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BILL ANALYSIS

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Senate Bill 386 (as passed by the Senate)
Sponsor: Senator Doug Carl
Committee: Finance

Date Completed: 7-13-89

RATIONALE

Under the Internal Revenue Code a savings institution that has incurred a net operating loss can, under certain conditions, apply the current-year loss to its tax liability in previous years. Claiming a "loss carryback", then, allows a savings institution to use an allowable deductible loss that is greater than its tax liability in the current year, and carry the loss back to a tax year when it had sufficient tax liability to use the deduction; the institution thus is able to claim a refund in the current year for previously paid Federal taxes. It has been pointed out that some savings institutions that claimed loss carrybacks for Federal tax purposes may, under the Single Business Tax (SBT) Act, be liable for additional single business tax amounts for the year to which a loss was carried back.

The additional SBT liability has to do with the effect of a loss carryback on the reserve that savings institutions are required to maintain in order to cover bad debts. An institution, in calculating Federal taxable income, is allowed under Section 593 of the Internal Revenue Code to deduct its yearly addition to its reserve for bad debts (known as the bad debt deduction). Due to a change in Federal tax law in 1978, if an institution carries a loss back to a year beginning after January 1, 1979, the bad debt deduction for that year must be recomputed because the deduction is based on a percentage of taxable income. (Loss carrybacks to tax years before 1979 did not require recomputation of the bad debt deduction.) Because a loss carryback reduces the taxable income of the year to which the loss is carried back, recomputing the bad debt deduction results in a lower deduction for that year. At the same time, however, lowering the bad debt reduction increases Federal taxable

income for the year. (Example: A savings institution incurs an operating loss in 1989 that exceeds the institution's tax liability for that year. The institution therefore chooses to carry the excess loss back to 1985, when it had sufficient tax liability to use the deduction. The institution must recalculate the bad debt deduction that it took in 1985. Because the institution's 1985 bad debt deduction is lower, its taxable income for that year is higher.)

For Federal tax purposes, an institution benefits by claiming a loss carryback because it makes the claim on the current-year tax filing and is not required to file an amended Federal return for the year to which the loss carryback is applied. The SBT Act, however, bases the SBT on Federal taxable income, but contains no provision for loss carrybacks to previous years. ("Tax base" is defined in the Act as business income plus or minus certain adjustments. "Business income" means Federal taxable income.) Thus, when a loss carryback is claimed against Federal taxes, and the required recomputation of the bad debt deduction is made and increases Federal taxable income, a savings institution's single business tax base for the year to which the loss carryback is applied will not reflect the recomputation.

Reportedly, the Department of Treasury has sent notices to financial institutions, that claimed loss carrybacks, that it intends to assess additional single business tax against those institutions. (In the preceding example, the savings institution would be assessed SBT on the increased amount of its 1985 Federal taxable income that resulted from lowering its 1985 bad debt deduction.) Some institutions have challenged the assessment, claiming that

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losses that result in lower Federal tax liability should not result in increased liability under the single business tax. It has been suggested that since the SBT Act was passed in 1975 and did not anticipate the 1978 change in Federal law to require recomputation of the bad debt deduction when claiming a loss carryback, the Act be amended so that financial institutions would not be liable for additional single business tax when they claim a loss carryback.

CONTENT

The bill would amend the SBT Act to require a financial organization that had a loss carryback of a net operating loss or a capital loss to calculate its tax base in the following way if certain conditions were present: if Federal law required the organization, solely because of the loss carryback, to recompute its allowable addition to the reserve for bad debts under Section 593 of the Internal Revenue Code, and if the recomputation resulted in an addition to business income, the financial organization would have to deduct the addition to business income from the loss carryback before adding the loss carryback to its tax base. The bill would require that this calculation be made for the tax year in which the financial organization sustained the loss resulting in the loss carryback for Federal tax purposes. (Section 593 applies, under certain conditions specified in the Code, to any domestic building and loan association (which includes savings and loan associations); mutual savings bank; or cooperative bank without capital stock organized and operated for mutual purposes and without profit.)

MCL 208.9

FISCAL IMPACT

Senate Bill 386 would lead to an indeterminate reduction in SBT taxes paid by savings and loan associations (S&Ls). Data are not available on the number of S&Ls that would be affected by Senate Bill 386 or the expected change in tax liability.

ARGUMENTS

Supporting Argument

Federal tax law allows savings institutions to employ a form of income averaging over a 10-

year tax period by using loss carrybacks--when a loss in one year exceeds an institution's tax liability it can apply the excess loss to a previous year's tax liability. A complex series of changes in Federal tax policy, and their effect on the way savings institutions calculate tax liability under the SBT Act, have left some institutions that claimed loss carrybacks with a potential single business tax liability for the year to which a loss carryback was applied. This has caused a situation in which some institutions, by claiming a loss carryback for Federal tax purposes in the current year to improve their tax position, are faced with the possibility of having to pay additional single business taxes for previous years. This is simply unfair. A loss in the current year that is used to reduce Federal taxes should not cause an increase in State taxes for previous years, simply because the required recomputation of the Federal tax changes the tax base upon which the single business tax is calculated. Such a system has the unjust effect of increasing tax liability in proportion to an increase in an institution's losses. The SBT Act, passed in 1975, could not have foreseen later changes in Federal tax law that would have the impact that loss carrybacks now have on savings institutions. The bill would update the Act to make it consistent with Federal tax law and would hold harmless those institutions that used loss carrybacks.

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