Franchise Tax Board

ANALYSIS OF AMENDED BILL

Author:	Lackey	Analyst:	Jon Feenstra	Bill Number:	AB 743
Related Bills:	See Legislative History	Telephone:	845-4870	Amended Dates:	March 27, 2017 April 4, 2017
		Attorney:	Bruce Langston	Sponsor:	

SUBJECT: Net Operating Loss Carryback for Home Construction Companies

SUMMARY

This bill would, under the Personal Income Tax Law and the Corporation Tax Law, extend the net operating loss (NOL) carryback period for qualified taxpayers from two to 20 years.

RECOMMENDATION – NO POSITION

Summary of Amendments

The March 27, 2017, amendments removed provisions of the bill related to the Sales and Use Tax Law, and replaced them with provisions extending the NOL carryback period. The April 4, 2017, amendments defined several terms.

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

REASON FOR THE BILL

The reason for the bill is to encourage the construction of additional affordable residential units in the state.

EFFECTIVE/OPERATIVE DATE

This bill would be effective January 1, 2018, and operative for taxable years beginning on or after January 1, 2017.

FEDERAL 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 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.

If any overpayment of income tax results from a carryback of an NOL, interest payable on that overpayment runs only from the filing date for the tax year in which the NOL arises.

STATE 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.[1]

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.

The carryback was 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.

No losses may be carried back to years beginning before January 1, 2011.

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.

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

The California Revenue and Taxation Code (R&TC)[2] and justified business needs allow the Franchise Tax Board (FTB) to retain data for a minimum of three years up to a maximum of 20 years, for those with outstanding liabilities.

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[1] R&TC sections 17276 and 24416.
[2] Sections 19058, 19059, 19065, 19087, 19255, 19306 and 19530.

THIS BILL

This bill would, for taxable years beginning on or after January 1, 2017, extend from two years to 20 years, a qualified taxpayer's NOL carryback period for losses from a project that contains an affordable housing component, for low-income to moderate-income residents,

This bill would define the following terms and phrases:

- "Affordable housing component" means the taxpayer has constructed new housing units, including single-family and multifamily dwellings, offered at a base sales price that is below the annual Federal Housing Administration loan limit designated for the county where the housing is constructed.
- "Primarily engaged in home construction" means the taxpayer can prove to the FTB that it has constructed at least 10 new housing units over the past 10 years.
- "Qualified taxpayer" means a taxpayer that is primarily engaged in home construction.

IMPLEMENTATION CONSIDERATIONS

Department staff has identified the following implementation considerations for purposes of a high-level discussion; additional concerns may be identified as the bill moves through the legislative process. Department staff is available to work with the author's office to resolve these and other concerns that may be identified.

This bill uses terms that are undefined, i.e., "project that contains," "low-income to moderate-income residents,", "constructed, and "new housing units." The absence of definitions to clarify these terms could lead to disputes with taxpayers and would complicate the administration of this bill. For clarity and to ensure consistency with the author's intent, this bill should be amended.

Absent provisions similar to federal law's modifications of the statute of limitation for refunds and payment of interest on overpayments applicable to NOL carrybacks, a qualified taxpayer would be limited to refunds generated in years with an open statute of limitations under current law (generally four years from the later of the due date of the return or the date the return was filed or one year from the date of payment). To allow refunds to be issued to earlier years within the intended 20-year carryback period, this bill should be amended to mirror federal provisions extending the statute of limitations for NOL carrybacks and accrual of interest on overpayments resulting from such carrybacks.

It is unclear how taxpayers and the department would verify overpayments attributable to carrybacks of up to 20 years. For example, the department retains copies of tax returns for approximately four years from the date a return is received, and under existing data retention policies, the FTB purges accounting records on a periodic basis. As a result, the FTB would not be able to determine the amounts of income, tax paid, and refunds for taxable years in which returns and accounting records are unavailable. This would increase the information necessary for taxpayers to justify claims for refund, resulting in more claimants being unable to meet their burden of proof.

It is recommended that this bill be amended to exempt the FTB from the Administrative Procedure Act (APA) when the FTB is prescribing rules, guidelines, or procedures necessary or appropriate to administer the NOL carryback that would be enacted by this bill.

To avoid confusion with existing cross-references to repealed R&TC sections 17276.2 and 24416.2, it is recommended that the bill be amended to use the section numbers 17276.25 and 24416.25 respectively.

LEGISLATIVE HISTORY

AB 1984 (Harkey, 2013/2014) would have, among other things, conformed to federal provisions modifying the general statute of limitations period when a taxpayer carried back a California NOL as well as the date used for purposes of calculating interest on an overpayment of tax resulting from a California NOL carryback. AB 1984 failed to pass out of the Assembly Appropriations Committee.

AB 2408 (Skinner, 2011/2012) would have eliminated the two-year carryback of NOLs.
AB 2408 failed passage in the Senate.

AB 1452 (Assembly Committee on Budget, Statutes of 2008, Chapter 763), among other things, 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 and Massachusetts laws provide for NOL carryovers. Neither state allows an NOL carryback.

Michigan law has stand-alone NOL computation provisions. NOL carryover and carryback periods follow federal limitations for the same periods.

Minnesota generally follows federal for individual taxpayer NOLs. Individuals are allowed a two year NOL carry back. No NOL carryback is allowed for corporations.

New York generally follows federal NOL rules which provide a 20-year carryover and two-year carryback, but limits the amount of the NOL carryback to $10,000.

FISCAL IMPACT

The department's costs to implement this bill have yet to be determined. As the bill moves through the legislative process and the implementation concerns are resolved, costs will be identified and an appropriation will be requested, if necessary.

ECONOMIC IMPACT

Revenue Estimate

This bill would result in the following revenue loss:

Estimated Revenue Impact of AB 743 As Amended April 4, 2017 Assumed Enactment After June 30, 2017 ($ in Millions)			
2016-17	2017-18	2018-19	2019-20
- $75	- $60	- $55	- $50

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

Revenue Discussion

Estimating the revenue impact of extending the NOL carryback period to 20 years would depend on the amount of NOLs generated by qualified taxpayers, the amount of positive state net income available to offset in taxable years prior to the current two-year carryback period, and the number of taxpayers with an open statute. Because it is difficult to predict the frequency and value of future NOLs, the revenue impact is highly sensitive to the underlying assumptions and can vary widely.

The FTB does not have the tax data available to determine the potential revenue impact attributable to NOL carrybacks up to 20 years with any precision. However, based on available tax return data an estimated $1.6 billion in NOLs could be generated in the 2017 taxable year for taxpayers with projects that contain an affordable housing component as defined in the bill and would be available to offset positive state income. Based upon aggregate historical income data, this estimate assumes roughly 45 percent of the NOLs generated, or $730 million, would be carried back to the 1997 through 2014 taxable years.

Applying an average tax rate of 7 percent results in an estimated revenue loss of approximately $50 million in the 2017 taxable year.

The revenue impact is accrued back one year because it is associated with prior tax years. The tax year estimates are converted to fiscal year estimates, and then rounded and reflected in the above table.

SUPPORT/OPPOSITION

Support: None provided.

Opposition: None provided.

ARGUMENTS

Proponents: Some may argue that providing tax benefits to businesses engaged in construction of affordable housing would increase the number of available affordable housing units.

Opponents: Some may argue that there are less burdensome methods for incentivizing the construction of affordable housing in the state.

POLICY CONCERNS

If this bill is intended to provide an incentive for future construction of affordable housing, the inclusion of a prospective operative date may be appropriate to more fully act as an inducement for future action or behavior, rather than providing a benefit for action taken without regard to the tax benefit this bill would establish.

This bill would create differences between federal and California tax law, thereby increasing the complexity of California tax return preparation.

This bill lacks a sunset date. Sunset dates generally are provided to allow periodic review of the effectiveness of a tax benefit by the Legislature.

LEGISLATIVE STAFF CONTACT

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