Franchise Tax Board

ANALYSIS OF ORIGINAL BILL

Author:	Florez	Analyst:	Jahna Alvarado	Bill Number:	SB 876
Related Bills:	See Legislative History	Telephone:	845-5683	Introduced Date:	January 11, 2010
		Attorney:	Patrick Kusiak	Sponsor:	

SUBJECT: Net Operating Loss Deduction/Fraudulent Investment Arrangement Losses

SUMMARY

This bill would allow net operating losses (NOLs) resulting from fraudulent investment arrangements, as specified, the same carryback and carryforward period as would be allowed for federal purposes.

PURPOSE OF THE BILL

The legislative findings and declarations indicate that the purpose of this bill is to provide tax relief for investors that are innocent victims of fraudulent investment schemes.

EFFECTIVE/OPERATIVE DATE

As a tax levy, this bill would be effective immediately upon enactment and specifically operative for taxable years beginning on or after January 1, 2008.

POSITION

Pending.

ANALYSIS

On March 17, 2009, in response to the losses resulting from the collapse of Bernard Madoff's decades-long Ponzi scheme, the IRS issued Revenue Ruling 2009-9 and Revenue Procedure 2009-20 to provide guidance to taxpayers who are victims of fraudulent investment schemes.

The Revenue Ruling clarifies the income tax law governing the treatment of losses from such schemes, including the nature of such losses (theft losses), the amount of such losses to be allowed, and the year of deductibility. The Revenue Procedure simplifies compliance procedures for taxpayers by providing an optional safe-harbor means of determining the year in which the losses are deemed to occur, and a simplified method of computing the amount of the loss.

Board Position:			Department Director	Date
_______ S	_______ NA	_______ NP		
_______ SA	_______ O	_______ NAR	Selvi Stanislaus	04/30/10
_______ N	_______ OUA	___X___ PENDING		

Federal and state laws are generally the same with respect to the deduction of theft losses. In general, where state law is in substantial conformity with the Internal Revenue Code, federal regulations, rulings and procedures are applicable for state purposes. Accordingly, Revenue Ruling 2009-9 and Revenue Procedure 2009-20 are applicable for state purposes to the extent federal and state laws are the same.

For purposes of applying the Revenue Ruling and Revenue Procedure, where the statutes of limitations for filing a claim for refund are different for federal and state purposes, the state statute of limitations will control and any reference to federal NOL carryforwards or carrybacks is not applicable for state purposes at this time, as state law does not currently allow carrybacks of NOLs, and carryforwards of such losses have been suspended until 2010.

A taxpayer that takes advantage of the safe harbor for federal purposes is not required to do so for state purposes.

FEDERAL LAW

When a taxpayer has an operating loss for the taxable year, the operating loss that may be used in other 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 2 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.

Recent changes in federal law extend the carryback period up to five years for specified losses as described below.

The American Recovery and Reinvestment Act allows certain taxpayers to make an irrevocable election to carry back applicable 2008 losses for up to 5 years (the normal carryback period is 2 years). The "applicable 2008 losses" are losses incurred in one taxable year that either begins or ends in 2008 by eligible small businesses (those whose average gross receipts are equal to or less than $15 million over a three-year period).

The Worker, Homeownership, and Business Assistance Act of 2009 allows taxpayers, other than taxpayers that received benefits under the Troubled Asset Relief Program, with business losses to make an irrevocable election to carry back losses incurred in one year (ending after 2007 and beginning before 2010) for up to 5 years.

Because Revenue Ruling 2009-9 defines losses on fraudulent investment schemes as businesses losses, an NOL resulting from a fraudulent investment loss is eligible for the extended NOL carryback period.

STATE LAW

In general, a California taxpayer calculates its NOL in accordance with federal rules. For NOLs attributable to taxable years beginning before January 1, 2011, NOL carrybacks are disallowed.

NOLs attributable to taxable years beginning on or after January 1, 2008, may be carried forward 20 years. California conforms to the federal NOL carryback rules for NOLs attributable to taxable years beginning on or after January 1, 2011, with the following modifications:

1. An NOL may be carried back only 2 years.
2. The amount of NOL carryback attributable to taxable year 2011 is limited to 50 percent of the NOL.
3. The amount of NOL carryback attributable to taxable year 2012 is limited to 75 percent of the NOL.

Current state law conforms to the federal carryback period for a Real Estate Investment Trust (REIT) and a corporate equity reduction interest loss, which is zero.

NOL deductions are suspended for taxable years beginning on or after January 1, 2008, and ending on or before December 31, 2009, for taxpayers with net business income of $500,000 or more. The carryforward period for suspended NOLs is extended by the same period of time as the suspension period.

THIS BILL

This bill would allow the “safe harbor” treatment for determining a fraudulent investment loss as set forth in the IRS’s Revenue Procedure 2009-20, when the same procedures are applied for both state and federal purposes.

This bill would allow a state NOL resulting from the application of the terms of the Revenue Procedure the same carryback and carryforward periods as would be allowed by federal law for the same tax year and would conform by reference to the federal statute of limitations rules with respect to NOL carrybacks for losses attributable to application of the Revenue Procedure.

This bill would exempt NOLs arising from a fraudulent investment loss from the existing suspension period.

This bill would preclude the department from challenging the treatment of a loss determined under the terms of the Revenue Procedure.

OTHER STATES

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 does not have a personal income tax. *Florida* law does not allow corporate NOLs to be carried back.

Illinois's personal income tax NOL carryback and carryforward periods generally mirror the federal periods because the calculation of *Illinois* state tax begins with federal adjusted gross income and NOLs are included in the calculation of federal adjusted gross income. *Illinois* corporate tax law allows an NOL carryforward period of up to 12 years. Corporate NOLs may not be carried back.

Massachusetts does not conform to federal treatment of theft losses, including the safe harbor treatment of fraudulent investment losses under Revenue Procedure 2009-20. Under current guidance from the *Massachusetts* Department of Revenue, taxpayers that paid tax in prior years on fictitious income from a fraudulent scheme may submit a claim for refund.

Minnesota has conformed to recent federal law changes that allow small businesses to carry back NOLs for up to five years (rather than the normal two-year carryback). This change applies to a loss generated in either a year beginning, or a year ending, in 2008.

Generally, *Michigan* allows the same NOL carryback and carryforward period for a *Michigan* NOL as would be allowed for federal purposes for the same tax year. For taxable year 2008, eligible taxpayers may qualify to use a 3, 4, or 5 year carryback period in the same manner as provided in the IRC. Any unused balance may be carried forward 20 years.

New York's personal income tax NOL carryback and carryforward periods generally mirror the federal periods because the calculation of *New York* state tax begins with federal adjusted gross income and NOLs are included in the calculation of federal adjusted gross income.

FISCAL IMPACT

Because fraudulent investment schemes are generally infrequent and limited in scope, the resulting workload is expected to be sporadic and the volume of affected taxpayers low. The department would absorb the additional costs that could be incurred to implement this bill.

ECONOMIC IMPACT

<u>Revenue Estimate</u>

This bill would result in the following revenue losses

Estimated Revenue Impact of SB 876 As Introduced January 11, 2010 Operative For Taxable Years Beginning On or After January 1, 2008 Enactment Assumed After June 30, 2010 ($ in Millions)			
2009-10	2010-11	2011-12	2012-13
-$9.9	-$8.7	-$0.5	-$0.03

This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this bill.

LEGISLATIVE STAFF CONTACT

Legislative Analyst
Jahna Alvarado
(916) 845-5683
jahna.alvarado@ftb.ca.gov

Revenue Manager
Monica Trefz
(916) 845-4002
monica.trefz@ftb.ca.gov

Legislative Director
Brian Putler
(916) 845-6333
brian.putler@ftb.ca.gov