



This Week in State Tax (TWIST)

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California: Budget Legislation Includes Revenue Raising Measures

Senate Bill 167, which has passed both chambers of the California legislature, makes several tax changes designed to alleviate the 2024-25 budget shortfall of \$27.6 billion and the projected \$ 28.4 deficit for the 2025-26 budget year. Details on key changes affecting business taxpayers are below.

NOL Suspension and Limits on Credits: California lawmakers have regularly limited the use of business credits and suspended the deduction of net operating losses during deficit years. For taxable years beginning on or after January 1, 2024 and before January 1, 2027, net operating losses (NOLs) are suspended for both corporate and personal income taxes. The suspension will not apply to any taxpayer with net business income or modified adjusted income of less than \$1 million. The existing 20-year carryforward period for NOLs is extended for up to three years if losses are not used due to the NOL suspension.

Another provision in Senate Bill 167 limits the use of credits for taxable years beginning on or after January 1, 2024 and before January 1, 2027. During this period, a business (including all taxpayers that are members of a combined report) may claim a total of \$5 million in credits only under both the Corporation and Personal Income Tax laws (including the carryover of any business credit). Most business credits, including the California R&D credit, are subject to this limitation. However, certain personal income tax credits and the low-income housing credit that applies to both corporate and personal income taxpayers are excluded. The carryover periods (if applicable) are extended by the number of years that a credit is disallowed by reason of this limitation.

Microsoft Fix: In *Microsoft*, the California Office of Tax Appeals concluded that the full amount of qualifying dividends deducted from income under R&TC section 24411 were includable in the taxpayer's sales factor. Senate Bill 167 adopts Legal Ruling 2006-1, which the FTB relied on in *Microsoft* as support for its position that only the portion of the qualifying dividends that remained in the tax base were included in the sales factor. In addition, the law is amended to provide that a transaction or activity, to the extent that it generates income or loss not included in "net income," subject to apportionment, shall be excluded from the apportionment formula. "Not included in net income" means income from transactions and activities that is not included in net income subject to apportionment for any reason, including, but not limited to, exclusion, deduction, exemption, elimination, or nonrecognition. This change, which Senate Bill 167 specifies does not constitute a change in law, applies to taxable years beginning before, on, or after the effective date of the bill.

Oil and Gas Provisions: Effective beginning with the 2024 tax year, Senate Bill 167 repeals the state's Enhanced Oil Recovery Cost Credit, which is modeled after the credit allowed under IRC section 43. California R&TC section 24423, which provides that the provisions of IRC section 263(i) apply to intangible drilling and development costs incurred outside the US, is repealed. Several provisions of the IRC that affect oil companies are no longer operative for California purposes as of January 1, 2024, including IRC sections 613(b)(2)(B) (in the case of oil shale), 613(b)(4) (relating to coal), and 613A (relating to limitations on percentage depletion in the case of oil and gas wells).

Sales Tax Bad Debt Deduction: California allows a bad debt deduction for sales and use taxes remitted to the state that relate to accounts that have been found to be worthless and charged off for income tax purposes or under GAAP for taxpayers not required to file income tax returns. A “retailer” includes certain entities affiliated with the retailer. Further, if an account is held by a lender, either the retailer or lender (if an election is made) is entitled to a deduction or a refund of the tax that the retailer has previously reported and paid if certain conditions are met. Senate Bill 167 suspends the bad debt deduction for affiliates of retailers on January 1, 2025. Further, electing lenders would not be entitled to the bad debt deduction unless the relevant account was found worthless and written off before January 1, 2025. On January 1, 2028, the current statute allowing a retailers and lenders a bad debt deduction is repealed entirely and only retailers (not including affiliates) will be entitled to the deduction going forward.

Administrative Changes: Senate Bill 167 amends current law to provide that the state’s Administrative Procedure Act or APA is not applicable to legal ruling of counsel issued by the California Department of Tax and Fee Administration. The Act is currently not applicable to a counsel ruling issued by the Franchise Tax Board. Finally, going forward, the Director of Finance, as opposed to the Franchise Tax Board, will determine whether a taxpayer is affected by a state of emergency.

Please contact [David Bertsch](#) with corporate tax questions, or [Jim Kuhl](#) with questions on sales tax.

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