ANALYSIS OF AMENDED BILL

Franchise Tax Board

Author:	Harkey	Analyst:	Diane Deatherage	Bill Number:	AB 1984
Related Bills:	See Legislative History	Telephone:	845-4783	Amended Date:	April 1, 2014
		Attorney:	Bruce Langston	Sponsor:	

SUBJECT: Net Operating Loss Deduction Carryback Conformity with Modifications

SUMMARY

This bill would have California conform to some of the federal net operating loss (NOL) carryback procedures under the Administration of Franchise and Income Tax Laws (AFITL).

RECOMMENDATION

No position.

Summary of Amendments

The April 1, 2014, amendments removed provisions of the bill related to sales and use tax, and replaced them with the provisions discussed in this analysis. This is the department's first analysis of the bill.

REASON FOR THE BILL

The reason for the bill is to benefit taxpayers by eliminating confusion during filing and allowing them to resolve their refund claim more quickly by conforming to federal law.

EFFECTIVE/OPERATIVE DATE

This bill would become effective and operative January 1, 2015. The regulations required by this bill would be due by January 1, 2016.

ANALYSIS

FEDERAL LAW

Net Operating Loss Law

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

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When a taxpayer has an operating loss for a taxable year, the operating loss that may be deducted in another year 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. 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.

Federal law modifies some of the provisions for the payment of interest and the statute of limitations for assessing additional tax when taxpayers take advantage of NOL carrybacks. In addition, federal law modifies the statute of limitations for assessing additional tax, and the provision for payment of interest on refunds applicable to NOL carrybacks.

Internal Revenue Code (IRC) Section 6164

Under federal law, a corporation that expects an NOL in the current tax year may file to extend the time for payment of tax for the immediately preceding tax year. This includes extending the time for payment of a tax deficiency. The payment of tax that can be postponed cannot exceed the expected overpayment from the carryback of the NOL.

In general, the extension for paying the tax expires at the end of the month in which the return for the tax year of the expected NOL is required to be filed, including extensions.

IRC Section 6411

Also, federal law provides for an expedited refund for NOL carrybacks by allowing taxpayers to file an application for tentative refund resulting from:

- The carryback of an NOL,
- The carryback of a net capital loss,
- The carryback of an unused general business credit,
- The carryback of a net contracts loss, or
- An overpayment of tax due to a claim of right adjustment.

The application for tentative refund must be filed no later than 12 months of the end of the tax year in which an NOL, net capital loss, unused credit, net contracts loss, or claim of right adjustment arose.

Within a period of 90 days from the date on which an application for a tentative carryback adjustment is filed, the Internal Revenue Service (IRS) must perform a limited examination of the application to discover omissions and errors of computation. The IRS may disallow the application if there are any material omissions or any errors of computation that are not corrected within the 90-day period.

Offset Law

If a taxpayer owes money because of certain delinquent debts, the IRS or the Department of Treasury's Financial Management Service, which issues IRS tax refunds, can offset or reduce the taxpayer's federal tax refund or withhold the entire amount to satisfy the debt.

Application of Overpayments

Federal tax law provides that the IRS is authorized to credit an overpayment of tax for one taxable year against estimated income tax for a preceding year.

<u>STATE LAW</u>

Net Operating Loss Law

In general, a California taxpayer calculates its NOL in accordance with federal rules. NOLs attributable to taxable years beginning on or after January 1, 2008, may be carried forward 20 years. For NOLs attributable to taxable years beginning before January 1, 2013, NOL carrybacks are unavailable. California conforms to the federal NOL carryback rules for NOLs attributable to taxable years beginning on or after January 1, 2013, with modifications.

California law provides that losses generated in taxable years beginning January 1, 2013, and later will be allowed to be carried back to the two preceding tax years. No losses may be carried back to years beginning before January 1, 2011.

The new carryback is phased in as follows:

- The law provides that 50 percent of the NOL generated in taxable years beginning in 2013 is eligible for a two year carryback.
- 75 percent of the NOL generated in taxable years beginning in 2014 is eligible for a two year carryback. Any excess that is not carried back may be carried forward.
- 100 percent of the NOL generated in taxable years beginning in 2015 is eligible for a two year carryback.

For a calendar year taxpayer, this means that a $10,000 loss generated in 2013 will be treated as follows:

- Up to 50 percent of the loss ($10,000 x 50% = $5,000) can be carried back to 2011 and 2012.
    - For example if $4,000 of the loss can be used in 2011, the remaining $1,000 could be carried to 2012.
- Any portion of that remaining $1,000 not used in 2012 (and the $5,000 not carried back at all) will be allowed to be carried forward to 2014 and later years.

For a calendar year taxpayer, this means that an $8,000 loss generated in 2014 will be treated as follows:

- Up to 75 percent of the loss ($8,000 x 75% = $6,000) can be carried back to 2012 and 2013.
    - For example if $4,000 of the loss can be used in 2012, the remaining $2,000 could be carried to 2013.
- Any portion of that remaining $2,000 not used in 2013 (and the $2,000 not carried back at all) will be allowed to be carried forward to 2015 and later years.

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

The NOL carryback provisions disregard the NOL suspension period and allow taxpayers to carryback an NOL, from a taxable year beginning on or after January 1, 2013, two years to a taxable year beginning on or after January 1, 2011.

California does not modify its rules for interest computations or statute of limitations relating to NOL carrybacks.

Offset Law

Under state law, the California State Controller is authorized to offset money due from an individual or entity by a state agency as payment for debts due California state agencies, cities and counties for an unpaid fine, penalty, assessment, bail, vehicle parking penalty, or court-ordered reimbursement for court-related services, and colleges, as well as the IRS. The Franchise Tax Board (FTB) operates the Intercept Program on behalf of the State Controller's office. Agencies wishing to participate in the Intercept Program are subject to approval by the State Controller. Participating agencies may send accounts to the FTB for offset only after other avenues of collection have failed and the debtor has been sent a notification of the impending offset. The agency referring the debt to the Intercept Program is responsible for the accuracy of the debt.

Application of Overpayments

State tax law provides that the FTB is authorized to credit an overpayment of tax for one taxable year against estimated income tax for a preceding year.

<u>THIS BILL</u>

This bill would conform to the federal provisions that allow a taxpayer with NOL carrybacks to obtain a tentative refund of taxes paid in prior tax years by filing a tentative carryback adjustment application (see the IRC section 6411 under the Federal Law section above) and allow a corporation to apply to extend the time for payment of taxes for the immediately preceding taxable year (see the IRC section 6164 under the Federal Law section above).

Also, this bill would require that the FTB prescribe regulations on or before January 1, 2016, that would provide for the crediting against the estimated tax of the amount determined to be an overpayment of tax for a preceding taxable year.

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.

As currently written, the bill, by application of federal law, would allow a fiscal year taxpayer, but exclude a calendar year taxpayer, from utilizing the tentative refund provision for an NOL arising in tax year 2013. For example, a calendar year taxpayer with an NOL carryback that originated in 2013 (first year NOL carrybacks are allowed) must file the application for tentative refund by December 31, 2014. Because the operative date is January 1, 2015, the taxpayer is unable to file a timely application for tentative refund. If this is different than the author's intent, the author may wish to amend the bill.

In the bill, SEC. 2. would require that the FTB prescribe regulations providing for the crediting against the estimated tax for any taxable year to be an overpayment of the tax for a preceding taxable year. State law already provides that the FTB may credit an overpayment of tax for one taxable year against estimated income tax for a preceding year and has the authority to issue regulations under current law. The author may wish to reconsider requiring the FTB to prescribe these regulations.

In the bill, federal law for corporations that are expecting carrybacks to extend the time for payment of taxes would apply for state purposes. California law does not allow the filing of consolidated returns by affiliated corporations. Instead, California allows affiliates that are unitary to file combined reports. The author may wish to amend the bill to add a modification to account for the difference.

Federal law modifies some of the provisions for the payment of interest and the statute of limitations for assessing additional tax when taxpayers take advantage of NOL carrybacks. In addition, federal law modifies the statute of limitations for assessing additional tax, and the provision for payment of interest on refunds applicable to NOL carrybacks. The author may wish to add additional language to the bill so California law would modify the same provisions for conformity purposes.

The provision for an application for a tentative carryback adjustment appears to be limited to the Corporation Tax Law because it does not include a reference to the Personal Income Tax Law NOL rules. If this is different than the author's intent, the bill should be amended.

LEGISLATIVE HISTORY

AB 2408 (Skinner, 2011/2012) would have eliminated the two-year carryback of NOLs so that NOLs could only be carried forward. AB 2408 failed passage in the Senate.

AB 1452 (Assembly Committee on Budget, Statutes of 2008, Chapter 763) disallowed the deduction for NOLs and NOL carryovers in the 2008 and 2009 taxable years. This bill extended the carryover period for those NOLs, thus allowing the taxpayers to have the same number of years to utilize the deduction as they would have if the change had not been enacted. This bill, for NOLs incurred in taxable years beginning on or after January 1, 2010, extended the carryover period to 20 years. This bill allowed NOLs attributable to taxable years beginning on or after January 1, 2011, to be carrybacks to each of the preceding two taxable years.

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 generally follows federal NOL rules for corporation income tax, 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 statute of limitations of the tax year, for which and NOL carryback was applied to, extends to match the statute of limitations 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 carryback is filed on an amended return for *Illinois* with a copy of the federal application for tentative refund attached.

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 federal for NOL deductions, 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 taxpayer NOLs. 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 federal law 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

This bill would significantly impact the department's printing, processing, and programming costs. As the bill continues to move through the legislative process, costs will be identified and an appropriation will be requested, if necessary.

ECONOMIC IMPACT

Revenue Estimate

Estimated Revenue Impact of AB 1984 As Amended April 1, 2014 Assumed Enactment After June 30, 2014 ($ in Millions)			
2013-14	2014-15	2015-16	2016-17
- $85	- $100	- $150	- $90

SUPPORT/OPPOSITION

Support: None provided.

Opposition: None provided.

ARGUMENTS

Proponents: Proponents may argue conforming to match the federal procedures would simplify the preparation of the California return by removing a second set of procedures for California related to an NOL carryback.

Opponents: Some may argue that California should conform to the federal tax laws in their entirety, not only in select provisions.

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