Date:	June 12, 2024
To:	Members, California State Senate
From:	Peter Blocker, Vice President of Policy
Subject:	**OPPOSITION to AB 167 (Assembly Budget Committee), as amended on June 8, 2024, and SB 167 (Senate Budget and Fiscal Review Committee), as amended on June 10, 2024**

The California Taxpayers Association and the organizations listed below respectfully opposes AB 167 and SB 167, a multibillion-dollar business tax increase that will lead to consumer price increases and job losses. These budget provisions would suspend the net operating loss deduction; limit the utilization of business tax incentives and credits, including the Research-and-Development Tax Credit; require certain income to be excluded from a businesses' apportionment factor when filing on a water's-edge basis; among several other changes that would harm the state's business climate.

California has the highest unemployment rate in the United States, according to April 2024 data from the U.S. Bureau of Labor Statistics. Together, AB 167 and SB 167 amount to a retroactive tax increase on California employers negatively impacting Californians who are struggling to find new employment opportunities.

CalTax opposes AB 167 and SB 167 for the following reasons:

1. **Suspension of the Net Operating Loss Deduction**

Net Operating Loss Deductions Are Critical for Business Growth. AB 167 and SB 167 would suspend the net operating loss deduction for tax years 2024, 2025, and 2026, for businesses with annual revenue exceeding $1 million. This would place California out of step with nearly every state in the country that levies a corporate income tax. While other states are trying to jump-start job creators, these provisions would do the opposite to California employers.

A net operating loss occurs when a business' expenses exceed its income within a single tax year. Broadly speaking, the NOL deduction makes it possible for businesses to be taxed fairly on their overall economic results by allowing NOLs incurred in one year to be deducted against income earned in a subsequent year. The purpose is to resolve an inequity in our tax structure that arises because businesses account for losses and profits according to arbitrary tax periods (e.g., one year) that do not necessarily coincide with a company's overall, long-term economic results.

For example, many start-up businesses, including biotech, artificial intelligence, and other technology-based companies, typically incur significant losses in the first few years of their existence before generating income and becoming profitable in later years. Good tax policy allows these companies to use the losses incurred in their early years to offset income earned in later years to reflect their overall economic results. Indeed, numerous start-ups that chose to locate in California years ago, knowing that the state applied this policy regarding NOLs, are now coming out of losses and have planned their finances accordingly. Changing the rules after the fact by removing their ability to deduct past losses pulls the rug out from under them financially and reduces their capital available to invest in California and create jobs.

Suspending NOL usage translates into a direct tax increase for businesses. Since employers make business plans over the long term, unexpected changes to investment incentives can have drastic consequences, even for medium and large businesses. 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.

Devastating to Industries With Cyclical Revenue. California's status as the leader of the tech industry, buoyed by the technological innovation of world-leading industries spawned in Silicon Valley, has elevated the state to the fifth-largest economy in the world. Many of these industries have cyclical revenue patterns, affected by macroeconomic trends, supply chain disruptions, or the boom-and-bust cycles of the stock market. For example, the semiconductor manufacturing industry – one the state has sought to prioritize through investments – can experience major losses based on economic trends. Major semiconductor manufacturing businesses located in the state faced severe losses in recent years from supply chain challenges and a decrease in demand as consumers faced inflationary pressures. NOLs are critical to industries like this that have cyclical revenue cycles, and California's tax policy should not punish these important industries, some of which are vital to our national security and should be encouraged by state policies to maintain domestic manufacturing.

Retroactive Changes to Tax Policies Harm Taxpayers. The Legislature's budget plan would suspend net operating losses retroactively for the 2024 tax year. Taxpayers consider tax policies when making long-term business operation plans, including equipment purchases, lease renewals, hiring, and other investments in their operations. Retroactively limiting deductions would have a devastating effect on business investment and make it impossible to plan long-term financial liabilities. When these types of retroactive tax increases are a possibility, California becomes a less attractive location to invest.

2. **Limitation of Business Tax Incentives, Including the Research-and-Development Tax Credit, Hiring Tax Credit, and Motion Picture Production Incentives**

These bills seek to raise taxes by prohibiting businesses from claiming more than $5 million in tax credits annually for the 2024, 2025, and 2026 tax years. While CalTax recognizes the Legislature's intent to provide refundability of tax credits for the disallowed years, the process, timeline, and mechanics for how refundability would work needs to be ironed out to ensure taxpayers are made whole after the suspension and that refunds do indeed materialize in future years.

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, the state has continued to lead the nation in creating new technologies to assist the state in reaching its ambitious climate goals. The policy decisions made today will determine where this sort of progress takes place tomorrow.

Credits limited by this proposal include:

- **Research-and-Development Tax Credit.** As California businesses develop new greenhouse gas reduction methods, vaccines for emerging diseases, methods to utilize artificial intelligence, and other new technologies, the proposed limit erodes California's leadership in cutting-edge innovation.

  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. This investment also creates jobs that benefit California's universities and colleges.

  The provisions to limit the R&D tax credit come at a particularly dire time. This would set back the ability for a taxpayer to claim credits under a typical five-year business plan during the affected 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 in California by making these types of investments more attractive in other states, particularly those that offer R&D tax credits for research conducted in their states and which do not suspend the use of these credits arbitrarily.

  Our ability to remain competitive as a state depends on a strong state R&D tax credit.

- **Incentives for Hiring California Workers.** This proposal would limit the utilization of policies that promote the employment of Californians, 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 encourage businesses to increase employment in the state. At a time when California's unemployment rate is the highest in the United States, hiring credits are a powerful tool to help Californians bounce back and find jobs.

- **Incentives for Filming Motion Pictures & Television Productions in California.** This proposal limits the utilization of the qualified expenditures for the Production of Qualified Motion Pictures (RTC Sections 23685, 23695, and 23698). These tax credits promote and incentivize the filming and production of film and television projects within the state of California. By limiting these tax credits, California is pushing taxpayers and the industry to move operations out of the state, undoing the important work the Legislature and state officials have done in recent years to stop runaway production. Every production creates jobs for writers, camera operators, wardrobe specialists, caterers, office staff and many other workers – and Californians need these jobs.

3. Corporate Tax Increase on Foreign Dividends

AB 167 and SB 167 require certain revenues to be excluded from a business' apportionment factor when filing on a water's-edge basis. This new law would directly reverse a recent Office of Tax Appeals (OTA) decision in the *Appeal of Microsoft*, which dealt specifically with the treatment of foreign dividends in the sales factor of a water's-edge filer. Taxpayers rarely prevail at the OTA, but in this case five administrative law judges with the OTA unanimously agreed that the correct interpretation of existing law was in the taxpayer's favor. This law would retroactively change that outcome.

Taxpayers rely on the technical expertise of OTA decisions when planning their long-term tax liabilities and make important business decisions with these opinions in mind.

In 2017, the Office of Tax Appeals was created to remove political influence from the appeals process, creating an independent, objective body to interpret California tax law. Due to the years it takes for an audit to make its way through the appeals process, the recent ruling was the most significant case to date decided by the OTA. By arbitrarily reversing this rare taxpayer victory, the May budget revision undermines the OTA's very purpose, independence and credibility, creating a process in which a taxpayer's successful appeal can be merely undone by statutory changes. This represents yet another bad example for the business community of California being a difficult and unreliable place to do business.

Imposes a Retroactive Tax Increase. The budget bills' so-called "clarification" of apportionment issues is more than clarification – it is a retroactive tax increase, overturning California law that has existed since the 1960s.

At issue in the *Appeal of Microsoft*:

1. Whether dividends from foreign subsidiaries that are deducted from income pursuant to R&TC section 24411 are includable in the sales factor of a water's-edge filer.

2. Whether these dividends should be excluded from the sales factor as a "substantial and occasional sale," pursuant to California Code of Regulations, title 18, (Regulation) section 25137(c)(1)(A).

The Legislature previously undertook an extensive effort to define what is included in the sales factor and what is excluded, but it did not address or "clarify" that dividends income should be reduced by deductions for purposes of the sales factor. The Legislature cannot reasonably claim now in a "clarification" that it meant to exclude other types of income received. Section 25120 states that all gross amounts received must be included in the sales factor, which dates back to the statute's original language enacted in 1966. It is unreasonable for the current Legislature to "clarify" what was meant by the Legislature almost 60 years ago.

Further, the OTA's ruling in *Microsoft* was unanimous, as was a second OTA panel's ruling to uphold the original decision, following a line of important court and OTA cases that have developed California common law regarding the meaning of “gross receipts” for purposes of the sales factor [*Microsoft Corporation v. Franchise Tax Board (2006)*; *Appeal of Robert Half International Inc. and Subsidiaries*, 2019-OTA-330; and *Appeal of Southern Minnesota Beet Sugar Cooperative and Subsidiary, 2023-OTA-342*].

Undermines Independence of OTA. Having the Legislature “overrule” a well-reasoned OTA decision by “clarifying” statutes enacted decades ago undermines the rule of law and the very purpose of the OTA to interpret California tax law.

The OTA was established in 2017 as part of the Taxpayer Transparency and Fairness Act. The OTA’s purpose was to provide a nonpartisan and fair adjudicatory body for taxpayers. In the declaratory statement for the legislation establishing the OTA, the Legislature remarked:

> *“Taxpayers deserve to have appeals considered by an independent, objective panel with sufficient expertise and a sole focus on tax issues. Any appeals forum must issue decisions in a transparent fashion, relying on well-established precedents in tax law, providing open public access and choice of representation, and building a record that both taxpayers and tax administration agencies can rely upon.”*

The Legislature recognized the importance of an independent process to handle technical disputes over tax law. Overturning the decisions of the OTA’s administrative law judges directly undermines the agency’s authority over tax matters and creates a chilling effect on taxpayers, where lawmakers could overturn any decision they see fit. Retaining the independence of the OTA as a non-political institution to resolve tax disputes should be prioritized by the Legislature.

4. <u>Other Changes Impacting Taxpayers</u>

Elimination of Bad Debt Deduction. The budget bills propose eliminating a provision of existing law that allows a retailer or lender to take a deduction of the sales and use tax paid by accounts that have been found to be worthless and charged off, otherwise known as the bad debt deduction. The deduction would be partially reinstated in 2028 under the proposal, but would be eliminated permanently for financial industry lenders.

Lenders and retailers rely on the bad debt deduction when deciding whether to provide loans to high-risk customers. The deduction provides certainty that if a customer defaults on their debt, the lender or retailer will be made whole for any sales tax the business remitted to the state. Eliminating the deduction – with a narrower reinstatement in 2028 – would result in higher interest rates for borrowers with poor credit.

CDTFA Legal Rulings Immune From APA Challenges. The budget bills would make the provisions of the Administrative Procedure Act inapplicable to legal rulings of counsel issued by the California Department of Tax and Fee Administration. CalTax believes that a legal ruling of counsel should not have general application and should only be specific applying to a single taxpayer.

For these reasons, CalTax and the organizations listed below are opposed to AB 167 and SB 167.

On behalf of…

California Taxpayers Association
Acclamation Insurance Management Services
Airlines for America
Alameda County Taxpayers Association
Allied Managed Care
California Beer and Beverage Distributors
California Association of Winegrape Growers
California Building Industry Association
California Business Properties Association
California Business Roundtable
California Chamber of Commerce
California Independent Petroleum Association
California League of Food Producers
California Manufacturers and Technology Association
California Retailers Association
California Trucking Association
Coalition of Sensible Taxpayers
Coalition of Small and Disabled Veteran Businesses
Council on State Taxation
Flasher Barricade Association
Kern County Taxpayers Association
Los Angeles Area Chamber of Commerce
National Federation of Independent Businesses
Orange County Taxpayers Association
Silicon Valley Leadership Group
Technet