Franchise Tax Board

ANALYSIS OF ORIGINAL BILL

Author:	Zettel	Analyst:	Roger Lackey	Bill Number:	AB 91
Related Bills:	See Legislative History	Telephone:	845-3627	Introduced Date:	01-09-2001
		Attorney:	Patrick Kusiak	Sponsor:	

SUBJECT: Net Operating Loss Deduction Conformity

SUMMARY

This bill would conform state law to federal tax law on net operating losses (NOL). It would:

- allow an NOL to be carried back,
- increase the time for NOL carryforwards, and
- allow 100 percent of an NOL to be claimed.

PURPOSE OF THE BILL

The author's office has indicated the purpose of this bill is to make state law the same as federal law for NOLs incurred on or after January 1, 2002.

EFFECTIVE/OPERATIVE DATE

As a tax levy, this bill would be effective immediately and specifies that it would be operative for taxable years beginning on or after January 1, 2002.

POSITION

Pending.

Summary of Suggested Amendments

As discussed with the author's staff, the attached amendments are included to resolve the implementation and technical considerations discussed in the analysis.

ANALYSIS

<u>FEDERAL/STATE LAW</u>

Federal law provides, in general, that an NOL can be carried back two years and forward 20 years. Special rules are provided for the carryback of NOLs arising from specified liability losses, excess interest losses, casualty or theft losses, disaster losses of a small business, and farming losses. An NOL is defined as the excess of allowable deductions (as specifically modified) over gross income computed under the law in effect for the loss year.

Board Position:			Department Director	Date
______ S	______ NA	______ NP		
______ SA	______ O	______ NAR	Alan Hunter for GHG	3/20/2001
______ N	______ OUA	__X__ PENDING		

Existing state law conforms to the federal computation of an NOL. However, California does not allow NOL carrybacks. Depending on the type of taxpayer or amount of a taxpayer's income, the amount of the NOL that is eligible to be carried forward and the number of years it can be carried forward will vary.

Existing state law provides for seven different types of NOLs:

Type of NOL	NOL % Allowed to be Carried Over	Carryover Period
General NOL	55% (2000- 2001) 60% (2002- 2003) 65% (2004-on)	10 Years
New Business Year 1 Year 2 Year 3	100% 100% 100%	10 Years
Eligible Small Business	100%	10 Years
Specified Disaster Loss	100% 50%	5 Years 10 Years
TTA, LAMBRA & EZ	100%	15 Years

Generally, for most taxpayers, the computed NOL may be carried forward for 10 years as follows:

- For taxable years beginning on or after January 1, 2000, and before January 1, 2002, 55% of the NOL may be carried forward.
- For taxable years beginning on or after January 1, 2002, and before January 1, 2004, 60% of the NOL may be carried forward.
- For taxable years beginning on or after January 1, 2004, 65% of the NOL may be carried forward

Special NOL treatment as stated in the above chart is provided for the following taxpayers:

- New businesses that are engaged in a trade or business activity that first commenced in California after January 1, 1994. "New business" special NOL treatment also applies to taxpayers engaged in certain biopharmaceutical activities for taxable years beginning on or after January 1, 1997, that have not received approval for any product from the U.S. Food and Drug Administration.

- Eligible small businesses that are engaged in a trade or business activity with gross receipts, less returns and allowances, of less than $1 million during the taxable year.

- Taxpayers that suffer a casualty loss in an area declared a disaster area by the Legislature may carry over 100% of an NOL for five years and 50% of any NOL remaining after the first five years for an additional 10 years.

- Taxpayers that operate a business in a Local Agency Military Base Recovery Area (LAMBRA), a Targeted Tax Area (TTA), or an Enterprise Zone (EZ). However, NOLs generated in these incentive areas may offset only income generated in the incentive areas, and the taxpayer may claim an NOL from only one incentive area in any year.

Special rules apply for taxpayers that have different types of NOLs generated in the same year. Generally, taxpayers operating in various tax incentive zones or within and outside tax incentive zones must allocate their overall loss between their various zone and non-zone activities. The deduction for such a taxpayer is limited to the NOL carryforward from one particular zone loss to the exclusion of all other losses or to a carryforward of the entire loss under the general NOL rules.

In the case of corporations doing business both within and outside of this state, California, as do most states, taxes corporations exclusively on a source basis, with source income being determined by use of an apportionment formula for business income of the unitary group and an allocation methodology for nonbusiness income. While a state cannot tax income from sources outside the state, it is similarly not obligated to consider losses from sources outside the state. Thus, the applicable apportionment rule governing NOLs provides that a taxpayer has a California NOL based on the sum (or net) of its California-apportioned business income (or loss) and its allocated nonbusiness income (or loss).

In addition, **California law** allows special carryforward treatment for losses incurred as a result of a disaster declared by the President or Governor. That is, 100% of the excess disaster loss may be carried over for up to five taxable years. If any of the excess loss remains after the five-year period, 50% of the remaining excess loss may be carried over for up to 10 additional years.

THIS BILL

This bill would repeal all current special California NOL provisions, other than disaster losses and the rules relating to apportioning taxpayers.

This bill would conform the Personal Income Tax Law (PITL) and the Bank and Corporation Tax Law (B&CTL) to the federal NOL provisions. Specifically, this bill would allow all taxpayers to carry back 100% of the NOL to offset the income of the two taxable years preceding the taxable year of the loss. It also would allow the taxpayer to carry forward the remaining NOL to offset the income of up to a maximum of 20 taxable years following the year of the loss.

IMPLEMENTATION CONSIDERATIONS

It is unclear if this bill would allow NOLs incurred prior to January 1, 2002, to be carried forward for 20 years as allowed by federal law or if they would continue to be carried forward as provided by current California law. Amendments 3, 4, 5, 7, 9, 10, 14, 16, 19, and 20 would revise the repeal language from the various NOL provisions and would also include operative date language that would clarify that unused NOLs may continue to be carried forward as allowed under current law.

Also, it is unclear if a taxpayer would be allowed to carry back a loss generated in January 1, 2002, to a taxable year beginning before January 1, 2002. If a taxpayer is allowed a carryback to a taxable year beginning before January 1, 2002, it could be interpreted as a gift of public funds. Amendments 5 and 15 would resolve the gift of public funds concern regarding carrybacks and clarify that no carrybacks would be available for NOLs generated in 2002, a one-year carryback would be allowed for NOLs generated in 2003, and a two-year carryback would be allowed for NOLs generated in 2004 and later.

Since this bill would allow 100% carryover of NOLs, including a 2 year carryback and 20 year carryforward, the disaster loss provisions would no longer be as attractive to the taxpayer. The author may wish to consider amending the applicable code sections. Amendment 1 and 11 would amend the disaster loss sections to become inoperative December 1, 2002. Amendment 2 and 12 would add new disaster loss language that would parallel the NOL provisions of this bill and be effective for disasters declared on or after January 1, 2002.

Technical Considerations:

This bill amends and repeals the Los Angeles Revitalization Zone NOL Sections (Sections 17276.4 and 24416.4). However, these sections ceased to be operative on December 1, 1998, and only serve to address NOL carryovers. Repealing these sections could lead to confusion for both the taxpayers and the department. Amendment 7 and 16 would delete the Los Angeles Revitalization Zone sections from the bill to retain the treatment provided under current law for these NOLs.

LEGISLATIVE HISTORY

SB 1774 (Lempert, Ch. 104., Stat. 2000) incrementally increased the general net operating loss (NOL) deduction carry forward (55%, 60%, 65%), and increased the carryover period to 10 years.

SB 1994 (1997/1998) would have conformed the state income tax law to federal law in regard to the treatment of NOLs. The bill was amended to prohibit carrybacks. The bill remained in the Senate Appropriations Committee.

OTHER STATES' INFORMATION

The laws of these states were reviewed because their tax laws are similar to California's income tax laws.

Florida income tax law, applicable only to corporations, provides a 20-year carryover but no carryback, and otherwise conforms to federal NOL rules.
Illinois income tax law conforms to federal NOL law.
Massachusetts income tax law does not allow NOL treatment for personal income taxpayers, but corporations are allowed a 100% NOL for only the first five years of the entity's existence.
Michigan income tax law conforms to federal NOL rules, including carrybacks for corporations. However, Michigan's personal income tax law does not allow carrybacks.
Minnesota personal income tax law conforms to federal NOL rules, while corporate taxpayers have no carrybacks and only a fifteen-year carryforward.

FISCAL IMPACT

This bill would not significantly impact the department's costs.

ECONOMIC IMPACT

Tax Revenue Estimate

Revenue losses under the Personal Income Tax Law and the Bank & Corporation Tax Law are estimated to be:

Fiscal Year Cash Flow Taxable Years Beginning After December 31, 2001 Enactment Assumed After June 30, 2001 $ Millions		
2002-03	2003-04	2004-05
-$65	-$500	-$645

This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this measure.

The revenue analysis reflects carrybacks beginning with NOL's incurred in tax year 2002 (applied over two prior tax years) and carryforwards beginning with operating losses incurred in 2002.

Tax Revenue Discussion

Revenue losses under the Personal Income Tax Law and Bank & Corporation Tax Law would depend on the amount of additional net operating loss deductions that can be applied against taxable income.

The above estimates are based on prior year tax return data which indicate the total amount of operating losses and the amounts that were applied under current law to reduce tax liabilities. This data was then simulated to determine how much additional losses could be applied by conforming to federal net operating losses.

ARGUMENTS/POLICY CONCERNS

Tax incentive areas, including EZs, LAMBRAs, and the TTA were primarily created to encourage development in economically disadvantaged areas. By eliminating the more favorable NOL provisions for these areas and substituting rules that place all taxpayers on an equal footing with respect to the treatment of NOLs, this bill eliminates one incentive for businesses to locate in these depressed areas.

Conforming to federal NOL rules would reduce complexity and eliminate taxpayer confusion regarding federal and California differences related to NOL treatment.

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FRANCHISE TAX BOARD'S
PROPOSED AMENDMENTS TO AB 91
As Introduced January 9, 2001

AMENDMENT 1

On page 2, before line 1, insert the following:

Section 1. Section 17207 of the Revenue and Taxation Code is amended to read:

17207. (a) An excess disaster loss, as defined in subdivision (c), shall be carried to other taxable years as provided in subdivision (b), with respect to losses resulting from any of the following disasters:

@@@@@@**LEG COUNSEL insert the remaining portion of subdivision (a) through subdivision (g)**

(h) This section shall cease to be operative on December 1, 2002. However, any unused disaster loss shall continue to be carried over to following years pursuant to the rules provided in this section. This section shall remain in effect until January 1, 2006, and as of that date is repealed.

AMENDMENT 2

On page 2, before line 1, insert the following:

Section 2. Section 17207.1 is added to the Revenue and Taxation Code to read:

17207.1 (a) For each taxable year beginning on or after January 1, 2002, the provisions of Section 165(i) of the Internal Revenue Code, relating to disaster losses, are modified to also be applicable to any loss attributable to a disaster identified in subdivision (c) occurring in an area of this state which was proclaimed by the Governor to be in a state of disaster.
(b) The election under Section 165(i) of the Internal Revenue Code for losses attributable to a disaster identified in subdivision (c) may be made on a return or amended return filed on or before the due date of the return (determined with regard to extension) for the taxable year in which the disaster occurred.
(c) This section shall apply to any loss attributable to any of the following disasters:

LEG COUNSEL renumber remaining "SEC"s as required.

AMENDMENT 3

On page 2, strikeout lines 22 to 25, inclusive.

AMENDMENT 4

On page 8, strikeout lines 7 and 8, and insert:

(l) This section shall cease to be operative on December 1, 2002. However, any unused net operating loss shall continue to be carried over to following years pursuant to the rules provided in this section. This section shall remain in effect until January 1, 2006, and as of that date is repealed.

AMENDMENT 5

On page 8, strikeout lines 11 to 14 inclusive, and insert:

17276. (a) For each taxable year beginning on or after January 1, 2002, Section 172 of the Internal Revenue Code, relating to net operating losses, including the amendments made by Public Law 105-277, shall apply except as otherwise provided.
(b) (1) For net operating losses incurred in any taxable year beginning on or after January 1, 2002, and before January 1, 2003, net operating loss carrybacks shall not be allowed.
(2) For net operating losses incurred in any taxable year beginning on or after January 1, 2003, and before January 1, 2004, the taxpayer may carry back the net operating loss to the taxable year preceding the taxable year of the loss.
(3) For net operating losses incurred in any taxable year beginning on or after January 1, 2004, the taxpayer may carry back a net operating loss as provided in Section 172 of the Internal Revenue Code.

AMENDMENT 6

On page 8, strikeout lines 39 and 40, and insert:

(d) This section shall cease to be operative on December 1, 2002. However, any unused net operating loss shall continue to be carried over to following years pursuant to the rules provided in this section. This section shall remain in effect until January 1, 2006, and as of that date is repealed.

AMENDMENT 7

On page 11, strikeout lines 8 and 9, and insert:

(e) This section shall cease to be operative on December 1, 2002. However, any unused net operating loss shall continue to be carried over to following years pursuant to the rules provided in this section. This section shall remain in effect until January 1, 2006, and as of that date is repealed.

AMENDMENT 8

On page 11, strikeout lines 10 to 40, page 12, strikeout lines 1 to 39, and on page 13, strikeout lines 1 to 37.

AMENDMENT 9

On page 16, strikeout lines 39 and 40, and insert:

(f) This section shall cease to be operative on December 1, 2002. However, any unused net operating loss shall continue to be carried over to following years pursuant to the rules provided in this section. This section shall remain in effect until January 1, 2006, and as of that date is repealed.

AMENDMENT 10

On page 19, strikeout lines 18 and 19, and insert:

(f) This section shall cease to be operative on December 1, 2002. However, any unused net operating loss shall continue to be carried over to following years pursuant to the rules provided in this section. This section shall remain in effect until January 1, 2006, and as of that date is repealed.

AMENDMENT 11

On page 19, between lines 19 and 20, insert the following:

Section ___. Section 24347.5 of the Revenue and Taxation Code is amended to read:

24347.5. (a) An excess disaster loss, as defined in subdivision (c), shall be carried to other taxable years as provided in subdivision (b), with respect to losses resulting from any of the following disasters:

@@@@@@**LEG COUNSEL insert the remaining portion of subdivision (a) through subdivision (g)**

<u>(h) This section shall cease to be operative on December 1, 2002. However, any unused disaster loss shall continue to be carried over to following years pursuant to the rules provided in this section. This section shall remain in effect until January 1, 2006, and as of that date is repealed.</u>

AMENDMENT 12

On page 19, between lines 19 and 20, insert the following:

Section __. Section 24347.6 is added to the Revenue and Taxation Code to read:

24347.6 (a) For each taxable year beginning on or after January 1, 2002, the provisions of Section 165(i) of the Internal Revenue Code, relating to disaster losses, are modified to also be applicable to any loss attributable to a disaster identified in subdivision (c) occurring in an area of this state which was proclaimed by the Governor to be in a state of disaster.

(b) The election under Section 165(i) of the Internal Revenue Code for losses attributable to a disaster identified in subdivision (c) may be made on a return or amended return filed on or before the due date of the return (determined with regard to extension) for the taxable year in which the disaster occurred.

(c) This section shall apply to any loss attributable to any of the following disasters:

AMENDMENT 13

On page 20, strikeout lines 3 to 6 inclusive.

AMENDMENT 14

On page 26, strikeout lines 1 and 2, and insert:

(m) This section shall cease to be operative on December 1, 2002. However, any unused net operating loss may continue to be carried over to following years as provided in this section. This section shall remain in effect only until January 1, 2006, and as of that date is repealed.

AMENDMENT 15

On page 26, strikeout lines 5 to 8 inclusive, and insert:

24416. (a) For each taxable year beginning on or after January 1, 2002, Section 172 of the Internal Revenue Code, relating to net operating losses, including the amendments made by Public Law 105-277, shall apply except as otherwise provided.

(b)(1) For net operating losses incurred in any taxable year beginning on or after January 1, 2002, and before January 1, 2003, net operating loss carrybacks shall not be allowed.

(2) For net operating losses incurred in any taxable year beginning on or after January 1, 2003, and before January 1, 2004, the taxpayer may carryback the net operating loss to the taxable year preceding the taxable year of the loss.

(3) For net operating losses incurred in any taxable year beginning on or after January 1, 2004, the taxpayer may carryback a net operating loss as provided in Section 172 of the Internal Revenue Code.

AMENDMENT 16

On page 27, strikeout lines 3 and 4, and insert:

(e) This section shall cease to be operative on December 1, 2002. However, any unused net operating loss shall continue to be carried over to following years pursuant to the rules provided in this section. This section shall remain in effect only until January 1, 2006, and as of that date is repealed.

AMENDMENT 17

On page 29, strikeout lines 12 and 13 and insert:

(e) This section shall cease to be operative on December 1, 2002. However, any unused net operating loss shall continue to be carried over to following years pursuant to the rules provided in this section. This section shall remain in effect only until January 1, 2006, and as of that date is repealed.

AMENDMENT 18

On page 29, strikeout lines 36 to 40, strikeout pages 30 and 31 inclusive, and on page 32, strikeout lines 1 to 27.

AMENDMENT 19

On page 35, strikeout lines 35 and 36, and insert:

(f) This section shall cease to be operative on December 1, 2002. However, any unused net operating loss shall continue to be carried over to following years pursuant to the rules provided in this section. This section shall remain in effect only until January 1, 2006, and as of that date is repealed.

AMENDMENT 20

On page 38, strikeout lines 16 and 17, and insert:

(e) This section shall cease to be operative on December 1, 2002. However, any unused net operating loss shall continue to be carried over to following years pursuant to the rules provided in this section. This section shall remain in effect only until January 1, 2006, and as of that date is repealed.