Tax Credits

Ending 2020's Emergency Tax Hikes Is the Right Decision

According to Governor Gavin Newsom, California is poised to have another "historic budget surplus," making now the time to reinstate suspended net operating loss deductions and capped business incentive tax credits.

EMERGENCY TAX HIKES

During summer 2020, the state anticipated a COVID-induced $54 billion deficit. To assist with closing this gap, the Legislature approved the Governor's proposal to suspend the use of personal and business net operating loss (NOL) deductions and cap business incentive tax credits, including the research and development (R&D) tax credit, at $5 million per taxpayer. The estimated $9 billion tax increase from AB 85 (Committee on Budget) wasn't permanent and was put into place for a period of three years with a carryback provision. California was borrowing the money interest-free to assist in closing the deficit with the intention of paying it back, in full, beginning after three years.

Fast forward to 2021 and the state actually experienced a once-in-a-generation, $76 billion surplus. Looking forward to 2022, the Legislative Analyst's Office (LAO) estimates a $31 billion surplus. While the 2020 deficit thankfully never came to pass, the temporary tax increases did, even as their intended purpose evaporated. Now is a perfect time to sunset these revenue-raising tax increases and assist California employers with their recovery and growth.

NET OPERATING LOSS DEDUCTIONS

Most businesses do not turn a profit during their formative years. To account for this, both the federal government and California allow businesses to offset their tax liability with an NOL deduction. An NOL deduction occurs when a business reports a net taxable loss of income in a year. This loss is carried forward to future years to offset profits, thus reducing the tax liability of the business.

The NOL deduction is most identified with the tech industry, since Silicon Valley startups typically operate at a loss during their initial years of operation. However, the NOL deduction also is vitally important to employers that suffer a loss but remain in business for years after the financial hit. Employers in the restaurant, hospitality and lodging industries were crippled by the pandemic-induced restrictions throughout 2020 and 2021. Now that these businesses are beginning to recover and operate at a profit, it is crucial they can offset their past losses at tax time by using the NOL deduction.

BUSINESS INCENTIVE TAX CREDITS

AB 85 also limited business incentive tax credits to $5 million per year per taxpayer. This limitation applies to research and development (R&D) credits, enterprise zone credits, hiring credits (including the California Competes Credit), college access credits, motion picture credits, and credits for produce donations by agricultural producers to food banks.

R&D is the backbone of the California economy and the credit cap has the potential to stifle innovation and well-paying job growth. This particular tax credit has incentivized California employers to substantially invest within the state and create high-wage jobs in our communities. According to the Milken Institute, since 1987, California's R&D tax credit has allowed companies to reduce their corporate income tax burden by 15% to 24% when they invest in three key areas. These include qualified research expenses, wages paid to those engaged in research or directly supervising or supporting research activities, and research supplies (other than land or land improvements).

Furthermore, the Milken Institute stated that industry actors performed more than $144.5 billion worth of R&D activities in California in 2018, nearly five times as much as the second-ranked state for industry investment in R&D. Four industries have strong ties to the R&D credit in California, including computers and mathematics, architecture and engineering, life and physical sciences, and arts, design and media. The Milken Institute determined that although computers and mathematics jobs are the state's single largest industry workforce supported

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by R&D, the level of job concentration (the size of the industry workforce relative to the state's economy as a whole) is highest in arts, design and media.

Although the R&D tax credit supports a wide variety of industries, it also is dispersed throughout California geographically and supports a number of jobs on the income spectrum. R&D investments are most closely tied to San Diego and the San Francisco Bay Area given the life sciences and information technology industries in those locations. Additionally, while R&D jobs are most heavily concentrated in California's coastal areas, R&D-supported workforces can be found in the Central Valley and Inland Empire. According to the Milken Institute:

"Because R&D supports job creation across a broad variety of activities, investments in R&D don't just generate jobs for people with advanced degrees who are directly engaged in research activities (including analysts, engineers, and lab technicians). These investments also create opportunities for residents with different academic credentials, levels of experience, and industry affiliations, including jobs indirectly related to research outcomes (such as maintenance technicians, marketing and advertising professionals, office managers, and sales associates). Among the occupations requiring an associate's degree that are projected to grow fastest by the Employment Development Department (EDD), several are directly supported by R&D investments, including web developers, network support specialists, and technicians in health care and the life sciences."

California's innovation-based economy thrives in large part because of the R&D tax credit. High-wage job growth is contingent upon expanding this tax credit. Because California never had to address a deficit, the tax credit cap must be restored.

CALCHAMBER POSITION

The California Chamber of Commerce commends Governor Newsom's budget for restoring NOL deductions and lifting the cap on business incentive tax credits. Tax credits and deductions play a vital role for employers in generating employment, expanding operations, and increasing economic output. These benefits also serve the state's economic needs by creating multiple streams of additional tax revenue and stimulating added investment and development within the state.

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