

# Temporary Limits on Business Tax Provisions

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**Summary.** This post provides background on temporary limits on the use of net operating loss deductions and business tax credits. It describes the Governor’s proposal to lift these limits one year early and provides some comments to the Legislature.

## Background

### **State Temporarily Raised Business Taxes to Address Anticipated Budget Problem.**

The onset of the COVID-19 pandemic had far-reaching negative impacts on the state economy and significantly impacted the state budget. In anticipation of a \$54 billion budget problem, Chapter 8 of 2020 (AB 85, Committee on Budget) limited the use of net operating loss deductions and business credits for 2020, 2021, and 2022 to temporarily increase tax revenue. This is a budget solution that the state previously has used, for example, to address the budget problem caused by the Great Recession in 2008.

**Net Operating Loss Deductions Smooth Business Profits and Losses Over Time.** Companies and individuals often incur operating losses associated with their business activities in some years. These companies are able to carry the net operating losses (NOLs) forward into future tax years and deduct NOLs from their operating income. The ability to deduct NOLs allows business taxpayers to smooth profits and losses over time. California tax law allows business taxpayers to carry forward such NOLs for up to 20 years.

### **NOL Suspension Affects About 4,000 Taxpayers.**

Assembly Bill 85 suspended the use of NOL deductions by corporations and individuals that have net business income over \$1 million for 2020, 2021, and 2022. **Figure 1** provides summary information about those taxpayers that had business income over \$1 million and used NOL deductions in 2019. The figure shows that 339 personal income tax (PIT) payers and 3,866 corporation taxpayers had business income over \$1 million and used a NOL deduction. The figure also shows the use of NOL deductions by corporate taxpayers across industry sectors. In 2019, for example, 619 taxpayers operating in the manufacturing industry had more than \$1 million in income and deducted \$3 billion in NOLs in total. The administration estimates that the NOL suspension increased revenues by about \$2 billion in 2020-21.

Figure 1

### **NOLs Deducted by Selected Taxpayers** 2019

	<b>Number of Returns With NOLs, Business Income &gt;\$1 Million</b>	<b>Amount of NOLs Claimed (Billions)</b>
<b>Personal Income Tax Returns</b>		
Resident	314	\$1.9
Nonresident	25	0.1
<b>Totals</b>	<b>339</b>	<b>\$2.0</b>
<b>Corporation Tax Returns</b>		
Retail and wholesale trade	895	\$2.7
Industry unknown	724	3.9
Manufacturing	619	3.0
Services	454	1.2
Information	386	1.1
Other industries	788	3.7
<b>Totals</b>	<b>3,866</b>	<b>\$15.6</b>

NOLs = net operating losses.

**Business Tax Credits Often Encourage Certain Types of Behavior.** Tax credits are provisions in California's tax laws that allow taxpayers to directly reduce their taxes dollar for dollar. Most business tax credits provide an incentive for companies to alter their behavior in certain ways. For example, the New Employment Tax Credit allows a company to claim a credit if they hire a qualified new full-time employee. The largest state business tax credit is the credit for qualified research and development (R&D) expenditures. Taxpayers claimed about \$3.1 billion in R&D credits in 2019. All other business credits amount to less than \$1 billion combined.

**Credit Limits Likely Affect Fewer Than 100 Corporations.** Assembly Bill 85 limited the amount of most business tax credits any taxpayer could claim to \$5 million for 2020, 2021, and 2022. **Figure 2** lists the tax credits limited by AB 85 and the amounts of each claimed in 2019 by the affected corporation taxpayers. Some affected taxpayers may have had several credits, for example, an affected corporation may have had both California Competes and R&D credits. The \$5 million limit on credits likely has affected fewer than 100 corporation taxpayers. (No individual business owner was affected by this provision because none had more than \$5 million in credits available to apply against the PIT. Taxpayers are allowed to carry unused credits forward to use in a future tax year. While different credits can be carried forward for varying amounts of time, R&D credits never expire. The administration estimates that the limit on business credits increased revenues by about \$2 billion in 2020-21.

**Interaction Between Suspending NOLs and Limiting Credits.** Some corporations have large balances of both NOLs and credits. If the state restricts the use of NOLs, such corporations will increase their use of credits. For this reason, placing limits on both NOLs and credits results in a larger revenue effect than limiting either NOLs or credits separately. The administration estimates that this interaction effect increased revenues by an estimated \$600 million in 2020-21.

## Governor's Proposal

**Lifts Temporary Limits on Business Tax Provisions.** The Governor's budget proposes to end, one year early, temporary limits on the ability of businesses to use NOL deductions and tax credits to reduce their tax payments. Lifting the NOL deduction and credit limits will reduce tax revenues by an estimated \$5.5 billion in 2022-23. **Figure 3** shows how the administration estimates that the proposal would affect General Fund revenues. Revenue increases in the years following 2022-23 because NOL deductions and credits that would have been used in future years instead will be used in 2022-23.

## Ending NOL and Credit Limits Early Is Reasonable

Lifting the limits one year early would be reasonable for a couple of key reasons.

Figure 2

### Tax Credits Used by Selected Corporation Taxpayers 2019

Credit	Number of Taxpayers	Amount (Millions)
Research and development	59	\$2,147
Enterprise zones	— <sup>a</sup>	258
Film production <sup>b</sup>	— <sup>a</sup>	109
Prior year alternative minimum tax	— <sup>a</sup>	63
California Competes	— <sup>a</sup>	27
New Advanced Strategic Aircraft	— <sup>a</sup>	19
<b>Totals</b>	<b>80</b>	<b>\$2,623</b>

<sup>a</sup> Fewer than ten taxpayers. The number may not be displayed to protect taxpayer confidentiality.

<sup>b</sup> Includes credits from both the first and second film tax credit programs.

Figure 3

### Estimated Revenue Change From Governor's Proposal to End Limits on Business Taxes

	FY 22-23	FY 23-24	FY 24-25	FY 25-26
Personal income tax	-275	8.5	42.5	33
Corporation tax	-5,225	161.5	807.5	617
<b>Totals</b>	<b>-5,500</b>	<b>170.0</b>	<b>850.0</b>	<b>650</b>

FY = fiscal year.

***Budget Solution No Longer Needed.***

The state's actual revenue situation improved significantly faster than the state anticipated when it adopted the temporary limits on NOL deductions and credits. The unusual economic effects of the pandemic resulted in unexpected growth in General Fund revenues. The *2020-21 Budget Act* forecast 2022-23 revenues of \$132 billion—an amount that reflected a sharp decline in 2020-21, followed by slower than average growth. The Governor's budget now forecasts that 2022-23 General Fund revenues will be \$196 billion, or 49 percent, higher than the projection when these business tax provisions were enacted. The provisions were enacted to address the anticipated budget problem, not to raise revenue for new state spending.

***Improved Budget Resilience in Future Years.*** The temporary limits on NOLs and credits effectively shift tax revenue from future years to the present. Given the strong budget position at present, it is not prudent to increase revenues in the current year if those increases come at the expense of reduced revenues in future years, when the budgetary situation is less certain. In addition to increasing future revenue, the Governor's proposal could improve budget resilience by maintaining the option to again place temporary limits on NOLs and credits should the state face a similar budget problem in the future.



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This post was prepared by Brian Weatherford, and reviewed by Brian Uhler and Carolyn Chu. The Legislative Analyst's Office (LAO) is a nonpartisan office that provides fiscal and policy information and advice to the Legislature.