STATE OF CALIFORNIA
Franchise Tax Board

Bill Analysis

Author: Petrie-Norris	Sponsor:	Bill Number: AB 1105
	Related Bills: See Legislative History	Introduced February 15, 2023, and Amended March 7, March 20, and April 17, 2023

SUBJECT

Gross Income Exclusion for Sales of Net Operating Losses

SUMMARY

This bill, under the Personal Income Tax Law (PITL) and the Corporation Tax Law (CTL), would allow a startup innovator, as defined, to sell a net operating loss (NOL) to an unrelated taxpayer. The bill would also exclude from gross income amounts received from the sale of an NOL for taxable years beginning on or after January 1, 2024, and before January 1, 2029.

RECOMMENDATION

No position.

SUMMARY OF AMENDMENTS

The March 7, 2023, amendments removed provisions of the bill relating to a Franchise Tax Board (FTB) business credit reporting requirement and replaced them with the provisions discussed in this analysis.

The March 20, 2023, amendments added a sunset date for the gross income exclusion and a repeal date for the sales of NOLs.

The April 17, 2023, amendments revised the definition of a "startup innovator;" added that the NOL purchaser can utilize the NOL in taxable years beginning on or after January 1, 2024, and cannot transfer the NOL; removed the requirement that the FTB establish a program for startup innovators to pay a fee and apply for the ability to sell an NOL; modified the FTB reporting date; and made other non-substantive changes.

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

REASON FOR THE BILL

The reason for the bill is to provide small startup innovators an opportunity to sell unused NOLs.

ANALYSIS

For taxable years beginning on or after January 1, 2023, and before January 1, 2029, this bill would add a provision to the existing NOL statute that would, under the PITL and CTL, allow a startup innovator to sell an NOL to a taxpayer that is not related to the startup innovator. The NOL sale price would be required to be at least 80% of the value of the NOL that is transferred. The startup innovator would be limited to selling $20 million worth of transferred NOLs during the lifetime of their business, including sales by a predecessor in interest of the startup innovator.

In addition, for taxable years beginning on or after January 1, 2024, and before January 1, 2029, the bill, under the PITL and CTL, would allow a gross income exclusion for amounts received by a startup innovator for the sale of an NOL.

A “startup innovator” would mean a taxpayer that satisfies the following:

- Is primarily engaged in activities described by NAICS code 311221, 311224, 325193, 325311, 325312, 325314, 325320, 325411, 325412, 325413, 325414, 334510, 334516, 334517, 339112, 339113, 339114, 423450, 424210, 424910, 541380, 541713, 541714, 541715, or 621511.
- Owns registered trademarks, copyrights, or patents.
- Has no more than 300 employees.
- Has not existed for longer than 10 years.
- Is not a member of a combined reporting group.
- Is headquartered in California.

The transferred NOL would retain the same characteristics in the hands of the purchaser as though it were generated by the purchaser in the same taxable year as it was generated by the startup innovator, including, but not limited to, carryback and carryforward provisions that may apply. The purchaser would not be able to claim a deduction, either as an ordinary and necessary business expense or otherwise, for the cost paid or incurred to purchase the NOL. The purchaser would be able to utilize the NOL in a taxable year beginning on or after January 1, 2024.

The startup innovator would be required to certify under penalty of perjury that all proceeds from their NOL sales were used to finance employee compensation related to direct research activities, contract expenses paid to independent contractors for research activities, or non-depreciable personal tangible property used to conduct research.

The FTB would be able to prescribe rules, guidelines, procedures, or other guidance to carry out the purposes of this provision. In addition, the FTB would be able to adopt regulations as necessary or appropriate to carry out the purposes of this provision. The adoption of regulations would be exempt from the requirements of the Administrative Procedure Act (APA) (Government Code section 11340 et seq.), i.e., would not be subject to review and approval by the Office of Administrative Law.

The bill would require the FTB to report to the Legislature the number of taxpayers that have sold NOLs and the total dollar value of NOLs sold. In addition, the FTB would be required to file the report in compliance with Government Code section 9795 requirements no later than April 1, 2027, and annually thereafter.

The provisions of this bill would be severable. If any provision or its application were to be held as invalid that would not affect other provisions or applications of this bill.

This program would be repealed on January 1, 2029.

Effective/Operative Date

As a tax levy, this bill would be effective immediately upon enactment. The NOL sale provision would be operative for taxable years beginning on or after January 1, 2023, and would be repealed on January 1, 2029. The gross income exclusion would be operative for taxable years beginning on or after January 1, 2024, and before January 1, 2029. The purchaser of an NOL could utilize the NOL in a taxable year beginning on or after January 1, 2024.

Federal/State Law

Gross Income Exclusion

Federal and state laws provide that gross income includes all income from whatever source derived, including compensation for services, business income, gains from property, interest, dividends, rents, and royalties, unless specifically excluded.

There are no federal or state laws comparable to the exclusion from gross income that would be allowed by the provisions of this bill.

Federal Law

NOLs

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 forward from a prior year. Over the years, there have been many changes to the federal NOL provisions.

For NOLs arising in taxable years beginning after December 31, 2017, the NOL deduction generally is limited to 80% 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% taxable income limitation. NOLs offset taxable income in the order of the taxable years to which the NOL may be carried.

The Coronavirus Aid, Relief, and Economic Security Act (CARES Act) (HR748; Public Law 116-136) suspended the application of the 80% taxable income limitation for taxable years beginning after December 31, 2017, and before January 1, 2021. 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, i.e., NOLs may be carried back to the five taxable years preceding the taxable year of such loss. Any NOL carryback must be carried to the earliest taxable years to which such loss may be carried.

The 80% taxable income limitation continues to apply to any taxable year beginning after December 31, 2020. The 80% 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. Additionally, 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% taxable income limitation.

There is no comparable federal law that allows a taxpayer to buy or sell an NOL.

State Law

NOLs

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, because California conforms to the Internal Revenue Code as of January 1, 2015.

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.

The 80% taxable income limitation is not applicable in California and any NOL arising in a taxable year beginning after December 31, 2017, and before January 1, 2021, may not be carried back.

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

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

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.

There is no comparable state law that allows a taxpayer to buy or sell an NOL.

RTC Section 41

Under RTC section 41, legislation that would create a new tax expenditure, which includes a credit, deduction, exclusion, exemption, or any other tax benefit as provided for by the state, is required to include specific goals, purposes, objectives, and performance measures to allow the Legislature to evaluate the effectiveness of the tax benefit.

Implementation Considerations

The FTB has identified the following implementation considerations and is available to work with the author's office to resolve these and other considerations that may be identified.

The bill is silent on or needs clarity for the following items: whether taxpayers could amend returns to exclude income from an NOL sale or claim a purchased NOL deduction; and the impact if the sold NOL is later disallowed upon audit by the FTB. The author may wish to amend the bill to provide clarity for these items.

The bill uses undefined terms and phrases, including, "'related to' the startup innovator;" "predecessor in interest of…;" "headquartered;" "related to 'direct' research activities." The absence of definitions could lead to confusion for taxpayers. For clarity, it is recommended that the bill be amended to define these terms. In addition, the author may want to define the term "primarily engaged" to clarify what percentage of the startup innovator's business needs to be engaged in the specified NAICS codes to qualify.

The provision that authorizes the sale of NOLs states the provision will "remain in effect only until January 1, 2029, and as of that date is repealed." It would be helpful to include an operative date that is applicable to certain taxable years to ensure that a taxpayer's NOLs would receive the same treatment throughout the entire taxable year if the taxpayer is a fiscal year filer. (A fiscal year filer's taxable year includes both months in 2028 and 2029).

With respect to prescribing rules, guidelines, procedures, or other guidance, the FTB would be subject to the rulemaking procedures required under the APA. Following these procedures may delay the implementation of this bill. To prevent delays, it is recommended that the author add a provision exempting the FTB from the APA when the FTB is prescribing rules, guidelines, or procedures necessary or appropriate to carry out the bill's purpose.

Technical Considerations

None noted.

Policy Considerations

This bill would establish an income exclusion for state taxable income for any income derived from the sale of the NOL. No comparable exclusion for federal tax law exists likely creating a taxable event at the federal level.

LEGISLATIVE HISTORY

No legislation similar to this bill has been identified.

PROGRAM BACKGROUND

None noted.

OTHER STATE INFORMATION

In 1995, the New Jersey Economic Recovery Act (Public Law 1995, c.137 (C.34:1B-7.37 et seq.)) established the New Jersey Emerging Technology and Biotechnology Financial Assistance Program (Program), which allows new or expanding emerging technology and biotechnology companies with unused amounts of research and development tax credits and NOL carryovers to surrender those tax benefits for use by a profitable New Jersey corporate taxpayer that is not an affiliated business.

Upon surrendering the tax benefits, the business is issued a Corporation Business Tax Benefit Transfer certificate for at least 80% of the amount of the surrendered tax benefit. The New Jersey Economic Development Authority determines eligibility, and the New Jersey Division of Taxation determines the value of the tax benefits. This allows the new or expanding company to receive private financial assistance in exchange for the surrendered tax benefits. The Program has been updated several times to increase the annual and project lifetime limitations.

FISCAL IMPACT

The FTB's costs to implement this bill have yet to be determined. As the bill moves through the legislative process, costs will be determined.

ECONOMIC IMPACT

Revenue Estimate

To estimate the revenue loss associated with this proposal, the amount of qualified NOLs sold and the tax rates of the buyer and seller would need to be known. Because the frequency of these sales and the amount associated with these sales would be difficult to predict, the revenue impact is unknown. However, it is estimated that for every $20 million in NOLs sold, there would be a $1.8 million revenue loss.

Revenue Discussion

To arrive at the $1.8 million revenue loss, it is assumed that a qualified C-Corporation would sell $20 million in NOLs at 80% of the NOL transferred, or $16 million. Assuming a tax rate of 8.84% the estimated revenue loss from the gross income exclusion on the sale of the NOL would be approximately $1.4 million. It is further assumed that should a Bank and Financial Corporation with a tax rate of 10.84% purchase the NOL, the estimated revenue gain from the expense deduction otherwise allowed under current law would be roughly $1.7 million. Should the Bank and Financial Corporation then use the entire $16 million NOL at a 10.84% tax rate in the same year as the purchase, the estimated revenue loss from the NOL deduction would be nearly $2.2 million.

The revenue impact from selling $20 million in NOLs would be the impact of netting these gains and losses, or a total revenue loss of $1.8 million. However, due to broad range of entity types that may buy and sell qualified NOLs and their respective tax rates, the revenue loss would vary.

Finally, upon reviewing this proposal it is unclear how many taxpayers would choose to buy these NOLs due to the high cost of entry. For the sale example above, it is estimated that the net cost to the corporation that purchases the NOL would be approximately $16 million.

LEGAL IMPACT

None noted.

APPOINTMENTS

None noted.

SUPPORT/OPPOSITION

Support

As per the Assembly Revenue and Taxation Committee analysis of AB 1105, dated April 21, 2023, the following organizations support the bill:

- Bay Area Council
- Biotechnology Innovation Organization
- CalChamber
- California Life Sciences
- California Manufacturers & Technology Association
- San Diego Regional Chamber of Commerce
- TechNet

Opposition

As per the same analysis, the following organizations oppose the bill:

- California School Employees Association, AFL-CIO
- California Teachers Association

ARGUMENTS

Proponents

As per the same analysis, the bill is supported by California Life Sciences, which noted:

> "Start-up innovator companies face significant challenges in California as they deal with obstacles such as insufficient capital or cash flow, recruiting employees, and marketing. Although California has the most startups businesses in the country, unfortunately most startups fail. In addition, recent interest rate hikes have spooked investors California School Employees Association, away from startups and made it even more difficult for startups to succeed. To preserve and expand its global innovation leadership, California must pursue creative opportunities to assist start-up companies which promote scientific and technological innovation, research, and economic growth. One such creative and established policy is the sale of Net Operating."

Opponents

As per the same analysis, the bill is opposed by the California School Employees Association, which noted:

> "Amid a projected $22.5 billion shortfall and growing, AB 1105 could cause even more revenue loss to our state general fund. This loss would be on top of the billions lost annually due to longstanding and pre-existing tax expenditure programs that disproportionately benefit high-net worth individuals and corporations.
>
> For every dollar in our state general fund, roughly 40 cents goes toward Proposition 98, which funds public education. When there is a revenue loss, there is a proportionate 40% loss to public education funding. Our students are our most precious investments, and we should be crafting solutions to increase funding for public education instead of policies that could adversely impact school funding."

LEGISLATIVE CONTACT

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