

**Franchise Tax Board**

**ANALYSIS OF ORIGINAL BILL**

Author: Bocanegra Analyst: David Scott Bill Number: AB 879  
 Related Bills: See Legislative History Telephone: 845-5806 Introduced Date: February 22, 2013  
 Attorney: Patrick Kusiak Sponsor: \_\_\_\_\_

**SUBJECT:** NOL Deduction/Corporation Business Tax Benefit Transfer Certificate Program

**SUMMARY**

This bill would establish a corporate business tax benefit certificate program that would allow a qualified transferor to surrender unused net operating losses (NOLs) to a qualified transferee in exchange for private financial assistance.

**RECOMMENDATION**

No position.

**REASON FOR THE BILL**

The reason for the bill is to provide an innovative way for new startup biotechnology and emerging technology companies to raise much-needed capital by allowing the sale of unused NOLs.

**EFFECTIVE/OPERATIVE DATE**

This bill would become effective January 1, 2014, and would apply to taxable years beginning on or after that January 1, 2013.

**ANALYSIS**

FEDERAL LAW

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 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. 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 2 years to 3, 4, or 5 years.

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## 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, 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 2 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

This bill would do the following, for taxable years beginning on or after January 1, 2013:

- Establish a program under the Treasurer's office for new and expanding emerging technology and biotechnology companies (Emerging Companies) (transferors), that are subject to the corporate income or franchise tax, to surrender unused NOLs and receive private financial assistance in return. The surrendered NOLs would become a corporation business tax benefit certificate (certificate).
- Allow corporate tax filers (transferees) to acquire certificates for providing financial assistance to Emerging Companies that surrender an NOL.
- Set the minimum amount of financial assistance to obtain the certificate at 80 percent of the amount of the "surrendered tax net operating losses" (surrendered losses).
- Define the tax benefit of the surrendered losses to mean the amount that is the product of the surrendered loss amount times the tax rate of the qualified transferee.
- Establish the following allocation process for the transfer of surrendered loss:
  - The Treasurer shall set aside at least \$25 million, of the total \$60 million to be allocated per fiscal year, for small qualified transferors, defined as having less than \$250,000 of available unused NOLs for transfer.
  - The remaining amount shall be allocated on a first-come first-served basis.
  - If applications for transfer exceed \$60 million, the excess shall be deemed applied for in the next fiscal year.

- Define the following terms: acquire, biotechnology, biotechnology company, full-time employee, group health plan, new or expanding, qualified transferee, qualified transferor, related person, small qualified transferor, and technology company.
- Establish the following criteria that Emerging Companies would be required to meet on both (1) the date its application is submitted and (2) the date its certificate is received, to be able to surrender NOLs:
  - Must not show positive net operating income on their Generally Accepted Accounting Principles (GAAP) financial statements in the two previous taxable years.
  - Must not be owned 50 percent or controlled by another corporation:
    - With positive net operating income on the group's GAAP financial statements for the previous two years.
    - That is part of a federal consolidated return group that shows positive net operating income on their GAAP financial statements for the two previous years.
  - Must have fewer than 225 employees in the US and:
    - If incorporated for less than three years, has at least one full-time employee working in this state,
    - If incorporated for more than three years but less than five years, at least five full-time employees in this state, or
    - If incorporated for more than five years, at least 10 full-time employees working in this state.
  - The Emerging Company must certify that they will continue as an Emerging Company and have no current intentions to cease operations.
- Establish a maximum lifetime limit of \$15 million that an Emerging Company can surrender under the program.
- Allow the Treasurer to establish rules specific to the recapture of the NOL benefit if the Emerging Company fails to use the financial assistance provided by the transferee as required.
- Require that the transferee apply to the Treasurer to acquire surrendered losses by June 30 of each year. The Franchise Tax Board (FTB) would assist in reviewing the applications.
- Prevent the transferee claiming the NOL amounts on the certificates until the first day of the fourth year after the date the certificate is issued.
- Exclude banks and financial corporations from being a transferee.
- Provide rules to limit churning of NOLs by companies becoming new entities when they reach the \$15 million maximum lifetime limit for surrendering NOLs.
- Make the election to surrender the NOLs irrevocable once made and the transferor must reduce the amount of their carryover by the amount of the surrendered NOLs.
- Prevent the resale of acquired NOLs by a transferee.
- Treat the qualified transferor as if it originally generated the NOL received, so that the transferee "stands in the shoes" of the transferor with respect to any limitations on the transferred NOLs.

- Exclude the transferee from carrying back the acquired NOLs.
- Hold the transferee and the transferor jointly and severally liable for any disallowance of any NOL surrendered and transferred.

### IMPLEMENTATION CONSIDERATIONS

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

This bill uses the undefined terms and phrases, "consideration," "emerging company," "financial assistance," and "unused but otherwise allowable net operating losses." The absence of a definition to clarify these phrases could lead to disputes with taxpayers and would complicate the administration of this program.

It is unclear if "private financial assistance" is considered to be "consideration paid by the transferee to the transferor". Without clarity, there could be multiple interpretations of the meaning and may lead to disputes between the department and taxpayers.

It is unclear why the level of private financial assistance would be based on a variable percentage subject to a minimum threshold amount as this could result in inconsistent private financial assistance being exchanged for the same amount of suspended NOL. If the author's intent is for the private financial assistance to be a specified percentage, this bill should be amended.

The definition of "new or expanding" omits companies that have been incorporated exactly three years and exactly five years. It is recommended that the author amend the definition to include those employers incorporated exactly three and exactly five years by changing the specified length of incorporation. For example, to include the exactly three years, the author may wish to change the period of incorporation to "at least three years but less than five years", and for the the exactly five years, the author may wish to change the period of incorporation to "five years or more".

### TECHNICAL CONSIDERATIONS

- On page 4, the definition of "qualified transferor" excluded banks and financials, but did so only indirectly. The author may wish to specifically exclude corporations subject to tax under Section 23181.
- On page 4, in the definition of "new or expanding", the term "working in this state" is included in two of the three requirements for employees in California, depending on the length of time the corporation has been incorporated. The author may wish to add "working" after "employees" on line 17, to make the requirements consistent.
- Paragraph (6) of subdivision (e) needs to be amended where the phrase "employees in the state" appears, as it should be "employees working in the state" for consistency within the paragraph.
- The definition of "qualified transferor" needs to be amended where the phrase "new or expanding emerging" appears as it should be "new or expanding" to correspond with the definition in paragraph (6) of subdivision (e).
- On page 5, line 32, the word "transferee" should be "transferor".

## LEGISLATIVE HISTORY

AB 2045 (Perea, 2011/12), a substantially similar bill, would have created a business tax benefit certificate transfer program. AB 2045 failed to pass out of the Assembly by the constitutional deadline.

## 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. None of the states surveyed had a similar law.

## FISCAL IMPACT

This bill would require system changes, to monitor and track the transfer and use of the NOLs, as well as changes to current forms. As a result, this bill would impact the department's printing, processing, and storage costs. The additional costs will be developed as the bill moves through the legislative process.

## ECONOMIC IMPACT

### Revenue Estimate

Estimated Revenue Impact of AB 879 As Introduced on February 22, 2013 For Taxable Years Beginning On or After January 1, 2013 Assumed Enactment After June 30, 2013 (\$ in Millions)			
2013-16	2016-17	2017-18	2018-19
0	-\$1.8	-\$4.6	-\$5.1

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

## LEGAL IMPACT

This bill would restrict the availability of transferring net operating losses to those qualified emerging companies that have a prescribed number of employees located within California. This 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 credits 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 credits such as the one proposed by this bill may be subject to constitutional challenge.

## **SUPPORT/OPPOSITION**

Support: None provided.

Opposition: None Provided.

## **ARGUMENTS**

Proponents: Supporters could argue that this bill would provide a means for new and emerging creators of innovation in California to monetize their unused NOLs to continue to pursue innovation in California.

Opponents: Some could argue that this bill would be unnecessary because creators of quality innovative ideas have little difficulty finding investments to further their innovative efforts.

## **LEGISLATIVE STAFF CONTACT**

David Scott  
Legislative Analyst, FTB  
(916) 845-5806  
[david.scott@ftb.ca.gov](mailto:david.scott@ftb.ca.gov)

Mandy Hayes  
Revenue Manager, FTB  
(916) 845-5125  
[mandy.hayes@ftb.ca.gov](mailto:mandy.hayes@ftb.ca.gov)

Gail Hall  
Legislative Director, FTB  
(916) 845-6333  
[gail.hall@ftb.ca.gov](mailto:gail.hall@ftb.ca.gov)