STATE OF CALIFORNIA
Franchise Tax Board

Analysis of Original Bill

Author: Brough	Sponsor: 3-Member FTB	Bill Number: AB 2855
Analyst: Jon Feenstra	Phone: (916) 845-4870	Introduced: February 16, 2018
Attorney: Bruce Langston	Related Bills: See Legislative History	

Subject: Net Operating Loss (NOL) Deduction Carryback/Modified Conformity

Summary

This bill would amend state law to establish an application for tentative refund (ATR) process, similar to the federal process for obtaining a tentative refund based on an NOL carryback, and specify the trigger date for the statute of limitations (SOL) and interest accrual applicable to an NOL carryback.

Recommendation

On December 7, 2017, the three-member Franchise Tax Board (FTB) voted 2-0 to sponsor the language included in this bill, with the representative of the Department of Finance abstaining.

Reason for the Bill

California's NOL carryback provisions, unlike federal law, lack provisions allowing expedited carryback refunds to reduce the impact of business losses, and fail to specify that the SOL and interest trigger date on a refund resulting from an NOL carryback are determined based on the filing date of the return that generated the NOL, thus inadvertently reducing the period for taxpayers and the department to correct an NOL carryback and increasing the interest accrual period on a refund resulting from an NOL carryback.

Effective/Operative Date

This bill would become effective and specifically operative on January 1, 2019.

Federal Law

NOL Law

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

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 limits the NOL deduction for losses arising after December 31, 2017, to the lesser of the following:

- The aggregate of the NOL carryover losses to such year plus the NOL carrybacks to such year; or
- 80 percent of taxable income (determined without regard to the deduction). Carryovers to other years are adjusted to apply this limitation and may be carried forward indefinitely.

In general, an NOL arising in taxable years after December 31, 2017, cannot be carried back to a taxable year preceding the loss, thus generally eliminating carrybacks for most taxpayers. Federal law does allow the carryforward of an NOL indefinitely. However, certain disaster losses incurred in the trade or business of farming are allowed a two-year carryback. In addition, a two-year carryback and 20-year carryforward for an NOL of a property and casualty insurance company[1] is allowed.

Application for Tentative Refund (ATR) – Internal Revenue Code (IRC) Section 6411

Federal law provides for an expedited refund for NOL carrybacks for losses arising in a taxable year before December 31, 2017, or for carrybacks related to certain disaster-related farming losses, or carrybacks of losses arising from a property or casualty insurance company by allowing taxpayers to file an ATR resulting from:

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

The ATR must be filed on or after the return filing date, but no later than 12 months after the end of the taxable year in which an NOL, net capital loss, unused credit, net contracts loss, or claim of right adjustment arose.

The Internal Revenue Service (IRS) must perform a limited examination of the ATR to discover omissions and errors of computation within the later of (1) 90 days from the date on which an ATR is filed, or (2) the last day of the month of the extended due date for the loss year return. The IRS may disallow the ATR if there are any material omissions or any errors of computation that are not corrected within the ATR processing period.

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[1] IRC section 816(a) defines a property and casualty insurance company as an insurance company other than a life insurance company.

NOL Carryback - SOL and Interest

Under federal law, for those taxpayers authorized to carry back NOLs, the computation of interest on overpayments that result from application of an NOL carryback begins on the date the loss year return was filed. The federal SOL to file a claim or issue an assessment, for a year with a reported NOL carryback, is the same as the loss year that generated the NOL carryback, but only to the extent of the amount refunded due to the carryback.

Corporation Payment Extension - IRC Section 6164

Under federal law, a corporation that is authorized to carry back losses and expects an NOL in the current taxable year may file to extend the time for payment of tax for the immediately preceding taxable 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.

The extension for payment of tax under this provision is granted until:

- The end of the month in which the return for the taxable year of the expected NOL is required to be filed, including extensions, or
- If filed prior to the above date, the date on which notice is mailed by the IRS allowing or disallowing an ATR.

State Law

NOL Law

In general, a California taxpayer[2] calculates an NOL in accordance with federal law under IRC section 172, as of the specified date of January 1, 2015.[3] 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. For NOLs that arise in taxable years beginning on or after January 1, 2013, California conforms, with modifications, to the federal NOL carryback rules.

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

California lacks an expedited ATR process and applies the general rules for interest computations and SOLs to returns reporting an NOL carryback.

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[2] Revenue and Taxation Code (R&TC) sections 17276 and 24416.
[3] R&TC sections 17024.5 and 23051.5.

Corporation Payment Extension

For taxable years beginning on or after January 1, 2015, California enacted[4] modified conformity to the federal extension of time for payment of taxes by corporations expecting an NOL carryback for the immediately preceding taxable year. For state purposes, the payment extension is allowed until the end of the month that the return for the taxable year of the expected NOL is required to be filed, including extensions.

This Bill

This bill would amend state law to establish an ATR process, similar to the federal process for obtaining a tentative refund based on an NOL carryback, and specify the trigger date for the SOL and interest accrual applicable to an NOL carryback, as described below.

ATR Process

In modified conformity to federal law, this bill would amend state law to establish an ATR process. Under this process, an ATR would be filed to report an NOL carryback. The ATR, (which could be on a single-issue amended return form) must be filed within 12 months of the end of the taxable year the NOL was generated and the FTB would have the later of 90 days, or the last day of the month of the extended due date for the loss year return, to process the ATR.

Amounts in excess of the overpayment attributable to the carryback would be assessed as an overstatement of a credit pursuant to R&TC section 19054.

NOL Carryback – SOL and Interest Accrual Trigger Dates

This bill would also mirror federal law regarding the SOL and interest accrual trigger dates applicable to an NOL carryback.

The SOL for claiming a refund based on, or assessing a deficiency attributable to, an NOL carryback would generally be the same as the SOL for the return that generated the NOL, including extensions.

The trigger date for interest accrual would be the same as the original filing date for the return that generated the NOL, exclusive of extensions.

Implementation Considerations

The FTB's automated processing systems are tax return-based and a new standalone ATR form could not be processed through existing filing systems without significant system modifications. An ATR on a single-issue amended return with corresponding form instructions would provide relatively small processing impacts while inputting data into FTB systems and serving the same function as a standalone ATR.

[4] AB 154 (Chapter 359, Statutes of 2015).

The department's data processing systems are unable to easily accommodate the changes required to automate the processing of reduced period interest calculations. As a result, carryover loss overpayment interest calculations that begin on the loss year filing due date would be processed manually.

Technical Considerations

A drafting error failed to change the reference to "Section 24416.20" to "Section 24416" on page 4, line 3. R&TC section 24416.20 was repealed and renumbered as R&TC section 24416 for taxable years beginning on or after January 1, 2016.

Legislative History

AB 154 (Ting, Statutes of 2015, Chapter 359) conformed to the federal NOL rules that allow corporations expecting an NOL carryback to extend the time for payment of taxes for the preceding taxable year.

AB 1984 (Harkey, 2013/2014) would have conformed 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, and allow a corporation to apply to extend the time for payment of taxes for the immediately preceding taxable year. AB 2408 failed to pass out of the Assembly Appropriations Committee by the constitutional deadline.

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 to pass out of the Senate 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 lacks 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 a stand-alone NOL computation.

Massachusetts lacks a federal NOL deduction, but has a stand-alone NOL for corporations. *Massachusetts* law does not allow NOLs to be carried back.

Michigan does not conform to IRC section 172, but instead has a stand-alone NOL computation. *Michigan's* 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 law for individual taxpayers. Individuals are allowed to carryover their NOL for 20 years and carry back for two taxable years. An NOL carryback is applied to a prior taxable year by filing an amended return and checking the box that identifies that the return is being amended for an NOL carryback from another taxable year. For corporations, *Minnesota* law lacks an NOL carryback, but does allow a 15-year carryover.

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 on an NOL carryback accrues from the filing date of the loss year. For taxable years beginning on or after January 1, 2015, *New York* corporate taxpayers are allowed an NOL carryover of 20 years and a carryback of three years.

Fiscal Impact

Staff estimates a cost of approximately $571,000 in fiscal year 2018-2019 and ongoing costs of $179,000 to develop, program, and test revisions to existing systems for this bill. The department will pursue a budget change proposal if necessary.

The estimated cost for this bill is significantly lower than the estimate prepared for a similar bill, AB 1984 (Harkey, 2013/2014), because this estimate is based on historical return processing information for NOL carryback returns that was unavailable at the time the earlier bill was developed.

Economic Impact

Revenue Estimate

This bill would result in the following revenue gain/loss:

Estimated Revenue Impact of AB 2855 as Introduced February 16, 2018
Net Operating Loss Deduction Carryback Modified Conformity
For Taxable Years Beginning On or After January 1, 2018
Assumed Enactment after June 30, 2018

($ in Millions)

	2019-20	2020-2021	2021-2022
Revenue Impact of Interest	+ $2.1	+ $2.2	+ $2.2
Revenue Impact of SOL	+ $3.4	+ $3.5	+ $3.6
Revenue Impact of Refund	- $60.0	- $10.0	- $2.4
Total	- $55.0	- $4.5	+ $3.3

***** Totals do not add due to rounding.

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

Revenue Discussion

The revenue impact of this bill was estimated using data on carryback refunds claimed by taxpayers against taxes paid during the 2011-2015 period.

The bill would change the date that the FTB must begin interest accrual to be the original filing date for the return that generated the NOL, exclusive of extensions. This change would reduce the amount of interest paid on these refunds by approximately one year for NOLs carried back one year and by approximately two years for NOLs carried back two years. Based on an analysis of carrybacks reported on corporate tax returns, the estimate assumes that 70 percent of NOLs reported for a taxable year are carried back two years and 30 percent one year. The applicable corporate and personal overpayment interest rates are applied to these refund claims. This interest rate was applied to the refund claims that were allowed by the FTB. The estimated revenue gain from this change is approximately $2.2 million per year.

Currently, if the FTB allows a refund for a carryback year, and later audits the loss year and reduces the NOL amount, it may be barred by the SOL from adjusting the refund amount. This estimate assumes that five percent of amounts refunded as carrybacks would be reversed by audits after the SOL expires. This bill would enable the FTB to recoup these refunds. The estimated revenue gain from this change is approximately $3.5 million per year.

When the FTB receives a refund request based on an NOL carryback, the return is examined quickly to identify issues that may affect the amount of the refund. The FTB is currently releasing $30 million in refunds after this initial examination and holding about $50 million in refund requests pending further examination. This bill would require the FTB to release refunds within the later of 90 days of receiving a carryback ATR, or the last day of the month of the extended due date for the loss year return. For refunds that the FTB ultimately approves, this accelerates the date of the refund, resulting in an initial cash outflow and a later, offsetting cash inflow. For refund amounts the FTB ultimately denies, this results in a refund that would not have been issued under current law followed by a repayment from the taxpayer after an audit assessment, also resulting in an initial cash outflow and a later, offsetting cash inflow. The initial outflow of revenue from this bill is $55 million.

The taxable-year estimate is converted to fiscal years, accrued back one year, and then rounded as reflected in the above table.

Support/Opposition

Support: None provided.

Opposition: None provided.

Arguments

Proponents: Some may argue that modified conformity to the specified federal NOL carryback procedures would enhance departmental enforcement abilities, eliminate excessive interest payments, and provide potentially quicker refunds for taxpayers.

Opponents: Some may argue that California should conform to recent changes in federal law that have eliminated nearly all NOL carrybacks, which would make this bill unnecessary.

Policy Concerns

Allowing an expedited ATR process and mirroring the federal SOL and interest accrual trigger-date applicable to NOL carrybacks would simplify the preparation of amended state tax returns for affected entities for the specified taxable years. However, if California conforms to recent changes to federal law that eliminated nearly all NOL carrybacks, the provisions of this bill would be largely unnecessary since they would only apply to a very limited number of taxpayers.

Legislative Staff Contact

Jon Feenstra
Legislative Analyst, FTB
(916) 845-4870
jon.feenstra@ftb.ca.gov

Jame Eiserman
Revenue Manager, FTB
(916) 845-7484
jame.eiserman@ftb.ca.gov

Diane Deatherage
Legislative Director, FTB
(916) 845-6333
diane.deatherage@ftb.ca.gov