

## California FTB Issues Guidance on Carryover of Tax Attributes for Apportioning Taxpayers

### Overview

On April 6, 2017, the California Franchise Tax Board ("FTB") issued Technical Advice Memorandum 2017-03 ("TAM 2017-03") regarding the application of Internal Revenue Code ("IRC") Sections 382, 383, and 384 for California tax purposes to multistate corporate taxpayers subject to apportionment.<sup>1</sup> Specifically, TAM 2017-03 provides guidance on whether the limitations on the use of tax attributes under IRC Sections 382, 383, and 384 are determined on a pre- or post-apportionment basis.<sup>2</sup>

This Tax Alert provides background on IRC Sections 382, 383 and 384, summarizes the conclusions set forth in TAM 2017-03, and provides some taxpayer considerations.

### Background on IRC Sections 382, 383, and 384

California Revenue and Taxation Code ("CRTC") Section 24451 incorporates by reference Subchapter C of Chapter 1 of Subtitle A of the IRC, which includes IRC Sections 382, 383, and 384, and thus, California generally conforms to these federal income tax provisions.<sup>3</sup>

IRC Section 382 applies when there has been a substantial change in a corporation's stock ownership and the acquired corporation possesses net operating losses ("NOLs") and/or net unrealized built-in losses ("NUBILs").<sup>4</sup> This type of corporation is referred to as a "loss corporation." Specifically, IRC Section 382 limits a corporation's ability to use pre-change NOLs and NUBILs to offset income in a post-change year.<sup>5</sup> This NOL limitation generally equals the value of the loss corporation at the time of its change in ownership multiplied by the federally approved long-term tax-exempt rate ("IRC Section 382 limitation").<sup>6</sup> IRC Section 383 provides the same IRC Section 382 limitation on the use of excess credits or capital loss carryovers ("IRC Section 383 limitation") from a loss corporation.<sup>7</sup>

Where the loss corporation possesses under-valued assets and over-valued assets at the time of the change in ownership, two potential scenarios can arise. First, if the amount of built-in gains exceeds the amount of built-in losses, the loss corporation has net unrealized built-in gains ("NUBIGs"). If any of the under-valued assets are disposed of for a gain, the gain (referred to as realized built-in gain ("RBIG")) is permitted to increase the loss corporation's IRC Section 382 limitation for that year.<sup>8</sup> Alternatively, if any over-valued assets are disposed of for a loss, the loss (referred to as a realized built-in loss ("RBIL")) is also subject to the IRC Section 382 limitation.<sup>9</sup> Under IRC Section 382(h)(1)(B), the aggregate of the RBILs that are allowed must not exceed the amount of NUBILs at the time of the change in ownership.<sup>10</sup> The Internal Revenue Service has provided guidance in its Notice 2003-65 for allowable methods for determining NUBIG/NUBIL and RBIG/RBIL in transactions in which IRC Section 382(h) applies.<sup>11</sup>

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<sup>1</sup> California Franchise Tax Board, Technical Advice Memorandum 2017-03 (April 6, 2017), available [here](#).

<sup>2</sup> *Id.*

<sup>3</sup> Cal. Rev. & Tax Code § 24451.

<sup>4</sup> I.R.C. § 382.

<sup>5</sup> I.R.C. § 382(a).

<sup>6</sup> IRC § 382(b)(1).

<sup>7</sup> IRC § 383.

<sup>8</sup> California Franchise Tax Board, Technical Advice Memorandum 2017-03.

<sup>9</sup> *Id.*

<sup>10</sup> IRC § 382(h)(1)(B).

<sup>11</sup> I.R.S. Notice 2003-65, 2003-2 C.B. 747

IRC Section 384 provides a similar limitation on the use of losses in certain types of corporate acquisitions and reorganizations.<sup>12</sup> Under IRC Section 384, if a corporation that has NOLs and NUBILs acquires a corporation with undervalued assets, any NUBIGs may not be offset by the acquiring corporation's NOLs or NUBILs.<sup>13</sup>

### Summary of TAM 2017-03

With respect to the IRC Section 382 and 383 limitations in general, the FTB concluded that, for California corporate tax purposes, the IRC Section 382 and 383 limitations should be determined on a pre-apportionment basis. The FTB reasoned that these limitations were the product of: (1) the value of the loss corporation, and (2) the long-term rate allowed by the federal government, and that under CRTC Section 25101, apportionment relates to net income, which is comprised of income, deductions, gains, or losses, but that none of the above two components involved any of these net income items. Moreover, the FTB stated that there is no California statutory or case authority that would allow the IRC Section 382 or 383 limitations to be applied on a post-apportionment basis.

Additionally, the FTB concluded that NUBIGs, RBIGs (including those considered under IRC Section 384), NUBILs, and RBILs should be determined on a post-apportionment basis. The FTB explained that these items relate to gains and losses which, in turn, relate to items of income that would be subject to apportionment under CRTC Section 25101. The FTB also stated that, because the RBIGs, RBILs, NUBIGs, and NUBILs relate to the time of the ownership change, the apportionment factor percentage that existed at the date of the ownership change should be applied.

Finally, the FTB concluded that, although IRC Section 383 and Treasury Regulations Section 1383-1 applies for California corporate tax purposes, the California corporate franchise tax rates should be substituted for the federal corporate income tax rates when applying the examples contained in Treasury Regulation Section 1.383-1(f) (which illustrate the application of IRC Section 383) to account for "obvious differences" when applying an applicable Treasury Regulation as required under CRTC Section 23051.5(h)(7).

### Considerations

TAM 2017-03 provides guidance on the application of IRC Sections 382, 383, and 384 for California corporate tax purposes. Although the FTB's interpretations in this TAM appear to provide taxpayers with an opportunity to utilize the same IRC Section 382 and 383 limitations for federal and California corporate tax purposes, the TAM does not provide guidance or otherwise address other potential differences between California and federal tax law. For example, unless specifically stated otherwise, California generally does not follow the federal consolidated return regulations under IRC Section 1502 when filing a California combined return. As such, California loss corporations that are members of a California combined return must consider any differences that may result in the determination of their federal IRC Section 382 and 383 limitations for California purposes without regard to application of federal consolidated return regulations and principles. Because California requires each taxpayer to carryforward its own NOL and does not have a consolidated NOL, the tracking of separate California limitations may be a challenging exercise for many taxpayers.

Further, as the TAM requires that NUBIGs, RBIGs (including those considered under IRC Section 384), NUBILs, and RBILs should be determined on a post-apportioned basis, consideration should be given as to whether the computation of a NUBIG/NUBIL for California purposes may result in significant differences in California taxable income or the utilization of California tax attributes in the years immediately following the ownership change. For example, RBILs that are determined to be deductible for federal purposes but not deductible for California purposes may also impact that amount of taxable income subject to California apportionment in addition to the amount of limitation applied to the utilization of a California NOL. Additionally, it could further complicate the process of tracking and applying these items in post-change years where some are computed on a pre-apportionment basis while others are computed on a post-apportionment basis, or where the California combined report includes corporations that are not subject to the IRC Section 382 limitations.

Taxpayers that have previously applied IRC Sections 382, 383, or 384 for California corporate tax purposes in a manner that varies with TAM 2017-03 should discuss their options with a California tax specialist, including whether they should re-compute their respective limitations for prior years and file claims for refund for years in which the statute of limitations is open or whether TAM 2017-03 impacts reporting for financial statement purposes.

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<sup>12</sup> IRC § 384.

<sup>13</sup> *Id.*

## External Multistate Tax Alert

If you have any questions regarding TAM 2017-03 or other California tax matters, please contact any of the following Deloitte Tax professionals:

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