Forbes

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TAXES 07/08/24

California Raises Taxes Again By Restricting Net Operating Loss Use

Taxes are annual, but if you are in business, you can generally rely on using a loss in one year to offset profit in another with net operating losses. There are rules of course, under federal tax law and the states, but subject to the details, net operating losses can mitigate the tax impact of your annual ups and downs. If you are in business in California, even a small business, California's business climate just got worse. The state passed legislation that includes important California tax provisions, including for NOLs.

The new law suspends the net operating loss deduction for tax years beginning on or after Jan. 1, 2024, and before Jan. 1, 2027. The suspension applies to taxpayers with greater than $1 million in net income for the tax year. Modified adjusted gross income excludes deductions from NOLs. Combined with the NOL suspension during 2020 to 2021, with the current pause on NOL deductions, only the taxable years 2022 to 2023 are eligible for the California NOL deduction.

To the extent any NOL deduction is denied as a result of this suspension, the allowable carryforward period for these NOLs is extended by the following:

- Three years for losses incurred in tax years beginning prior to Jan. 1, 2024

- Two years for losses incurred in tax years beginning on or after Jan. 1, 2024, and prior to Jan. 1, 2025

- One year for losses incurred in tax years beginning on or after Jan. 1, 2025, and prior to Jan. 1, 2026

It is possible that this tough new rules may not last beyond 2024 or 2025, but only if there's a big turnaround in state revenue. The law includes a revenue trigger provision restoring the deduction for 2025 and/or 2026 if, for each year individually, it is determined by May 14, that the state's general fund is sufficient without the impact of the NOL suspension and credit limitation. The suspension pause for the respective year must also be accounted for in the annual budget.

There are tax credit cutbacks too. Under the new law, total business tax credits cannot offset more than $5 million in California tax liabilities for tax years 2024 to 2026 subject to a few exceptions, such as for the Low-Income Housing Tax Credit and the Pass-Through Entity Elective Tax Credit. Any excess business credits are carried forward and those credits with time limitations will be extended based on when the credit is freed up from the $5 million limitation.

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