Senate Governance and Finance Informational Hearing
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The Tax Cuts and Jobs Act (also known as H.R. 1) was signed into law on December 22, 2017, and contains the most significant modifications to the federal tax code in over 30 years.

My presentation will cover some initial impressions of our review of the federal tax reform language. Please keep in mind that the Franchise Tax Board will be issuing a Summary of Federal Income Tax Changes Report with revenue impacts by April 20, 2018 as required by statute.

Generally the provisions in the federal language are effective for taxable years beginning after December 31, 2017 - meaning that they will affect 2018 federal tax returns that will be filed in 2019. Although - there are a few provisions that are retroactive.

Generally, the personal income tax provision changes in the new federal law are temporary whereas the corporate provisions are generally permanent.

CONFORMITY

Before I start to cover some of the items in new federal Act, I would like to talk about conformity to address how these federal changes will affect current stat tax law.

Generally, the changes in H.R. 1 will not automatically change California's tax law.

The California Legislature created the concept of the "specified date" so we all could easily identify which version of the IRC (based on a specified date) to apply to a specific taxable year for California purposes. The Legislature decides what the specified date should be by codifying the date in the California Revenue and Taxation Code. California's current specified date is January 1, 2015.

This means that, for provisions that are enacted for federal purposes in 2016 or 2017, California would not conform to those provisions but would instead conform, with limited exceptions, to the Internal Revenue Code (IRC) as it read on January 1, 2015.

The specified date for federal conformity doesn't apply to every section of the R&TC. There are many exceptions – examples are most pension provisions and filing status provisions.

So unless California specifically enacts legislation to conform to the provisions in H.R. 1, most changes of the Act will not apply.

To illustrate this I'll cover several provisions from H.R. 1 and what the impact is to California tax law.

First, let's go over the changes in tax rates:

On the corporation side, under the prior law, there was a progressive tax rate. Under H.R. 1, the corporate rate is now a flat 21%.

The alternative minimum tax is fully repealed at the federal level. Any existing alternative minimum tax carryforward can be used to offset the corporate taxpayer's regular tax liability and is refundable, within limits, starting in 2019. California's corporate alternative minimum tax rules remaining the same as before H.R. 1 because we don't conform to the new changes.

On the personal income tax side, individual tax rates and the taxable income brackets have been revised. You can see the changes on the handouts that I gave out. The first page (front and back) are for 2017 and the second page (front and back) are the new amounts under H.R. 1.

As you can see on the tables 6 and 7 on the first page as compared to tables 3 and 4 of the second page, the alternative minimum tax will be lesser of a burden on taxpayers.

For personal income taxpayers, the exemptions amounts have increased significantly, as well as the phase-out thresholds have increased considerably.

California does not automatically conform to these federal changes and so the lower exemption amounts are retained.

Now that we've covered tax rates, let's discuss some personal income tax provisions in the new federal law.

To begin, we'll start with PERSONAL EXEMPTIONS, STANDARD DEDUCTIONS, and CHILD TAX CREDIT.

> Previously, a taxpayer could claim a $4,050 personal exemption for themselves, their spouse, and each child which would lower the taxpayer's taxable income. Now personal exemptions have been eliminated but taxpayers will be allowed a higher standard deduction (the amount is almost double the previous standard deduction). California still allows exemption credits and has not increased the standard deduction, so many taxpayers may now itemize for California but not federal.
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> Instead of the $1,000 child tax credit, there is a family credit of $2,000 per qualifying child under the age of 17 and $500 for each dependent who is not a qualifying child under the age of 17. Maximum refundable amount is $1,400. These amounts are subject to phase-out thresholds. California doesn't have a comparable child tax credit.

Next, let's go over changes to ITEMIZED DEDUCTIONS.

The state and local tax (SALT) deduction has been in the news frequently so we'll cover that first.

Under the old federal law, taxpayers could deduct 100% of their state and local taxes — including income and property taxes — as an itemized deduction on their federal return. Under the new law, they can deduct a total of $10,000 in state and local taxes combined, that amount would be $5,000 for Married Filing Separately taxpayers.

Also, there is a provision in H.R. 1 that specifically disallows prepaying state or local income tax for taxable years beginning after December 31, 2017. California does not allow an itemized deduction for state income tax, but does allows a deduction for property tax and that deduction is not subject to a cap.

The Mortgage Interest Deduction is another itemized deduction that many taxpayers report.

Under the new federal tax law, HR 1 suspends home equity loan interest deduction for taxable years after December 31, 2017 and prior to 2026.

Also, HR 1 adds a limitation of $750,000 ($375,000 MFS) of debt incurred for which an interest deduction is allowed for taxable years after December 31, 2017 and prior to 2026. Taxpayers with home loans made prior to December 15, 2017 would not be affected by the lower cap – they would still be subject to the $1 million limitation. California retains the $1 million limit.

Next, I'll talk a little about the Disaster Loss Deduction.

Under previous federal law and current California law, a taxpayer can claim an itemized deduction for property losses that aren't reimbursed by insurance and that stem from natural disasters, fires, accidents, or other events. The total of a taxpayer's losses on personal property must exceed 10 percent of your adjusted gross income.

With the new federal law, taxpayers may claim personal casualty losses only if the damage is attributable to a disaster declared by the president. This limitation starts in after December 31, 2017 and years prior to 2026.

The next few provisions for itemized deductions cover Medical Expenses, Unreimbursed Employee-Related Expenses, Tax Preparation Expenses, etc.

For medical expenses, federal law lowered the adjusted gross income threshold for 2017 and 2018 from current 10% to 7.5% thereby potentially increasing a taxpayer's allowable deduction for medical expenses, but the threshold goes back to 10% in 2019. California currently uses the 7.5% threshold, which means the federal deductible amounts in 2017 and 2018 will be the same for California.

Federal repeals the miscellaneous itemized deductions that exceed 2% of adjusted gross income starting in 2018, those are items like unreimbursed employee-related expenses (job travel, union dues, and job education), safe deposit box, investment expenses, and tax preparation fees. California doesn't conform so those itemized deductions will still be deductible on a taxpayer's California tax return.

BUSINESS ENTITY PROVISIONS

We already covered that for corporations the tax rate will be 21% instead of using the progressive tax rate that could be as high as 39%.

PASS THROUGH DEDUCTION

Pass thru entities are allowed a deduction for a percentage of their taxable income. Starting in 2018, a deduction will be allowed for individual taxpayers who have "qualified business income" from a pass thru entity (which would be a partnership, S corporation, limited liability company (LLC) treated as a partnership, or sole proprietorship), subject to limitations. Service businesses have additional limitations.

For a really simple general example, if a pass thru entity makes $100,000, and passes through 50% to an individual partner, that individual's deduction tentatively equals $10,000 (20% of the 50% distributive share of the $100,000). There are a number of limitations on the formula.

California does not allow such a deduction.

NET OPERATING LOSS

H.R. 1 Limits the net operating loss deduction to 80% of taxable income (determined without regard to the deduction) and removes the 20-year carryforward limitation.

Under the new federal law, the two-year NOL carryback and the special carryback provisions have been repealed, but provides for a two-year carryback in the case of certain disaster losses incurred in the trade/business of farming, or by certain small businesses. California allows carrybacks and carryforwards without the 80% limitation because California doesn't conform to this federal change.

DEPRECIATION

100% expensing through bonus deprecation of certain business assets placed in service after September 27, 2017 through December 31, 2022 is allowed under the new federal law. The amount of bonus deprecation allowed is then phased down over four years:

80% in 2023
60% in 2024

40% in 2025
20% in 2026

Something to point out - The property does not need to be "brand new" as in previous law – the property need only be "new" to the taxpayer.

Under federal law (Internal Revenue Code section 179), a taxpayer can elect to recover all or part of the cost of certain qualifying property, up to a limit, by deducting it in the year you place the property in service. This is the IRC section 179 deduction. A taxpayer can elect the section 179 deduction instead of recovering the cost by taking depreciation deductions.

H.R. 1 changed some of the rules of IRC section 179 deduction. The limits have been increased to $1,000,000 with the phase-out thresholds being increased to $2.5 million with both thresholds subject to inflation increases for taxable year beginning after December 31, 2017. The California limit is $25,000 and the phase-out starts at $200,000.

INTERNATIONAL INCOME PROVISIONS

H.R. 1 changes the current US international tax system to a "territorial" system where generally only earnings in the US are taxed in the US.

H.R. 1 requires a "deemed" repatriation of undistributed foreign earnings and profits on the final 2017 federal return.

California uses the worldwide combined reporting method, with the ability to make a water's-edge election in some circumstances. California does not conform to the "deemed" repatriation provision, so only actual paid dividends will be taken into account for California purposes, which will generally be 100% eliminated for worldwide combined reporting taxpayers and 25% of any such actual dividends paid for water's-edge electors will be potentially subject to California tax (after apportionment and allocation, as applicable).

ESTATE AND GIFT TAXES

The lifetime exclusion was increased from $5.49 million to $10 million (double for married couples) for decedents dying and gifts made after 2017 and before 2026 under H.R. 1. California currently has no estate tax or pickup tax.

Those are the various provisions that I wanted to cover – but I would like to state again that generally, the changes in H.R. 1 will not automatically change California's tax law.

Unless California specifically enacts legislation to conform to the federal Act, most changes of the Act will not apply for California.

As a result of non-conformity, taxpayers will need to make adjustments from their federal return to their California return. This will add to the complexity of complying with California's tax laws when preparing their tax returns.

For instance, we expect that the federal schedule A (Itemized Deductions) will look differently for tax year 2018 with the various changes to itemized deductions under H.R. 1. California will still allow those deductions as specified January 1, 2015 and taxpayers won't be able to utilize their federal schedule A as we currently know it. These changes will require that taxpayers keep more documentation to support the amounts that they report on their California tax returns. Taxpayers should still remember the old federal tax rules and save their receipts, as they may be able to deduct expenses on their California return even though federal law no longer allows the deduction.

We are unsure how federal data that FTB uses will be impacted by the changes in H.R. 1. For instance, will some of the forms change because the information is no longer required to be reported by the IRS but yet FTB would still need the information? An example is: Form 1098-Mortgage Interest Statement may not contain information that details mortgage interest on a principal residence v. interest on an equity loan. The IRS may have the mortgage lenders only report mortgage interest on a principal residence – FTB will not have information to show the amount on interest paid by a taxpayer on their equity loans.

FTB may need to verify amounts/information that taxpayers report on their CA return as those same amounts/information will no longer be required to be reported to the IRS. For example, alimony deduction and income from alimony, moving expenses, etc. Our return validation will be impacted because we won't have the same information that we used in the past to validate California return information using federal data.

The federal audit report information that the IRS shares with the Franchise Tax Board will change. The Franchise Tax Board makes corresponding adjustments to taxpayers' returns based on the federal audit adjustments (RARs). The amounts of federal audit adjustments on certain audit issues will stop or be diminished, especially relating to itemized deductions as more taxpayers will be taking a standard deduction for federal purposes but still itemize for state purposes (mortgage interest, property taxes, unreimbursed employee expenses, etc.)

As an impact to our department, we expect that our public service staff will receive more questions from taxpayers to assist them with determining how the new federal changes will impact their California taxes and how to report these changes on their return.

CONCLUSION

The items that I discussed are initial impressions of our review of the federal tax reform language. The Summary of Federal Income Tax Changes Report with revenue impacts will be released to the Legislature and posted online by April 20, 2018.