



Date: June 9, 2020

To: Members, California State Legislature

Subject: **OPPOSITION to BUDGET PROPOSAL TO INCREASE TAXES BY \$9.2 BILLION BY SUSPENDING THE NET OPERATING LOSS DEDUCTION AND LIMIT UTILIZATION OF BUSINESS TAX INCENTIVES & CREDITS**

The California Taxpayers Association and the organizations listed below oppose the proposal in the May budget revision that would raise taxes by \$9.2 billion on businesses during the worst economic downturn since the Great Depression. The May Revise would suspend the net operating loss deduction, as well as limit the utilization of business tax incentives and credits, including the Research and Development Tax Credit.

A survey released June 3<sup>rd</sup> by the California Public Policy Institute of California found that **60 percent of likely voters OPPOSE including higher taxes in the state budget.**

California is facing an unprecedented, sudden economic collapse. Unemployment is at a record high. For the first time in decades, businesses of all sizes are severely impacted including some large corporate taxpayers that are unprofitable. Many small businesses will struggle to reopen –

and to stay open afterward. These combined forces are having an immediate impact on tax revenue in the current and upcoming fiscal years.

The Department of Finance forecasts that California will see a General Fund revenue shortfall of \$41 billion in fiscal year 2019-20 and 2020-21. However, there seems to be disagreement among the available models about the size of California's budget shortfall. For example, the Legislative Analyst Office "[Spring Fiscal Outlook](#)" projects a much more hopeful fiscal scenario, specifically:

***Revenues and Other Resources Available Lower by \$26 Billion to \$39 Billion. Under both recession scenarios, our revenue estimates are tens of billions of dollars lower than the Governor's budget estimates in January. In the U-shaped scenario, revenues and other resources (specifically, the Special Fund for Economic Uncertainties [SFEU]) are lower by \$26 billion from 2018-19 to 2020-21. In the L-shaped scenario, resources are lower by \$39 billion across the same years. These revenue losses account for federal reimbursements from the state and federal disaster declaration ... and the estimated SFEU balance in the Governor's budget.***

There is no playbook for forecasting this economy. Given the unprecedented level of uncertainty, the \$9.2 billion tax increase contained in the May Revise should be reconsidered. Now is not the time to pick winners and losers in a frail economy, while so many Californians are hurting.

This is an unprecedented time, and accurately predicting the economic impact is impossible, but one thing remains certain: California businesses are the only engine that can pull the state out of recession and get Californians back on their feet. Just as California employers played a pivotal role in creating the large reserves that are helping the state avoid billions of dollars in budget cuts, they will be critical to the state's recovery. Now is not the time to put economic hurdles in front of these struggling home-state businesses.

The corporate tax provisions outlined in the May Revise would prolong the recession, extend California's fiscal crisis, lower future tax receipts, and necessitate future budget cuts from schools and critical services.

There is a time and a place for tax credits and incentives. Times like these are when the policies have the most power. Tax credits and incentives can be powerful tools to promote economic expansion, encourage rehiring, incentivize businesses to locate in the state, and help businesses regain economic footing.

The May Revise contains two major, retroactive taxes that amount to a \$9.2 billion tax from fiscal year 2020-21 through 2022-23 on businesses:

### **1) Suspension of Net Operating Loss Deduction ("NOL")**

The May revision proposes to suspend the net operating loss deduction for tax years 2020, 2021, and 2022, for "medium and large businesses." This would place California out-of-step with every other state that levies a corporate income tax in the country. While other states are trying to jump-start job creators, these provisions would do the opposite to California employers.

Under California law, businesses may carry forward their NOLs to deduct against taxable income in future years. NOLs incurred in 2013 through 2018 can be carried back to the prior two years to deduct against taxable income. However, NOLs incurred in 2019 and after cannot be carried back to previous years. The proposed NOL suspension would prevent businesses from applying their NOLs to deduct against taxable income

during taxable years 2020 through 2022. Further, this suspension would be retroactive to January 1, 2020, causing a major disruption for businesses that already made planning decisions for 2020.

A net operating loss occurs when a business' expenses exceed its income within a single tax year. Broadly speaking, the two parts of the NOL deduction make it possible for businesses to manage their losses by allowing them to offset or deduct one tax year's losses from another tax year's profits. The purpose is to resolve an inequity in our tax structure that arises because businesses experience losses and profits according to timeframes or cycles that do not necessarily coincide with government tax filing deadlines that are arbitrary to begin with.

Reducing or eliminating deductions to solve budget problems translates into a direct tax increase for businesses. Since employers tend to make business plans over the long term, unexpected changes to investment incentives can have drastic consequences, even for medium and large businesses – operations that could emerge from the pandemic as small businesses, if they survive at all. Merely proposing such changes creates instability and unpredictability that chill investment and growth. Now more than ever, California needs to encourage employers to invest here and get us back on the road to recovery.

Suspending NOLs would compound the economic harm already facing so many businesses because of COVID-19. Many businesses that have had long-term growth cycles are, for the first time in decades – or ever – expecting to operate at a loss in 2020 because of COVID-19. As businesses hopefully begin to recover in 2021 and later, it may take years for these businesses to restore what was lost in 2020. Maintaining NOLs is vital to ensuring that once businesses regain profitability, they can deduct losses resulting from COVID-19 in 2021 and 2022, allowing for a quick economic recovery.

NOLs, by definition, help businesses that are struggling with losses. Without the ability to deduct these losses against future income, taxpayers would appear to be profitable when in fact they are not. The pandemic has placed many more businesses in this category. The state should not take the air out of this desperately needed assistance.

## **2) Limitation of Business Tax Incentives, including Research & Development Tax Credit ("R&D"), Hiring Tax Credit & Motion Picture Production Incentives**

The May Revise seeks to raise taxes by prohibiting businesses from claiming more than \$5 million in tax credits per tax year in 2020, 2021, and 2022. While it is unclear which credits or incentives are included in this proposal, the largest business tax incentive allowed under the Corporate Income and Franchise Tax Code is the Research and Development Tax Credit. Other credits and incentives allowed under current law should not be limited, as the May Revise proposes.

R&D is the most important activity taking place on this planet. As California businesses begin to develop a vaccine, treatment, testing and new technologies to respond to COVID-19, they should be supported by all of us. The state (and the country) will not return to normal and move past this pandemic without R&D, and we should be doing everything possible to make sure this activity happens here in California. The May Revise seeks to penalize these efforts.

The R&D credit supports labor expenses, supplies and materials (except equipment) used for research performed in California. R&D involves highly compensated research jobs that boost personal income, sales and property tax revenue for the state. For higher education, this investment also creates jobs that benefit California's universities and

colleges. Through years of trial-and-error research and long days spent turning ideas into groundbreaking consumer products, California companies led the world into a technological age. Thanks to California-grown technology, it is possible for people around the world to continue earning income while working from home, and California's state government has been able to continue serving the public during a pandemic that requires physical distancing. The policy decisions made today will determine where this sort of progress takes place tomorrow.

The proposal to limit the R&D tax credit comes at a particularly dire time. This proposal would set back the ability for a taxpayer to claim credits under a typical five-year business plan over those years. Research projects are long-term investments that can take years from conception to fruition. A temporary deferral would dampen this wellspring of innovation and jobs.

Our ability to remain competitive as a state, and to retain our position as the world's fifth-largest economy, depends on a strong state R&D tax credit.

Additionally, budget trailer bill language released by Department of Finance on May 18, 2020 would also limit the following:

- **Incentives for Hiring Employees.** The proposal would limit the utilization of hiring credits, including the Hiring Credit (RTC Section 23621), Hiring Credit for Employees in Designated Census Tracts (RTC Section 23626), and the GO-BIZ Hiring Tax Credit (RTC Section 23689). Hiring credits encourages businesses to hire and increase employment in the state. At a time when unemployment is at record-levels, hiring credits could be a powerful tool to encourage employers to begin rehiring once the economy begins to recover.
- **Incentives for Filming Motion Pictures & Television in California.** The proposal limits the utilization of the qualified expenditures for Production of Qualified Motion Pictures (RTC Sections 23685, 23695, and 23698). These tax credits for motion pictures promote and incentivize the filming and production of film and television within the state of California. In a 2018 study conducted by Film L.A., California was ranked #4 in terms of top 100 domestic films produced by location. In 2013, California was tied for #1 and Georgia was tied for #4. However, in the most recent rankings, Georgia ranked ahead of California at #2, demonstrating how effective they have been in attracting the motion picture industry through its various incentives. By limiting these tax credits, California is pushing taxpayers and industry to move their operations out of state, at a time when the focus should be on keeping and increasing the number of working Californians to help in the economic recovery.
- **Incentives for Building Affordable Housing.** The proposal limits the State Low-Income Housing Tax Credit (RTC Section 23610.5) and Qualified rehabilitation expenditures with respect to a certified historic structure (RTC Section 23691). These tax credits were intended to further incentivize taxpayers to increase affordable housing within the state. The taxpayer receives a credit if they build, rehabilitate, or acquire low-income housing within California, meet all of the other requirements, and have the credit authorized by California Tax Credit Allocation Committee. The taxpayers wishing to claim these credits during tax years 2020, 2021, and 2022 have already fulfilled their end of the bargain by increasing the supply of affordable housing in California, which has become even more essential during this unprecedented crisis. By limiting this credit after the fact, Californians may see their access to affordable housing decrease as taxpayers begin to rethink their investment decisions.

We look forward to engaging in further discussions, and we continue to be mindful of the timeline for quickly developing solutions to solve the state's immediate budget shortfall.

Sincerely,



Robert Gutierrez  
President & CEO  
California Taxpayers Association

On behalf of:

Acclamation Insurance Management Services  
Advanced Medical Technology Association  
Agricultural Council of California  
Airlines for America  
Alliance for Automobile Innovation  
Allied Managed Care  
Almond Alliance of California  
American Property Casualty Insurance Association  
Associated General Contractors  
Association of California Egg Farmers  
Bay Area Council  
BFBA, LLP  
Biocom  
Biotechnology Innovation Association (BIO)  
Business Software Alliance (BSA)  
California Association of Wheat Growers  
California Bean Shippers Association  
California Beer & Beverage Distributors  
California Building Industry Association  
California Cable & Telecommunications Association  
California Farm Bureau Federation  
California Fuels and Convenience Alliance  
California Grain & Feed Association  
California Hispanic Chamber of Commerce  
California League of Food Producers  
California Life Sciences Association  
California Manufacturers & Technology Association

California Pear Growers Association  
California Restaurant Association  
California Retailers Association  
California Seed Association  
California State Floral Association  
California Warehouse Association  
Cellular Telecommunications Industry Association  
CompTIA  
Contra Costa Taxpayers Association  
Council on State Taxation  
Family Business Association of California  
Fountain Valley Chamber of Commerce  
Greater San Fernando Valley Chamber of Commerce  
Kern County Taxpayers Association  
Orange County Business Council  
Orange County Taxpayers Association  
Pacific Coast Rendering Association  
Pacific Egg & Poultry Association  
Pharmaceutical Research and Manufacturers of America (PhRMA)  
San Gabriel Valley Economic Partnership  
Silicon Valley Leadership Group  
Solano County Taxpayers Association  
Sutter County Taxpayers Association  
TechNet  
West Coast Lumber & Building Material Association  
Western Growers Association  
Western States Petroleum Association