

California Conforms to Several Federal Tax Reform Provisions

Overview

On July 1, 2019, California's Governor signed Assembly Bill 91 ("A.B. 91") into law.¹ A.B. 91 selectively conforms California's tax laws to certain changes made under the Tax Cuts and Jobs Act of 2017 ("TCJA").² These changes impact both California's Personal Income Tax Laws ("PIT Laws") and Corporation Tax Laws ("CT Laws").³ Although California does not conform to all of the changes made under the TCJA, as it conforms to the Internal Revenue Code ("IRC") as of January 1, 2015,⁴ the following highlights the most notable changes made under A.B. 91:

- Eliminates a taxpayer's ability to make California-only IRC section 338 elections.
- Repeals the partnership technical termination provision to conform to federal income tax law, as amended by the TCJA, applicable for tax years beginning January 1, 2019. Partnerships may elect to apply conformity to partnership taxable years beginning after December 31, 2017, and before January 1, 2019.
- Disallows net operating loss ("NOL") carrybacks for California PIT Law and CT Law purposes for NOLs attributable to taxable years beginning after December 31, 2018.
- Indefinitely adopts the federal limitation on excess business losses for noncorporate taxpayers, as amended by the TCJA, for taxable years beginning after December 31, 2018 (federal sunset date does not apply).
- Limits the application of like-kind exchanges to real property for exchanges completed after January 10, 2019 by businesses or individuals with an adjusted gross income over a certain threshold in the taxable year the exchange begins (the threshold is \$250,000 for taxpayers filing an individual return; \$500,000 for taxpayers that file as head of household, surviving spouse, or spouses filing jointly).
- Expands the scope of the limitation imposed on excessive employee compensation by conforming to IRC section 162(m), as amended by the TCJA.⁵

This Tax Alert summarizes the more notable changes made under A.B. 91, which are generally effective July 1, 2019, unless otherwise specified.

Eliminates Separate California IRC Section 338 Election⁶

Generally, IRC section 338 allows corporations to treat certain qualified stock purchases as asset acquisitions for federal income tax purposes.⁷ Prior to A.B. 91, California allowed corporations to make a separate California IRC section 338 election, which could be different from the election for federal income tax purposes, but now taxpayers must follow the federal election.⁸ Therefore, if a corporation makes an IRC section 338 election for federal income tax purposes, the election is binding for California CT Law purposes. Similarly, if the corporation did not timely elect IRC section 338 treatment for federal income tax purposes, the corporation may not make an election for California CT Law purposes. This section does not apply to acquisitions subject to a binding contract entered into before July 1, 2019, and which remains binding at all times after July 1, 2019.⁹

Repeals Partnership Technical Termination Provision

Prior to TCJA, if there was a sale or exchange of fifty percent or more of the total interest in the partnership's capital and profits within a 12-month period, the partnership was treated as technically terminated for federal income tax

¹ A.B. 91, 2019-2020 Reg. Sess. (Cal. 2019). A copy of the adopted law is accessible [here](#).

² H.R. 1, Pub. L. No., 115-97 (Dec. 22, 2017).

³ A.B. 91, 2019-2020 Reg. Sess. (Cal. 2019).

⁴ See Cal. Rev. & Tax Code §§ 17024.5; 23051.5

⁵ A.B. 91 also conforms to other changes made under the TCJA, including certain changes relating to accounting for small businesses. See e.g., A.B. 91 §§ 14, 15, 27, 29, 30, 31, 32, 33.

⁶ The provision in A.B. 91 relating to IRC section 338 elections was not included as part of the TCJA. However, the California Legislature included this provision in A.B. 91. See A.B. 91 § 28.

⁷ I.R.C. § 338.

⁸ Cal. Rev. & Tax. Code § 23051.5(e)(3)(A); *but see* Cal. Rev. & Tax. Code § 23806.

⁹ *Id.*

purposes generally triggering a federal income tax filing obligation.¹⁰ However, the TCJA repealed this provision for taxable years beginning after December 31, 2017.¹¹ Because California conforms to the IRC as of January 1, 2015, California had not yet conformed to this repeal, thus prior to enactment of A.B. 91, for taxable years beginning after December 31, 2017, a technical termination was deemed to occur for California tax purposes, regardless of federal treatment.

A.B. 91 conforms California to the repeal of technical terminations for taxable years beginning on or after January 1, 2019.¹² Additionally, taxpayers may elect to have conformity apply to taxable years beginning after December 31, 2017 and before January 1, 2019.¹³

Modifies NOL Carryback Rules

Generally, the TCJA repealed the two-year carryback and the special carryback provisions (with an exception for farming losses), and extended the carryforward period (subject to certain limitations) for taxable years ending after December 31, 2017, pursuant to IRC section 172.¹⁴ Prior to A.B. 91, California's PIT Laws and CT Laws allowed taxpayers to carryback NOLs attributable to taxable years beginning on or after January 1, 2013 to the preceding two taxable years.¹⁵ A.B. 91 changes this rule by disallowing NOL carrybacks (with limited exceptions) for taxable years beginning after December 31, 2018.¹⁶ A two-year carryback is still permitted for NOLs attributable to taxable years beginning on or after January 1, 2013 and before January 1, 2019 (the amount of which may be limited depending on the taxable year in which the NOL was generated).¹⁷

Limits Business Losses that May Be Deducted by a Noncorporate Taxpayer

For taxable years beginning after December 31, 2017 and before January 1, 2026, under the TCJA a noncorporate taxpayer is not entitled to deduct any "excess business loss", as defined therein.¹⁸ The disallowed amount is treated as a NOL carryforward in subsequent taxable years.¹⁹ A.B. 91 provides for modified conformity to the changes made under the TCJA. Specifically, California does not conform to the federal sunset date (January 1, 2026) and thus, these new provisions will apply to taxable years beginning after December 31, 2018.²⁰ Additionally, any disallowed excess business loss is treated as a carryover excess business loss, as compared to a NOL, and a taxpayer may include the carryover excess business loss in its computation of "excess business loss" in the following taxable year.²¹

Restricts Property that Qualifies for Like-Kind Exchange Treatment

For California PIT Law and CT Law purposes, California generally conforms to IRC section 1031, relating to like kind exchanges, with certain modifications.²² For like-kind exchanges completed after December 31, 2017, the TCJA limited the property eligible for like-kind exchange treatment.²³

A.B. 91 generally conforms to the changes made under the TCJA with some modifications. First, California conforms only for exchanges completed after January 10, 2019.²⁴ Second, these provisions apply only to businesses and individuals with an adjusted gross income over a certain threshold in the taxable year in which the exchange begins (that threshold is \$250,000 for taxpayers filing an individual return and \$500,000 for taxpayers that file as head of household, surviving spouse, or spouses filing a joint return).²⁵ Finally, these provisions do not apply "to an exchange where the property to be disposed of by the taxpayer in the exchange is disposed of by that taxpayer on or before January 10, 2019, or where the property to be received by the taxpayer in the exchange is received by that taxpayer on or before January 10, 2019."²⁶

¹⁰ Cal. Rev. & Tax. Code § 17851; I.R.C. § 708; 26 C.F.R. § 1.708-1(b)(2).

¹¹ H.R. 1, Pub. L. No., 115-97, § 13504 (Dec. 22, 2017).

¹² A.B. 91, § 16.

¹³ *Id.*

¹⁴ H.R. 1, Pub. L. No., 115-97, § 13302.

¹⁵ See Cal. Rev. and Tax Code §§ 17276, 24416 (2018).

¹⁶ See A.B. 91, §§ 10, 12, 24, 26. California did not conform to all of the changes made under the TCJA to the NOL provisions under IRC section 172. NOL carrybacks are still disallowed for NOLs attributable to taxable years beginning before January 1, 2013.

¹⁷ *Id.*

¹⁸ H.R. 1, Pub. L. No., 115-97, § 11012.

¹⁹ *Id.*

²⁰ A.B. 91, § 13.

²¹ *Id.*

²² Cal. Rev & Tax Code §§ 18031, 18031.5, 24941, 24941.5.

²³ H.R. 1, Pub. L. No., 115-97, § 13303.

²⁴ A.B. 91 §§ 18, 35.

²⁵ *Id.*

²⁶ *Id.*

Expands Limits on Excessive Employee Compensation

IRC section 162 generally allows a deduction from gross income for ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business.²⁷ California generally conformed to IRC section 162 with certain modifications.²⁸ IRC Section 162(m) disallows a deduction for employee remuneration with respect to any covered employee to the extent that the amount of the remuneration for the taxable year for that employee exceeds \$1 million.²⁹ The TCJA made significant amendments to IRC section 162(m), including amending the definition of applicable employer remuneration to eliminate exceptions for qualified performance-based compensation and commissions, expanding the definitions of covered employee and publicly held corporation, and adding a transition rule to allow for grandfathering certain payments.³⁰

Under A.B. 91, for taxable years beginning on or after January 1, 2019, California generally conforms California's PIT Laws and CT Laws to new IRC section 162.³¹ However, for California purposes, the grandfathering period applies to contracts that were in effect on March 31, 2019 (as opposed to November 2, 2017 under the TCJA) and which were not modified in any material respect on or after that date.³²

Considerations

Notwithstanding the changes above, California still generally conforms to the IRC as of January 1, 2015 and only selectively conforms to certain IRC provisions. Therefore, California did not automatically, and has not affirmatively, conformed to many of the federal changes under the TCJA, including treatment of Global Intangible Low-Taxed Income ("GILTI"), Foreign-Derived Intangible Income ("FDII"), IRC section 163(j), IRC section 245A, IRC section 274, and IRC section 451(c). Therefore, taxpayers should consider federal-state differences on items where California differs from federal income tax laws.

In addition to California-specific guidance regarding the respective non-conforming provisions, taxpayers engaged in state tax return preparation should consider California's provisions governing the accuracy-related penalty, the large corporate understatement penalty ("LCUP") and California's disclosure requirements for positions taken on tax returns.

Although this Alert covers the more notable changes made under A.B. 91, it does not cover all of the changes made under this bill. Taxpayers should consult with their California tax advisors on the changes made under A.B. 91 and how they may have an impact upon California tax return filing requirements and tax liabilities.

²⁷ I.R.C. § 162.

²⁸ Cal. Rev. & Tax Code §§ 17201, 24343.

²⁹ I.R.C. § 162(m)(1).

³⁰ See *Impact of state disconformity with federal section 162(m) changes* (May 28, 2019) (available [here](#)).

³¹ A.B. 91 §§ 9, 22.

³² *Id.*

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