Franchise Tax Board

SUMMARY ANALYSIS OF AMENDED BILL

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

Related Bills: See Prior Analysis | Telephone: 845-6111 | Amended Date: May 3, 2006

Attorney: Patrick Kusiak | Sponsor:

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

____ DEPARTMENT AMENDMENTS ACCEPTED. Amendments reflect suggestions of previous analysis of bill as introduced/amended ________________.

X AMENDMENTS IMPACT REVENUE. A new revenue estimate is provided.

X AMENDMENTS RESOLVE A PORTION OF THE DEPARTMENTS CONCERNS stated in the previous analysis of bill as amended April 25, 2006.

X FURTHER AMENDMENTS NECESSARY.

____ DEPARTMENT POSITION CHANGED TO ________________.

X REMAINDER OF PREVIOUS ANALYSIS OF BILL AS AMENDED April 25, 2006, STILL APPLIES.

X OTHER – See comments below.

SUMMARY

This bill would provide taxpayers subject to the Personal Income Tax Law (PITL) and the corporate Tax Law (CTL) involved in certain biopharmaceutical and other biotechnology (bioscience) business activities the following:

- A longer period to deduct losses incurred from bioscience business activities for PITL and CTL taxpayers.
- A new rule under the CTL that would allow a bioscience company based in California to sell NOLs to another bioscience company that employs at least 500 employees in California.

SUMMARY OF AMENDMENTS

The May 3, 2006, amendments made the following changes to the bill:

- Established additional criteria for the Franchise Tax Board (FTB) to utilize when approving bioscience company applications to sell and purchase NOLs, and authorized the FTB to

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require the company to substantiate the requirements in a manner and form determined by the FTB.

- Clarified that it is the “tax value” of the NOL that is sold and subject to the limitations required in the bill.
- Provided a $100 million maximum cap on the aggregate amount of NOLs, based on tax value, which may be sold annually by all qualified bioscience companies.
- Limited the amount of NOL, based on tax value, a qualified seller may sell each taxable year.
- Required the qualified seller and the qualified buyer to pay a $1,000 application fee to the Franchise Tax Board at the time of the application, and gives the FTB the authority to determine and refine user fees for processing applications.

POSITION

Pending.

ANALYSIS

THIS BILL

This bill would provide the following:

- Add a second type of NOL specific to bioscience activities of a qualified taxpayer. This additional 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.
- 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.
- Add a provision to the CTL that would authorize a qualified seller to sell unused NOLs to a qualified buyer. A qualified buyer means any company that employs 500 or more employees in California. A qualified seller means a bioscience company that satisfies the following:
    1. Is based in the state.
    2. Has at least 50 percent of its annual expenditures related to bioscience products.
    3. Substantiates in a form and manner required by FTB the following:
        - The qualified seller, at the time it submits its application to FTB, must have had negative profits relating to product sales for any years in the last five years.

- Is headquartered or incorporated in California.
- Has raised 400 percent of the tax value of the proposed NOL sale from public or private funding sources in the prior 24 months.

- Provides that the maximum tax value of unused NOLs that may be sold by all qualified sellers each taxable year is $100 million. Each qualified seller may only sell unused NOLs with a tax value of $10 million or less for each taxable year.
- Provides that a qualified seller and buyer would be required to submit applications to FTB for the sale of unused NOLs. The bill authorizes FTB to administer the application process, and requires the qualified seller and buyer to pay to FTB a $1,000 application fee. The bill authorizes FTB to determine and refine user fees for processing applications.
- Provides that the qualified seller must sell the unused NOLs to the qualified buyer for at least 75% of the NOL's tax value. In addition, the gross sales proceeds received by the qualified seller from the NOL sale would be excluded from the gross income of the qualified seller.
- Provides that a qualified buyer may only deduct the purchased NOL against gross income derived from bioscience products. The qualified buyer would be required to begin using the NOLs within five years of purchase.

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 bill lacks a limitation on the amount of NOL a qualified buyer may purchase each year. If this is the intent of the author, no amendment is needed.

2. The bill lacks definitions of "bioscience company," "bioscience products," "tax value," "positive net income from product sales," and "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 bill 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 bill would allow for the sale of NOLs beginning on January 1, 2007, but the department lacks procedures for processing and approving the applications 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. The bill would limit the amount of NOL deduction the qualified buyer may use to offset gross income derived from bioscience products, but the bill lacks 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 bill would specify that the qualified buyer must begin using the NOL within five years of purchase; however, the bill 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 qualified seller would apply to the qualified buyer. If this is not the intent, it is possible that a qualified 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 qualified seller were to use the NOL itself. Clarification of this issue would prevent disputes between taxpayers and the department.

7. The bill would specify that any sale proceeds received by the qualified seller on the sale of the NOL be excluded from gross income, but the bill 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. The bill is unclear on what would happen if a company 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 qualified seller or qualified buyer or both would be liable for any assessments resulting from adjustments to the NOL.

9. The bill is unclear on how its provisions 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.”

10. The bill provides that the qualified seller and buyer would submit applications to FTB, but it is unclear how FTB would administer the approval process if several applications were submitted. Would the applications be prioritized on a first come, first serve basis? Would FTB use a prorata method if several applications are submitted and the $100 million annual cap is exceeded?

11. The provisions allowing a bioscience company to sell an unused NOL only appear in the CTL. However, the present language could be interpreted to apply to the sale on unused NOLs by any bioscience company, including those subject to tax under the PTL (such as sole proprietorships).

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).

3. The bill establishes an annual $100 million limit on the total tax value of NOLs sold by all qualified sellers, but establishes a time frame limit by referring to "each taxable year." Therefore, this limitation could not be implemented. This bill should be revised to establish the limit for a fixed 12-month period such as a calendar year or the State's fiscal year.

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

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 and subsequent 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 (Sale of NOLs) Enactment Assumed After June 30, 2006 ($ Millions)					
	2006-7	2007-8	2008-9	2009-10	
Sale of Unused NOLs	$0	$2	-$90	-$190	

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

The revenue impact of creating an NOL with a 20-year carryover would be a negligible revenue loss of less than $250,000 beginning in fiscal year 2017/2018.

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 FDA 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%).

Sale of NOLs

Using company-level data on the net incomes of bioscience corporations the projected tax value of unused NOLs in 2007 exceeded the $100 million limitation. Therefore, the tax value for this year was constrained to equal $100 million. The amount of unused NOLs that exceeded the tax value of $100 million was assumed to be available for sale in subsequent years. Additionally, the amount of unused NOLs that were not sold in 2007 due to the 10% limitation were assumed to be carried forward and used in subsequent years. The tax value was calculated using the statutory 8.84 percent tax rate for corporations. The tax values of NOLs carried forward plus the total tax values generated in subsequent years were projected to exceed $100 million for both 2008 and 2009. Therefore, these numbers were also constrained to equal $100 million. Qualified buyers, therefore, would accumulate $300 million of NOLs purchased in 2007, 2008, and 2009 that could be potentially used in 2009.

It was assumed that 80 percent of the NOLs purchased in 2007, 2008, and 2009 by qualified buyers would be used in 2009 and the remaining 20 percent in 2010, for a total revenue loss of $300 million. In addition, it was assumed that a very small percentage of the NOLs purchased could have been used by the seller if not sold. These amounts represent revenue gains of $2 million in 2007/2008, $3 million in 2008/2009, and $1 million in 2009/2010. These gains offset the $300 million of revenue losses and then applied on a fiscal year basis to determine the revenue impact summarized in the chart above.

Revenue gains from the fees would be minor (less than $100,000).

LEGAL IMPACT

The requirement that the qualified buyer 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", "incorporated", or "headquartered" 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. C corporations, S corporations, and bank and financial corporations all have different tax rates. Without a clear definition for "tax value," it is unclear whether tax value would be based on the qualified seller's tax rate or the qualified buyer's tax rate. The tax value may be calculated differently by each of these types of corporations.

2. Assuming the sale of unused NOLs is limited to corporations, the bill would provide a tax benefit for certain bioscience corporations that would exclude other bioscience business entities (e.g., noncorporate partners of partnerships, limited partnerships, sole proprietorships). Thus, the bill would provide differing treatment based solely on classification or form of organization.

3. The bill 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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