

MEMORANDUM

TO: Joani Woelfel

FROM: Lance Formwalt and Brandon Oldham

DATE: July 23, 2019

SUBJECT: California Assembly Bill 91

On July 1, 2019, California’s Governor signed Assembly Bill 91 (AB91) into law. California state tax law does not automatically mirror federal tax law. California is one of several states that from time to time votes to conform their state tax laws to the relevant federal law. The last time this was done was in 2015 when California voted to adopt (for the most part) the same tax rules as were found in the Internal Revenue Code (the Code) as of January 1st, 2015.

In 2017, the Code was greatly modified with the passing of the Tax Cuts and Jobs Act (the name of this Act was later changed but we will use the term TCJA to refer to this act). To more closely mirror federal tax law, AB91 was passed to adopt many of the provisions of the TCJA. Although AB 91 touches on many areas of the Code, below is on overview of the changes that we believe may be most relevant to dealers and their customers. The changes are effective for tax years beginning January 1, 2019 or after, but taxpayers may elect to have the changes apply retroactively to the tax year beginning January 1, 2018 or after.

**1031 Exchanges**

Prior to the TCJA, when a dealership customer gave the dealer used equipment on trade as partial payment for new equipment the Section 1031”like-kind” exchange rules allowed the customer to avoid paying tax on any profit in the difference between the trade-in credit and the customer’s tax basis in the trade-in.

When the TCJA was passed, the tax deferral of 1031 transactions was limited to apply only to real property. However, to mitigate the impact of the change, Congress also authorized 100% bonus depreciation which allows customers to expense the full value of any equipment purchased in the year of the purchase.

As part of AB91, California adopted the section of the TCJA that limits 1031 transactions to real property. Unfortunately, AB91 did not also adopt the amendment allowing full expensing of equipment in the year it is purchased. Because of this, in most situations a California customer will owe a higher amount of taxes for the year of the trade-in transaction than before AB91 was passed. Please note that an important exception to this rule is that for individual taxpayers with adjusted gross income under certain limits ($250,000 for single or $500,000 for married filing jointly) the pre-AB91 rules continue to apply. For these customers, trade-ins would still qualify for like-kind treatment for purposes of calculating California state income tax.

For a more detailed look at how the new Section 1031 and expensing rules affect dealers under the federal law, please see the attached article.



**Disallowance of Net Operating Loss Carryback**

Prior to the TCJA businesses could carry back net operating losses for two years and claim a tax refund. The TCJA repealed the two-year carryback provisions and extended the carryforward period for taxable years ending after December 31, 2017.

AB91 adopts this new disallowance of the two year carryback for taxable years beginning after December 31, 2018. A two year carryback is still permitted for net operating losses attributable to taxable years beginning on or after January 1, 2013 and before January 1, 2019.

The TCJA limited loss carryforwards each year to a maximum of 80% of taxable income. However, AB91 did not adopt this change so loss carryforwards may continue to offset 100% of taxable income for state income tax purposes.

**Interest Expense Deduction**

Beginning with the 2018 tax year, the TCJA limited the amount of interest expense deductions to the sum of 30% of the taxpayer’s adjusted taxable income plus the taxpayer’s business interest income plus, only to the extent a dealer uses floor plan financing for farm machinery and equipment, the taxpayer’s floor plan interest. The federal limits on deductibility of interest expense apply only to businesses with over $25 million in annual gross receipts.

AB 91 did NOT adopt this provision and therefore businesses have no limitation on interest deductions for state income tax purposes.

**Accounting Methods**

The TCJA allows taxpayers with three years of average annual gross receipts under $25 million to switch to the cash method of reporting income and expenses.

California adopted this provision of the TCJA effective for tax years beginning on or after January 1, 2019 raising the limit from $5,000,000 to $25,000,000.

**179 Expensing**

Section 179 allows taxpayers to deduct the cost of certain property as an expense when the property is placed in service. The TCJA increased the maximum expense deduction from $500,000 to $1,000,000.

California did not adopt this (or previous) increases. Because of this, the Section 179 expense deduction is capped at $25,000 for California taxes.