suspension provisions.

Treas. Reg. section 1.172-4(a)(3) provides that "[f]or the purpose of determining the taxable (or net) income for any such preceding taxable year, the various net operating loss carryovers and carrybacks to such taxable year are considered to be applied in reduction of the taxable (or net) income 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." Treas. Reg. section 1.172-5 provides that this process continues until all NOLs from the earliest years are absorbed. As a result, 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.

Under California law, the carryover period for NOLs arising in taxable years beginning on or after January 1, 1987, and before January 1, 2000, is five (5) taxable years.⁶ The carryover period for NOLs arising in taxable years beginning on or after January 1, 2000, and before January 1, 2008, is ten (10) taxable years.⁷ The carryover period for NOLs arising in taxable years beginning on or after January 1, 2008, is twenty (20) taxable years.⁸

The carryover period for NOLs for which a deduction is denied for the 2002 or 2003 taxable years is extended by one (1) year if the NOL is from taxable years beginning on or after January 1, 2002, and before January 1, 2003, and by two (2) years if the NOL is from taxable years beginning before January 1, 2002.⁹ The carryover period for NOLs for which a deduction is denied for the 2008, 2009, 2010 or 2011 taxable years is extended by one (1) year if the NOL is from taxable years beginning on or after January 1, 2010, and before January 1, 2011, two (2) years if the NOL is from taxable years beginning on or after January 1, 2009, and before January 1, 2010, three (3) years if the NOL is from taxable years beginning on or after January 1, 2008, and before January 1, 2009, and four (4) years if the NOL is from taxable years beginning before January 1, 2008.¹⁰

A NOL from a taxable year beginning on or after January 1, 2013, shall be carried back two (2) years for both personal income taxpayers and corporate taxpayers.¹¹ The carryback provisions apply even where a NOL deduction is suspended pursuant to RTC sections 17276.21, subdivision (a), or 24416.21, subdivision (a).¹² Only a portion of these post-2012 NOLs are eligible for carryback, with 50% of the NOL from the 2013 taxable year eligible to be carried back to the 2011 and 2012 taxable years, and 75% of the NOL from the 2014 taxable year eligible to be carried back to the 2012 and 2013 taxable years.¹³ The full amount of the NOLs starting from the 2015 taxable year may be carried back to the 2013 taxable year and any

⁵ RTC §§ 17276.21, subd. (b) (and 17276.3, subd. (b)), & 24416.21, subd. (b) (and 24416.3, subd. (b)).

⁶ RTC §§ 17276.20, subd. (d)(1)(A), & 24416.20, subd. (e)(1)(A).

⁷ RTC §§ 17276.20, subd. (d)(1)(B), & 24416.20, subd. (e)(1)(B).

⁸ RTC §§ 17276.22 and 24416.22.

⁹ RTC §§ 17276.3, subd. (b)(1) & (2), & 24416.3, subd. (b) (1) & (2).

¹⁰ RTC §§ 17276.21, subd. (b)(1) through (4), & 24416.21, subd. (b)(1) through (4).

¹¹ RTC §§ 17276.20, subd. (c)(2), & 24416.20, subd. (d)(2).

¹² RTC §§ 17276.21, subd. (c), & 24416.21, subd. (c).

¹³ RTC §§ 17276.20, subd. (c)(2)(A) & (B), & 24416.20, subd. (d)(2)(A) & (B).

taxable year thereafter.¹⁴ Under Treas. Reg. section 1.172-4(b)(1), a NOL shall first be carried to the earliest of the several taxable years for which such loss is allowable as a carryback or a carryover, and shall then be carried to the next earliest of such several taxable years, etc.

Under IRC section 172(b)(3), a taxpayer may elect to "relinquish" the entire carryback period with respect to a NOL for any taxable year. If the taxpayer elects to relinquish the carryback period, the NOL is carried forward only to the years eligible under the applicable carryover period. However, if a taxpayer does not make an election to relinquish the carryback, or if an attempted election is invalid, the taxpayer must carry the NOL back each year in the carryback period before carrying the NOL forward.¹⁵

HOLDINGS

SITUATION 1

W's 2006 NOL deduction is suspended for both the 2008 and 2009 taxable years, but W's 2007 NOL is not suspended for either 2008 or 2009 under these facts.

Under these facts, since W's 2006 NOL must be taken into account first under IRC section 172(b)(2), \$500,000 of W's 2006 NOL deduction for 2008 is suspended, and an additional \$500,000 of W's 2006 NOL deduction is suspended for 2009 by operation of the suspension provisions of RTC section 24416.21, subdivision (a). The exception to the suspension provisions found under RTC section 24416.21, subdivision (d), does not apply to W. W's 2007 NOL is not affected in either 2008 or 2009 since it could not be used until the 2006 NOL is fully absorbed under Treas. Reg. section 1.172-5, and thus W's 2007 NOL is not suspended and the carryover period for that NOL is not extended.

Situation 1 Summary

Taxable year	Income Subject to Tax	NOL	Amount of 2006 NOL carryover suspended	Amount of 2006 NOL carryover that has not been suspended	Amount of 2007 NOL carryover suspended	Amount of 2007 NOL carryover that has not been suspended
2006	---	\$20,000,000	NA	NA	NA	NA
2007	---	\$20,000,000	NA	\$20,000,000	NA	NA
2008	\$500,000	---	\$500,000	\$19,500,000	0	\$20,000,000
2009	\$500,000	---	\$500,000	\$19,000,000	0	\$20,000,000
2010	0	0	0	\$19,000,000	0	\$20,000,000
2011	0	0	0	\$19,000,000	0	\$20,000,000

¹⁴ RTC §§ 17276.20, subd. (c)(2)(C), & 24416.20, subd. (d)(2)(C).

¹⁵ *Miller v. Comm'r* (11th Cir. 1996) 99 F.3d 1042, revg. (1995) 104 T.C. 330; *Farmer v. Comm'r*, T.C. Memo 1998-327.

Under RTC section 24416.20, subdivision (e)(1)(B), the carryover periods for W's 2006 and 2007 NOLs are originally 10 taxable years, so that W's 2006 and 2007 NOLs originally expire at the end of the 2016 and 2017 taxable years, respectively.

Under RTC section 24416.21, subdivision (b)(4), because a portion of W's 2006 NOL deduction is suspended by operation of the suspension provisions, the carryover period for the full amount of W's remaining 2006 NOL is extended by four (4) years and expires at the end of the 2020 taxable year. However, because none of W's 2007 NOL deduction is denied by operation of the suspension provisions, the extended carryover provisions found under RTC section 24416.21, subdivision (b), do not apply to W's 2007 NOL. As a result, on the first day of W's 2012 taxable year, W will have nine (9) remaining taxable years to use its 2006 NOL, and six (6) remaining taxable years to use its 2007 NOL.

Taxable Year	NOL	Original NOL Expiration Date	Extended Date
2006	\$20,000,000	2016	2020
2007	\$20,000,000	2017	NA

SITUATION 2

On the first day of X's 2014 taxable year, X has a 2001 NOL carryover of \$500,000, but does not have a 2003 NOL carryover, which expired unused.

Under RTC section 24416.20, subdivision (b)(1)(B), X's 2001 NOL is limited to 55% of its entire amount, thus giving its 2001 NOL a carryover amount of \$1,500,000 under these facts. Under RTC section 24416.20, subdivision (e)(1)(B), X's 2001 NOL carryover period would be 10 taxable years, and would expire at the end of X's 2011 taxable year. In 2002, \$500,000 of X's 2001 NOL deduction is suspended. Therefore, pursuant to RTC section 24416.3, subdivision (b)(2), the carryover period for X's 2001 NOL carryover is extended by 2 taxable years. In 2008, \$500,000 of X's 2001 NOL deduction is denied. Therefore, pursuant to RTC section 24416.21, subdivision (b)(4), the carryover period for X's 2001 NOL carryover is extended by an additional 4 taxable years. Thus, the 2001 NOL would expire at the end of X's 2017 taxable year.

Under RTC section 24416.20, subdivision (b)(1)(C), X's 2003 NOL is limited to 60% of its entire amount, thus giving its 2003 NOL a carryover amount of \$1,000,000. Under RTC section 24416.20, subdivision (e)(1)(B), X's 2003 NOL carryover period would be 10 taxable years, and would expire at the end of X's 2013 taxable year. X's 2003 NOL is not suspended in 2008 since it could not be used until the 2001 NOL is fully absorbed under Treas. Reg. section 1.172-5. Under Treas. Reg. section 1.172-4(a)(3), X must first use its 2001 NOL for X's 2013 taxable year. Thus, X would deduct \$1,000,000 of its \$1,500,000 2001 NOL carryover at the end of the 2013 taxable year, leaving X with a \$500,000 2001 NOL carryover remaining for use in the 2014 taxable year. As a result, X's 2003 NOL would expire unused at the end of X's 2013 taxable year.

Situation 2 Summary

Taxable year	Income Subject to Tax	NOL	Amount of 2001 NOL carryover suspended	Amount of 2001 NOL carryover that has not been suspended	Amount of 2003 NOL carryover suspended	Amount of 2003 NOL carryover that has not been suspended
2001		\$2,727,273		NA †	NA	NA
2002	\$500,000		\$500,000	\$1,000,000	NA	NA
2003		\$1,666,667	0	\$1,000,000	NA	NA††
2004	0	0	NA	\$1,000,000	NA	\$1,000,000
2005	0	0	NA	\$1,000,000	NA	\$1,000,000
2006	0	0	NA	\$1,000,000	NA	\$1,000,000
2007	0	0	NA	\$1,000,000	NA	\$1,000,000
2008	\$500,000		\$500,000	\$500,000	0	\$1,000,000
2009	0	0	0	\$500,000	0	\$1,000,000
2010	0	0	0	\$500,000	0	\$1,000,000
2011	0	0	0	\$500,000	0	\$1,000,000
2012	0	0	NA	\$500,000	NA	\$1,000,000

† In the 2001 taxable year, X had a \$2,727,273 NOL. X could only use 55% of this NOL, thus giving its 2001 NOL a carryover amount of \$1,500,000. (RTC § 24416.20, subd. (b)(1)(B).)

†† In the 2003 taxable year, X had a \$1,666,667 NOL. X could only use 60% of this NOL, thus giving its 2001 NOL a carryover amount of \$1,000,000. (RTC § 24416.20, subd. (b)(1)(C).)

SITUATION 3

On the first day of Y's 2015 taxable year, Y's remaining 2012 NOL carryover is \$25,000, and Y's remaining 2013 NOL carryover is \$50,000.

Under RTC section 24416.20, subdivision (d)(1), Y cannot carry back its 2012 NOL because it was incurred in a taxable year beginning before January 1, 2013. With respect to Y's 2013 NOL, although Y would not have been allowed a NOL deduction for a NOL carryover from any prior year in 2011 under the suspension provisions since it had \$300,000 of income subject to tax, it is allowed a NOL deduction for its 2013 NOL carryback, under RTC section 24416.21, subdivision (c), and is required to carryback 50 percent of its 2013 NOL to 2011, unless Y elects to relinquish its 2013 NOL carryback under IRC section 172(b)(3).

On the first day of Y's 2014 taxable year, Y's remaining 2012 NOL carryover is \$100,000, and Y's remaining 2013 NOL carryover is \$50,000. Under Treas. Reg. section 1.172-4(a)(3), Y must first use its 2012 NOL for the 2014 taxable year. Y deducts \$75,000 of its 2012 NOL in the 2014 taxable year, so that at the start of the 2015 taxable year, Y's remaining 2012 NOL carryover is \$25,000.

Situation 3 Summary

Taxable year	Income Subject to Tax	NOL	2012			2013		
			Starting NOL balance	NOL carryback balance from that year	Ending carry-forward balance	Starting NOL carry-forward balance	NOL carryback balance from that year	Ending carryover balance
2011	\$100,000		---	---	---	---	---	---
2012		\$100,000	---	NA	\$100,000	---	---	---
2013		\$100,000	\$100,000	NA	\$100,000	---	\$50,000‡	\$50,000
2014	\$75,000		\$100,000	NA	\$25,000	\$50,000	0	\$50,000
2015	Unknown	Unknown	\$25,000	NA	Unknown	\$50,000	0	Unknown

‡ Y's 2013 NOL carryback is used as a deduction against Y's income subject to tax for the 2011 taxable year.

DRAFTING INFORMATION

The principal author of this ruling is Ted Tourian of the Franchise Tax Board Legal Division. For further information regarding this ruling, contact Mr. Tourian at the Franchise Tax Board Legal Division, P.O. Box 1720, Rancho Cordova, CA 95741-1720.