

CHAPTER OF CONTENTS:

8000	Net Operating Loss
8010	General NOL
8015	NOL Carryback
8020	Qualified Business NOL
8030	New Business NOL
8040	Small Business NOL
8050	NOL For Members of a Combined Report
8060	Limitation Following Ownership Change
8070	NOL for Water's-Edge Taxpayers
8080	Recomputing Prior Year NOL Carryovers

8000 NET OPERATING LOSS

In general, California conforms to IRC §172, modified by R&TC §24416.20, relating to net operating losses (NOLs). The specific rules for California NOLs have changed over the years, however. The MATM discussion is limited to NOLs incurred in 1987 and after. If you are examining an NOL that was incurred prior to 1987, review the appropriate section under R&TC §24416.20.

For California purposes, several different NOL provisions are available. Each NOL has different qualifications, as well as different carryover percentages and periods.

For specific prior years, you should reference the form 3805Q instructions for that specific year.

8010 General NOL

The Net Operating Loss (NOL) deduction resolves an inequity that comes from businesses experiencing losses and profits according to timeframes or cycles that differ from California tax deadlines. Without the NOL deduction, a business that experienced income evenly over a 10-year period may pay less in taxes than one experiencing the same overall net income, but with both income years and loss years. The NOL deduction allows businesses to level out their income and losses over time.

California initially allowed a modified NOL for 1984. It has been expanded and at times suspended over the years. The California NOL is provided for in R&TC §24416.20 including R&TC §24416.05 through R&TC §24416.22.

Until 2008, in general California's NOL deduction differed from federal law in two ways:

- California's allowed losses to be carried over to a subsequent year, up to 10 years, while the federal allowed for up to 20 years.
 - Prior to 1994, losses incurred after 1986 could be carried forward for 15 tax years.
 - Effective for tax years starting in 1994, the carry forward period was shortened to 5 tax years.
 - Effective for tax years starting in 2000, the carry forward period was lengthened to 10 tax years.
 - Effective for tax years starting in 2008, the carry forward period was lengthened to 20 tax years.

- California provided no carryback, while federal law provided a two-year carryback.

Note that California references tax years, which includes short tax years. Therefore, the carry forward is for x number of tax years, which may be less than x number of calendar years since tax years can be less than 365 day years.

Refer to R&TC §23041 for a definition of taxable year.

SUSPENDED YEARS

The deduction of general NOLs was suspended for tax years beginning in 1991, 1992, 2002, and 2003.

For tax years beginning in 2008 and 2009, pursuant to R&TC §24416.21, the deduction of general NOLs was suspended for taxpayers with intrastated business income by company over \$500,000. The \$500,000 amount is determined based on line 19 of Form

100 and line 16 of Form 100S; these amounts include nonbusiness income and are after apportionment.

For tax years beginning in 2010 and 2011 (R&TC § 24416.21), the deduction of general NOLs was suspended for taxpayers with preapportioned income over \$300,000. The \$300,000 amount is determined based on line 18 of the 2010 California Form 100, line 18 of the 2010 California Form 100W or line 1(c) of the 2010 California Schedule R, and applies to the aggregate amount of preapportioned income for all members included in a combined report (R&TC § 24416.21(e)(3)).

Preapportioned income means the "net income after state adjustments before the application of the apportionment and allocation provisions under the CTL."^[1]

The carry forward period is extended based on when the NOL was incurred.

On September 23, 2011, [Legal Ruling 2011-04](#) was issued. This ruling sets forth how the suspension rules operate in situations where an NOL has been suspended, and the calculation of the remaining carryover periods.

GENERAL PERCENTAGE CARRIED FORWARD

- The carry forward percentage was set at 50 percent through tax years starting in 1999. (R&TC §24416.20(b)(1)(A).)
- The carry forward percentage was increased to 55 percent for tax years starting in 2000 and 2001. (R&TC §24416.20(b)(1)(B).)
- The carry forward percentage was increased to 60 percent for tax years starting in 2002 and 2003. (R&TC §24416.20(b)(1)(C).)
- The carry forward percentage was increased to 100 percent for tax years starting in 2004 and later. (R&TC §24416.20(b)(1)(D).)

The following table provides a brief summary of NOL limitations:

Taxable Years	Carryover Period Allowed	Carryover Rate	Extension if Denied in 2002 or 2003	Extension if Denied in 2008 through 2011
January 1, 1987 - December 31, 1999	5 Years	50%	2 Years	Expired

January 1, 2000 - December 31, 2001	10 Years	55%	2 Years	4 Years*
January 1, 2002 - December 31, 2002	10 Years	60%	1 Year	4 Years
January 1, 2003 - December 31, 2003	10 Years	60%	N/A	4 Years
January 1, 2004 - December 31, 2007	10 Years	100%	N/A	4 Years
January 1, 2008 - December 31, 2008	20 Years	100%	N/A	3 Years
January 1, 2009 - December 31, 2009	20 Years	100%	N/A	2 Years
January 1, 2010 - December 31, 2010	20 Years	100%	N/A	1 Year
January 1, 2011 - December 31, 2011	20 Years	100%	N/A	N/A
January 1, 2012 - December 31, 2012	20 Years	100%	N/A	N/A

*GEN, NB, ESB NOL incurred on or after 01/01/2000 and before 01/01/2001 is expired in 2016.

8015 NOL Carryback

California law initially provided for NOL carrybacks beginning in 2011, but the law was modified in 2010 to delay implementation.

As of December 2010, California law provides that losses generated in tax years beginning January 1, 2013 and later will be allowed to be carried back to the two preceding tax years (R&TC §24416.20(d)). No losses may be carried back to years beginning before January 1, 2011 (R&TC § 24416.20(d)(4)).

The new carryback is phased in as follows:

- The law provides that 50 percent of the NOL generated in tax years beginning in 2013 is eligible for a 2 tax year carryback and;
- 75 percent of the NOL generated in tax years beginning in 2014 is eligible for a 2 tax year carryback. Whatever is not carried back may be carried forward. A carryback of 100 percent of the NOL generated in 2015 and later is eligible to be carried back 2 tax years.

For a calendar year taxpayer, this means that a \$10,000 loss in 2013 will be treated as follows:

- Up to 50 percent of the loss (\$5,000) can be carried back to 2011 and 2012.
 - For example if \$4,000 of the loss can be used in 2011,
the remaining \$1,000 could be carried to 2012.
- Any portion of that remaining \$1,000 not used in 2012 (and the \$5,000 not carried back at all) will be allowed to be carried forward to 2014 and later years.

For a calendar year taxpayer, this means that an \$8,000 loss in 2014 will be treated as follows:

- Up to 75 percent of the loss (\$6,000) can be carried back to 2012 and 2013.
 - For example, if \$4,000 of the loss can be used in 2012,
the remaining \$2,000 could be carried to 2013.
- Any portion of that remaining \$2,000 not used in 2013 (and the \$2,000 not carried back at all) will be allowed to be carried forward to 2015 and later years.

Situation 3 in [Legal Ruling 2011-04](#) provides guidance on how to carry back NOLs starting in 2013, where a taxpayer has NOL carryovers from prior years.

8020 Qualified Business NOL

NOLs incurred from activities conducted in an Enterprise Zone, Program Area, Targeted Tax Area, or Los Angeles Revitalization Zone (LARZ) may be treated separately (R&TC §24416.1). For years beginning on or after January 1, 1995, losses from business activity in a Local Agency Military Base Recovery Area (LAMBRA) may also be carried forward for 15 years at 100 percent. For years beginning on or after January 1, 2008, losses arising from these activities may be carried forward 20 years (RTC § 24416.22).

The taxpayer must elect to treat the NOL as a Qualified NOL. Generally, the NOL election must be made on the original return. However, since FTB did not distribute the LARZ forms and booklets until August 1993, the 1992 LARZ NOL election can be made on an amended return. The amended return must have been filed by June 30, 1994. This extension does not apply to the Enterprise Zone or Program Area NOL elections. For years starting in 1993 and after, all LARZ elections must be made on the original return. (FTB Notice 1994-1.)

See [Economic Development Area Manual](#) – § 5000 for additional information.

A business that commences in California on or after January 1, 1994 can deduct 100 percent of the NOL incurred in its first three tax years of business (R&TC § 24416.20(b)(2)). The carryover periods are as follows:

- 1st year's loss carried over for 8 tax years
- 2nd year's loss carried over for 7 tax years
- 3rd year's loss carried over for 6 tax years (R&TC § 24416.20(e)(2)).

For tax years starting January 1, 2000 or later, first, second, and third tax year losses may be carried over for 10 years (R&TC § 24416.20(e)(1)(B)).

[Legal Ruling 96-5](#) sets forth the Franchise Tax Board's position as to the scope of the terms "eligible small business" and "new business" as used in R&TC § 24416.20, relating to net operating losses. In addition, [Legal Ruling 99-2](#) 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.

8040 Small Business NOL

Losses during tax years starting on or after January 1, 1994 and incurred by businesses with less than \$1 million in gross receipts can be carried over at 100 percent for five tax years (R&TC §24416.20(b)(3)). The carryover period was increased to 10 tax years for losses during tax years starting on or after January 1, 2000.

If a taxpayer qualifies as both a new business for purposes of R&TC §24416.20(b)(2) and a small business for purposes of R&TC §24416.20(b)(3), it will be treated as a new business during the first three years of operation (R&TC §24416.20(b)(4)).

If the taxpayer is involved in multiple businesses, the rules relating to new business NOLs will be applied first to any portion of the loss that is from a new business, after which the rules for small business NOLs will be applied to any remaining portion of the loss that is from an eligible small business. If the NOL is greater than the loss incurred by the new business and eligible small business, then the excess will be subject to the normal NOL rules (50 percent of the loss carried over for five tax years).

[Legal Ruling 96-5](#) sets forth the Franchise Tax Board's position as to the scope of the terms "eligible small business" and "new business" as used in R&TC §24416.20, relating to net operating losses. In addition, [Legal Ruling 99-2](#) 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.

8050 NOL For Members of a Combined Report

Corporations that are members of a combined report must separately compute their share of the NOL using intrastate apportionment rules. Likewise, each member of the combined report will have its own NOL carryover that may only be applied against the income intrastate apportioned to that member in subsequent years. (R&TC §25108.) See MATM 7900 for an explanation of intrastate apportionment. An example of the computations involved in determining and applying an NOL in a combined report is included in the annual FTB Publication 1061, *Guidelines for Corporations Filing a Combined Report*.

8060 Limitation Following Ownership Change

R&TC §24451 conforms to IRC §382, pertaining to the carryover of NOLs after certain ownership changes. Special limits generally apply to NOL carryovers when a corporation has any ownership shifts or equity structure shifts that cause the percentage of stock owned by any one or more "5 percent shareholders" to increase by more than 50 percentage points over the lowest percentage of stock owned by such shareholders during the testing period (usually three years). The NOL carryover limitation is limited to the corporation's value (fair market value of its stock) immediately prior to the change in

ownership, multiplied by the federal long-term tax-exempt rate. Revenue Rulings are issued monthly to publish this rate. The Revenue Ruling for any given month may be found by looking under "interest" in the index of the Internal Revenue Cumulative Bulletin for the appropriate year. If this limitation exceeds the taxable income, the next year's limitation amount will be increased by the excess amount.

EXAMPLE

S Corporation has a \$10 million NOL. On January 1, 2007, B Corporation buys all the stock of S for \$1,000,000. The tax-exempt long-term bond rate on that date is 7.30 percent. During 2007, S has net income of \$2 million. Under IRC §382, B can use only \$73,000 ($\$1,000,000 \times 7.30$ percent) of the NOL carryover.

EXAMPLE

Assume the same facts as above, except that S only has \$40,000 in income for this example. S can now offset the full \$40,000 in 2007 and the limitation for 2008 will increase to \$106,000 ($\$33,000 + \$73,000$).

The allowable loss will be reduced to zero if the surviving corporation does not continue the "old" corporation's historic business activity for two years after the date of the ownership change.

The IRC §382 limitation applies not only to NOLs, but also to any unrealized built-in losses that exist as of the date of the ownership change. Also, to the extent that the loss corporation has net unrealized built-in gains when the ownership change occurs, the limitation for any one year may be increased by the amount of the built-in gain that is recognized in that year.

This is a very general overview of the IRC §382 limitation, and the actual application of the limitation can become very complex. The federal regulations under IRC §382 are extensive, and you should refer to those regulations if issues arise in this area. You should be aware, however, that there are some unique California problems that arise when the federal rules are applied to an apportioning taxpayer. Some of the federal vs. California differences are:

- California allocates NOLs among the taxpayer members of the group, and the NOLs, as allocated, can only be utilized against that member's share of future allocated net income.
- Since California generally has a different stock basis, each member of the group has to calculate a different net built in gain or loss for California, different than for federal purposes.

- Internal Revenue Service Notice 2008-83 relating to treatment of deductions following an ownership change per IRC §382(h) is not applicable for California purposes.

Generally, you should be alert for IRC §382 issues when a corporation has undergone an ownership change and is deducting NOL carryovers or other losses that are large in relation to the value of the corporation. Adjustments from federal to California generally limit the amount of the Net Operating Loss carryover that can be utilized in a given year.

8070 NOL for Water's-Edge Taxpayers

When a water's-edge election is made, the taxpayers sometimes have NOL carryovers that were generated in worldwide years (R&TC §24416.20(c)). To the extent that the NOL carryover was generated by a corporation that is not in the water's-edge group due to the water's-edge election, the carryover will not be allowed. To determine whether the NOL carryover is limited, the NOL must be recalculated as if the taxpayer had filed on a water's-edge basis in the year in which the NOL was incurred. Although the carryover may be limited as a result of this recalculation, NOL carryovers cannot be increased based upon a water's-edge recalculation. Examples of the computations necessary to adjust the water's-edge NOL carryover may be found in Chapter 16(c), Water's-Edge Manual.

8080 Recomputing Prior Year NOL Carryovers

The Franchise Tax Board may redetermine the correct taxable income in a closed year in order to ascertain either the amount of a net operating loss (NOL), or the amount of a NOL that is absorbed in the closed year for purposes of determining the correct NOL deduction for an open year. The authority for doing so is R&TC §19504(a) (which conforms in part to IRC §7602(a)), which states, in part:

"The Franchise Tax Board, for the purpose of administering its duties under this part, including ascertaining the correctness of any return, ... shall have the power to require by demand, that an entity of any kind ... provide information or make available for

examination or copying at a specified time and place, or both, any book, papers, or other data which may be relevant to that purpose."

It is well established through federal case law that income items may be examined and recomputed in years barred by the statute of limitations (SOL) in order to determine the correct amount of NOL carryover to apply in a current year. Since California conforms to the federal NOL provisions (IRC § 172), the case law interpreting those federal provisions is applicable for California purposes.

Lone Manor Farms, Inc. v. Commissioner, 61 T.C. 436, 440 (1974).

In *Lone Manor Farms*, the court held that the Internal Revenue Code does not prevent it from *computing* — as distinguished from *determining* — the correct tax liability for a year that is not being reviewed by the court when such a computation is necessary to a determination of the correct tax liability for a year that is at issue.

Phoenix Coal Co. v. Commissioner [56-1 USTC para 9366].

Phoenix Coal Co., Inc., allowed recomputation of the taxable income in a closed year in order to determine the correct amount of a loss deduction which could be carried back.

Although there are no citable California cases on point, the State Board of Equalization has upheld the recomputation of NOLs from closed years in a mini-decision. (*Appeal of Eastern Trading & Contracting*, October 5, 1994.)

If your case involves an NOL carryover, review prior years, even if barred by statute, to determine the correct amount of NOL carryover in a current year.

This issue can be material in unitary cases where the method of filing in the prior year is incorrect. An adjustment to the prior years' method of filing may reduce or eliminate the NOL carryover. You should also always take into consideration any prior audit findings when examining the NOL carryover deduction.