

# Net Operating Loss (NOL) Deduction Provides Businesses with Taxpayer Equity

## Summary

### Background

The net operating loss (NOL) deduction gives individuals and businesses more flexibility to manage their losses over more than one tax year. A net operating loss is simply when a business's expenses exceed its income within a single tax year. The NOL deduction works by allowing a business to offset or deduct one tax year's losses from another tax year's profits. When the state was facing budgetary challenges in the 2002–03 budget, the NOL deduction was suspended for two years, but was followed by a significant improvement—an increase in the deduction from 60 percent of losses to 100 percent.

### Federal/State Policy

The NOL deduction sometimes is inaccurately characterized as a “tax loophole” or “tax break.” In actuality, the NOL deduction resolves an inequity that comes from businesses experiencing losses or profits according to timeframes or cycles that differ from government tax deadlines.

Without the NOL deduction, a business that experienced losses evenly over a 10-year period may pay less in taxes than one experiencing the same losses, but in severe peaks and valleys. The NOL deduction allows businesses to level out their losses over time. Small businesses often have limited cash flow, making the deduction critical to survival, while larger businesses may experience more dramatic peaks and valleys in profits and losses from year to year.

Until 2008, California's NOL deduction differed from federal law in two ways: California's allowed losses to be carried over to a subsequent year, up to 10 years, while the federal allowed for up to 20 years. Also, California provided no carryback, while federal law provided a two-year carryback.

### Recent Legislation

The fall 2008 budget package suspended the NOL deduction for two years. In order to partially offset the harm caused by the NOL suspension, the state also adopted some improvements to the NOL deduction, in partial conformity with federal law.

One improvement was expansion of the NOL carryover from 10 to 20 years, which took effect January 1, 2010. The longer carryover is crucial for companies such as biotech startups that may operate at a loss for many years while conducting research and development.

The other improvement was the adoption of a two-year carryback, effective January 1, 2011. This allows a company experiencing losses to amend the prior two years' tax returns to offset tax liability going backward in time. This can free up cash needed to survive, pay bills and make investments. Unlike the carryforward, which can be used only in the future against profits, the carryback can be a lifeline to companies that need money today. The federal government recently expanded the federal carryback period from two years to five years for small businesses.

As the *Guide* went to print, two ballot initiative proposals were pending that would repeal the carryforward and carryback improvements.

## CalChamber Position

The California Chamber of Commerce opposes any attempts to undermine, suspend or reduce the NOL deduction and supports continued conformity with federal law.

## Reasons for Position

- The NOL deduction resolved an inequity in the tax structure that comes from businesses experiencing losses or profits according to different timeframes or cycles over time.
- Eliminating, suspending or reducing the NOL deduction to increase state revenue during tough economic times places additional burdens on the businesses most needing to recover.

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