Department of Legislative Services

Maryland General Assembly
2010 Session

FISCAL AND POLICY NOTE

House Bill 241 (Delegate Hixson, *et al.*)
Ways and Means

Income Tax - Net Operating Loss Deductions - Loss from Criminal Fraud or Embezzlement

This emergency bill allows certain net operating losses resulting from criminal fraud or embezzlement to be carried back to additional tax years by conforming State law to federal income tax law as enacted by the American Recovery and Reinvestment Act (ARRA) of 2009.

The bill applies to any tax year to which Section 172(b)(1)(H) of the Internal Revenue Code, as amended by ARRA, applies.

Fiscal Summary

State Effect: General fund revenues may decrease by up to $1.0 million in FY 2010 as a result of conforming to federal law. Any decrease in revenue is due to a timing issue and is not due to a net decrease in revenue collections. Expenditures are not affected.

Local Effect: Local income tax revenues may decrease by up to $700,000 in FY 2010. The vast majority of any revenue loss is expected to occur in Montgomery County. Expenditures are not affected.

Small Business Effect: Minimal.

Analysis

Bill Summary: The bill allows certain net operating losses resulting from criminal fraud or embezzlement to be carried back to additional tax years by conforming State law to federal income tax law. The bill states that the add-back to federal adjusted gross income as required by Tax-General 10-210.1(b)(2) does not apply to any net operating loss (NOL) covered under IRS Revenue Ruling 2009-9 and substantiated under IRS Revenue Procedure 2009-20. The bill applies to any tax year to which Section 172(b)(1)(H) of IRC, as amended by the ARRA, applies.

Current Law/Background:

Net Operating Losses

An NOL occurs when a taxpayer's deductions exceed the income in the tax year, typically eliminating the taxpayer's tax liability in the year. The taxpayer may not receive the benefit of the losses in excess of the amount required to eliminate the current year's tax liability. Federal law provides that these losses can be applied to other tax years. Generally, an NOL for a tax year can be carried back to the two tax years before the year in which the loss occurred (the carryback period) and can be carried forward 20 years after the NOL year (the carryforward period). A taxpayer applying an NOL to a previous tax year files an amended return for that year, realize a reduction in income tax liability if the taxpayer was not also operating a loss in that year, and will receive a refund. A taxpayer applying an NOL to a future tax year will not receive the benefit of the NOL until the time in which a tax return can be filed for the year.

Federal and State Laws Related to Carryback periods

Federal law provides several exceptions to the two-year carryback period. Individuals may carry back NOLs resulting from casualty or theft to three tax years. The U.S. Congress has periodically enacted legislation allowing eligible businesses extended periods to carry back losses in an attempt to promote economic growth during periods of economic distress. Examples include the federal Job Creation and Worker Assistance Act of 2002 and American Recovery and Reinvestment Act of 2009, which allowed eligible small business with losses occurring in specific time periods to qualify for three-, four-, or five-year carryback periods.

State law generally conforms to the federal tax treatment of NOLs. However, in response to concerns over the potential decrease in State revenues, the Budget Reconciliation and Financing Act (BRFA) of 2002 (Chapter 44) decoupled the State income tax from the special five-year net operating loss carryback provision enacted by the federal Job Creation and Worker Assistance Act of 2002. BRFA of 2009 (Chapter 487) clarified the State's extended net operating loss carryback period for income tax modification purposes and decoupled from ARRA provisions relating to extended net operating loss carryovers. As a result, under Tax-General 10-210.1 individuals are required to add back to federal adjusted gross income any amount included under a net operating loss election under Section 172(b)(1)(H) of IRC and may not carry back these NOLs to additional tax years as provided under federal law.

Recent Investment Losses and IRS Regulations

Large-scale investor losses have recently resulted from several fraudulent investment arrangements, commonly referred to as "Ponzi" schemes. The most prominent of these schemes was discovered in 2008 as the result of investor losses from a New York investment firm run by Bernard Madoff. In response, IRS issued regulations in 2009 providing guidance for the proper income tax treatment for individuals affected by eligible fraud-related theft losses. The regulations included Revenue Procedure 2009-20 and Revenue Ruling 2009-9. The rules provided qualified taxpayers with a uniform manner for defining losses by determining (1) eligible losses were to be deducted as theft losses; (2) eligible losses are to be claimed in the tax year in which the loss was discovered (tax year 2008 and later); and (3) the amount of the deduction, which was generally 75% to 95% of the loss minus any actual or potential recovery.

ARRA allowed an eligible small business to elect a three-, four-, or five-year net operating loss for an applicable 2008 net operating loss. IRS ruled that losses covered by the these regulations could be treated as a business deduction and that a casualty loss an individual sustains after December 31, 2007, is considered a loss from a sole proprietorship – allowing the individual to carryback NOL for up to five years for an applicable 2008 net operating loss. The individual must also meet an applicable gross receipts test. If the individual or the loss does not meet these qualifications, the individual may carry back up to three years a net operating loss in the year the loss is deducted.

State Revenues: The bill will allow certain net operating losses to be carried back to additional tax years. As a result, general fund revenues may decrease by a maximum of $1.0 million in fiscal 2010. Any decrease in revenue is due to a timing issue and is not due to a net decrease in revenue collections.

Under current State law, NOLs occurring in tax year 2008 may only be carried back as far back as tax year 2005. The bill will allow eligible taxpayers to carry back certain NOLs to tax year 2003 and receive a refund for taxes paid in the previous tax years once an amended return is filed. The Comptroller's Office has currently identified 27 returns that have claimed criminal fraud or embezzlement losses in tax year 2008, resulting in $3.4 million in refunds or $127,400 per return. An additional $17.8 million in losses could not be claimed due to insufficient tax liability in tax year 2005 through 2008. To the extent taxpayers have sufficient tax liability in tax year 2009 to carry forward these losses and file a return before July 1, 2010, revenue losses in fiscal 2010 will be less than estimated.

Additional Information

Prior Introductions: SB 1069 of 2009 was not reported from the Senate Rules Committee.

Cross File: SB 574 (Senator Madaleno, *et al.*) - Budget and Taxation.

Information Source(s): Comptroller's Office, Department of Legislative Services

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