

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 11, 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 _____.
- AMENDMENTS IMPACT REVENUE. A new revenue estimate is provided.
- AMENDMENTS DID NOT RESOLVE THE DEPARTMENTS CONCERNS stated in the previous analysis of bill as amended May 3, 2006.
- FURTHER AMENDMENTS NECESSARY.
- DEPARTMENT POSITION CHANGED TO _____.
- REMAINDER OF PREVIOUS ANALYSIS OF BILL AS AMENDED MAY 3, 2006, STILL APPLIES.
- 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 11, 2006, amendments removed the requirement that the qualified seller and the qualified buyer pay a \$1,000 application fee to the Franchise Tax Board (FTB) at the time of the application for the sale of unused NOLs and deletes the authority given to FTB to set such fees.

Board Position:	Legislative Director	Date
<input type="checkbox"/> S	Brian Putler	5/19/06
<input type="checkbox"/> NA		
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<input checked="" type="checkbox"/> PENDING		

Except for the discussion in this analysis, the remainder of the department's analysis of the bill as amended May 3, 2006, still applies. The implementation considerations, technical considerations, and arguments/tax policy concerns as discussed in the analysis as amended May 3, 2006, are repeated for convenience.

POSITION

Pending.

ANALYSIS

IMPLEMENTATION CONSIDERATIONS

The following implementation concerns should be addressed so the department can implement the bill. Department staff is available to work with the author's office to resolve these and other concerns that may be identified.

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 lacks 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 be interpreted to 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 pro rata 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).

12. 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.

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 operative 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.

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 (\$ in 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.

The following supplements the revenue discussion in the ECONOMIC IMPACT section of the analysis of the bill as amended May 3, 2006.

Revenue Discussion

The May 11, 2006, amendments removed the requirement that the qualified seller and the qualified buyer pay a \$1,000 application fee to FTB at the time of the application for the sale of unused NOLs. The minor revenue gains from the fees (less than \$100,000) discussed in the analysis of the bill as amended May 3, 2006, no longer applies.

LEGAL IMPACT

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. 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.
2. 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.
3. 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.
4. 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

Gail Hall
Franchise Tax Board
(916) 845-6111
gail.hall@ftb.ca.gov

Brian Putler
Franchise Tax Board
(916) 845-6333
brian.putler@ftb.ca.gov

Analyst Gail Hall
Telephone # 916-845-6111
Attorney Patrick Kusiak

FRANCHISE TAX BOARD'S
PROPOSED AMENDMENTS TO AB 2270
As Amended May 11, 2006

AMENDMENT 1

On page 7, strikeout lines 26 through 34, inclusive.

AMENDMENT 2

On page 7, line 35, strikeout "(C)" and insert:

(B)

AMENDMENT 3

On page 14, strikeout lines 36 through 40, inclusive, and on page 15, strikeout lines 1 through 4, inclusive.

AMENDMENT 4

On page 15, line 5, strikeout "(C)" and insert:

(B)

AMENDMENT 5

On Page 9, revise lines 9 through 12 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 22 through 25 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.