Tax Tools for Business

Budget Deficit Means Businesses Lose Tax Tools as California Suspends NOL Deduction, Caps Business Tax Credits

When COVID descended upon the American economy in 2020, California fiscal experts prognosticated an imminent state budget deficit. In response, state lawmakers suspended net operating loss (NOL) deductions and capped businesses tax incentives. As it turned out, California enjoyed a $76 billion surplus and two years elapsed before the tax tools were reinstated.

Fast forward to 2024 and California's state budget suffered an actual deficit. In response, lawmakers turned yet again to California businesses to help close the revenue gap by suspending NOL deductions and capping business tax credits.

BUDGET BILLS

AB 167 (Committee on Budget) and SB 167 (Committee on Budget and Fiscal Review) suspended the net operating loss deduction for tax years 2024, 2025, and 2026, for businesses with annual revenue exceeding $1 million. The NOL suspension was enacted to apply retroactively to January 1, 2024. This means that until tax year 2027, companies seeking to offset past losses cannot utilize the NOL deductions they had planned on using.

These budget bills also prohibit businesses from claiming more than $5 million in most tax credits annually for the 2024, 2025, and 2026 tax years.

SB 175 provides for a potential early sunset of the NOL suspension period in either the 2025 or 2026 tax year if the Director of Finance and the Legislature agree that the General Fund over the multiyear forecast is sufficient without the revenue impact of the NOL suspension and credit limitation provisions.

NET OPERATING LOSS DEDUCTIONS

Typically, business revenues are cyclical with an ebb and flow relative to the annual calendar. Longtime tax policy regarding NOLs recognizes this concept and ensures that businesses are taxed on average profitability over time, since the carrybacks acknowledge that business revenues span multiple years. Losses during one business cycle should be recognized at a subsequent time in order to ease the tax burdens organizations face over time and to avoid penalizing businesses with varying profitability from year to year.

Limiting NOL carryforwards will have the most negative impact on start-ups as well as industries that were forced to shutter during the pandemic. Start-ups traditionally accumulate NOLs in the first years of operation; this tax policy is reflected in their business plans. A start-up's ability to use those NOLs when it becomes profitable is vital to its continued growth until it becomes net profitable over the span of its operations. Limiting these carryforwards will create inequities between companies with stable profits year-to-year and companies making significant long-term investments as well as other companies with annual volatility in profits. This inequity can create substantial differences in tax liability. Limiting these carryforwards will, over time, reduce innovation in California, as idea-based ventures see a more difficult path to economic success.

Many businesses operated at a loss over the past several years due to the pandemic and an NOL carryforward limitation will compound the economic harm companies have suffered. As companies have recovered, allowing an NOL carryover to future years reduces taxes owed once a business is profitable again, which can spur economic recovery. However, an NOL carryforward limitation ignores the devastating past losses experienced by many companies and makes these cash-strapped, recovering organizations pay taxes where they normally would not. In the aggregate, this could diminish economic recovery.

BUSINESS INCENTIVE TAX CREDITS

The budget bills also limited business incentive tax credits to a total of $5 million. This limitation would apply to all tax credits except Low-Income Housing and Pass-through Entity Elective tax credits. Most concerning, this limitation would be aimed at one of California's most coveted tools for businesses of all sizes — the Research and Development (R&D) credit.

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 invest substantially 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 "in California, businesses fund 94% of their own R&D activities — a higher proportion than the nationwide average (87%) — highlighting the vital role industry actors play within the state's innovation ecosystem. Private sector R&D spending grew an average of 13% year-over-year from $132 billion in 2017 (in total expenditures) to $212 billion in 2021." Four industries with strong ties to the R&D credit in California include computers and mathematics, architecture and engineering, life and physical sciences, and arts, design, and media.

The Milken Institute determined that while computers and mathematics jobs are the state's single largest industry workforce supported 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.

While 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 Bay Area given the life sciences and information technology industries in those locations. In addition, while R&D jobs are concentrated most heavily 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 this tax credit's expansion. The concern this proposal evokes is intensified since it proposes to cap credits that businesses have already planned and budgeted to use.

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 because they create multiple streams of additional tax revenue and stimulate added investment and development within the state.

CALCHAMBER POSITION

The California Chamber of Commerce will continue to support the restoration of the NOL deduction and lifting the cap on business 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 because they create multiple streams of additional tax revenue and stimulate added investment and development within the state.

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