ANALYSIS OF ORIGINAL BILL

Franchise Tax Board

Author:	Houston	Analyst:	Marion Mann DeJong	Bill Number:	AB 1654
Related Bills:	See Legislative History	Telephone:	845-6979	Introduced Date:	02/21/2003
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SUBJECT: NOL Deduction/Unused Losses May Be Sold to Another Corporation

SUMMARY

This bill would allow corporations to sell unused net operating losses (NOLs) to another corporation.

PURPOSE OF THE BILL

The purpose of this bill appears to be to allow corporations to sell their tax benefit to another corporation rather than lose the benefit when it expires.

EFFECTIVE/OPERATIVE DATE

As a tax levy, this bill would become effective immediately upon enactment and would be operative for taxable years beginning on or after January 1, 2003. However, the purchasing corporation could not deduct the NOL until the 2004 taxable year because the NOL deduction is currently suspended.

POSITION

Pending.

Summary of Suggested Amendments

Amendments are needed to resolve the “Implementation Considerations” discussed below before the department can implement this bill. Department staff is available to assist the author with necessary amendments.

ANALYSIS

FEDERAL/STATE LAW

Simply stated, NOLs are beneficial tax rules for losses that allow a taxpayer to deduct (offset) those losses in other years when the taxpayer recognizes income. These NOL rules are designed to mitigate the occasional harsh effects of the annual accounting concept applicable to the tax law.

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
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Generally, an NOL may be carried back or forward only by the taxpayer who sustained the loss. After a reorganization or other change in corporate ownership of the taxpayer, the future use of NOL carry forwards are limited or prohibited.

Existing state law conforms to the federal computation of an NOL, except for the following modifications: California does not allow NOL carrybacks. In addition, depending on the type of taxpayer or amount of a taxpayer's income, the percentage of the NOL that is eligible to be carried forward and the number of years it can be carried forward varies. State law also conforms to the limitations and prohibitions of NOL carryovers after a reorganization or other change in corporate ownership.

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, 100% of the NOL may be carried forward.

All deductions for NOLs for the 2002 and 2003 taxable years have been suspended. However, taxpayers may generate an NOL during the suspension that may be applied when the suspension is removed. The carryover period for NOLS incurred in taxable years before January 1, 2002, is extended by two years. The carryover period for NOLS incurred in taxable year 2002 is extended by one year. For taxable years beginning on or after January 1, 2004, the NOL carryover percentage will be 100% of the loss.

THIS BILL

This bill would allow a corporate taxpayer to sell any unused NOLs to another corporation.

IMPLEMENTATION CONSIDERATIONS

The following implementation concerns must be addressed before the department can implement this bill. Additional concerns may arise as the bill is further developed.

- It is unclear how requirements for special NOL treatment would apply to the purchasing corporation under certain circumstances. For example, 100% NOL deduction is allowed for taxpayers conducting activities within an enterprise zone. Must the purchasing corporation conduct activities within the zone to deduct the NOL?

- The bill does not specify whether the purchase of the NOL would impact the carry forward period. Without clarification, the department would assume that the remaining NOL carryover period for the selling corporation would apply to the purchaser. Clarification of this issue would prevent disputes between taxpayers and the department.

- The bill does not specify whether the sale of an NOL would be a tax-free transaction. Disputes may arise between taxpayers and the department as to the proper tax treatment of consideration paid for an NOL.

- It is unclear what would happen if a taxpayer sells an NOL and the NOL is partially or completely disallowed in a subsequent audit by the department. The bill should clarify the department's legal authority to adjust the tax liability of the purchaser and reclaim the NOL deduction amount, with interest, from the purchaser, especially if the seller is either no longer in existence or no longer subject to California's taxing jurisdiction. Moreover, since there may be occasion where the department's audit of the seller's return may occur after normal expiration of the statute of limitations (i.e., under a waiver), it might become necessary for the department to request waiver of the purchaser's statute of limitations to prevent the department from being foreclosed from adjusting the purchaser's tax liability when the department determines that part or all of the claimed NOL deduction should never have been allowed. Further, the department would need to be specifically authorized to disclose the necessary confidential tax information of the seller to the purchaser if such situation arose. Conversely, the purchaser would statutorily need authorization to obtain tax information from the seller about the circumstances surrounding their deduction of the NOL in order to defend a subsequent proposed adjustment by the department.

LEGISLATIVE HISTORY

AB 234 (Corbett, 2003/2004) would allow a special NOL for a taxpayer engaged in biopharmaceutical or other biotechnology business activities. This special NOL would allow a 100% deduction with a 20-year carryover

AB 743 (Mullin, 2003/2004) would allow corporations that incur NOLs from the development or marketing of biomedical products to transfer the NOL to another corporation.

AB 2065 (Oropeza, Stats. 2002. Ch. 488) suspended all NOL deductions for the 2002 and 2003 taxable years, extended the carryover period for the suspended years, and increased the carryover percentage to 100% for tax years beginning on or after January 1, 2004.

OTHER STATES' INFORMATION

The laws of *Florida, Illinois, Massachusetts, Michigan, and Minnesota* were reviewed because their tax laws are similar to California's income tax laws. It did not appear that any of these states allow corporations to sell NOLs to another corporation. The following is general information regarding NOLs provisions for these states:

Florida income tax law, with respect to corporations, provides a 20-year carryover period but no carryback, and otherwise conforms to federal NOL laws. *Florida* has no personal income tax.

Illinois income tax law conforms to federal law regarding NOLs.

Massachusetts income tax law does not allow NOL treatment for personal income taxpayers, but corporations are allowed a 100% NOL that applies to the first five years of the entity's existence.

Michigan income tax law conforms to federal NOL laws, including the allowance of NOL carrybacks for corporations. However, *Michigan's* personal income tax law does not allow NOL carrybacks.

Minnesota personal income tax law conforms to federal NOL laws, while corporate taxpayers determine NOLs pursuant to federal law but have no NOL carrybacks and only a 15-year carry forward period.

FISCAL IMPACT

The department's costs to administer this bill cannot be determined until implementation concerns have been resolved.

ECONOMIC IMPACT

<u>Revenue Estimate</u>

The potential revenue loss of this bill would be very significant, easily in excess of $1 billion per year beginning with fiscal year 2004/05.

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

<u>Revenue Discussion</u>

The potential revenue impact of this proposal would depend on the amount of accumulated NOLs sold, or exchanged in any given year for which more NOL deductions are claimed than would be allowed under current law.

Unused NOLs are estimated to be about $100 billion in 2002. With the suspension of NOLs in 2002 and 2003, and with 100% of NOLs allowed to be carried forward starting in 2004, unused NOLs are estimated to grow quickly to $190 billion in 2004. Allowing unused NOLs to be sold and used freely would affect the corporate tax liability to the point that corporations receiving NOLs would pay a much-reduced measured tax or only the minimum tax.

ARGUMENTS/POLICY CONCERNS

- The bill does not require that the NOL be sourced to California. Thus, a California corporation purchasing an NOL could claim an NOL deduction for losses incurred outside of California.

- Internal Revenue Code section 382, to which California conforms, has very stringent requirements regarding the utilization of NOLs following any "ownership change" of greater than 5%. These federal rules have evolved over the past 35 years in response to perceived trafficking in NOLs by corporations that have acquired loss corporations for the primary purpose of utilizing the locked NOL tax benefits inherent in such corporations. In contrast to that policy, this bill would sanction such trafficking in NOLs.

- The Joint Committee on Taxation on the subject of transferable NOLs has expressed concern that transferring or selling NOLs would effectively use the tax system to subsidize corporate losses. The Committee reasoned that the NOL provisions are intended to perform an averaging function by reducing the distortions caused by the annual account system. If, on the other hand, carryovers are transferred in a way that permits a loss to offset unrelated income, no legitimate averaging function is performed. With completely free transferability of tax losses, the carryover provisions become a mechanism for partial recoupment of losses through the tax system.

LEGISLATIVE STAFF CONTACT

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