

State Tax Observations

California Legislation Impacts NOLs/Credit Limits and Pass-Through Entity Tax

By Steven J. Eller, JD, CPA

California Governor Newsom recently signed taxpayer-friendly legislation affecting net operating losses (NOLs), business credits and the pass-through entity tax.

Net Operating Losses and Business Credits

The legislation restores the use of NOLs and removes the limit on business tax credits for tax years beginning on or after January 1, 2022. Under prior law, NOLs were suspended for California taxpayers with net business income of \$1 million or more.

Also, the amount of business tax credits that could be used in a year was limited to \$5 million for tax years 2020 through 2022. These credits include the research and development credit, the jobs tax credit, the CA competes credit, motion picture production credits (including the motion picture production credits as applied to CA sales and use tax), and insurance tax credits. The credit limitation was removed for tax years beginning on or after January 1, 2022.

Pass-Through Entity Tax

A link to our prior article containing an overview of CA's pass-through entity tax (PTET) may be found [here](#). The legislation makes the following changes to the PTET effective for tax years beginning on or after January 1, 2021 (retroactively) and before January 1, 2026:

- Amends the definition of a qualified entity to include a partnership as an eligible partner, shareholder or member;
- Allows disregarded single member LLCs that satisfy certain conditions to be a qualified taxpayer;
- Includes guaranteed payments in determining qualified income; and
- Allows the PTET credit to reduce the regular tax below the tentative minimum tax.

In addition, effective for tax years beginning on or after January 1, 2022, the legislation requires CA's PTE credit be applied against the net tax after credits for taxes paid to other states.

Observations

The use of either NOLs or credits could favorably impact a business's 2022 estimated taxes. However, it should be noted that the \$1 million NOL limitation, and the \$5 million credit limitation continue to apply for the 2021 tax year.

Regarding the CA PTET, the new legislation addresses some previous concerns, but does not:

- make the credit refundable;
- reduce or eliminate the nonresident withholding requirement; or
- increase the PTE tax rate to maximize the benefit.

Contact Us

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