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The Governor's Proposed Tax Conformity Package

In 2017, President Trump signed into law the Tax Cuts and Jobs Act (TCJA) – the most extensive revision of the tax code since 1986. While the TCJA primarily cuts taxes for the wealthy and corporations, the new law also includes some reasonable changes that *raise* federal tax revenue by limiting federal tax breaks that are costly, unfair, or economically inefficient. California now has the opportunity to increase state revenue by adopting (or "conforming to") some of these provisions, while making the state's tax system more fair.

Corporations that have profits in California currently pay significantly less in state income taxes as a portion of their state profits than they did in the 1980s, partly reflecting the increase in the number and generosity of state tax breaks that have been created over the past few decades. The state can narrow some of these tax breaks by selectively conforming to federal law. While the state's fiscal situation is currently very positive, Governor Newsom has proposed ambitious new investments that will require new ongoing expenditures, such as more than doubling the total amount of credits provided under the state's Earned Income Tax Credit (CalEITC). The Governor proposes to offset revenue losses from the CalEITC expansion by conforming to certain federal tax law changes mainly affecting businesses. The Administration estimates its proposed tax conformity package will raise $1.4 billion annually, which would fully cover the cost of the expanded CalEITC.

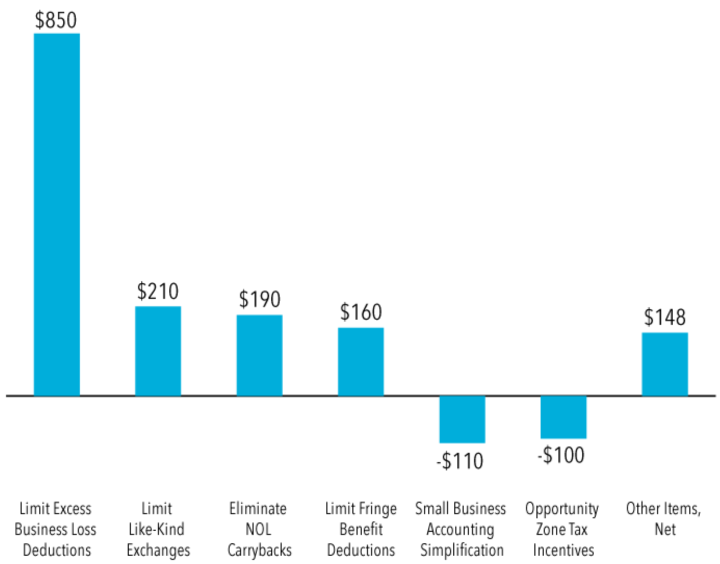
Provisions in the Governor's Conformity Package

Limitation on Losses for Non-Corporate Taxpayers: $850 Million Revenue Gain

For taxpayers that have interests in so-called "pass-through businesses" such as S corporations, partnerships, limited liability companies, and sole proprietorships, the TCJA limits the federal deduction for business losses that can offset other income, such as salary and investment income. Prior to the TCJA, business losses could be used to reduce or even zero out federal tax liability, even for individuals with significant income from non-business sources. As with any tax deduction for individuals, higher-income taxpayers receive a larger tax benefit per dollar deducted because they are in higher tax brackets. Federal law now only allows taxpayers to deduct up to $250,000 ($500,000 for married filers) in "excess business losses" (defined as the amount by which business-related deductions exceed business-related income). For federal purposes, any excess business loss above the threshold would have to be carried forward to offset income in future tax years as part of the taxpayer's Net Operating Loss (which are also limited by the new federal law, as discussed below). Under the Governor's proposal, the excess losses above the threshold would be carried forward to be part of the taxpayer's excess business loss in the following taxable years, subject to the $250,000/$500,000 limit.

Governor's Tax Conformity Package Would Raise $1.4 Billion in Annual Net Revenues

Estimated State Revenue Gain/Loss, 2020-21 (Dollars in Millions)



"NOL" = Net Operating Loss
Source: Department of Finance

California Budget & Policy Center
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Limitation on Like-Kind Exchanges: $210 Million Revenue Gain

Generally, when taxpayers sell or exchange an asset and make a profit, they owe tax on that capital gain. Prior federal law allowed taxpayers to defer taxes on gains from an exchange of a business or investment property (excluding inventory, stocks, bonds, and other securities, and other specified types of property) if it was exchanged for a similar ("like-kind") property. The capital gain would only be recognized once the taxpayer sold or exchanged the new asset in a later taxable transaction. Under the TCJA, like-kind exchange deferrals are limited to real property and are no longer available for personal property. For example, a taxpayer can still defer capital gains on the exchange of a building, but not on the exchange of a vehicle.

Elimination of Net Operating Loss Carrybacks: $190 Million Revenue Gain

A net operating loss occurs when a taxpayer's total tax deductions exceed total income for the tax year. NOLs can be claimed by both corporate and individual taxpayers, but are usually related to losses from operating a business. Pass-through businesses like S corporations and partnerships cannot claim NOLs at the entity level, but their shareholders or partners can claim NOLs based on their respective shares of the businesses' income and deductions. Before the

TCJA, taxpayers were permitted to carry back these NOLs to offset federal taxable income, dollar-for-dollar, for up to two years prior to the year the NOL was incurred. In addition, they were able to carry forward NOLs to offset taxable income for up to 20 years into the future. Under the TCJA, corporations and other taxpayers are no longer able to carry back their NOLs (with the exception of certain disaster-related farm losses) to offset federal taxable income. There is a legitimate rationale for allowing businesses to average income over several years for tax purposes, given that businesses often incur losses in early years and during economic downturns. However, allowing NOL carrybacks can exacerbate state fiscal challenges during a recession, since it requires that the state refund tax revenues that have likely already been spent. Without NOL carrybacks, businesses may still reap the benefits of income averaging by claiming NOL carryforwards.

Limitations on Fringe Benefit Deductions: $160 Million Revenue Gain

The TCJA places new restrictions on federal tax deductions employers may take for certain expenses, including entertainment-related activities, transportation benefits, and some meals. Under prior federal law, businesses could deduct 50% of the costs of activities "generally considered to constitute entertainment, amusement, or recreation" (for example, a sporting event or theater performance) as long as they were directly related to the active conduct of the taxpayer's trade or business. The TCJA disallowed this deduction. The previous federal deduction for transportation-related fringe benefits, such as parking and commuter benefits, is also disallowed except to ensure an employee's safety. Additionally, expenses related to meals provided to employees through certain on-site eating facilities or for the convenience of the employer, which were previously fully deductible, are now limited to 50% through 2025 and are not deductible in subsequent years.

Small Business Accounting Method Reform and Simplification: $110 Million Revenue Loss

The TCJA provides more flexibility for smaller businesses by exempting businesses with gross receipts of up to $25 million from several tax-related accounting rules. Prior to the TCJA, certain businesses with gross receipts above $5 million were generally required to use the accrual accounting method, while smaller businesses were permitted to use the cash method. The cash method is simpler than the accrual method and provides the taxpayer flexibility in the timing of income recognition. Under the TCJA, businesses with gross receipts up to $25 million can now elect to use the cash method, and are also exempted from certain other accounting requirements. Conforming to this provision would make filing taxes simpler for California businesses affected by the change in federal law, since it would be administratively burdensome to use different accounting methods for federal and state tax purposes.

Opportunity Zone Tax Incentives: $100 Million Revenue Loss

The Governor has proposed to partially conform to the federal Opportunity Zone incentives, which allow investors to defer and reduce their capital gains taxes if they invest in economically distressed areas designated as Opportunity Zones. The Governor's proposal would only provide incentives for investments in affordable housing and green technology, but few additional details have been provided by the Administration thus far. A significant portion of this lost revenue may subsidize projects that would have gone forward in California even without the state tax incentives and would thus provide a windfall benefit for investors. Additionally, the state already has tested mechanisms for encouraging affordable housing production, such as the low-income housing tax credit. The revenue that would be lost to Opportunity Zone incentives might be better spent on expanding such programs. Due to the lack of clarity provided on how the state incentives would be structured, it may be advisable for the Legislature to consider what, if any, additional incentives should be provided for Opportunity Zone investments at a later time rather than as a part of the 2019-20 budget. The administration estimates the annual revenue losses from Opportunity Zone investments to be $100 million in the early years, but these estimates are highly uncertain since it is unclear how widely these incentives would be used.

Other Provisions in the Conformity Package: $148 Million Net Revenue Gain

In addition to the items described above, the Administration proposes conforming to several other TCJA provisions which have smaller revenue effects, including but not limited to tightening the limitations on deductions businesses can take for executive compensation, limiting the deductions large financial institutions can claim for FDIC premiums, and increasing allowed taxpayer contributions to tax-favored savings programs for disabled individuals (ABLE accounts). These provisions would raise $148 million on net.

Major Business-Related TCJA Provisions Not Included in the Governor's Conformity Proposal

The Governor's proposal does not include a couple of TCJA provisions related to corporate and business income that would have resulted in large revenue gains for the state. The Franchise Tax Board (FTB) estimated last spring that conforming to the TCJA's limitation on business interest deductions (with exceptions for small businesses) would raise $650 million annually. The TCJA also limited Net Operating Loss carryforwards to 80% of taxable income in any given year. FTB estimated that eliminating NOL carrybacks and limiting NOL carryforwards would raise a combined $650 million annually, significantly more than the $190 million estimated to be raised from eliminating carrybacks alone.

Note on Revenue Estimates: The revenue estimates for the items in the Governor's conformity package are from the Department of Finance for the 2020-21 fiscal year. The estimates for 2019-20 are not used because it is our understanding that they include partial-year revenues in addition to the full-year estimates. The revenue estimates for the items not included in the Governor's proposal are from the Franchise Tax Board's Summary of Federal Income Tax Changes for 2017, released last spring.