

ANALYSIS OF ORIGINAL BILL

Franchise Tax Board

Author: Hayashi, et al. Analyst: Gail Hall Bill Number: AB 1370
Related Bills: See Legislative History Telephone: 845-6111 Introduced Date: February 23, 2007
Attorney: Patrick Kusiak Sponsor: _____

SUBJECT: Net Operating Loss Deduction/Allow Carryforward For 20 Years Beginning On Or After January 1, 2008

SUMMARY

This bill would provide certain income taxpayers an election to have a longer period to deduct losses incurred from certain business activities.

PURPOSE OF THE BILL

The author's staff has indicated that the purpose of this bill is to encourage investments in medical science and provide additional revenue for emerging biotechnology companies to sustain their growth, expand their workforce, expedite research, and develop and continue the development of new products.

EFFECTIVE/OPERATIVE DATE

As a tax levy, this bill would become effective immediately upon enactment and would specifically apply to net operating losses (NOLs) created in taxable years beginning on or after January 1, 2008.

POSITION

Pending.

ANALYSIS

FEDERAL LAW

When a taxpayer has an operating loss for the tax year, the operating loss that may be used in subsequent years is called an NOL. An operating loss 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.

Board Position:

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Department Director

Date

Selvi Stanislaus

4/19/07

by Lynette Iwafuchi

STATE LAW

In general, a California taxpayer calculates its NOL in accordance with federal rules. One important 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 number 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 (Current State Law)
General NOL	100%	10 Years
New Business NOL	100%	10 Years
Eligible Small Business	100%	10 Years
Specified Disaster Loss	100%	15 Years
Pierce's Disease	100%	9 Years
Economic Development Areas	100%	15 Years

THIS BILL

This bill would allow certain personal income taxpayers and corporate taxpayers to have a longer period to deduct NOLs incurred from certain biopharmaceutical and other biotechnology (bioscience) business activities.

This bill would add an additional type of NOL that would be specific to bioscience activities of a qualified taxpayer. This new NOL would have a 20-year carryover period, following an election by the taxpayer. A "qualified taxpayer" would be defined as a taxpayer engaged in bioscience activities described in Codes 325411 to 325414 and 541710 of the NAICS¹ (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.

¹ North American Industry Classification System.

TECHNICAL CONSIDERATIONS

If the author meant for the NOL election to be irrevocable, the following amendments are recommended:

1. On page 2, line 17, after “incurred”, insert:

“and shall be irrevocable”

2. On page 2, line 37, after “incurred”, insert:

“and shall be irrevocable”

LEGISLATIVE HISTORY

AB 1147 (Mullin/Lieber, 2007/2008) would allow a bioscience corporation based in California to sell NOLs to another bioscience corporation that employs at least 500 employees in California. AB 1147 is currently at the Assembly Desk.

AB 2270 (Houston, 2005/2006) and AB 234 (Corbett, 2003/2004) would have allowed a 20-year NOL carryover for a taxpayer engaged in biopharmaceutical or other biotechnology business activities similar to this bill. AB 2270 and AB 234 did not pass both houses by the constitutional deadline.

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.

- *Florida* income tax law, applicable only to corporations, provides a 20-year NOL carryover period.
- *Illinois* provides a 20-year NOL carryover period for both personal income tax and corporation taxpayers.
- *Massachusetts* income tax law disallows NOL treatment for personal income taxpayers, but corporations are allowed a five-year NOL carryover period.
- *Michigan* provides a 20-year NOL carryover period for personal income taxpayers but has no NOL carryover provision relating to the Michigan Single Business Entity Tax.
- *Minnesota* provides a 20-year NOL carryover period for personal income taxpayers and a 15-year NOL carryover period for corporation taxpayers.
- *New York* provides a 20-year NOL carryover period for both personal income tax and corporation taxpayers.

Research conducted on the above listed states found no special NOL rules for bioscience business activities. *Minnesota* has designated a biotechnology and health science industry zone where qualified businesses located in the zone may receive certain tax benefits.

FISCAL IMPACT

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

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 1370 Enactment Assumed After June 30, 2007				
	2007-8	2008-9	2009-18	2019-20
Revenue Impact	\$0	\$0	\$0	\$300,000*

* This bill would result in revenue losses beginning in 2018/19 fiscal year. (See Revenue Discussion below).

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

Revenue Discussion:

Under current law, NOLs created in 2008 would be potentially usable for 10 years, until the tax year beginning 2018. If the NOLs are unused, they are lost. This bill would allow a taxpayer 10 additional NOL carryover years. The first revenue impact of the bill would be in 2019, when unused losses created in 2008 could be used. Using company-level data and a micro-simulation model, it was estimated that \$6 million of NOLs generated by the qualified taxpayers in 2008 would be used in 2019. Using an estimated tax rate of 5%, this would result in a revenue loss of \$300,000 in that year.

Taking into account the losses generated after 2008, the sum of all the losses carried forward would reach a maximum of about \$20 million per year in 2028 resulting in a revenue loss of \$1 million in 2028 (\$20 million × 5% tax rate).

LEGISLATIVE STAFF CONTACT

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APPENDIX A
AB 1370 QUALIFIED TAXPAYER DEFINITION
NAICS

NAICS 325411 – Medicinal and Botanical Manufacturing:

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

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 tests 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.