



## Analysis of Original Bill

Authors: Petrie-Norris, et al.    Sponsor:    Bill Number: AB 593  
Related Bills: See Legislative History    Introduced: February 11, 2021

## SUBJECT

Exemption from Net Operating Loss (NOL) Suspension and Exemption from \$5 Million Tax Credit Limitation for Specified Researchers

## SUMMARY

This bill would, for taxpayers performing clinical, biomedical, or other research, development, or testing needed for COVID-19 or other diseases, do the following:

Provision No. 1: For taxable years beginning on or after January 1, 2021, and before January 2, 2023, under the Personal Income Tax Law (PITL) and the Corporation Tax Law (CTL), provide that the \$5 million limitation on allowable credits a taxpayer may claim to reduce tax shall not apply.

Provision No. 2: For taxable years beginning on or after January 1, 2021, and before January 1, 2023, under PITL, provide that the suspension of the NOL deduction shall not apply.

## RECOMMENDATION

No position.

## SUMMARY OF AMENDMENTS

Not applicable.

## REASON FOR THE BILL

The reason for the bill is to not apply the business credit limitation or the suspension of NOL deductions for taxpayers performing clinical, biomedical, or other research, development, or testing for COVID-19 or other diseases.

## ANALYSIS

### Provision No. 1: \$5 Million Exemption from Tax Credit Limitation

For taxable years beginning on or after January 1, 2021, and before January 2, 2023, under the PITL and CTL, taxpayers performing clinical, biomedical, or other research, development, or testing needed for COVID-19 or other diseases, would be excluded from the \$5 million limitation on business tax credits and their carryovers.

### Effective/Operative Date

As a tax levy, this provision would be effective immediately upon enactment and specifically operative for taxable years beginning on or after January 1, 2021, and before January 2, 2023.

### Federal/State Law

Current federal law does not specify a dollar limit on the total amount of all credits that can reduce the tax otherwise due similar to the limit this provision would address.

Current state law, under the PITL and CTL, limits the amount of business tax credits that may reduce tax for three tax years and states the following:

- Limits the amount of allowable business tax credits that may reduce tax to \$5 million for taxable years beginning on or after January 1, 2020, and before January 1, 2023. For taxpayers included in a combined report, this determination is made at the group level.
- The carryforward period for credits subject to the limitation is increased by the number of taxable years the credit was not allowed by operation of this limitation.
- The Low Income Housing Credit (LIHC) and amounts included in an election under Revenue and Taxation Code (RTC) section 6902.5 to apply film credits against qualified sales and use tax are not included in the credit limitation.

For purposes of the PITL credit limitation, the \$5 million credit limit applies to “business credits” as defined. In addition to excluding the LIHC, the definition of business credits specifically excludes the credits relating to earned income, young child, household and dependent care, adoption costs, renters, personal exemption, joint custody head of household and for care of dependent parent, senior head of household, and excess contributions of unemployment compensation. Business credits, as limited, are required to be applied against the tax due before the excluded credits.

### 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.

The bill uses undefined terms to describe research such as “clinical” or “biomedical”. The author of the bill may want to use terms “Biopharmaceutical research activities” and “other biotechnology research and development activities” as defined by state law for the Research credit. The author may wish to amend the bill to define the terms.

This bill does not specify that research activities will take place in California. Limited guidance could cause disputes between taxpayers and the department. To resolve these considerations, this bill should be amended.

Implementing this provision would require some changes to existing tax forms and instructions and information systems, which could be accomplished during the normal annual update.

### *Technical Considerations*

In general, tax provisions that are specifically operative are operative for taxable years beginning on or after January 1 of a specified year and before January 1 of a specified year. This business credit limitation provision in this bill would be specifically operative for taxable years beginning on or after January 1, 2021, and before January 2, 2023. If the author's intent is for the inoperative date to be for taxable years before January 1, 2023, then page 4, line 14 and page 6, line 31, should be amended by replacing "January 2, 2023" with "January 1, 2023."

### *Policy Considerations*

The bill does not limit the credits that would be exempt from the \$5 million to only particular credits. If the intention is to specify that the limitation be removed only with respect to the research credit, the bill should be amended.

## **LEGISLATIVE HISTORY**

AB 85, (Committee on Budget, Chapter 8, Statutes of 2020) was signed into law by Governor Newsom on June 29, 2020. For taxable years 2020, 2021, and 2022, under the California PITL, Sections 6 and 14 of this bill required that business tax credits reduce tax liability by no more than \$5 million, and under the CTL, requires that tax credits reduce tax liability by no more than \$5 million. This provision extended the credit carryover period for credits disallowed under this provision.

AB 1452 (Assembly Committee on Budget, Chapter 763, Statutes of 2008) among other things, limited to an applicable amount the "business credits" that could reduce the tax due for taxable years beginning on or after January 1, 2008, and before January 1, 2010.

## **PROGRAM BACKGROUND**

None noted.

## **FISCAL IMPACT**

This provision would not significantly impact the department's costs.

## **LEGAL IMPACT**

None noted.

## **APPOINTMENTS**

None noted.

## **SUPPORT/OIPPOSITION**

To be determined.

## **ARGUMENTS**

To be determined.

## **ANALYSIS**

### **Provision No. 2: Exemption from NOL Suspension under PITL**

This bill would, under PITL, for taxable years beginning on or after January 1, 2020, and before January 1, 2023, provide that the suspension of the NOL deduction does not apply to taxpayers performing clinical, biomedical, or other research, development, or testing needed for COVID-19 or other diseases.

#### *Effective/Operative Date*

As a tax levy, Provision No.2 would be effective immediately upon enactment and specifically operative for taxable years beginning on or after January 1, 2021, and before January 1, 2023.

#### *Federal/State Law*

#### *Federal Law*

An NOL generally means the amount by which a taxpayer's business deductions exceed its gross income. A taxpayer generally may deduct in a taxable year an NOL carried to such year.

### **Prior to the Coronavirus Aid, Relief, and Economic Security Act<sup>1</sup> (CARES Act)**

For NOLs arising in taxable years beginning after December 31, 2017, the NOL deduction generally is limited to 80 percent of taxable income determined without regard to the NOL deduction. Excess losses generally may be carried forward indefinitely, but not back, and carryovers of such NOLs to other taxable years are adjusted to take account of the 80-percent taxable income limitation. NOLs offset taxable income in the order of the taxable years to which the NOL may be carried.

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<sup>1</sup> Coronavirus Aid, Relief, and Economic Security Act (HR748; Pub. L. 116-136).

NOLs arising in taxable years beginning before January 1, 2018, are not subject to the 80-percent taxable income limitation. Further, such NOLs remain subject to the 20-year carryover limitation and the relevant carryback rules in effect for taxable years beginning before January 1, 2018.

A taxpayer with NOL carryovers to a taxable year from both taxable years beginning before 2018 and taxable years beginning after 2017 computes its tax liability as follows. First, the taxpayer may deduct an NOL in the amount of its pre-2018 NOL carryovers without limitation. Second, the taxpayer may deduct an additional NOL equal to the lesser of (1) its post-2017 NOL carryovers or (2) 80 percent of the excess (if any) of the taxpayer's taxable income (before any NOL deduction attributable to post-2017 NOL carryovers) over the NOL deduction attributable to pre-2018 NOL carryovers.

### **Changes made by the CARES Act**

The CARES Act suspended the application of the 80-percent taxable income limitation for taxable years beginning after December 31, 2017, and before January 1, 2021.<sup>2</sup> The 80-percent taxable income limitation continues to apply in the case of any taxable year beginning after December 31, 2020. The 80-percent taxable income limitation was also eliminated for NOLs arising in taxable years beginning after December 31, 2017, that were generated in taxable years beginning on or before December 31, 2017, and carried to such a taxable year.<sup>3</sup>

The CARES Act also modified the rules regarding carrybacks for NOLs arising in 2018, 2019, and 2020.<sup>4</sup> Specifically, any NOL arising in a taxable year beginning after December 31, 2017, and before January 1, 2021, may be carried back to the five taxable years preceding the taxable year of such loss.<sup>5</sup>

### *State Law*

Over the years, there have been several changes to the California NOL provisions. In general, California allows a taxpayer to calculate an NOL in accordance with federal rules, but has not conformed to the federal changes that apply to taxable years beginning after December 31, 2017.

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<sup>2</sup> Coronavirus Aid, Relief, and Economic Security Act (HR748; Pub. L. 116-136).

<sup>3</sup> Internal Revenue Code (IRC) section 172(a)(2). IRC section 172(a)(2)(A) provides that NOLs arising in taxable years beginning before January 1, 2018, carried to a taxable year beginning after December 31, 2020, are not subject to the 80-percent taxable income limitation.

<sup>4</sup> IRC section 172(b)(1)(D).

<sup>5</sup> See IRC section 172(b)(1)(D)(i). Pursuant to IRC section 172(b)(2), any NOL carryback must be carried to the earliest taxable years to which such loss may be carried. NOLs eligible for the five-year carryback period include, for example, those arising with respect to farming losses, which would otherwise be subject to a two-year carryback period. See, e.g., IRC section 172(b)(1)(B).

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, and after December 31, 2018, 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, and before January 1, 2019, with modifications.

California law provides that losses generated in taxable years beginning on or after January 1, 2013, and before January 1, 2019, are allowed to be carried back to the two preceding taxable years.

The carryback was phased in as follows:

- 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.
- 100-percent of the NOL generated in taxable years beginning in 2015 through 2018 is eligible for a two-year carryback.

For taxable years beginning in 2008 and 2009, California suspended the NOL carryover deduction. Taxpayers continued to compute and carryover their NOL during the suspension period. However, individuals with a net business income of less than \$500,000, and corporations with taxable income of less than \$500,000, were not affected by the NOL suspension rules.

For taxable years 2020, 2021, and 2022, NOL deductions are suspended, unless the taxpayer:

- Under the PITL, has modified adjusted gross income or net business income, as defined, of less than \$1,000,000.
- Under the CTL, has income subject to tax of less than \$1,000,000.

The NOL carryover period is extended by one year for NOLs incurred in taxable year 2021, two years for NOLs incurred in taxable year 2020, and three years for NOLs incurred in taxable years beginning before 2020.

### *Implementation Considerations*

The bill uses undefined terms to describe research such as “clinical” or “biomedical”. The author of the bill may want to use terms “Biopharmaceutical research activities” and “other biotechnology research and development activities” as defined by state law for the Research credit. The author may wish to amend the bill to define the terms.

This bill does not specify that research activities will take place in California. Limited guidance could cause disputes between taxpayers and the department. To resolve these considerations, this bill should be amended.

Implementing this provision would require some changes to existing tax forms and instructions and information systems, which could be accomplished during the normal annual update.

### *Technical Considerations*

For consistency, on page 4, line 15, and page 6, line 32, strike out "taxpayers" and insert "a taxpayer".

On page 4, line 16, page 5, line 7, and page 6 line 33, strike out "perform" and insert "performs".

On page 5, line 5, strike out "a".

### *Policy Considerations*

This bill would provide a tax benefit for sole proprietorships, non C corporation partners of partnerships, limited partnerships, and limited liability companies not electing to be taxed as corporations, limited liability partnerships, and real estate mortgage investment conduits under the PITL that would not be provided to other business entities such as corporations. Thus, this bill would provide differing treatment based solely on classification.

## **LEGISLATIVE HISTORY**

AB 85, (Committee on Budget, Chapter 8, Statutes of 2020), summarized above, was signed into law by Governor Newsom on June 29, 2020.

AB 91 (Burke, Chapter 39, Statutes of 2019) disallowed the carryback of NOLs that were incurred in taxable years beginning on or after January 1, 2019, for individual and corporate taxpayers.

AB 2855 (Brough, 2017/2018) would have established an application for a tentative refund process, similar to the federal process for obtaining a tentative refund based on an NOL carryback, and specified the trigger date for the statute of limitations and interest accrual applicable to an NOL carryback. AB 2855 did not pass out of the Senate Appropriations Committee by the constitutional deadline.

AB 154 (Ting, Chapter 359, Statutes of 2015) 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 1984 did not 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 did not pass out of the Senate by the constitutional deadline.

### **PROGRAM BACKGROUND**

None noted.

### **FISCAL IMPACT**

This provision would not significantly impact the department's costs.

### **ECONOMIC IMPACT (Both Provisions)**

#### *Revenue Estimate*

This bill would result in the following revenue loss:

Estimated revenue impact of this bill as introduced on February 11, 2021 including the impact of both the credit limitation exemption and the NOL suspension provisions.

(\$ in Millions)

<b>Fiscal Year</b>	<b>Revenue</b>
2021-2022	-\$180
2022-2023	-\$85
2023-2024	-\$9.9

This analysis does not account for changes in employment, personal income, or gross state product that could result from this bill or for the net final payment method of accrual.



### *Revenue Discussion*

It is estimated that approximately 60 qualified businesses would benefit from the provisions in this bill, which would result in a revenue loss of roughly \$200 million in the 2021 taxable year.

The business codes associated with the relevant research areas were identified, and based on tax return data, tax liability was calculated with and without the credit limitation and NOL suspension.

Under the personal income tax, the benefit of this exclusion would be confined to a few individual income taxpayers, and the resulting impact minor.

The tax year estimates are converted to fiscal year estimates, and then rounded to arrive at the amounts reflected in the above table.

### **LEGAL IMPACT**

None noted.

### **APPOINTMENTS**

None Noted.

### **SUPPORT/OPPOSITION**

To be determined.

### **ARGUMENTS**

To be determined.

### **LEGISLATIVE CONTACT**

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