

**California Suspends Net Operating Loss Deduction**

**Michael J. Cataldo**

**B**y enactment of Assembly Bill 1452, California has temporarily suspended the net operating loss carryover deduction for two years and increased the net operating loss carryover period to twenty years, and will phase in a deduction for net operating loss carrybacks.

Historically, California has limited the carryover amount of net operating losses (“NOLs”).<sup>1</sup> For NOLs sustained in tax years beginning after 1986 but before 2000, the carryover was limited to 50 percent.<sup>2</sup> For tax years 2000 and 2001 the carryover was limited to 55 percent. For tax years 2002 and 2003, the carryover was limited to 60 percent. For NOLs sustained in 2004 and thereafter, 100 percent of the NOL sustained could be carried over.<sup>3</sup>

**Suspension of NOL Deduction**

**A**ssembly Bill (“AB”) 1452 suspends the deduction for NOL carryovers for both corporate and individual taxpayers for tax years beginning in 2008 and 2009.<sup>4</sup> The carryover period for any NOL deduction suspended as a result of this legislation is extended for the number of years the NOL deduction is suspended.<sup>5</sup>

**C**orporate taxpayers with less than \$500,000 of taxable income subject to California corporation franchise or income tax for the tax year, and individual taxpayers subject to the Personal Income Tax Law (“PITL”) with net business income of less than \$500,000 for the tax year

are exempt from the suspension of the NOL carryover deduction for that year.<sup>6</sup>

The \$500,000 income limit for corporate taxpayers is based on the taxpayer’s California source income.<sup>7</sup> For taxpayers subject to the PITL, “business income” means income from a trade or business, whether conducted directly by the taxpayer, or by a pass-through entity owned directly or indirectly by the taxpayer, income from rental activity, and income attributable to a farming business.<sup>8</sup> A pass-through entity is defined as a partnership or S corporation for these purposes.<sup>9</sup>

*Also in this Bulletin*

*Guidance on California’s New Twenty Percent Corporate Understatement Penalty..... 2*

*Important Notice to Readers..... 4*

**NOL Carryover Period Increased**

**AB** 1452 extends the carryover period for NOLs attributable to a tax year beginning on or after January 1, 2008 to 20 years.<sup>10</sup> The NOL carryover period for earlier tax years remains unchanged, as follows:<sup>11</sup>

- NOLs sustained before the beginning of the 2008 tax year but after the 1999 tax year are carried over for 10 years;

<sup>1</sup> In California, NOLs are entity specific. Thus, a unitary business filing a combined report that sustains an overall NOL must intrastate apportion the NOL among each taxpayer member of the combined report.

<sup>2</sup> NOLs attributable to tax years beginning before 1987 may not be carried forward.

<sup>3</sup> NOL deductions were suspended for tax years beginning in 2002 and 2003, but the carryover period was extended for the number of years the deductions were suspended.

<sup>4</sup> Sections 17276.9(a) and 24416.9(a). All statutory references are to the California Revenue and Taxation Code.

<sup>5</sup> Sections 17276.9(b) and 24416.9(b).

<sup>6</sup> Sections 17276.9(d) and 24416.9(d).

<sup>7</sup> See *FTB Tax News*, January 2009, and FTB Form 100 Instructions, *What’s New/Tax Law Changes*. The author has confirmed in an informal discussion with FTB legal counsel that the \$500,000 threshold is considered on a post-apportioned basis, and that the amount reported on line 19 of Form 100 must be less than \$500,000 for the exemption from the suspension of the NOL carryover deduction to apply.

<sup>8</sup> Section 17276.9(d)(1)–(3).

<sup>9</sup> Section 17276.9(d)(1).

<sup>10</sup> Sections 17276.10 and 24416.10.

<sup>11</sup> Sections 17276(d)(1) and 24416(e)(1).

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- NOLs sustained prior to the 2000 tax year but after the 1986 tax year are carried over for 5 years;
- NOLs sustained prior to the 1987 tax year may not be carried over.<sup>12</sup>

### NOL Carryback Phase-In

California has never allowed NOL carrybacks. Now, with the passage of AB 1452, NOLs sustained during or after tax years beginning in 2011 may be carried back two years.<sup>13</sup> The NOL carryback deduction will be phased in gradually, allowing carryback of 50 percent of the NOL sustained in 2011, 75 percent of the NOL

<sup>12</sup> Sections 17276(a)(2) and 24416(a)(2).

<sup>13</sup> Sections 17276(c)(2) and 24416(d)(2).

sustained in 2012, and all of the NOL sustained on or after January 1, 2013.<sup>14</sup> An NOL may be carried back to tax years beginning in 2009, notwithstanding the 2009 suspension of the deduction for NOL carryovers.<sup>15</sup>

### Concluding Thoughts

As the foregoing indicates, California has a myriad of special rules regarding NOLs. Taxpayers should carefully review these rules and note that they substantially deviate from the rules governing federal NOLs.

<sup>14</sup> Sections 17276(c)(2)(A)–(C) and 24416(d)(2)(A)–(C).

<sup>15</sup> Sections 17276.9(c) and 24416.9(c).

## Guidance on California's New Twenty Percent Corporate Understatement Penalty

Michael J. Cataldo

The California Franchise Tax Board has released FTB Notice 2009-03, revised Frequently Asked Questions (“FAQs”), and a report on a recent interested parties meeting relating to filing amended returns under the cure provision of the large corporate understatement penalty imposed upon corporations with understatements of tax in excess of \$1 million. These materials can be accessed on a newly created Franchise Tax Board webpage dedicated exclusively to the penalty.<sup>1</sup>

### The Penalty

The large corporate understatement penalty (“Penalty”) applies to the entire amount of any corporate understatement of tax if the understatement is in excess of \$1 million.<sup>2</sup> The Penalty applies to taxable years beginning on or after January 1, 2003. For combined reporting groups, the \$1 million threshold is determined on a group basis. For the 2003 through 2007

taxable years, taxpayers may file amended returns and pay the additional tax reported by May 31, 2009, to avoid imposition of the Penalty (the “cure provision”).<sup>3</sup>

### The Cure Provision

On March 23, 2009, the Franchise Tax Board (“FTB”) held an interested parties meeting (“IPM”) to elicit public comment on draft FAQs relating to the cure provision, and subsequently released revised FAQs, Notice 2009-03 (“Notice”), and a report on the IPM (“Report”). The revised FAQs eliminate the requirement contained in the draft FAQs<sup>4</sup> that taxpayers must submit supporting documentation with curative amended returns. The Report confirms that there are no additional requirements for the curative amended return than

<sup>3</sup> The revised FAQs note that the May 31, 2009 curative amended return due date is actually due June 1, 2009, since May 31, 2009 falls on a Sunday.

<sup>4</sup> Released January 22, 2009.

<sup>1</sup> [http://www.ftb.ca.gov/businesses/large\\_corporate\\_understatement\\_penalty.shtml](http://www.ftb.ca.gov/businesses/large_corporate_understatement_penalty.shtml)

<sup>2</sup> For earlier discussions of the Penalty, see *California Imposes New 20 Percent Understatement Penalty on Corporate Taxpayers* in our October 2008 State & Local Tax Bulletin and *California Franchise Tax Board Releases Draft FAQs for New 20 Percent Corporate Understatement Penalty* in our March 2009 State & Local Tax Bulletin.

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for any other valid amended return. The revised FAQs further relax the curative amended return requirements set forth in the draft FAQs by allowing taxpayers to use “the best information available at the time the return is filed” to satisfy the requirement that the return provide “a detailed explanation of adjustments.”

The Notice formalizes FTB’s position that the statutory language of the cure provision does not permit tax deposits, and that even a simplified amended return stating “potential future adjustments” is insufficient. The Notice states that the curative amended return “must be sufficiently detailed that it can be determined what item of income, deduction, or credit is being adjusted” and “represent an honest and reasonable attempt to satisfy the requirements of the tax law.” The Notice also states that taxpayers “will be notified and given a reasonable time period to perfect any amended returns that lack such detail.” FTB has yet to provide additional details regarding the amount of time it will provide to taxpayers to perfect such amended returns.

While taxpayers must specify the adjustments on the curative amended returns with sufficient detail, FTB staff stated at the IPM that the computations on the curative amended return are not required to be set out on an issue-by-issue, dollar-for-dollar basis. For example, FTB staff stated that if a taxpayer suspects issues A, B, and C are likely to be adjusted by the Internal Revenue Service (“IRS”), and files a curative amended return with the FTB reflecting the potential IRS adjustments, FTB would consider the curative amended return valid even if the IRS ultimately does not adjust issue A, but does adjust unanticipated issue D. So long as the curative amended return identifies the federal issues “as best as possible under the circumstances at the time,” FTB will consider the curative amended return to be valid. However, the Report states that FTB staff, “upon further consideration” believes building an estimated amount of income into anticipated federal adjustments is “inconsistent with the statute” and that taxpayers should “make a good faith estimate of the nature of each adjustment, and specifically identify the source/reason for each adjustment, and assign a dollar amount to it.”

The Notice also provides limited exceptions to the amended return requirement. Where a current Notice of Proposed Assessment (“NPA”) or Notice of Action

(“NOA”) is outstanding on or before May 31, 2009, taxpayers may elect to use FTB Form 650 in lieu of an amended return, but only if the taxpayer either agrees or disagrees entirely with the NPA or NOA and makes full payment by May 31, 2009. The Notice also provides that settlement and closing agreements executed by the taxpayer on or before May 31, 2009, will serve as an amended return for purposes of the cure provision so long as the full amount of tax reflected in the settlement or closing agreement is paid by May 31, 2009.

The Notice and revised FAQs confirm that taxpayers will be permitted to apply overpayments to any taxable year for purposes of avoiding the Penalty, but prior year returns with overpayments previously applied to one tax year may not be re-applied to a different taxable year. Furthermore, pending refund claims or proposed overpayments cannot be applied to satisfy the payment requirement unless the claim is allowed or the overpayment becomes final on or before May 31, 2009.

The revised FAQs note that filing a curative amended return will not trigger a penalty for underpayment of estimated taxes. The amount of tax reported on the curative amended return will be treated as a tax shown on the original return only for purposes of the Penalty, and not for purposes of estimated taxes. The revised FAQs also note that the curative provision does not require payment of interest to avoid the Penalty.

Curative amended returns may be mailed together with offsetting refund claims. FTB noted at the IPM that even though curative amended returns must be submitted by May 31, 2009, the concurrent receipt of an offsetting refund claim with the curative amended return will not disturb the effect of the amended return for purposes of the curative provision.

### Future Returns

The method of filing future original returns to avoid the Penalty was briefly addressed at the IPM. FTB staff stated that taxpayers should estimate any anticipated adjustments and reflect them on the line for “other state adjustments” or on FTB Form 100, line 1, with a detailed explanation, but noted it had not yet fully considered the issue. FTB expects to release further guidance and solicit public comment regarding future tax return compliance to avoid the Penalty in the near future.

### Change of Law Provision

The Penalty is inapplicable where the understatement of tax is attributable to a “change of law” that is enacted, promulgated, issued, or becomes final after the date the taxpayer files its return for the taxable year. A “change of law” means a statutory change or an interpretation of law or rule of law by regulation, legal ruling of counsel, or a published federal or California court decision. FTB has requested interested parties to submit specific examples of where the “change of law” provision should apply.

### Concluding Remarks

On April 24, 2009, a Sacramento Superior Court judge overruled the FTB’s demurrer in a suit challenging the constitutionality of the Penalty. While the decision did not reach the merits, it does leave open the very real possibility that the Penalty will not be upheld in the courts. In deciding whether to file curative amended returns prior to the May 31, 2009 deadline, taxpayers should consider this possibility.<sup>5</sup>

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<sup>5</sup> *California Taxpayers’ Association v. Franchise Tax Board*, Sacramento Superior Court Case No. 34-2009 80000168.

#### Important Notice to Readers

This material is not intended to constitute a complete analysis of all tax considerations. Internal Revenue Service regulations generally provide that, for the purpose of avoiding United States federal tax penalties, a taxpayer may rely only on formal written opinions meeting specific regulatory requirements. This material does not meet those requirements. Accordingly, this material was not intended or written to be used, and a taxpayer cannot use it, for the purpose of avoiding United States federal or other tax penalties or of promoting, marketing or recommending to another party any tax-related matters.