Franchise Tax Board

SUMMARY ANALYSIS OF AMENDED BILL

Author:	Houston	Analyst:	Gail Hall	Bill Number:	AB 2270
Related Bills:	See Legislative History	Telephone:	845-6111	Amended Date:	April 25, 2006
		Attorney:	Patrick Kusiak	Sponsor:	

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

SUMMARY

This bill would provide a taxpayer involved in certain biopharmaceutical and other biotechnology (bioscience) business activities the following:

- A longer period to deduct losses incurred from bioscience business activities for a personal income taxpayer (PITL) and corporate taxpayer (CTL).
- A new rule that would allow a bioscience corporation based in California to sell NOLs to another bioscience corporation that employs at least 500 employees in California.

SUMMARY OF AMENDMENTS

The April 25, 2006, amendments added new provisions allowing certain corporations that are bioscience companies with unused NOLs to sell these NOLs to any company with income derived from bioscience products that employs at least 500 employees in California.

Except for the discussion in this analysis, the remainder of the department's analysis of the bill as amended April 6, 2006, still applies. The technical considerations and proposed amendments discussed in the analysis of the bill as amended April 6, 2006, are included in the Technical Considerations section of this analysis for convenience.

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.

Board Position:			Legislative Director	Date
_______ S	_______ NA	_______ NP	Brian Putler	5/3/06
_______ SA	_______ O	_______ NAR		
_______ N	_______ OUA	___X___ PENDING		

EFFECTIVE/OPERATIVE DATE

As a tax levy, this bill would become effective immediately upon enactment and would apply as follows:

1. The April 6, 2006, amendments adding a new bioscience NOL with a 20-year carryover and changing the definition of a new bioscience activity would specifically apply to net operating losses incurred in taxable years beginning on or after January 1, 2007.

2. The amendments adding provisions allowing bioscience corporations to sell NOLs would be operative for taxable years beginning on or after January 1, 2007; however, the purchasing corporation could not deduct the NOL until taxable years beginning on or after January 1, 2009.

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 amendments.

ANALYSIS

FEDERAL/STATE LAW

The following supplements the State Law discussion in the analysis of the bill as amended April 6, 2006.

Internal Revenue Code (IRC) Section 382 was added to the Internal Revenue Code in 1954 to guard against "trafficking of NOL carryovers." When a corporation acquires another corporation with NOLs, IRC Section 382 limits the amount of acquired NOL the buyer may deduct on its tax return each year. The purpose of this rule is to make NOLs a neutral factor in a corporate acquisition. Prior to the limitation, corporations with large NOLs were being purchased by corporations with large taxable incomes simply because the acquired corporation's NOLs could be used to reduce the buyer's taxable income.

Current federal and state law lacks provisions that allow a corporation to sell an NOL to another corporation.

THIS BILL

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

The sale of the unused NOLs 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 should be addressed so the department can implement the bill. Additional concerns may arise as the bill is further developed.

1. The amendments would prevent a sale of NOLs for an amount 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 per seller or per buyer or both. It is also unclear whether the $ 10 million limitation is an aggregate limit per seller or per buyer or both. These items should be clarified to ensure that the department is able to implement these provisions as the author intends.

2. The amendments lack definitions of “bioscience company,” “bioscience products,” or “based in this state.” Without these definitions, and in particular because the department lacks the necessary expertise and clear legal authority (via a legislative rulemaking delegation) to supply an enforceable definition for these terms, it cannot be determined if a sale of an NOL would qualify. In addition, undefined terms can lead to disputes between taxpayers and the department.

3. The amendments would require the qualified buyer to employ at least 500 employees in California; however, the amendments are silent about whether 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 after the purchase or are simply measured on the purchase date. The 500 employee requirement in particular would be difficult to measure if a date other than an EDD quarterly filing date were used because the number of employees in large corporations is a constantly changing amount.

4. The amendments would require the seller and buyer to apply to the department for the purchase and sale of an NOL. However, the amendments lack a grant to the department of authority to create rules or specify what criteria the department is to use in approving or denying a sale. This may result in disputes between the department, taxpayers, Board of Equalization, and the courts. In addition, although the amendments allow for the sale of NOLs beginning on January 1, 2007, 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.

5. Although the amendments would limit the amount of NOL deduction the purchaser may use to offset gross income derived from bioscience products, the amendments lack specificity about how to determine that amount. This may require corporations to make special calculations to separate income streams, perhaps similar to the calculation that is required for certain enterprise zone incentive provisions.

6. The amendments specify that the purchaser must begin using the NOL within five years of purchase; however, the amendments lack specificity about 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. 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.

7. Although the amendments specify that any sale proceeds received by the seller on the sale of the NOL be excluded from gross income, it lacks specifics for 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 because 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.

8. It is unclear what would happen if a corporation sells an NOL and the NOL is partially or completely disallowed in a subsequent audit by the department. It is recommended that the language clarify whether the seller or purchaser or both would be liable for any assessments resulting from adjustments to the NOL.

9. It is unclear how the amendments would apply to unitary groups. Normally, NOLs belong to the separate entities within the group. When defining a “qualified seller” and “qualified buyer” the bill lacks specifics on whether it applies to the “taxpayer” buying or selling the NOL. The present language could allow a unitary group (or any single member of that group) to purchase an NOL if any one affiliate is a “qualified buyer.”

TECHNICAL CONSIDERATIONS

The department has identified the following technical considerations as discussed in the analysis of the bill as amended April 6, 2006. 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).

   The amendments would allow unlimited sales of the same NOL. If this is not the intent of the author, amendments would be necessary.

LEGISLATIVE HISTORY

The following supplements the Legislative History discussion in the analysis of the bill as amended April 6, 2006.

AB 2230 (Corbett, et. al., 2003/04) and SB 1572 (Alpert and Morrow, 2003/04) were identical bills that would have provided special tax benefits to life science companies, including the ability to sell unused NOLs to other life science companies. AB 2230 and SB 1572 were held in their respective appropriation committees.

AB 743 (Mullin, 2003/2004) would have allowed 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 have allowed corporations to sell NOLs to another corporation. AB 1654 failed to pass from the house of origin by the Constitutional deadline.

OTHER STATES' INFORMATION

The following supplements the Other States' Information discussion in the analysis of the bill as amended April 6, 2006.

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 taxpayers to sell NOLs to other bioscience taxpayers.

New Jersey allows high-technology companies to trade NOLs and research and development tax credits to other entities through a certificate program in exchange for private financial assistance from the entity acquiring the surrendered tax benefits. The New Jersey Economic Development authority is authorized to approve the transfer of no more than $60 million for fiscal years on or after 2005.

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.

FISCAL IMPACT

The department's costs to administer the amendments 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 approval of the sale.

ECONOMIC IMPACT

Revenue Estimate

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

Revenue Impact of AB 2270 (Extending the Carryover Years to 20/Sale of NOLs) Enactment Assumed After June 30, 2006 $ (Millions)				
	2006-7	2007-8	2008-9	2017-18
Revenue Impact	$0	$0	$0	*

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

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

Revenue Discussion

NOL – 20-Year Carryover

Under current PITL and CTL, taxpayers may carry over 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 million x 80% x 5%).

<u>Sale of NOLs</u>

This amendment would allow a bioscience company to sell its unused net operating losses (NOLs) to a qualified buyer beginning on or after January 1, 2007. The qualified buyer would be able to use these NOLs beginning on or after January 1, 2009. A qualified buyer is defined as any company that employs 500 or more employees in California. Any purchased NOL may be used only as a deduction against income derived from bioscience products.

The sale of the unused NOLs must be for at least 75 percent of the dollar amount of the NOL and may not exceed $10 million. Because the buyer would be required to pay 75 percent of the dollar amount of the NOL, but receive a much smaller tax benefit from deducting the NOL, it is determined that no company would be willing to purchase these unused NOLs from other companies (See the Arguments/Policy Concerns section below for further discussion). Therefore, this portion of the proposed amendment would have no revenue impact.

LEGAL IMPACT

The requirement that the purchaser have 500 employees in California may be subject to constitutional challenge. The U.S. Court of Appeals for the 6th Circuit ruled in *Cuno v. DaimlerChrysler, Inc.* (2004) 386 F. 3d 738 that Ohio's Investment Tax Credit is unconstitutional because it gives improper preferential treatment to companies to locate or expand in Ohio rather than in other states and, therefore, violates the Commerce Clause of the U.S. Constitution. The U.S. Supreme Court is currently reviewing this case. The Court will issue its decision on this case by the end of June, 2006. Although the outcome of this decision and its affects on the income tax incentives of other states, including California, is unknown, targeted tax incentives that are conditioned on activities in California may be subject to constitutional challenge.

In addition, the requirement that the seller be "based in California" may be subject to constitutional challenge because it favors California based companies over companies based in other states. In *Farmer Bros.Co. v. Franchise Tax Board*, 108 Cal App 4th 976 (2003) the California Court of Appeal found that the dividend deduction allowed under state law discriminated against interstate commerce in violation of the Commerce Clause of the United States Constitution because it favored in-state investment by taxing out-of-state investments at a higher rate.

ARGUMENTS/POLICY CONCERNS

1. The amendments would require that the purchaser pay at least 75% of the NOL amount instead of 75% of the tax benefit of the NOL. Because a purchaser would be required to pay much more than the received tax benefit, it is unlikely that a corporation would purchase an NOL as provided under the amendments. For example:

   If a seller has an unused NOL carryover of $1,000,000, a qualified buyer must pay at least $750,000 for the NOL. The tax benefit the buyer, subject to the 8.84% corporate tax rate, would receive from the purchased NOL would equal $66,300 ($750,000 x 8.84%). It is unlikely a buyer would pay $750,000 for an NOL to receive a $66,300 tax benefit.

2. The amendments would provide a tax benefit for certain bioscience corporations that would exclude other bioscience business entities (e.g., noncorporate partners of partnerships, limited partnerships). Thus, the amendments would provide differing treatment based solely on classification or form of organization.

3. The amendments would create federal/state differences because the seller would be required to report the income from the sale of the NOL on the federal corporate tax return, but not the state tax return. This conflicts with the general policy of federal/state conformity.

4. Internal Revenue Code Section 382, to which California conforms, has 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 long-standing federal policy, to which California has long conformed, the amendments would specifically permit such selling in NOLs.

5. 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.

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FRANCHISE TAX BOARD'S
PROPOSED AMENDMENTS TO AB 2270
As Amended April 25, 2006

AMENDMENT 1

On page 7, strikeout lines 21 to 29.

AMENDMENT 2

On page 7, line 30, strikeout "(C)" and insert:

(B)

AMENDMENT 3

On page 14, strikeout lines 31 to 39.

AMENDMENT 4

On page 15, line 40, strikeout "(C)" and insert:

(B)

AMENDMENT 5

On Page 9, revise lines 5 to 8 as follows:

(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, revise lines 17 to 20 as follows:

(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.