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California: "Loophole closing" legislation adopts certain TCJA changes

California has somewhat unusual conformity to the Internal Revenue Code in that the state: (1) does not adopt the Code as a whole, but incorporates only certain provisions by reference; and (2) only rather sporadically advances the conformity date for the sections of the Code that are incorporated into California law.

California's governor on July 1, 2019, signed Assembly Bill 91, the "Loophole Closure and Small Business and Working Families Tax Relief Act of 2019." The "loophole" closures in the bill generally adopt certain provisions of the U.S. 2017 federal tax law (Pub. L. No. 115-97)—the law that is commonly referred to as the "Tax Cuts and Jobs Act" (TCJA)—that is, provisions that benefitted businesses when California did not conform.

California continues to generally conform to the Internal Revenue Code as of January 1, 2015. However, under Assembly Bill 91, California adopts the following TCJA changes for tax years beginning on or after January 1, 2019 (unless otherwise noted):

- Disallowance of deductions for FDIC premiums paid by certain financial institutions under IRC section 162(r)
- Modifications to the limit on "excessive employee remuneration" under IRC section 162(m)
    - This change does not apply to a covered employee subject to a written binding contract in effect on March 31, 2019 (November 2, 2017 is the relevant date for federal purposes).
    - California does not adopt the federal change disallowing a 50% deduction for business-related entertainment expenses or changes related to the deductibility of certain fringe benefits.
- Elimination of net operating loss (NOL) carrybacks

- The law has been amended to provide that only losses attributable to tax years beginning on or after January 1, 2013, and before January 1, 2019, are available for carryback.

- Limitations on losses for certain taxpayers other than corporations
  - For federal tax purposes, this change expires for tax years ending before January 1, 2026, but the California provision does not sunset.

- Repeal of the technical termination rule for partnerships
  - Partnerships may elect to apply this provision (i.e., to not have a technical termination) for tax years beginning on or after January 1, 2018.

- Elimination of the deferral of gain on like-kind exchanges of personal property
  - This change applies to exchanges completed on or after January 11, 2019.
  - There is an exception for certain individual taxpayers with adjusted gross income of less than $500,000 (married filing jointly) or less than $250,000 (single filers).

- Adoption of certain small business accounting method changes (i.e., amendments to IRC sections 263A, 447, 448, 460, and 471)
  - For contracts subject to IRC section 460, the rule applies to contracts entered into on or after July 1, 2019.
  - A taxpayer may elect to apply these provisions to tax years beginning on or after January 1, 2018, and before January 1, 2019 (or in the case of contracts subject to IRC section 460, for contracts entered into on or after January 1, 2018).

In addition to adopting these TCJA changes, Assembly Bill 91 eliminates the ability for taxpayers to make separate state and federal elections under IRC section 338. This change is effective for acquisitions made on or after the date the bill was signed (July 1, 2019) unless the acquisition was subject to a binding contract that was entered into before July 1, 2019, and the contract remains binding at all times after that date.

KPMG observation

California remains decoupled from all of the other TCJA provisions affecting businesses, including the international changes and the limitations on the deductibility of interest expenses under IRC section 163(j). Furthermore, the few provisions that California adopts under Assembly Bill 91 will not affect 2018 returns because they generally apply beginning with the 2019 tax year. While there were always significant "disconnects" between California and federal law, going forward these disconnects will likely lead to additional complexities when preparing California returns.

For more information, contact a KPMG State and Local Tax professional:

Gina Rodriquez | +1 916-551-3132 | grodriquez@kpmg.com

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