STATE OF CALIFORNIA
**Franchise Tax Board**

# PRELIMINARY REPORT ON SPECIFIC PROVISIONS OF THE FEDERAL TAX CUTS AND JOBS ACT

## Introduction

On December 22, 2017, President Trump signed into law H.R. 1, originally known as the Tax Cuts and Jobs Act of 2017 (Act).[1]

This new federal law will have considerable impact on California's tax system. Because California's tax system is based in part on specified date conformity to provisions of federal tax law, each federal provision in the Act is being analyzed to determine its impact on California's Revenue and Taxation Code (R&TC). The Franchise Tax Board (FTB) presents this analysis in the Summary of Federal Income Tax Changes Report.

The FTB is required to submit to the Legislature, and make available to the public, a report on all changes to the Internal Revenue Code (IRC) enacted into law in the prior year.[2] If the changes to the IRC are enacted after September 15, the report will be due within 120 days of enactment. Because the Act became law in late December, the FTB is required by statute to submit this report to the Legislature by April 20, 2018. This report will be made available on our website.

## Preliminary Report on Specific Provisions

The FTB prepared this preliminary report to provide initial information on three topics:

- Temporary Reduction in Medical Expense Deduction Floor (pages 3-4)
- Limitation on Deduction for State and Local Taxes (pages 5-6)
  (Supplemental analysis information is provided on the limitation on state and local tax deductions on pages 7-15)
- Repatriation (pages 16-21)

[1] Public Law 115-97.
[2] R&TC section 19522.



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These three topics were selected due to either the provision(s) retroactivity (medical expense deduction and repatriation) or taxpayer and media inquiries (limitation on state and local taxes deduction). The section of this report on the Deduction of State and Local Taxes includes a supplemental analysis that examines the impact of changes to this deduction on the federal tax of California taxpayers. The reported impacts should not be viewed in isolation because they may be offset by the impacts of other provisions of the Act. This supplemental analysis will not be included in the full conformity report.

## Communication Plan for the FTB's Summary of Federal Tax Changes Report Information

Because of the significance of the federal changes this year, the FTB is planning to provide a communication plan for the rollout of various portions of the Summary of Federal Tax Changes Report as they are completed. Our tentative plan is to release information on or before the following dates:

- March 2, 2018
- March 26, 2018
- April 20, 2018 (Final Summary of Federal Income Tax Changes Report)



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This information explains the new 2017 federal laws along with the effective dates, the corresponding California law, if any, and the impact on California revenue if California were to conform to applicable federal changes. The information also contains citations to the section numbers of federal Public Laws, the IRC, and the California R&TC impacted by the federal changes.

| Section | Section Title |
| --- | --- |
| 11027 | Temporary Reduction in Medical Expense Deduction Floor |

## Background

Individuals may claim an itemized deduction for unreimbursed medical expenses, but only to the extent that such expenses exceed 10 percent of adjusted gross income (AGI).[3] For taxable years beginning before January 1, 2017, the 10-percent threshold is reduced to 7.5 percent in the case of taxpayers who have attained the age of 65 before the close of the taxable year. In the case of married taxpayers, the more favorable 7.5-percent threshold applies if either spouse has obtained the age of 65 before the close of the taxable year. For these taxpayers, during these years, in computing alternative minimum taxable income, the threshold is 10 percent for alternative minimum tax (AMT) purposes.

## New Federal Law (Internal Revenue Code (IRC) sections 56 and 213)

The provision provides that, for taxable years beginning after December 31, 2016, and ending before January 1, 2019, the threshold for deducting medical expenses shall be 7.5 percent of AGI for all taxpayers. For these years, this threshold applies for purposes of the AMT in addition to the regular tax. For taxable years after January 1, 2019, the threshold for deducting medical expenses shall return to 10 percent of AGI for all taxpayers.

## Effective Dates

The provision is effective for taxable years beginning after December 31, 2016.

[3] IRC section 213. The threshold was amended by the Patient Protection and Affordable Care Act (Pubic Law Number 111-118). For taxable years beginning before January 1, 2013, the threshold was 7.5 percent and 10 percent for AMT purposes.



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California Law (Revenue and Taxation Code (R&TC) sections 17062, 17062.3, 17062.5, 17201, and 17241)

California conforms, under the Personal Income Tax Law (PITL), relating to the itemized deduction for unreimbursed medical expenses under IRC section 213, as of the "specified date" of January 1, 2015,[4] with modifications. California's modified conformity allows a deduction for the amount of medical expenses unreimbursed by insurance that exceed 7.5 percent of federal AGI.[5] As a result, the threshold percentage of unreimbursed medical expenses is the same for both federal and state purposes for the 2018 tax year for purposes of the personal income tax. However, for taxable years beginning on or after January 1, 2019, the threshold for deducting unreimbursed medical expenses for federal and state taxes will differ – 10 percent of federal AGI for federal taxes and 7.5 percent of federal AGI for state income taxes.

Alternative Minimum Tax (AMT)

California conforms, under the PITL, relating to the AMT under IRC section 56, as of the "specified date" of January 1, 2015, with modifications.[6] However, California does not conform to the federal change to the AMT medical expense threshold from 10 percent to 7.5 percent of AGI. For California AMT purposes, the unreimbursed medical expense threshold remains 10 percent of federal AGI.[7]

Impact on California Revenue

Not applicable.

[4] R&TC section 17024.5.
[5] R&TC sections 17241 and 17024.5(h)(2)(A).
[6] R&TC section 17062.
[7] IRC section 56(b)(1)(B).



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This information explains the new 2017 federal laws along with the effective dates, the corresponding California law, if any, and the impact on California revenue if California were to conform to applicable federal changes. The information also contains citations to the section numbers of federal Public Laws, the IRC, and the California R&TC impacted by the federal changes.

| Section | Section Title |
| --- | --- |
| 11042 | Limitation on Deduction for State and Local, Etc. Taxes |

Background

Individuals are permitted a deduction for certain taxes paid or accrued, whether or not incurred in a taxpayer's trade or business. These taxes are: (i) State and local real and foreign property taxes;[8] (ii) State and local personal property taxes;[9] (iii) State, local, and foreign income, war profits, and excess profits taxes.[10] At the election of the taxpayer, an itemized deduction may be taken for State and local general sales taxes in lieu of the itemized deduction for State and local income taxes.[11]

Property taxes may be allowed as a deduction in computing AGI if incurred in connection with property used in a trade or business; otherwise they are an itemized deduction. In the case of State and local income taxes, the deduction is an itemized deduction notwithstanding that the tax may be imposed on profits from a trade or business.[12]

Individuals also are permitted a deduction for Federal and State generation skipping transfer (GST) tax imposed on certain income distributions that are included in the gross income of the distributee.[13]

In determining a taxpayer's alternative minimum taxable income, no itemized deduction for property, income, or sales tax is allowed.

New Federal Law (IRC section 164)

This provision provides that a individual may claim an itemized deduction of up to $10,000 ($5,000 for married taxpayers filing a separate return) for the aggregate of (i) state and local property taxes not accrued in carrying on a trade or business, or an activity described in section 212, and (ii) state and local income, foreign, income, war profits, and excess profits taxes (or sales taxes in lieu of income, etc. taxes) paid or accrued in the taxable year. Individuals are also not allowed a deduction for foreign real property taxes. The above rules apply to taxable years beginning after December 31, 2017, and beginning before January 1, 2026.

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[8] IRC section 164(a)(1).
[9] IRC section 164(a)(2).
[10] IRC section 164(a)(3). A foreign tax credit, in lieu of a deduction, is allowable for foreign taxes if the taxpayer so elects.
[11] IRC section 164(b)(5).
[12] See H. Rep. No. 1365 to accompany Individual Income Tax Bill of 1944 (78th Congress, 2nd Session), reprinted at 19 Cumulative Bulletin 839 (1944)).
[13] IRC section 164(a)(4).



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The limitations above do not apply to state and local property taxes, state and local personal property taxes, foreign property taxes, or sales taxes paid or accrued in the taxable year if paid or accrued in carrying on a trade or business or an activity described in IRC section 212. For instance, in the case of property taxes, an individual may deduct such items in full only if these taxes were imposed on business assets (such as residential rental property).

The provision also provides that, in the case of an amount paid in a taxable year beginning before January 1, 2018, with respect to a state or local income tax imposed for a taxable year beginning after December 31, 2017, the payment shall be treated as paid on the last day of the taxable year for which such tax is so imposed for purposes of applying the provision limiting the dollar amount of the deduction. Thus, under the provision, an individual may not claim an itemized deduction for the 2017 tax year on a prepayment of income tax for a future taxable year in order to avoid the dollar limitation applicable for taxable years beginning after 2017.

Effective Dates

The provision is effective for taxable years beginning after December 31, 2016.

California Law (R&TC sections 17201 and 17220)

California conforms, under the PITL, relating to the deductibility of taxes under IRC section 164, as of the "specified date" of January 1, 2015, with modifications.[14] However, California does not allow a deduction for state and local, foreign, income, war profits, and excess profits taxes or the election to deduct sales taxes. California conforms, under the PITL, to the other provisions related to deductibility of taxes under IRC section 164, as of the "specified date" of January 1, 2015,[15] with modifications.

Impact on California Revenue

| Estimated Conformity Revenue Impact of<br>Limitation on Deduction for State and Local, Etc. Taxes<br>For Taxable Years Beginning On or After January 1, 2018<br>Enactment Assumed After June 30, 2018 | | | |
|---|---|---|---|
| 2017-18 | 2018-19 | 2019-20 | 2020-21 |
| Not applicable | $550,000,000 | $350,000,000 | $360,000,000 |

[14] R&TC section 17062.
[15] R&TC section 17024.5.



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## Supplemental Analysis of the Impact of the $10,000 limit on State and Local Tax (SALT) Deductions on Californians' Federal Taxes

Below, we present data on deductions taken by Californians in 2015. After offering some caveats on how our analysis should be interpreted, we have estimated the extent to which the new limit may affect individual California taxpayers and provided examples of specific taxpayer circumstances that may produce some of the outcomes described in this section.

In 2015, 5.9 million California resident taxpayers reported itemized deductions on federal individual income tax returns. The total amount of itemized deductions reported was $213 billion. Of this total, $110 billion in deductions were for state and local taxes assumed (for this estimate) to be affected by the new federal limit on SALT deductions, which includes:

- $80 billion on line 5 of federal Schedule A (income & sales taxes);
- $28 billion on line 6 of federal Schedule A (property taxes); and
- $2 billion on lines 8 and 9 of federal Schedule A (personal property and other taxes).

Table 1 presents these hereafter SALT deductions by Adjusted Gross Income (AGI) class:

**State and Local Tax Deductions By AGI Class**

| Adjusted Gross Income Class | Number of Taxpayers Reporting Deduction (Thousands) | Amount of State and Local Income and Sales Taxes (Billions) | Amount of Real Estate Taxes (Billions) | Amount of Personal Property Taxes & Other Taxes (Billions) | Total (Billions) |
|---|---|---|---|---|---|
| Less than $0 | 66 | $0.3 | $1 | $ 0.02 | $1 |
| $0 TO $99,999 | 3,041 | $8 | $9 | $1 | $19 |
| $100,000 TO $249,999 | 2,115 | $20 | $11 | $0.8 | $32 |
| $250,000 TO $499,999 | 463 | $12 | $4 | $0.2 | $17 |
| $500,000 TO $999,999 | 129 | $8 | $2 | $0.1 | $10 |
| More than $1,000,000 | 71 | $30 | $2 | $0.1 | $33 |
| TOTAL | 5,885 | $80 | $28 | $2 | $110 |

*Details may not add to totals due to rounding.



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Table 2 presents these deductions by the amount of SALT deduction claimed:

**State and Local Tax Deduction by Amount of SALT Deduction Claimed**

| State and Local Tax | Number of Taxpayers Reporting Deduction (Thousands) | Amount of State and Local Taxes (Billions) |
|---|---|---|
| $0- $5,000 | 1,418 | $4 |
| $5,000- $10,000 | 1,861 | $14 |
| $10,000 - $15,000 | 1,051 | $13 |
| $15,000 - $20,000 | 532 | $9 |
| $20,000 - $30,000 | 478 | $12 |
| $30,000 - $40,000 | 195 | $7 |
| $40,000 - $50,000 | 102 | $5 |
| $50,000 - $75,000 | 110 | $7 |
| $75,000 - $150,000 | 82 | $8 |
| $150,000 - $500,000 | 42 | $11 |
| $500,000 - $1,000,000 | 7 | $5 |
| More than $1,000,000 | 6 | $17 |
| All | 5,885 | $110 |

*Details may not add to totals due to rounding.

As can be seen in Table 2, approximately 2.6 million taxpayers reported more than the $10,000 limit. This taxpayer group claimed $93 billion in SALT deductions. Under the new law, taxpayers will still be able to deduct up to $10,000 for state and local taxes paid. Therefore, a taxpayer previously deducting $12,000 would have their deduction reduced by $2,000 because of the limit.



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**Table 3** presents the SALT deductions by AGI ranges affected and amount of SALT in excess of the $10,000 limit. The second column from the right shows the total amount of SALT deductions taken in 2015 by taxpayers who are over the limit. The far right column shows the amount by which those deductions would be reduced had the $10,000 limit been in place in 2015:

**Taxpayers with SALT Deductions in Excess of $10,000**

| Adjusted Gross Income Class | Number of Taxpayers Reporting Deduction (Thousands) | Amount of State and Local Tax (Billions) | Amount of State and Local Tax in Excess of $10,000 (Billions) |
|---|---|---|---|
| Less than $0 | 19 | $1 | $0.5 |
| $0 TO $99,999 | 352 | $5 | $2 |
| $100,000 TO $249,999 | 1,582 | $27 | $12 |
| $250,000 TO $499,999 | 456 | $17 | $12 |
| $500,000 TO $999,999 | 128 | $10 | $9 |
| More than $1,000,000 | 69 | $33 | $32 |
| TOTAL | 2,606 | $93 | $67 |

*Details may not add to totals due to rounding.

The $10,000 SALT limit is one part of a large package of changes to the federal tax code. These federal tax code changes also include provisions that will reduce the federal tax paid by individual California taxpayers and other provisions that will increase their taxes, depending on the income sources, deductions, and other specific circumstances of the individual taxpayer. Two of the most important provisions reducing federal taxes are the increase in the standard deduction and the reduction in tax rates. As a result of these provisions, there are some taxpayers who were previously claiming more than $10,000 in SALT deductions who will have their overall federal tax burden reduced by the changes to the federal tax code.

To illustrate the federal tax effect to Californian taxpayers, the FTB has constructed a model to estimate the impact of the tax reform package on California residents. The model uses data from our Personal Income Tax Sample, a stratified random sample of over 300,000 California tax returns.

There are a number of limitations to this model:

- The estimates reported below are estimates of what would have happened if the new federal law had been law in 2015. They do not account for changes in the economy since 2015.
- The estimates assume no change in taxpayer behavior in response to the law change.



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- The estimate are based on California tax filers. Each year, more than 1 million taxpayers who are not required to file California returns file federal returns with California addresses. Our sample does not account for these taxpayers. This omission may not be a significant concern for this analysis because taxpayers not required to file California returns generally have low income and are unlikely to be affected by the limit on SALT deductions.
- Since our model is based on data filed with the California return, it does not contain all of the data elements necessary to precisely calculate the federal tax due under the new law. For example, we have no way of knowing how much income reported by taxpayers on federal Schedules C and E qualifies for the new federal deduction applicable to “qualified” income from certain small businesses.
- We do not have all of the data necessary to accurately calculate federal Alternative Minimum Tax (AMT) under the new law. Many taxpayers reporting SALT deductions have the value of those deductions reduced or eliminated by the AMT. We cannot precisely estimate the interaction between these provisions.
- We do not have information necessary to model the expansion of the Child Tax Credit to cover older children.
- We do not capture the portion of ordinary dividends deemed qualified dividends (line 9b of federal Form 1040). Therefore, a taxpayer’s qualified dividends eligible for preferential tax rates are modeled based on state averages.

The increase in the federal standard deduction would cause many taxpayers to switch from itemizing their deductions to taking the standard deduction, even without the $10,000 limit on the SALT deduction. Many taxpayers would have continued itemizing even with the larger standard deduction if the $10,000 limit had not been imposed, but will switch to the expanded standard deduction with the SALT limit imposed. Other taxpayers will continue to itemize their deductions with the new law.



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**Table 4** presents the number of taxpayers with SALT deductions over the $10,000 limit in each of these categories. The table also shows estimates of the number of taxpayers in each category whose overall federal liability from the entire federal tax change package would increase by more than $100, change by less than $100 in either direction, or decrease by more than $100.

**Itemized vs. Standard Deduction and Change in Tax Liability Under New Federal Tax Law for Taxpayers with SALT Deductions Greater than $10,000 Limit**

| Estimated Change in Federal Tax Liability | Taxpayers Itemizing Deductions Under New Law (Thousands) | Taxpayers Switching to Standard Deduction Under New Law With or Without SALT Limit (Thousands) | Taxpayers Switching to Standard Deduction Under New Law that Would Itemize if the SALT Limit was Removed (Thousands) | TOTAL (Thousands) |
|---|---|---|---|---|
| REDUCTION > $100 | 416 | 267 | 229 | 912 |
| -$100 < and < $100 | 86 | 25 | 22 | 132 |
| INCREASE > $100 | 1,138 | 140 | 285 | 1,563 |
| TOTAL | 1,639 | 432 | 536 | 2,607 |

*Details may not add to totals due to rounding.

Table 4 shows that our model estimates that about 1.6 million California taxpayers with SALT deductions greater than $10,000 will continue to itemize under the new federal law. About 500 thousand California taxpayers will switch to the standard deduction under the new law, but would revert to itemizing if the SALT deduction cap were eliminated. About 400 thousand California taxpayers would choose the standard deduction under the new law even if the SALT cap were eliminated.

Table 4 also shows that, taking the entire federal tax change package into account, of the 2.6 million taxpayers with more than $10,000 in SALT deductions, about 900 thousand California taxpayers have lower federal tax liability under the new law then under the old law, about 100 thousand California taxpayers would have approximately the same federal tax liability, and about 1.6 million California taxpayers have an increase in federal tax liability.

Based on overall federal tax change package, there are about 400,000 California taxpayers who will switch to the standard deduction even if the SALT cap is eliminated and, therefore, would not benefit from the elimination of the SALT deduction cap. Of the 2.2 million California taxpayers who would benefit from the elimination of the SALT deduction cap, about 1.4 million are estimated to have a liability increase greater than $100 under the new law and about 800 thousand would not.



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**Table 5** provides a breakout by AGI class of the 1.4 million taxpayers estimated to have an increase in liability under the new federal law and to benefit from eliminating the SALT deduction limit. Table 5 also provides estimates of the amount by which these taxpayers' liability would be reduced if the $10,000 SALT deduction limit were eliminated but all of the other changes to federal law were retained. The federal tax impact of the SALT deduction limit for these California taxpayers is estimated to be about $15 billion.

**Taxpayers with Estimated Tax Increases Greater Than $100 and Who Would Benefit From Eliminating the SALT Deduction Limit, by AGI Class**

| Adjusted Gross Income Class | Number of Taxpayers (Thousands) | Amount of Tax Reduction if SALT Limit is Removed (Billions) |
|---|---:|---:|
| Less than $0 | 1 | $0.01 |
| $0 TO $99,999 | 182 | $0.1 |
| $100,000 TO $249,999 | 934 | $2 |
| $250,000 TO $499,999 | 184 | $2 |
| $500,000 TO $999,999 | 70 | $2 |
| More than $1,000,000 | 51 | $10 |
| TOTAL | 1,423 | $15 |

*Details may not add to totals due to rounding.

**Table 6** provides the same information for all 2.2 million individual taxpayers that would benefit from eliminating the SALT deduction limit, not just those whose liability from the whole federal tax change package increased. The federal tax impact of the SALT limit for this larger group of taxpayers is estimated to be about $19 billion.

| Adjusted Gross Income Class | Number of Taxpayer (Thousands) | Amount of Tax Reduction if SALT Limit is Removed (Billions) |
|---|---:|---:|
| $ NEGATIVE | 17 | $0.02 |
| $0 TO $99,999 | 275 | $0.2 |
| $100,000 TO $249,999 | 1,248 | $2 |
| $250,000 TO $499,999 | 439 | $3 |
| $500,000 TO $999,999 | 128 | $3 |
| $1,000,000 TO $HIGH | 69 | $11 |
| TOTAL | 2,175 | $19 |

*Details may not add to totals due to rounding.

In order to illustrate how some elements of the federal tax package affect California taxpayers, we present four examples of hypothetical taxpayers to illustrate some interesting features of the analysis of the SALT deduction limit and overall impact of the new federal tax changes.



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## Examples

**Example 1**- Some taxpayers' federal taxes will increase under the new federal tax law, even if the SALT deduction limit is removed.

The taxpayers are married with 3 dependent children. They reported wages of $201,000. Under the new federal law, taxpayers reported itemized deductions of $35,000. This amount consists of state and local taxes of $15,500 which was capped at $10,000 and charitable contributions of $25,000. Under current law, their tax liability would be $28,419, $1,707 more than under prior law. Even if the state and local tax deduction cap was removed, they would still pay $447 more than under prior law. The primary reason for the change in tax is the repeal of the personal exemptions under the new federal law.

| Taxpayers: Married, three dependents, and wages of $201,000 | | | |
|---|---|---|---|
| | Prior Federal Law | New Federal Law | New Federal Law Without SALT Limit |
| Federal AGI | $201,000 | $201,000 | $201,000 |
| Deductions | itemize | itemize | itemize |
| Itemized Deductions | $40,500 | $35,000 | $40,500 |
| Personal Exemptions | $20,000 | $0 | $0 |
| Taxable Income | $140,500 | $166,000 | $160,500 |
| Tax | $26,713 | $28,419 | $27,189 |
| Difference From Prior Law | NA | $1,707 | $477 |

**Example 2**- Some taxpayers will switch to the standard deduction under the new federal tax law, even if the SALT deduction limit was removed.

The taxpayer is a single mom with three children ages 12, 9, and 7. She filed a head of household return and claimed three dependent children. She reported wages of $175,000 and itemized deductions of $16,000, which includes state and local taxes of $11,000, mortgage interest of $5,000, and personal exemptions of $16,000. Under prior federal tax law, her tax is $30,474.

Under the new federal tax law, her tax would be $30,538, an increase of $104. The increase in tax is primarily attributable to the inability to claim the personal exemptions. Even if the SALT deduction limit was removed, she would still pay $104 more than prior federal tax law.



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| Taxpayers: Head of household, three dependents, with wages of approximately $175,000 | | | |
|---|---|---|---|
| | Prior Federal Law | New Federal Law | New Federal Law Without SALT Limit |
| W-2 Wages | $175,000 | $175,000 | $175,000 |
| Deductions | itemize | standard | standard |
| Standard Deduction | $0 | $18,000 | $18,000 |
| Itemized Deductions and Exemptions | $16,000 | $0 | $0 |
| Personal Exemptions | $16,000 | $0 | $0 |
| Taxable Income | $143,000 | $157,000 | $157,000 |
| AMT | $0 | $0 | $0 |
| Total Tax | $30,474 | $30,578 | $30,578 |
| Difference From Prior Law | NA | $104 | $104 |

Example 3- Some taxpayers whose federal taxes increased under the new federal tax law would instead have their taxes reduced if the SALT deduction limit is removed.

The taxpayers are married individuals with one dependent child. They have adjusted gross income of $250,000 consisting entirely of wages. They paid SALT of $35,000 and mortgage interest of $10,000. Under current law, the SALT deduction is limited to $10,000. As a result of the SALT deduction limit, they claimed the standard deduction of $24,000 instead of itemized deductions of $20,000. Under current federal tax law, their federal tax liability would be $42,819, $1,727 more than under prior federal tax law. However, if the SALT deduction limit is removed from the new federal tax law, they would benefit by switching back to itemized deductions and their federal tax liability would be $37,779.

| Taxpayers : Married, two Dependents and an AGI of $250,000 | | | |
|---|---|---|---|
| | Prior Federal Law | New Federal Law | New Federal Law Without SALT Limit |
| Federal AGI | $250,000 | $250,000 | $250,000 |
| Deductions | itemize | standard | itemize |
| Standard Deduction | $0 | $24,000 | $0 |
| Itemized Deductions | $45,000 | $0 | $45,000 |
| Personal Exemptions | $12,000 | $0 | $0 |
| Taxable Income | $193,000 | $226,000 | $205,000 |
| Tax | $41,092 | $42,819 | $37,779 |
| Difference From Prior Law | NA | $1,727 | ($3,313) |



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**Example 4**–Whether the taxes of taxpayers with pass-through income has increased or decreased may depend on whether or not the pass-through income qualifies for the new federal deduction that applies to some of this income. The estimates of the number of taxpayers whose taxes either increased or decreased is imprecise because we cannot identify which pass-through income is qualified for the deduction.

The taxpayer is self-employed and his wife is a stay-at-home mom. They reported wages of $60,000, pass-through income of $139,871, other income of $1,408, and total deductions from adjusted gross income of $11,000. They filed a joint return and had itemized deductions of $39,262, which included state and local tax of $7,494, property tax of $5,805, charitable contributions of $5,957 and home mortgage interest of $20,006. Under prior federal tax law, their tax is $25,332.

Under the new federal tax law, assuming the pass-through income is qualified business income (QBI), they will receive a 20 percent deduction from taxable income of almost $28,000. Under the new law their tax would be $19,665, a decrease of almost $5,700. The decrease in tax attributable to the new deduction for QBI and the decrease in the tax rate more than offset the SALT deduction limitation and the elimination of exemptions. Should their pass-through income not qualify as QBI, the loss of the personal exemptions and cap on the SALT deduction limit would cause their taxable income to increase to $154,276. Under the new federal tax law without QBI, their tax would be $25,820, an increase of almost $500 over prior law.

| Taxpayers : Married, two dependents and wages of $60,000 | | | |
|---|---|---|---|
| | Prior Federal Law | New Federal Law with Qualified Business Income Deduction | New Federal Law without Qualified Business Income Deduction |
| Filing Status | married | married | married |
| Dependents | two | two | two |
| W-2 Wages | $60,000 | $60,000 | $60,000 |
| Deductions | itemize | itemize | itemize |
| Pass-through Income | $139,871 | $139,871 | $139,871 |
| Federal AGI[16] | $190,239 | $190,239 | $190,239 |
| Itemized Deductions and Exemptions | $55,262 | $35,963 | $35,963 |
| Qualified Business Income Deduction (New Law) | NA | $27,974 | $0 |
| Taxable Income | $134,977 | $126,302 | $154,276 |
| Tax | $25,332 | $19,666 | $25,820 |
| Difference From Prior Law | NA | ($5,667) | $488 |

[16] This is after deductions from AGI of $11,040. These deductions from AGI are allowed under both prior and new law.



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## Tax Cuts and Jobs Act Repatriation Provisions

### Introduction

As previously described above, Congress recently enacted the new federal law, which made sweeping changes to the federal income tax law, including changes to the international tax provisions under the Internal Revenue Code (IRC). The Act:

- Added new IRC section 245A permitting tax-free repatriations of future foreign profits of foreign corporations to their 10 percent U.S. shareholders that are domestic corporations;
- Amended IRC section 965 imposing an immediate one-time tax at a reduced rate on all U.S. shareholders on accumulated earnings of foreign corporations that are controlled foreign corporations (CFCs) or which have 10 percent U.S. shareholders via a one-time deemed repatriation of those earnings;
- Added IRC section 951A imposing a current tax, similar to subpart F,[17] on a U.S. shareholder's "global intangible low-taxed income" (GILTI) of a CFC;
- Modified certain aspects of the "subpart F" anti-deferral rules; and
- Enacted several new provisions intended to prevent erosion of the U.S. tax base.

The discussion below (1) provides a background summarizing the federal tax scheme and the California tax scheme involving certain cross border transactions; (2) briefly describes the repatriation provisions under the Act; and (3) explains whether California conforms to the repatriation provisions.

### Background

### Federal Tax Law

Generally, the U.S. government taxes all the income of a U.S. corporation, regardless of source, and allows a credit for taxes paid on its foreign-source income. On the other hand, the U.S. taxes a foreign corporation only on the foreign corporation's U.S.-source income. Under the IRC, a corporation is a separate taxpayer, and the shareholders are not taxable on income of the corporation until that income is actually distributed to them. In addition, foreign corporations that are not engaged in a U.S. trade or business are not currently subject to U.S. taxation. As a result, under the general rules no U.S. tax would be paid on earnings of a foreign corporation owned by U.S. taxpayers until those earnings actually are distributed as dividends or until the disposition of the stock of the foreign corporation. This tax system permitted a U.S. taxpayer to defer indefinitely U.S. taxation on profits earned by the foreign corporation by not distributing those earnings and instead retaining the earnings in the foreign corporation.

[17] IRC §§ 951-965. Subpart F of Part III of Subchapter N of Chapter 1 of Subtitle A of Title 26 of the United States Code ("subpart F").



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To address concerns caused by the deferral of foreign income under those rules, in 1962 Congress enacted the anti-deferral provisions under subpart F of the IRC. Under the subpart F rules, U.S. shareholders who own a 10-percent-or-greater interest in a foreign corporation that is a CFC must include in taxable income their pro-rata share of certain of the CFC's undistributed foreign source income (subpart F income) through a constructive dividend mechanism.

California Corporation Tax Law (CTL)

Worldwide Unitary Method

California corporate taxpayers doing business both within and without California are required to compute their California tax using the worldwide unitary method. Under this method, a corporate taxpayer's business income from both domestic and foreign unitary operations is considered in the calculation of the taxpayer's tax base, and a share of that business income is then "apportioned" to California using a formula. Income apportioned to California is subject to California income tax. The formula measures relative levels of business activity in the state by using the amount of the taxpayer's sales in California divided by the taxpayer's sales everywhere.[18] This measure of activities is commonly called the "single sales-factor formula." The amount of sales from both domestic and foreign activities are included in the calculation of the apportionment formula. Generally, dividends paid from one member to another within the unitary group are eliminated from tax computations.

California Water's-Edge Election

As an alternative to the worldwide unitary method, California law allows corporations to elect to determine the business income of their combined reporting group on a "water's-edge" basis. In general, the water's-edge method excludes foreign corporations from the calculation of business income. An exception to this general rule is a CFC with subpart F income. The income and factors of the CFC are included in a water's-edge combined report based on the CFC's inclusion ratio. The ratio is equal to the CFC's current year subpart F income divided by to the CFC's current year earnings and profits. While California does not conform to the subpart F scheme of the IRC, for purposes of computing the CFC's inclusion ratio, California incorporates the federal definitions of "subpart F income" and "earnings and profits." Generally dividends paid to the water's-edge combined reporting group from foreign affiliates are income on the water's-edge combined report. California taxpayers electing water's-edge treatment are generally entitled to a 75 percent dividends-received deduction on such dividends.

[18] An apportioning trade or business conducting certain qualified business activities is required to use an evenly weighted three-factor formula consisting of property, payroll, and sales to apportion its business income to California. (Rev. & Tax. Code § 25128.



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Taxpayers can and do change their decision to elect water's-edge treatment. A taxpayer who elects water's-edge treatment must elect that treatment for seven years before they can terminate their election at their own discretion. A taxpayer who had terminated a water's-edge election and is thereafter using worldwide combined reporting treatment must wait seven years before they can re-elect for water's-edge treatment.

## Repatriation Provisions of the Act

### IRC section 245A

The Act ends the tax on repatriations to U.S. corporations from foreign corporations in which they hold 10-percent interests by establishing a "participation exemption system." Under the participation exemption system, a U.S. corporation that owns 10 percent or more of a foreign corporation will receive a 100 percent dividends-received deduction (DRD) on dividends paid by the foreign corporation out of its foreign-source earnings. No foreign tax credit or other deduction is allowed to U.S. shareholders on dividends for which they receive a DRD. The DRD does not apply to 10-percent shareholders that are not corporations.

### IRC section 965

The Act imposes a one-time deemed repatriation tax on untaxed earnings of foreign corporations accumulated prior to 2018. The earnings held as "cash or cash equivalents" (referred to as the "cash position") are taxed a rate of 15.5 percent, and all other earnings are taxed at a rate of 8 percent. The earnings are included in the income of a U.S. shareholder on the last day of the last taxable year of the foreign corporation that began before January 1, 2018. A U.S. shareholder may elect to pay its net tax liability on the one-time deemed repatriation in installments over eight years.

The one-time deemed repatriation is taken into account by all U.S. shareholders of foreign corporations if the foreign corporation is a CFC or with respect to which a domestic corporation is a U.S. shareholder. Any U.S. shareholder that becomes an expatriated entity (*e.g.*, through an inversion) during the 10-year period following the enactment of the Act is liable for tax on the full deemed repatriated amount at a 35 percent rate and no foreign tax credits are permitted to offset the additional tax.



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IRC section 951A

New IRC section 951A subjects U.S. shareholders of CFCs with "global intangible low-taxed income" (GILTI) to current tax. The full amount of the U.S. shareholder's share of the GILTI is treated as an income inclusion, but U.S. corporations are provided a 50 percent deduction (reduced to 37.5 percent in 2026). The earnings subject to the tax exclude a 10 percent return on certain investments, reduced by net interest expense.

Corporate U.S. shareholders may be eligible for a foreign tax credit of up to 80 percent of the amount of foreign taxes deemed paid, but also must include 100 percent of the foreign taxes deemed paid in income under the IRC section 78 gross-up provision. The Act also modifies the existing foreign tax credit rules by creating a new basket of foreign tax credits paid or accrued with respect to GILTI. Such foreign tax credit can only be used to offset tax on GILTI inclusions, and not tax on other types of income, and cannot be carried back or forward.

The GILTI inclusion is equal to the U.S. shareholder's share of:

- The CFC's gross income (subject to certain exclusions, such as income effectively connected with the conduct of a U.S. trade or business and subpart F Income); reduced by
- The excess of (i) 10 percent of the CFC's aggregate adjusted bases in depreciable tangible property used in its trade or business, over (ii) the CFC's net interest expense.

The tax on GILTI is intended to reduce the incentive to relocate CFCs to low-tax jurisdictions, since any tax savings achieved by the CFC may be partially offset by an increase in taxes to the U.S. shareholders.

California Conformity

Generally, when California's CTL incorporates provisions of the IRC by reference, it is done by specified conformity date. Currently, general conformity is to the IRC as of January 1, 2015[19]. One exception to the general conformity by specified date rule applies to the water's-edge election provisions. When water's-edge provisions refer to an IRC provision, it is the IRC provision that is not otherwise applicable, it is the IRC provision in effect for federal purposes for the same taxable period.[20] The FTB's long-standing position interprets this special conformity exception as only conforming to the IRC provisions for those IRC provisions specifically referred to in the water's-edge provisions. The IRC provisions not specifically referred to in the water's-edge provisions are subject to conformity by specified date.

[19] R&TC section 23051.5.
[20] Rev. & Tax. Code § 25116.



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Existing California CTL does not incorporate by reference IRC sections 245A, 951A, and 965. In addition, the water's-edge provisions within the California CTL do not specifically refer to IRC sections 245A, 951A, and 965; therefore, existing California water's-edge provisions do not conform to those repatriation provisions.

Effects on California of Federal law change

As stated previously, California does not conform to IRC section 965. However, U.S. taxpayers with large cash reserves abroad are no longer under a disincentive to repatriate earnings. Now that the disincentive has been removed, many taxpayers may have an extraordinary repatriation dividend. Media sources have indicated that there may be taxpayers with large foreign cash reserves that intend to repatriate at least some part of their foreign cash reserves. Therefore, it seems that although the federal law change to IRC section 965 will not directly affect California without legislative action, it will nonetheless result in some California taxpayers and their unitary U.S. corporations increasing their repatriation dividends, which will in turn have tax effects under California law. This is because due to differences between federal tax law and California tax law, the repatriation amounts may be characterized as taxable distributions for federal tax purposes but not for California tax purposes, and vice versa.

IRC section 245A, which provides a DRD for, and IRC section 951A, which requires current taxation on, foreign-source profits, may have a similar impact on U.S. shareholders' behavior that will increase the California water's-edge tax base in the longer term.

Below we present an overview of the impacts of these changes on California corporate tax revenue. The analysis does not consider any impacts on personal taxes that may result from increased capital gains or dividend income if repatriated funds are used for share repurchases or for increased dividends from repatriating corporations to individual shareholders. The calculation of California corporate tax on repatriated amounts includes the following steps:

- Dividends are included in the apportionable income base.
- Dividends paid from earnings produced in years that the taxpayer filed on a worldwide basis are eliminated because those earnings were included in the worldwide combined report in the year that they were generated.
- The remaining dividends receive a 75 percent dividends received deduction.
- The remaining income is then multiplied by the taxpayer’s California apportionment factor.
- The taxpayer’s post-apportionment income is offset by any available net operating losses.
- The tax rate is applied.
- The resulting tax may be reduced by any tax credits that the taxpayer has available.



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We examined tax returns for taxpayers linked in media reports to approximately $950 billion that may be subject to IRC section 965. This examination assumed that these taxpayers will repatriate all of the $950 billion, will not change their election to file on a water's-edge or worldwide basis, and have the same apportionment factors in the year of repatriation as in the tax year that we examined. Based on these assumptions, we estimate that the examined taxpayers would have an increase of approximately $1.25 billion in tax before credits, but would offset about $1 billion of this with available credits for a net revenue gain of about $250 million. Taxpayers are not, however, required to repatriate all of these earnings. If we assume that taxpayers in this group who are not able to offset the tax increase with unused credits only repatriate about 50 percent of the available funds, the revenue increase from this group would be about $125 million.

The taxpayers examined have only about 35 percent of publicly reported unrepatriated earnings. If unexamined taxpayers are similar to examined taxpayers, the revenue gain could be approximately $350 million. We believe that taxpayers not included in this analysis likely will not be able to offset as high a percentage of their increased tax before credits with unused tax credits as those included in the analysis. On the other hand, a higher percentage of taxpayers in the unexamined group file on a worldwide basis, and we believe that the ones who file water's-edge returns are likely to repatriate a smaller portion of their overseas cash than those in the examined group. We do not know with certainty which of these effects will be larger, so the net increase in California revenue from the adoption of IRC 965 could be greater or less than $350 million. This revenue increase could be smaller if taxpayers change their water's-edge election, their apportionment factors, or their generation of credits, or if a recession occurs within the next few years and taxpayers generate net operating losses to offset the additional income from repatriation.

The timing of this increase in revenues depends on when taxpayers actually repatriate the money. We do not know when this will occur. If we assume that 50 percent of the $350 million is from dividends paid in 2018, 30 percent in 2019, and 20 percent in 2020, the impact by fiscal year would be $50 million in 2017-18, $150 million in 2018-19, $110 million in 2018-19, and $40 million in 2019-20.

Finally, to the extent that some repatriation would have occurred in future years if federal law had not been changed, there would be a revenue loss in those future years partially offsetting the immediate revenue increases.



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