

Chapter 13 Net Operating Loss

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13.1 Water's-Edge Net Operating Loss

California generally conforms to the federal Net Operating Loss (NOL) provisions. However, California has provisions unique to this state, such as the intrastating of the NOL for taxpayers filing on a combined basis, the application of special rules when reorganizations occur, and the recomputation of an NOL that was generated prior to a taxpayer making a water's-edge election. Refer to MATM 8000 for a detailed discussion of the general NOL provisions.

This chapter provides a basis for understanding Revenue and Taxation Code (R&TC) §24416(c) and its application to water's-edge taxpayers.

The NOL provisions in R&TC §24416 are applicable to taxpayers filing either on a worldwide or water's-edge basis. In addition, R&TC §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 carryforward 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.

Example 1

A unitary group comprised of foreign and domestic entities filed a combined report on a worldwide basis for TY 2010 and 2011. In TY 2012, the group elected to file on a water's-edge basis excluding foreign entities (assume no CFC inclusion ratio or ECI income).

Assume, the group reported the following on their CA original returns:

Taxable Year	Income	NOL	NOL C/O Deduction	NOL C/O
2010WW	0	(5,000,000)	0	5,000,000
2011WW	4,000,000	0	4,000,000	1,000,000
2012WE	2,000,000	0	1,000,000	0

Impact on NOL carryover from an R&TC §24416(c) adjustment:

Taxable Year	Income	NOL	NOL C/O Deduction	NOL C/O
2010WW	0	(3,000,000)	0	3,000,000
2011WW	4,000,000	0	3,000,000	0
2012WE	2,000,000	0	0	0

The NOL carryover coming from the worldwide year (TY 2010) is recomputed to determine what the amount of NOL would have been if a water's-edge election had been in effect.

It is important to note that R&TC §24416(c) only imposes a limitation on the NOL deduction and it calls for a recomputation of the NOL, not income. In Example 1 above, the income generated in TY 2011 was not recomputed. In addition, under this section an NOL carryover may be decreased, but it cannot be increased. R&TC §24416(c) does not contain any provision that would allow a taxpayer to increase an NOL carryover.

Example 2

A unitary group comprised of foreign and domestic entities filed a combined report on a water's-edge basis for TY 2010 and 2011. In TY 2012, the group ended their election and filed on a worldwide basis.

Assume, the group reported the following on their CA original returns:

Taxable Year	Income	NOL	NOL C/O Deduction	NOL C/O
2010WE	0	(5,000,000)	0	5,000,000
2011WE	4,000,000	0	4,000,000	1,000,000
2012WW	2,000,000	0	1,000,000	0

Impact on NOL carryover from an R&TC §24416(c) adjustment: None. In this situation, the NOL is not recomputed, as the statute does not provide for a recomputation of an NOL carryover generated in a water's-edge year.

Example 3

The unitary group filed a combined report on a water's-edge basis for TY 2013 and 2014, generating income. In TY 2015, the group ended their election and filed on a worldwide basis. The group also generated a loss in TY 2015 which can be carried back to the two previous taxable years.

Assume, the group reported the following on their CA original returns:

Taxable Year	Income	NOL	NOL C/O Deduction	NOL C/B Deduction	NOL C/O
2013WE	10,000,000	0	0	10,000,000	
2014WE	5,000,000	0	0	5,000,000	
2015WW	0	(20,000,000)	0	0	5,000,000

Impact on NOL carry back deduction from an R&TC §24416(c) adjustment: None. The NOL carry back is not recomputed as the statute does not provide for a recomputation in this scenario.

To summarize, 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 MATM 8050, 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.

13.2 Possible Issues and Suggested Audit Procedures

- 1. Review the tax return to determine the year in which the NOL carryover was generated. If this information is not available in the return, request workpapers showing the calculation of the carryover.

- 2. Determine if a water's-edge election was in effect in the year the losses were incurred. BETS conversation
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- 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 recalculate 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.