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California: Budget tax changes enacted

California Senate Bill 167 was signed into law by the acting governor on June 27, 2024. The bill makes several tax changes designed to alleviate the 2024-2025 budget shortfall of $27.6 billion and the projected $28.4 deficit for the 2025-2026 budget year.

A follow up bill—Senate Bill 175—which is still pending signature, provides some relief for businesses affected by the revenue raising measures in Senate Bill 167.

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 able to be 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 only $5 million in credits under both the Corporation and Personal Income Tax laws (including the carryover of any business credit). Most business credits, including the California research and development (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.

Senate Bill 175 provides that the limits and suspensions do not apply for the 2025 and 2026 tax years if, by May 14, 2025 or 2026, the Director of Finance determines that General Fund money over the multiyear forecast is sufficient without the revenue impact of the NOL suspension and credit limitation.

Senate Bill 175 also authorizes taxpayers to make an irrevocable election to receive an annual refundable credit amount of qualified credits (credits that are subject to the limitation) during the three-year limitation period. The “annual refundable credit amount” is 20% of the credit amount for the taxable year. “Credit amount” means the amount of the qualified credits that would otherwise have been available to reduce net tax in the taxable year of the election but for the limitation. For the first five tax years beginning with the third

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taxable year after the taxpayer makes the election, the annual refundable credit amount shall be allowed as a credit against the tax.

As an example, if a business had $10 million in qualified credits for the 2024 tax year, but could only utilize $5 million due to the limitation, the taxpayer might elect on an original timely filed 2024 return to receive a refundable credit. Beginning with the 2027 tax year, this refundable credit could be applied $1 million each year for five years.

Microsoft fix

In *Microsoft,* the California Office of Tax Appeals concluded that the full amount of qualifying dividends deducted from income under California R&TC section 24411 were includable in the taxpayer's sales factor. Senate Bill 167 adopts Legal Ruling 2006-1, which the Franchise Tax Board (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 has been 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 amendment, 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 and use 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 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 (APA) is not applicable to legal ruling of counsel issued by the California Department of Tax and Fee Administration. The APA is currently not applicable to a counsel ruling issued by the FTB. Finally, going forward, the Director of Finance, as opposed to the FTB, will determine whether a taxpayer is affected by a state of emergency.

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