

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 losses they experience within timeframes and cycles that differ from government tax filing deadlines. 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.

Due to the state's escalating budgetary problems, the NOL deduction has again become a focal point. When the state was facing budgetary challenges in the early 2000s, it looked to suspending the NOL deduction as a source of revenue. In the 2002–03 budget, the NOL deduction was suspended for two years, but the suspension was followed by a significant improvement — an increase in the deduction from 60 percent of losses to 100 percent.

Federal and State Policy

The NOL deduction sometimes is erroneously and inaccurately characterized as a “tax loophole” or “tax break.” In actuality, the public policy behind the NOL deduction is to resolve an inequity in the tax structure, which comes from businesses experiencing losses or profits according to different timeframes or cycles over time, in relation to government tax deadlines.

Without the NOL deduction, two different businesses with the same profits and losses could end up owing different amounts in taxes, simply because the timing of those profits and losses differed. For example, a business that experienced losses evenly over a 10-year period may pay less in taxes than a business that experienced the same amounts of losses, but did so in severe peaks and valleys. The NOL deduction allows the business with the severe peaks and valleys to level out those losses over time.

Both small businesses and large businesses rely on the NOL deduction. Small businesses often have limited cash flow, making the deduction critical to survival, while larger businesses may experience dramatic peaks and valleys in profits and losses from year to year.

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

Recent Legislation

As part of the 2008–09 budget, California again suspended the NOL deduction for both individuals and businesses for two years. The suspension was estimated to raise \$1.6 billion over two years. The suspension will have a direct impact on marginally profitable businesses attempting to emerge from losses due to increased tax liability and reduced cash flow.

The legislation, AB 1452 (Committee on Budget), also provided an offsetting improvement for business by fully conforming state law to federal carryover and carryback provisions. The change will benefit some companies needing more flexibility in use of the NOL deduction.

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, which 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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