

Franchise Tax Board

ANALYSIS OF ORIGINAL BILL

Author: Calderon Analyst: Gail Hall Bill Number: ABX1 1
Related Bills: See Legislative History Telephone: 845-6111 Introduced Date: December 8, 2008
Attorney: Patrick Kusiak Sponsor:

SUBJECT: Internal Revenue Code (IRC) Section 382 And Notice 2008-83

SUMMARY

This bill provides that California will not follow specific federal guidelines related to certain items of deductions or loss.

PURPOSE OF THE BILL

According to the author's staff, the purpose of the bill is for the Legislature to declare their findings relating to a recent federal guideline.

EFFECTIVE/OPERATIVE DATE

As an urgency measure, this provision would be effective immediately upon enactment. The bill specifies that it would apply to the same taxable periods to which any federal guidance described in Notice 2008-83 is applicable.

POSITION

Pending.

ANALYSIS

PROGRAM BACKGROUND

History of the Section 382 Limitation

Section 382, originally added to the Internal Revenue Code (IRC) in 1954 and completely rewritten in 1986, is intended to guard against "trafficking in loss carryovers." The current version of Section 382 prescribes mechanical rules known as the "Section 382 limitation" that effectively preclude a buyer from using the net operating and built-in losses of the acquired entity at a faster rate than the acquired corporation could have used them if it had sold its assets and invested the proceeds in tax-exempt governmental obligations. The purpose of this rule is to make losses a neutral factor in a corporate acquisition. Prior to the enactment of this limitation, corporations with large losses were being purchased by corporations with large taxable incomes simply because the acquired corporation's losses could be used to reduce the buyer's taxable income and therefore reduce the net cost to the buyer of the acquisition.

Table with Board Position (S, NA, NP, SA, O, NAR, N, OUA, X, PENDING) and Department Director (Brian Putler) and Date (01/13/10).

Since enactment of the current IRC 382 limitation rules in 1986, the built-in gain and loss rules have been difficult to understand. In response to these difficulties, the Internal Revenue Service (IRS) has studied two alternative methods that might be used to identify built-in gains and losses. In 2003, the Service published Notice 2003-65 to explain the two alternatives (known as the 1374 Approach and the 338 Approach) and to request comments. Taxpayers were permitted to rely upon Notice 2003-65 until the IRS and Treasury Department issue temporary or final regulations.

The Treasury Department issued Notice 2008-83 (see Appendix A), which provides that any deduction properly allowed after an ownership change to a bank with respect to losses on loans or bad debts (including any deduction for a reasonable addition to a reserve for bad debts) will not be treated as a built-in loss or a deduction that is attributable to periods before the change date, and therefore, would not be subject to IRC 382 limitations.

Controversy Over Notice 2008-83

After Notice 2008-83 was issued by the Treasury Department, numerous articles were published discussing the controversy and issues surrounding issuance of the notice. The following are excerpts from a sample of publications addressing Notice 2008-83:

- Washington Post:¹ "The financial world was fixated on Capitol Hill as Congress battled over the Bush administration's request for a \$700 billion bailout of the banking industry. In the midst of this late-September drama, the Treasury Department issued a five-sentence notice that attracted almost no public attention."

"The sweeping change to two decades of tax policy escaped the notice of lawmakers for several days, as they remained consumed with the controversial bailout bill. When they found out, some legislators were furious. Some congressional staff members have privately concluded that the notice was illegal. But they have worried that saying so publicly could unravel several recent bank mergers made possible by the change and send the economy into an even deeper tailspin."

"Did the Treasury Department have the authority to do this? I think almost every tax expert would agree that the answer is no," said George K. Yin, the former chief of staff of the Joint Committee on Taxation, the nonpartisan congressional authority on taxes. "They basically repealed a 22-year-old law that Congress passed as a backdoor way of providing aid to banks."

- Senate Finance Committee Release:² Sen. Chuck Grassley, ranking member of the Committee on Finance, today asked the Treasury Department inspector general to review the circumstances and any possible conflicts of interest involving the Treasury Department's administrative move that gives a big tax break to banks that acquire poorly performing banks.

¹ Amit R. Paley, "A Quiet Windfall For U.S. Banks," *Washington Post*, Page A01, November 10, 2008.

² Senate Finance Committee Release, *Grassley Seeks Inspector General Review of Treasury Bank Merger Move*, 110th Congress, November 18, 2008.

"Treasury's move took a lot of people by surprise," Grassley said. "It was a big policy change for an agency to take administratively. Treasury didn't involve Congress, so there were no checks and balances to vet the policy. The relationships of the players involved might give the appearance of conflicts of interest. I'm asking the inspector general to look at Treasury's move after the fact and make sure the agency was fair, unbiased and above board in its actions."

- BNA's Tax and Accounting Center³: "Controversy is increasing around embattled Notice 2008-83, the Treasury Department's guidance lifting the limits on the use of losses by banks following acquisitions, with two bills introduced on Capitol Hill to overturn the notice and other legislators considering the issue."

"Clamor against the notice, originally issued along with a series of other guidance to help struggling banks survive, appears to be intensifying. Senate Finance Committee ranking Republican Charles Grassley (Iowa), who already asked Treasury Inspector General Eric Thorson to investigate the notice, is "still exploring his options," Grassley spokeswoman Jill Gerber told BNA Nov. 25. "He hasn't ruled out legislation."

"As questions continue to be raised about Treasury's authority to issue the guidance, which the agency has defended in recent days, the two measures unveiled in recent days would spell differing degrees of trouble for Notice 2008-83."

The two bills take different approaches. "Both bills—S. 3692, unveiled by Sen. Bernard Sanders (I-Vt.), and H.R. 7300, introduced by House Ways and Means Committee member Rep. Lloyd Doggett (D-Texas)—would overrule Notice 2008-83. Issued Sept. 30, the notice allows banks far greater freedom to use losses under IRC section 382(h) in mergers and acquisitions."

FEDERAL LAW

When a corporation acquires another corporation with losses (i.e. net operating losses (NOLs) and unrealized built-in losses such as bad debt deductions), federal law limits the amount of acquired losses the buyer may deduct on its tax return each year. This limitation is referred to as the "Section 382 limitation." The Section 382 limitation is calculated by multiplying the fair market value of the stock of the acquired corporation immediately prior to the change in ownership by the federal long-term tax-exempt rate. The IRS publishes this rate monthly.

An NOL occurs when a corporation has a net taxable loss for the tax year. An NOL may be carried forward to future tax years and taken as a deduction to reduce taxable income or carried back to prior tax years and deducted to reduce taxable income for the prior year. An unrealized built-in loss is the amount of the value of the assets reported on the acquired corporation's books that exceeds the fair market value of its assets immediately before the corporation is acquired⁴.

³ Alison Bennett, "Controversy Over Bank Loss Notice Grows As New Measures Aim to Overturn Guidance," *BNA's Tax and Accounting Center*, December 1, 2008.

⁴ Internal Revenue Code section 382(h)(3)(i).

If that net unrealized loss does not exceed the lesser of \$10 million or 15 percent of the fair market value of the “variable assets⁵,” then there is no net unrealized built-in loss and no IRC 382 limitation.

The IRS issued Notice 2003-65, 2003-40 I.R.B. 747 (10/6/2003) and Notice 2008-83, 2008-42 I.R.B. 905 (10/1/2008) providing guidance to taxpayers relating to identifying built-in gains, losses, and deductions for the IRC 382 limitation. No subsequent federal regulations have been issued.

STATE LAW

The Personal Income Tax Law (PITL) and the Corporation Tax Law (CTL), in general, conform to the IRC either by reference to federal law as of a “specified date” or by stand-alone language that mirrors the federal provision. Currently, California law is conformed to the IRC as of January 1, 2005, unless a specific provision provides otherwise.⁶ In addition, state law provides that where federal and state law are the same temporary and final regulations issued by the Treasury shall apply to California unless the regulations conflict with state law or state regulations.⁷ State statutory law is silent as to the effect of other federal administrative guidance (such as IRS Notices). However, the department has consistently followed such guidance unless there are differences in state and federal law.

California conforms to IRC Section 382 as of January 1, 2005.

THIS BILL

This bill provides the following legislative declarations and findings:

- The California Revenue & Taxation Code (R&TC) provides for specified conformity to various referenced provisions of the Internal Revenue Code, as enacted as of a specified date.
- For taxable years beginning on or after January 1, 2005, California conforms to those referenced IRC sections, except as otherwise specifically provided.
- California conforms to IRC section 382 as enacted as of January 1, 2005.
- As enacted as of January 1, 2005, IRC section 382 applied to financial institutions and included no regulations to exempt banks or other financial institutions from its provisions.
- On October 20, 2008, the IRS issued Notice 2008-83 stating that any deduction properly allowed after an ownership change to a bank with respect to losses on loans or bad debts would not be subject to the IRC 382 limitation.
- Notice 2008-83 constitutes a substantial change to IRC section 382 as enacted as of January 1, 2005.

⁵ “Variable assets” is a shorthand description for a class of assets which may appreciate or decline in value. The variable assets are all assets except cash and cash items and marketable securities that have not changed significantly in value from their bases. (IRC section 382(h)(3)(B)(ii).)

⁶ Revenue & Taxation Code (R&TC) sections 17024.5 and 23051.5.

⁷ R&TC sections 17024.5(d) and 23051.5(d).

- The Legislature's action in conforming to IRS section 382 did not anticipate the substantive change provided in Notice 2008-83.
- In as much as the Legislature has determined that the changes set forth in Notice 2008-83 are inconsistent and conflict with the intent of the Legislature, Notice 2008-83 and any administrative guidance and regulations issued after October 20, 2008, which have the same or similar effect regarding the application of IRC section 382 to banks shall not apply for purposes of the PITL and the CTL.

This bill addresses a fiscal emergency declared by the governor by proclamation on December 1, 2008.

TECHNICAL CONSIDERATIONS

The department has identified the following technical considerations. Department staff is available to work with the author's office to resolve these and other concerns that may be identified.

- The bill provides that Notice 2008-83 was issued on October 20, 2008. Notice 2008-83 was released to the public on September 30, 2008, but published in the Internal Revenue Bulletin with a publication date of October 20, 2008. The author should consider changing "issued" to "released."

LEGISLATIVE HISTORY

AB 11 (De Leon, 2009/2010) and ABX1 14 (De Leon, 2009/2010) are similar to this bill and provide legislative findings and declarations related to IRS Notice 2008-83 and direct the FTB to not apply Notice 2008-83 and any other administrative guidance or federal regulations issued after October 20, 2008, which have the same or similar effect for purposes of the PITL and CTL. AB 11 is currently at the Assembly Desk.

ABX4 6(Laird, 2007/2008) and ABX4 18 (Calderon, 2007/2008) provided legislative findings and declarations similar to those reflected in this bill and would have directed the FTB to not apply Notice 2008-83 and any other administrative guidance or federal regulations issued after October 20, 2008, which have the same or similar effect for purposes of the PITL and the CTL. Both bills provided specific operative date language. ABX4 6 and ABX4 18 failed passage in the fourth extraordinary session.

AB 2998 (Frommer, 2005/2006) would have added provisions to current law that limit the usage of deductions, losses and tax credits from acquired corporations by taking the federal limitation on acquired NOLs and multiplying it by the average of the acquired corporation's California apportionment percentages for the year of the acquisition and the two immediately preceding tax years. AB 2998 was held in the Assembly Revenue & Taxation Committee.

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.

Research found that *Florida and Illinois* conform to federal IRC 382, *Minnesota and New York* substantially follow IRC 382, but *Massachusetts and Michigan* do not conform to IRC 382.

FISCAL IMPACT

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

ECONOMIC IMPACT

Due to resource constraints and workload prioritization, a revenue impact for this bill was not developed.

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**APPENDIX A
(IRS NOTICE 2008-83)⁸**

Internal Revenue Bulletin: 2008-42

October 20, 2008

Notice 2008-83

Application of Section 382(h) to Banks

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SECTION 1. OVERVIEW

The Internal Revenue Service and Treasury Department are studying the proper treatment under section 382(h) of the Internal Revenue Code (Code) of certain items of deduction or loss allowed after an ownership change to a corporation that is a bank (as defined in section 581) both immediately before and after the change date (as defined in section 382(j)). As described below under the heading Reliance on Notice, such banks may rely upon this guidance unless and until there is additional guidance.

SECTION 2. TREATMENT OF DEDUCTIONS UNDER SECTION 382(h)

For purposes of section 382(h), any deduction properly allowed after an ownership change (as defined in section 382(g)) to a bank with respect to losses on loans or bad debts (including any deduction for a reasonable addition to a reserve for bad debts) shall not be treated as a built-in loss or a deduction that is attributable to periods before the change date.

SECTION 3. RELIANCE ON NOTICE

Corporations described in section 1 of this notice may rely on the treatment set forth in this notice, unless and until there is additional guidance.

SECTION 4. SCOPE

This notice does not address the application of any provision of the Code other than section 382.

The principal author of this notice is Mark S. Jennings of the Office of Associate Chief Counsel (Corporate). For further information regarding this notice, contact Mark S. Jennings at (202) 622-7750 (not a toll-free call).

⁸ http://www.irs.gov/irb/2008-42_IRB/ar08.html