**Franchise Tax Board**

# ANALYSIS OF AMENDED BILL

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Related Bills: ______ | Telephone: 845-3410 | Amended Date: 01/03/2000

Attorney: Patrick Kusiak | Sponsor: ______

**SUBJECT**: Biotechnology Or Technology Company Research Expenses Credit/Allows Transfer Or Refund of Unused Tax Benefits

____ DEPARTMENT AMENDMENTS ACCEPTED. Amendments reflect suggestions of previous analysis of bill as introduced/amended _________.

X AMENDMENTS IMPACT REVENUE. A new revenue estimate is provided.

____ AMENDMENTS DID NOT RESOLVE THE DEPARTMENT'S CONCERNS stated in the previous analysis of bill as introduced/amended _________.

____ FURTHER AMENDMENTS NECESSARY.

____ DEPARTMENT POSITION CHANGED TO _______________________.

____ REMAINDER OF PREVIOUS ANALYSIS OF BILL AS INTRODUCED/AMENDED ___________ STILL APPLIES.

X OTHER - See comments below.

SUMMARY OF BILL

Under the Bank and Corporation Tax Law (B&CTL), this bill would modify the research and development credit to allow a special allocation of a partnership's credit to a taxpayer that is a biotechnology or technology company and is a partner in a partnership with a biotechnology or technology company.

Under the B&CTL, this bill also would allow a biotechnology or technology company with unused research and development credit carryovers or net operating loss carryovers to transfer (i.e., sell) those unused tax benefits for up to 75% of the tax benefits' value to another taxpayer or surrender those benefits to the state for a refund equal to 50% of the value of the unused tax benefit.

SUMMARY OF AMENDMENT

The proposed amendments deleted the intent language contained in the bill as introduced and added the provisions discussed in this analysis regarding transfer of the research credit and the sale or refund of unused tax benefits.

EFFECTIVE DATE

As a tax levy, this bill would become effective immediately upon enactment and would apply to income years beginning on or after January 1, 2000.

LEGISLATIVE HISTORY

AB 1315 (1999, as introduced) would have allowed the transfer of the manufacturers' investment credit between affiliated corporations that file a single combined report. AB 482 (1999) would allow taxpayers to assign to

| Board Position: | | | Department Director | Date |
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| ____ SA | ____ O | ____ NAR | Alan Hunter for G.H.G. | 01/11/00 |
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affiliated corporations the California seed capital and early stage corporation fund credit. AB 1230 (1999) would allow a taxpayer that claims the research expenses credit to transfer the credit to another taxpayer that has a tax liability under the B&CTL and would require the department to develop a system for registering tax credits for the purposes of transfer among taxpayers.

## SPECIFIC FINDINGS

**Existing state and federal laws** provide various tax credits that are designed to provide tax relief for taxpayers that must incur certain expenses (e.g., child and dependent care credits) or to influence behavior, including business practices and decisions (e.g., research credits).

**Under existing state and federal laws**, generally tax credits may be claimed only by the taxpayer that incurred the credit-related expense. In the case of the low-income housing credit, if a property is acquired during the credit period, the credit may be transferred to the acquiring taxpayer. In addition, for state purposes, a specific statutory authorization permits the low-income housing credit to be transferred between wholly-owned affiliated corporations.

Generally, a net operating loss (NOL) results when a taxpayer's business expenses exceed income in a particular year, thereby resulting in an "operating loss" for that year which is carried forward (or back) as a "net operating loss."

**Under federal law**, an NOL can be carried back to each of the two preceding years and carried forward to each of the 20 following years. **State law** generally conforms to the federal NOL provisions with three major exceptions:
(1) California law prohibits carry-back of the NOL deduction, (2) the carryover is generally five years, and (3) generally only 50% of the NOL can be carried forward[1].

**Federal law** treats an NOL as a tax attribute of the taxpayer. If a corporation with an NOL (the “loss corporation”) ceases to exist as a result of a reorganization described in Internal Revenue Code (IRC) Section 381, the successor corporation will stand in the shoes of the loss corporation with respect to the carryover and deduction of the NOL.

If an ownership change occurs in which the percentage of a loss corporation’s stock owned by 5% or more shareholders increases by more than 50 percentage points, then a ceiling is placed on the amount of the loss corporation’s NOL that can be deducted in any one year. The ceiling is the value of the loss corporation immediately before the ownership change, multiplied by the long-term tax-exempt rate[2]. The purpose of the ceiling is to prevent the buying and selling of NOLs that might occur if new owners were able to transfer profitable operations into a newly purchased corporation with unused NOL carryovers.

[1] State law contains special NOL provisions for taxpayers that operate “new businesses” or “eligible small businesses;” suffer disaster losses; or that operate businesses within an enterprise zone, a local agency military base recovery area (LAMBRA), or a targeted tax area (TTA). These special NOL provisions are not discussed in this analysis.

[2] The long-term tax-exempt rate means the highest of the adjusted federal long-term rates in effect for any month in the three-calendar month period ending with the calendar month in which the ownership change occurs.

When a consolidated return is filed for **federal purposes**, NOLs generally are computed and carried back or forward on a consolidated group basis. Exceptions occur when corporations enter or leave the consolidated group. If an entering member has an NOL carryover from a pre-consolidation year (this is termed a "separate return limitation year" or SRLY), that NOL may be deducted only against the portion of the consolidated taxable income that is attributable to that corporation. If a corporation that generated a consolidated NOL carryover leaves the consolidated group, it takes with it an allocated portion of the group's unused NOL carryover.

**California law** does not conform to the federal consolidated return rules. Instead, California source income for corporations that operate both within and without the state is determined using unitary principles and combined reporting. As an alternative to the worldwide combined report, California law allows corporations to elect to determine their income on a "water's-edge" basis. Water's-edge electors generally may exclude unitary foreign affiliates from the combined report used to determine income derived from or attributable to California sources. A fundamental difference between a California combined report (either worldwide or water's-edge) and a federal consolidated return is the concept of a group vs. separate entities. The federal consolidated return generally treats the group as a single taxpayer. The members of a California combined report are treated as a unit for purposes of combination and apportionment, but their separate entity status is preserved for all other purposes.

Unlike federal consolidated NOLs that are generally computed on a group basis, NOLS of members of a California combined report are separately computed. Each taxpayer member of a California combined report is attributed a share of the unitary group's California-source business income or loss (this is known as intrastate apportionment), which it aggregates with its own California-source nonbusiness income or loss. If the result is a net operating loss, that taxpayer will carry the NOL forward to be deducted against its California-source income in subsequent years. Because each member of a combined reporting group tracks and applies its own NOL, generally there is no need for special rules to account for members entering or leaving the combined reporting group.

**Under the B&CTL, this bill** would do the following:

1. <u>Partnership Allocation of Research Credit</u>: modify the research and development credit to allow a special allocation of a partnership's credit to a taxpayer that is a biotechnology or technology company and is a partner in a partnership with a biotechnology or technology company. For such a taxpayer, its share of the qualified research expenses and basic research payments or share of the research and development credit would equal the sum of (1) the taxpayer's share of the qualified research expenses and basic research payments, or share of the credit allocated or apportioned to that partner under current law, and (2) any portion of another partner's share of expenses, payments, or research and development credit allocated under current law to the other partner that the other partner agrees to allocate to the taxpayer. The total qualified research expense and basic research payment, or total credit for the income year with respect to any partner, may not exceed 125% of the amount that would be allocated to that partner under current law.

2. <u>Tax Benefit Transfer</u>: allow a biotechnology or technology company (as defined) with unused tax benefits (research and development credit carryovers and NOL carryovers) to transfer those benefits to another corporate taxpayer in the State of California. The taxpayer receiving transferred tax benefits could not be affiliated with the corporation that is transferring its tax benefits and the transferee must pay the transferor an amount equal to at least 75% of the value of the transferred tax benefit. The transferor and transferee are affiliated if the same entity directly or indirectly owns or controls 10% or more of the voting rights or 10% of the value of all classes of stock of both taxpayers. The maximum lifetime value of transferred tax benefits that a corporation is allowed to transfer would be $20 million. The bill would require "private financial assistance," which is undefined, to be used for expenses incurred in connection with the operation of a biotechnology company or technology company in this state.

3. <u>Tax Benefit Surrender</u>: allow a biotechnology or technology company with unused tax benefits (research and development credit carryovers and NOL carryovers) to surrender those benefits to the State for a refund equal to 50% of the value of the unused tax benefit. The maximum lifetime refund that may be received by a corporation and its affiliated corporations would be $20 million. For the refund, a corporation is affiliated with the taxpayer if either the taxpayer directly or indirectly owns or controls 10% or more of the voting rights or 10% of the value of all classes of stock of that corporation or another organization directly or indirectly owns or controls 10% or more of the voting rights or 10% of the value of all classes of stock of both the taxpayer and that corporation.

Once unused tax benefits are transferred or surrendered by the taxpayer, the taxpayer would be prohibited from claiming the tax benefits on its tax return or transferring or surrendering the tax benefits more than one time.

The department would be required to maintain a cumulative total value of all unused tax benefits transferred or surrendered by all taxpayers for any income year. At least 30 days prior to the transfer or surrender, the taxpayer would be required to notify the department of the value of the unused tax benefit being transferred or surrendered. The department would be required to notify the taxpayer if the value of the unused tax benefit exceeds the maximum annual amount that may be transferred under the bill. The maximum annual amount for transfers and surrenders would be $25 million each.

<u>Constitutional Considerations</u>

The requirement in this bill that a corporation must have either its headquarters or base of operations in California likely is a violation of the Commerce Clause of the United States Constitution.

While providing a tax incentive to taxpayers that engage in certain activities in this state generally would not be considered a constitutional violation because it is the activity itself that is being rewarded, a limitation based on a standard of having the corporate headquarters or base of operation in this state, irrespective of the taxable income generated in California, is much more likely a Commerce Clause violation because it rewards taxpayers merely because of location.

Policy Considerations

This bill, as proposed to be amended, raises the following policy considerations.

1. Generally, tax credits are allowed to the taxpayer that incurs the related expense. Under state law, only the low-income housing credit permits the credit to be assigned, which allows transfer of the credit to the purchaser of the property or between affiliated corporations as long as the affiliation is 100% ownership. Conversely, this bill would allow unused tax benefits to be transferred to unaffiliated transferees, which would create a precedent by allowing tax benefits to be transferred from the taxpayer who incurred the expenses to any other taxpayer. This bill would allow tax benefits to taxpayers that did not incur the expense on which the benefits are based, thus providing a benefit to one taxpayer for the action of another taxpayer.

   Further, it would create a system of "tax benefit transfers" similar to the old federal safe harbor leasing regime. However, tax credits transferable under federal safe harbor leasing rules were limited to tax credits for the purchase of certain property, and the transfer was accomplished by a nominal sale-lease back of that property in which the rights of the parties were clearly defined. The research expenses tax credit is based on various expenses such as wages, supplies, rental charges, etc.

2. This bill would provide a tax benefit for taxpayers filing under the B&CTL that would not be provided to other similarly situated taxpayers that file under the Personal Income Tax Law (PITL). Thus, this bill would provide differing treatment based solely on entity classification.

3. Historically, fraud has been associated with refundable credits (such as the state renter's credit, the federal Earned Income Tax Credit, and the federal farm gas credit).

Implementation Considerations

Department staff has identified the following implementation considerations. These implementation considerations would make it very difficult, if not impossible to properly implement this bill. Additional concerns may be raised as the department continues to analyze the bill. Department staff is willing to assist the author with any necessary amendments to resolve these concerns.

1. The department has not administered a refundable tax credit under the PITL since the refundable renter's credit was suspended in 1993. The department has never administered a refundable tax credit under the B&CTL. Establishing a refundable tax benefit process would have a significant impact on the department's programs and operations and require extensive changes to forms and systems. Further, the department would have to establish a tracking system to maintain a cumulative total of the value of tax benefits transferred and surrendered.

2. It is expected that the department would manually review the claims for refunds and attached documentation since the refund amounts could be significant.

3. This bill is silent with regard to the proper tax treatment by transferor and transferee of the amount paid for the transfer of the tax benefits. It appears that the transferor would include the amount received for the tax benefit in income, and the transferee arguably could receive a business expense deduction for the purchase of the tax benefit. In the absence of clarification, disputes may arise between taxpayers and the department as to the proper tax treatment of the amount paid in connection with the transfer of a tax benefit under this bill.

4. This bill leaves unclear whether the transferee taxpayer could use the transferred tax benefit in the same income year as the transferor earned the tax benefit or whether the transferee only can use the transferred tax benefit in the succeeding income year (and subsequent income years if limited).

5. The bill does not address whether the entire unused tax benefit only or portions of the unused tax benefit may be transferred. If portions of the unused tax benefit may be transferred, the bill does not address whether or how one tax benefit may be divided among multiple transferees.

6. If audit results modify the research and development credit that has been allocated among the partners or modify a taxpayer’s unused tax benefits that have been transferred, it is unclear which partner or taxpayer would be responsible for the tax related to the audit adjustment. The bill should clarify the department’s authority to readjust the tax liability of the transferee and reclaim the transferred amount. Moreover, since there may be occasion where the department's audit of the transferor taxpayer's return may occur after normal expiration of the statute of limitations (i.e., under a waiver), it might become necessary for the department to request waiver of the transferee's statute of limitations to prevent the department from being foreclosed from adjusting the transferee's tax liability when the department determines that part or all of the claimed tax benefit should never have been allowed.

   Alternatively, if the claimed tax benefit of the transferor is disallowed only in part, it is unclear how this disallowance would be allocated between the transferor and the transferee, especially if the statute of limitations has expired for one, but not both, of the affected taxpayers.

7. It is unclear whether the department could reduce or offset refund amounts for other amounts owed.

8. It is unclear how the value of the tax benefits should be determined. The bill in one place provides that the value is the amount of the research and development credit carryover or the net operating loss carryover, but the definition for the values uses the terms “credit” and “loss” which are different from the “credit carryover” and “loss carryover.”

9. If the amount of tax benefits transferred or refunded during a year do not exceed the maximum annual amount, it is unclear whether the maximum amount could be transferred to the succeeding year and thereby increase the next year's maximum amount.

10. The transfer and refund provisions use “biotechnology company” and “technology company,” terms that are not clearly defined. Various other terms are used that are not defined, such as “highly educated,” “highly trained,” “corporation business taxpayer,” and “private financial assistance.” Further, words are used inconsistently and in unusual context adding confusion to the provisions. Undefined terms and unclear definitions can lead to disputes between taxpayers and the department.

Technical Considerations

The department has various technical considerations regarding the proposed language. Department staff will work with the author to resolve these concerns.

## FISCAL IMPACT

### Departmental Costs

The department’s costs to administer this bill cannot be determined until implementation concerns have been resolved.

### Tax Revenue Estimate

It is not possible to project in advance the response of biotechnology and technology companies that in any give year would transfer or surrender unused credits and/or net operating losses at 75% or 50%, respectively, of the tax value. The impact of the special allocation of partnership credits between partners is speculative.

Revenue effects would include both cash-flow acceleration of tax credit and net operating loss usage and absolute revenue losses. The former would reflect more immediate use of tax benefits by transferees rather than later by transferors, and the latter would reflect the fact that some transferors never would use all the potential tax benefits.

The following data compiled from department records shows the current research expenses credit and net operating loss activity.

**Research Expenses Credit:**

- It can be assumed that taxpayers that qualify for the research expenses credit likely would qualify under the provisions of this bill.
- In 1997 1,696 corporations reported $675 million of research expenses credits.
  - 1,482 corporations used $349 million in research expenses credits to reduce their tax;
  - 958 corporations reported $326 million of unused credits;

  - Of this unused credit amount, $267 million was for California domiciled corporations (the universe that likely would qualify under this bill).
- It is likely that some corporations with losses do not file research expenses credit forms since they could not use the credit, it is likely that the stock of unused research expenses credits is substantially larger.

**Net Operating Loss (NOL):**

- At the end of 1998 the stock of unused NOLs was $63.7 billion. At an 8.84% tax rate, this would translate to $5.6 billion in taxes.
- For perspective, in the 1998-99 fiscal year the bank and corporation tax brought in $5.5 billion.
- Most NOLs are never applied. For NOLs generated from 1985 to 1993, less than 30% were ever applied to reduce tax.

BOARD POSITION

Pending.