Franchise Tax Board

ANALYSIS OF ORIGINAL BILL

Author:	Calderon	Analyst:	Gail Hall	Bill Number:	AB 692
Related Bills:	See Legislative History	Telephone:	845-6111	Introduced Date:	February 26, 2009
		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 statutory deduction and loss items.

PURPOSE OF THE BILL

According to the author's staff, the purpose of the bill is to reinforce a proposed Franchise Tax Board (FTB) regulation and clarify that Internal Revenue Service (IRS) Notice 2008-83 (Notice 2008-83) does not apply to California's Personal Income Tax or Corporation Tax laws.

EFFECTIVE/OPERATIVE DATE

This bill would be effective January 1, 2010, and would specifically apply to the same taxable periods to which any federal guidance pertaining to matters described in Notice 2008-83 is applicable.

POSITION

Pending.

BACKGROUND

The three-member Franchise Tax Board (Board) took action at its December 4, 2008, meeting directing staff to begin regulatory action to make Notice 2008-83 inapplicable for California purposes. At its March 19, 2009, meeting the three-member Board authorized staff to proceed with formal procedures under the Administrative Procedures Act to adopt this regulation.

Board Position:			Department Director	Date
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ANALYSIS

STATUTORY BACKGROUND

History of the Section 382 Limitation

Section 382, originally added to the 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.

Since enactment of the current IRC section 382 limitation rules in 1986, the built-in gain and loss rules have been difficult to understand. In response to these difficulties, the IRS has studied two alternative methods that might be used to identify built-in gains and losses. In 2003, the IRS 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 section 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."

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

"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.

  "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 Center[3]: "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 would have taken 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."

The American Recovery and Reinvestment Act of 2009 (ARRA), signed into law February 17, 2009, revoked Notice 2008-83. See FEDERAL LAW section in this analysis for further discussion.

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

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 acquired.[4] If that net unrealized loss does not exceed the lesser of $10 million or 15% of the fair market value of the "variable assets,"[5] 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.

On February 17, 2009, ARRA was signed into federal law. ARRA provides that the Secretary of the Treasury is not authorized under federal law[6] to provide exemptions or special rules that are restricted to particular industries or classes of taxpayer, and that Notice 2008-83 is inconsistent with the Congressional intent of federal law.[7] In addition, ARRA provides that although the legal authority to prescribe Notice 2008-83 is doubtful, for taxpayers who have already relied upon its guidance, it is effective only for ownership changes occurring on or before January 16, 2009[8], except that the guidance is effective for ownership changes occurring after January 16, 2009, that were made under the following circumstances:

- Under a written binding contract entered into on or before January 16, 2009, or
- Under a written agreement entered into on or before January 16, 2009, if the agreement was described on or before that date in a public announcement or in a filing with the Securities Exchange Commission required by reason of the ownership change.[9]

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[4] IRC section 382(h)(3)(i).
[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 IRC section 382(m).
[7] 2009 ARRA section 1261(a).
[8] 2009 ARRA section 1261(b)(1).
[9] 2009 ARRA section 1261(b)(2).

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.[10] In addition, state law provides that where federal and state law are the same temporary and final regulations issued by the Treasury shall apply for California purposes unless the regulations conflict with state law or state regulations.[11] 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 IRC, 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 section 382 included no specific authority for regulatory actions by the IRS or the Department of Treasury to exempt banks or other financial institutions from under 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 substantive change to IRC section 382 as enacted as of January 1, 2005.
- California conforms to IRC section 382 as enacted on January 1, 2005, but the Legislature's action in conforming to IRC section 382 did not contemplate the substantive change in the application of IRC section 382 set forth in Notice 2008-83.
- Inasmuch as the Legislature had determined that the changes set forth in Notice 2008-83 are inconsistent with, and in conflict with, the intent of the Legislature in conforming with IRC section 382, the Legislature directs FTB to not apply the provision of Notice 2008-83 for purposes of California PITL or CTL.

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[10] Revenue & Taxation Code (R&TC) sections 17024.5 and 23051.5.
[11] R&TC sections 17024.5(d) and 23051.5(d).

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.

1. Notice 2008-83 makes no reference to "financial institutions," therefore, the author may want to revise the legislative findings and declarations and remove references to the words "financial institution" and replace these words with "bank."

2. The author may want to include in the Legislative findings and declarations that on February 17, 2009, President Barack Obama signed the American Recovery and Reinvestment Act of 2009 (Public Law 111-5), which in part asserts that Notice 2008-83 is inconsistent with the congressional intent in enacting IRC section 382.

3. On page 3, line 8, it appears that the operative date language should reference "that paragraph" instead of "that subdivision."

LEGISLATIVE HISTORY

AB 11(De Leon, 2009/2010) is similar to this bill and would provide legislative findings and declarations related to Notice 2008-83 and directs 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 in the Assembly Revenue and Taxation Committee.

ABX1 1 (Calderon, 2009/2010) is similar to this bill and would provide legislative findings and declarations related to Notice 2008-83 and directs 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. ABX1 1 is an urgency measure and provides specific operative date language. ABX1 1 died at Desk.

ABX1 14 (De Leon, 2009/2010) and ABX3 21 are similar to this bill and provide legislative findings and declarations related to Notice 2008-83 and directs 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. ABX1 14 died at Desk and ABX3 21 is 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 ABX1 1 and would have directed 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.

FISCAL IMPACT

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

ECONOMIC IMPACT

<u>Revenue Estimate and Discussion</u>

Based on the enactment of Section 1261 of ARRA,[12] FTB staff concludes Notice 2008-83 has no legal effect for purposes of California tax laws, therefore, AB 692 would have no revenue impact.

LEGISLATIVE STAFF CONTACT

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[12] the American Recovery and Reinvestment Act of 2009 (Public Law 111-5), enacted February 17, 2009

APPENDIX A
(IRS NOTICE 2008-83)[13]

Internal Revenue Bulletin: 2008-42
October 20, 2008
Notice 2008-83

Application of Section 382(h) to Banks

Table of Contents

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).

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[13] http://www.irs.gov/irb/2008-42_IRB/ar08.html