Franchise Tax Board

ANALYSIS OF AMENDED BILL

Author:	Anderson	Analyst:	David Scott	Bill Number:	SB 797
Related Bills:	See Legislative History	Telephone:	845-5806	Amended Date:	April 1, 2013
		Attorney:	Patrick Kusiak	Sponsor:	

SUBJECT: Net Operating Loss Deduction/Fraudulent Investment Arrangement Losses

SUMMARY

This bill would modify the Personal Income Tax Law and the Corporation Tax Law to match the federal income tax treatment of losses incurred by victims of fraudulent investment arrangements.

RECOMMENDATION

No position.

Summary of Amendments

The April 1, 2013, amendments removed the bill's provision related to property tax exemptions and replaced it with the provisions discussed in this analysis.

This is the department's first analysis of this bill.

Summary of Suggested Amendments

Amendments 1 through 6 would resolve the technical concerns regarding Internal Revenue Code (IRC) "relating to" language.

REASON FOR THE BILL

The reason for the 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.

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ANALYSIS

FEDERAL/STATE LAW

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.

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.

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 a net operating loss (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 that allow a 3 year period for the carryback of NOLs relating to casualty or theft 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, 2013, 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, 2013, with the following modifications:

1. An NOL may be carried back only 2 years.
2. The amount of NOL carryback attributable to taxable year 2013 is limited to 50 percent of the NOL.
3. The amount of NOL carryback attributable to taxable year 2014 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 2010 and 2011 for a taxpayer with modified adjusted gross income (Personal Income Tax Law) or preapportioned income (Corporation Tax Law) of $300,000 or more.[1] However, deductions for NOL carrybacks from taxable years beginning on or after January 1, 2013, are allowed. As a result of the suspension, the NOL carryover period is extended by one year for NOLs incurred in taxable year 2010.

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,[2] 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.

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[1] "Modified adjusted gross income" means the amount required to be shown as adjusted gross income on the federal tax return for the same taxable year without taking into consideration the NOL deduction under the Personal Income Tax Law. "Preapportioned income" means net income after state adjustments before the application of the apportionment and allocation provisions under the Corporation Tax Law.

[2] http://www.irs.gov/irb/2009-14_IRB/ar11.html

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

TECHNICAL CONSIDERATIONS

This bill would be specifically operative for taxable years beginning on or after January 1, 2008. IRS Revenue Procedure 2009-20 would not re-open the recently closed statute of limitations (SOL) for 2008 calendar year taxpayers. If the author's intent is to include unclaimed fraudulent investment losses for 2008 in the scope of this bill, the author may wish to amend the bill to include a limited period, after the bill is chaptered, for taxpayers to file a claim for previously unclaimed fraudulent investment losses for any 2008 taxable year that the SOL has expired.

Additionally, amendments 1 through 6 are suggested to make minor technical modifications to the "relating to" labels of IRC sections, subsections, paragraphs, etc.

LEGISLATIVE HISTORY

SB 157 (Anderson, 2011/2012) would have provided similar relief for fraudulent investment losses as this bill would provide. SB 157 failed to pass out of the Senate Governance and Finance Committee by the constitutional deadline.

SB 876 (Florez, 2009/2010) would have provided similar relief for fraudulent investment losses as this bill would provide. SB 876 failed to pass out of the Senate Revenue and Taxation Committee 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.

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

Illinois' 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. NOLs for a corporate taxpayer are generally allowed as a carryover to each of the 12 taxable years following the taxable year of the loss. In the case of a corporation (other than an S corporation), no carryover deduction is allowed for any taxable year ending after December 31, 2010, and prior to December 31, 2014. NOLs may not be carried back under *Illinois* law.

Massachusetts does not conform to federal treatment of theft losses, including the safe harbor treatment of fraudulent investment losses under Revenue Procedure 2009-20. 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 personal income taxpayers 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. For purposes of the Michigan Business Tax, the federal NOL is added back in determining the tax base. However, a business loss may be carried forward for up to ten years.

New York recognizes the safe harbor under Revenue Procedure 2009-20. Taxpayers using the safe harbor provisions to calculate their federal theft loss deduction are allowed to use the same amount in computing their *New York* itemized deduction. *New York's* 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. Under New York law, there is a $10,000 limit on the amount of an NOL that may be carried back.

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

Revenue Estimate

Estimated Revenue Impact of SB 797 As Amended April 1, 2013 For Taxable Years Beginning On or After January 1, 2013 Enactment Assumed After June 30, 2013 ($ in Millions)					
2012-13	2013-14	2014-15	2015-16	2016-17	2017-18
- $6.0	+ $2.9	+ $2.2	+ $0.7	$0.0	$0.0

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

SUPPORT/OPPOSITION

Support: None provided.

Opposition: None provided.

ARGUMENTS

Proponents: Some may say that providing relief for the tax on "phantom income" paid by some taxpayers is merely an attempt to match the tax paid to the income actually received.

Opponents: It could be argued that providing relief to one group of taxpayers would make the tax code less fair overall.

LEGISLATIVE STAFF CONTACT

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FRANCHISE TAX BOARD'S
PROPOSED AMENDMENTS TO

SB 797 as Amended on April 1, 2013

AMENDMENT 1

On page 2, line 15, after "Code", insert:

relating to theft loss

AMENDMENT 2

On page 2, line 23, after "Code", insert:

relating to net operating loss

AMENDMENT 3

On page 4, strikeout line 8, and on line 9, strikeout "of limitation with respect"

AMENDMENT 4

On page 4, line 16, strikeout "the limitations on credit or refund with respect to the"

AMENDMENT 5

On page 4, line 35, after "Code", insert:

relating to theft loss

AMENDMENT 6

On page 5, line 3, after "Code", insert:

relating to net operating loss