HOUSE RESEARCH ORGANIZATION bill analysis 5/18/2001

SB 1689
Ellis
(Y. Davis)

SUBJECT: Treatment of business loss carryforward for franchise tax purposes

COMMITTEE: Ways and Means — favorable, with amendment

VOTE: 8 ayes — Oliveira, McCall, Hartnett, Bonnen, Y. Davis, Heflin, Keffer, Ritter

1 nay — Craddick

2 absent — Hilbert, Ramsay

SENATE VOTE: On final passage, April 30 — voice vote

WITNESSES: For — None

Against — Dale K. Craymer, Texas Taxpayers and Research Association

On — Jesse Ancira, Eleanor Kim, and James Le Bas, Comptroller's Office

BACKGROUND: In 1991, the first called session of the 72nd Legislature enacted HB 11 by Hury, an omnibus tax bill that included provisions for determining the net taxable earned surplus for purposes of the corporate franchise tax (Tax Code, sec. 171.110). A corporation's business loss can be carried forward as a deduction to the taxable earned surplus, thus reducing franchise tax liability, for up to five years after the loss year. In 1996, the comptroller adopted an administrative rule under which a corporation may not convey, assign, or transfer a business loss to another entity, including, but not limited to, by a merger (Administrative Code, Title 34, Part 1, chapter 3, subchapter V, sec. 3.555(g)(3)).

DIGEST: SB 1689, as amended, would provide that, for purposes of determining the net taxable earned surplus subject to the franchise tax, a business loss could be carried forward only by the corporation that incurred the loss and could not be transferred to or claimed by any other entity, including the survivor of a merger if the loss was incurred by the merged corporation.

The bill also would amend the Tax Code to specify that an insurance organization, title insurance company, or title insurance agent authorized to do business in Texas and required to pay an annual premium tax or maintenance tax or fee under the Insurance Code is exempt from the franchise tax. It would specify that an insurance organization performing management or accounting activities in Texas on behalf of a nonadmitted captive insurance company (unauthorized insurance company) that must pay a gross premium receipts tax during a tax year is exempt from the franchise tax for that tax year. Farm mutuals, local mutual aid associations, and burial associations also would be exempt from the franchise tax.

The bill would take effect September 1, 2001, and would not affect taxes imposed before that date.

SUPPORTERS SAY:

SB 1689 would codify the comptroller's policy of not allowing corporations to carry forward business losses in the event of a merger. Currently, a corporation that incurs a business loss can transfer that loss to offset future franchise tax liability up to five years. Since the enactment of that statutory provision in 1991, the Comptroller's Office has prohibited one corporation from claiming a business loss incurred by another corporation, even in the case of a merger. The comptroller now is involved in litigation as a result of corporations' challenging this policy. This bill would clarify and create consistency in how the comptroller applies the tax law.

Failure to pass this bill would create a tax loophole for large corporations with significant franchise-tax liability. If the state allowed one corporation to transfer the losses of another, the following example could arise: Corporation A reports profits in one year of $1 million. Corporation A then acquires Corporation B, which has losses of $1 million in the same year. Corporation A could carry forward the losses of Corporation B and, in essence, zero out its profits so that Corporation A would not have to pay taxes on its earnings.

The bill also would clarify what insurance companies are exempt from the franchise tax. Corporations that pay the insurance gross premiums tax need not also pay the corporate franchise tax.

OPPONENTS SAY:

SB 1689 is a retroactive bill intended to strengthen the comptroller's legal position, now the subject of three active lawsuits, that business losses, with regard to taxable income, cannot be transferred or carried forward by a corporation or other entity as part of a merger, if the loss was incurred by a corporation that did not survive the merger. The concept of transferring net operating losses in merger transactions is not new or unusual. The federal government and 38 other states have laws allowing such transfers.

The 1991 legislation establishing the earned surplus calculation contained no provision for mergers. However, under regular corporate law, all property of a nonsurviving corporation in a merger, including assets and tangible and intangible liabilities, transfers to the surviving corporation. Since adopting an administrative rule in 1996, the comptroller has prohibited transfers of losses to the survivor of a merger. That rule has no basis in statute.

Transferability of net operating losses has economic benefits. A Texas company with accumulated losses that might be on the verge of insolvency is more attractive to a potential purchaser if the net operating losses transfer to the survivor. These losses could be used mitigate future taxes for the merged entity. If the losses would not transfer, the company would be less attractive as an acquisition. That scenario would increase the likelihood of a bankruptcy filing, the potential for job losses, and a greater probability that Texas creditors would go unpaid.

NOTES:

The committee amendment would delete from the Senate engrossed version of SB 1689 a provision that would authorize the surviving corporation of a merger to claim the nonsurviving corporation's business loss for tax reports due on or after January 1, 2004, and carry such losses forward for up to five years following the merger, or until the losses were exhausted. According to the fiscal note for the Senate version, the state would have to pay $200 million in refunds in fiscal 2002 and would lose $50 million per year in franchise tax revenues as a result of this change. The estimate was based on the comptroller's analysis of franchise tax records.

The committee amendment also would specify that farm mutuals, local mutual aid associations, and burial associations are exempt from the franchise tax.

The fiscal note for SB 1689 as amended estimates a net gain of $1.2 million per year in general revenue over the next five years. The comptroller's biennial revenue estimate for fiscal 2002-03 withheld annual franchise tax revenue in that amount as a contingency for the business loss carryforward issue. By codifying the comptroller's interpretation of this issue, SB 1689 as amended would restore that money to the revenue estimate.