Franchise Tax Board

ANALYSIS OF ORIGINAL BILL

Author:	Houston	Analyst:	Marion Mann DeJong	Bill Number:	AB 2192
Related Bills:	See Legislative History	Telephone:	845-6979	Introduced Date:	02/18/2004
		Attorney:	Patrick Kusiak	Sponsor:	

SUBJECT: NOL Deduction/Unused Losses of Bioscience Company May Be Sold To Another Bioscience Company

SUMMARY

This bill would allow certain bioscience corporations that incur net operating losses (NOLs) to sell the NOLs to other bioscience corporations that employ at least 500 bioscience employees in California.

PURPOSE OF THE BILL

According to the author's office, this bill is intended to allow California based bioscience companies engaged in research to convert unused NOLs to cash by selling the NOL deductions at a discount to another bioscience corporation.

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, 2004. However, the purchasing corporation could not deduct the NOL until the 2006 taxable year.

POSITION

Pending.

Summary of Suggested Amendments

Amendments are needed before the department can implement this bill. Please see "Implementation Considerations" below. Department staff is available to assist the author with any 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.

Board Position:			Department Director	Date
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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.

Generally, an NOL may be carried back or forward only by the taxpayer who sustained the loss. After a reorganization or other substantial change in corporate ownership of the taxpayer, the future use of NOL carry forwards may be limited or completely 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. For most taxpayers, 100% of the computed NOL may be carried forward for 10 years. State law also conforms to the limitations and prohibitions of NOL carryovers after reorganization or other change in corporate ownership.

All deductions for state NOLs for the 2002 and 2003 taxable years were suspended. However, taxpayers could generate an NOL during the suspension that could be applied in a future year after 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 is 100% of the loss. For the 2002 and 2003 taxable years, 60% of the computed NOL could be carried forward.

New businesses that are engaged in a trade or business activity that first commenced in California on or after January 1, 1994, are provided special NOL treatment. They are allowed to carry forward 100% of the NOL incurred during the first three years of business. This “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.

THIS BILL

This bill would allow a bioscience company to sell unused NOLs to a bioscience company that employs at least 500 employees in the bioscience field in California. The seller must be (1) based in California, and (2) spend at least 50% of its annual expenses for research and development relating to bioscience products.

The sale must be for at least 75% of the dollar amount of the NOL and may not exceed $10 million. Any revenues received by the seller for the sale of an NOL would be excluded from the gross income of the seller.

NOLs purchased by a buyer may be used only as deduction from gross income derived from bioscience products. The buyer must begin using the NOLs within five years of purchase.

The seller and buyer must apply to the Franchise Tax Board for the purchase and sale of unused NOLs.

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.

- The bill requires that the purchaser pay at least 75% of the NOL amount instead of 75% of the tax benefit of the NOL. Since a purchaser would be required to pay much more than the received tax benefit, it is unlikely that a taxpayer would purchase an NOL as provided under this bill. According to the author's staff, this bill will be amended to require the purchaser to pay at least 75% of the surrendered tax benefit, similar to what was required under Hawaii law.

- The bill prevents the seller from selling NOLs for less than 75% of the dollar amount, or for more than $10 million. It is unclear whether the $10 million limitation is an annual limit or an aggregate limit. This should be clarified to ensure that the bill is implemented as the author intends.

- The bill does not define "bioscience company," "bioscience field," "bioscience products" or "based in this state." Without these definitions, and in particular because the department lacks the necessary expertise to supply a definition for these terms, it cannot be determined if a sale of an NOL would qualify under this bill. In addition, undefined terms can lead to disputes between taxpayers and the department.

- This bill would require the qualified buyer to employ at least 500 employees in the bioscience field in California. However, the bill does not specify when this test must be met on the sale date, on an ongoing basis as the NOLs are applied, or something else, or whether the 500 employees must be retained.

- The bill would require the seller and buyer to apply to the department for the purchase and sale of an NOL. However, the bill does not specify what criteria the department is to use in approving or denying a sale. Also, although the bill allows for the sale of NOLs beginning on January 1, 2004, there are currently no procedures for processing and approving the purchases and the department could not approve sales immediately. The author might consider a delayed implementation date. The author might also want to consider an appeals process if an application is denied.

- Although the bill would limit the amount of NOL deduction the purchaser may use to offset gross income derived from bioscience products, the bill does not specify how to determine that amount. This may require taxpayers to make special calculations to separate income streams, perhaps similar to the calculation that is required for certain zone incentive provisions.

- It is unclear how requirements for special NOL treatment would apply to purchasing corporations 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 receive the NOL?

- The bill specifies that the purchaser must begin using the NOL within five years of purchase. However, the bill does not specify whether the sale of the NOL would impact the carry forward period. Without clarification, the department would assume that the remaining NOL carryover period for the seller corporation would apply to the purchaser. However, if this is not the intent, it is possible that a buyer could purchase an NOL with only three years remaining in its carryover period and possibly either get an extended new period, or be stuck with the three-year period remaining if the seller were to use the NOL itself. Clarification of this issue would prevent disputes between taxpayers and the department.

- Although the bill specifies that any revenue received by the seller on the sale of the NOL be excluded from gross income, it does not specify what basis (value) the NOL will have for the purchaser. If the buyer is to receive a basis in the NOL, then it might properly be required to amortize or otherwise recover that basis as the NOL is used, and since the NOL will be purchased at some discount to its face amount, the buyer might also be properly required to recognize as income the discount amount over some time period. Ultimately, disputes may arise between taxpayers and the department as to the proper tax treatment of any consideration paid in connection with the sale of an NOL under this bill. Further, the purchaser could claim a deduction for the purchase price of the NOL, providing a double tax benefit.

- 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 author should clarify whether the seller, purchaser, or both would be liable for any assessments resulting from adjustments to the NOL.

    - It is unclear how the provisions of this bill would apply to unitary groups. Normally, NOLs belong to the separate entities within the group. However, when defining a “qualified seller” and “qualified buyer” the bill does not specify whether it applies to the “taxpayer” buying or selling the NOL. This could allow a unitary group (or any singe member of that group) to purchase a NOL if any one affiliate is a “qualified buyer.”

LEGISLATIVE HISTORY

AB 2230 (Corbett, et. al., 2003/04) and SB 1572 (Alpert and Morrow, 2003/04) are identical bills, recently introduced, that would provide special tax benefits to life science companies, including the ability to sell unused NOLs to other life science companies.

AB 234 (Corbett, 2003/2004) would have allowed 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 234 failed to pass from the house of origin by the Constitutional deadline.

AB 743 (Mullin, 2003/2004) would allow corporations that have NOLs from the development or marketing of biomedical products to transfer the NOL to another corporation. AB 743 failed to pass from the house of origin by the Constitutional deadline.

AB 1654 (Houston, 2003/2004) would allow corporations to sell NOLs to another corporation.
AB 1654 failed to pass from the house of origin by the Constitutional deadline.

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.

SB 38 (Lockyer, Stats. 1996, Ch. 954) added taxpayers engaged in certain biopharmaceutical and other biotechnology business activities to the definition of "new businesses," allowing them the special NOL deduction of 100% for the first three years.

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 could not be determined if these states provide special NOL treatment for taxpayers engaged in biomedical activities.

The author provided information regarding *Hawaii* and *New Jersey* laws that allow certain companies to sell NOLs.

Hawaii allowed certain high technology businesses, including biotechnology businesses, to sell unused NOL carryovers to other taxpayers. The Department of Taxation approved all sales. Sales were allowed from January 1, 2001 to December 31, 2003.

New Jersey allows new or expanding technology and biotechnology businesses to sell unused NOLs to any corporate taxpayer. The New Jersey Economic Development Authority annually approves these sales.

FISCAL IMPACT

The department's costs to administer this bill cannot be determined until the department's implementation concerns have been resolved. If the department is required to implement a sales approval process there could be significant costs depending upon the level of audit and approval activity required prior to approving of the sale.

ECONOMIC IMPACT

<u>Revenue Estimate</u>

The revenue impact of this measure, under the assumptions discussed below, is estimated to be as follows:

Revenue Impact of AB 2192 (2/18,2004) Tax Years Beginning On or After 1/1/2004 Enactment Assumed After June 30, 2004 $ Millions				
	2004-05	2005-06	2006-07	2007-08
Revenue Impact	-2	-26	-90	-104

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

Revenue Discussion

The revenue impact of this bill was estimated using a micro-simulation model as follows. Total available stocks of unused NOLs for tax years 2004 and beyond, as well as state net incomes of eligible bioscience corporations were projected. The following assumptions were made in the estimation of the revenue impact:

- A relatively small percentage (10%) of qualified losses would be purchased in 2004 but increasing percentages thereafter. This is because some qualified sellers would not be willing to sell their NOLs because of the expectation that they may be able to use them in future years when products are marketed.
- Similarly, some qualified buyers would not be willing to buy NOLs in 2004 because of uncertainty about having enough income in the future to use them. Moreover, the buyers face the risk that in the future NOL deductions may once again be suspended.
- For similar reasons it was assumed that no more than 50% of the qualified NOLs would be sold in 2005.
- Since beginning January 1, 2006, qualified buyers can use the purchased NOLs in the year of purchase, there would be little uncertainty about the amount of usage on their part. The qualified buyers would, therefore, be willing to buy all the NOLs they could use. Some qualified sellers, on the other hand, may expect to use the NOLs themselves in future years. For this reason it was assumed that 70% of qualified NOLs would be sold in 2006 and beyond.
- Buyers would be able to deduct the amounts paid to purchase NOLs in the year of the purchase.
- The buyers would be willing to pay 90% of the benefits they derive from the qualified NOLs. The benefits were defined as the reduction in tax liability resulting from the purchase.
- Qualified buyers would be able to carry unused NOLs forward to subsequent years.
- It is projected, for example, that the amount of purchased NOLs available for deduction in 2006 would be about $1.3 billion.

LEGAL IMPACT

The requirements that the seller be "based in California" and that the purchaser have 500 employees in California could be a violation of the federal commerce clause.

ARGUMENTS/POLICY CONCERNS

- This bill would provide a tax benefit for certain bioscience corporations that would not be provided to other bioscience business entities (e.g., noncorporate partners of partnerships, limited partnerships). Thus, this bill would provide differing treatment based solely on classification or form of organization.

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

- The bill would allow the sales of NOLs between affiliated taxpayers.

- The bill would allow unlimited sales of the same NOL.

- This bill would create federal/state differences with respect to the NOL and the reporting of income or expenses from the sale of the NOL. This conflicts with the general policy of federal/state conformity.

- 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 specifically permit such trafficking in NOLs.

- The Congressional 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 accounting system for any particular taxpayer. 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

Marion Mann DeJong
Franchise Tax Board
845-6979
marion.dejong@ftb.ca.gov

Brian Putler
Franchise Tax Board
845-6333
brian.putler@ftb.ca.gov