Franchise Tax Board

SUMMARY ANALYSIS OF AMENDED BILL

Author: Florez/Ashburn Analyst: Nicole Kwon Bill Number: SB 923

Related Bills: See Prior Analysis Telephone: 845-7800 Amended Date: June 15, 2005

Attorney: Patrick Kusiak Sponsor:

SUBJECT: Special NOL Losses Sustained On Or After January 1, 2005 As A Result Of The West Nile Virus

____	DEPARTMENT AMENDMENTS ACCEPTED. Amendments reflect suggestions of previous analysis of bill as amended ________.
X	AMENDMENTS IMPACT REVENUE. A new revenue estimate is provided.
____	AMENDMENTS DID NOT RESOLVE THE DEPARTMENTS CONCERNS stated in the previous analysis of bill as introduced/amended ________.
____	FURTHER AMENDMENTS NECESSARY.
____	DEPARTMENT POSITION CHANGED TO ________.
X	REMAINDER OF PREVIOUS ANALYSIS OF BILL AS AMENDED March 29, 2005, STILL APPLIES.
X	OTHER – See comments below.

SUMMARY

This bill would allow taxpayers special tax treatment for losses sustained as a result of the West Nile virus.

SUMMARY OF AMENDMENTS

The June 15, 2005, amendments would change the special tax treatment for losses sustained as a result of the West Nile virus from a disaster loss deduction to a special net operating loss (NOL) deduction.

A revised discussion of FEDERAL/STATE LAW and THIS BILL are provided below.

As a result of the amendments, the implementation and policy considerations discussed in the department's analysis of the bill as amended March 29 and April 26, 2005, have been resolved. Along with a revised revenue estimate, included is each a new implementation, technical, and policy consideration. In addition, a new legal impact issue is identified. The remainder of the department's analysis of the bill as amended on March 29, 2005, still applies.

Board Position:			Legislative Director	Date
____ S	____ NA	____ NP		
____ SA	____ O	____ NAR	Brian Putler	6/20/05
____ N	____ OUA	X PENDING		

ANALYSIS

FEDERAL/STATE LAW

An NOL is defined as the excess of allowable deductions (as specifically modified) over gross income. **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.

Existing state law conforms to the federal computation of an NOL. However, California does not allow NOL carrybacks. Depending on the type of taxpayer or amount of a taxpayer's income, the amount of the NOL that is eligible to be carried forward and the number of years it can be carried forward will vary.

For most taxpayers, the computed NOL may be carried forward for 10 years as follows:

- 50% for any taxable year beginning before January 1, 2000.
- 55% for any taxable year beginning on or after January 1, 2000, and before January 1, 2002.
- 65% for any taxable year beginning on or after January 1, 2002, and before January 1, 2004.
- 100% for any taxable year beginning on or after January 1, 2004.

In the case of corporations doing business both within and outside of this state, California, as do most states, taxes corporations exclusively on a source basis, with source income being determined by use of an apportionment formula for business income and an allocation methodology for nonbusiness income. While a state cannot tax income from sources outside the state, it is similarly not obligated to consider losses from sources outside the state. Thus, the applicable apportionment rule governing NOLs provides that a taxpayer has a California NOL based on the sum (or net) of its California-source business income (or loss) and its allocated nonbusiness income (or loss).

Under existing state and federal law, taxpayers engaged in the business of farming are allowed to deduct the expenses related to planting and growing crops as an ordinary and necessary business expense.

Under existing state and federal law, farm losses may be deducted as an ordinary loss, limited to the taxpayer’s farm income, in the taxable year sustained.

THIS BILL

This bill would do the following:

- Allow special NOL treatment for losses sustained by farmers as a result of the West Nile virus.
- Specify that a taxpayer may claim the NOL for the farm loss only if the Department of Food and Agriculture (DFA) or the State Department of Health Services (DHS) confirms that the taxpayer’s farm NOL was due to the West Nile virus.

- Give DFA and DHS the authority to prescribe regulations to make the necessary determinations that the West Nile virus and its vectors caused the NOL.
- Require Franchise Tax Board (FTB) to develop an agreement with cooperation of DFA and DHS to establish procedures by which FTB can secure the information specified in the above determination by DFA or DHS. DFA or DHS would not need to confirm more than the fact that the taxpayer's farming business was affected by the West Nile virus and its vectors during the year for which the qualified taxpayer seeks a deduction.
- Require FTB to verify a taxpayer's eligibility to use the special NOL under the specified provisions.
- Limit the special NOL carryover period to the nine taxable years following the loss.

POSITION

Pending.

IMPLEMENTATION CONSIDERATIONS

This bill would authorize DFA and DHS to prescribe regulations to make the necessary determinations. Since there are no regulations in place for West Nile virus, especially what is considered a related loss due to West Nile virus, DFA and DHS would need to develop new regulations relating to the West Nile virus and its vectors. Due to lack of clear regulations to make the necessary determinations regarding the West Nile virus, there could be disputes between FTB and the taxpayers to determine if an NOL claimed by a taxpayer would be valid.

This bill would require FTB to verify the taxpayer's eligibility to use the special NOL under the specified conditions. This bill would already require DFA and DHS to determine that the loss is due to the West Nile virus. Requiring FTB to also verify the eligibility appears to be a duplicate effort. Instead, it is recommended that the bill simply require the taxpayer to maintain the records verifying eligibility for the special NOL and to provide these records only if requested by FTB. The author's staff has indicated that the bill will be amended to reflect this recommendation.

TECHNICAL CONSIDERATION

Since the special NOL deductions provided under the amendments are deductions in subsequent years, not the year in which the NOL was generated, the author may wish to remove "during the year for which the qualified taxpayer seeks a deduction under this section" on page 14, lines 1-2, and replace it with "during the taxable year for which the qualified taxpayer incurred the loss deductible under this section."

ECONOMIC IMPACT

Revenue Estimate

This bill is not anticipated to significantly impact the amount of income tax revenue associated with allowing special NOL treatment for losses sustained by farmers as a result of the West Nile virus.

Revenue Discussion

The revenue impact of this bill is dependent on the number of personal income taxpayers and businesses that incur farming business losses due to the West Nile virus and elect the special NOL treatment under this bill. Personal income taxpayers and businesses that incur losses are currently allowed NOL provisions with 100% carryover for ten years.

This bill would require a nine year carryover limitation and would restrict taxpayers from reporting a loss due to the West Nile virus during the tenth year. Since taxpayers are already allowed NOL provisions with 100% carryover for ten years, there does not appear to be any additional tax benefit under this bill. Therefore, taxpayers would most likely elect the general NOL under the current law.

ARGUMENTS/POLICY CONSIDERATIONS

Since this bill would limit the special NOL carryover period to the nine taxable years following the loss, rather than the currently allowed ten taxable years, there does not appear to be any additional tax benefit to taxpayers electing the special NOL under this bill rather than the general NOL.

LEGAL IMPACT

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. Ohio is seeking review by the U.S. Supreme Court. Although the outcome of this decision and its affects on the income tax credits of other states, including California, is unknown, targeted tax incentives that are conditioned on activities in California may be subject to constitutional challenge.

Recently introduced federal legislation entitled, "Economic Development Act of 2005," S. 1066 and H.R. 2471, would authorize state targeted tax incentives for economic development purposes that may otherwise be subject to constitutional challenge as discriminatory.

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