Franchise Tax Board

ANALYSIS OF AMENDED BILL

Author:	Bonta	Analyst:	Diane Deatherage	Bill Number:	AB 1661
Related Bills:	None	Telephone:	845-4783	Amended Dates:	April 1 & 21, 2014
		Attorney:	Bruce Langston	Sponsor:	

SUBJECT: Tax Credit Based on Gross Sales and Net Operating Loss Deduction Carryover/25 Years for Healthy Options for Everyone (HOPE) Incentive Zone Businesses

SUMMARY

This bill would under the Government Code, establish the Healthy Options for Everyone Act of 2014 (HOPE Act) and, under the Personal Income Tax Law (PITL) and Corporation Tax Law (CTL) allow qualified businesses (1) a credit based on gross sales and (2) extend the net operating loss (NOL) carryover period.

Where appropriate, the provisions that would allow a tax credit based on gross sales and extend the NOL carryover deduction period are discussed separately in this analysis.

RECOMMENDATION

No position.

Summary of Amendments

The April 1, 2014, amendments added a provision to the language establishing the HOPE Act that would extend the NOL carryover period for qualified businesses.

The April 21, 2014, amendments would allow qualified businesses a tax credit in the amount equal to 20 percent of the gross sales.

This is the department's first analysis of the bill. This analysis only addresses the provisions of this bill that impact the department's programs and operations.

REASON FOR THE BILL

The reason for the bill is to spur the creation of new businesses, and the expansion of existing businesses, within designated HOPE Incentive Zones by providing state and local incentives to reduce the tax burden and costs of doing business.

EFFECTIVE/OPERATIVE DATE

Tax Credit Based on Gross Sales

This provision would become effective January 1, 2015, and operative for taxable years beginning on or after January 1, 2015.

Board Position:			Executive Officer	Date
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Extension of NOL Carryover Period

This provision would become effective January 1, 2015, and specifically operative for NOLs generated in taxable years beginning on or after January 1, 2015.

ANALYSIS

FEDERAL/STATE LAW

Tax Credit Based on Gross Sales

Existing state and federal laws provide various tax credits designed to provide tax relief for taxpayers who incur certain expenses (e.g., child adoption) or to influence behavior, including business practices and decisions (e.g., research credits or economic development area hiring credits). These credits generally are designed to provide incentives for taxpayers to perform various actions or activities that they may not otherwise undertake.

Current state and federal laws generally allow taxpayers engaged in a trade or business to deduct all expenses that are considered ordinary and necessary in conducting that trade or business.

Extension of NOL Carryover Period

Federal law generally defines an NOL as the excess of business deductions allowed over the gross income of the business.

When a taxpayer has an operating loss for a taxable year, the operating loss that may be deducted in subsequent years is called an NOL. An operating loss occurs when a taxpayer's allowed business 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. For NOLs arising in tax years ending after December 31, 2007, an eligible small business could elect to increase the NOL carryback period for an applicable 2008 or 2009 NOL from two years to three, four, or five years.

In general, a California taxpayer calculates its NOL in accordance with federal rules. For NOLs attributable to taxable years beginning before January 1, 2008, California limits the carry forward period to 10 years in circumstances where federal law allows 20 years. NOLs attributable to taxable years beginning on or after January 1, 2008, may be carried forward 20 years.

California law denied NOL carryback prior to conforming to the federal NOL carryback rules for taxable years beginning on or after January 1, 2013, with the following modifications:

1. An NOL may be carried back only two years. (Federal law has special rules that in some cases allow an NOL to be carried back for a longer period).
2. The amount of an NOL carryback attributable to taxable year 2013 is limited to 50 percent of the NOL.

3. The amount of an NOL carryback attributable to taxable year 2014 is limited to 75 percent of the NOL.
4. The amount of an NOL carryback attributable to taxable year 2015 and thereafter is 100 percent of the NOL.

Generally, NOL deductions were suspended for taxable years 2008 through 2011. For taxable years 2008 and 2009, the suspension applied to taxpayers with net business income of $500,000 or more. For taxable years 2010 and 2011, the suspension applied to taxpayers with pre-apportioned income of $300,000 or more.

THIS BILL

The bill would establish the Healthy Options for Everyone Act of 2014. The HOPE Act would allow a city, county, or city and county, after a public hearing, to establish by ordinance a HOPE Incentive Zone within its boundaries for the purpose of increasing the availability of fresh fruits and vegetables, and other grown foods within the zone.

The bill would allow a tax credit in an amount equal to 20 percent of a qualified taxpayer's gross sales within a HOPE Incentive Zone during the taxable year and would allow a qualified taxpayer to extend its NOL carryover period to 25 years.

The bill would define the following term and phrases:

- "Qualified business" means a business primarily engaged in the retail sale of canned food, dry goods, fresh fruits and vegetables, and fresh meats, fish, and poultry.
- "Primarily" means 80 percent or more.
- "Qualified taxpayer" means a qualified business that has primarily done business within a HOPE Incentive Zone during the taxable year.

IMPLEMENTATION CONSIDERATIONS

Department staff has identified the following implementation considerations for purposes of a high-level discussion; additional concerns may be identified as the bill moves through the legislative process. Department staff is available to work with the author's office to resolve these and other concerns that may be identified.

The bill refers to the definition of a "qualified business" that is defined as a business primarily engaged in the retail sale of canned food, dry goods, fresh fruits and vegetables, and fresh meats, fish, and poultry. "Primarily" means 80 percent or more. The absence of the basis on which the determination of a "qualified business" should be made (i.e., dollar amount of gross sales, number of items sold, etc.) could lead to disputes with taxpayers and would complicate the administration of this bill.

The bill uses a term that is undefined, i.e., "dry goods." Some definitions of "dry goods" include clothing. The absence of a definition to clarify this term could lead to disputes with taxpayers and would complicate the administration of this bill.

This bill uses a phrase that is undefined, i.e., “primarily done business.” The absence of the definition to clarify this term could lead to disputes with taxpayers and would complicate the administration of this bill.

It is unclear how the department would determine that the "primarily" requirements had been met. For example, in some communities, a box truck that is a market on wheels (mobile market) comes around. How would the Franchise Tax Board verify that the truck (or business with multiple trucks) had met the 80 percent threshold?

The HOPE incentives as listed in the findings and declarations are inconsistent with the incentives this bill would create. The author may wish to amend the bill language for overall clarification of the incentives.

TECHNICAL CONSIDERATIONS

This bill needs to be amended where the phrase "as that term is used in Section 51043.3 of the Government Code" appears, as it should be "as defined in Section 51043.3 of the Government Code."

OTHER STATES’ INFORMATION

Tax Credit Based on Gross Sales

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 an individual income tax. For corporate income tax, *Florida* legislators have recently introduced two similar bills that would provide an income tax credit for certain businesses that sell nutrient-dense food items in areas designated as food deserts.

Illinois, Massachusetts, Michigan, Minnesota, and *New York* do not provide a credit comparable to the credit allowed by this bill.

Extension of NOL Carryover Period

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 an individual income tax. For corporate income tax, *Florida* generally follows federal NOL rules, but does not allow an NOL carryback.

Illinois does not conform to federal NOL rules, but has an *Illinois* NOL computation. For corporations, partnerships, and S corporations filing in *Illinois,* there was no NOL deduction allowed for 2010-2012. No carryover deduction can exceed $100,000 for any taxable year ending on or after December 31, 2012, and prior to December 31, 2014. Any excess may be carried forward for up to 12 years. The SOL of the tax year, for which and NOL carryback was applied to, extends to match the SOL for the loss year that generated the NOL. Interest on an overpayment related to an NOL carryback is calculated from the date the loss year return is filed and no interest is paid if the refund is paid within 90 days. The NOL carry back is filed on an amended return for *Illinois* with a copy of the federal application for tentative refund attached.

Massachusetts does not allow an NOL for personal income taxpayers. *Massachusetts* does not allow a federal NOL deduction, but does have its own NOL computation for corporations. NOL carrybacks are not allowed. NOL carryovers are allowed to be shared by members of a combined report.

Michigan does not conform to IRC §172, but instead has a separate *Michigan* NOL computation. NOL carryover and carryback periods follow federal limitations for the same periods. The NOL carryback is filed on *Michigan* form 1045 for individuals and amended returns for corporations.

Minnesota generally follows federal for individual taxpayers. Individuals are allowed to carryover their NOL for 20 years and carry back for two taxable years. For corporations, *Minnesota* does not allow a NOL carryback, but does allow a 15 year carryover. Corporations compute their NOL following IRC §172 with modifications. An NOL carryback is applied to a prior tax year by filing an amended return and checking the box that identifies that the return is being amended for an NOL carryback from another tax year.

New York generally follows federal NOL rules, but limits the amount of the NOL carryback to $10,000. The balance of the NOL may be carried forward for up to 20 years. Interest is accrued from the filing date of the loss year.

FISCAL IMPACT

Department staff is unable to determine the costs to administer this bill until the implementation concerns have been resolved, but anticipates the costs to be significant.

ECONOMIC IMPACT

<u>Revenue Estimate</u>

Estimated Revenue Impact of AB 1661 As Amended April 21, 2014 Assumed Enactment After June 30, 2014 ($ in Millions)			
	2014-15	2015-16	2016-17
Tax Credit Based on Gross Sales	- $360	- $900	- $950
Extension of NOL Carryover Period*	$0	$0	$0

*This provision would have no immediate tax revenue impact because the NOL provision would not take effect until after twenty years, but is estimated to have a negligible impact on tax revenues after twenty years.

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

LEGAL IMPACT

The bill would restrict the HOPE incentives to a qualified business that has primarily done business within a HOPE Incentive Zone as designated by a city, county, or city and county of California. The bill could raise constitutional concerns under the Commerce Clause of the United States Constitution because it could appear to improperly favor in-state activity over out-of-state activity. On August 28, 2012, (*Cutler* v. Franchise Tax Board), the Court of Appeal issued a unanimous opinion holding that California's Qualified Small Business Stock statutes were unconstitutional. Specifically, the Court of Appeal held that the statutory scheme's requirement of a large California presence in order to qualify for an investment incentive discriminated against interstate commerce, and therefore violated the federal dormant commerce clause. While no court decision has yet invalidated, as a general matter, state income tax benefits that provide an incentive for in-state activity, i.e., property placed in service in the state, employees employed in the state, etc., targeted tax benefits such as a credit based on gross sales and the extension of an NOL carryover period for a qualified business that has primarily done business within a HOPE Incentive Zone located in California may be subject to constitutional challenge.

SUPPORT/OPPOSITION

Support: None provided.

Opposition: None provided.

ARGUMENTS

Proponents: Supporters may argue that the bill would provide incentives that would reduce the tax burden of businesses within a HOPE Incentive Zone.

Opponents: Some may argue that income tax credits may be an inefficient way to encourage economic development because economic investment decision-making is often separate from tax planning decision-making. Also, some may argue that a business that has NOLs to carryover for more than 20 years may no longer be existence to benefit from the extension of the NOL carryover period.

POLICY CONCERNS

Tax Credit Based on Gross Sales

This provision lacks carryover language. As a result, any unused credit would be lost if the taxpayer is unable to use the entire credit amount in the year claimed.

This provision lacks a sunset date. Sunset dates generally are provided to allow periodic review of the effectiveness of the credit by the Legislature.

The bill specifies that only 80 percent of the qualified taxpayer's sales are required to be "canned food, dry goods, fresh fruits and vegetables, and fresh meats, fish, and poultry." This provision is silent on if the taxpayer is allowed only to offset income generated within the HOPE Incentive Zone with the HOPE Incentive Zone credit. Also, if a taxpayer has only 80 percent sales of canned food, dry goods, fresh fruits and vegetables, and fresh meats, fish, and poultry, the bill is silent on whether the credit be computed on 100 percent of gross sales within a HOPE Incentive Zone (which includes 20 percent of items other than canned food, dry goods, fresh fruits and vegetables, and fresh meats, fish, and poultry) or if the credit would be limited to only the 80 percent of gross sales of the listed specified foods within the zone.

This bill fails to limit the amount of the credit that may be taken. Credits that could potentially be quite costly are sometimes limited either on a per-project or per-taxpayer basis. This bill would provide an unlimited amount of credit which would be unprecedented.

Generally, credits are limited as a percentage of amounts paid or incurred. This bill would allow a credit based on the amount of the taxpayer's gross sales, which is unprecedented. The result of allowing a credit on gross sales would be to increase a taxpayer's profit margin via a tax credit.

Extension of NOL Carryover Period

This provision would allow a qualified business that has primarily done business within a HOPE Incentive Zone during the taxable year to carryover NOLs for 25 years; however, this provision is silent as to whether a business must only offset income generated within the zone with the NOL created within the zone.

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