

## California Enacts 3-Year NOL Suspension and Business Tax Credit Limit

### Overview

On June 29, 2020, California's Governor Newsom signed Assembly Bill 85 ("A.B. 85"), which now becomes California law.<sup>1</sup> In the Governor's May Revision,<sup>2</sup> the Governor projected a budget deficit of approximately \$54 billion (before the changes proposed in the May Revision) as a result of the coronavirus (COVID-19) pandemic.<sup>3</sup> This budget deficit was based on a projected decline in General Fund revenues of over \$41 billion, the increased costs in health and human services programs, and the added costs to address the COVID-19 pandemic.<sup>4</sup> A.B. 85, which includes several tax measures, provides for a three-year suspension of the use of net operating losses for medium and large businesses and a three-year cap on the use of business incentive tax credits to offset no more than \$5 million of tax per year.

This Tax Alert summarizes some of the more notable changes and provides some taxpayer considerations.

### Overview of Notable Changes to Tax Provisions

The most notable changes in A.B. 85 impacting California income taxes relate to the suspension of net operating losses and the limitation on business incentive tax credits.<sup>5</sup> Revenue estimates for A.B. 85 project that these two temporary changes will generate revenue of \$4.4 billion in 2020-2021, \$3.3 billion in 2021-2022, and \$1.5 billion in 2022-2023.<sup>6</sup>

### **Suspension of Net Operating Losses:**

Generally, A.B. 85 suspends the use of net operating losses for taxable years 2020, 2021, and 2022 for taxpayers with taxable income of \$1 million or more.<sup>7</sup> Specifically, A.B. 85 adds two new sections to the California Revenue and Taxation Code (CRTC): Section 17276.23 under the Personal Income Tax Laws (PITL); and, Section 24416.23 under the Corporation Tax Laws (CTL).<sup>8</sup> Under both sections, the suspension applies to "any taxable year beginning on or after January 1, 2020, and before January 1, 2023."<sup>9</sup>

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<sup>1</sup> A.B. 85, 2019-2020 REG. SESS. (CAL. 2020) (available [here](#)); see also Governor Newsom Signs 2020 Budget Act, June 29, 2020 (available [here](#)).

<sup>2</sup> The Governor's proposed budget is originally submitted to the California Legislature on or before January 10 of each year and incorporates revenue and expenditure estimates based on information available through mid-December ("Governor's Budget"). See BUDGET PROCESS OVERVIEW (available [here](#)). The May Revision revises the Governor's Budget and accounts for subsequent changes made by the Finance Department to revenue and expenditure estimates for the current and budget years. See *id.* On May 14, 2020, Governor Newsom submitted to the California Legislature the May Revision.

<sup>3</sup> CALIFORNIA BUDGET SUMMARY: MAY REVISION, INTRODUCTION, May 14, 2020 (available [here](#)).

<sup>4</sup> *Id.*

<sup>5</sup> See A.B. 85, 2019-2020 REG. SESS. (CAL. 2020) (available [here](#)) for other changes in A.B. 85 which include, but are not limited to: (i) Requiring used car dealers to remit sales tax to the Department of Motor Vehicles; (ii) Extending the carryover period for film credits awarded under Program 2.0 from 6 years to 9 years; (iii) Extending the current exemption from the minimum tax for first year corporations to first year LLCs, LPs, and LLPs for a limited period; (iv) Limiting refunds/credits claimed in lieu of qualified motion picture tax credits under the Personal Income Tax Laws and Corporation Tax Laws to \$5 million for 2020 through 2022; and (v) Limiting insurance tax credits including carryovers to \$5 million for 2020 through 2022. Please see relevant sections of A.B. 85 for specific details relating to these other changes.

<sup>6</sup> See A.B. 85, 2019-2020 REG. SESS. (CAL. 2020), SENATE FLOOR ANALYSES, JUNE 15, 2020 AND ASSEMBLY FLOOR ANALYSIS, JUNE 15, 2020 (both available [here](#)); see also CALIFORNIA BUDGET SUMMARY: MAY REVISION, REVENUE ESTIMATES, May 14, 2020 (available [here](#)).

<sup>7</sup> See A.B. 85 §§ 8; 16.

<sup>8</sup> *Id.* (adding Cal. Rev. & Tax Code §§ 17276.23 and 24416.23).

<sup>9</sup> CAL. REV. & TAX CODE §§ 17276.23(a); 24416.23(a).

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A.B. 85 allows an extension of the carryover period for any net operating losses that were suspended under this provision.<sup>10</sup> Specifically, these provisions provide:

[f]or any net operating loss or carryover of a net operating loss for which a deduction is denied by subdivision (a), the carryover period under section 172 of the Internal Revenue Code shall be extended as follows:

- (1) By one year, for losses incurred in taxable years beginning on or after January 1, 2021, and before January 1, 2022.
- (2) By two years, for losses incurred in taxable years beginning on or after January 1, 2020, and before January 1, 2021.
- (3) By three years, for losses incurred in taxable years beginning before January 1, 2020.<sup>11</sup>

A.B. 85 provides that certain taxpayers are exempt from the suspension of net operating losses. Specifically, A.B. 85 provides that, for taxpayers subject to the PITL provision (new CRTC Section 17276.23), the suspension does not apply to a taxpayer with "net business income" or "modified adjusted gross income" of less than one million dollars for the taxable year.<sup>12</sup> For taxpayers subject to the CTL (new CRTC Section 24416.23), the suspension does not apply to taxpayers with "income subject to tax under [Part 11] of less than one million dollars...for the taxable year."<sup>13</sup>

### **Limitation on Business Incentive Tax Credits:**

A.B. 85 also limits the use of business incentive tax credits for taxable years 2020, 2021, and 2022, requiring that credits (including carryovers) to which these sections apply may not reduce the applicable tax "by more than five million dollars".<sup>14</sup> Specifically, A.B. 85 adds two new sections to the CRTC – Section 17039.3 to the PITL and Section 23036.3 to the CTL.<sup>15</sup> Under both sections, the credit limitation applies to "taxable years beginning on or after January 1, 2020, and before January 1, 2023."<sup>16</sup> Generally, for corporate taxpayers required to be included in a combined report, this \$5 million threshold is applied on an aggregate basis – meaning for each taxable year beginning on or after January 1, 2020, and before January 1, 2023, credits allowable (including carryovers) "by all members of the combined report shall not reduce the aggregate amount of 'tax' (as defined in [CRTC] Section 23036) of all members of the combined report by more than five million dollars."<sup>17</sup>

Under new CRTC Section 17039.3, the credits subject to this limitation include any credits allowable under Chapter 2 of the PITL (commencing with CRTC Section 17041),<sup>18</sup> except for certain delineated credits that are still allowed notwithstanding this provision.<sup>19</sup> For purposes of new CRTC Section 23036.3, the credits subject to this limitation include any credits allowable under Chapter 3.5 of the CTL (commencing with CRTC Section 23604), with no carve-out for otherwise allowable credits like there is in the PITL provision, except for the credit for low-income housing.<sup>20</sup>

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<sup>10</sup> CAL. REV. & TAX CODE §§ 17276.23(b); 24416.23(b).

<sup>11</sup> *Id.*

<sup>12</sup> CAL. REV. & TAX CODE § 17276.23(c)(1)-(2); *see also* CAL. REV. & TAX CODE § 17276.23(d) (defining "business income," "modified adjusted gross income," and "passthrough entity").

<sup>13</sup> CAL. REV. & TAX CODE § 24416.23(c).

<sup>14</sup> *See* A.B. 85 §§ 6; 14 (defining "tax" for purposes of these provisions).

<sup>15</sup> *Id.* (adding Cal. Rev. & Tax Code §§ 17039.3 and 23036.3; amending, *inter alia*, Cal. Rev. & Tax Code §§ 6902.5, relating to the election to apply the qualified motion picture credit against the sales and use tax in lieu of claiming the credit under the PITL or CTL provisions).

<sup>16</sup> CAL. REV. & TAX CODE §§ 17039.3(a)-(b); 23036.3(a)-(b).

<sup>17</sup> CAL. REV. & TAX CODE §§ 17039.3(b); 23036.3(b). This provision applies to taxpayers required to be included in a combined report under CRTC §§ 25101, 25110, or "authorized to be included in a combined report under CRTC 25101.15." *See Id.*

<sup>18</sup> *See* CAL. REV. & TAX CODE § 17039.3(a)-(c).

<sup>19</sup> The following credits are still allowed under CRTC § 17039.3: § 17052 (credit for earned income); § 17052.1 (credit for young child); § 17052.6 (credit for household and dependent care); § 17052.25 (credit for adoption costs); § 17053.5 (renter's tax credit); § 17054 (credit for personal exemption); § 17054.5 (credit for qualified joint custody head of household and qualified taxpayer with a dependent parent); § 17054.7 (credit for qualified senior head of household); § 17058 (credit for low-income housing); and § 17061 (refunds pursuant to the Unemployment Insurance Code). *See* CAL. REV. & TAX CODE § 17039.3(c).

<sup>20</sup> *See* CAL. REV. & TAX CODE § 23036.3(a)-(b); CAL. REV. & TAX CODE § 23036.3(d) (stating that the limitation shall not apply to the credit allowed under CRTC § 23610.5 (credit for low-income housing)).

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Under both sections, the credits that are limited include, but are not limited to, the research credit (CRTC Sections 17052.12 and 23609), new employment credit (CRTC Sections 17053.73 and 23626), jobs tax credit (CRTC Sections 17053.7 and 23621), California competes credit (CRTC Sections 17059.2 and 23689), qualified motion picture credits (CRTC Sections 17053.85, 17053.95, 17053.98, 23685, 23695, and 23698), the oil recovery credit (CRTC Sections 17052.8 and 23604), credit for transporting donated agricultural product (CRTC Sections 17053.12 and 23608), credit for rehabilitating certified historic structures (CRTC Sections 17053.91 and 23691), natural preservation credit (CRTC Sections 17053.30 and 23630), and prison inmate labor credit (CRTC Sections 17053.6 and 23624).<sup>21</sup>

Additionally, under both sections, any credit that is disallowed under these new provisions "shall remain a credit carryover amount" and "[t]he carryover period...shall be increased by the number of taxable years the credit or any portion thereof was not allowed."<sup>22</sup>

### Considerations

Now that Governor Newsom has signed A.B. 85, it becomes California law and is effective for taxable years beginning on or after January 1, 2020, and before January 1, 2023. Although this tax alert covers the more notable changes made under A.B. 85, it does not cover all of the changes made under this bill. Taxpayers should consult with their California tax advisors on the changes made under A.B. 85 and the impact that these changes may have on their California tax liabilities.

### Contacts:

If you have questions regarding A.B. 85 or other California tax matters, please contact any of the following Deloitte professionals:

#### David Vistica

##### Managing Director

Deloitte Tax LLP, Washington  
National Tax  
+1 202 370 2268  
[dvistica@deloitte.com](mailto:dvistica@deloitte.com)

#### Robert Waldow

##### Principal

Deloitte Tax LLP, Washington  
National Tax  
+1 612 397 4487  
[rwaldow@deloitte.com](mailto:rwaldow@deloitte.com)

#### Kathy Freeman

##### Managing Director

Deloitte Tax LLP, Sacramento  
+1 916 288 3392  
[katfreeman@deloitte.com](mailto:katfreeman@deloitte.com)

#### Christopher Campbell

##### Principal

Deloitte Tax LLP, Los Angeles  
+1 213 553 3072  
[cwcampbell@deloitte.com](mailto:cwcampbell@deloitte.com)

#### Jerry McTeague

##### Partner

Deloitte Tax LLP, San Jose  
+1 408 704 4477  
[jmcteague@deloitte.com](mailto:jmcteague@deloitte.com)

#### Jairaj Guleria

##### Partner

Deloitte Tax LLP, San Jose  
+1 415-783-4636  
[jguleria@deloitte.com](mailto:jguleria@deloitte.com)

#### Bart Baer

##### Principal

Deloitte Tax LLP, San Francisco  
+1 415 783 6090  
[bartbaer@deloitte.com](mailto:bartbaer@deloitte.com)

#### Shirley Wei

##### Senior Manager

Deloitte Tax LLP, Washington  
National Tax  
+1 213 553 1715  
[shiwei@deloitte.com](mailto:shiwei@deloitte.com)

#### Valerie Dickerson

##### Partner

Deloitte Tax LLP, Washington  
National Tax  
+1 202 220 2693  
[vdickerson@deloitte.com](mailto:vdickerson@deloitte.com)

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<sup>21</sup> This list does not include all the credits subject to the limitation under CRTC §§17039.3 and 23036.3. For details relating to other credits that may be subject to this limitation, please see Chapter 2 of the PITL and Chapter 3.5 of the CTL.

<sup>22</sup> CAL. REV. & TAX CODE §§ 17039.3(e)-(f); 23036.3(e)-(f); see also CAL. REV. & TAX CODE §§ 17039.3(g), (h); 23036.3(c), (g).

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