

ANALYSIS OF AMENDED BILL

Author: Houston Analyst: Gail Hall Bill Number: AB 2270

Related Bills: See Legislative History Telephone: 845-6111 As Introduced And Amended Dates: March 30, 2006 & April 6, 2006

Attorney: Patrick Kusiak Sponsor: _____

SUBJECT: NOL Deduction/100% Deduction For Biopharmaceutical & Biotechnology Business Activities

SUMMARY

This bill would provide personal income taxpayers (PITL) and corporate taxpayers (CTL) a longer period to deduct losses incurred from certain biopharmaceutical and other biotechnology (bioscience) business activities.

PURPOSE OF THE BILL

The author's staff has indicated that the purpose of the bill is to provide taxpayers engaged in bioscience business activities tax relief to enhance the state's economy by retaining existing companies, attracting new companies, and creating new high paying jobs.

SUMMARY OF AMENDMENTS

The April 6, 2006, amendments removed the language as introduced on March 30, 2006, that would have allowed bioscience corporations to sell their net operating losses (NOLs). The amendments added a new NOL for taxpayers engaged in bioscience business activities and changed the new business definition to utilize a different industry index.

On March 30, 2006, the bill as introduced would have allowed certain bioscience corporations with NOL carryovers to sell the NOLs to other bioscience corporations that employ at least 500 bioscience employees in California.

EFFECTIVE/OPERATIVE DATE

As a tax levy, this bill would become effective immediately upon enactment and would specifically apply to net operating losses incurred in taxable years beginning on or after January 1, 2007.

POSITION

Pending.

Board Position:

<input type="checkbox"/> S	<input type="checkbox"/> NA	<input type="checkbox"/> NP
<input type="checkbox"/> SA	<input type="checkbox"/> O	<input type="checkbox"/> NAR
<input type="checkbox"/> N	<input type="checkbox"/> OUA	<input checked="" type="checkbox"/> PENDING

Department Director

Date

S. Stanislaus

5/2/06

ANALYSIS

Federal Law

When a taxpayer has a net taxable loss for the tax year, the net taxable loss is called an NOL. An NOL occurs when a taxpayer's allowed deductions exceed their gross income for that year. Federal law provides, in general, that an NOL can be carried back two years and forward 20 years and deducted. Special rules are provided for the carryback of NOLs relating to issues such as specified liability losses, casualty or theft losses, disaster losses of a small business, and farming losses.

State Law

In general, California determines its NOL in accordance with federal rules. One difference is that California does not allow the carryback of NOLs. Depending on the type of taxpayer or amount of a taxpayer's income, the amount of NOL that is eligible to be carried forward and the numbers of years it can be carried forward will vary.

The taxpayer must make an election from the following list as to the type of NOL the taxpayer has incurred.

Existing state law provides for the following types of NOLs:

Type of NOL and Description	NOL % Allowed To Be Carried Over	Carryover Period
General NOL	100%	10 Years
New Business NOL	100%	10 Years
Eligible Small Business	100%	10 Years
Specified Disaster Loss	100%	15 Years
Economic Development Areas	100%	15 Years

The general NOL rules define "new business" to also include bioscience activities as described in the Standard Industrial Classification (SIC) Manual. As shown in the table above, the "new business" is entitled to 100 percent of the loss and a carryover period of 10 years.

THIS BILL

This bill would add a second type of NOL specific to bioscience activities of a qualified taxpayer. This new NOL would have a 20-year carryover period. A "qualified taxpayer" would be defined as

a taxpayer engaged in bioscience activities described in Codes 325411 to 325414 and 541710 of the NAICS (2002 edition and as further amended), that has not yet received regulatory approval for any product from the United States Food and Drug Administration (FDA). See Appendix A for a description of the NAICS codes used in the definition of a qualified taxpayer.

In addition, this bill would amend the existing law Bioscience new business NOL, with a current carryover period of 10 years, by changing the definition of a “new business” to mean any taxpayer engaged in bioscience activities described in NAICS codes 325411 to 325414 and 541710 instead of current law’s definition that references codes 2833 to 2836 described in the Standard Industrial Classification (SIC) Manual.

IMPLEMENTATION CONSIDERATIONS

Implementing this bill would not significantly impact the department’s programs and operations.

TECHNICAL CONSIDERATIONS

The department has identified the following technical considerations. Department staff is available to work with the author’s office to resolve these and other concerns that may be identified.

1. It is unnecessary to provide an NOL with a 10-year carryover for new bioscience businesses when current law provides a 10-year carryforward for all taxpayers. In addition, providing two different types of NOLs for the bioscience companies may cause confusion for taxpayers as to which type of NOL to elect. The author should consider removing the NOL for new bioscience activities for taxable years on or after January 1, 2007. (See attached Amendments 1 to 4).
2. The effective date language of the bill should be amended to be consistent with other NOL Code sections. (See attached Amendments 5 and 6).

LEGISLATIVE HISTORY

AB 234 (Corbett, 2003/2004) would have allowed a 20-year carryover for a taxpayer engaged in biopharmaceutical or other biotechnology business activities similar to this bill. AB 234 did not pass both houses by the constitutional deadline.

SB 38 (Lockyer, Stats. 1996, Ch. 954), under the general NOL statute, included in the definition of new businesses “taxpayers engaged in certain biopharmaceutical and other biotechnology business activities.”

OTHER STATES’ INFORMATION

The states surveyed include *Florida, Illinois, Massachusetts, Michigan, Minnesota, and New York*. These states were selected due to their similarities to California’s economy, business entity types, and tax laws. These states lack provisions allowing bioscience corporations to carryover NOLs for

20 years. Listed below is a summary of the general NOL carryback and carryover periods for these states:

	<u>Carryback</u>	<u>Carryforward</u>
<i>Florida</i>	None	20 years
<i>Illinois</i>	None	12 years
<i>Massachusetts</i>	None	5 years
<i>Michigan</i>	***No NOL Allowed***	
<i>Minnesota</i>	None	15 years
<i>New York</i>	2 years	20 years

FISCAL IMPACT

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

ECONOMIC IMPACT

Revenue Estimate

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

Revenue Impact of AB 2270 Enactment Assumed After June 30, 2006 \$ (Millions)				
	2006-7	2007-8	2008-9	2017-18
Revenue Impact	\$0	\$0	\$0	*

* This bill would result in revenue losses beginning in 2018 fiscal year.

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

Revenue Discussion

Under current PITL and CTL, taxpayers may carryover 100 percent of their NOLs for 10 years. Under this bill, for losses incurred on or after January 1, 2007, the carryover period for NOLs would be increased from 10 years to 20 years for bioscience taxpayers that have not received regulatory approval for any product from the FDA. There would be no revenue impact until 2018, because under current law, losses incurred in 2007 could be carried forward 10 years to 2017 and would expire in 2018. Using company-level data and a micro-simulation model, it was estimated that \$5 million of NOLs generated in 2007 would expire in 2018. If this bill became law, the \$5 million of NOLs could be deducted in 2018. Using an estimated tax rate of 5 percent, the revenue impact for 2018 would be a revenue loss of \$250,000 (5% x \$5 million).

The amount of NOLs that may be carried forward and deducted in future years would increase in subsequent years as losses generated in 2008 and beyond become usable. Taking into account the losses generated after 2007, the sum of all the losses carried forward would reach a maximum of about \$25 million per year in 2027. Assuming firms without products that have been approved by the Food and Drug Administration generate 80 percent of these losses, the maximum revenue loss would reach approximately \$1 million per year in 2027. ($\$25 \text{ million} \times 80\% \times 5\%$).

LEGISLATIVE STAFF CONTACT

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APPENDIX A
QUALIFIED TAXPAYER DEFINITION
NAICS

AB 2270

NAICS 325411 – Medicinal and Botanical Manufacturing:

This industry comprises of establishments primarily engaged in (1) manufacturing uncompounded medicinal chemicals and their derivatives (i.e., generally for used by pharmaceutical preparation manufacturers) and/or (2) grading, grinding, and milling uncompounded botanicals.

NAICS 325412 – Pharmaceutical Preparation Manufacturing:

This industry comprises of establishments primarily engaged in manufacturing in-vivo diagnostic substances and pharmaceutical preparations (except biological) intended for internal and external consumption in dose forms, such a ampoules, tablets, capsules, vials, ointments, powders, solutions, and suspensions.

NAICS 325413 – In-Vitro Diagnostic Substance Manufacturing:

This industry comprises of establishments primarily engaged in manufacturing in-vitro (i.e., not taken internally) diagnostic substances, such as chemical, biological, or radioactive substances. The substances are used for diagnostic test that are performed in test tubes, Petri dishes, machines, and other diagnostic test-type devices.

NAICS 325414 – Biological Product (except Diagnostic) Manufacturing:

This industry comprises of establishments primarily engaged in manufacturing vaccines, toxoids, blood fractions, and culture media of plant or animal origin (except diagnostic).

NAICS 541710 – Research and development in the Physical, Engineering, and Life Sciences:

This industry comprises of establishments primarily engaged in conducting research and experimental development in the physical, engineering, and life sciences, such as agriculture, electronics, environmental, biology, botany, biotechnology, computers, chemistry, food, fisheries, forests, geology, health, mathematics, medicine, oceanography, pharmacy, physics, veterinary, and other allied subjects.

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FRANCHISE TAX BOARD'S
PROPOSED AMENDMENTS TO AB 2270
As Amended April 6, 2006

AMENDMENT 1

On page 7, strikeout lines 30 to 38.

AMENDMENT 2

On page 7, line 40, strikeout "(C)" and insert:

(B)

AMENDMENT 3

On page 15, strikeout lines 4 to 12.

AMENDMENT 4

On page 15, line 14, strikeout "(C)" and insert:

(B)

AMENDMENT 5

On Page 9, lines 15 to 18, make the following changes:

(d) This section shall only apply to net operating losses incurred by a qualified taxpayer as a net operating loss ~~that occurred during the~~ in taxable years beginning on or after January 1, 2007.

AMENDMENT 6

On page 16, lines 30 to 33, make the following changes:

(d) This section shall only apply to net operating losses incurred by a qualified taxpayer as a net operating loss ~~that occurred during the~~ in taxable years beginning on or after January 1, 2007.