State of California
Franchise Tax Board

Summary of Federal Income Tax Changes 2013

Laws Affected

Personal Income Tax Law
Corporation Tax Law
Administration of Franchise and Income Tax Law

Summary of Federal Income Tax Changes
2013

Prepared by the Staff of the

Franchise Tax Board

STATE OF CALIFORNIA

This report is submitted in fulfillment of the requirement in Revenue and Taxation Code section 19522.

TABLE OF CONTENTS

EXECUTIVE SUMMARY

Prepared by the Staff of the
Franchise Tax Board (FTB)
State of California

During 2013, the Internal Revenue Code (IRC) or its application by California was changed by:

PUBLIC LAW	TITLE	DATE
112-240	American Taxpayer Relief Act of 2012 (ATRA)	January 2, 2013
113-63	Fallen Firefighters Assistance Tax Clarification Act of 2013	December 20, 2013
113-15 and 113-22	Miscellaneous Acts Impacting the IRC Not Requiring a California Response	Various

This report explains the new federal laws along with the effective dates, the corresponding California law, if any, including an explanation of any changes made in response to the new federal law, and the impact on California revenue were California to conform to the federal changes. This report also contains citations to the section numbers of federal Public Laws, the IRC, and the California Revenue and Taxation Code (R&TC) impacted by the federal changes.

This report contains the following exhibits:

Exhibit A — *2013 Miscellaneous Federal Acts Impacting the IRC Not Requiring a California Response* - Short explanations of federal law changes that are either not administered by the FTB or are not applicable to California.

Exhibit B — *Expiring Tax Provisions* - A complete listing of expiring provisions in California tax law.

Exhibit C — *Revenue Tables* - The impact on California revenue were California to conform to the federal changes.

Section	Section Title
101	Permanent Extension and Modification of 2001 Tax Relief
102	Permanent Extension and Modification of 2003 Tax Relief
103	Extension of 2009 Tax Relief

A. Individual Income Tax Rate Reductions

Background

In General

To determine regular tax liability, a taxpayer generally must apply the tax rate schedules (or the tax tables) to his or her regular taxable income. The rate schedules are broken into several ranges of income, known as income brackets, and the marginal tax rate increases as a taxpayer's income increases.

Prior to the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA),[1] the rate brackets were 15, 28, 31, 36, and 39.6 percent. EGTRRA created a new 10-percent regular income tax bracket for a portion of taxable income that was previously taxed at 15 percent. EGTRRA also reduced the other regular income tax rates; EGTRRA reduced the tax rates in excess of 15 percent to 25 percent, 28 percent, 33 percent, and 35 percent.

Tax Rate Schedules

Separate rate schedules apply based on an individual's filing status. For 2012, the regular individual income tax rate schedules are as follows:

[1] The Economic Growth and Tax Relief Act of 2001 (Public Law 107-16) provided a sunset provision that made the provisions of that Act inapplicable to taxable years beginning after December 31, 2010, and in the case of estate, gift, and generation-skipping transfer taxes, to estates of decedents dying, gifts made, or generation-skipping transfers made after that date. Subsequent legislation repealed the sunset provision for certain provisions of that Act. The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (Public Law 111-312) extended the sunset date for two years (through 2012).

The Jobs and Growth Tax Relief Act of 2003 (Public Law 108-27) provided a sunset provision that made the provisions of that Act relating to the reduction in taxes on dividends and capital gains inapplicable to taxable years beginning after December 31, 2008. The Tax Increase Prevention and Reconciliation Act of 2005 (Public Law 109-222) extended the sunset for two years (through 2010) and the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (Public Law 111-312) extended the sunset date for two additional years (through 2012).

References to EGTRRA are to that Act as amended by subsequent legislation.

Table 1 – Federal Individual Income Tax Rates for 2012

If taxable income is:	Then income tax equals:
Single Individuals	
Not over $8,700	10% of the taxable income
Over $8,700 but not over $35,350	$870 plus 15% of the excess over $8,700
Over $35,350 but not over $85,650	$4,867.50 plus 25% of the excess over $35,350
Over $85,650 but not over $178,650	$17,442.50 plus 28% of the excess over $85,650
Over $178,650 but not over $388,350	$43,482.50 plus 33% of the excess over $178,650
Over $388,350	$112,683.50 plus 35% of the excess over $388,350
Heads of Households	
Not over $12,400	10% of the taxable income
Over $12,400 but not over $47,350	$1,240 plus 15% of the excess over $12,400
Over $47,350 but not over $122,300	$6,482.50 plus 25% of the excess over $47,350
Over $122,300 but not over $198,050	$25,220 plus 28% of the excess over $122,300
Over $198,050 but not over $388,350	$46,430 plus 33% of the excess over $198,050
Over $388,350	$109,229 plus 35% of the excess over $388,350
Married Individuals Filing Joint Returns and Surviving Spouses	
Not over $17,400	10% of the taxable income
Over $17,400 but not over $70,700	$1,740 plus 15% of the excess over $17,400
Over $70,700 but not over $142,700	$9,735 plus 25% of the excess over $70,700
Over $142,700 but not over $217,450	$27,735 plus 28% of the excess over $142,700
Over $217,450 but not over $388,350	$48,665 plus 33% of the excess over $217,450
Over $388,350	$105,062 plus 35% of the excess over $388,350
Married Individuals Filing Separate Returns	
Not over $8,700	10% of the taxable income
Over $8,700 but not over $35,350	$870 plus 15% of the excess over $8,700
Over $35,350 but not over $71,350	$4,867.50 plus 25% of the excess over $35,350
Over $71,350 but not over $108,725	$13,867.50 plus 28% of the excess over $71,350
Over $108,725 but not over $194,175	$24,332.50 plus 33% of the excess over $108,725
Over $194,175	$52,531 plus 35% of the excess over $194,175

The following table is the Joint Committee on Taxation's estimates of the individual rate structure in 2013 (after the expiration of the EGTRRA sunset and before the changes made by this provision):

Table 2 – Federal Individual Income Tax Rates for 2013 (Prior to the ATRA Changes)

If taxable income is:	Then income tax equals:
Single Individuals	
Not over $36,100	15% of the taxable income
Over $36,100 but not over $87,550	$5,422 plus 28% of the excess over $36,100
Over $87,550 but not over $182,600	$19,814 plus 31% of the excess over $87,550
Over $182,600 but not over $397,000	$49,280 plus 36% of the excess over $182,600
Over $397,000	$126,464 plus 39.6% of the excess over $397,000
Heads of Households	
Not over $48,400	15% of the taxable income
Over $48,400 but not over $125,000	$7,260 plus 28% of the excess over $48,400
Over $125,000 but not over $202,450	$28,708 plus 31% of the excess over $125,000
Over $202,450 but not over $397,000	$52,718 plus 36% of the excess over $202,450
Over $397,000	$122,756 plus 39.6% of the excess over $397,000
Married Individuals Filing Joint Returns and Surviving Spouses	
Not over $60,350	15% of the taxable income
Over $60,350 but not over $145,900	$9,052 plus 28% of the excess over $60,350
Over $145,900 but not over $222,300	$33,006 plus 31% of the excess over $145,900
Over $222,300 but not over $397,000	$56,690 plus 36% of the excess over $222,300
Over $397,000	$119,582 plus 39.6% of the excess over $397,000
Married Individuals Filing Separate Returns	
Not over $30,175	15% of the taxable income
Over $30,175 but not over $72,950	$4,526 plus 28% of the excess over $30,175
Over $72,950 but not over $111,150	$16,503 plus 31% of the excess over $72,950
Over $111,150 but not over $198,500	$28,345 plus 36% of the excess over $111,150
Over $198,500	$59,791 plus 39.6% of the excess over $198,500

<u>New Federal Law (IRC section 1)</u>

The provision makes permanent the EGTRRA income tax rates for individual taxpayers whose taxable income is at or below a $400,000 threshold amount ($450,000 for married couples filing a joint return), and increases the tax rate to 39.6 percent for individuals who exceed the threshold amount. The rate structure is indexed for inflation.

A comparison of Table 3, below, with Table 2, above, illustrates the tax-rate changes.

Table 3 – Federal Individual Income Tax Rates for 2013 (With the ATRA Changes)

If taxable income is:	Then income tax equals:
Single Individuals	
Not over $8,925	10% of the taxable income
Over $8,925 but not over $36,250	$892.50 plus 15% of the excess over $8,925
Over $36,250 but not over $87,850	$4,991.25 plus 25% of the excess over $36,250
Over $87,850 but not over $183,250	$17,891.25 plus 28% of the excess over $87,850
Over $183,250 but not over $398,350	$44,603.25 plus 33% of the excess over $183,250
Over $398,350 but not over $400,000	$115,586.25 plus 35% of the excess over $398,350
Over $400,000	$116,163.75 plus 39.6% of the excess over $400,000
Heads of Households	
Not over $12,750	10% of the taxable income
Over $12,750 but not over $48,600	$1,275 plus 15% of the excess over $12,750
Over $48,600 but not over $125,450	$6,652.50 plus 25% of the excess over $48,600
Over $125,450 but not over $203,150	$25,865 plus 28% of the excess over $125,450
Over $203,150 but not over $398,350	$47,621 plus 33% of the excess over $203,150
Over $398,350 but not over $425,000	$112,037 plus 35% of the excess over 398,350
Over $425,000	$121,364.50 plus 39.6% of the excess over $425,000
Married Individuals Filing Joint Returns and Surviving Spouses	
Not over $17,850	10% of the taxable income
Over $17,850 but not over $72,500	$1,740 plus 15% of the excess over $17,400
Over $72,500 but not over $146,400	$9,735 plus 25% of the excess over $70,700
Over $146,400 but not over $223,050	$27,735 plus 28% of the excess over $142,700
Over $223,050 but not over $398,350	$48,665 plus 33% of the excess over $217,450
Over $398,350 but not over $450,000	$107,768.50 plus 35% of the excess over $398,350
Over $450,000	$125,846 plus 39.6% of the excess over $450,000
Married Individuals Filing Separate Returns	
Not over $8,925	10% of the taxable income
Over $8,925 but not over $36,250	$892.50 plus 15% of the excess over $8,925
Over $36,250 but not over $73,200	$4,991.25 plus 25% of the excess over $36,250
Over $73,200 but not over $111,525	$14,228.75 plus 28% of the excess over $73,200
Over $111,525 but not over $199,175	$24,959.75 plus 33% of the excess over $111,525
Over $199,175 but not over $225,000	$53,884.25 plus 35% of the excess over $199,175
Over $225,000	$62,923 plus 39.6% of the excess over $225,000

Effective Date

The provision applies to taxable years beginning after December 31, 2012.

California Law (R&TC sections 17041 and 17043)

California does not conform to federal individual income tax rates, and instead has its own individual income tax rates under the Personal Income Tax Law that range from 1 percent to 12.3 percent.[2] Additionally, there is an additional tax of 1 percent on the portion of a taxpayer's taxable income that exceeds $1,000,000.[3]

Impact on California Revenue

Not applicable.

B. The Overall Limitation on Itemized Deductions and the Personal Exemption Phase-Out

Background

Overall Limitation on Itemized Deductions ("Pease" Limitation)[4]

An individual may elect to claim his or her itemized deductions for a taxable year in lieu of the standard deduction. Itemized deductions generally are those deductions which are not allowed in computing adjusted gross income (AGI). Itemized deductions include unreimbursed medical expenses, investment interest, casualty and theft losses, wagering losses, charitable contributions, qualified residence interest, state and local income taxes (or in lieu of income, sales taxes), property taxes, unreimbursed employee business expenses, and certain other miscellaneous expenses.

Prior to EGTRRA, the total amount of otherwise allowable itemized deductions (other than medical expenses, investment interest, and casualty, theft, or wagering losses) was limited for upper-income taxpayers ("Pease" limitation). In computing this reduction of total itemized deductions, all limitations applicable to such deductions (such as the separate floors) were first applied and, then, the otherwise allowable total amount of itemized deductions was reduced by three percent of the amount by which the taxpayer's AGI exceeded a threshold amount, which was indexed

[2] R&TC section 17041. Proposition 30, passed by a majority of California voters on November 6, 2012, added Section 36 to Article XIII of the California Constitution, which temporarily increases the top tax rate of 9.3 percent under R&TC section 17041. For taxable years beginning on or after January 1, 2013, and before January 1, 2019, the 9.3 percent tax rate is increased for taxpayers that have taxable income over $250,000. The increased tax rates are 10.3 percent for the portion of taxable income that is over $250,000 but not over $300,000, 11.3 percent for the portion of taxable income that is over $300,000 but not over $500,000, and 12.3 percent for the portion of taxable income that is over $500,000.

[3] R&TC section 17043.

[4] IRC section 68. This overall limitation on itemized deductions is commonly referred to as the "Pease" limitation after the Congressman who originally proposed the provision.

annually for inflation. The otherwise allowable itemized deductions (other than medical expenses, investment interest, and casualty, theft, or wagering losses) could not be reduced by more than 80 percent.

EGTRRA phased-out and terminated the Pease limitation. Pursuant to the general EGTRRA sunset as amended by the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010,[5] the Pease limitation becomes fully effective again in 2013. Adjusting for inflation, the Joint Committee on Taxation staff estimates the AGI thresholds for 2013 would be: (1) $178,150 for single individuals; (2) $267,200 for married couples filing joint returns; and (3) $222,700 for heads of households.

Personal Exemption Phase-Out for Certain Taxpayers ("PEP")

Personal exemptions generally are allowed for the taxpayer, his or her spouse, and any dependents. For 2012, the amount deductible for each personal exemption is $3,800. This amount is indexed annually for inflation.

Prior to EGTRRA, the deduction for personal exemptions was reduced or eliminated for taxpayers with incomes over certain thresholds, which were indexed annually for inflation. Specifically, the total amount of exemptions that a taxpayer could claim was reduced by two percent for each $2,500 (or portion thereof) by which the taxpayer's AGI exceeded the applicable threshold. The phase-out rate was two percent for each $1,250 for married taxpayers filing separate returns. Thus, a taxpayer's available personal exemptions were phased-out over a $122,500 range (which was not indexed for inflation), beginning at the applicable threshold.

Pursuant to the general EGTRRA sunset as amended by the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, the personal exemption phase-out becomes fully effective again in 2013. According to Joint Committee Staff estimates, the PEP thresholds for 2013 would be: (1) $178,150 for single individuals; (2) $267,200 for married couples filing joint returns; and (3) $222,700 for heads of households.

<u>New Federal Law (IRC sections 68 and 151)</u>

Overall Limitation on Itemized Deductions ("Pease" Limitation)

This provision makes the Pease limitation permanent, with modified AGI thresholds. For taxable years beginning in 2013, the AGI thresholds are: (1) $250,000 for single individuals, (2) $300,000 for married couples filing joint returns, and (2) $275,000 for heads of households. These amounts are indexed for inflation for taxable years beginning in calendar years after 2013.

Personal Exemption Phase-Out for Certain Taxpayers ("PEP")

This provision makes the PEP permanent, with modified AGI thresholds. For taxable years beginning in 2013, the AGI thresholds are: (1) $250,000 for single individuals, (2) $300,000 for

[5] Public Law 111-312.

married couples filing joint returns, and (2) $275,000 for heads of households. These amounts are indexed for inflation for taxable years beginning after 2013.

California Law (R&TC sections 17054, 17054.1, and 17077)

Overall Limitation on Itemized Deductions ("Pease" Limitation)

The Personal Income Tax Law conforms to the federal overall limitation on itemized deductions as of the "specified date" of January 1, 2009, with modifications.[6] California provides its own indexed-for-inflation limitation amounts, and specifically does not conform to the phase out and temporary repeal of the overall limitation on itemized deductions.[7] Under California law, the 2013 amount of otherwise allowable itemized deductions (other than medical expenses, investment interest, and casualty, theft, or wagering losses) is reduced by six percent of the amount of the taxpayer's AGI in excess of $172,615 for single or married-filing-separate taxpayers, $345,235 for married taxpayers filing a joint return, and $258,927 for taxpayers who file under the head-of-household status. The otherwise allowable itemized deductions (other than medical expenses, investment interest, and casualty, theft, or wagering losses) are not reduced by more than 80 percent.

Personal Exemption Phase-Out for Certain Taxpayers ("PEP")

California does not conform to federal personal-exemption deductions. Instead of personal-exemption deductions, the Personal Income Tax Law provides personal-exemption tax credits.[8] For taxable year 2013, individual taxpayers are allowed personal-exemption tax credits in the amounts shown below:

Exemption Type	Number of Exemptions	Exemption Amount
Personal Exemption	One exemption for themselves, and one for a spouse, if married filing joint (MFJ).	$106
Senior	One additional exemption if 65 or older, and one for a spouse 65 or older, if MFJ.	$106
Blind	One additional exemption if visually impaired and one for a visually impaired spouse.	$106
Dependent	One exemption for each qualifying dependent.	$326

[6] R&TC section 17077 conforms to IRC section 68, relating to the overall limitation on itemized deductions, as of the specified date of January 1, 2009, with modifications.

[7] R&TC section 17077(d) and (e).

[8] R&TC section 17054. The exemption credits are adjusted annually based on the California Consumer Price Index.

The personal-exemption tax credits are reduced when a taxpayer's federal AGI exceeds a threshold amount.[9] For taxable year 2013, the exemption credits are reduced by $6 ($12 if married filing joint) for each $2,500 ($1,250 if married filing separately) of AGI or fraction thereof, that exceeds the following threshold amounts:

Single or Married/Registered Domestic Partner (RDP) filing separate	$172,615
Married/RDP filing joint	$345,235
Head of Household	$258,927

Impact on California Revenue

Not applicable.

C. Increase the Child Tax Credit

Background

An individual may claim a tax credit for each qualifying child under the age of 17. The amount of the credit per child is $1,000 through 2012 and $500 thereafter.[10] A child who is not a citizen, national, or resident of the United States cannot be a qualifying child.[11]

The aggregate amount of child credits that may be claimed is phased out for individuals with income over certain threshold amounts. Specifically, the otherwise allowable child tax credit is reduced by $50 for each $1,000 (or fraction thereof) of modified adjusted gross income (AGI) over $75,000 for single individuals or heads of households, $110,000 for married individuals filing joint returns, and $55,000 for married individuals filing separate returns. For purposes of this limitation, modified AGI includes certain otherwise excludable income earned by U.S. citizens or residents living abroad or in certain U.S. territories.[12]

The credit is allowable against the regular tax and, for taxable years beginning before January 1, 2013, is allowed against the alternative minimum tax (AMT). For taxable years beginning after December 31, 2012, the credit is not allowed against the AMT. To the extent that the child credit exceeds the taxpayer's income tax liability, the taxpayer is eligible for a refundable credit[13] (the additional child tax credit) equal to 15 percent of earned income in excess of a threshold dollar amount (the "earned-income" formula).[14] The threshold dollar amount enacted by

[9] R&TC section 17054.1. The phase-out thresholds are adjusted annually based on the California Consumer Price Index.

[10] IRC section 24(a).

[11] IRC section 24(c).

[12] IRC section 24(b).

[13] The refundable credit may not exceed the maximum credit per child of $1,000 through 2012 and $500 thereafter.

[14] IRC section 24(d).

EGTRRA was $10,000 indexed for inflation. The American Recovery and Reinvestment Act of 2009 (ARRA) reduced the threshold dollar amount to $3,000 (not indexed) for 2009 and 2010. The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 extended the $3,000 threshold for both 2011 and 2012. After 2012, the ability to determine the refundable child credit based on earned income in excess of the threshold dollar amount expires.

Families with three or more children may determine the additional child tax credit using the "alternative formula," if this results in a larger credit than determined under the earned-income formula. Under the alternative formula, the additional child tax credit equals the amount by which the taxpayer's social security taxes exceed the taxpayer's earned income tax credit (EITC). After 2012, due to the expiration of the earned-income formula, this is the only manner of obtaining a refundable child credit.

Earned income is defined as the sum of wages, salaries, tips, and other taxable employee compensation plus net self-employment earnings. At the taxpayer's election, combat pay may be treated as earned income for these purposes. Unlike the EITC, which also includes the preceding items in its definition of earned income, the additional child tax credit is based only on earned income to the extent it is included in computing taxable income. For example, some ministers' parsonage allowances are considered self-employment income, and thus are considered earned income for purposes of computing the EITC, but the allowances are excluded from gross income for individual income tax purposes, and thus are not considered earned income for purposes of the additional child tax credit since the income is not included in taxable income.

Any credit or refund allowed or made to an individual under this provision (including to any resident of a U.S. possession) is not taken into account as income and shall not be taken into account as resources for the month of receipt and the following two months for purposes of determining eligibility of such individual or any other individual for benefits or assistance, or the amount or extent of benefits or assistance, under any federal program or under any state or local program financed in whole or in part with federal funds.

New Federal Law (IRC section 24)

This provision makes permanent the $1,000 child tax credit. The provision also permanently extends the repeal of a prior-law provision that reduced the refundable child credit by the amount of the AMT. Under the provision, the staff of the Joint Committee on Taxation calculates that in 2013, the earned income threshold for computing the refundable child credit is $13,400.[15] Finally, the provision permanently extends the rule that the refundable portion of the child tax credit does not constitute income and shall not be treated as resources for purposes of determining eligibility or the amount or nature of benefits or assistance under any federal program or any state or local program financed with federal funds.

Effective Date

The provision applies to taxable years beginning after December 31, 2012.

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[15] This amount is $10,000 indexed for inflation from 2001.

California Law (None)

California does not conform to the federal child tax credit.

Impact on California Revenue

Not applicable.

D. Marriage Penalty Relief and Earned Income Tax Credit Simplification

Background

Marriage Penalty

A married couple generally is treated as one tax unit that must pay tax on the couple's total taxable income. Although married couples may elect to file separate returns, the rate schedules and other provisions are structured so that filing separate returns usually results in a higher tax than filing a joint return. Other rate schedules apply to single persons and to single heads of households.

A "marriage penalty" exists when the combined tax liability of a married couple filing a joint return is greater than the sum of the tax liabilities of each individual computed as if they were not married. A "marriage bonus" exists when the combined tax liability of a married couple filing a joint return is less than the sum of the tax liabilities of each individual computed as if they were not married.

Basic Standard Deduction

EGTRRA temporarily increased the basic standard deduction for a married couple filing a joint return to twice the basic standard deduction for an unmarried individual filing a single return, and the increase was extended through 2012 by the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010. The basic standard deduction for a married taxpayer filing separately continued to equal one-half of the basic standard deduction for a married couple filing jointly; thus, the basic standard deduction for unmarried individuals filing a single return and for married couples filing separately are the same. Under the sunset provision of EGTRRA, as extended by the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, the provision will no longer apply for taxable years beginning after December 31, 2012.

Fifteen-Percent Rate Bracket

EGTRRA temporarily increased the size of the 15-percent regular income tax rate bracket for a married couple filing a joint return to twice the size of the corresponding rate bracket for an unmarried individual filing a single return. Under the sunset provision of EGTRRA, as extended by the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, the provision will no longer apply for taxable years beginning after December 31, 2012.

Earned Income Tax Credit

The earned income tax credit (EITC) is a refundable credit available to certain low-income taxpayers. Generally, the amount of an individual's allowable earned income credit is dependent on the individual's earned income, adjusted gross income (AGI), and the number of qualifying children. EGTRRA temporarily modified certain EITC provisions that include: (1) a simplified definition of earned income; (2) a simplified relationship test; (3) use of AGI instead of modified AGI; (4) a simplified tie-breaking rule; (5) additional math error authority for the IRS; (6) a repeal of the prior-law provision that reduced an individual's EITC by the amount of his alternative minimum tax liability; and (7) increases in the beginning and ending points of the credit phase-out for married taxpayers by $5,000.[16] Under the sunset provision of EGTRRA, as extended by the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, the provision will no longer apply for taxable years beginning after December 31, 2012.

New Federal Law (IRC sections 1, 32, and 63)

Basic Standard Deduction

The provision permanently increases the basic standard deduction for a married couple filing a joint return to twice the basic standard deduction for an unmarried individual filing a single return.

Fifteen Percent Rate Bracket

The provision permanently increases the size of the 15-percent regular income tax rate bracket for a married couple filing a joint return to twice the 15-percent regular income tax rate bracket for an unmarried individual filing a single return.

Earned Income Tax Credit

The provision makes permanent certain EITC provisions enacted by EGTRRA. These include: (1) a simplified definition of earned income; (2) a simplified relationship test; (3) a simplified tie-breaking rule; (4) additional math error authority for the IRS; (5) a repeal of the prior-law provision that reduced an individual's EITC by the amount of his alternative minimum tax liability; and (6) a $5,000 increase in the beginning and ending points of the credit phase-out for married taxpayers.

Effective Date

The provision applies to taxable years beginning after December 31, 2012.

[16] The amount is indexed for inflation annually.

California Law (R&TC sections 17073.5 and 17041)

Basic Standard Deduction

California does not conform to the federal standard deduction, and instead provides its own standard deduction under the Personal Income Tax Law that is indexed for inflation annually.[17] And, the California standard deduction does not have a marriage penalty; that is, the standard deduction for a married couple filing a joint return is twice the amount of the standard deduction of an unmarried individual or a married individual filing separately.

Fifteen Percent Rate Bracket

California does not conform to federal income tax rate brackets, and instead provides its own income tax rate brackets under the Personal Income Tax Law.[18]

Earned Income Tax Credit

California does not conform to the federal EITC.

Impact on California Revenue

Not applicable.

E. Education Incentives

Background

Income and Wage Exclusion for Awards under the National Health Service Corps Scholarship Program and the F. Edward Hebert Armed Forces Health Professions Scholarship and Financial Assistance Program

Gross income does not include amounts received as a qualified scholarship by an individual who is a candidate for a degree and used for tuition and fees required for the enrollment or attendance (or for fees, books, supplies, and equipment required for courses of instruction) at a primary, secondary, or post-secondary educational institution.[19] This exclusion does not extend to scholarship amounts covering regular living expenses, such as room and board. In addition to the exclusion for qualified scholarships, IRC section 117 provides an exclusion from gross income for qualified tuition reductions for certain education provided to employees (and their spouses and dependents) of certain educational organizations. Amounts excludable from gross income as

[17] R&TC section 17073.5.

[18] R&TC section 17041.

[19] IRC section 117.

amounts received as qualified scholarships are also excludable from wages for payroll tax purposes.[20]

The exclusion for qualified scholarships and qualified tuition reductions does not apply to any amount received by a student that represents payment for teaching, research, or other services by the student required as a condition for receiving the scholarship or tuition reduction. An exception to this rule applies in the case of the National Health Service Corps Scholarship Program (the "NHSC Scholarship Program") and the F. Edward Hebert Armed Forces Health Professions Scholarship and Financial Assistance Program (the "Armed Forces Scholarship Program").

The NHSC Scholarship Program and the Armed Forces Scholarship Program provide education awards to participants on the condition that the participants provide certain services. In the case of the NHSC Scholarship Program, the recipient of the scholarship is obligated to provide medical services in a geographic area (or to an underserved population group or designated facility) identified by the Public Health Service as having a shortage of health care professionals. In the case of the Armed Forces Scholarship Program, the recipient of the scholarship is obligated to serve a certain number of years in the military at an armed forces medical facility.

Under the sunset provisions of EGTRRA, as extended by the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, the exclusion from gross income and wages for the NHSC Scholarship Program and the Armed Forces Scholarship Program will no longer apply for taxable years beginning after December 31, 2012.

Income and Wage Exclusion for Employer-Provided Educational Assistance

If certain requirements are satisfied, up to $5,250 annually of educational assistance, provided by an employer to an employee, is excludable from gross income for income tax purposes and from wages for employment tax purposes.[21] Under EGTRRA, this exclusion applies to both graduate and undergraduate courses.[22] For the exclusion to apply, certain requirements must be satisfied. The educational assistance must be provided pursuant to a separate written plan of the employer. The employer's educational assistance program must not discriminate in favor of highly-compensated employees. In addition, no more than five percent of the amounts paid or incurred by the employer during the year for educational assistance under a qualified educational assistance program can be provided for the class of individuals consisting of more-than-five-percent owners of the employer and the spouses or dependents of such more-than-five-percent owners.

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[20] IRC section 3121(a)(20).

[21] IRC sections 127 and 3121(a)(18).

[22] The exclusion has not always applied to graduate courses. The exclusion was first made inapplicable to graduate-level courses by the Technical and Miscellaneous Revenue Act of 1988. The exclusion was reinstated with respect to graduate-level courses by the Omnibus Budget Reconciliation Act of 1990, effective for taxable years beginning after December 31, 1990. The exclusion was again made inapplicable to graduate-level courses by the Small Business Job Protection Act of 1996, effective for courses beginning after June 30, 1996. The exclusion's applicability to graduate-level courses was reinstated by EGTRRA, extended by the Tax Relief, Unemployment Reauthorization, and Job Creation Act of 2010, and does not apply to taxable years beginning after December 31, 2012.

For purposes of the exclusion, educational assistance means the payment by an employer of expenses incurred by or on behalf of the employee for education of the employee including, but not limited to, tuition, fees, and similar payments, books, supplies, and equipment. Educational assistance also includes the provision by the employer of courses of instruction for the employee (including books, supplies, and equipment). Educational assistance does not include: (1) tools or supplies that may be retained by the employee after completion of a course; (2) meals, lodging, or transportation; or (3) any education involving sports, games, or hobbies. The exclusion for employer-provided educational assistance applies only with respect to education provided to the employee (e.g., it does not apply to education provided to the spouse or a child of the employee).

In the absence of the specific exclusion for employer-provided educational assistance, employer-provided educational assistance is excludable from gross income and wages only if the education expenses qualify as a working condition fringe benefit.[23] In general, education qualifies as a working condition fringe benefit if the employee could have deducted the education expenses under IRC section 162 if the employee paid for the education. In general, education expenses are deductible by an individual under IRC section 162 if the education: (1) maintains or improves a skill required in a trade or business currently engaged in by the taxpayer; or (2) meets the express requirements of the taxpayer's employer, applicable law, or regulations imposed as a condition of continued employment. However, education expenses are generally not deductible if they relate to certain minimum educational requirements or to education or training that enables a taxpayer to begin working in a new trade or business. In determining the amount deductible for this purpose, the two-percent floor on miscellaneous itemized deductions is disregarded.

The specific exclusion for employer-provided educational assistance was originally enacted on a temporary basis, and, before EGTRRA, was subject to an expiration date of December 31, 2001.[24] EGTRRA deleted the exclusion's explicit expiration date and extended the exclusion to graduate courses. However, those changes are subject to EGTRRA's sunset provision, as extended by the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, so that the exclusion will not be available for taxable years beginning after December 31, 2012. Thus, at that time, educational assistance will be excludable from gross income only if it qualifies as a working condition fringe benefit (i.e., the expenses would have been deductible as business expenses if paid by the employee). As previously discussed, to meet such requirement, the expenses must be related to the employee's current job.[25]

Deduction for Student Loan Interest

Certain individuals who have paid interest on qualified education loans may claim an above-the-line deduction for such interest expenses, subject to a maximum annual deduction limit.[26]

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[23] IRC section 132(d).

[24] The exclusion was first enacted as part of the Revenue Act of 1978 (with a 1983 expiration date), and was subsequently extended on a temporary basis many times.

[25] Treas. Reg. section 1.162-5.

[26] IRC section 221.

Required payments of interest generally do not include voluntary payments, such as interest payments made during a period of loan forbearance. No deduction is allowed to an individual if that individual is claimed as a dependent on another taxpayer's return for the taxable year. A qualified education loan generally is defined as any indebtedness incurred solely to pay for the costs of attendance (including room and board) of the taxpayer, the taxpayer's spouse, or any dependent of the taxpayer as of the time the indebtedness was incurred in attending an eligible educational institution on at least a half-time basis. Eligible educational institutions are: (1) post-secondary educational institutions and certain vocational schools defined by reference to section 481 of the Higher Education Act of 1965; or (2) institutions conducting internship or residency programs leading to a degree or certificate from an institution of higher education, a hospital, or a health care facility conducting postgraduate training. Additionally, to qualify as an eligible educational institution, an institution must be eligible to participate in Department of Education student aid programs.

The maximum allowable deduction per year is $2,500. For 2012, the deduction is phased out ratably for single taxpayers with AGI between $60,000 and $75,000 and between $125,000 and $155,000 for married taxpayers filing a joint return. The income phase-out ranges are indexed for inflation and rounded to the next lowest multiple of $5,000.

Effective for taxable years beginning after December 31, 2012, the changes made by EGTRRA[27] to the student loan provisions no longer apply. The EGTRRA changes scheduled to expire are: (1) increases that were made in the AGI phase-out ranges for the deduction; and (2) rules that extended deductibility of interest beyond the first 60 months that interest payments are required. With the expiration of the EGTRRA changes, the phase-out ranges will revert to a base level of $40,000 to $55,000 ($60,000 to $75,000 in the case of a married couple filing jointly), but with an adjustment for inflation occurring since 2002. Thus, the Joint Committee on Taxation estimates that the phase-out ranges will be $50,000 to $65,000 ($75,000 to $90,000 in the case of a married couple filing jointly) for 2013.

Coverdell Education Savings Accounts

A Coverdell education savings account is a trust or custodial account created exclusively for the purpose of paying qualified education expenses of a named beneficiary.[28] Annual contributions to Coverdell education savings accounts may not exceed $2,000 per designated beneficiary and may not be made after the designated beneficiary reaches age 18 (except in the case of a special needs beneficiary). The contribution limit is phased out for taxpayers with modified AGI between $95,000 and $110,000 ($190,000 and $220,000 for married taxpayers filing a joint return); the AGI of the contributor, and not that of the beneficiary, controls whether a contribution is permitted by the taxpayer.

[27] As extended by the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010.

[28] IRC section 530.

Earnings on contributions to a Coverdell education savings account generally are subject to tax when withdrawn.[29] However, distributions from a Coverdell education savings account are excludable from the gross income of the distributee (i.e., the student) to the extent that the distribution does not exceed the qualified education expenses incurred by the beneficiary during the year the distribution is made. The earnings portion of a Coverdell education savings account distribution not used to pay qualified education expenses is includible in the gross income of the distributee and generally is subject to an additional 10-percent tax.[30]

Tax-free (including free of the additional 10-percent tax) transfers or rollovers of account balances from one Coverdell education savings account benefiting one beneficiary to another Coverdell education savings account benefiting another beneficiary (as well as re-designations of the named beneficiary) are permitted, provided that the new beneficiary is a member of the family of the prior beneficiary and is under age 30 (except in the case of a special needs beneficiary). In general, any balance remaining in a Coverdell education savings account is deemed to be distributed within 30 days after the date that the beneficiary reaches age 30 (or, if the beneficiary dies before attaining age 30, within 30 days of the date that the beneficiary dies).

Qualified education expenses include "qualified higher education expenses" and "qualified elementary and secondary education expenses."

The term "qualified higher education expenses" includes tuition, fees, books, supplies, and equipment required for the enrollment or attendance of the designated beneficiary at an eligible education institution, regardless of whether the beneficiary is enrolled at an eligible educational institution on a full-time, half-time, or less than half-time basis.[31] Moreover, qualified higher education expenses include certain room and board expenses for any period during which the beneficiary is at least a half-time student. Qualified higher education expenses include expenses with respect to undergraduate or graduate-level courses. In addition, qualified higher education expenses include amounts paid or incurred to purchase tuition credits (or to make contributions to an account) under a qualified tuition program for the benefit of the beneficiary of the Coverdell education savings account.[32]

The term "qualified elementary and secondary education expenses" means expenses for: (1) tuition, fees, academic tutoring, special needs services, books, supplies, and other equipment incurred in connection with the enrollment or attendance of the beneficiary at a public, private, or religious school providing elementary or secondary education (kindergarten through grade 12) as determined under state law; (2) room and board, uniforms, transportation, and supplementary items or services (including extended day programs) required or provided by such a school in

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[29] In addition, Coverdell education savings accounts are subject to the unrelated business income tax imposed by IRC section 511.

[30] This 10-percent additional tax does not apply if a distribution from an education savings account is made on account of the death or disability of the designated beneficiary, or if made on account of a scholarship received by the designated beneficiary.

[31] Qualified higher education expenses are defined in the same manner as for qualified tuition programs.

[32] IRC section 530(b)(2)(B).

connection with such enrollment or attendance of the beneficiary; and (3) the purchase of any computer technology or equipment (as defined in IRC section 170(e)(6)(F)(i)) or Internet access and related services, if such technology, equipment, or services are to be used by the beneficiary and the beneficiary's family during any of the years the beneficiary is in elementary or secondary school. Computer software primarily involving sports, games, or hobbies is not considered a qualified elementary and secondary education expense unless the software is predominantly educational in nature.

Qualified education expenses generally include only out-of-pocket expenses. Such qualified education expenses do not include expenses covered by employer-provided educational assistance or scholarships for the benefit of the beneficiary that are excludable from gross income. Thus, total qualified education expenses are reduced by scholarship or fellowship grants excludable from gross income under IRC section 117, as well as any other tax-free educational benefits, such as employer-provided educational assistance, that are excludable from the employee's gross income under IRC section 127.

Effective for taxable years beginning after December 31, 2012, the changes made by EGTRRA[33] to Coverdell education savings accounts no longer apply. The EGTRRA changes scheduled to expire are: (1) the increase in the contribution limit to $2,000 from $500; (2) the increase in the phase-out range for married taxpayers filing jointly to $190,000 - $220,000 from $150,000 - $160,000; (3) the expansion of qualified expenses to include elementary and secondary education expenses; (4) special age rules for special needs beneficiaries; (5) clarification that corporations and other entities are permitted to make contributions, regardless of the income of the corporation or entity during the year of the contribution; (6) certain rules regarding when contributions are deemed made and extending the time during which excess contributions may be returned without additional tax; (7) certain rules regarding coordination with the Hope and Lifetime Learning credits; and (8) certain rules regarding coordination with qualified tuition programs.

Amount of Governmental Bonds that May be Issued by Governments Qualifying for the "Small Governmental Unit" Arbitrage Rebate Exception

To prevent state and local governments from issuing more federally subsidized tax-exempt bonds than is necessary for the activity being financed or from issuing such bonds earlier than needed for the purpose of the borrowing, the IRC includes arbitrage restrictions limiting the ability to profit from investment of tax-exempt bond proceeds.[34] The IRC also provides certain exceptions to the arbitrage restrictions. Under one such exception, small issuers of governmental bonds issued for local governmental activities are not subject to the rebate requirement.[35] To qualify for this

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[33] As extended by the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010.

[34] The exclusion from gross income for interest on state and local bonds does not apply to any arbitrage bond (IRC section 103(a), (b)(2)). A bond is an arbitrage bond if it is part of an issue that violates the restrictions against investing in higher-yielding investments under IRC section 148(a) or that fails to satisfy the requirement to rebate arbitrage earnings under IRC section 148(f).

[35] Ninety-five percent or more of the net proceeds of a governmental bond issue are to be used for local governmental activities of the issuer. IRC section 148(f)(4)(D).

exception the governmental bonds must be issued by a governmental unit with general taxing powers that reasonably expects to issue no more than $5 million of tax-exempt governmental bonds in a calendar year.[36] Prior to EGTRRA, the $5 million limit was increased to $10 million if at least $5 million of the bonds are used to finance public schools. EGTRRA provided the additional amount of governmental bonds for public schools that small governmental units may issue without being subject to the arbitrage rebate requirements is increased from $5 million to $10 million.[37] Thus, these governmental units may issue up to $15 million of governmental bonds in a calendar year provided that at least $10 million of the bonds are used to finance public school construction expenditures. This increase is subject to the EGTRRA sunset, as extended by the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010.

Issuance of Tax-Exempt Private Activity Bonds for Public School Facilities

Interest on bonds that nominally are issued by state or local governments, but the proceeds of which are used (directly or indirectly) by a private person and payment of which is derived from funds of such a private person is taxable unless the purpose of the borrowing is approved specifically in the IRC or in a non-IRC provision of a revenue act. These bonds are called "private activity bonds."[38] The term "private person" includes the federal government and all other individuals and entities other than state or local governments.

Only specified private activity bonds are tax-exempt. EGTRRA added a new type of private activity bond that is subject to the EGTRRA sunset, as extended by the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010. This category is bonds for elementary and secondary public school facilities that are owned by private, for-profit corporations pursuant to public-private partnership agreements with a state or local educational agency.[39] The term school facility includes school buildings and functionally-related and subordinate land (including stadiums or other athletic facilities primarily used for school events) and depreciable personal property used in the school facility. The school facilities for which these bonds are issued must be operated by a public educational agency as part of a system of public schools.

A public-private partnership agreement is defined as an arrangement pursuant to which the for-profit corporate party constructs, rehabilitates, refurbishes, or equips a school facility for a public school agency (typically pursuant to a lease arrangement). The agreement must provide that, at the end of the contract term, ownership of the bond-financed property is transferred to the public school agency party to the agreement for no additional consideration.

Issuance of these bonds is subject to a separate annual per-state private activity bond volume limit equal to $10 per resident ($5 million, if greater) in lieu of the present-law state private

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[36] Under the Treasury regulations, an issuer may apply a fact-based rather than an expectations-based test. Treas. Reg. section 1.148-8(c)(1).

[37] IRC section 148(f)(4)(D)(vii).

[38] The IRC provides that the exclusion from gross income does not apply to interest on private activity bonds that are not qualified bonds within the meaning of IRC section 141. See IRC sections 103(b)(1) and 141.

[39] IRC sections 142(a)(13) and 142(k).

activity bond volume limits. As with the present-law state private activity bond volume limits, states can decide how to allocate the bond authority to state and local government agencies. Bond authority that is unused in the year in which it arises may be carried forward for up to three years for public school projects under rules similar to the carry-forward rules of the present-law private activity bond volume limits.

New Federal Law (IRC sections 117, 127, 142, 146-148, 221, and 530)

The provision makes permanent the EGTRRA changes to the NHSC Scholarship Program and the Armed Forces Scholarship Program, the IRC section 127 exclusion from income and wages for employer-provided educational assistance, the student loan interest deduction, Coverdell education savings accounts, the expansion of the small government unit exception to the arbitrage rebate and the allowance of the issuance of tax-exempt private activity bonds for public school facilities. Thus, all these education tax benefits for education continue to be available after 2012.

Effective Date

The provision applies to taxable years beginning after December 31, 2012.

California Law (R&TC sections 17072, 17131, 17143, 17151, 17201, 23712, and 24272)

Income and Wage Exclusion for awards under the NHSC Scholarship Program and the Armed Forces Health Professions Scholarship Program

- *Income Exclusion*

  The Personal Income Tax Law conforms to the federal income exclusion for qualified scholarships, including the EGTRRA income exclusion for awards under the NHSC and Armed-Forces-Health-Professions Scholarship Programs, as of the “specified date” of January 1, 2009.[40] And, because the Personal Income Tax Law also conforms to the repeal of the EGTRRA sunset date,[41] California conforms to this provision that makes this income exclusion permanent. In other words, as it is under federal law, the gross income exclusion for awards under the NHSC and Armed Forces Health Professions Scholarship Programs is permanent under California Law.

- *Wage Exclusion*

  The FTB does not administer payroll taxes. Defer to the Employment Development Department (EDD).

[40] R&TC section 17131 conforms to IRC section 117, relating to qualified scholarships, as of the “specified date” of January 1, 2009.

[41] R&TC section 17024.5(a)(2)(B).

Income and Wage Exclusion for Employer-Provided Educational Assistance

- *Income Exclusion*

  The Personal Income Tax Law specifically does not conform to the federal income exclusion for educational assistance programs, and instead provides its own educational assistance exclusion that allows a maximum exclusion of $5,250 that may be claimed by both undergraduate and graduate students, and is permanent.[42] Thus, with the EGTRRA changes being made permanent, the federal and state exclusions for employer-provided educational assistance are similar; that is, both federal and state law permanently allow a maximum exclusion of $5,250 for employer-provided educational assistance that may be claimed by both undergraduate and graduate students.

- *Wage Exclusion*

  The FTB does not administer payroll taxes. Defer to the EDD.

Deduction for Student Loan Interest

The Personal Income Tax Law conforms to the federal deduction for student loan interest as of the "specified date" of January 1, 2009.[43] And, because the Personal Income Tax Law also conforms to the repeal of the EGTRRA sunset date,[44] California conforms to this provision that makes the EGTRRA changes to the deduction for student loans permanent. That is, California conforms to the EGTRRA changes that increase the student-loan AGI phase out and extend the deductibility of student-loan interest beyond the first 60 months, and to this provision that makes those EGTRRA changes permanent.

Coverdell Education Savings Accounts

The Corporation Tax Law conforms to the federal rules for Coverdell education savings accounts as of the "specified date" of January 1, 2009, with modifications.[45] Additionally, the Corporation Tax Law conforms to the repeal of the EGTRRA sunset date.[46] Thus, California conforms to the EGTRRA modifications to Coverdell education savings accounts and to this provision that makes such modifications permanent.

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[42] R&TC section 17151.

[43] R&TC section 17072 conforms to IRC section 62, relating to adjusted gross income, as of the "specified date" of January 1, 2009, with modifications; and, R&TC section 17201 conforms to IRC section 221, relating to interest on education loans, as of the "specified date" of January 1, 2009.

[44] R&TC section 17024.5(a)(2)(B).

[45] R&TC section 23712 conforms to IRC section 530, relating to Coverdell education savings accounts, as of the "specified date" of January 1, 2009, with modifications.

[46] R&TC section 23051.5(a)(2)(B).

Amount of Governmental Bonds that May be Issued by Governments Qualifying for the "Small Governmental Unit" Arbitrage Rebate Exception; and, Issuance of Tax-Exempt Private Activity Bonds for Public School Facilities

The Personal Income Tax Law specifically does not conform to the federal rules relating to interest on government bonds.[47] In addition, the federal "private-activity-bond" rules have not been adopted by California. The general rule in California is that for income tax purposes, all interest received or accrued is fully taxable, except for interest on federal obligations (such as Treasury bills, notes, and bonds) and tax-exempt bonds issued by this state or a local government in this state.

Under the Corporation Tax Law, interest received from federal, state, municipal, or other bonds is includable in the gross income of corporations taxable under the franchise tax.[48] The franchise tax is a nondiscriminatory privilege tax for the right to exercise the corporate franchise, and is not a tax on the income received. In other words, bond interest income is not subject to the corporation income tax under the Corporation Tax Law, but is included in the measure of a corporation's income in order to compute its franchise tax.

Impact on California Revenue

Income and Wage Exclusion for awards under the NHSC Scholarship Program and the Armed Forces Health Professions Scholarship Program

- *Income Exclusion*

  Baseline—based on a proration of federal estimates developed by the Joint Committee on Taxation, baseline losses are estimated to be $5,600,000, $5,100,000, and $5,300,000 in fiscal years 2013-14, 2014-15, and 2015-16, respectively.

- *Wage Exclusion*

  Defer to the EDD.

Income and Wage Exclusion for Employer-Provided Educational Assistance

- *Income Exclusion*

  Baseline—although California does not conform to the federal exclusion and instead provides its own state exclusion, the state exclusion is similar to the federal exclusion, and the EGTRAA extension will have a baseline revenue impact to the extent that it impacts the amount of employer-provided educational assistance that employers provide.

- *Wage Exclusion*

  Defer to the EDD.

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[47] R&TC section 17143.

[48] R&TC section 24272.

Deduction for Student Loan Interest

Baseline—based on a proration of federal estimates developed by the Joint Committee on Taxation, baseline losses are estimated to be $26,000,000, $37,000,000, and $38,000,000 in fiscal years 2013-14, 2014-15, and 2015-16, respectively.

Coverdell Education Savings Accounts

Baseline—based on a proration of federal estimates developed by the Joint Committee on Taxation, baseline losses are estimated to be $500,000, $600,000, and $700,000 in fiscal years 2013-14, 2014-15, and 2015-16, respectively.

Amount of Governmental Bonds that May be Issued by Governments Qualifying for the "Small Governmental Unit" Arbitrage Rebate Exception; and, Issuance of Tax-Exempt Private Activity Bonds for Public School Facilities

Not applicable.

F. Other Incentives for Families and Children

<u>Background</u>

Adoption Credit and Exclusion from Income for Employer-Provided Adoption Assistance

Present law for 2012 provides: (1) a maximum adoption credit of $12,650 per eligible child (both special-needs and non-special-needs adoptions); and (2) a maximum exclusion for employer-provided adoption assistance of $12,650 per eligible child (both special-needs and non-special needs adoptions).[49] For 2012, the credit is not refundable. These dollar amounts are adjusted annually for inflation. These benefits are phased out over a $40,000 range for taxpayers with modified adjusted gross income in excess of certain dollar levels. For 2012, the phase-out range is between $189,710 and $229,710. The phase-out threshold is adjusted for inflation annually, but the phase-out range remains a $40,000 range. Under present law, for purposes of the credit and exclusion, a special-needs adoption finalized during the taxable year is deemed to include $12,650 of eligible expenses associated with that adoption, regardless of whether expenses rose

[49] IRC sections 36C and 137. EGTRRA increased the maximum credit and exclusion to $10,000 (indexed for inflation after 2002) for both non-special-needs and special-needs adoptions, and increased the phase-out starting point to $150,000 (indexed for inflation after 2002). Section 10909 of the Patient Protection and Affordable Care Act, Public Law 111-148: (1) extended the EGTRRA expansion of the adoption credit and exclusion for employer-provided adoption assistance for one year (for 2011); (2) increased by $1,000 (to $13,170, indexed for inflation) the maximum adoption credit and exclusion from income for employer-provided adoption assistance for two years (2010 and 2011); and (3) made the credit refundable for two years (2010 and 2011). The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 extended for one year (2012) the EGTRRA expansion of the adoption credit and the exclusion from income for employer-provided adoption assistance. The changes to the adoption credit and exclusion from employer-provided adoption assistance for 2010 and 2011 (relating to the $1,000 increase in the maximum credit and exclusion and the refundability of the credit), enacted as part of the Patient Protection and Affordable Care Act, were not extended by the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, or otherwise to date.

to that level. Present law allows taxpayers to claim the adoption credit against their alternative minimum tax liability.

For taxable years beginning after December 31, 2012, the amount of the adoption credit is reduced to $6,000, and only applies in the case of special-needs adoptions. The employer-provided adoption assistance exclusion terminates. The phase-out range is reduced to lower income levels (i.e., between $75,000 and $115,000). The maximum credit, exclusion, and phase-out range are not indexed for inflation. The provision providing for special rules regarding the expenses relating to special-needs adoptions do not apply, and the credit may not offset alternative minimum tax liability.

Employer-Provided Child Care Tax Credit

Taxpayers receive a tax credit equal to 25 percent of qualified expenses for employee child care and 10 percent of qualified expenses for child care resource and referral services. The maximum total credit that may be claimed by a taxpayer cannot exceed $150,000 per taxable year.

Qualified child care expenses include costs paid or incurred: (1) to acquire, construct, rehabilitate or expand property that is to be used as part of the taxpayer's qualified child care facility; (2) for the operation of the taxpayer's qualified child care facility, including the costs of training and certain compensation for employees of the child care facility, and scholarship programs; or (3) under a contract with a qualified child care facility to provide child care services to employees of the taxpayer. To be a qualified child care facility, the principal use of the facility must be for child care (unless it is the principal residence of the taxpayer), and the facility must meet all applicable state and local laws and regulations, including any licensing laws. A facility is not treated as a qualified child care facility with respect to a taxpayer unless: (1) it has open enrollment to the employees of the taxpayer; (2) use of the facility (or eligibility to use such facility) does not discriminate in favor of highly-compensated employees of the taxpayer (within the meaning of IRC section 414(q)); and (3) at least 30 percent of the children enrolled in the center are dependents of the taxpayer's employees, if the facility is the principal trade or business of the taxpayer. Qualified child care resource and referral expenses are amounts paid or incurred under a contract to provide child care resource and referral services to the employees of the taxpayer. Qualified child care services and qualified child care resource and referral expenditures must be provided (or be eligible for use) in a way that does not discriminate in favor of highly-compensated employees of the taxpayer (within the meaning of IRC section 414(q)).

Any amounts for which the taxpayer may otherwise claim a tax deduction are reduced by the amount of these credits. Similarly, if the credits are taken for expenses of acquiring, constructing, rehabilitating, or expanding a facility, the taxpayer's basis in the facility is reduced by the amount of the credits.

Credits taken for the expenses of acquiring, constructing, rehabilitating, or expanding a qualified facility are subject to recapture for the first ten years after the qualified child care facility is placed in service. The amount of recapture is reduced as a percentage of the applicable credit over the 10-year recapture period. Recapture takes effect if the taxpayer either ceases operation of the qualified child care facility or transfers its interest in the qualified child care facility without securing an agreement to assume recapture liability for the transferee. The recapture tax is not treated as a tax for purposes of determining the amount of other credits or determining the amount of the alternative minimum tax. Other rules apply.

This tax credit expires for taxable years beginning after December 31, 2012.

Dependent Care Tax Credit

The maximum dependent care tax credit is $1,050 (35 percent of up to $3,000 of eligible expenses) if there is one qualifying individual, and $2,100 (35 percent of up to $6,000 of eligible expenses) if there are two or more qualifying individuals.[50] The 35-percent credit rate is reduced, but not below 20 percent, by one percentage point for each $2,000 (or fraction thereof) of adjusted gross income (AGI) above $15,000. Therefore, the credit percentage is reduced to 20 percent for taxpayers with AGI over $43,000. Generally, eligible expenses include expenses for household services and expenses for the care of a qualifying individual but only if such expenses are incurred to enable the taxpayer to be gainfully employed.

The level of this credit is reduced for taxable years beginning after December 31, 2012, under EGTRRA.

<u>New Federal Law (IRC sections 21, 23, 36C, 45D, and 137)</u>

Adoption Credit and Exclusion from Income for Employer-Provided Adoption Assistance

The provision makes permanent the EGTRRA expansion of these two provisions. Therefore, for 2013, the maximum benefit is $12,170 (indexed for inflation after 2010). The adoption credit and exclusion are phased out ratably for taxpayers with modified adjusted gross income between $193,930 and $233,930 (indexed for inflation) for 2013.[51] The 2012 rules relating to expenses for special-needs adoptions are retained, and taxpayers remain able to offset their alternative minimum tax liability with the credit.

Employer-Provided Child Care Tax Credit

The provision makes permanent the EGTRRA expansion of the employer-provided child care tax credit.

Dependent Care Tax Credit

The provision makes permanent the EGTRRA expansion of the dependent care tax credit.

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[50] IRC section 21.

[51] The changes to the adoption credit and exclusion from employer-provided adoption assistance for 2010 and 2011 (relating to the $1,000 increase in the maximum credit and exclusion and the refundability of the credit) enacted as part of the Patient Protection and Affordable Care Act, are not extended or made permanent by the provision.

Effective Date

The provision applies to taxable years beginning after December 31, 2012.

California Law (R&TC sections 17052.6, 17052.17, 17052.18, 17052.25, 17131, 23617, and 23617.5)

Adoption Credit and Exclusion from Income for Employer-Provided Adoption Assistance

Adoption Credit

California does not conform to the federal adoption credit; instead, the Personal Income Tax Law provides a stand-alone state credit for adoption costs.[52] The state adoption credit is equal to 50 percent of the cost of adopting a minor child who is an American citizen and is in the custody of a California public agency or a political subdivision of California. The credit is claimed in the taxable year in which the decree or order of adoption is entered, although qualifying costs paid or incurred in prior years can qualify for the credit.

Costs eligible for the credit include: (1) fees for required services of either the Department of Social Services or a licensed adoption agency, (2) travel and related expenses for the adoptive family that are directly related to the adoption process, and (3) medical fees and expenses that are not reimbursed by insurance and are directly related to the adoption process.

The maximum allowable credit cannot exceed $2,500 per minor child. The credit cannot reduce regular tax below tentative minimum tax for alternative minimum tax purposes; however, credit amounts subject to this limitation may be carried over to succeeding taxable years until exhausted.

Adoption Exclusion

The Personal Income Tax Law conforms to the employee gross income exclusion of expenses paid or reimbursed by an employer under an adoption assistance program as of the specified date of January 1, 2009.[53] Additionally, the Personal Income Tax Law conforms to the repeal of the EGTRRA sunset.[54] Thus, the EGTRRA expansion is permanent under California law; for 2013, the maximum benefit is $12,170 (indexed for inflation after 2010), and the exclusion is phased out ratably for taxpayers with modified adjusted gross income between $193,930 and $233,930 (indexed for inflation) for 2013.

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[52] R&TC section 17052.25.

[53] For taxable years beginning on or after January 1, 2010, R&TC section 17131 conforms to IRC section 137, relating to adoption assistance programs, as of the "specified date" of January 1, 2009.

[54] R&TC section 17024.5(a)(2)(B).

Employer-Provided Child Care Tax Credit

California does not conform to the federal employer-provided child care credit. California law previously provided a stand-alone state credit for employer-provided child care assistance;[55] however, that credit was repealed on December 1, 2012.

Expansion of Dependent Care Tax Credit

The Personal Income Tax Law allows a dependent care credit that is computed as a percentage of the allowable federal credit.[56] The credit percentage varies based on the taxpayer's federal adjusted gross income (AGI), as follows:

AGI Amount	Percentage
$40,000 or less	50 percent
$40,001 - $70,000	43 percent
$70,001 - $100,000	34 percent
Over $100,000	0 percent

The credit only applies to expenses for household services and care provided in this state. Other rules apply.

<u>Impact on California Revenue</u>

Adoption Credit and Exclusion from Income for Employer-Provided Adoption Assistance

Adoption Credit

Not applicable.

Adoption Exclusion

Baseline—based on a proration of the federal estimate developed for this provision by the Joint Committee on Taxation, baseline revenue losses are estimated to be $800,000, $1,000,000, and $1,000,000 in fiscal years 2013-14, 2014-15, and 2015-16, respectively.

Employer-Provided Child Care Tax Credit

Not applicable.

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[55] Former R&TC sections 17052.17 and 23617.5.

[56] R&TC section 17052.6.

Expansion of Dependent Care Tax Credit

Baseline—based on a proration of the federal estimate developed for this provision by the Joint Committee on Taxation, baseline revenue losses are estimated to be $8,300,000, $9,800,000, and $9,300,000 in fiscal years 2013-14, 2014-15, and 2015-16, respectively.

G. Alaska Native Settlement Trusts

Background

The Alaska Native Claims Settlement Act (ANCSA)[57] established Alaska Native Corporations to hold property for Alaska Natives. Alaska Natives are generally the only permitted common shareholders of those corporations under section 7(h) of the ANCSA, which provides restrictions regarding the transfer of Settlement Common Stock, unless an Alaska Native Corporation specifically allows other shareholders under specified procedures.

The ANCSA permits an Alaska Native Corporation to transfer money or other property to an Alaska Native Settlement Trust ("Settlement Trust") for the benefit of beneficiaries who constitute all or a class of the shareholders of the Alaska Native Corporation, to promote the health, education and welfare of beneficiaries and to preserve the heritage and culture of Alaska Natives.[58]

Alaska Native Corporations and Settlement Trusts, as well as their shareholders and beneficiaries, are generally subject to tax under the same rules and in the same manner as other taxpayers that are corporations, trusts, shareholders, or beneficiaries.

Special temporary tax rules enacted in EGTRRA[59] allow an election to use a more favorable tax regime for transfers of property by an Alaska Native Corporation to a Settlement Trust and for income taxation of the Settlement Trust.[60] There is also temporary simplified reporting to beneficiaries.[61]

Under the special tax rules, a Settlement Trust may make an irrevocable election to pay tax on taxable income at the lowest rate specified for individuals (rather than the highest rate that is generally applicable to trusts) and to pay tax on capital gains at a rate consistent with being subject to such lowest rate of tax. As described further below, beneficiaries may generally thereafter exclude from gross income distributions from a trust that has made this election. Also, contributions from an Alaska Native Corporation to an electing Settlement Trust generally will not

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57 43 U.S.C. 1601 *et. seq.*

58 With certain exceptions, once an Alaska Native Corporation has made a conveyance to a Settlement Trust, the assets conveyed shall not be subject to attachment, distraint, or sale or execution of judgment, except with respect to the lawful debts and obligations of the Settlement Trust.

59 The special rules were subsequently extended by the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, and sunset/expire for taxable years beginning after 2012.

60 IRC section 646.

61 IRC section 6039H, that sunsets/expires for taxable years beginning after 2012.

result in the recognition of gross income by beneficiaries on account of the contribution. An electing Settlement Trust remains subject to generally applicable requirements for classification and taxation as a trust.

A Settlement Trust distribution is excludable from the gross income of beneficiaries to the extent of the taxable income of the Settlement Trust for the taxable year and all prior taxable years for which an election was in effect, decreased by income tax paid by the Trust, plus tax-exempt interest from state and local bonds for the same period. Amounts distributed in excess of the amount excludable is taxed to the beneficiaries as if distributed by the sponsoring Alaska Native Corporation in the year of distribution by the Trust, which means that the beneficiaries must include in gross income as dividends the amount of the distribution, up to the current and accumulated earnings and profits of the Alaska Native Corporation. Amounts distributed in excess of the current and accumulated earnings and profits are not included in gross income by the beneficiaries.

A special loss disallowance rule reduces (but not below zero) any loss that would otherwise be recognized upon disposition of stock of a sponsoring Alaska Native Corporation by a proportion, determined on a per-share basis, of all contributions to all electing Settlement Trusts by the sponsoring Alaska Native Corporation. This rule prevents a stockholder from being able to take advantage of a decrease in value of an Alaska Native Corporation that is caused by a transfer of assets from the Alaska Native Corporation to a Settlement Trust.

The fiduciary of an electing Settlement Trust is obligated to provide certain information relating to distributions from the trust in lieu of reporting requirements under IRC section 6034A.

The earnings and profits of an Alaska Native Corporation are not reduced by the amount of its contributions to an electing Trust at the time of the contributions. However, the Alaska Native Corporation earnings and profits are reduced as and when distributions to the beneficiaries are thereafter made by the electing Trust that are taxed to the beneficiaries as dividends from the Alaska Native Corporation.

The election to pay tax at the lowest rate is not available in certain disqualifying cases: (a) where transfer restrictions have been modified either to allow a transfer of a beneficial interest that would not be permitted by section 7(h) of the Alaska Native Claims Settlement Act if the interest were Settlement Common Stock, or (b) where transfer restrictions have been modified to allow a transfer of any stock in an Alaska Native Corporation that would not be permitted by section 7(h) if it were Settlement Common Stock and the Alaska Native Corporation thereafter makes a transfer to the Trust. Where an election is already in effect at the time of such disqualifying situations, the special rules applicable to an electing trust cease to apply and rules generally applicable to trusts apply. In addition, the distributable net income of the trust is increased by undistributed current and accumulated earnings and profits of the trust, limited by the fair market value of trust assets at the date the trust becomes so disposable. The effect is to cause the trust to be taxed at regular trust rates on the amount of recomputed distributable net income not distributed to beneficiaries, and to cause the beneficiaries to be taxed on the amount of any distributions received consistent with the applicable tax-rate bracket.

New Federal Law (IRC section 646)

The provision makes permanent the EGTRRA amendments relating to electing Settlement Trusts.

Effective Date

The provision applies to taxable years beginning after December 31, 2012.

California Law (R&TC section 17734.6)

The Personal Income Tax Law specifically does not conform to the federal rules relating to the tax treatment of electing Alaska Native Settlement Trusts.

Impact on California Revenue

Not applicable.

H. Estate, Gift, and Generation Skipping Transfer Taxes

Background

In General

In general, a gift tax is imposed on certain lifetime transfers and an estate tax is imposed on certain transfers at death. A generation skipping transfer tax generally is imposed on certain transfers, made either directly or in trust or using a similar arrangement, to a ‘‘skip person’’ (i.e., a beneficiary in a generation more than one generation younger than that of the transferor). Transfers subject to the generation skipping transfer tax include direct skips, taxable terminations, and taxable distributions.

A unified credit is available with respect to taxable transfers by gift and at death.[62] The unified credit offsets tax computed at the lowest estate and gift tax rates on a specified amount of transfers, referred to as the applicable exclusion amount. The applicable exclusion amount for estate and gift tax is $5 million (indexed for inflation for years after 2011). For 2012, the inflation-indexed estate and gift tax applicable exclusion amount is $5.12 million. The generation skipping transfer tax exclusion is equal to the applicable exclusion amount for estate tax purposes. The top estate and gift tax rate is 35 percent.

A deduction is allowed for certain death taxes paid to any state or the District of Columbia.

The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (‘‘2010 Extension Act’’)[63] extended certain special temporary rules originally enacted as part of EGTRRA

[62] IRC section 2010.

[63] Public Law 111–312. Title III of the 2010 Extension Act generally extended and modified the estate and gift tax provisions of EGTRRA.

relating to: (1) allocation of generation skipping transfer tax exemption; (2) estate tax conservation easements; (3) installment payments of estate taxes, and (4) a deduction for certain death taxes paid (rather than a credit for state taxes paid, as explained below).

State Death Tax Credit; Deduction for State Death Taxes Paid

State Death Tax Credit under Prior Law

Prior to 2002, federal law allowed for a credit against the federal estate tax for any estate, inheritance, legacy or succession taxes (referred to as state death taxes) actually paid to any state or the District of Columbia with respect to any property included in the decedent's gross estate.[64] The maximum amount of credit was determined under a graduated rate table set forth in IRC section 2011(b), the top rate of which was 16 percent, which ties the maximum credit amount to the adjusted taxable estate, which is the taxable estate reduced by $60,000.

Phase-out of State Death Tax Credit; Deduction for State Death Taxes Paid

Under EGTRRA and the 2010 Extension Act, the amount of allowable state death tax credit was reduced from 2002 through 2004. For decedents dying after 2004 and before 2013, the state death tax credit was repealed and replaced with a deduction for death taxes actually paid to any state or the District of Columbia, in respect of property included in the gross estate of the decedent.[65] Such state taxes generally must be paid and claimed before the later of: (1) four years after the filing of the estate tax return; or (2) (a) 60 days after a decision of the U.S. Tax Court determining the estate tax liability becomes final, (b) the expiration of the period of extension to pay estate taxes over time under IRC section 6166, or (c) the expiration of the period of limitations in which to file a claim for refund or 60 days after a decision of a court in which such refund suit has become final. For decedents dying after 2012, the death tax credit as in effect for decedents who died prior to 2002 applies.

Portability of Unused Exclusion between Spouses

Under a temporary provision enacted as part of the 2010 Extension Act, any applicable exclusion amount that remains unused as of the death of a spouse who dies after December 31, 2010 (the deceased spousal unused exclusion amount), generally is available for use by the surviving spouse, as an addition to such surviving spouse's applicable exclusion amount.[66]

Sunset of EGTRRA and 2010 Extension Act Estate and Gift Tax Provisions

The estate, gift, and generation skipping transfer tax provisions of EGTRRA, as extended and modified by the 2010 Extension Act, apply for decedents dying, generation skipping transfers

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[64] IRC section 2011.

[65] IRC section 2058.

[66] IRC section 2010(c). The provision does not allow a surviving spouse to use the unused generation skipping transfer tax exemption of a predeceased spouse.

made, and gifts made before 2013. For transfers after December 31, 2012, the law scheduled to be in effect prior to the enactment of EGTRRA will apply. In general, this includes: (1) an estate and gift tax applicable exclusion amount of $1 million; (2) a top estate and gift tax rate of 55 percent; (3) no portability of unused exclusion between spouses; (4) a credit (rather than a deduction) for certain death taxes paid to any state or the District of Columbia; and (5) expiration of the special rules enacted under EGTRRA relating to allocation of generation skipping transfer tax exemption, estate tax conservation easements, and installment payments of estate taxes.

New Federal Law (IRC sections 2001 and 2010)

The provision makes permanent the estate and gift tax provisions of EGTRRA, as extended and modified by the 2010 Extension Act, with the modifications described below.

For 2013, the inflation-indexed estate and gift tax applicable exclusion amount is $5.25 million.

The provision also increases the top estate and gift tax rate to 40 percent and makes a technical correction to the portability provision.[67]

Effective Date

The provision generally is effective for decedents dying, generation skipping transfers made, and gifts made after December 31, 2012.

The technical correction to the portability provision is effective as if included in the 2010 Extension Act (i.e., effective for decedents dying after December 31, 2010).

California Law (R&TC sections 13302 and 18035.6)

California does not conform to the federal estate and generation skipping transfer taxes. California law imposes what is referred to as the estate "pick-up" tax. The “pick-up” tax is administered by the State Controller’s Office, and is a tax equal to the maximum federal estate “state death tax credit” allowed. However, the federal estate “state death tax credit” has been repealed since 2005, and this provision makes that repeal permanent;[68] thus, with no federal estate “state death tax credit,” there is no state “pick up” tax.

[67] IRC section 2010(c)(4)(B)(i) is amended replacing ‘‘basic exclusion amount’’ with ‘‘applicable exclusion amount’’ to reflect the original intent of the statute. See, Joint Committee on Taxation, General Explanation of Tax Legislation Enacted in the 111th Congress (JCS–2–11), March 2011; and Joint Committee on Taxation, ERRATA—General Explanation of Tax Legislation Enacted in the 111th Congress (JCX–20–11), March 2011.

[68] Specifically, the federal estate tax credit was repealed temporarily by EGTRRA for decedents dying after 2004 and before 2011 (and replaced with a deduction for death taxes actually paid to any state or the District of Columbia). The 2010 Extension Act extended the repeal of the federal estate tax credit, and the deduction for death taxes actually paid to any state or the District of Columbia for two years, for decedents dying before 2013. This provision makes permanent the repeal of the federal estate state death tax credit and replacement with a deduction for death taxes actually paid to any state or the District of Columbia.

Impact on California Revenue

Defer to the State Controller's Office.

I. Reduced Rates on Capital Gains and Dividends

Background

Capital Gains

In General

In general, gain or loss reflected in the value of an asset is not recognized for income tax purposes until a taxpayer disposes of the asset. On the sale or exchange of a capital asset, any gain generally is included in income. Any net capital gain of an individual generally is taxed at rates lower than rates applicable to ordinary income. Net capital gain is the excess of the net long-term capital gain for the taxable year over the net short-term capital loss for the year. Gain or loss is treated as long-term if the asset is held for more than one year.

Capital losses generally are deductible in full against capital gains. In addition, individual taxpayers may deduct capital losses against up to $3,000 of ordinary income in each year. Any remaining unused capital losses may be carried forward indefinitely to another taxable year.

A capital asset generally means any property except: (1) inventory, stock in trade, or property held primarily for sale to customers in the ordinary course of the taxpayer's trade or business, (2) depreciable or real property used in the taxpayer's trade or business, (3) specified literary or artistic property, (4) business accounts or notes receivable, (5) certain U.S. publications, (6) certain commodity derivative financial instruments, (7) hedging transactions, and (8) business supplies. In addition, the net gain from the disposition of certain property used in the taxpayer's trade or business is treated as long-term capital gain. Gain from the disposition of depreciable personal property is not treated as capital gain to the extent of all previous depreciation allowances. Gain from the disposition of depreciable real property is generally not treated as capital gain to the extent of the depreciation allowances in excess of the allowances available under the straight-line method of depreciation.

Tax Rates Before 2013

Under present law, for taxable years beginning before January 1, 2013, the maximum rate of tax on the adjusted net capital gain of an individual is 15 percent. Any adjusted net capital gain which otherwise would be taxed at a 10- or 15-percent rate is taxed at a zero rate. These rates apply for purposes of both the regular tax and the alternative minimum tax.

Under present law, the "adjusted net capital gain" of an individual is the net capital gain reduced (but not below zero) by the sum of the 28-percent rate gain and the unrecaptured IRC section 1250 gain. The net capital gain is reduced by the amount of gain that the individual treats as investment income for purposes of determining the investment interest limitation under IRC section 163(d).

The term "28-percent rate gain" means the excess of the sum of the amount of net gain attributable to long-term capital gains and losses from the sale or exchange of collectibles (as defined in IRC section 408(m) without regard to paragraph (3) thereof) and the amount of gain equal to the additional amount of gain that would be excluded from gross income under IRC section 1202 (relating to certain small business stock) if the percentage limitations of IRC section 1202(a) did not apply, over the sum of the net short-term capital loss for the taxable year and any long-term capital loss carryover to the taxable year.

"Unrecaptured IRC section 1250 gain" means any long-term capital gain from the sale or exchange of IRC section 1250 property (i.e., depreciable real estate) held more than one year to the extent of the gain that would have been treated as ordinary income if IRC section 1250 applied to all depreciation, reduced by the net loss (if any) attributable to the items taken into account in computing 28-percent-rate gain. The amount of unrecaptured IRC section 1250 gain (before the reduction for the net loss) attributable to the disposition of property to which IRC section 1231 (relating to certain property used in a trade or business) applies may not exceed the net IRC section 1231 gain for the year.

An individual's unrecaptured IRC section 1250 gain is taxed at a maximum rate of 25 percent, and the 28-percent-rate gain is taxed at a maximum rate of 28 percent. Any amount of unrecaptured IRC section 1250 gain or 28-percent rate gain otherwise taxed at a 10- or 15-percent rate is taxed at the otherwise applicable rate.

Tax Rates After 2012

For taxable years beginning after December 31, 2012, the maximum rate of tax on the adjusted net capital gain of an individual is 20 percent. Any adjusted net capital gain which otherwise would be taxed at the 15-percent rate is taxed at a 10-percent rate.

In addition, any gain from the sale or exchange of property held more than five years that would otherwise have been taxed at the 10-percent capital-gain rate is taxed at an 8-percent rate. Any gain from the sale or exchange of property held more than five years and the holding period for which began after December 31, 2000, that would otherwise have been taxed at a 20-percent rate, is taxed at an 18-percent rate.

The tax rates on 28-percent gain and unrecaptured IRC section 1250 gain are the same as for taxable years beginning before 2013.

For taxable years beginning after December 31, 2012, a tax is imposed on net investment income (which includes net gain included in gross income from the disposition of property other than certain property held in a trade or business) in the case of an individual, estate, or trust. In the case of an individual, the tax is 3.8 percent of the lesser of net investment income or the excess of modified adjusted gross income over the threshold amount.[69] The threshold amount is $250,000 in the case of a joint return or surviving spouse, $125,000 in the case of a married individual filing a separate return, and $200,000 in any other case.

Dividends

In General

A dividend is the distribution of property made by a corporation to its shareholders out of its after-tax earnings and profits.

Tax Rates Before 2013

An individual's qualified dividend income is taxed at the same rates that apply to net capital gain. This treatment applies for purposes of both the regular tax and the alternative minimum tax. Thus, for taxable years beginning before 2013, an individual's qualified dividend income is taxed at rates of zero and 15 percent. The zero-percent rate applies to qualified dividend income which otherwise would be taxed at a 10- or 15-percent rate if the special rates did not apply.

Qualified dividend income generally includes dividends received from domestic corporations and qualified foreign corporations. The term "qualified foreign corporation" includes a foreign corporation that is eligible for the benefits of a comprehensive income tax treaty with the United States which the Treasury Department determines to be satisfactory and that includes an exchange-of-information program. In addition, a foreign corporation is treated as a qualified foreign corporation for any dividend paid by the corporation with respect to stock that is readily tradable on an established securities market in the United States.

If a shareholder does not hold a share of stock for more than 60 days during the 121-day period beginning 60 days before the ex-dividend date (as measured under IRC section 246(c)), dividends received on the stock are not eligible for the reduced rates. Also, the reduced rates are not available for dividends to the extent that the taxpayer is obligated to make related payments with respect to positions in substantially similar or related property.

Dividends received from a corporation that is a passive foreign investment company (as defined in IRC section 1297) in either the taxable year of the distribution, or the preceding taxable year, are not qualified dividends.

Special rules apply in determining a taxpayer's foreign tax credit limitation under IRC section 904 in the case of qualified dividend income. For these purposes, rules similar to the rules of IRC section 904(b)(2)(B) concerning adjustments to the foreign tax credit limitation to reflect any capital gain rate differential will apply to any qualified dividend income.

[69] The tax is subject to the individual estimated tax provisions. The tax is not deductible in computing any tax imposed by subtitle A of the IRC (relating to income taxes).

If a taxpayer receives an extraordinary dividend (within the meaning of IRC section 1059(c)) eligible for the reduced rates with respect to any share of stock, any loss on the sale of the stock is treated as a long-term capital loss to the extent of the dividend.

A dividend is treated as investment income for purposes of determining the amount of deductible investment interest only if the taxpayer elects to treat the dividend as not eligible for the reduced rates.

The amount of dividends qualifying for reduced rates that may be paid by a regulated investment company (RIC) for any taxable year in which the qualified dividend income received by the RIC is less than 95 percent of its gross income (as specially computed) may not exceed the sum of: (1) the qualified dividend income of the RIC for the taxable year, and (2) the amount of earnings and profits accumulated in a non-RIC taxable year that were distributed by the RIC during the taxable year.

The amount of dividends qualifying for reduced rates that may be paid by a real estate investment trust (REIT) for any taxable year may not exceed the sum of: (1) the qualified dividend income of the REIT for the taxable year, (2) an amount equal to the excess of the income subject to the taxes imposed by IRC section 857(b)(1) and the regulations prescribed under IRC section 337(d) for the preceding taxable year over the amount of these taxes for the preceding taxable year, and (3) the amount of earnings and profits accumulated in a non-REIT taxable year that were distributed by the REIT during the taxable year.

The reduced rates do not apply to dividends received from an organization that was exempt from tax under IRC section 501 or was a tax-exempt farmers' cooperative in either the taxable year of the distribution or the preceding taxable year; dividends received from a mutual savings bank that received a deduction under IRC section 591; or deductible dividends paid on employer securities.[70]

Tax Rates After 2012

For taxable years beginning after 2012, all dividends received by an individual are taxed at ordinary income tax rates.

For taxable years beginning after December 31, 2012, a tax is imposed on net investment income in the case of an individual, estate, or trust. In the case of an individual, the tax is 3.8 percent of the lesser of net investment income, which includes dividends, or the excess of modified adjusted gross income over the threshold amount.[71] The threshold amount is $250,000 in the case of a

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[70] In addition, for taxable years beginning before 2013, amounts treated as ordinary income on the disposition of certain preferred stock (IRC section 306) are treated as dividends for purposes of applying the reduced rates; the tax rate for the accumulated earnings tax (IRC section 531) and the personal holding company tax (IRC section 541) is reduced to 15 percent; and the collapsible corporation rules (IRC section 341) are repealed.

[71] The tax is subject to the individual estimated tax provisions. The tax is not deductible in computing any tax imposed by subtitle A of the IRC (relating to income taxes).

joint return or surviving spouse, $125,000 in the case of a married individual filing a separate return, and $200,000 in any other case.

New Federal Law (IRC section 1)

Under the provision, the tax rates in effect before 2013 for adjusted net capital gain and qualified dividend income are made permanent, except that the 15-percent rate applies only to adjusted net capital gain and qualified dividend income which otherwise would be taxed at a rate below 39.6 percent under the regular tax. A 20-percent rate applies to amounts which would otherwise be taxed at a 39.6-percent rate.[72] These rates apply for purposes of both the regular tax and the alternative minimum tax. Thus, tax rates of 0, 15, and 20 percent apply to this income. The provision does not change the tax on net investment income.

Effective Date

The provision applies to taxable years beginning after December 31, 2012.

California Law (R&TC sections 17321, 18151, 24451, and 24990)

Dividends

The Personal Income Tax Law and the Corporation Tax Law generally conform to the federal rules for computing dividends.[73] However, the Personal Income Tax Law and the Corporation Tax Law do not provide special tax rates for dividends; instead, dividends are taxed at the same rates as ordinary income.

Capital Gains

The Personal Income Tax Law and the Corporation Tax Law generally conform to the federal rules for computing capital gains and losses.[74] However, the Personal Income Tax Law and the Corporation Tax Law do not provide special tax rates for net capital gain; instead, such gain is taxed at the same rates as ordinary income.

Impact on California Revenue

Not applicable.

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[72] The provisions set forth in the preceding footnote relating to IRC sections 306 and 341 are made permanent, and the tax rate for the accumulated earnings tax and the personal holding company tax is 20 percent.

[73] R&TC sections 17321 and 24451 conform to Subchapter C of Chapter 1 of Subtitle A of the IRC, relating to corporate distributions and adjustments, as of the "specified date" of January 1, 2009.

[74] R&TC sections 18151 and 24990 conform to Subchapter P of Chapter 1 of Subtitle A of the IRC, relating to capital gains and losses, as of the "specified date" of January 1, 2009.

J. The American Opportunity Tax Credit

Background

Hope Scholarship Credit

For taxable years beginning before 2009 and after 2012, individual taxpayers are allowed to claim a nonrefundable credit, the Hope credit, against federal income taxes of up to $1,800 (for 2008) per eligible student per year for qualified tuition and related expenses paid for the first two years of the student's post-secondary education in a degree or certificate program.[75] The Hope credit rate is 100 percent on the first $1,200 of qualified tuition and related expenses, and 50 percent on the next $1,200 of qualified tuition and related expenses; these dollar amounts are indexed for inflation, with the amount rounded down to the next lowest multiple of $100. Thus, for example, a taxpayer who incurs $1,200 of qualified tuition and related expenses for an eligible student is eligible (subject to the adjusted gross income phase-out described below) for a $1,200 Hope credit. If a taxpayer incurs $2,400 of qualified tuition and related expenses for an eligible student, then he or she is eligible for a $1,800 Hope credit.

The Hope credit that a taxpayer may otherwise claim is phased out ratably for taxpayers with modified AGI between $48,000 and $58,000 ($96,000 and $116,000 for married taxpayers filing a joint return) for 2008. The beginning points of the AGI phase-out ranges are indexed for inflation, with the amount rounded down to the next lowest multiple of $1,000. The size of the phase-out ranges are always $10,000 and $20,000, respectively.

The qualified tuition and related expenses must be incurred on behalf of the taxpayer, the taxpayer's spouse, or a dependent of the taxpayer. The Hope credit is available with respect to an individual student for two taxable years, provided that the student has not completed the first two years of post-secondary education before the beginning of the second taxable year.

The Hope credit is available in the taxable year the expenses are paid, subject to the requirement that the education is furnished to the student during that year or during an academic period beginning during the first three months of the next taxable year. Qualified tuition and related expenses paid with the proceeds of a loan generally are eligible for the Hope credit. The repayment of a loan itself is not a qualified tuition or related expense.

A taxpayer may claim the Hope credit with respect to an eligible student who is not the taxpayer or the taxpayer's spouse (e.g., in cases in which the student is the taxpayer's child) only if the taxpayer claims the student as a dependent for the taxable year for which the credit is claimed. If a student is claimed as a dependent, the student is not entitled to claim a Hope credit for that taxable year on the student's own tax return. If a parent (or other taxpayer) claims a student as a dependent, any qualified tuition and related expenses paid by the student are treated as paid by the parent (or other taxpayer) for purposes of determining the amount of qualified tuition and related expenses paid by such parent (or other taxpayer) under the provision. In addition, for each

[75] IRC section 25A. The Hope credit generally may not be claimed against a taxpayer's alternative minimum tax liability. However, the credit may be claimed against a taxpayer's alternative minimum tax liability for taxable years beginning prior to January 1, 2012.

taxable year, a taxpayer may elect the Hope credit, the Lifetime Learning credit, or an above-the-line deduction for qualified tuition and related expenses with respect to an eligible student.

The Hope credit is available for "qualified tuition and related expenses," that include tuition and fees (excluding nonacademic fees) required to be paid to an eligible educational institution as a condition of enrollment or attendance of an eligible student at the institution. Charges and fees associated with meals, lodging, insurance, transportation, and similar personal, living, or family expenses are not eligible for the credit. The expenses of education involving sports, games, or hobbies are not qualified tuition and related expenses unless this education is part of the student's degree program.

Qualified tuition and related expenses generally include only out-of-pocket expenses. Qualified tuition and related expenses do not include expenses covered by employer-provided educational assistance and scholarships that are not required to be included in the gross income of either the student or the taxpayer claiming the credit. Thus, total qualified tuition and related expenses are reduced by any scholarship or fellowship grants excludable from gross income under IRC section 117 and any other tax-free educational benefits received by the student (or the taxpayer claiming the credit) during the taxable year. The Hope credit is not allowed with respect to any education expense for which a deduction is claimed under IRC section 162 or any other section of the IRC.

An eligible student for purposes of the Hope credit is an individual who is enrolled in a degree, certificate, or other program (including a program of study abroad approved for credit by the institution at which such student is enrolled) leading to a recognized educational credential at an eligible educational institution. The student must pursue a course of study on at least a halftime basis. A student is considered to pursue a course of study on at least a half-time basis if the student carries at least one half the normal full-time work load for the course of study the student is pursuing for at least one academic period that begins during the taxable year. To be eligible for the Hope credit, a student must not have been convicted of a federal or state felony consisting of the possession or distribution of a controlled substance.

Eligible educational institutions generally are accredited post-secondary educational institutions offering credit toward a bachelor's degree, an associate's degree, or another recognized post-secondary credential. Certain proprietary institutions and post-secondary vocational institutions also are eligible educational institutions. To qualify as an eligible educational institution, an institution must be eligible to participate in Department of Education student aid programs.

American Opportunity Tax Credit

The American Opportunity Tax Credit refers to modifications to the Hope credit that apply for taxable years beginning in 2009, 2010, 2011, and 2012. The maximum allowable modified credit is $2,500 per eligible student per year for qualified tuition and related expenses paid for each of the first four years of the student's post-secondary education in a degree or certificate program. The modified credit rate is 100 percent on the first $2,000 of qualified tuition and related expenses, and 25 percent on the next $2,000 of qualified tuition and related expenses. For purposes of the modified credit, the definition of qualified tuition and related expenses is expanded to include course materials.

Under the provision, the modified credit is available with respect to an individual student for four years, provided that the student has not completed the first four years of post-secondary education before the beginning of the fourth taxable year. Thus, the modified credit, in addition to other modifications, extends the application of the Hope credit to two more years of postsecondary education.

The modified credit that a taxpayer may otherwise claim is phased out ratably for taxpayers with modified AGI between $80,000 and $90,000 ($160,000 and $180,000 for married taxpayers filing a joint return). The modified credit may be claimed against a taxpayer's alternative minimum tax liability.

Forty percent of a taxpayer's otherwise allowable modified credit is refundable. However, no portion of the modified credit is refundable if the taxpayer claiming the credit is a child to whom IRC section 1(g) applies for such taxable year (generally, any child who has at least one living parent, does not file a joint return, and is either under age 18 or under age 24 and a student providing less than one-half of his or her own support).

Bona fide residents of the U.S. possessions are not permitted to claim the refundable portion of the modified credit in the United States. Rather, a bona fide resident of a mirror IRC possession (Commonwealth of the Northern Mariana Islands, Guam, and the Virgin Islands) may claim the refundable portion of the credit in the possession in which the individual is a resident. Similarly, a bona fide resident of a non-mirror IRC possession (Commonwealth of Puerto Rico and American Samoa) may claim the refundable portion of the credit in the possession in which the individual is resident, but only if the possession establishes a plan for permitting the claim under its internal law. The U.S. Treasury will make payments to the possession in respect of credits allowable to their residents under their internal laws.

<u>New Federal Law (IRC section 25A)</u>

The provision extends for five years (through 2017) the temporary modifications to the Hope credit for taxable years beginning in 2009, 2010, 2011, and 2012 that are known as the American Opportunity Tax Credit, including the rules governing the treatment of the U.S. possessions.

<u>Effective Date</u>

The provision is effective for taxable years beginning after December 31, 2012.

<u>California Law (None)</u>

California does not conform to the Hope credit or to the American Opportunity Tax Credit modifications.

Impact on California Revenue

Not applicable.

K. Extension of Reduced Earnings Threshold for Additional Child Tax Credit

Background

An individual may claim a tax credit for each qualifying child under the age of 17. The maximum amount of the credit per child is $1,000 through 2012 and $500 thereafter. A child who is not a citizen, national, or resident of the United States cannot be a qualifying child.

The aggregate amount of child credits that may be claimed is phased out for individuals with income over certain threshold amounts. Specifically, the otherwise allowable aggregate child tax credit amount is reduced by $50 for each $1,000 (or fraction thereof) of modified adjusted gross income (modified AGI) over $75,000 for single individuals or heads of households, $110,000 for married individuals filing joint returns, and $55,000 for married individuals filing separate returns. For purposes of this limitation, modified AGI includes certain otherwise excludable income earned by U.S. citizens or residents living abroad or in certain U.S. territories.

The credit is allowable against the regular tax and, for taxable years beginning before January 1, 2013, is allowed against the alternative minimum tax (AMT). To the extent that the child tax credit exceeds the taxpayer's tax liability, the taxpayer is eligible for a refundable credit (the additional child tax credit) equal to 15 percent of earned income in excess of a threshold dollar amount (the earned-income formula). EGTRRA provided, in general, that this threshold dollar amount is $10,000 indexed for inflation from 2001. The American Recovery and Reinvestment Act, as extended by the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 ("2010 Extension Act")[76] set the threshold at $3,000 for taxable years 2009 to 2012. After 2012, the ability to determine the refundable child credit based on earned income in excess of the threshold dollar amount expires.

Families with three or more qualifying children may determine the additional child tax credit using the "alternative formula" if this results in a larger credit than determined under the earned-income formula. Under the alternative formula, the additional child tax credit equals the amount by which the taxpayer's social security taxes exceed the taxpayer's earned income tax credit (EITC). After 2012, due to the expiration of the earned-income formula, this is the only manner of obtaining a refundable child credit.

Earned income is defined as the sum of wages, salaries, tips, and other taxable employee compensation plus net self-employment earnings. Unlike the EITC, which also includes the preceding items in its definition of earned income, the additional child tax credit is based only on earned income to the extent it is included in computing taxable income. For example, some ministers' parsonage allowances are considered self-employment income, and thus are considered earned income for purposes of computing the EITC, but the allowances are excluded

[76] Public Law 111-312.

from gross income for individual income tax purposes, and thus are not considered earned income for purposes of the additional child tax credit since the income is not included in taxable income.

New Federal Law (IRC section 24)

The provision extends for five years the earned income threshold of $3,000.

Effective Date

The provision applies to taxable years beginning after December 31, 2012.

California Law (None)

California does not conform to the federal child tax credit.

Impact on California Revenue

Not applicable.

L. Extension and Modification of the Earned Income Tax Credit

Background

Overview

Low- and moderate-income workers may be eligible for the refundable earned income tax credit (EITC).[77] Eligibility for the EITC is based on earned income, adjusted gross income, investment income, filing status, number of children, and immigration and work status in the United States. The amount of the EITC is based on the presence and number of qualifying children in the worker's family, as well as on adjusted gross income and earned income.

The EITC generally equals a specified percentage of earned income[78] up to a maximum dollar amount. The maximum amount applies over a certain income range and then diminishes to zero over a specified phase-out range. For taxpayers with earned income (or adjusted gross income (AGI), if greater) in excess of the beginning of the phase-out range, the maximum EITC amount is reduced by the phase-out rate multiplied by the amount of earned income (or AGI, if greater) in excess of the beginning of the phase-out range. For taxpayers with earned income (or AGI, if greater) in excess of the end of the phase-out range, no credit is allowed.

[77] IRC section 32.

[78] For purposes of the EITC, earned income is defined as (1) wages, salaries, tips, and other employee compensation, but only if such amounts are includible in gross income, plus (2) the amount of the individual's net self-employment earnings. At the taxpayer's election, combat pay may be treated as earned income for these purposes.

An individual is not eligible for the EITC if the aggregate amount of disqualified income of the taxpayer for the taxable year exceeds $3,200 (for 2012). This threshold is indexed for inflation. Disqualified income is the sum of: (1) interest (both taxable and tax exempt); (2) dividends; (3) net rent and royalty income (if greater than zero); (4) capital gain net income; and (5) net passive income that is not self-employment income (if greater than zero).

The EITC is a refundable credit, meaning that if the amount of the credit exceeds the taxpayer's federal income tax liability, the excess is payable to the taxpayer as a direct transfer payment.

Filing Status

An unmarried individual may claim the EITC if he or she files as a single filer or as a head of household. Married individuals generally may not claim the EITC unless they file jointly. An exception to the joint-return filing requirement applies to certain spouses who are separated. Under this exception, a married taxpayer who is separated from his or her spouse for the last six months of the taxable year is not considered to be married (and, accordingly, may file a return as head of household and claim the EITC), provided that the taxpayer maintains a household that constitutes the principal place of abode for a dependent child (including a son, stepson, daughter, stepdaughter, adopted child, or a foster child) for over half the taxable year, and pays over half the cost of maintaining the household in which he or she resides with the child during the year.

Presence of Qualifying Children and Amount of the Earned Income Credit

Four separate credit schedules apply: one schedule for taxpayers with no qualifying children, one schedule for taxpayers with one qualifying child, one schedule for taxpayers with two qualifying children, and one schedule for taxpayers with three or more qualifying children.[79]

Taxpayers with no qualifying children may claim a credit if they are over age 24 and below age 65. The credit is 7.65 percent of earnings up to $6,210, resulting in a maximum credit of $475 for 2012. The maximum is available for those with incomes between $6,210 and $7,770 ($12,980 if married filing jointly). The credit begins to phase out at a rate of 7.65 percent of earnings above $7,770 ($12,980 if married filing jointly) resulting in a $0 credit at $13,980 of earnings ($19,190 if married filing jointly).

Taxpayers with one qualifying child may claim a credit in 2012 of 34 percent of their earnings up to $9,320, resulting in a maximum credit of $3,169. The maximum credit is available for those with earnings between $9,320 and $17,090 ($22,300 if married filing jointly). The credit begins to phase out at a rate of 15.98 percent of earnings above $17,090 ($22,300 if married filing jointly). The credit is completely phased out at $36,920 of earnings ($42,130 if married filing jointly).

Taxpayers with two qualifying children may claim a credit in 2012 of 40 percent of earnings up to $13,090, resulting in a maximum credit of $5,236. The maximum credit is available for those with earnings between $13,090 and $17,090 ($22,300 if married filing jointly). The credit begins

[79] All income thresholds are indexed for inflation annually.

to phase out at a rate of 21.06 percent of earnings above $17,090 ($22,300 if married filing jointly). The credit is completely phased out at $41,952 of earnings ($47,162 if married filing jointly).

A temporary provision enacted by the Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010[80] allows taxpayers with three or more qualifying children to claim a credit of 45 percent for 2011 and 2012. For example, in 2012 taxpayers with three or more qualifying children may claim a credit of 45 percent of earnings up to $13,090, resulting in a maximum credit of $5,891. The maximum credit is available for those with earnings between $13,090 and $17,090 ($22,300 if married filing jointly). The credit begins to phase out at a rate of 21.06 percent of earnings above $17,090 ($22,300 if married filing jointly). The credit is completely phased out at $45,060 of earnings ($50,270 if married filing jointly).

Under a provision of the American Recovery and Reinvestment Act of 2009, the phase-out thresholds for married couples were raised to an amount $5,000 (indexed for inflation from 2009) above that for other filers. The increase is $5,210 for 2012.

If more than one taxpayer lives with a qualifying child, only one of these taxpayers may claim the child for purposes of the EITC. If multiple eligible taxpayers actually claim the same qualifying child, then a tiebreaker rule determines which taxpayer is entitled to the EITC with respect to the qualifying child. Any eligible taxpayer with at least one qualifying child who does not claim the EITC with respect to qualifying children due to failure to meet certain identification requirements with respect to such children (i.e., providing the name, age and taxpayer identification number of each of such children) may not claim the EITC for taxpayers without qualifying children.

<u>New Federal Law (IRC section 32)</u>

The provision extends the EITC at a rate of 45 percent for three or more qualifying children for five years (through 2017).

The provision extends the higher phase-out thresholds for married couples filing joint returns enacted as part of ARRA for five years (through 2017).

<u>Effective Date</u>

The provision applies to taxable years beginning after December 31, 2012.

<u>California Law (None)</u>

California does not conform to the earned income tax credit.

<u>Impact on California Revenue</u>

Not applicable.

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[80] Public Law 111-312.

M. Refunds Disregarded in the Administration of Federal Programs and Federally Assisted Programs

Background

Any tax refund (or advance payment with respect to a refundable credit) made to any individual in calendar year 2010, 2011, or 2012 is not taken into account as a resource for a period of 12 months from receipt for purposes of determining the eligibility of such individual (or any other individual) for benefits or assistance (or the amount or extent of benefits or assistance) under any federal program or under any state or local program financed in whole or in part with federal funds.

New Federal Law (IRC section 6409)

The provision makes permanent the present law provision for any tax refund (or advance payment with respect to a refundable credit) made to any individual.

Effective Date

The provision is effective for amounts received after December 31, 2012.

California Law (None)

California does not conform to the federal eligibility benefit rules under IRC section 6409.

Impact on California Revenue

Not applicable.

Section	Section Title
104	Permanent Alternative Minimum Tax Relief

Background

Present law imposes an alternative minimum tax (AMT) on individuals. The AMT is the amount by which the tentative minimum tax exceeds the regular income tax. An individual's tentative minimum tax is the sum of: (1) 26 percent of so much of the taxable excess as does not exceed $175,000 ($87,500 in the case of a married individual filing a separate return) and (2) 28 percent of the remaining taxable excess. The taxable excess is so much of the alternative minimum taxable income (AMTI) as exceeds the exemption amount. The maximum tax rates on net capital gain and dividends used in computing the regular tax are used in computing the tentative minimum tax. AMTI is the individual's taxable income adjusted to take account of specified preferences and adjustments.

The exemption amounts are: (1) $74,450 for taxable years beginning in 2011 and $45,000 in taxable years beginning thereafter in the case of married individuals filing a joint return and surviving spouses; (2) $48,450 for taxable years beginning in 2011 and $33,750 in taxable years beginning thereafter in the case of other unmarried individuals; (3) $37,225 for taxable years beginning in 2011 and $22,500 in taxable years thereafter in the case of married individuals filing separate returns; and (4) $22,500 in the case of an estate or trust. The exemption amounts are phased out by an amount equal to 25 percent of the amount by which the individual's AMTI exceeds (1) $150,000 in the case of married individuals filing a joint return and surviving spouses, (2) $112,500 in the case of other unmarried individuals, and (3) $75,000 in the case of married individuals filing separate returns or an estate or a trust. These amounts are not indexed for inflation.

Present law provides for certain nonrefundable personal tax credits. These credits include the dependent care credit, the credit for the elderly and disabled, the adoption credit, the child credit, the credit for interest on certain home mortgages, the Hope Scholarship and Lifetime Learning credits, the credit for savers, the credit for certain nonbusiness energy property, the credit for residential energy efficient property, the credit for certain plug-in electric vehicles, the credit for alternative motor vehicles, the credit for new qualified plug-in electric drive motor vehicles, and the D.C. first-time homebuyer credit.

For taxable years beginning before 2012, the nonrefundable personal credits are allowed to the extent of the full amount of the individual's regular tax and alternative minimum tax. For taxable years beginning after 2011, the nonrefundable personal credits (other than the adoption credit, the child credit, the Hope Scholarship credit (for taxable years beginning after 2012), the credit for savers, the credit for residential energy efficient property, the credit for certain plug-in electric vehicles, the credit for alternative motor vehicles, and the credit for new qualified plug-in electric drive motor vehicles) are allowed only to the extent that the individual's regular income tax liability exceeds the individual's tentative minimum tax, determined without regard to the minimum tax foreign tax credit. The adoption credit, the child credit, the Hope Scholarship credit (for taxable years beginning before 2013), the credit for savers, the credit for residential energy efficient property, the credit for certain plug-in electric vehicles, the credit for alternative motor vehicles, and the credit for new qualified plug-in electric drive motor vehicles are allowed to the full extent of the individual's regular tax and alternative minimum tax.

<u>New Federal Law (IRC sections 23, 24, 25, 25A, 25B, 25C, 25D, 30, 30B, 30D, 55, and 1400C)</u>

The provision provides that the individual AMT exemption amounts for taxable years beginning in 2012 are $78,750, in the case of married individuals filing a joint return and surviving spouses, $50,600 in the case of other unmarried individuals, and $39,375 in the case of married individuals filing separate returns. The provision also permanently indexes the AMT exemption amounts for inflation (known as the permanent AMT "patch").

The provision permanently allows an individual to offset the entire regular tax liability and alternative minimum tax liability by the nonrefundable personal credits.

Effective Date

The provision is effective for taxable years beginning after December 31, 2011.

California Law (R&TC sections 17062, 23400, and 23455)

The Personal Income Tax Law and the Corporation Tax Law conform to federal AMT rules as of the "specified date" of January 1, 2009, with modifications.[81] As a result, the California AMT is similar to federal AMT in many respects, but California has its own AMT exemption amounts that are permanently indexed for California inflation. Thus, this provision's modification to permanently index the federal AMT exemption amounts (i.e., the permanent AMT "patch") has no impact on the California AMT.

Impact on California Revenue

Not applicable.

Section	Section Title
201	Extension of Deduction for Certain Expenses of Elementary and Secondary School Teachers

Background

In general, ordinary and necessary business expenses are deductible. However, unreimbursed employee business expenses generally are deductible only as an itemized deduction and only to the extent that the individual's total miscellaneous deductions (including employee business expenses) exceed two percent of adjusted gross income. For taxable years beginning after 2012, an individual's otherwise allowable itemized deductions may be further limited by the overall limitation on itemized deductions, which reduces itemized deductions for taxpayers with adjusted gross income in excess of a threshold amount. In addition, miscellaneous itemized deductions are not allowable under the alternative minimum tax.

Certain expenses of eligible educators are allowed as an above-the-line deduction. Specifically, for taxable years beginning prior to January 1, 2012, an above-the-line deduction is allowed for up to $250 annually of expenses paid or incurred by an eligible educator for books, supplies (other than nonathletic supplies for courses of instruction in health or physical education), computer equipment (including related software and services) and other equipment, and supplementary

[81] R&TC sections 17062 and 23400 conform to Part VI of Subchapter A of Chapter 1 of Subtitle A of the IRC, containing IRC sections 55 to 59, as of the "specified date" of January 1, 2009, with modifications.

materials used by the eligible educator in the classroom.[82] To be eligible for this deduction, the expenses must be otherwise deductible under IRC section 162 as a trade or business expense. A deduction is allowed only to the extent the amount of expenses exceeds the amount excludable from income under IRC section 135 (relating to education savings bonds), IRC section 529(c)(1) (relating to qualified tuition programs), and IRC section 530(d)(2) (relating to Coverdell education savings accounts).

An eligible educator is a kindergarten-through-grade-twelve teacher, instructor, counselor, principal, or aide in a school for at least 900 hours during a school year. A school means any school that provides elementary education or secondary education (kindergarten through grade 12), as determined under state law.

The above-the-line deduction for eligible educators is not allowed for taxable years beginning after December 31, 2011.

New Federal Law (IRC section 62)

The provision extends the deduction for eligible educator expenses for two years so that it is available for taxable years beginning before January 1, 2014.

Effective Date

The provision is effective for taxable years beginning after January 1, 2011.

California Law (R&TC section 17072)

The Personal Income Tax Law specifically does not conform to the above-the-line deduction for certain expenses of elementary and secondary school teachers. As a result, any amount that teachers deduct on their federal tax returns as "educator expenses" must be added back on their California tax returns by reporting this as a California adjustment on Schedule CA (540/540NR).

Impact on California Revenue

Not applicable.

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[82] IRC section 62(a)(2)(D).

Section	Section Title
202	Extension of Exclusion from Gross Income of Discharge of Qualified Principal Residence Indebtedness

Background

In General

Gross income includes income that is realized by a debtor from the discharge of indebtedness, subject to certain exceptions for debtors in Title 11 bankruptcy cases, insolvent debtors, certain student loans, certain farm indebtedness, and certain real property business indebtedness.[83] In cases involving discharges of indebtedness that are excluded from gross income under the exceptions to the general rule, taxpayers generally reduce certain tax attributes, including basis in property, by the amount of the discharge of indebtedness.

The amount of discharge of indebtedness excluded from income by an insolvent debtor not in a Title 11 bankruptcy case cannot exceed the amount by which the debtor is insolvent. In the case of a discharge in bankruptcy or where the debtor is insolvent, any reduction in basis may not exceed the excess of the aggregate bases of properties held by the taxpayer immediately after the discharge over the aggregate of the liabilities of the taxpayer immediately after the discharge.[84]

For all taxpayers, the amount of discharge of indebtedness generally is equal to the difference between the adjusted issue price of the debt being cancelled and the amount used to satisfy the debt. These rules generally apply to the exchange of an old obligation for a new obligation, including a modification of indebtedness that is treated as an exchange (a debt-for-debt exchange).

Qualified Principal Residence Indebtedness

An exclusion from gross income is provided for any discharge of indebtedness income by reason of a discharge (in whole or in part) of qualified principal residence indebtedness. Qualified principal residence indebtedness means acquisition indebtedness (within the meaning of IRC section 163(h)(3)(B), except that the dollar limitation is $2,000,000) with respect to the taxpayer's principal residence. Acquisition indebtedness with respect to a principal residence generally means indebtedness which is incurred in the acquisition, construction, or substantial improvement of the principal residence of the individual and is secured by the residence. It also includes refinancing of such indebtedness to the extent the amount of the indebtedness resulting from such refinancing does not exceed the amount of the refinanced indebtedness. For these purposes, the term "principal residence" has the same meaning as under IRC section 121.

[83] IRC sections 61(a)(12) and 108.

[84] IRC section 1017.

If, immediately before the discharge, only a portion of a discharged indebtedness is qualified principal residence indebtedness, the exclusion applies only to so much of the amount discharged as exceeds the portion of the debt which is not qualified principal residence indebtedness. Thus, assume that a principal residence is secured by an indebtedness of $1 million, of which $800,000 is qualified principal residence indebtedness. If the residence is sold for $700,000 and $300,000 debt is discharged, then only $100,000 of the amount discharged may be excluded from gross income under the qualified principal residence indebtedness exclusion.

The basis of the individual's principal residence is reduced by the amount excluded from income under the provision.

The qualified principal residence indebtedness exclusion does not apply to a taxpayer in a Title 11 case; instead the general exclusion rules apply. In the case of an insolvent taxpayer not in a Title 11 case, the qualified principal residence indebtedness exclusion applies unless the taxpayer elects to have the general exclusion rules apply instead.

The exclusion does not apply to the discharge of a loan if the discharge is on account of services performed for the lender or any other factor not directly related to a decline in the value of the residence or to the financial condition of the taxpayer.

The exclusion for qualified principal residence indebtedness is effective for discharges of indebtedness occurring before January 1, 2013.

<u>New Federal Law (IRC section 108)</u>

The provision extends the exclusion for qualified principal residence indebtedness for one year, for discharges of indebtedness occurring before January 1, 2014.

<u>Effective Date</u>

This provision applies to indebtedness discharged after December 31, 2012.

<u>California Law (R&TC sections 17071 and 17144.5)</u>

The Personal Income Tax Law generally conforms to the federal definition of gross income, and conforms to the federal rules for the exclusion of discharge-of-indebtedness income by reason of a discharge of qualified principal residence indebtedness (i.e., mortgage forgiveness debt relief), with the following modifications:

A. The exclusion does not apply to discharges occurring in 2013:

    - The California exclusion applies to discharges occurring on or after January 1, 2007, and before January 1, 2013.
    - The federal exclusion applies to discharges occurring on or after January 1, 2007, and before January 1, 2014.

B. The maximum amount of qualified principal residence indebtedness (i.e., the amount of principal residence indebtedness eligible for the exclusion) is reduced:

- The California maximum amount of qualified principal residence indebtedness is $800,000 ($400,000 in the case of a married individual/registered domestic partner (RDP) filing a separate return).
- The federal maximum amount of qualified principal residence indebtedness is $2,000,000 ($1,000,000 in the case of a married individual/RDP filing a separate return).

C. The total amount that may be excluded from gross income is limited.

- For discharges occurring in 2007 or 2008, California limits the total amount that may be excluded from gross income to $250,000 ($125,000 in the case of a married individual/RDP filing a separate return).
- For discharges occurring in 2009, 2010, 2011, or 2012, California limits the total amount that may be excluded from gross income to $500,000 ($250,000 in the case of a married individual/RDP filing a separate return).
- There is no comparable federal limitation in any year.

D. Interest and penalties are not imposed with respect to 2007 or 2009 discharges.

- California prohibits the imposition of any interest or penalties with respect to discharges of qualified principal residence that occurred during the 2007 or 2009 taxable years.
- There is no comparable federal prohibition.

If the amount of forgiven mortgage debt that is excludable for federal purposes is more than the amount excludable under California law, taxpayers report the difference as a California adjustment on Schedule CA (540/540NR). Additionally, taxpayers who exclude cancellation of indebtedness income for California purposes are required to file a copy of their federal returns including Form 982, Reduction of Tax Attributes Due to Discharge of Indebtedness (and Section 1082 Basis Adjustment), with their California returns.

<u>Impact on California Revenue</u>

None (the federal provision expired for discharges occurring after December 31, 2013).

Section	Section Title
203	Extension of Parity for Exclusion from Income for Employer-Provided Mass Transit and Parking Benefits

Background

Qualified transportation fringe benefits provided by an employer are excluded from an employee's gross income for income tax purposes and from an employee's wages for employment tax purposes.[85] Qualified transportation fringe benefits include parking, transit passes, vanpool benefits, and qualified bicycle commuting reimbursements. No amount is includible in the income of an employee merely because the employer offers the employee a choice between cash and qualified transportation fringe benefits (other than a qualified bicycle commuting reimbursement). Qualified transportation fringe benefits also include a cash reimbursement (under a bona fide reimbursement arrangement) by an employer to an employee for parking, transit passes, or vanpooling. In the case of transit passes, however, a cash reimbursement is considered a qualified transportation fringe benefit only if a voucher, or similar item that may be exchanged only for a transit pass, is not readily available for direct distribution by the employer to the employee.

Before February 17, 2009, the amount that could be excluded as qualified transportation fringe benefits was limited to $100 per month in combined transit pass and vanpool benefits and $175 per month in qualified parking benefits. These limits are adjusted annually for inflation, using 1998 as the base year; for 2012 the limits are $125 and $240, respectively. The American Recovery and Reinvestment Act of 2009[86] provided parity in qualified transportation fringe benefits by temporarily increasing the monthly exclusion for combined employer-provided transit pass and vanpool benefits to the same level as the exclusion for employer-provided parking, effective for months beginning on or after the date of enactment (February 17, 2009) and before January 1, 2011. The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010[87] extended parity in qualified transportation fringe benefits through December 31, 2011.

Effective January 1, 2012, the amount that can be excluded as qualified transportation fringe benefits is limited to $125 per month in combined transit pass and vanpool benefits and $240 per month in qualified parking benefits.

New Federal Law (IRC section 132)

The provision extends parity in qualified transportation fringe benefits through December 31, 2013. Thus, for 2012, the monthly limit on the exclusion for combined transit pass and vanpool benefits is $240.

[85] IRC sections 132(a)(5) and (f), 3121(a)(20), 3231(e)(5), 3306(b)(16), and 3401(a)(19).

[86] Public Law 111-5.

[87] Public Law 111-312.

In order for the extension to be effective retroactive to January 1, 2012, expenses incurred during 2012 by an employee for employer-provided vanpool and transit benefits may be reimbursed (under a bona fide reimbursement arrangement) by employers on a tax-free basis to the extent they exceed $125 per month and are less than $240 per month. Congress intends that the rule that an employer reimbursement is excludible only if vouchers are not available to provide the benefit shall continue to apply, except in the case of reimbursements for vanpool or transit benefits between $125 and $240 for months during 2012. Further, Congress intends that reimbursements for expenses incurred for months during 2012 may be made in addition to the provision of benefits or reimbursements of up to $245 per month for expenses incurred during 2013.

Effective Date

The provision is effective for months after December, 2011.

California Law (R&TC sections 17131 and 17149)

The Personal Income Tax Law generally conforms to the federal rules for items specifically excluded from gross income as of the "specified date" of January 1, 2009,[88] and as a result conforms to the federal exclusion for qualified transportation fringe benefits under IRC section 132 as of that "specified date." However, the Personal Income Tax Law additionally provides its own exclusion for qualified California transportation fringe benefits,[89] and this exclusion under state law is not subject to any limitation; thus, while California does not conform to the parity in qualified transportation fringe benefits that is being extended by this provision, the enhanced exclusion is allowable under current California law to the extent that the benefits are qualified California transportation benefits.

Impact on California Revenue

Baseline—although California does not conform to this provision because it was enacted after the "specified date," California's Personal Income Tax Law allows an unlimited exclusion for qualified California transportation fringe benefits.[90] Thus, because some employers are expected to change the amount of transportation fringe benefits offered based on this federal extension of parity of qualified transportation fringe benefits, this provision is estimated to result in a baseline revenue loss of $8,200,000 in fiscal year 2013-14.

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[88] R&TC section 17131 conforms to Part III of Subchapter B of Chapter 1 of Subtitle A of the IRC, containing IRC sections 101 to 138, as of the "specified date" of January 1, 2009, with modifications.

[89] R&TC section 17149.

[90] If taxpayers have qualified California transportation fringe benefits that are excludable for state purposes, but not excludable for federal purposes because of the federal limitations, they report the state-only excludable amounts as California adjustments on Schedule CA (540/540NR).

Section	Section Title
204	Extension of Mortgage Insurance Premiums Treated as Qualified Residence Interest

Background

In General

Present law provides that qualified residence interest is deductible notwithstanding the general rule that personal interest is nondeductible.[91]

Acquisition Indebtedness and Home Equity Indebtedness

Qualified residence interest is interest on acquisition indebtedness and home equity indebtedness with respect to a principal and a second residence of the taxpayer. The maximum amount of acquisition indebtedness is $1 million. The maximum amount of home equity indebtedness is $100,000. Acquisition indebtedness means debt that is incurred in acquiring, constructing, or substantially improving a qualified residence of the taxpayer, and that is secured by the residence. Home equity indebtedness is debt (other than acquisition indebtedness) that is secured by the taxpayer's principal or second residence, to the extent the aggregate amount of such debt does not exceed the difference between the total acquisition indebtedness with respect to the residence, and the fair market value of the residence.

Private Mortgage Insurance

Certain premiums paid or accrued for qualified mortgage insurance by a taxpayer during the taxable year in connection with acquisition indebtedness on a qualified residence of the taxpayer are treated as interest that is qualified residence interest and thus deductible.

The amount allowable as a deduction is phased out ratably by 10 percent for each $1,000 by which the taxpayer's adjusted gross income exceeds $100,000 ($500 and $50,000, respectively, in the case of a married individual filing a separate return). Thus, the deduction is not allowed if the taxpayer's adjusted gross income exceeds $110,000 ($55,000 in the case of married individual filing a separate return).

For this purpose, qualified mortgage insurance means mortgage insurance provided by the Veterans Administration, the Federal Housing Administration, or the Rural Housing Administration,[92] and private mortgage insurance (defined in section two of the Homeowners Protection Act of 1998 as in effect on January 1, 2013).

Amounts paid for qualified mortgage insurance that are properly allocable to periods after the close of the taxable year are treated as paid in the period to which they are allocated. No

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[91] IRC section 163(h).

[92] The Veterans Administration and the Rural Housing Administration have been succeeded by the Department of Veterans Affairs and the Rural Housing Service, respectively.

deduction is allowed for the unamortized balance if the mortgage is paid before its term (except in the case of qualified mortgage insurance provided by the Department of Veterans Affairs or the Rural Housing Service).

The provision does not apply with respect to any mortgage insurance contract issued before January 1, 2007.

The provision terminates for any amount paid or accrued after December 31, 2011, or properly allocable to any period after that date.

Reporting rules apply under the provision.

New Federal Law (IRC section 163)

The provision extends the deduction for private mortgage insurance premiums for two years, through 2013 (with respect to contracts entered into after December 31, 2006). Thus, the provision applies to amounts paid or accrued in 2012 and 2013 (and not properly allocable to any period after 2013).[93]

Effective Date

The provision is effective for amounts paid or accrued after December 31, 2011.

California Law (R&TC section 17225)

The Personal Income Tax Law specifically does not conform to the federal deduction for private mortgage insurance premiums. As a result, private mortgage insurance premiums are not deductible under California law, and taxpayers who deduct such premiums on their federal tax returns report the amount deducted for federal purposes as a California adjustment on Schedule CA (540/540NR).

Impact on California Revenue

Not applicable.

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[93] The provision corrects the names of the Department of Veterans Affairs and the Rural Housing Service.

Section	Section Title
205	Extension of Deduction of State and Local General Sales Taxes

Background

For purposes of determining regular tax liability, an itemized deduction is permitted for certain state and local taxes paid, including individual income taxes, real property taxes, and personal property taxes. The itemized deduction is not permitted for purposes of determining a taxpayer's alternative minimum taxable income. For taxable years beginning before 2012, 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 provided under present law for state and local income taxes. As is the case for state and local income taxes, the itemized deduction for state and local general sales taxes is not permitted for purposes of determining a taxpayer's alternative minimum taxable income.

Taxpayers have two options with respect to the determination of the sales tax deduction amount. Taxpayers may deduct the total amount of general state and local sales taxes paid by accumulating receipts showing general sales taxes paid. Alternatively, taxpayers may use tables created by the Secretary of the Treasury that show the allowable deduction. The tables are based on average consumption by taxpayers on a state-by-state basis taking into account number of dependents, modified adjusted gross income, and rates of state and local general sales taxation. Taxpayers who live in more than one jurisdiction during the tax year are required to pro-rate the table amounts based on the time they live in each jurisdiction. Taxpayers who use the tables created by the Secretary of the Treasury may, in addition to the table amounts, deduct eligible general sales taxes paid with respect to the purchase of motor vehicles, boats, and other items specified by the Secretary of the Treasury. Sales taxes for items that may be added to the tables are not reflected in the tables themselves.

A general sales tax is a tax imposed at one rate with respect to the sale at retail of a broad range of classes of items.[94] No deduction is allowed for any general sales tax imposed with respect to an item at a rate other than the general rate of tax. However, in the case of food, clothing, medical supplies, and motor vehicles, the above rules are relaxed in two ways. First, if the tax does not apply with respect to some or all of such items, a tax that applies to other such items can still be considered a general sales tax. Second, the rate of tax applicable with respect to some or all of these items may be lower than the general rate. However, in the case of motor vehicles, if the rate of tax exceeds the general rate, such excess is disregarded and the general rate is treated as the rate of tax.

A compensating use tax with respect to an item is treated as a general sales tax, provided such tax is complementary to a general sales tax and a deduction for sales taxes is allowable with respect to items sold at retail in the taxing jurisdiction that are similar to such item.

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[94] IRC section 164(b)(5)(B).

New Federal Law (IRC section 164)

The provision allowing taxpayers to elect to deduct state and local sales taxes in lieu of state and local income taxes is extended for two years, through December 31, 2013.

Effective Date

The provision applies to taxable years beginning after December 31, 2011.

California Law (R&TC section 17220)

The Personal Income Tax Law specifically does not conform to the federal deduction allowed for state and local sales taxes.

Impact on California Revenue

Not applicable.

Section	Section Title
206	Extension of Special Rule for Contributions of Capital Gain Real Property Made for Conservation Purposes

Background

Charitable Contributions Generally

In general, a deduction is permitted for charitable contributions, subject to certain limitations that depend on the type of taxpayer, the property contributed, and the donee organization. The amount of deduction generally equals the fair market value of the contributed property on the date of the contribution. Charitable deductions are provided for income, estate, and gift tax purposes.[95]

In general, in any taxable year, charitable contributions by a corporation are not deductible to the extent the aggregate contributions exceed 10 percent of the corporation's taxable income computed without regard to net operating or capital loss carrybacks. Total deductible contributions of an individual taxpayer to public charities, private operating foundations, and certain types of private non-operating foundations generally may not exceed 50 percent of the taxpayer's contribution base, which is the taxpayer's adjusted gross income for a taxable year (disregarding any net operating loss carryback). To the extent a taxpayer has not exceeded the 50-percent limitation: (1) contributions of capital gain property to public charities generally may be deducted up to 30 percent of the taxpayer's contribution base; (2) contributions of cash to most

[95] IRC sections 170, 2055, and 2522, respectively.

private non-operating foundations and certain other charitable organizations generally may be deducted up to 30 percent of the taxpayer's contribution base; and (3) contributions of capital gain property to private foundations and certain other charitable organizations generally may be deducted up to 20 percent of the taxpayer's contribution base.

Contributions in excess of the applicable percentage limits generally may be carried over and deducted over the next five taxable years, subject to the relevant percentage limitations on the deduction in each of those years.

Capital Gain Property

Capital gain property means any capital asset or property used in the taxpayer's trade or business the sale of which at its fair market value, at the time of contribution, would have resulted in gain that would have been long-term capital gain. Contributions of capital gain property to a qualified charity are deductible at fair market value within certain limitations. Contributions of capital gain property to charitable organizations described in IRC section 170(b)(1)(A) (e.g., public charities, private foundations other than private non-operating foundations, and certain governmental units) generally are deductible up to 30 percent of the taxpayer's contribution base. An individual may elect, however, to bring all these contributions of capital gain property for a taxable year within the 50-percent limitation category by reducing the amount of the contribution deduction by the amount of the appreciation in the capital gain property. Contributions of capital gain property to charitable organizations described in IRC section 170(b)(1)(B) (e.g., private non-operating foundations) are deductible up to 20 percent of the taxpayer's contribution base.

For purposes of determining whether a taxpayer's aggregate charitable contributions in a taxable year exceed the applicable percentage limitation, contributions of capital gain property are taken into account after other charitable contributions.

Qualified Conservation Contributions

Qualified conservation contributions are one exception to the ''partial-interest'' rule, which generally bars deductions for charitable contributions of partial interests in property.[96] A qualified conservation contribution is a contribution of a qualified real property interest to a qualified organization exclusively for conservation purposes. A qualified real property interest is defined as: (1) the entire interest of the donor other than a qualified mineral interest; (2) a remainder interest; or (3) a restriction (granted in perpetuity) on the use that may be made of the real property.

Qualified organizations include certain governmental units, public charities that meet certain public support tests, and certain supporting organizations.

Conservation purposes include: (1) the preservation of land areas for outdoor recreation by, or for the education of, the general public; (2) the protection of a relatively natural habitat of fish, wildlife, or plants, or similar ecosystem; (3) the preservation of open space (including farmland and forest land) where such preservation will yield a significant public benefit and is either for the

[96] IRC sections 170(f)(3)(B)(iii) and 170(h).

scenic enjoyment of the general public or pursuant to a clearly delineated federal, state, or local governmental conservation policy; and (4) the preservation of an historically important land area or a certified historic structure.

Qualified conservation contributions of capital gain property are subject to the same limitations and carryover rules as other charitable contributions of capital gain property.

Temporary Rules Regarding Contributions of Capital Gain Real Property for Conservation Purposes

In General

Under a temporary provision,[97] the 30-percent contribution base limitation on contributions of capital gain property by individuals does not apply to qualified conservation contributions (as defined under present law). Instead, individuals may deduct the fair market value of any qualified conservation contribution to the extent of the excess of 50 percent of the contribution base over the amount of all other allowable charitable contributions. These contributions are not taken into account in determining the amount of other allowable charitable contributions.

Individuals are allowed to carry over any qualified conservation contributions that exceed the 50-percent limitation for up to 15 years.

For example, assume an individual with a contribution base of $100 makes a qualified conservation contribution of property with a fair market value of $80 and makes other charitable contributions subject to the 50-percent limitation of $60. The individual is allowed a deduction of $50 in the current taxable year for the non-conservation contributions (50 percent of the $100 contribution base) and is allowed to carry over the excess $10 for up to 5 years. No current deduction is allowed for the qualified conservation contribution, but the entire $80 qualified conservation contribution may be carried forward for up to 15 years.

Farmers and Ranchers

In the case of an individual who is a qualified farmer or rancher for the taxable year in which the contribution is made, a qualified conservation contribution is allowable up to 100 percent of the excess of the taxpayer's contribution base over the amount of all other allowable charitable contributions.

In the above example, if the individual is a qualified farmer or rancher, in addition to the $50 deduction for non-conservation contributions, an additional $50 for the qualified conservation contribution is allowed and $30 may be carried forward for up to 15 years as a contribution subject to the 100-percent limitation.

In the case of a corporation (other than a publicly traded corporation) that is a qualified farmer or rancher for the taxable year in which the contribution is made, any qualified conservation

[97] IRC section 170(b)(1)(E).

contribution is allowable up to 100 percent of the excess of the corporation's taxable income (as computed under IRC section 170(b)(2)) over the amount of all other allowable charitable contributions. Any excess may be carried forward for up to 15 years as a contribution subject to the 100-percent limitation.[98]

As an additional condition of eligibility for the 100 percent limitation, with respect to any contribution of property in agriculture or livestock production, or that is available for such production, by a qualified farmer or rancher, the qualified real property interest must include a restriction that the property remains generally available for such production. (There is no requirement as to any specific use in agriculture or farming, or necessarily that the property be used for such purposes, merely that the property remain available for such purposes.)

A qualified farmer or rancher means a taxpayer whose gross income from the trade or business of farming (within the meaning of IRC section 2032A(e)(5)) is greater than 50 percent of the taxpayer's gross income for the taxable year.

Termination

The temporary rules regarding contributions of capital gain real property for conservation purposes do not apply to contributions made in taxable years beginning after December 31, 2011.[99]

New Federal Law (IRC section 170)

The provision extends the special rule regarding contributions of capital gain real property for conservation purposes for two years, for contributions made in taxable years beginning before January 1, 2014.

Effective Date

The provision is effective for contributions made in taxable years beginning after December 31, 2011.

California Law (R&TC sections 17201, 17275.5, and 24357-24357.9)

The Personal Income Tax Law conforms to the federal rules for charitable contributions as of the "specified date" of January 1, 2009, with modifications.[100] Thus, the Personal Income Tax Law generally conforms to the federal rules for general charitable contributions and the rules for contributions of capital gain property, but does not conform to the federal special rule regarding

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[98] IRC section 170(b)(2)(B).

[99] IRC sections 170(b)(1)(E)(vi) and 170(b)(2)(B)(iii).

[100] For taxable years beginning on or after January 1, 2010, R&TC section 17201 conforms to IRC section 170, relating to charitable contributions, as of the "specified date" of January 1, 2009, with modifications in R&TC section 17275.5.

contributions of capital gain real property for conservation purposes. As a result, qualified conservation contributions of capital gain real property under the Personal Income Tax Law are subject to the same limitations and carryover rules as other charitable contributions of capital gain property.

Under the Corporation Tax Law, California has stand-alone law for corporate charitable contribution deductions that incorporates some of the federal contribution rules by reference.[101] In general, in any taxable year, charitable contributions by a corporation are not deductible to the extent the aggregate contributions exceed 10 percent of the corporation's taxable income computed without regard to net operating or capital loss carrybacks, and any excess may be carried forward for up to five years.[102] The Corporation Tax Law provides its own rules for qualified conservation contributions that generally parallel the federal rules for such contributions;[103] for example, such contributions are not subject to the "partial interest" rule. However, the Corporation Tax Law does not conform to the federal special rule regarding contributions of capital gain real property (by certain corporate farmers and ranchers) for conservation purposes; instead, the amount of charitable contribution deduction for such contributed property is specifically limited to the adjusted basis of that property.[104]

Impact on California Revenue

None (the federal provision expired for contributions made in taxable years beginning after December 31, 2013).

Section	Section Title
207	Extension of Above-the-Line Deduction for Qualified Tuition and Related Expenses

Background

An individual is allowed a deduction for qualified tuition and related expenses for higher education paid by the individual during the taxable year.[105] The deduction is allowed in computing adjusted gross income. The term "qualified tuition and related expenses" is defined in the same manner as for the Hope and Lifetime Learning credits, and includes tuition and fees required for the enrollment or attendance of the taxpayer, the taxpayer's spouse, or any dependent of the taxpayer with respect to whom the taxpayer may claim a personal exemption, at an eligible institution of

[101] R&TC sections 24357-24357.9.

[102] R&TC section 24357.

[103] R&TC sections 24357.2 and 24357.7.

[104] R&TC section 24357.1.

[105] IRC section 222.

higher education for courses of instruction of such individual at such institution.[106] The expenses must be in connection with enrollment at an institution of higher education during the taxable year, or with an academic period beginning during the taxable year or during the first three months of the next taxable year. The deduction is not available for tuition and related expenses paid for elementary or secondary education.

The maximum deduction is $4,000 for an individual whose adjusted gross income for the taxable year does not exceed $65,000 ($130,000 in the case of a joint return), or $2,000 for other individuals whose adjusted gross income does not exceed $80,000 ($160,000 in the case of a joint return). No deduction is allowed for an individual whose adjusted gross income exceeds the relevant adjusted gross income limitations, for a married individual who does not file a joint return, or for an individual with respect to whom a personal exemption deduction may be claimed by another taxpayer for the taxable year. The deduction is not available for taxable years beginning after December 31, 2011.

The amount of qualified tuition and related expenses must be reduced by certain scholarships, educational assistance allowances, and other amounts paid for the benefit of such individual,[107] and by the amount of such expenses taken into account for purposes of determining any exclusion from gross income of: (1) income from certain U.S. savings bonds used to pay higher education tuition and fees; and (2) income from a Coverdell education savings account.[108] Additionally, such expenses must be reduced by the earnings portion (but not the return of principal) of distributions from a qualified tuition program if an exclusion from income under IRC section 529 is claimed with respect to expenses eligible for the qualified tuition deduction. No deduction is allowed for any expense for which a deduction is otherwise allowed or with respect to an individual for whom a Hope or Lifetime Learning credit is elected for such taxable year.

<u>New Federal Law (IRC section 222)</u>

The provision extends the qualified tuition deduction for two years, through 2013.

<u>Effective Date</u>

The provision is effective for taxable years beginning after December 31, 2011.

<u>California Law (R&TC section 17204.7)</u>

California specifically does not conform to the federal qualified tuition deduction. As a result, California does not allow a deduction for qualified tuition and related expenses, and taxpayers

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[106] The deduction generally is not available for expenses with respect to a course or education involving sports, games, or hobbies, and is not available for student activity fees, athletic fees, insurance expenses, or other expenses unrelated to an individual's academic course of instruction.

[107] IRC sections 222(d)(1) and 25A(g)(2).

[108] IRC section 222(c). These reductions are the same as those that apply to the Hope and Lifetime Learning credits.

who deduct such expenses on their federal tax returns report the amount deducted for federal purposes as a California adjustment on Schedule CA (540/540NR).

Impact on California Revenue

Not applicable.

Section	Section Title
208	Extension of Tax-Free Distributions from Individual Retirement Plans for Charitable Purposes

Background

In General

If an amount withdrawn from a traditional individual retirement arrangement (IRA) or a Roth IRA is donated to a charitable organization, the rules relating to the tax treatment of withdrawals from IRAs apply to the amount withdrawn and the charitable contribution is subject to the normally applicable limitations on the deductibility of such contributions. An exception applies in the case of a qualified charitable distribution.

Charitable Contributions

In computing taxable income, an individual taxpayer who itemizes deductions generally is allowed to deduct the amount of cash and up to the fair market value of property contributed to the following entities: (1) a charity described in IRC section 170(c)(2); (2) certain veterans' organizations, fraternal societies, and cemetery companies;[109] and (3) a federal, state, or local governmental entity, but only if the contribution is made for exclusively public purposes.[110] The deduction also is allowed for purposes of calculating alternative minimum taxable income.

The amount of the deduction allowable for a taxable year with respect to a charitable contribution of property may be reduced depending on the type of property contributed, the type of charitable organization to which the property is contributed, and the income of the taxpayer.[111]

A taxpayer who takes the standard deduction (i.e., who does not itemize deductions) may not take a separate deduction for charitable contributions.[112]

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[109] IRC sections 170(c)(3)-(5).

[110] IRC section 170(c)(1).

[111] IRC sections 170(b) and (e).

[112] IRC section 170(a).

A payment to a charity (regardless of whether it is termed a ‘‘contribution’’) in exchange for which the donor receives an economic benefit is not deductible, except to the extent that the donor can demonstrate, among other things, that the payment exceeds the fair market value of the benefit received from the charity. To facilitate distinguishing charitable contributions from purchases of goods or services from charities, present law provides that no charitable contribution deduction is allowed for a separate contribution of $250 or more unless the donor obtains a contemporaneous written acknowledgement of the contribution from the charity indicating whether the charity provided any good or service (and an estimate of the value of any such good or service provided) to the taxpayer in consideration for the contribution.[113] In addition, present law requires that any charity that receives a contribution exceeding $75 made partly as a gift and partly as consideration for goods or services furnished by the charity (a ‘‘quid-pro-quo’’ contribution) is required to inform the contributor in writing of an estimate of the value of the goods or services furnished by the charity and that only the portion exceeding the value of the goods or services may be deductible as a charitable contribution.[114]

Under present law, total deductible contributions of an individual taxpayer to public charities, private operating foundations, and certain types of private non-operating foundations generally may not exceed 50 percent of the taxpayer’s contribution base, which is the taxpayer’s adjusted gross income for a taxable year (disregarding any net operating loss carryback). To the extent a taxpayer has not exceeded the 50-percent limitation, (1) contributions of capital gain property to public charities generally may be deducted up to 30 percent of the taxpayer’s contribution base, (2) contributions of cash to most private non-operating foundations and certain other charitable organizations generally may be deducted up to 30 percent of the taxpayer’s contribution base, and (3) contributions of capital gain property to private foundations and certain other charitable organizations generally may be deducted up to 20 percent of the taxpayer’s contribution base.

Contributions by individuals in excess of the 50-percent, 30-percent, and 20-percent limits generally may be carried over and deducted over the next five taxable years, subject to the relevant percentage limitations on the deduction in each of those years.

In general, a charitable deduction is not allowed for income, estate, or gift tax purposes if the donor transfers an interest in property to a charity (e.g., a remainder) while also either retaining an interest in that property (e.g., an income interest) or transferring an interest in that property to a non-charity for less than full and adequate consideration.[115] Exceptions to this general rule are provided for, among other interests, remainder interests in charitable remainder annuity trusts, charitable remainder unitrusts, pooled income funds, and present interests in the form of a

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[113] IRC section 170(f)(8). For any contribution of cash, check, or other monetary gift, no deduction is allowed unless the donor maintains as a record of such contribution a bank record or written communication from the donee charity showing the name of the donee organization, the date of the contribution, and the amount of the contribution. IRC section 170(f)(17).

[114] IRC section 6115.

[115] IRC sections 170(f), 2055(e)(2), and 2522(c)(2).

guaranteed annuity or a fixed percentage of the annual value of the property.[116] For such interests, a charitable deduction is allowed to the extent of the present value of the interest designated for a charitable organization.

IRA Rules

Within limits, individuals may make deductible and nondeductible contributions to a traditional IRA. Amounts in a traditional IRA are includible in income when withdrawn (except to the extent the withdrawal represents a return of nondeductible contributions). Certain individuals also may make nondeductible contributions to a Roth IRA (deductible contributions cannot be made to Roth IRAs). Qualified withdrawals from a Roth IRA are excludable from gross income. Withdrawals from a Roth IRA that are not qualified withdrawals are includible in gross income to the extent attributable to earnings. Includible amounts withdrawn from a traditional IRA or a Roth IRA before attainment of age 59½ are subject to an additional 10-percent early withdrawal tax, unless an exception applies. Under present law, minimum distributions are required to be made from tax-favored retirement arrangements, including IRAs. Minimum required distributions from a traditional IRA must generally begin by April 1 of the calendar year following the year in which the IRA owner attains age 70½.[117]

If an individual has made nondeductible contributions to a traditional IRA, a portion of each distribution from an IRA is nontaxable until the total amount of nondeductible contributions has been received. In general, the amount of a distribution that is nontaxable is determined by multiplying the amount of the distribution by the ratio of the remaining nondeductible contributions to the account balance. In making the calculation, all traditional IRAs of an individual are treated as a single IRA, all distributions during any taxable year are treated as a single distribution, and the value of the contract, income on the contract, and investment in the contract are computed as of the close of the calendar year.

In the case of a distribution from a Roth IRA that is not a qualified distribution, in determining the portion of the distribution attributable to earnings, contributions, and distributions are deemed to be distributed in the following order: (1) regular Roth IRA contributions; (2) taxable conversion contributions;[118] (3) nontaxable conversion contributions; and (4) earnings. In determining the amount of taxable distributions from a Roth IRA, all Roth IRA distributions in the same taxable year are treated as a single distribution, all regular Roth IRA contributions for a year are treated as a single contribution, and all conversion contributions during the year are treated as a single contribution.

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[116] IRC section 170(f)(2).

[117] Minimum distribution rules also apply in the case of distributions after the death of a traditional or Roth IRA owner.

[118] Conversion contributions refer to conversions of amounts in a traditional IRA to a Roth IRA.

Distributions from an IRA (other than a Roth IRA) are generally subject to withholding unless the individual elects not to have withholding apply.[119] Elections not to have withholding apply are to be made in the time and manner prescribed by the Secretary of the Treasury.

Qualified Charitable Distributions

Under a temporary provision applicable for taxable years beginning before January 1, 2012, otherwise taxable IRA distributions from a traditional or Roth IRA are excluded from gross income to the extent they are qualified charitable distributions.[120] The exclusion may not exceed $100,000 per taxpayer per taxable year. Special rules apply in determining the amount of an IRA distribution that is otherwise taxable. The otherwise applicable rules regarding taxation of IRA distributions and the deduction of charitable contributions continue to apply to distributions from an IRA that are not qualified charitable distributions. A qualified charitable distribution is taken into account for purposes of the minimum distribution rules applicable to traditional IRAs to the same extent the distribution would have been taken into account under such rules had the distribution not been directly distributed under the qualified charitable distribution provision. An IRA does not fail to qualify as an IRA as a result of qualified charitable distributions being made from the IRA.

A qualified charitable distribution is any distribution from an IRA directly by the IRA trustee to an organization described in IRC section 170(b)(1)(A) (other than an organization described in IRC section 509(a)(3) or a donor advised fund (as defined in IRC section 4966(d)(2)). Distributions are eligible for the exclusion only if made on or after the date the IRA owner attains age 70½ and only to the extent the distribution would be includible in gross income (without regard to this provision).

The exclusion applies only if a charitable contribution deduction for the entire distribution otherwise would be allowable (under present law), determined without regard to the generally applicable percentage limitations. Thus, for example, if the deductible amount is reduced because of a benefit received in exchange, or if a deduction is not allowable because the donor did not obtain sufficient substantiation, the exclusion is not available with respect to any part of the IRA distribution.

If the IRA owner has any IRA that includes nondeductible contributions, a special rule applies in determining the portion of a distribution that is includible in gross income (but for the qualified charitable distribution provision) and thus is eligible for qualified charitable distribution treatment. Under the special rule, the distribution is treated as consisting of income first, up to the aggregate amount that would be includible in gross income (but for the qualified charitable distribution provision) if the aggregate balance of all IRAs having the same owner were distributed during the same year. In determining the amount of subsequent IRA distributions includible in income,

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[119] IRC section 3405.

[120] IRC section 408(d)(8). The exclusion does not apply to distributions from employer-sponsored retirement plans, including SIMPLE IRAs and simplified employee pensions (SEPs).

proper adjustments are to be made to reflect the amount treated as a qualified charitable distribution under the special rule.

Distributions that are excluded from gross income by reason of the qualified charitable distribution provision are not taken into account in determining the deduction for charitable contributions under IRC section 170.

Under present law, the exclusion does not apply to distributions made in taxable years beginning after December 31, 2011.

New Federal Law (IRC section 408)

The provision extends the exclusion for qualified charitable distributions for two years, to distributions made in taxable years beginning before January 1, 2014.

The provision contains two special rules. First, the provision permits taxpayers to elect (in such form and manner as the Secretary of the Treasury may prescribe) to have qualified charitable distributions made in January 2013 treated as having been made on December 31, 2012, for purposes of IRC sections 408(a)(6), 408(b)(3), and 408(d)(8). Thus, a qualified charitable distribution made in January 2013 is permitted to be (1) treated as made in the taxpayer's 2012 taxable year and thus permitted to count against the 2012 $100,000 limitation on the exclusion, and (2) treated as made in the 2012 calendar year and thus permitted to be used to satisfy the taxpayer's minimum distribution requirement for 2012.

Second, the provision permits taxpayers to elect (in such form and manner as the Secretary of the Treasury may prescribe) to treat any portion of a distribution from an IRA that occurred after November 30, 2012, and before January 1, 2013, as a qualified charitable distribution to the extent that the following requirements are met: (1) the portion is transferred in cash, after the distribution and before February 1, 2013, to a charitable organization described in section 408(d)(8)(B)(i); and (2) the portion is part of a distribution that would have met the requirements of a qualified charitable distribution but for the fact that the distribution was not transferred directly to the charitable organization.

Effective Date

The provision is effective for distributions made in taxable years beginning after December 31, 2011.

California Law (R&TC section 17501)

The Personal Income Tax Law generally conforms by reference to the federal IRA rules under IRC section 408 as of the "specified date" of January 1, 2009.[121] However, except for the allowable amount of elective deferrals, the Personal Income Tax Law additionally provides that federal changes to IRC section 408 apply without regard to taxable year to the same extent as

[121] R&TC section 17501 conforms to Subchapter D of Chapter 1 of Subtitle A of the IRC (consisting of IRC sections 401 to 436), relating to deferred compensation.

applicable for federal income tax purposes.[122] In other words, except for elective deferrals, the Personal Income Tax Law automatically conforms to federal changes made to IRC section 408. As a result, this provision's two-year extension of the exclusion for qualified charitable distributions automatically applies under California law, and the exclusion from gross income for qualified charitable distributions from an IRA is the same for federal and state purposes.

Impact on California Revenue

Baseline—based on a proration of the federal estimate developed for this provision by the Joint Committee on Taxation, baseline revenue losses are estimated to be $15,000,000, $4,100,000, and $1,600,000 in fiscal years 2013-14, 2014-15, and 2015-16, respectively.

Section	Section Title
209	Improve and Make Permanent the Provision Authorizing the Internal Revenue Service to Disclose Certain Return and Return Information to Certain Prison Officials

Background

IRC section 6103 provides that returns and return information are confidential and may not be disclosed by the IRS, other federal employees, state employees, and certain others having access to the information except as provided in the IRC.[123] A "return" is any tax or information return, declaration of estimated tax, or claim for refund required by, or permitted under, the IRC, that is filed with the Secretary of the Treasury by, on behalf of, or with respect to any person.[124] "Return" also includes any amendment or supplement thereto, including supporting schedules, attachments, or lists which are supplemental to, or part of, the return so filed.

The definition of "return information" is very broad and includes any information gathered by the IRS with respect to a person's liability or possible liability under the IRC.[125]

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[122] R&TC section 17501(b). For taxable years beginning on or after January 1, 2010, the maximum amount of elective deferrals under the Personal Income Tax Law are the same as the maximum amount allowed for federal purposes as of January 1, 2010.

[123] IRC section 6103(a).

[124] IRC section 6103(b)(1).

[125] IRC section 6103(b)(2). Return information is: (1) a taxpayer's identity, the nature, source, or amount of his income, payments, receipts, deductions, exemptions, credits, assets, liabilities, net worth, tax liability, tax withheld, deficiencies, over-assessments, or tax payments, whether the taxpayer's return was, is being, or will be examined or subject to other investigation or processing, or any other data, received by, recorded by, prepared by, furnished to, or collected by the Secretary of the Treasury with respect to a return or with respect to the determination of the existence, or possible existence, of liability (or the amount thereof) of any person under this title for any tax, penalty, interest, fine, forfeiture, or other imposition, or offense, (2) any part of any written determination or any background file document relating to such written determination (as such terms are defined in IRC section 6110(b)) which is not open to public inspection under IRC section 6110, (3) any advance pricing agreement entered into by a taxpayer and

However, data in a form that cannot be associated with, or otherwise identify, directly or indirectly, a particular taxpayer is not "return information" for IRC section 6103 purposes.

IRC section 6103 contains a number of exceptions to the general rule of confidentiality, which permit disclosure in specifically identified circumstances when certain conditions are satisfied.[126]

For example, one exception permits disclosure to the head of the Federal Bureau of Prisons and to the head of a state agency charged with administration of a state prison of return information with respect to prisoners whom the Secretary of the Treasury has determined may have filed or facilitated the filing of false or fraudulent tax returns. Such information may be re-disclosed to officers and employees of such Bureau or agency. The Secretary of the Treasury may disclose only such information as is necessary to permit effective tax administration with respect to prisoners. The disclosure authority expired December 31, 2011.

<u>New Federal Law (IRC sections 6103 and 7213)</u>

The provision makes permanent the authority of the IRS to disclose tax information relating to prisoner misconduct to the federal Bureau of Prisons and state prison officials. In addition, the provision: (1) authorizes the disclosure of actual returns (not just return information), (2) allows the disclosure to be made directly to officers and employees of the prison agency rather than through the head of such agency, (3) allows re-disclosure of return information to contractors that operate prisons, and (4) clarifies the authority for the disclosure to, and use by, legal representatives in proceedings.

<u>Effective Date</u>

The provision is effective for disclosures made on or after January 2, 2013.

<u>California Law (R&TC sections 19542-19564)</u>

The FTB receives certain information from the IRS, and is required to follow the federal rules under IRC section 6103, relating to confidentiality and disclosure of returns and return information. Additionally, California law provides specific disclosure rules and penalties for returns and other information provided to the FTB.

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the Secretary and any background information related to such agreement or any application for an advance pricing agreement, and (4) any closing agreement under IRC section 7121, and any similar agreement, and any background information related to such an agreement or request for such an agreement.

[126] IRC section 6103(c) - (o). Such exceptions include disclosures by consent of the taxpayer, disclosures to state tax officials, disclosures to the taxpayer and persons having a material interest, disclosures to committees of Congress, disclosures to the President, disclosures to federal employees for tax administration purposes, disclosures to federal employees for nontax criminal law enforcement purposes and to the Government Accountability Office, disclosures for statistical purposes, disclosures for miscellaneous tax administration purposes, disclosures for purposes other than tax administration, disclosures of taxpayer identity information, disclosures to tax administration contractors, and disclosures with respect to wagering excise taxes.

However, other than the baseline benefit to the state (of fewer fraudulent prisoner state tax returns that is likely to result from this provision's permanent federal specific disclosure authority for prisons), the provision does not directly impact the FTB because it relates solely to disclosures between the IRS, the Federal Bureau of Prisons and state agencies charged with the responsibility for administration of prisons.

Impact on California Revenue

Baseline.

Section	Section Title
301	Extension and Modification of Research Credit

Background

General Rule

For general research expenditures, a taxpayer may claim a research credit equal to 20 percent of the amount by which the taxpayer's qualified research expenses for a taxable year exceed its base amount for that year.[127] Thus, the research credit generally is available with respect to incremental increases in qualified research. An alternative simplified research credit (with a 14 percent rate and a different base amount) may be claimed in lieu of this credit.[128]

University Basic Research Credit

A 20-percent research credit is also available with respect to the excess of: (1) 100 percent of corporate cash expenses (including grants or contributions) paid for basic research conducted by universities (and certain nonprofit scientific research organizations), over (2) the sum of (a) the greater of two minimum basic research floors, plus (b) an amount reflecting any decrease in non-research giving to universities by the corporation as compared to such giving during a fixed-base period, as adjusted for inflation. This separate credit computation is commonly referred to as the university basic research credit.[129]

[127] IRC section 41.

[128] The alternative simplified research credit is equal to 14 percent of qualified research expenses that exceed 50 percent of the average qualified research expenses for the three preceding taxable years. The rate is reduced to 6 percent if a taxpayer has no qualified research expenses in any one of the three preceding taxable years. An election to use the alternative simplified credit applies to all succeeding taxable years unless revoked with the consent of the Secretary of the Treasury.

[129] IRC section 41(e).

Energy Research Credit

A research credit is available for a taxpayer's expenditures on research undertaken by an energy research consortium. This separate credit computation is commonly referred to as the energy research credit. Unlike the other research credits, the energy research credit applies to all qualified expenditures, not just those in excess of a base amount.

Credit Expiration

The research credit, including the university basic research credit and the energy research credit, is not available for amounts paid or incurred after December 31, 2011.[130]

Computation of Allowable Credit

Except for energy research payments and certain university basic research payments made by corporations, the research credit applies only to the extent that the taxpayer's qualified research expenses for the current taxable year exceed its base amount. The base amount for the current year generally is computed by multiplying the taxpayer's fixed-base percentage by the average amount of the taxpayer's gross receipts for the four preceding years. If a taxpayer both incurred qualified research expenses and had gross receipts during each of at least three years from 1984 through 1988, then its fixed-base percentage is the ratio that its total qualified research expenses for the 1984–1988 period bears to its total gross receipts for that period (subject to a maximum fixed-base percentage of 16 percent). Special rules apply to all other taxpayers (so called start-up firms).[131] In computing the credit, a taxpayer's base amount cannot be less than 50 percent of its current-year qualified research expenses.

To prevent artificial increases in research expenditures by shifting expenditures among commonly controlled or otherwise related entities, a special aggregation rule provides that all members of the same controlled group of corporations or all members of a group of businesses under common control are treated as a single taxpayer.[132] The credit allowable to each member is its proportionate share of the qualified research expenses, basic research payments, and energy research payments giving rise to the credit.

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[130] IRC section 41(h), as amended by Section 731 of the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (Public Law 111-312).

[131] The Small Business Job Protection Act of 1996 expanded the definition of start-up firms under IRC section 41(c)(3)(B)(i) to include any firm if the first taxable year in which such firm had both gross receipts and qualified research expenses began after 1983. A special rule (enacted in 1993) is designed to gradually re-compute a start-up firm's fixed-base percentage based on its actual research experience. Under this special rule, a start-up firm is assigned a fixed-base percentage of three percent for each of its first five taxable years after 1993 in which it incurs qualified research expenses. A start-up firm's fixed-base percentage for its sixth through tenth taxable years after 1993 in which it incurs qualified research expenses is a phased-in ratio based on the firm's actual research experience. For all subsequent taxable years, the taxpayer's fixed-base percentage is its actual ratio of qualified research expenses to gross receipts for any five years selected by the taxpayer from its fifth through tenth taxable years after 1993. IRC section 41(c)(3)(B).

[132] IRC section 41(f)(1).

Under regulations prescribed by the Secretary of the Treasury, special rules apply for computing the research credit when a major portion of a trade or business (or unit thereof) changes hands. Under these rules, qualified research expenses and gross receipts arising in taxable years prior to the change of ownership of a trade or business are treated as transferred to the acquiring taxpayer with the trade or business that gave rise to those expenses and receipts for purposes of re-computing the acquiring taxpayer's fixed-base percentage.[133] Qualified research expenses incurred during the taxable year including or ending with a change of ownership are treated as transferred to the acquiring taxpayer with the trade or business for purposes of determining the credit for the acquiring taxpayer's first taxable year including the acquisition.

Alternative Incremental Research Credit

For taxable years beginning before January 1, 2009, taxpayers were allowed to elect an alternative incremental research credit regime.[134] A taxpayer electing to be subject to this alternative regime was assigned a three-tiered fixed-base percentage (that was lower than the fixed-base percentage otherwise applicable) and the credit rate likewise was reduced.

Generally, for amounts paid or incurred prior to 2007, under the alternative incremental credit regime, a credit rate of 2.65 percent applied to the extent that a taxpayer's current-year research expenses exceeded a base amount computed by using a fixed-base percentage of one percent (i.e., the base amount equaled one percent of the taxpayer's average gross receipts for the four preceding years) but did not exceed a base amount computed by using a fixed-base percentage of 1.5 percent. A credit rate of 3.2 percent applied to the extent that a taxpayer's current-year research expenses exceeded a base amount computed by using a fixed-base percentage of 1.5 percent but did not exceed a base amount computed by using a fixed-base percentage of 2 percent. A credit rate of 3.75 percent applied to the extent that a taxpayer's current-year research expenses exceeded a base amount computed by using a fixed-base percentage of 2 percent. Generally, for amounts paid or incurred after 2006, the credit rates listed above were increased to three percent, four percent, and five percent, respectively.[135]

Alternative Simplified Credit

The alternative simplified research credit is equal to 14 percent of qualified research expenses that exceed 50 percent of the average qualified research expenses for the three preceding taxable years. The rate is reduced to six percent if a taxpayer has no qualified research expenses in any one of the three preceding taxable years. An election to use the alternative simplified credit applies to all succeeding taxable years unless revoked with the consent of the Secretary of the Treasury.

[133] IRC section 41(f)(3).

[134] IRC section 41(c)(4).

[135] A special transition rule applied for fiscal year 2006-2007 taxpayers.

Eligible Expenses

Qualified research expenses eligible for the research tax credit consist of: (1) in-house expenses of the taxpayer for wages and supplies attributable to qualified research, (2) certain time-sharing costs for computer use in qualified research, and (3) 65 percent of amounts paid or incurred by the taxpayer to certain other persons for qualified research conducted on the taxpayer's behalf (so-called contract research expenses).[136] Notwithstanding the limitation for contract research expenses, qualified research expenses include 100 percent of amounts paid or incurred by the taxpayer to an eligible small business, university, or federal laboratory for qualified energy research.

To be eligible for the credit, the research not only has to satisfy the requirements of present-law IRC section 174 (described below) but also must be undertaken for the purpose of discovering information that is technological in nature, the application of which is intended to be useful in the development of a new or improved business component of the taxpayer, and substantially all of the activities of which constitute elements of a process of experimentation for functional aspects, performance, reliability, or quality of a business component. Research does not qualify for the credit if substantially all of the activities relate to style, taste, or cosmetic or seasonal design factors.[137] In addition, research does not qualify for the credit if (1) conducted after the beginning of commercial production of the business component, (2) related to the adaptation of an existing business component to a particular customer's requirements, (3) related to the duplication of an existing business component from a physical examination of the component itself or certain other information, (4) related to certain efficiency surveys, management function or technique, market research, market testing, or market development, routine data collection or routine quality control, (5) related to software developed primarily for internal use by the taxpayer, (6) related to social sciences, arts, or humanities, or (7) funded by any grant, contract, or otherwise by another person (or governmental entity).[138] Research does not qualify for the credit if it is conducted outside the United States, Puerto Rico, or any U.S. possession.

Relation to Deduction

Under IRC section 174, taxpayers may elect to deduct currently the amount of certain research or experimental expenditures paid or incurred in connection with a trade or business, notwithstanding the general rule that business expenses to develop or create an asset that has a useful life extending beyond the current year must be capitalized.[139] However, deductions

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[136] Under a special rule, 75 percent of amounts paid to a research consortium for qualified research are treated as qualified research expenses eligible for the research credit (rather than 65 percent under the general rule under IRC section 41(b)(3) governing contract research expenses) if (1) such research consortium is a tax-exempt organization that is described in IRC section 501(c)(3) (other than a private foundation) or IRC section 501(c)(6) and is organized and operated primarily to conduct scientific research, and (2) such qualified research is conducted by the consortium on behalf of the taxpayer and one or more persons not related to the taxpayer. IRC section 41(b)(3)(C).

[137] IRC section 41(d)(3).

[138] IRC section 41(d)(4).

[139] Taxpayers may elect 10-year amortization of certain research expenditures allowable as a deduction under IRC section 174(a). IRC sections 174(f)(2) and 59(e).

allowed to a taxpayer under IRC section 174 (or any other section) are reduced by an amount equal to 100 percent of the taxpayer's research tax credit determined for the taxable year.[140] Taxpayers may alternatively elect to claim a reduced research tax credit amount under IRC section 41 in lieu of reducing deductions otherwise allowed.[141]

New Federal Law (IRC sections 41 and 45C)

Extension

The provision extends the research credit for two years (through 2013).

Modifications to Acquisitions, Dispositions, and Aggregation of Expenditures

Under the provision, the special rules for taxpayers under common control and the special rules for computing the credit when a major portion of a trade or business (or unit thereof) changes hands are modified. Qualified research expenses paid or incurred by the disposing taxpayer in a taxable year that includes or ends with a change in ownership are treated as current year qualified research expenses of the disposing taxpayer and such expenses are not treated as current year qualified research expenses of the acquiring taxpayer. Further, the disposing taxpayer's and acquiring taxpayer's base period amounts are adjusted by a pro-rated amount. In addition, the credit allowable to each member of a controlled group of corporations or each member of a group of businesses under common control is determined on a proportionate basis to its share of the current year aggregate qualified research expenses (i.e., the gross qualified research expense allocation method).[142]

Effective Date

The extension of the credit is effective for amounts paid or incurred after December 31, 2011. The modifications to acquisitions, dispositions, and aggregation of expenditures are effective for taxable years beginning after December 31, 2011.

California Law (R&TC sections 17052.12 and 23609)

General Conformity to the Federal Research Credit

The Personal Income Tax Law and the Corporation Tax Law generally conform to the federal research credit as of the "specified date" of January 1, 2009, with modifications, as generally described below.

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[140] IRC section 280C(c).

[141] IRC section 280C(c)(3).

[142] The provision overturns the stand-alone entity credit approach contained in Treas. Reg. section 1.41–6(c).

Credit Percentages

California modifies the general credit to be 15 percent of qualified expenses (instead of the federal rate of 20 percent of qualified expenses) and modifies the university "basic research" credit to be 24 percent of qualified expenses (instead of the federal rate of 20 percent of qualified expenses).

California Requirements

The terms "qualified research" and "basic research" include only research conducted in California. In computing gross receipts under IRC section 41(c)(5), only gross receipts from the sale of property held for sale in the ordinary course of business, that is delivered or shipped to a purchaser within California, are included. Qualified research expenses are modified to exclude any amount paid or incurred for tangible personal property that is eligible for the exemption from sales or use tax under R&TC section 6378.

University "Basic Research" Credit

Similar to federal law, only corporations qualify for the credit for the university "basic research" credit. However, California modifies "basic research" to include any basic or applied research including scientific inquiry or original investigation for advancement of scientific or engineering knowledge or the improved effectiveness of commercial products, except the term does not include any of the following:

1. Basic research conducted outside California;
2. Basic research in social sciences, arts or humanities;
3. Basic research for purposes of improving a commercial product if the improvements relate to style, taste, cosmetic, or seasonal design factors; or,
4. Any expenditure paid or incurred to ascertain existence, location, extent, or quality of any deposit of ore or other mineral, including oil or gas.

Alternative Incremental Research Credit

California conforms to the alternative incremental credit as of the "specified date" of January 1, 2009, with modifications. For California purposes, the federal credit rates of 3 percent, 4 percent and 5 percent are modified to be 1.49 percent, 1.98 percent, and 2.48 percent, respectively.[143] Additionally, the federal December 31, 2008, election-termination date does not apply,[144] meaning taxpayers may continue to elect the alternative incremental credit regime under California law even though such an election may not be made for federal purposes in taxable years beginning after December 31, 2008.

[143] R&TC sections 17052.12(g) and 23609(h).

[144] R&TC sections 17052.12(h) and 23609(i).

Alternative Simplified Credit

California specifically does not conform to the alternative simplified credit.[145]

Eligible Expenses

California generally conforms to the federal rules for eligible expenses, but does not conform to the special rules that allow qualified research expenses to include 100 percent of amounts paid or incurred by the taxpayer to an eligible small business, university, or federal laboratory for qualified energy research.

Extension

The Personal Income Tax Law and the Corporation Tax Law specifically do not conform to the federal credit termination date,[146] which means the research credit is permanent under California law, and this provision's two-year extension does not apply.

Modifications to Acquisitions, Dispositions, and Aggregation of Expenditures

The Personal Income Tax Law and the Corporation Tax Law conform to the federal rules[147] that relate to the aggregation of expenditures, allocations, and adjustments for certain acquisitions, etc., as of the "specified date" of January 1, 2009, and thus do not conform to this provision's modifications to those rules.

<u>Impact on California Revenue</u>

Extension

Not applicable.

Modifications to Acquisitions, Dispositions, and Aggregation of Expenditures

Negligible.

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[145] R&TC sections 17052.12(g)(4) and 23609(g)(4).

[146] R&TC sections 17052.12(h) and 23609(i).

[147] Under IRC section 41(f).

Section	Section Title
302	Extension of Temporary Minimum Low-Income Tax Credit Rate for Non-Federally Subsidized New Buildings

Background

In General

The low-income housing credit may be claimed over a 10-year credit period after each low-income building is placed in service. The amount of the credit for any taxable year in the credit period is the applicable percentage of the qualified basis of each qualified low-income building.

Present Value Credit

The calculation of the applicable percentage is designed to produce a credit equal to: (1) 70 percent of the present value of the building's qualified basis in the case of newly constructed or substantially rehabilitated housing that is not federally subsidized (the "70-percent credit"), or (2) 30 percent of the present value of the building's qualified basis in the case of newly-constructed or substantially-rehabilitated housing that is federally subsidized and existing housing that is substantially rehabilitated (the "30-percent credit"). Where existing housing is substantially rehabilitated, the existing housing is eligible for the 30-percent credit and the qualified rehabilitation expenses (if not federally subsidized) are eligible for the 70-percent credit.

Calculation of the Applicable Percentage

In General

The credit percentage for a low-income building is set for the earlier of (1) the month the building is placed in service, or (2) at the election of the taxpayer, (a) the month the taxpayer and the housing credit agency enter into a binding agreement with respect to such building for a credit allocation, or (b) in the case of a tax-exempt bond-financed project for which no credit allocation is required, the month in which the tax-exempt bonds are issued.

These credit percentages (used for the 70-percent credit and 30-percent credit) are adjusted monthly by the IRS on a discounted after-tax basis (assuming a 28-percent tax rate) based on the average of the applicable federal rates for mid-term and long-term obligations for the month the building is placed in service. The discounting formula assumes that each credit is received on the last day of each year and that the present value is computed on the last day of the first year. In a project consisting of two or more buildings placed in service in different months, a separate credit percentage may apply to each building.

Special Rule

Under a special rule, the applicable percentage is set at a minimum of 9 percent for newly-constructed non-federally subsidized buildings placed in service after July 30, 2008, and before December 31, 2013.

New Federal Law (IRC section 42)

The provision extends the temporary minimum applicable percentage of 9 percent for newly-constructed non-federally subsidized buildings with respect to which credit allocations are made before January 1, 2014.

Effective Date

The provision is effective on January 2, 2013.

California Law (R&TC sections 17057.5, 17058, 23610.4, and 23610.5)

General Conformity to Federal Law

The Personal Income Tax Law and the Corporation Tax Law conform to IRC section 42, relating to the low-income housing credit, as of the "specified date" of January 1, 2009,[148] modified to provide that the applicable percentage for newly-constructed non-federally subsidized buildings for the first three years is the percentage prescribed by the Secretary of the Treasury for the taxable year, and for the fourth year, the percentage is the difference between 30 percent and the sum of the credit percentages for the first three years.[149] Additional California modifications are discussed below.

California Housing

In order to qualify for the California low-income housing credit, the low-income housing project must be located in California.

California Tax Credit Allocation Committee

The California Tax Credit Allocation Committee is required to allocate this credit based on the project's need for economic feasibility. Thus, the amount of the California tax credit allocated to a project cannot exceed the amount that, in addition to the federal credit allocated to that project, is necessary for the financial feasibility of the project and its viability throughout the extended-use period.

Credit Amount and Credit Period

Generally, the percentage of costs for which the credit may be taken in the first three years is the highest percentage allowed under federal law in the month the building is placed in service. For the fourth year, the percentage is the difference between 30 percent and the sum of the credit percentage for the first three years.

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[148] R&TC sections 17058 and 23610.5 conform to IRC section 42 as of the "specified date" of January 1, 2009, with modifications.

[149] R&TC sections 17058(c)(2) and 23610.5(c)(2).

For new buildings that are federally subsidized and existing buildings that are at risk of conversion to market rental rates, the percentage of creditable costs in the first three years is the same as the federal percentage applicable to the subsidized new buildings. For the fourth year, the percentage is the difference between 13 percent and the sum of the credit percentages for the first three years.

Compliance Period

California uses a 30-year compliance period instead of the federal 15-year period.

Basis Adjustments

California modifies the federal rule for the increase in qualified basis after the first year of the credit period.[150] When the basis of a building that has been granted a low-income housing tax credit is increased and exceeds the basis at the end of the first year of the four-year credit period, the taxpayer is eligible for a credit on the excess basis. This additional credit is also taken over a four-year period beginning with the taxable year in which the increase in qualified basis occurs.

Partnership Allocations

For partnership allocations of low-income housing credits occurring on or after January 1, 2009, and before January 1, 2016, the credit must be allocated to the partners of a partnership owning the project based on the partnership agreement, regardless how the federal credit is allocated and regardless of whether the allocation of the credit under the partnership agreement has "substantial economic effect" within the meaning of IRC section 704(b). To the extent the allocation of the credit to a partner lacks substantial economic effect, any loss or deduction attributable to the sale, transfer, exchange, abandonment, or any other disposition of a partnership interest prior to the federal credit's expiration is deferred and treated as if it occurred in the first taxable year immediately following the taxable year in which the federal credit period expires.[151]

<u>Impact on California Revenue</u>

None—although California law does not conform to this provision's changes that extend the temporary minimum applicable percentage of 9 percent for newly-constructed non-federally subsidized buildings with respect to which credit allocations are made before January 1, 2014, there is no net revenue impact because the California Tax Credit Allocation Committee currently allocates the entire amount of state credit available.

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[150] IRC section 42(f)(3).

[151] R&TC section 23610.5(b)(1)(C).

Section	Section Title
303	Extension of Housing Allowance Exclusion for Determining Area Median Gross Income for Qualified Residential Rental Project Exempt Facility Bonds

Background

In General

In order to be eligible for the low-income housing credit, a qualified low-income building must be part of a qualified low-income housing project. In general, a qualified low-income housing project is defined as a project that satisfies one of two tests at the election of the taxpayer. The first test is met if 20 percent or more of the residential units in the project are both rent-restricted, and occupied by individuals whose income is 50 percent or less of area median gross income (the "20–50 test"). The second test is met if 40 percent or more of the residential units in such project are both rent-restricted, and occupied by individuals whose income is 60 percent or less of area median gross income (the "40–60 test"). These income figures are adjusted for family size.

Rule for Income Determinations – On or Before July 30, 2008, and On or After January 1, 2012

The recipients of the military basic housing allowance must include these amounts for purposes of low-income credit eligibility income test, as described above.

Special Rule for Income Determinations - Before January 1, 2012

Under the provision the basic housing allowance (i.e., payments under 37 U.S.C. sec. 403) is not included in income for the low-income credit income eligibility rules. The provision is limited in application to qualified buildings. A qualified building is defined as any building located in:

1. Any county which contains a qualified military installation to which the number of members of the Armed Forces assigned to units based out of such qualified military installation has increased by 20 percent or more as of June 1, 2008, over the personnel level on December 31, 2005; and
2. Any counties adjacent to a county described in (1), above. For these purposes, a qualified military installation is any military installation or facility with at least 1,000 members of the Armed Forces assigned to it.

The provision applies to income determinations (1) made after July 30, 2008, and before January 1, 2012, in the case of qualified buildings which received credit allocations on or before July 30, 2008, or qualified buildings placed in service on or before July 30, 2008, to the extent a credit allocation was not required with respect to such building by reason of IRC section 42(h)(4) (i.e. such qualified building was at least 50 percent tax-exempt bond financed with bonds subject to the private activity bond volume cap) but only with respect to bonds issued before July 30, 2008, and (2) made after July 30, 2008, in the case of qualified buildings which received credit allocations after July 30, 2008, and before January 1, 2012, or qualified buildings placed in service after July 30, 2008, and before January 1, 2012, to the extent a credit allocation was not required with respect to such qualified building by reason of IRC section 42(h)(4) (i.e. such qualified building was at least 50 percent tax-exempt bond financed with bonds subject to the private activity bond volume cap) but only with respect to bonds issued after July 30, 2008, and before January 1, 2012.

New Federal Law (IRC section 142)

The provision extends the special rule for two additional years (through December 31, 2013).

Effective Date

The provision is effective as if included in the enactment of Section 3005 of the Housing Assistance Tax Act of 2008.[152]

California Law (R&TC sections 17057.5, 17058, 17143, 23610.4, and 23610.5)

Exempt Facility Bonds

California does not conform to, or adopt, IRC section 142, relating to exempt facility bonds.[153]

California Low-Income Housing Credit – General Conformity to Federal Law

The Personal Income Tax Law and the Corporation Tax Law conform by reference to IRC section 42, relating to the low-income housing credit, as of the "specified date" of January 1, 2009, with modifications.[154]

California law does not conform to this provision's changes to the extent that they modify the applicable low-income eligibility rules for purposes of determining qualified buildings. However, there is no net change to the total amount of California low-income housing credits because the California Tax Credit Allocation Committee currently allocates the entire amount of state credit available.

California Low-Income Housing Credit – In General

In order to qualify for the California low-income housing credit, the low-income housing project must be located in California. Additional California modifications to the federal credit are discussed below.

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[152] Public Law 110-289.

[153] R&TC section 17143.

[154] R&TC sections 17058 and 23610.5 conform to IRC section 42 as of the "specified date" of January 1, 2009, with modifications.

California Tax Credit Allocation Committee

The California Tax Credit Allocation Committee is required to allocate this credit based on the project's need for economic feasibility. Thus, the amount of the California tax credit allocated to a project cannot exceed the amount that, in addition to the federal credit allocated to that project, is necessary for the financial feasibility of the project and its viability throughout the extended use period.

Credit Amount and Credit Period

Generally, the percentage of costs for which the credit may be taken in the first three years is the highest percentage allowed under federal law in the month the building is placed in service. For the fourth year, the percentage is the difference between 30 percent and the sum of the credit percentage for the first three years.

For new buildings that are federally subsidized and existing buildings that are at risk of conversion to market rental rates, the percentage of creditable costs in the first three years is the same as the federal percentage applicable to the subsidized new buildings. For the fourth year, the percentage is the difference between 13 percent and the sum of the credit percentages for the first three years.

Compliance Period

California uses a 30-year compliance period instead of the federal 15-year period.

Basis Adjustments

California modifies the federal rule for the increase in qualified basis after the first year of the credit period.[155] When the basis of a building that has been granted a low-income housing tax credit is increased and exceeds the basis at the end of the first year of the four-year credit period, the taxpayer is eligible for a credit on the excess basis. This additional credit is also taken over a four-year period beginning with the taxable year in which the increase in qualified basis occurs.

Partnership Allocations

For partnership allocations of low-income housing credits occurring on or after January 1, 2009, and before January 1, 2016, the credit must be allocated to the partners of a partnership owning the project based on the partnership agreement, regardless of how the federal credit is allocated and regardless of whether the allocation of the credit under the partnership agreement has "substantial economic effect" within the meaning of IRC section 704(b). To the extent the allocation of the credit to a partner lacks substantial economic effect, any loss or deduction attributable to the sale, transfer, exchange, abandonment, or any other disposition of a partnership interest prior to the federal credit's expiration is deferred and treated as if it occurred

[155] IRC section 42(f)(3).

in the first taxable year immediately following the taxable year in which the federal credit period expires.[156]

Impact on California Revenue

None—to the extent that California would conform to this provision's extension of the special rule for income determinations (i.e., the exclusion of the basic housing allowance for purposes of determining qualified buildings), there would be no net revenue impact because the California Tax Credit Allocation Committee currently allocates the entire amount of state credit available.

Section	Section Title
304	Extension of Indian Employment Tax Credit

Background

In general, a credit against income tax liability is allowed to employers for the first $20,000 of qualified wages and qualified employee health insurance costs paid or incurred by the employer with respect to certain employees.[157] The credit is equal to 20 percent of the excess of eligible employee qualified wages and health insurance costs during the current year over the amount of such wages and costs incurred by the employer during 1993. The credit is an incremental credit, such that an employer's current-year qualified wages and qualified employee health insurance costs (up to $20,000 per employee) are eligible for the credit only to the extent that the sum of such costs exceeds the sum of comparable costs paid during 1993. No deduction is allowed for the portion of the wages equal to the amount of the credit.

Qualified wages means wages paid or incurred by an employer for services performed by a qualified employee. A qualified employee means any employee who is an enrolled member of an Indian tribe or the spouse of an enrolled member of an Indian tribe, who performs substantially all of the services within an Indian reservation, and whose principal place of abode while performing such services is on or near the reservation in which the services are performed.

An "Indian reservation" is a reservation as defined in section 3(d) of the Indian Financing Act of 1974[158] or section 4(10) of the Indian Child Welfare Act of 1978.[159] For purposes of the preceding sentence, section 3(d) is applied by treating "former Indian reservations in Oklahoma" as including only lands that are (1) within the jurisdictional area of an Oklahoma Indian tribe as

[156] R&TC section 23610.5(b)(1)(C).

[157] IRC section 45A.

[158] Public Law 93–262.

[159] Public Law 95–608.

determined by the Secretary of the Interior, and (2) recognized by such Secretary as an area eligible for trust land status under 25 C.F.R. Part 151 (as in effect on August 5, 1997).

An employee is not treated as a qualified employee for any taxable year of the employer if the total amount of wages paid or incurred by the employer with respect to such employee during the taxable year exceeds an amount determined at an annual rate of $30,000 (which after adjusted for inflation is $45,000 for 2011). In addition, an employee will not be treated as a qualified employee under certain specific circumstances, such as where the employee is related to the employer (in the case of an individual employer) or to one of the employer's shareholders, partners, or grantors. Similarly, an employee will not be treated as a qualified employee where the employee has more than a five-percent ownership interest in the employer. Finally, an employee will not be considered a qualified employee to the extent the employee's services relate to gaming activities or are performed in a building housing such activities.

The wage credit is available for wages paid or incurred in taxable years that begin before January 1, 2012.

<u>New Federal Law (IRC section 45A)</u>

The provision extends for two years the present-law employment credit provision (through taxable years beginning on or before December 31, 2013).

<u>Effective Date</u>

The provision is effective for taxable years beginning after December 31, 2011.

<u>California Law (None)</u>

California does not conform to the Indian Employment Tax Credit.

<u>Impact on California Revenue</u>

Not applicable.

<u>Section</u>	<u>Section Title</u>
305	Extension of New Markets Tax Credit

<u>Background</u>

IRC section 45D provides a new markets tax credit for qualified equity investments made to acquire stock in a corporation, or a capital interest in a partnership, that is a qualified community development entity (CDE).[160] The amount of the credit allowable to the investor (either the original purchaser or a subsequent holder) is: (1) a five-percent credit for the year in which the equity interest is purchased from the CDE and for each of the following two years, and (2) a six-percent credit for each of the following four years.[161] The credit is determined by applying the applicable percentage (five or six percent) to the amount paid to the CDE for the investment at its original issue, and is available to the taxpayer who holds the qualified equity investment on the date of the initial investment or on the respective anniversary date that occurs during the taxable year.[162] The credit is recaptured if at any time during the seven-year period that begins on the date of the original issue of the investment the entity: (1) ceases to be a qualified CDE, (2) the proceeds of the investment cease to be used as required, or (3) the equity investment is redeemed.[163]

A qualified CDE is any domestic corporation or partnership: (1) whose primary mission is serving or providing investment capital for low-income communities or low-income persons, (2) that maintains accountability to residents of low-income communities by their representation on any governing board of or any advisory board to the CDE, and (3) that is certified by the Secretary of the Treasury as being a qualified CDE.[164] A qualified equity investment means stock (other than nonqualified preferred stock) in a corporation or a capital interest in a partnership that is acquired directly from a CDE for cash, and includes an investment of a subsequent purchaser if such investment was a qualified equity investment in the hands of the prior holder.[165] Substantially all of the investment proceeds must be used by the CDE to make qualified low-income community investments. For this purpose, qualified low-income community investments include: (1) capital or equity investments in, or loans to, qualified active low-income community businesses, (2) certain financial counseling and other services to businesses and residents in low-income communities, (3) the purchase from another CDE of any loan made by such entity that is a qualified low-income community investment, or (4) an equity investment in, or loan to, another CDE.[166]

A "low-income community" is a population census tract with either a poverty rate of at least 20 percent or median family income which does not exceed 80 percent of the greater of metropolitan area median family income or statewide median family income (for a non-metropolitan census tract, does not exceed 80 percent of statewide median family income). In the case of a population census tract located within a high migration rural county, low-income is defined by reference to 85 percent (as opposed to 80 percent) of statewide median family

[160] IRC section 45D was added by section 121(a) of the Community Renewal Tax Relief Act of 2000, Public Law 106-554 (December 21, 2000).

[161] IRC section 45D(a)(2).

[162] IRC section 45D(a)(3).

[163] IRC section 45D(g).

[164] IRC section 45D(c).

[165] IRC section 45D(b).

[166] IRC section 45D(d).

income.[167] For this purpose, a high migration rural county is any county that, during the 20-year period ending with the year in which the most recent census was conducted, has a net out-migration of inhabitants from the county of at least 10 percent of the population of the county at the beginning of such period.

The Secretary of the Treasury is authorized to designate "targeted populations" as low-income communities for purposes of the new markets tax credit.[168] For this purpose, a "targeted population" is defined by reference to section 103(20) of the Riegle Community Development and Regulatory Improvement Act of 1994[169] (the "Act") to mean individuals, or an identifiable group of individuals, including an Indian tribe, who are low-income persons or otherwise lack adequate access to loans or equity investments. Section 103(17) of the Act provides that "low-income" means: (1) for a targeted population within a metropolitan area, less than 80 percent of the area median family income, and (2) for a targeted population within a non-metropolitan area, less than the greater of 80 percent of the area median family income, or 80 percent of the statewide non-metropolitan area median family income.[170] A targeted population is not required to be within any census tract. In addition, a population census tract with a population of less than 2,000 is treated as a low-income community for purposes of the credit if such tract is within an empowerment zone, the designation of which is in effect under IRC section 1391, and is contiguous to one or more low-income communities.

A qualified active low-income community business is defined as a business that satisfies, with respect to a taxable year, the following requirements: (1) at least 50 percent of the total gross income of the business is derived from the active conduct of trade or business activities in any low-income community, (2) a substantial portion of the tangible property of the business is used in a low-income community, (3) a substantial portion of the services performed for the business by its employees is performed in a low-income community, and (4) less than five percent of the average of the aggregate unadjusted bases of the property of the business is attributable to certain financial property or to certain collectibles.[171]

The maximum annual amount of qualified equity investments was $3.5 billion for calendar years 2010 and 2011. The new markets tax credit expired on December 31, 2011.

<u>New Federal Law (IRC section 45D)</u>

The provision extends the new markets tax credit for two years, through 2013, permitting up to $3.5 billion in qualified equity investments for each of the 2012 and 2013 calendar years. The provision also extends for two years, through 2018, the carryover period for unused new markets tax credits.

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[167] IRC section 45D(e).

[168] IRC section 45D(e)(2).

[169] Public Law 103-325.

[170] Public Law 103-325.

[171] IRC section 45D(d)(2).

Effective Date

The provision applies to calendar years beginning after December 31, 2011.

California Law (R&TC sections 17053.57 and 23657)

New Markets Tax Credit

California does not conform to the federal new markets tax credit.

California Community Development Financial Institution Credit

The Personal Income Tax Law and the Corporation Tax Law provide a state-only credit that is 20 percent of each "qualified investment" in a California community development financial institution (CDFI). The "qualified investment" in the California CDFI must be at least $50,000, be for a minimum duration of 60 months, and consist of either: (1) a deposit or loan that does not earn interest, or (2) an equity investment.

A California CDFI is defined as a private financial institution located in California that has community development as its primary mission and lends in urban, rural, or reservation-based communities in California. A CDFI includes a community development bank, a community development loan fund, a community development credit union, a micro-enterprise fund, a community development corporation-based lender, or a community development venture fund.

The California CDFI credit will cease to be operative for taxable years beginning on or after January 1, 2017.

Impact on California Revenue

Not applicable.

Section	Section Title
306	Extension of Railroad Track Maintenance Credit

Background

Present law provides a 50-percent business tax credit for qualified railroad track maintenance expenditures paid or incurred by an eligible taxpayer during taxable years beginning before January 1, 2012.[172] The credit is limited to the product of $3,500 times the number of miles of railroad track owned or leased by an eligible taxpayer as of the close of its taxable year, and

[172] IRC section 45G(a).

assigned to the eligible taxpayer by a Class II or Class III railroad that owns or leases such track at the close of the taxable year.[173] Each mile of railroad track may be taken into account only once, either by the owner of such mile or by the owner's assignee, in computing the per-mile limitation. The credit may also reduce a taxpayer's tax liability below its tentative minimum tax.[174]

Qualified railroad track maintenance expenditures are defined as gross expenditures (whether or not otherwise chargeable to capital account) for maintaining railroad track (including roadbed, bridges, and related track structures) owned or leased as of January 1, 2005, by a Class II or Class III railroad (determined without regard to any consideration for such expenditure given by the Class II or Class III railroad which made the assignment of such track).[175]

An eligible taxpayer means any Class II or Class III railroad, and any person who transports property using the rail facilities of a Class II or Class III railroad or who furnishes railroad-related property or services to a Class II or Class III railroad, but only with respect to miles of railroad track assigned to such person by such railroad under the provision.[176]

The terms Class II or Class III railroad have the meanings given by the Surface Transportation Board.[177]

New Federal Law (IRC section 45G)

The provision extends the present law credit for two years, for qualified railroad track maintenance expenses paid or incurred during taxable years beginning after December 31, 2011, and before January 1, 2014.

Effective Date

The provision is effective for expenses paid or incurred in taxable years beginning after December 31, 2011.

California Law (None)

California does not conform to the railroad track maintenance credit.

Impact on California Revenue

Not applicable.

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173 IRC section 45G(b)(1).

174 IRC section 38(c)(4).

175 IRC section 45G(d).

176 IRC section 45G(c).

177 IRC section 45G(e)(1).

Section	Section Title
307	Extension of Mine Rescue Team Training Credit

Background

An eligible employer may claim a general business credit against income tax with respect to each qualified mine rescue team employee equal to the lesser of: (1) 20 percent of the amount paid or incurred by the taxpayer during the taxable year with respect to the training program costs of the qualified mine rescue team employee (including the wages of the employee while attending the program), or (2) $10,000. A qualified mine rescue team employee is any full-time employee of the taxpayer who is a miner eligible for more than six months of a taxable year to serve as a mine rescue team member by virtue of either having completed the initial 20 hour course of instruction prescribed by the Mine Safety and Health Administration's Office of Educational Policy and Development, or receiving at least 40 hours of refresher training in such instruction.
An eligible employer is any taxpayer that employs individuals as miners in underground mines in the United States. The term "wages" has the meaning given to such term by IRC section 3306(b)[178] (determined without regard to any dollar limitation contained in that section).

No deduction is allowed for the portion of the expenses otherwise deductible that is equal to the amount of the credit,[179] and the credit may not offset the alternative minimum tax.[180]

The credit does not apply to taxable years beginning after December 31, 2011.

New Federal Law (IRC section 45N)

The provision extends the credit for two years through taxable years beginning on or before December 31, 2013.

Effective Date

The provision generally is effective for taxable years beginning after December 31, 2011.

California Law (None)

California does not conform to the mine rescue team training credit.

Impact on California Revenue

Not applicable.

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[178] IRC section 3306(b) defines wages for purposes of Federal Unemployment Tax.

[179] IRC section 280C(e).

[180] IRC section 38(c).

Section	Section Title
308	Extension of Employer Wage Credit for Employees Who Are Active Duty Members of the Uniformed Services

Background

Differential Pay

In general, compensation paid by an employer to an employee is deductible by the employer under IRC section 162(a)(1), unless the expense must be capitalized. In the case of an employee who is called to active duty with respect to the armed forces of the United States, some employers voluntarily pay the employee the difference between the compensation that the employer would have paid to the employee during the period of military service less the amount of pay received by the employee from the military. This payment by the employer is often referred to as "differential pay."

Wage Credit for Differential Pay

If an employer qualifies as an eligible small business employer, the employer is allowed to take a credit against its income tax liability for a taxable year in an amount equal to 20 percent of the sum of the eligible differential wage payments for each of the employer's qualified employees for the taxable year.[181]

An eligible small business employer means, with respect to a taxable year, any taxpayer that: (1) employed on average less than 50 employees on business days during the taxable year, and (2) under a written plan of the taxpayer, provides eligible differential wage payments to every qualified employee of the taxpayer. Taxpayers under common control are aggregated for purposes of determining whether a taxpayer is an eligible small business employer. The credit is not available with respect to a taxpayer who has failed to comply with the employment and reemployment rights of members of the uniformed services (as provided under Chapter 43 of Title 38 of the United States Code).

Differential wage payment means any payment that: (1) is made by an employer to an individual with respect to any period during which the individual is performing service in the uniformed services of the United States while on active duty for a period of more than 30 days, and (2) represents all or a portion of the wages that the individual would have received from the employer if the individual were performing services for the employer. The term eligible differential wage payments means so much of the differential wage payments paid to a qualified employee as does not exceed $20,000. A qualified employee is an individual who has been an employee for the 91-day period immediately preceding the period for which any differential wage payment is made.

[181] IRC section 45P.

No deduction may be taken for that portion of compensation which is equal to the credit. In addition, the amount of any other credit otherwise allowable with respect to compensation paid to an employee must be reduced by the differential wage payment credit allowed with respect to such employee.

The differential wage payment credit is part of the general business credit, and thus this credit is subject to the rules applicable to business credits. For example, an unused credit generally may be carried back to the taxable year that precedes an unused credit year or carried forward to each of the 20 taxable years following the unused credit year. Further, the credit is not allowable against a taxpayer's alternative minimum tax liability.

Rules similar to the rules in IRC section 52(c), which bars the work opportunity tax credit for tax-exempt organizations other than certain farmer's cooperatives, apply to the differential wage payment credit. Additionally, rules similar to the rules in IRC section 52(e), which limits the work opportunity tax credit allowable to regulated investment companies, real estate investment trusts, and certain cooperatives, apply to the differential wage payment credit.

The credit is available with respect to amounts paid after June 17, 2008,[182] and before January 1, 2012.

New Federal Law (IRC section 45P)

The provision extends the availability of the credit to amounts paid before January 1, 2014.

Effective Date

The provision applies to payments made after December 31, 2011.

California Law (None)

California does not conform to the employer wage credit for employees who are active duty members of the uniformed services.

Impact on California Revenue

Not applicable.

[182] This date is the date of enactment of the Heroes Earnings Assistance and Relief Tax Act of 2008, Public Law 110-245.

Section	Section Title
309	Extension of Work Opportunity Tax Credit

Background

In General

The work opportunity tax credit is available on an elective basis for employers hiring individuals from one or more of nine targeted groups. The amount of the credit available to an employer is determined by the amount of qualified wages paid by the employer. Generally, qualified wages consist of wages attributable to service rendered by a member of a targeted group during the one-year period beginning with the day the individual begins work for the employer (two years in the case of an individual in the long-term family assistance recipient category).

Targeted Groups Eligible for the Credit

Generally, an employer is eligible for the credit only for qualified wages paid to members of a targeted group, which include:

(1) Families Receiving TANF

An eligible recipient is an individual certified by a designated local employment agency (e.g., a state employment agency) as being a member of a family eligible to receive benefits under the Temporary Assistance for Needy Families Program ("TANF") for a period of at least nine months part of which is during the 18-month period ending on the hiring date. For these purposes, members of the family are defined to include only those individuals taken into account for purposes of determining eligibility for the TANF.

(2) Qualified Veteran

Prior to enactment of the "VOW to Hire Heroes Act of 2011" (the "VOW Act"),[183] there were two subcategories of qualified veterans to whom wages paid by an employer were eligible for the credit. Employers who hired veterans who were eligible to receive assistance under a supplemental nutritional assistance program were entitled to a maximum credit of 40 percent of $6,000 of qualified first-year wages paid to such individual.[184] Employers who hired veterans who were entitled to compensation for a service-connected disability were entitled to a maximum wage credit of 40 percent of $12,000 of qualified first-year wages paid to such individual.[185]

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[183] Public Law 112–56 (November 21, 2011).

[184] For these purposes, a qualified veteran must be certified by the designated local agency as a member of a family receiving assistance under a supplemental nutrition assistance program under the Food and Nutrition Act of 2008 for a period of at least three months part of which is during the 12-month period ending on the hiring date. For these purposes, members of a family are defined to include only those individuals taken into account for purposes of determining eligibility for a supplemental nutrition assistance program under the Food and Nutrition Act of 2008.

[185] The qualified veteran must be certified as entitled to compensation for a service-connected disability and: (1) have a hiring date which is not more than one year after having been discharged or released from active duty in the Armed Forces of the United States, or (2) have been unemployed for six months or more (whether or not consecutive) during the one-year period ending on the date of hiring. For these purposes, being entitled to compensation for a service-connected disability is defined with reference to section 101 of Title 38, U.S. Code, which means having a disability rating of 10 percent or higher for service connected injuries.

The VOW Act modified the work opportunity credit with respect to qualified veterans, by adding additional subcategories. There are now five subcategories of qualified veterans: (1) in the case of veterans who were eligible to receive assistance under a supplemental nutritional assistance program (for at least a three month period during the year prior to the hiring date) the employer is entitled to a maximum credit of 40 percent of $6,000 of qualified first-year wages; (2) in the case of a qualified veteran who is entitled to compensation for a service connected disability, who is hired within one year of discharge, the employer is entitled to a maximum credit of 40 percent of $12,000 of qualified first-year wages; (3) in the case of a qualified veteran who is entitled to compensation for a service-connected disability, and who has been unemployed for an aggregate of at least six months during the one year period ending on the hiring date, the employer is entitled to a maximum credit of 40 percent of $24,000 of qualified first-year wages; (4) in the case of a qualified veteran unemployed for at least four weeks but less than six months (whether or not consecutive) during the one-year period ending on the date of hiring, the maximum credit equals 40 percent of $6,000 of qualified first-year wages; and (5) in the case of a qualified veteran unemployed for at least six months (whether or not consecutive) during the one-year period ending on the date of hiring, the maximum credit equals 40 percent of $14,000 of qualified first-year wages.

A veteran is an individual who has served on active duty (other than for training) in the Armed Forces for more than 180 days or who has been discharged or released from active duty in the Armed Forces for a service-connected disability. However, any individual who has served for a period of more than 90 days during which the individual was on active duty (other than for training) is not a qualified veteran if any of this active duty occurred during the 60-day period ending on the date the individual was hired by the employer. This latter rule is intended to prevent employers who hire current members of the armed services (or those departed from service within the last 60 days) from receiving the credit.

(3) Qualified Ex-Felon

A qualified ex-felon is an individual certified as: (1) having been convicted of a felony under any state or federal law, and (2) having a hiring date within one year of release from prison or the date of conviction.

(4) Designated Community Resident

A designated community resident is an individual certified as being at least age 18 but not yet age 40 on the hiring date and as having a principal place of abode within an empowerment zone, enterprise community, renewal community, or a rural renewal community. For these purposes, a rural renewal county is a county outside a metropolitan statistical area (as defined by the Office of Management and Budget) which had a net population loss during the five-year periods 1990–1994 and 1995–1999. Qualified wages do not include wages paid or incurred for services performed after the individual moves outside an empowerment zone, enterprise community, renewal community, or a rural renewal community.

(5) Vocational Rehabilitation Referral

A vocational rehabilitation referral is an individual who is certified by a designated local agency as an individual who has a physical or mental disability that constitutes a substantial handicap to employment and who has been referred to the employer while receiving, or after completing: (a) vocational rehabilitation services under an individualized, written plan for employment under a state plan approved under the Rehabilitation Act of 1973, (b) under a rehabilitation plan for veterans carried out under Chapter 31 of Title 38, U.S. Code, or (c) an individual work plan developed and implemented by an employment network pursuant to subsection (g) of section 1148 of the Social Security Act. Certification will be provided by the designated local employment agency upon assurances from the vocational rehabilitation agency that the employee has met the above conditions.

(6) Qualified Summer Youth Employee

A qualified summer youth employee is an individual: (1) who performs services during any 90-day period between May 1 and September 15, (2) who is certified by the designated local agency as being 16 or 17 years of age on the hiring date, (3) who has not been an employee of that employer before, and (4) who is certified by the designated local agency as having a principal place of abode within an empowerment zone, enterprise community, or renewal community. As with designated community residents, no credit is available on wages paid or incurred for service performed after the qualified summer youth moves outside of an empowerment zone, enterprise community, or renewal community. If, after the end of the 90-day period, the employer continues to employ a youth who was certified during the 90-day period as a member of another targeted group, the limit on qualified first-year wages will take into account wages paid to the youth while a qualified summer youth employee.

(7) Qualified Supplemental Nutrition Assistance Program Benefits Recipient

A qualified supplemental nutrition assistance program benefits recipient is an individual at least age 18 but not yet age 40 certified by a designated local employment agency as being a member of a family receiving assistance under a food and nutrition program under the Food and Nutrition Act of 2008 for a period of at least six months ending on the hiring date. In the case of families that cease to be eligible for food and nutrition assistance under section 6(o) of the Food and Nutrition Act of 2008, the six-month requirement is replaced with a requirement that the family has been receiving food and nutrition assistance for at least three of the five months ending on the date of hire. For these purposes, members of the family are defined to include only those individuals taken into account for purposes of determining eligibility for a food and nutrition assistance program under the Food and Nutrition Act of 2008.

(8) Qualified SSI Recipient

A qualified SSI recipient is an individual designated by a local agency as receiving supplemental security income (SSI) benefits under Title XVI of the Social Security Act for any month ending within the 60-day period ending on the hiring date.

(9) Long-Term Family Assistance Recipient

A qualified long-term family assistance recipient is an individual certified by a designated local agency as being: (1) a member of a family that has received family assistance for at least 18 consecutive months ending on the hiring date, (2) a member of a family that has received such family assistance for a total of at least 18 months (whether or not consecutive) after August 5, 1997 (the date of enactment of the welfare-to-work tax credit)[186] if the individual is hired within two years after the date that the 18-month total is reached, or (3) a member of a family who is no longer eligible for family assistance because of either federal or state time limits, if the individual is hired within two years after the federal or state time limits made the family ineligible for family assistance.

Qualified Wages

Generally, qualified wages are defined as cash wages paid by the employer to a member of a targeted group. The employer's deduction for wages is reduced by the amount of the credit. For purposes of the credit, generally, wages are defined by reference to the FUTA definition of wages contained in IRC section 3306(b) (without regard to the dollar limitation therein contained). Special rules apply in the case of certain agricultural labor and certain railroad labor.

Calculation of the Credit

The credit available to an employer for qualified wages paid to members of all targeted groups except for long-term family assistance recipients equals 40 percent (25 percent for employment of 400 hours or less) of qualified first-year wages. Generally, qualified first-year wages are qualified wages (not in excess of $6,000) attributable to service rendered by a member of a targeted group during the one-year period beginning with the day the individual began work for the employer. Therefore, the maximum credit per employee is $2,400 (40 percent of the first $6,000 of qualified first-year wages). With respect to qualified summer youth employees, the maximum credit is $1,200 (40 percent of the first $3,000 of qualified first-year wages). Except for long-term family assistance recipients, no credit is allowed for second-year wages.

In the case of long-term family assistance recipients, the credit equals 40 percent (25 percent for employment of 400 hours or less) of $10,000 for qualified first-year wages and 50 percent of the first $10,000 of qualified second-year wages. Generally, qualified second-year wages are qualified wages (not in excess of $10,000) attributable to service rendered by a member of the

[186] The welfare-to-work tax credit was consolidated into the work opportunity tax credit in the Tax Relief and Health Care Act of 2006, Public Law 109–432, for qualified individuals who begin to work for an employer after December 31, 2006.

long-term family assistance category during the one-year period beginning on the day after the one-year period beginning with the day the individual began work for the employer. Therefore, the maximum credit per employee is $9,000 (40 percent of the first $10,000 of qualified first-year wages plus 50 percent of the first $10,000 of qualified second-year wages).

For calculation of the credit with respect to qualified veterans, see the description of "qualified veteran" above.

Certification Rules

Generally, an individual is not treated as a member of a targeted group unless: (1) on or before the day on which an individual begins work for an employer, the employer has received a certification from a designated local agency that such individual is a member of a targeted group, or (2) on or before the day an individual is offered employment with the employer, a pre-screening notice is completed by the employer with respect to such individual, and not later than the 28th day after the individual begins work for the employer, the employer submits such notice, signed by the employer and the individual under penalties of perjury, to the designated local agency as part of a written request for certification. For these purposes, a pre-screening notice is a document (in such form as the Secretary may prescribe) which contains information provided by the individual on the basis of which the employer believes that the individual is a member of a targeted group.

An otherwise qualified unemployed veteran is treated as certified by the designated local agency as having aggregate periods of unemployment (whichever is applicable under the qualified veterans rules described above) if such veteran is certified by such agency as being in receipt of unemployment compensation under a state or federal law for such applicable periods. The Secretary of the Treasury is authorized to provide alternative methods of certification for unemployed veterans.

Minimum Employment Period

No credit is allowed for qualified wages paid to employees who work less than 120 hours in the first year of employment.

Qualified Tax-Exempt Organizations Employing Qualified Veterans

The credit is not available to qualified tax-exempt organizations other than those employing qualified veterans. The special rules, described below, were enacted in the "VOW to Hire Heroes Act of 2011" (the "VOW Act.")

If a qualified tax-exempt organization employs a qualified veteran (as described above), a tax credit against the FICA taxes of the organization is allowed on the wages of the qualified veteran which are paid for the veteran's services in furtherance of the activities related to the function or purpose constituting the basis of the organization's exemption under IRC section 501.

The credit available to such tax-exempt employer for qualified wages paid to a qualified veteran equals 26 percent (16.25 percent for employment of 400 hours or less) of qualified first-year wages. The amount of qualified first-year wages eligible for the credit is the same as those for non-tax-exempt employers (i.e., $6,000, $12,000, $14,000 or $24,000, depending on the category of qualified veteran).

A qualified tax-exempt organization means an employer that is described in IRC section 501(c) and exempt from tax under IRC section 501(a).

The Social Security Trust Funds are held harmless from the effects of this provision by a transfer from the Treasury General Fund.

Treatment of Possessions

The VOW Act provided a reimbursement mechanism for the U.S. possessions (American Samoa, Guam, the Commonwealth of the Northern Mariana Islands, the Commonwealth of Puerto Rico, and the United States Virgin Islands). The Treasury Secretary is to pay to each mirror code possession (Guam, the Commonwealth of the Northern Mariana Islands, and the United States Virgin Islands) an amount equal to the loss to that possession as a result of the VOW Act changes to the qualified veterans rules. Similarly, the Treasury Secretary is to pay to each non-mirror IRC possession (American Samoa and the Commonwealth of Puerto Rico) the amount that the Secretary estimates as being equal to the loss to that possession that would have occurred as a result of the VOW Act changes if a mirror code tax system had been in effect in that possession. The Secretary will make this payment to a non-mirror IRC possession only if that possession establishes to the satisfaction of the Secretary that the possession has implemented (or, at the discretion of the Secretary, will implement) an income tax benefit that is substantially equivalent to the qualified veterans credit allowed under the VOW Act modifications.

An employer that is allowed a credit against U.S. tax under the VOW Act with respect to a qualified veteran must reduce the amount of the credit claimed by the amount of any credit (or, in the case of a non-mirror IRC possession, another tax benefit) that the employer claims against its possession income tax.

Other Rules

The work opportunity tax credit is not allowed for wages paid to a relative or dependent of the taxpayer. No credit is allowed for wages paid to an individual who is a more than 50-percent owner of the entity. Similarly, wages that are paid to replacement workers during a strike or lockout are not eligible for the work opportunity tax credit. Wages paid to any employee during any period for which the employer received on-the-job training program payments with respect to that employee are not eligible for the work opportunity tax credit. The work opportunity tax credit generally is not allowed for wages paid to individuals who had previously been employed by the employer. In addition, many other technical rules apply.

Expiration

Generally, the work opportunity tax credit is not available for individuals who begin work for an employer after December 31, 2011. The work opportunity tax credit for employers of qualified veterans is not available for such individuals who begin work for an employer after December 31, 2012.

New Federal Law (IRC section 51)

The credit is extended for all eligible categories through December 31, 2013.

Effective Date

The provision is effective for individuals who begin work for the employer after December 31, 2011 (in the case of certain qualified veterans, after December 31, 2012).

California Law

California does not conform to the federal work opportunity tax credit allowed under IRC section 51. However, the following California hiring credits[187] are reduced by the amount of an employer's federal work opportunity tax credit: (1) the enterprise zone credit,[188] (2) the manufacturing enhancement area credit,[189] and (3) the local agency military base recovery area credit.[190] Because the reduction to the California hiring credits is the amount of the federal work opportunity tax credits allowed under IRC section 51 as of the "specified date" of January 1, 2009, the California hiring credits are not reduced by any federal work opportunity tax credits enacted or extended after that "specified date," including the work opportunity tax credits extended by this provision.

[187] For employees employed by taxpayers within the 60-month period immediately preceding January 1, 2014, California law provides hiring credits for taxpayers conducting business activities within geographically targeted economic development areas (EDAs). Employers located in an EDA (i.e., qualified employers) are eligible for hiring credits equal to a percentage of wages paid to individuals from targeted groups (i.e., qualified employees). EDAs impacted by this provision are enterprise zones (EZs), manufacturing enhancement areas (MEAs), and local agency military base recovery areas (LAMBRAs).

The California EDA hiring credits generally cease to be operative for taxable years beginning on or after January 1, 2014; however, the credits continue to apply for taxable years beginning on or after January 1, 2014, with respect to qualified employees who are employed by qualified taxpayers within the 60-month period immediately preceding that date (Chapter 69 of the Statutes of 2013).

[188] R&TC sections 17053.74(b)(4)(A)(iv)(XI) and 23622.7(b)(4)(A)(iv)(XI).

[189] R&TC sections 17053.47(f) and 23622.8(e).

[190] R&TC sections 17053.46(g) and 23646(g).

Impact on California Revenue

Estimated Conformity Revenue Impact of Extension of Work Opportunity Tax Credit For Taxable Years Beginning On or After January 1, 2014 Enactment Assumed After June 30, 2014		
2014-15	2015-16	2016-17
$3,700,000	$1,000,000	$400,000

This estimate is based on a proration of the federal estimate developed for this provision by the Joint Committee on Taxation.

Section Section Title

310 Extension of Qualified Zone Academy Bonds

Background

Tax-Exempt Bonds

Interest on state and local governmental bonds generally is excluded from gross income for federal income tax purposes if the proceeds of the bonds are used to finance direct activities of these governmental units or if the bonds are repaid with revenues of the governmental units. These can include tax-exempt bonds which finance public schools.[191] An issuer must file with the Internal Revenue Service certain information about the bonds issued in order for that bond issue to be tax-exempt.[192] Generally, this information return is required to be filed no later the 15th day of the second month after the close of the calendar quarter in which the bonds were issued.

The tax exemption for state and local bonds does not apply to any arbitrage bond.[193] An arbitrage bond is defined as any bond that is part of an issue if any proceeds of the issue are reasonably expected to be used (or intentionally are used) to acquire higher-yielding investments or to replace funds that are used to acquire higher-yielding investments.[194] In general, arbitrage profits may be earned only during specified periods (e.g., defined "temporary periods") before funds are needed for the purpose of the borrowing or on specified types of investments (e.g., "reasonably required

[191] IRC section 103.

[192] IRC section 149(e).

[193] IRC section 103(a) and (b)(2).

[194] IRC section 148.

reserve or replacement funds"). Subject to limited exceptions, investment profits that are earned during these periods or on such investments must be rebated to the federal government.

Qualified Zone Academy Bonds

As an alternative to traditional tax-exempt bonds, states and local governments were given the authority to issue "qualified zone academy bonds."[195]

A total of $400 million of qualified zone academy bonds is authorized to be issued annually in calendar years 1998 through 2008, $1,400 million in 2009 and 2010, and $400 million in 2011. Each calendar year's bond limitation is allocated to the states according to their respective populations of individuals below the poverty line. Each state, in turn, allocates the credit authority to qualified zone academies within such state.

A taxpayer holding a qualified zone academy bond on the credit allowance date is entitled to a credit. The credit is includible in gross income (as if it were a taxable interest payment on the bond), and may be claimed against regular income tax and alternative minimum tax liability.

Qualified zone academy bonds are a type of qualified tax credit bond and subject to the general rules applicable to qualified tax credit bonds.[196] The Treasury Department sets the credit rate at a rate estimated to allow issuance of qualified zone academy bonds without discount and without interest cost to the issuer.[197] The Secretary of the Treasury determines credit rates for tax credit bonds based on general assumptions about credit quality of the class of potential eligible issuers and such other factors as the Secretary deems appropriate. The Secretary may determine credit rates based on general credit market yield indexes and credit ratings. The maximum term of the bond is determined by the Treasury Department, so that the present value of the obligation to repay the principal on the bond is 50 percent of the face value of the bond.

"Qualified zone academy bonds" are defined as any bond issued by a state or local government, provided that: (1) at least 100 percent of the available project proceeds are used for the purpose of renovating, providing equipment to, developing course materials for use at, or training teachers and other school personnel in a "qualified zone academy," and (2) private entities have promised to contribute to the qualified zone academy certain equipment, technical assistance or training, employee services, or other property or services with a value equal to at least 10 percent of the bond proceeds.

A school is a "qualified zone academy" if: (1) the school is a public school that provides education and training below the college level, (2) the school operates a special academic program in cooperation with businesses to enhance the academic curriculum and increase graduation and employment rates, and (3) either (a) the school is located in an empowerment zone or enterprise

[195] See IRC sections 54E and 1397E.

[196] IRC section 54A.

[197] Given the differences in credit quality and other characteristics of individual issuers, the Secretary of the Treasury cannot set credit rates in a manner that will allow each issuer to issue tax credit bonds at par.

community designated under the IRC, or (b) it is reasonably expected that at least 35 percent of the students at the school will be eligible for free or reduced-cost lunches under the school lunch program established under the National School Lunch Act.

Under IRC section 6431, an issuer of specified tax credit bonds may elect to receive a payment in lieu of a credit being allowed to the holder of the bond. This provision is not available for qualified zone academy bond allocations from the 2011 national limitation or any carry forward of the 2011 allocation.[198]

New Federal Law (IRC section 54E)

The provision extends the qualified zone academy bond program for two years. The provision authorizes issuance of up to $400 million of qualified zone academy bonds per year for 2012 and 2013.

The issuer election to receive a payment in lieu of providing a tax credit to the holder of the qualified zone academy bond is not available for bonds issued with the 2012 or 2013 national limitations.[199] The provision has no effect on bonds issued with limitation carried forward from 2009 or 2010.

Effective Date

The provision applies to obligations issued after December 31, 2011.

California Law (R&TC sections 17143 and 24272)

In General

California does not conform to IRC section 54E, relating to qualified zone academy bonds, and income from such bonds is not includible in California gross income.

California specifically does not conform to IRC sections 103 and 141 through 150, relating to the federal rules exempting the interest earned on state or municipal bonds and the arbitrage rebate rules. In addition, the federal “private-activity-bond” rules have not been adopted by California.

California State and Municipal Bonds

The general rule in California is that for income tax purposes, all interest received or accrued is fully taxable, except for interest on federal obligations (such as Treasury bills, notes, and bonds, as more fully described below) and tax-exempt bonds issued by this state or a local government in this state.

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[198] IRC section 6431(f)(3)(A)(iii).

[199] A technical correction to IRC section 6431(f) may be needed so that the statute reflects this intent.

Unlike federal law, the interest earned on bonds issued by other states and municipalities in other states is fully taxable to a resident of California. The California exemption from income taxation of interest on bonds of the state and its political subdivisions is contained in the California Constitution (subdivision (b) of section 26 of Article XIII). California law further provides that the federal private-activity-bond analysis shall not be made in determining whether interest on bonds issued by the state or a political subdivision thereof is exempt from California income tax. Thus, in California, if the use of the bond proceeds of a state or local California issue is for private business use or is secured by property used for a private business use, the interest on that bond is still treated for California income tax purposes as tax exempt, even though the interest on the bond may be taxable for federal income tax purposes.

California Conduit Revenue Bonds

Conduit revenue bonds are issued by a governmental (state or municipal) entity for various purposes, including economic development, educational and health facilities construction, and multi-family housing. The funds obtained from the financing are loaned to a non-governmental borrower who builds and operates the project. The use by a private firm (via expenditure of the bond proceeds) of a governmental agency's authority to issue tax-exempt debt is premised on the fact that the project will provide a public benefit. A conduit revenue bond is payable solely from the loan payments received from the non-governmental party (unless the bond is insured by a third party who guarantees payment in the event of a default by the private firm who has pledged the revenue source). The governmental issuer typically has no liability for debt service on the bonds, except for the administration of the bond. Although the issuer has no actual liability on the bonds, their reputation and standing with respect to future debt financing may be negatively affected in the event of a default on the bonds. More importantly, should the bonds go into default, the governmental entity will likely be drawn into the settlement process. Most conduit revenue bonds are sold at negotiated sales with the interest rate and other terms of the bonds negotiated between the issuer, the non-governmental borrower, and an underwriter. The security for some of these transactions is sufficient to allow the underwriter to act as a pass-through for the bonds and in so doing act as a placement agent rather than an underwriter. Because the public agency's credit is not at risk, many issuers do not participate in any substantive fashion in the sale of the bonds. Rather, they may limit their role to reviewing the bond purchase contract and other legal and disclosure documents to ensure that they are adequately indemnified against liabilities, and to accurately describe their role to investors as issuers and not as borrowers or guarantors of the debt.

Because the conduit revenue bonds issued in California are issued by this state or a local government in this state, the interest paid on such bonds is exempt from state income taxation under the California Constitution.

California Treatment of Federal Bond Interest

Interest earned on federal bonds is also tax-exempt for California income tax purposes. This results from federal law (31 U.S.C. § 3124(a)) that prohibits all states from imposing a discriminatory income tax on interest income from direct obligations of the federal government.

Examples of bonds that are exempt for California income tax purposes include those issued by federal land banks, the Federal Home Loan Bank, and Banks for Cooperatives.

Not all federal bonds are direct obligations of the U.S. government, and interest on those bonds is taxable. Examples of federal bonds not exempt are those issued by the Federal National Mortgage Association (Fannie Maes), Government National Mortgage Association (Ginnie Maes), and Federal Loan Home Mortgage Corporation (Freddie Macs).

California Franchise Tax Treatment

Interest received from federal, state, municipal, or other bonds is includable in the gross income of corporations taxable under the franchise tax. The franchise tax is a nondiscriminatory privilege tax for the right to exercise the corporate franchise and is not a tax on the income received, but instead merely uses that income as the measure of the tax for the privilege of exercising the corporate franchise.

<u>Impact on California Revenue</u>

Not applicable.

<u>Section</u>	<u>Section Title</u>
311	Extension of 15-Year Straight-Line Cost Recovery for Qualified Leasehold Improvements, Qualified Restaurant Buildings and Improvements, and Qualified Retail Improvements

<u>Background</u>

In General

A taxpayer generally must capitalize the cost of property used in a trade or business and recover such cost over time through annual deductions for depreciation or amortization. Tangible property generally is depreciated under the modified accelerated cost recovery system (MACRS), which determines depreciation by applying specific recovery periods, placed-in-service conventions, and depreciation methods to the cost of various types of depreciable property.[200] The cost of nonresidential real property is recovered using the straight-line method of depreciation and a recovery period of 39 years. Nonresidential real property is subject to the mid-month placed-in-service convention. Under the mid-month convention, the depreciation allowance for the first year property is placed in service is based on the number of months the property was in service, and property placed in service at any time during a month is treated as having been placed in service in the middle of the month.

[200] IRC section 168.

Depreciation of Leasehold Improvements

Generally, depreciation allowances for improvements made on leased property are determined under MACRS, even if the MACRS recovery period assigned to the property is longer than the term of the lease. This rule applies regardless of whether the lessor or the lessee places the leasehold improvements in service. If a leasehold improvement constitutes an addition or improvement to nonresidential real property already placed in service, the improvement generally is depreciated using the straight-line method over a 39-year recovery period, beginning in the month the addition or improvement was placed in service. However, exceptions exist for certain qualified leasehold improvements, qualified restaurant property, and qualified retail improvement property.

Qualified Leasehold Improvement Property

IRC section 168(e)(3)(E)(iv) provides a statutory 15-year recovery period for qualified leasehold improvement property placed in service before January 1, 2012. Qualified leasehold improvement property is any improvement to an interior portion of a building that is nonresidential real property, provided certain requirements are met.[201] The improvement must be made under or pursuant to a lease either by the lessee (or sublessee), or by the lessor, of that portion of the building to be occupied exclusively by the lessee (or sublessee). The improvement must be placed in service more than three years after the date the building was first placed in service. Qualified leasehold improvement property does not include any improvement for which the expenditure is attributable to the enlargement of the building, any elevator or escalator, any structural component benefiting a common area, or the internal structural framework of the building. If a lessor makes an improvement that qualifies as qualified leasehold improvement property, such improvement does not qualify as qualified leasehold improvement property to any subsequent owner of such improvement. An exception to the rule applies in the case of death and certain transfers of property that qualify for non-recognition treatment.

Qualified leasehold improvement property is recovered using the straight-line method and a half-year convention. Qualified leasehold improvement property placed in service after December 31, 2011, is subject to the general rules described above.

Qualified Restaurant Property

IRC section 168(e)(3)(E)(v) provides a statutory 15-year recovery period for qualified restaurant property placed in service before January 1, 2012. Qualified restaurant property is any IRC section 1250 property that is a building or an improvement to a building, if more than 50 percent of the building's square footage is devoted to the preparation of, and seating for on-premises consumption of, prepared meals.[202] Qualified restaurant property is recovered using

[201] IRC section 168(e)(6).

[202] IRC section 168(e)(7).

the straight-line method and a half-year convention. Additionally, qualified restaurant property is not eligible for bonus depreciation.[203] Qualified restaurant property placed in service after December 31, 2011, is subject to the general rules described above.

Qualified Retail Improvement Property

IRC section 168(e)(3)(E)(ix) provides a statutory 15-year recovery period for qualified retail improvement property placed in service before January 1, 2012. Qualified retail improvement property is any improvement to an interior portion of a building which is nonresidential real property if such portion is open to the general public[204] and is used in the retail trade or business of selling tangible personal property to the general public, and such improvement is placed in service more than three years after the date the building was first placed in service.[205] Qualified retail improvement property does not include any improvement for which the expenditure is attributable to the enlargement of the building, any elevator or escalator, any structural component benefiting a common area, or the internal structural framework of the building. In the case of an improvement made by the owner of such improvement, the improvement is a qualified retail improvement only so long as the improvement is held by such owner.

Retail establishments that qualify for the 15-year recovery period include those primarily engaged in the sale of goods. Examples of these retail establishments include, but are not limited to, grocery stores, clothing stores, hardware stores, and convenience stores. Establishments primarily engaged in providing services, such as professional services, financial services, personal services, health services, and entertainment, do not qualify. Generally, it is intended that businesses defined as a store retailer under the current North American Industry Classification System (industry sub-sectors 441 through 453) qualify while those in other industry classes do not qualify.

Qualified retail improvement property is recovered using the straight-line method and a half-year convention. Additionally, qualified retail improvement property is not eligible for bonus depreciation.[206] Qualified retail improvement property placed in service after December 31, 2011, is subject to the general rules described above.

<u>New Federal Law (IRC section 168)</u>

The present law provisions for qualified leasehold improvement property, qualified restaurant property, and qualified retail improvement property are extended for two years to apply to property placed in service on or before December 31, 2013.

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[203] Property that satisfies the definition of both qualified leasehold improvement property and qualified restaurant property is eligible for bonus depreciation.

[204] Improvements to portions of a building not open to the general public (e.g., stock room in back of retail space) do not qualify under the provision.

[205] IRC section 168(e)(8).

[206] Property that satisfies the definition of both qualified leasehold improvement property and qualified retail property is eligible for bonus depreciation.

Effective Date

The provision is effective for property placed in service after December 31, 2011.

California Law (R&TC sections 17201, 17250, and 24349-24355.4)

This provision is not applicable under California law.

The Personal Income Tax Law generally conforms to MACRS, with modifications, but specifically does not conform to the MACRS exception that allows 15-year straight-line cost recovery for qualified leasehold improvements, qualified restaurant improvements, and qualified retail improvements.[207]

The Corporation Tax Law does not adopt MACRS. Instead, the Corporation Tax Law is generally in substantial conformity to the pre-1981 federal asset depreciation range (ADR) depreciation rules, which generally allow property to be depreciated based on its useful life.[208] Additionally, the Corporation Tax Law allows the use of component depreciation.[209]

Impact on California Revenue

Not applicable.

Section	Section Title
312	Extension of 7-Year Recovery Period for Motorsports Entertainment Complexes

Background

A taxpayer generally must capitalize the cost of property used in a trade or business and recover such cost over time through annual deductions for depreciation or amortization. Tangible property generally is depreciated under the modified accelerated cost recovery system (MACRS), which determines depreciation by applying specific recovery periods, placed-in-service conventions, and depreciation methods to the cost of various types of depreciable property.[210] The cost of nonresidential real property is recovered using the straight-line method of depreciation

[207] R&TC section 17250(a)(6).

[208] R&TC sections 24349-24355.4.

[209] Prior to the adoption of accelerated cost recovery system (ACRS) by the Economic Recovery Tax Act of 1981, federal law allowed taxpayers to depreciate various components of a building as separate assets with separate useful lives, known as “component depreciation.” The Corporation Tax Law has never been amended to repeal the use of component depreciation, and has never adopted ACRS or MACRS.

[210] IRC section 168.

and a recovery period of 39 years. Nonresidential real property is subject to the mid-month placed-in-service convention. Under the mid-month convention, the depreciation allowance for the first year property is placed in service is based on the number of months the property was in service, and property placed in service at any time during a month is treated as having been placed in service in the middle of the month. Land improvements (such as roads and fences) are recovered over 15 years. An exception exists for the theme and amusement park industry, whose assets are assigned a recovery period of seven years. Additionally, a motorsports entertainment complex placed in service on or before December 31, 2011, is assigned a recovery period of seven years.[211] For these purposes, a motorsports entertainment complex means a racing track facility which is permanently situated on land and which during the 36-month period following its placed-in-service date hosts a racing event.[212] The term motorsports entertainment complex also includes ancillary facilities, land improvements (e.g., parking lots, sidewalks, fences), support facilities (e.g., food and beverage retailing, souvenir vending), and appurtenances associated with such facilities (e.g., ticket booths, grandstands, etc.).

New Federal Law (IRC section 168)

The provision extends the present-law seven-year recovery period for motorsports entertainment complexes for two years to apply to property placed in service before January 1, 2014.

California Law (R&TC sections 17250 and 24349)

This provision is not applicable under California law.

The Personal Income Tax Law generally conforms to MACRS, with modifications. Regarding the recovery period for motorsports entertainment complexes, the Personal Income Tax Law conformed to the seven-year recovery period for property placed in service on or after January 1, 2005, and before December 31, 2007,[213] and specifically does not conform to the seven-year recovery period for property placed in service on or after January 1, 2008.[214]

The Corporation Tax Law does not adopt MACRS. Instead, the Corporation Tax Law is generally in substantial conformity to the pre-1981 federal asset depreciation range (ADR) depreciation rules, which generally allow property to be depreciated based on its useful life.[215]

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[211] IRC section 168(e)(3)(C)(ii).

[212] IRC section 168(i)(15).

[213] For taxable years beginning on or after January 1, 2005, and before January 1, 2010, the Personal Income Tax Law conformed to the IRC section 168(i)(15) seven-year recovery period under RT&C section 17250, as of the "specified date" of January 1, 2005; thus, California conformed to the December 31, 2007, termination date contained in IRC section 168(i)(15) that applied as of January 1, 2005.

[214] R&TC section 17250(a)(11).

[215] R&TC sections 24349-24355.4.

The Corporation Tax Law temporarily adopted the seven-year recovery period for motorsports entertainment complexes, for property placed in service on or after January 1, 2005, and before December 31, 2007,[216] but that seven-year recovery period is not allowed for property placed in service on or after January 1, 2008.

Impact on California Revenue

Not applicable.

Section	Section Title
313	Extension of Accelerated Depreciation for Business Property on an Indian Reservation

Background

With respect to certain property used in connection with the conduct of a trade or business within an Indian reservation, depreciation deductions under IRC section 168(j) are determined using the following recovery periods:

3-year property	2 years
5-year property	3 years
7-year property	4 years
10-year property	6 years
15-year property	9 years
20-year property	12 years
Nonresidential real property	22 years

"Qualified Indian reservation property" eligible for accelerated depreciation includes property described in the table above which is: (1) used by the taxpayer predominantly in the active conduct of a trade or business within an Indian reservation, (2) not used or located outside the reservation on a regular basis, (3) not acquired (directly or indirectly) by the taxpayer from a person who is related to the taxpayer,[217] and (4) is not property placed in service for purposes of conducting gaming activities.[218] Certain "qualified infrastructure property" may be eligible for the accelerated depreciation even if located outside an Indian reservation, provided that the purpose

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[216] Former R&TC section 24355.3, as added by Chapter 691 of the Statutes of 2005, allowed the seven-year recovery period under the Corporation Tax Law for the same period that was allowed under the Personal Income Tax Law, for property placed in service on or after January 1, 2005, and before December 31, 2007. Former R&TC section 24355.3 was repealed by Section 68 of Chapter 14 of the Statutes of 2010.

[217] For these purposes, "related persons" is defined in IRC section 465(b)(3)(C).

[218] IRC section 168(j)(4)(A).

of such property is to connect with qualified infrastructure property located within the reservation (e.g., roads, power lines, water systems, railroad spurs, and communications facilities).[219]

An "Indian reservation" means a reservation as defined in section 3(d) of the Indian Financing Act of 1974[220] or section 4(10) of the Indian Child Welfare Act of 1978 (25 U.S.C. 1903(10)).[221] For purposes of the preceding sentence, section 3(d) is applied by treating "former Indian reservations in Oklahoma" as including only lands that are (1) within the jurisdictional area of an Oklahoma Indian tribe as determined by the Secretary of the Interior, and (2) recognized by such Secretary as an area eligible for trust land status under 25 C.F.R. Part 151 (as in effect on August 5, 1997).

The depreciation deduction allowed for regular tax purposes is also allowed for purposes of the alternative minimum tax. The accelerated depreciation for qualified Indian reservation property is available with respect to property placed in service before January 1, 2012.

<u>New Federal Law (IRC section 168)</u>

The provision extends for two years the present-law accelerated MACRS recovery periods for qualified Indian reservation property to apply to property placed in service before January 1, 2014.

<u>Effective Date</u>

The provision is effective for property placed in service after December 31, 2011.

<u>California Law (R&TC sections 17250 and 24349-24355.4)</u>

This provision is not applicable under California law.

The Personal Income Tax Law generally conforms to MACRS recovery periods, but specifically does not conform to accelerated depreciation for business property on an Indian Reservation.[222]

The Corporation Tax Law does not adopt MACRS. The Corporation Tax Law is generally in substantial conformity to the pre-1981 federal asset depreciation range (ADR) depreciation rules, which generally allow property to be depreciated based on its "useful life."[223]

<u>Impact on California Revenue</u>

Not applicable.

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[219] IRC section 168(j)(4)(C).

[220] Public Law 93–262.

[221] Public Law 95–608.

[222] R&TC section 17250(a)(3).

[223] R&TC sections 24349-24355.4.

Section	Section Title
314	Extension of Enhanced Charitable Deduction for Contributions of Food Inventory

Background

Charitable Contributions in General

In general, an income tax deduction is permitted for charitable contributions, subject to certain limitations that depend on the type of taxpayer, the property contributed, and the donee organization.[224]

Charitable contributions of cash are deductible in the amount contributed. In general, contributions of capital gain property are deductible at fair market value with certain exceptions. Capital gain property means any capital asset or property used in the taxpayer's trade or business the sale of which at its fair market value, at the time of contribution, would have resulted in gain that would have been long-term capital gain. Contributions of other appreciated property generally are deductible at the donor's basis in the property. Contributions of depreciated property generally are deductible at the fair market value of the property.

General Rules Regarding Contributions of Inventory

Under present law, a taxpayer's deduction for charitable contributions of inventory generally is limited to the taxpayer's basis (typically, cost) in the inventory, or if less, the fair market value of the inventory.

For certain contributions of inventory, C corporations may claim an enhanced deduction equal to the lesser of: (1) basis plus one-half of the item's appreciation (i.e., basis plus one-half of fair market value in excess of basis) or (2) two times basis.[225] In general, a C corporation's charitable contribution deductions for a year may not exceed 10 percent of the corporation's taxable income.[226] To be eligible for the enhanced deduction, the contributed property generally must be inventory of the taxpayer and must be contributed to a charitable organization described in IRC section 501(c)(3) (except for private non-operating foundations), and the donee must: (1) use the property consistent with the donee's exempt purpose solely for the care of the ill, the needy, or infants, (2) not transfer the property in exchange for money, other property, or services, and (3) provide the taxpayer a written statement that the donee's use of the property will be consistent with such requirements.[227] In the case of contributed property subject to the Federal Food, Drug, and Cosmetic Act, as amended, the property must satisfy the applicable requirements of such Act on the date of transfer and for 180 days prior to the transfer.[228]

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[224] IRC section 170.

[225] IRC section 170(e)(3).

[226] IRC section 170(b)(2).

[227] IRC section 170(e)(3)(A)(i)-(iii).

[228] IRC section 170(e)(3)(A)(iv).

A donor making a charitable contribution of inventory must make a corresponding adjustment to the cost of goods sold by decreasing the cost of goods sold by the lesser of the fair market value of the property or the donor's basis with respect to the inventory.[229]

To use the enhanced deduction, the taxpayer must establish that the fair market value of the donated item exceeds basis. The valuation of food inventory has been the subject of disputes between taxpayers and the IRS.[230]

Temporary Rule Expanding and Modifying the Enhanced Deduction for Contributions of Food Inventory

Under a special temporary provision, any taxpayer engaged in a trade or business, whether or not a C corporation, is eligible to claim the enhanced deduction for donations of food inventory.[231] For taxpayers other than C corporations, the total deduction for donations of food inventory in a taxable year generally may not exceed 10 percent of the taxpayer's net income for such taxable year from all sole proprietorships, S corporations, or partnerships (or other non C corporations) from which contributions of apparently wholesome food are made. For example, if a taxpayer is a sole proprietor, a shareholder in an S corporation, and a partner in a partnership, and each business makes charitable contributions of food inventory, the taxpayer's deduction for donations of food inventory is limited to 10 percent of the taxpayer's net income from the sole proprietorship and the taxpayer's interests in the S corporation and partnership. However, if only the sole proprietorship and the S corporation made charitable contributions of food inventory, the taxpayer's deduction would be limited to 10 percent of the net income from the trade or business of the sole proprietorship and the taxpayer's interest in the S corporation, but not the taxpayer's interest in the partnership.[232]

Under the temporary provision, the enhanced deduction for food is available only for food that qualifies as "apparently wholesome food." Apparently wholesome food is defined as food intended for human consumption that meets all quality and labeling standards imposed by federal, state, and local laws and regulations even though the food may not be readily marketable due to appearance, age, freshness, grade, size, surplus, or other conditions.

The temporary provision does not apply to contributions made after December 31, 2011.

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[229] Treas. Reg. section 1.170A–4A(c)(3).

[230] *Lucky Stores Inc. v. Commissioner*, 105 T.C. 420 (1995) (holding that the value of surplus bread inventory donated to charity was the full retail price of the bread rather than half the retail price, as the IRS asserted).

[231] IRC section 170(e)(3)(C).

[232] The 10-percent limitation does not affect the application of the generally applicable percentage limitations. For example, if 10 percent of a sole proprietor's net income from the proprietor's trade or business was greater than 50 percent of the proprietor's contribution base, the available deduction for the taxable year (with respect to contributions to public charities) would be 50 percent of the proprietor's contribution base. Consistent with present law, such contributions may be carried forward because they exceed the 50 percent limitation. Contributions of food inventory, by a taxpayer that is not a C corporation, that exceed the 10 percent limitation but not the 50 percent limitation, could not be carried forward.

New Federal Law (IRC section 170)

The provision extends the expansion of, and modifications to, the enhanced deduction for charitable contributions of food inventory to contributions made before January 1, 2014.

Effective Date

The provision is effective for contributions made after December 31, 2011.

California Law (R&TC sections 17201, 17275.2, 17275.5, and 24357–24359.1)

This provision is not applicable under California law.

The Personal Income Tax Law generally conforms to the federal rules relating to charitable contributions as of the "specified date" of January 1, 2009,[233] but specifically does not conform to the enhanced deduction for a contribution of food inventory.[234] The deduction under the Personal Income Tax Law for charitable contributions of inventory is limited to the taxpayer's basis in the inventory, generally its cost.

The Corporation Tax Law does not adopt the general federal rules that allow enhanced deductions for C-corporation contributions of inventory, and does not adopt the enhanced deduction for a contribution of food inventory. The deduction under the Corporation Tax Law for contributions of inventory is limited to the taxpayer's basis in the inventory (generally its cost), and may not exceed ten percent of the corporation's net income. Any excess may be carried forward for up to five years.[235]

Impact on California Revenue

Not applicable.

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[233] R&TC section 17201 conforms to IRC section 170, relating to charitable contributions and gifts, as of the "specified date" of January 1, 2009, with modifications.

[234] R&TC section 17275.2.

[235] R&TC sections 24357–24359.1.

Section	Section Title
315	Extension of Increased Expensing Limitations and Treatment of Certain Real Property as Section 179 Property

Background

A taxpayer may elect under IRC section 179 to deduct (or "expense") the cost of qualifying property, rather than to recover such costs through depreciation deductions, subject to limitation.[236] For taxable years beginning in 2012, the maximum amount a taxpayer may expense is $125,000 of the cost of qualifying property placed in service for the taxable year. The $125,000 amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds $500,000.[237] The $125,000 and $500,000 amounts are indexed for inflation occurring since 2006.[238] The indexed amounts for 2012 are $139,000 and $560,000. In general, qualifying property is defined as depreciable tangible personal property that is purchased for use in the active conduct of a trade or business. Off-the-shelf computer software placed in service in taxable years beginning before 2013 also is treated as qualifying property.

For taxable years beginning in 2010 and 2011, the maximum amount a taxpayer may expense is $500,000 of the cost of qualifying property placed in service for the taxable year. The $500,000 amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds $2,000,000. For taxable years beginning in 2010 and 2011, qualifying property also includes certain real property (i.e., qualified leasehold improvement property, qualified restaurant property, and qualified retail improvement property).[239] Of the $500,000 expense amount available under IRC section 179 for 2010 and 2011, the maximum amount available with respect to qualified real property is $250,000 for each taxable year.

For taxable years beginning in 2013 and thereafter, a taxpayer may elect to deduct up to $25,000 of the cost of qualifying property placed in service for the taxable year, subject to limitation. The $25,000 amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds $200,000. The $25,000 and $200,000 amounts are not indexed for inflation. In general, qualifying property is defined as depreciable tangible personal property (not including off-the-shelf computer software) that is purchased for use in the active conduct of a trade or business.

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[236] Additional IRC section 179 incentives have been provided with respect to qualified property meeting applicable requirements that is used by a business in an empowerment zone (IRC section 1397A), a renewal community (IRC section 1400J), or the Gulf Opportunity Zone (IRC section 1400N(e)). In addition, IRC section 179(e) provides for an enhanced IRC section 179 deduction for qualified disaster assistance property.

[237] IRC section 179(b)(2).

[238] IRC section 179(b)(6).

[239] IRC section 179(f).

The amount eligible to be expensed for a taxable year may not exceed the taxable income for such taxable year that is derived from the active conduct of a trade or business (determined without regard to this provision). Any amount that is not allowed as a deduction because of the taxable income limitation may be carried forward to succeeding taxable years (subject to limitations). However, amounts attributable to qualified real property that are disallowed under the trade or business income limitation may only be carried over to taxable years in which the definition of eligible IRC section 179 property includes qualified real property.[240] Thus, if a taxpayer's IRC section 179 deduction for 2010 with respect to qualified real property is limited by the taxpayer's active trade or business income, such disallowed amount may be carried over to 2011. Any such carryover amounts that are not used in 2011 are treated as property placed in service in 2011 for purposes of computing depreciation. That is, the unused carryover amount from 2010 is considered placed in service on the first day of the 2011 taxable year.[241]

No general business credit under IRC section 38 is allowed with respect to any amount for which a deduction is allowed under IRC section 179. An expensing election is made under rules prescribed by the Secretary of the Treasury.[242] In general, any election or specification made with respect to any property may not be revoked except with the consent of the Secretary of the Treasury. However, an election or specification under IRC section 179 may be revoked by the taxpayer without consent of the Secretary of the Treasury for taxable years beginning after 2002 and before 2013.[243]

New Federal Law (IRC section 179)

The provision provides that the maximum amount a taxpayer may expense, for taxable years beginning in 2012 and 2013, is $500,000 of the cost of qualifying property placed in service for the taxable year. The $500,000 amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds $2,000,000.

In addition, the provision extends, for taxable years beginning in 2013, the treatment of off-the-shelf computer software as qualifying property. The provision also extends the treatment of qualified real property as eligible IRC section 179 property for taxable years beginning in 2012 and 2013, including the limitation on carryovers and the maximum amount of $250,000 for each

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[240] IRC section 179(f)(4) details the special rules that apply to disallowed amounts.

[241] For example, assume that during 2010, a company's only asset purchases are IRC section 179-eligible equipment costing $100,000 and qualifying leasehold improvements costing $200,000. Assume the company has no other asset purchases during 2010, and has a taxable income limitation of $150,000. The maximum IRC section 179 deduction the company can claim for 2010 is $150,000, which is allocated pro rata between the properties, such that the carryover to 2011 is allocated $100,000 to the qualified leasehold improvements and $50,000 to the equipment.
Assume further that in 2011, the company had no asset purchases and had taxable income of $-0-. The $100,000 carryover from 2010 attributable to qualified leasehold improvements is treated as placed in service as of the first day of the company's 2011 taxable year. The $50,000 carryover allocated to equipment is carried over to 2012 under IRC section 179(b)(3)(B).

[242] IRC section 179(c)(1).

[243] IRC section 179(c)(2).

taxable year. The provision makes a technical drafting correction by clarifying that for the last taxable year beginning in 2013, the taxable income limitation[244] is computed without regard to any additional depreciation expense resulting from the application of the carryover limitation of IRC section 179(f)(4). For taxable years beginning in 2013, the provision continues to permit a taxpayer to amend or irrevocably revoke an election for a taxable year under IRC section 179 without the consent of the Secretary of the Treasury.

Effective Date

The provision is effective for taxable years beginning after December 31, 2011.

California Law (R&TC sections 17201, 17255, and 24356)

California conforms to the federal election to deduct (or "expense") the cost of qualifying property under IRC section 179, rather than to recover such costs through depreciation deductions (commonly referred to as "small business expensing"), as of the "specified date" of January 1, 2009,[245] with significant modifications.

California specifically does not conform to the increased "small business expensing" that was first enacted in the Jobs and Growth Tax Relief Reconciliation Act of 2003[246] and then extended and modified in several subsequent federal acts.[247] Thus, under California law, both corporate and non-corporate taxpayers with a sufficiently small amount of annual investment in qualified depreciable property may elect to deduct up to $25,000 of the cost of qualifying property placed in service for the taxable year. The $25,000 amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds $200,000. The $25,000 and $200,000 amounts are not indexed for inflation.

In general, qualifying property is defined as depreciable tangible personal property that is purchased for use in the active conduct of a trade or business. The amount eligible to be expensed for a taxable year may not exceed the taxable income for a taxable year that is derived from the active conduct of a trade or business (determined without regard to this provision). Any amount that is not allowed as a deduction because of the taxable income limitation may be carried forward to succeeding taxable years (subject to similar limitations).

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[244] IRC section 179(b)(3).

[245] Under the Personal Income Tax Law, R&TC section 17201(a) conforms to IRC section 179 as of the "specified date" of January 1, 2009, with modifications in R&TC section 17255. Under the Corporation Tax Law, R&TC 24356(b) conforms to IRC section 179 as of the "specified date" of January 1, 2009, with modifications.

[246] Public Law 108-27, Section 202.

[247] Public Law 108-357, Section 201; Public Law 109-222, Section 101; Public Law 110-28, Section 8212; Public Law 111-5, Section 1202; Public Law 111-147, Section 201; Public Law 111-240, Section 2021; and Public Law 111-312, Section 402.

Impact on California Revenue

Not applicable.

Section	Section Title
316	Extension of Election to Expense Mine Safety Equipment

Background

A taxpayer is allowed to recover, through annual depreciation deductions, the cost of certain property used in a trade or business or for the production of income. The amount of the depreciation deduction allowed with respect to tangible property for a taxable year is determined under the modified accelerated cost recovery system (MACRS).[248] Under MACRS, different types of property generally are assigned applicable recovery periods and depreciation methods. The recovery periods applicable to most tangible personal property (generally tangible property other than residential rental property and nonresidential real property) range from 3 to 20 years. The depreciation methods generally applicable to tangible personal property are the 200-percent and 150-percent declining balance methods, switching to the straight-line method for the taxable year in which the depreciation deduction would be maximized.

In lieu of depreciation, a taxpayer with a sufficiently small amount of annual investment may elect to deduct (or "expense") such costs under IRC section 179. Present law provides that the maximum amount a taxpayer may expense for taxable years beginning in 2012 is $125,000 of the cost of the qualifying property for the taxable year. In general, qualifying property is defined as depreciable tangible personal property that is purchased for use in the active conduct of a trade or business.[249] The $125,000 amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds $500,000.

A taxpayer may elect to treat 50 percent of the cost of any qualified advanced mine safety equipment property as an expense in the taxable year in which the equipment is placed in service.[250] The deduction under IRC section 179E is allowed for both regular and alternative minimum tax purposes, including adjusted current earnings. In computing earnings and profits, the amount deductible under IRC section 179E is allowed as a deduction ratably over five taxable years beginning with the year the amount is deductible under IRC section 179E.[251]

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[248] IRC section 168.

[249] The definition of qualifying property was temporarily (for 2010 and 2011) expanded to include up to $250,000 of qualified leasehold improvement property, qualified restaurant property, and qualified retail improvement property. See IRC section 179(c).

[250] IRC section 179E(a).

[251] IRC section 312(k)(3).

"Qualified advanced mine safety equipment property" means any advanced mine safety equipment property for use in any underground mine located in the United States the original use of which commences with the taxpayer and which is placed in service before January 1, 2012.[252]

Advanced mine safety equipment property means any of the following: (1) emergency communication technology or devices used to allow a miner to maintain constant communication with an individual who is not in the mine, (2) electronic identification and location devices that allow individuals not in the mine to track at all times the movements and location of miners working in or at the mine, (3) emergency oxygen-generating, self-rescue devices that provide oxygen for at least 90 minutes, (4) pre-positioned supplies of oxygen providing each miner on a shift the ability to survive for at least 48 hours, and (5) comprehensive atmospheric monitoring systems that monitor the levels of carbon monoxide, methane and oxygen that are present in all areas of the mine and that can detect smoke in the case of a fire in a mine.[253]

The portion of the cost of any property with respect to which an expensing election under IRC section 179 is made may not be taken into account for purposes of the 50-percent deduction under IRC section 179E.[254] In addition, a taxpayer making an election under IRC section 179E must file with the Secretary of the Treasury a report containing information with respect to the operation of the mines of the taxpayer as required by the Secretary.[255]

<u>New Federal Law (IRC section 179E)</u>

The provision extends for two years (through December 31, 2013) the present-law placed-in-service date relating to expensing of mine safety equipment.

<u>Effective Date</u>

The provision applies to property placed in service after December 31, 2011.

<u>California Law (R&TC sections 17201, 17255, 17257.4, and 24356)</u>

This provision is not applicable under California law.

Under the Personal Income Tax Law, California specifically does not conform to the federal election to expense advanced mine safety equipment,[256] and the election has not been adopted under the Corporation Tax Law. Under both the Personal Income Tax Law and the Corporation Tax

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[252] IRC sections 179E(c) and (g).

[253] IRC section 179E(d).

[254] IRC section 179E(e).

[255] IRC section 179E(f).

[256] R&TC section 17257.4.

Law, as it relates to the election to deduct (or "expense") costs in lieu of depreciation, California conforms to IRC section 179, with significant modifications.[257]

Taxpayers with a sufficiently small amount of annual investment may elect to deduct up to $25,000 of the cost of qualifying property placed in service for the taxable year. The $25,000 amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds $200,000. The amount eligible to be expensed for a taxable year may not exceed the taxable income for a taxable year that is derived from the active conduct of a trade or business (determined without regard to this provision). Any amount that is not allowed as a deduction because of the taxable income limitation may be carried forward to succeeding taxable years (subject to similar limitations.).

Impact on California Revenue

Not applicable.

Section	Section Title
317	Extension of Special Expensing Rules for Certain Film and Television Productions

Background

The modified accelerated cost recovery system (MACRS) does not apply to certain property, including any motion picture film, video tape, or sound recording, or to any other property if the taxpayer elects to exclude such property from MACRS and the taxpayer properly applies a unit-of-production method or other method of depreciation not expressed in a term of years.

IRC section 197, which allows amortization for certain intangible property, does not apply to some intangible property, including property produced by the taxpayer or any interest in a film, sound recording, video tape, book or similar property not acquired in a transaction (or a series of related transactions) involving the acquisition of assets constituting a trade or business or substantial portion thereof. Thus, the recovery of the cost of a film, video tape, or similar property that is produced by the taxpayer or is acquired on a "stand-alone" basis by the taxpayer may not be determined under either the MACRS depreciation provisions or under the IRC section 197 amortization provisions. The cost recovery of such property may be determined under IRC section 167, which allows a depreciation deduction for the reasonable allowance for the exhaustion, wear and tear, or obsolescence of the property. A taxpayer is allowed to recover, through annual depreciation deductions, the cost of certain property used in a trade or business or for the production of income. IRC section 167(g) provides that the cost of motion picture films, sound recordings, copyrights, books, and patents are eligible to be recovered using the income-forecast method of depreciation.

[257] R&TC sections 17255 and 24356.

Under IRC section 181, taxpayers may elect[258] to deduct the cost of any qualifying film and television production, commencing prior to January 1, 2012, in the year the expenditure is incurred in lieu of capitalizing the cost and recovering it through depreciation allowances.[259] Taxpayers may elect to deduct up to $15 million of the aggregate cost of the film or television production under this section.[260] The threshold is increased to $20 million if a significant amount of the production expenditures are incurred in areas eligible for designation as a low-income community or eligible for designation by the Delta Regional Authority as a distressed county or isolated area of distress.[261]

A qualified film or television production means any production of a motion picture (whether released theatrically or directly to video cassette or any other format) or television program if at least 75 percent of the total compensation expended on the production is for services performed in the United States by actors, directors, producers, and other relevant production personnel.[262] The term "compensation" does not include participations and residuals (as defined in IRC section 167(g)(7)(B)).[263] With respect to property which is one or more episodes in a television series, each episode is treated as a separate production and only the first 44 episodes qualify under the provision.[264] Qualified property does not include sexually explicit productions as defined by section 2257 of title 18 of the U.S. Code.[265]

For purposes of recapture under IRC section 1245, any deduction allowed under IRC section 181 is treated as if it were a deduction allowable for amortization.[266]

New Federal Law (IRC section 181)

The provision extends the present-law expensing provision for two years, to qualified film and television productions commencing prior to January 1, 2014.

Effective Date

The provision applies to qualified film and television productions commencing after December 31, 2011.

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258 For rules on making an election under this section, see Temp. Treas. Reg. section 1.181–2T.

259 For this purpose, a production is treated as commencing on the first date of principal photography.

260 IRC section 181(a)(2)(A).

261 IRC section 181(a)(2)(B).

262 IRC section 181(d)(3)(A).

263 IRC section 181(d)(3)(B).

264 IRC section 181(d)(2)(B).

265 IRC section 81(d)(2)(C).

266 IRC section 1245(a)(2)(C).

California Law (R&TC sections 17250, 17201.5, 17250.5, and 24349)

This provision is not applicable under California law.

Under the Personal Income Tax Law, California specifically does not conform to the federal election to deduct the cost of any qualifying film and television production in the year the expenditure is incurred in lieu of capitalizing the cost and recovering it through depreciation allowances,[267] and the election has not been adopted under the Corporation Tax Law.

Under both the Personal Income Tax Law and the Corporation Tax Law, California generally conforms to the federal income-forecast method to determine the depreciation recovery periods of property such as films, videotapes, television, book rights, patents, master sound recordings, video games, and like items.[268]

Impact on California Revenue

Not applicable.

Section	Section Title
318	Extension of Deduction Allowable with Respect to Income Attributable to Domestic Production Activities in Puerto Rico

Background

In General

Present law provides a deduction from taxable income (or, in the case of an individual, adjusted gross income) that is equal to nine percent of the lesser of the taxpayer's qualified production activities income or taxable income for the taxable year. For taxpayers subject to the 35-percent corporate income tax rate, the nine-percent deduction effectively reduces the corporate income tax rate to slightly less than 32 percent on qualified production activities income.

In general, qualified production activities income is equal to domestic production gross receipts reduced by the sum of: (1) the costs of goods sold that are allocable to those receipts, and (2) other expenses, losses, or deductions which are properly allocable to those receipts.

Domestic production gross receipts generally are gross receipts of a taxpayer that are derived from: (1) any sale, exchange, or other disposition, or any lease, rental, or license, of qualifying

[267] R&TC section 17201.5.

[268] R&TC sections 17250.5 and 24349(f) conform to IRC section 167(g), relating to depreciation under the income forecast method, as of the "specified date" of January 1, 2009, with modifications.

production property[269] that was manufactured, produced, grown or extracted by the taxpayer in whole or in significant part within the United States, (2) any sale, exchange, or other disposition, or any lease, rental, or license, of qualified film[270] produced by the taxpayer, (3) any lease, rental, license, sale, exchange, or other disposition of electricity, natural gas, or potable water produced by the taxpayer in the United States, (4) construction of real property performed in the United States by a taxpayer in the ordinary course of a construction trade or business, or (5) engineering or architectural services performed in the United States for the construction of real property located in the United States.

The amount of the deduction for a taxable year is limited to 50 percent of the wages paid by the taxpayer, and properly allocable to domestic production gross receipts, during the calendar year that ends in such taxable year.[271] Wages paid to bona fide residents of Puerto Rico generally are not included in the definition of wages for purposes of computing the wage limitation amount.[272]

Rules for Puerto Rico

When used in the IRC in a geographical sense, the term "United States" generally includes only the states and the District of Columbia.[273] A special rule for determining domestic production gross receipts, however, provides that in the case of any taxpayer with gross receipts from sources within the Commonwealth of Puerto Rico, the term "United States" includes the Commonwealth of Puerto Rico, but only if all of the taxpayer's Puerto Rico-sourced gross receipts are taxable under the federal income tax for individuals or corporations.[274] In computing the 50-percent wage limitation, the taxpayer is permitted to take into account wages paid to bona fide residents of Puerto Rico for services performed in Puerto Rico.[275]

The special rules for Puerto Rico apply only with respect to the first six taxable years of a taxpayer beginning after December 31, 2005 and before January 1, 2012.

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[269] Qualifying production property generally includes any tangible personal property, computer software, and sound recordings.

[270] Qualified film includes any motion picture film or videotape (including live or delayed television programming, but not including certain sexually explicit productions) if 50 percent or more of the total compensation relating to the production of the film (including compensation in the form of residuals and participations) constitutes compensation for services performed in the United States by actors, production personnel, directors, and producers.

[271] For purposes of the provision, "wages" include the sum of the amounts of wages as defined in IRC section 3401(a) and elective deferrals that the taxpayer properly reports to the Social Security Administration with respect to the employment of employees of the taxpayer during the calendar year ending during the taxpayer's taxable year.

[272] IRC section 3401(a)(8)(C) excludes wages paid to United States citizens who are bona fide residents of Puerto Rico from the term wages for purposes of income tax withholding.

[273] IRC section 7701(a)(9).

[274] IRC section 199(d)(8)(A).

[275] IRC section 199(d)(8)(B).

New Federal Law (IRC section 199)

The provision extends the special domestic production activities rules for Puerto Rico to apply for the first eight taxable years of a taxpayer beginning after December 31, 2005 and before January 1, 2014.

Effective Date

The provision is effective for taxable years beginning after December 31, 2011.

California Law (R&TC sections 17250 and 17201.6)

This provision is not applicable under California law. Under the Personal Income Tax Law, California specifically does not conform to the deduction for income attributable to domestic production entities, and the deduction has not been adopted under the Corporation Tax Law.

Impact on California Revenue

Not applicable.

Section	Section Title
319	Extension of Modification of Tax Treatment of Certain Payments to Controlling Exempt Organizations

Background

In general, organizations exempt from federal income tax are subject to the unrelated business income tax on income derived from a trade or business regularly carried on by the organization that is not substantially related to the performance of the organization's tax-exempt functions.[276] In general, interest, rents, royalties, and annuities are excluded from the unrelated business income of tax-exempt organizations.[277]

IRC section 512(b)(13) provides special rules regarding income derived by an exempt organization from a controlled subsidiary. In general, IRC section 512(b)(13) treats otherwise excluded rent, royalty, annuity, and interest income as unrelated business taxable income if such income is received from a taxable or tax-exempt subsidiary that is 50-percent controlled by the parent tax-exempt organization to the extent the payment reduces the net unrelated income (or increases any net unrelated loss) of the controlled entity (determined as if the entity were tax exempt). However, a special rule provides that, for payments made pursuant to a binding written contract in

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[276] IRC section 511.

[277] IRC section 512(b).

effect on August 17, 2006 (or renewal of such a contract on substantially similar terms), the general rule of IRC section 512(b)(13) applies only to the portion of payments received or accrued in a taxable year that exceeds the amount of the payment that would have been paid or accrued if the amount of such payment had been determined under the principles of IRC section 482 (i.e., at arm's length).[278] In addition, the special rule imposes a 20-percent penalty on the larger of such excess determined without regard to any amendment or supplement to a return of tax, or such excess determined with regard to all such amendments and supplements.

In the case of a stock subsidiary, "control" means ownership by vote or value of more than 50 percent of the stock. In the case of a partnership or other entity, "control" means ownership of more than 50 percent of the profits, capital, or beneficial interests. In addition, present law applies the constructive ownership rules of IRC section 318 for purposes of IRC section 512(b)(13). Thus, a parent exempt organization is deemed to control any subsidiary in which it holds more than 50 percent of the voting power or value, directly (as in the case of a first-tier subsidiary) or indirectly (as in the case of a second-tier subsidiary).

The special rule does not apply to payments received or accrued after December 31, 2011.

<u>New Federal Law (IRC section 512)</u>

The provision extends the special rule for two years to payments received or accrued before January 1, 2014. Accordingly, under the provision, payments of rent, royalties, annuities, or interest income by a controlled organization to a controlling organization pursuant to a binding written contract in effect on August 17, 2006 (or renewal of such a contract on substantially similar terms), may be includible in the unrelated business taxable income of the controlling organization only to the extent the payment exceeds the amount of the payment determined under the principles of IRC section 482 (i.e., at arm's length). Any such excess is subject to a 20-percent penalty on the larger of such excess determined without regard to any amendment or supplement to a return of tax, or such excess determined with regard to all such amendments and supplements.

<u>Effective Date</u>

The provision is effective for payments received or accrued after December 31, 2011.

<u>California Law (R&TC sections 17651, 23731, 23732, and 23772)</u>

California imposes a tax on the "unrelated business income" of organizations and trusts exempt from tax,[279] and generally conforms to the federal rules that apply to unrelated business taxable income as of the "specified date" of January 1, 2009.[280] However, California law does not

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278 IRC section 512(b)(13)(E).

279 R&TC sections 17561 and 23732.

280 R&TC section 23732 conforms to IRC section 512, relating to unrelated business taxable income, as of the "specified date" of January 1, 2009, with modifications.

conform to the federal special rule for certain amounts received or accrued by exempt organizations from controlled entities. California never conformed to that special rule for payments received or accrued on or before December 31, 2009, and because both this extension and the prior federal extension (that extended the special rule through 2011)[281] were enacted after the "specified date" of January 1, 2009, California law does not conform to them.

Impact on California Revenue

None (this provision expires for payments received or accrued after December 31, 2013).

Section	Section Title
320	Extension of Treatment of Certain Dividends of Regulated Investment Companies

In General

A regulated investment company (RIC) is an entity that meets certain requirements (including a requirement that its income generally be derived from passive investments such as dividends and interest and a requirement that it distribute at least 90 percent of its income) and that elects to be taxed under a special tax regime. Unlike an ordinary corporation, an entity that is taxed as a RIC can deduct amounts paid to its shareholders as dividends. In this manner, tax on RIC income is generally not paid by the RIC but rather by its shareholders. Income of a RIC distributed to shareholders as dividends is generally treated as an ordinary income dividend by those shareholders, unless other special rules apply. Dividends received by foreign persons from a RIC are generally subject to gross-basis tax under IRC sections 871(a) or 881, and the RIC payor of such dividends is obligated to withhold such tax under IRC sections 1441 and 1442.

Under a temporary provision of prior law, a RIC that earned certain interest income that generally would not be subject to U.S. tax if earned by a foreign person directly could, to the extent of such net interest income, designate a dividend it paid as derived from such interest income for purposes of the treatment of a foreign RIC shareholder. A foreign person who is a shareholder in the RIC generally could treat such a dividend as exempt from gross-basis U.S. tax. Also, subject to certain requirements, the RIC was exempt from withholding the gross-basis tax on such dividends. Similar rules applied with respect to the designation of certain short-term capital gain dividends. However, these provisions relating to dividends with respect to interest income and short-term capital gain of the RIC do not apply to dividends with respect to any taxable year of a RIC beginning after December 31, 2011.[282]

[281] Public Law 111-312, section 747, December 17, 2010.

[282] IRC sections 871(k), 881(e), 1441(c)(12), and 1441(a).

New Federal Law (IRC section 871)

The provision extends the rules exempting from gross basis tax and from withholding tax the interest-related dividends and short-term capital gain dividends received from a RIC, to dividends with respect to taxable years of a RIC beginning before January 1, 2014.

Effective Date

The provision applies to dividends paid with respect to any taxable year of the RIC beginning after December 31, 2011.

California Law (None)

California does not conform to the federal gross-basis tax.

Impact on California Revenue

Not applicable.

Section	Section Title
321	Extension of RIC Qualified Investment Entity Treatment Under FIRPTA

Background

Special U.S. tax rules apply to capital gains of foreign persons that are attributable to dispositions of interests in U.S. real property. In general, although a foreign person (a foreign corporation or a nonresident alien individual) is not generally taxed on U.S. source capital gains unless certain personal presence or active business requirements are met, a foreign person who sells a U.S. real property interest (USRPI) is subject to tax at the same rates as a U.S. person, under the Foreign Investment in Real Property Tax Act (FIRPTA) provisions codified in IRC section 897. Withholding tax is also imposed under IRC section 1445.

A USRPI includes stock or a beneficial interest in any domestic corporation unless such corporation has not been a U.S. real property holding corporation (as defined) during the testing period. A USRPI does not include an interest in a domestically controlled "qualified investment entity." A distribution from a "qualified investment entity" that is attributable to the sale of a USRPI is also subject to tax under FIRPTA unless the distribution is with respect to an interest that is regularly traded on an established securities market located in the United States and the recipient foreign corporation or nonresident alien individual did not hold more than five percent of that class of stock or beneficial interest within the one-year period ending on the date of distribution.[283] Special rules apply to situations involving tiers of qualified investment entities.

The term "qualified investment entity" includes a real estate investment trust (REIT) and also includes a regulated investment company (RIC) that meets certain requirements, although the inclusion of a RIC in that definition does not apply for certain purposes after December 31, 2011.[284]

New Federal Law (IRC section 897)

The provision extends the inclusion of a RIC within the definition of a "qualified investment entity" under IRC section 897 through December 31, 2013, for those situations in which that inclusion would otherwise have expired after December 31, 2011.

Effective Date

The provision is generally effective on January 1, 2012. The provision does not apply with respect to the withholding requirement under IRC section 1445 for any payment made before January 2, 2013, but a RIC that withheld and remitted tax under IRC section 1445 on distributions made after December 31, 2011, and before January 2, 2013, is not liable to the distributee with respect to such withheld and remitted amounts.

California Law (None)

California does not conform to the federal rules for sourcing the income of foreign corporations.

Impact on California Revenue

Not applicable.

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[283] IRC sections 857(b)(3)(F), 852(b)(3)(E), and 871(k)(2)(E) require dividend treatment, rather than capital gain treatment, for certain distributions to which FIRPTA does not apply by reason of this exception. See also IRC section 881(e)(2).

[284] IRC section 897(h).

Section	Section Title
322	Extension of Subpart F Exception for Active Financing Income

Background

Under the subpart F rules,[285] 10-percent-or-greater U.S. shareholders of a controlled foreign corporation (CFC) are subject to U.S. tax currently on certain income earned by the CFC, whether or not such income is distributed to the shareholders. The income subject to current inclusion under the subpart F rules includes, among other things, insurance income and foreign base company income. Foreign base company income includes, among other things, foreign personal holding company income and foreign base company services income (i.e., income derived from services performed for or on behalf of a related person outside the country in which the CFC is organized).

Foreign personal holding company income generally consists of the following: (1) dividends, interest, royalties, rents, and annuities; (2) net gains from the sale or exchange of (a) property that gives rise to the preceding types of income, (b) property that does not give rise to income, and (c) interests in trusts, partnerships, and real estate mortgage investment conduits (REMICs); (3) net gains from commodities transactions; (4) net gains from certain foreign currency transactions; (5) income that is equivalent to interest; (6) income from notional principal contracts; (7) payments in lieu of dividends; and (8) amounts received under personal service contracts.

Insurance income subject to current inclusion under the subpart F rules includes any income of a CFC attributable to the issuing or reinsuring of any insurance or annuity contract in connection with risks located in a country other than the CFC's country of organization. Subpart F insurance income also includes income attributable to an insurance contract in connection with risks located within the CFC's country of organization, as the result of an arrangement under which another corporation receives a substantially equal amount of consideration for insurance of other country risks. Investment income of a CFC that is allocable to any insurance or annuity contract related to risks located outside the CFC's country of organization is taxable as subpart F insurance income.[286]

Temporary exceptions from foreign personal holding company income, foreign base company services income, and insurance income apply for subpart F purposes for certain income that is derived in the active conduct of a banking, financing, or similar business, as a securities dealer, or in the conduct of an insurance business (so-called "active financing income").

With respect to income derived in the active conduct of a banking, financing, or similar business, a CFC is required to be predominantly engaged in such business and to conduct substantial activity with respect to such business in order to qualify for the active-financing exceptions. In addition, certain nexus requirements apply, which provide that income derived by a CFC or a

[285] IRC sections 951–964.

[286] Prop. Treas. Reg. section 1.953–1(a).

qualified business unit (QBU) of a CFC from transactions with customers is eligible for the exceptions if, among other things, substantially all of the activities in connection with such transactions are conducted directly by the CFC or QBU in its home country, and such income is treated as earned by the CFC or QBU in its home country for purposes of such country's tax laws. Moreover, the exceptions apply to income derived from certain cross border transactions, provided that certain requirements are met. Additional exceptions from foreign personal holding company income apply for certain income derived by a securities dealer within the meaning of IRC section 475 and for gain from the sale of active financing assets.

In the case of a securities dealer, the temporary exception from foreign personal holding company income applies to certain income. The income covered by the exception is any interest or dividend (or certain equivalent amounts) from any transaction, including a hedging transaction or a transaction consisting of a deposit of collateral or margin, entered into in the ordinary course of the dealer's trade or business as a dealer in securities within the meaning of IRC section 475. In the case of a QBU of the dealer, the income is required to be attributable to activities of the QBU in the country of incorporation, or to a QBU in the country in which the QBU both maintains its principal office and conducts substantial business activity. A coordination rule provides that this exception generally takes precedence over the exception for income of a banking, financing or similar business, in the case of a securities dealer.

In the case of insurance, a temporary exception from foreign personal holding company income applies for certain income of a qualifying insurance company with respect to risks located within the CFC's country of creation or organization. In the case of insurance, temporary exceptions from insurance income and from foreign personal holding company income also apply for certain income of a qualifying branch of a qualifying insurance company with respect to risks located within the home country of the branch, provided certain requirements are met under each of the exceptions. Further, additional temporary exceptions from insurance income and from foreign personal holding company income apply for certain income of certain CFCs or branches with respect to risks located in a country other than the United States, provided that the requirements for these exceptions are met. In the case of a life insurance or annuity contract, reserves for such contracts are determined under rules specific to the temporary exceptions. Present law also permits a taxpayer in certain circumstances, subject to approval by the IRS through the ruling process or in published guidance, to establish that the reserve of a life insurance company for life insurance and annuity contracts is the amount taken into account in determining the foreign statement reserve for the contract (reduced by catastrophe, equalization, or deficiency reserve or any similar reserve). IRS approval is to be based on whether the method, the interest rate, the mortality and morbidity assumptions, and any other factors taken into account in determining foreign statement reserves (taken together or separately) provide an appropriate means of measuring income for federal income tax purposes.

New Federal Law (IRC sections 953 and 954)

The provision extends for two years (for taxable years beginning before January 1, 2014) the temporary exceptions from subpart F foreign personal holding company income, foreign base company services income, and insurance income for certain income that is derived in the active conduct of a banking, financing, or similar business, or in the conduct of an insurance business.

Effective Date

The provision is effective for taxable years of foreign corporations beginning after December 31, 2011, and for taxable years of U.S. shareholders with or within which such taxable years of such foreign corporations end.

California Law (R&TC sections 25110 and 25116)

The Corporation Tax Law does not conform by reference to subpart F rules under IRC sections 951 through 971. However, relating to the water's-edge election, the Corporation Tax Law specifically provides that the amount of a CFC's income and apportionment factors included in California taxable income when the CFC has federal subpart F income is determined by multiplying these items by the ratio, the numerator of which is the CFC's federal subpart F income for the current year, and the denominator of which is the CFC's current year federal earnings and profits, as defined by IRC section 964. Subpart F income, as defined in IRC section 952, includes:

- Insurance income;[287]
- Foreign base company income;[288]
- International boycott income;[289]
- Income from illegal bribes and kickbacks;[290] and
- Foreign country income ineligible for the foreign tax credit.[291]

When applying provisions of the IRC in connection with a water's-edge election that are otherwise not applicable, such as subpart F rules, the federal rules—as applicable for federal purposes—apply.[292] Thus, under California water's-edge rules, the two-year extension of the active-financing-income exception automatically applies.

Impact on California Revenue

Baseline—based on a proration of the federal estimate developed for this provision by the Joint Committee on Taxation, baseline revenue losses are estimated to be $37,000,000 and $7,300,000 in fiscal years 2013-14 and 2014-15, respectively.

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[287] IRC section 953.

[288] IRC section 954.

[289] IRC sections 952(a)(3) and 999.

[290] IRC section 952(a)(4).

[291] IRC sections 901(j) and 952(a)(5).

[292] R&TC section 25116.

Section	Section Title
323	Extension of Look-Thru Treatment of Payments Between Related Controlled Foreign Corporations Under Foreign Personal Holding Company Rules

Background

In General

The rules of subpart F[293] require U.S. shareholders with a 10-percent or greater interest in a controlled foreign corporation (CFC) to include certain income of the CFC (referred to as "subpart F income") on a current basis for U.S. tax purposes, regardless of whether the income is distributed to the shareholders.

Subpart F income includes foreign base company income. One category of foreign base company income is foreign personal holding company income. For subpart F purposes, foreign personal holding company income generally includes dividends, interest, rents, and royalties, among other types of income. There are several exceptions to these rules. For example, foreign personal holding company income does not include dividends and interest received by a CFC from a related corporation organized and operating in the same foreign country in which the CFC is organized, or rents and royalties received by a CFC from a related corporation for the use of property within the country in which the CFC is organized. Interest, rent, and royalty payments do not qualify for this exclusion to the extent that such payments reduce the subpart F income of the payor. In addition, subpart F income of a CFC does not include any item of income from sources within the United States that is effectively connected with the conduct by such CFC of a trade or business within the United States ("ECI") unless such item is exempt from taxation (or is subject to a reduced rate of tax) pursuant to a tax treaty.

The "Look-Thru Rule"

Under the "look-thru rule" (IRC section 954(c)(6)), dividends, interest (including factoring income that is treated as equivalent to interest under IRC section 954(c)(1)(E)), rents, and royalties received or accrued by one CFC from a related CFC are not treated as foreign personal holding company income to the extent attributable or properly allocable to income of the payor that is neither subpart F income nor treated as ECI. For this purpose, a related CFC is a CFC that controls or is controlled by the other CFC, or a CFC that is controlled by the same person or persons that control the other CFC. Ownership of more than 50 percent of the CFC's stock (by vote or value) constitutes control for these purposes.

The Secretary of the Treasury is authorized to prescribe regulations that are necessary or appropriate to carry out the look-thru rule, including such regulations as are necessary or appropriate to prevent the abuse of the purposes of such rule.

[293] IRC sections 951–964.

The look-thru rule is effective for taxable years of foreign corporations beginning before January 1, 2012, and for taxable years of U.S. shareholders with or within which such taxable years of foreign corporations end.

New Federal Law (IRC section 954)

The provision extends for two years the application of the look-thru rule, to taxable years of foreign corporations ending before January 1, 2014, and for taxable years of U.S. shareholders with or within which such taxable years of foreign corporations end.

Effective Date

The provision is effective for taxable years of foreign corporations beginning after December 31, 2011, and for taxable years of U.S. shareholders with or within which such taxable years of foreign corporations end.

California Law (R&TC sections 25110 and 25116)

The Corporation Tax Law does not conform by reference to subpart F rules under IRC sections 951 through 971. However, relating to the water's-edge election, the Corporation Tax Law specifically provides that the amount of a CFC's income and apportionment factors included in California taxable income when the CFC has federal subpart F income is determined by multiplying these items by the ratio, the numerator of which is the CFC's federal subpart F income for the current year, and the denominator of which is the CFC's current year federal earnings and profits, as defined by IRC section 964. Subpart F income, as defined in IRC section 952, includes:

- Insurance income;[294]
- Foreign base company income;[295]
- International boycott income;[296]
- Income from illegal bribes and kickbacks;[297] and
- Foreign country income ineligible for the foreign tax credit.[298]

When applying provisions of the IRC in connection with a water's-edge election that are otherwise not applicable, such as subpart F rules, the federal rules—as applicable for federal purposes—apply.[299] Thus, under California water's-edge rules, the two-year extension of the look-thru rule automatically applies.

[294] IRC section 953.

[295] IRC section 954.

[296] IRC sections 952(a)(3) and 999.

[297] IRC section 952(a)(4).

[298] IRC sections 901(j) and 952(a)(5).

[299] R&TC section 25116.

Impact on California Revenue

Baseline—based on a proration of the federal estimate developed for this provision by the Joint Committee on Taxation, baseline revenue losses are estimated to be $4,900,000 and $1,000,000 in fiscal years 2013-14 and 2014-15, respectively.

Section	Section Title
324	Extension of Temporary Exclusion of 100 Percent of Gain on Certain Small Business Stock

Background

In General

A taxpayer other than a corporation may exclude 50 percent (60 percent for certain empowerment zone businesses) of the gain from the sale of certain small business stock acquired at original issue and held for at least five years.[300] The amount of gain eligible for the exclusion by an eligible taxpayer with respect to the stock of any qualifying domestic C corporation is the greater of: (1) ten times the taxpayer's basis in the stock, or (2) $10 million (reduced by the amount of gain eligible for exclusion in prior years). To qualify as a qualified small business, when the stock is issued, the aggregate gross assets (i.e., cash plus aggregate adjusted basis of other property) held by the domestic C corporation may not exceed $50 million. The corporation also must meet certain active trade or business requirements.

The portion of the gain includible in taxable income is taxed at a maximum rate of 28 percent under the regular tax.[301] A percentage of the excluded gain is an alternative minimum tax preference;[302] the portion of the gain includible in alternative minimum taxable income is taxed at a maximum rate of 28 percent under the alternative minimum tax.

Gain from the sale of qualified small business stock generally is taxed at effective rates of 14 percent under the regular tax[303] and (i) 14.98 percent under the alternative minimum tax for dispositions in a taxable year beginning before January 1, 2013; (ii) 19.88 percent under the

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[300] IRC section 1202.

[301] IRC section 1(h).

[302] IRC section 57(a)(7). In the case of qualified small business stock, the percentage of gain excluded from gross income which is an alternative minimum tax preference is (i) seven percent in the case of stock disposed of in a taxable year beginning before 2013; (ii) 42 percent in the case of stock acquired before January 1, 2001, and disposed of in a taxable year beginning after 2012; and (iii) 28 percent in the case of stock acquired after December 31, 2000, and disposed of in a taxable year beginning after 2012.

[303] The 50 percent of gain included in taxable income is taxed at a maximum rate of 28 percent.

alternative minimum tax for dispositions in a taxable year beginning after December 31, 2012, in the case of stock acquired before January 1, 2001; and (iii) 17.92 percent under the alternative minimum tax for dispositions in a taxable year beginning after December 31, 2012, in the case of stock acquired after December 31, 2000.[304]

Special Rules for Certain Qualified Small Business Stock Acquired in 2009, 2010, and 2011

For qualified small business stock acquired after February 17, 2009, and before September 28, 2010, the percentage exclusion is increased to 75 percent.

As a result of the increased exclusion, gain from the sale of qualified small business stock to which the provision applies is taxed at maximum effective rates of seven percent under the regular tax[305] and 12.88 percent under the AMT.[306]

For qualified small business stock acquired after September 27, 2010, and before January 1, 2012, the percentage exclusion is increased to 100 percent and the minimum tax preference does not apply.

Rollover of Gain

A taxpayer other than a corporation may elect to rollover gain from the sale of qualified small business stock held more than six months where other qualified small business stock is purchased during the 60-day period beginning on the date of sale.[307] The holding period for the replacement stock includes the period the original stock was held.[308]

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[304] The amount of gain included in alternative minimum tax is taxed at a maximum rate of 28 percent. The amount so included is the sum of (i) 50 percent (the percentage included in taxable income) of the total gain and (ii) the applicable preference percentage of the one-half gain that is excluded from taxable income.

[305] The 25 percent of gain included in taxable income is taxed at a maximum rate of 28 percent.

[306] The 46 percent of gain included in AMTI is taxed at a maximum rate of 28 percent. Forty-six percent is the sum of 25 percent (the percentage of total gain included in taxable income) plus 21 percent (the percentage of total gain which is an alternative minimum tax preference).

[307] IRC section 1045.

[308] IRC section 1223(13). Under present law, it is unclear whether the tacked-holding-period applies for purposes of determining when the replacement stock was acquired for purposes of determining the exclusion percentage. One commentator has suggested ''it appears that 1223(13)'s tacked-holding-period should apply for this latter purpose [i.e., determining the date the replacement stock was acquired] as well.'' Ginsburg, Levin, and Rocap, Mergers, Acquisitions, and Buyouts, p. 2–399 (Feb. 2012).

New Federal Law (IRC section 1202)

The provision extends the 100-percent exclusion and the exception from minimum tax preference treatment for two years (for stock acquired before January 1, 2014).[309]

The provision clarifies that in the case of any qualified small business stock acquired (determined without regard to the tacked holding period) after February 17, 2009, and before January 1, 2014, the date of acquisition for purposes of determining the exclusion percentage is the date the holding period for the stock begins.[310] Thus, for example, if an individual (i) acquires qualified small business stock at its original issue for $1 million on July 1, 2006, (ii) sells the stock on March 1, 2012, for $2 million in a transaction in which gain is not recognized by reason of IRC section 1045, (iii) acquires qualified replacement stock at its original issue on March 15, 2012, for $2 million, and (iv) sells the replacement stock for $3 million, 50 percent (and not 100 percent) of the $2 million gain on the sale of the replacement stock is excluded from gross income.[311]

Effective Date

The provision is generally effective for stock acquired after December 31, 2011. The clarification applies to stock acquired after February 17, 2009.

California Law (R&TC sections 17062, 18038.5, 18152, and 18152.5)

California Qualified Small Business Stock Provisions - Deemed Unconstitutional

Overview of California Small Business Stock Provisions – Prior to Being Found Unconstitutional

The Personal Income Tax Law specifically did not conform to the federal exclusion for gain on qualified small business stock,[312] and instead had its own exclusion that provided that noncorporate taxpayers could exclude from gross income 50 percent of gain from the sale or exchange of California qualified small business stock acquired at original issue and held for more than five years.[313] The amount of gain eligible for the exclusion with respect to any corporation was the greater of: (1) ten times the taxpayer's basis in the stock; or (2) $10 million.

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[309] Section 102 of the Act makes permanent the seven-percent minimum tax preference amount for qualified small business stock acquired before September 28, 2010.

[310] The provision is not intended to change the acquisition date determined under IRC section 1202(i)(1)(A) for certain stock exchanged for property.

[311] This example assumes all the requirements of IRC section 1202 are met with respect to the original stock and the replacement stock.

[312] R&TC section 18152.

[313] R&TC section 18152.5. The California exclusion under R&TC section 18152.5 generally paralleled the federal exclusion under IRC section 1202, with modifications. Additionally, prior to being deemed unconstitutional, R&TC section 18038.5 generally paralleled the federal rules for the rollover of gain of qualified small business stock under IRC section 1045 by providing that noncorporate taxpayers could defer the gain from the sale of California qualified small business stock held more than six months where other California qualified small business stock (replacement stock) was purchased within the 60-day period beginning on the date of the sale.

California qualified small business stock generally meant stock in a C corporation[314] that: (1) had gross assets that did not exceed $50 million; (2) had at least 80 percent of its payroll attributable to employment located in California; and (3) used at least 80 percent of the value of its assets in the active conduct of one or more qualified trades or businesses in California.

Deemed Unconstitutional by the Second District Court of Appeal – August 28, 2012

In the superior court case of *Cutler v. Franchise Tax Board,*[315] a taxpayer raised the issue of the constitutionality of California's qualified small business stock provisions (R&TC sections 18152.5 and 18038.5). The superior court upheld the constitutionality of these statutes. However, on appeal, the Second District Court of Appeal reversed the trial court's determination and held that because the purpose and effect of California's qualified small business stock statutes is to favor California corporations—those with property and payroll primarily within California—over their foreign competitors in raising capital among California residents, the statutes are discriminatory and cannot stand under the commerce clause of the U.S. Constitution.[316]

As a result, the FTB determined that because the Court of Appeal held that R&TC sections 18152.5 and 18038.5 are unconstitutional, these sections became invalid and unenforceable.[317]

2013 Legislation Allows a Limited, Modified California Qualified Small Business Stock Exclusion

AB 1412 (Chapter 546 of the Statutes of 2013) provides a limited, modified California qualified small business stock exclusion by allowing taxpayers to exclude 50 percent of the gain from the sale or exchange of their California qualified small business stock for taxable years beginning on or after January 1, 2008, and before January 1, 2013. In addition, taxpayers are allowed to exclude 50 percent of the gain included in installment payments received, or that will be received, in taxable years beginning on or after January 1, 2008, for sales of California qualified small business stock made in taxable years beginning before January 1, 2013.

For purposes of this limited, modified exclusion, the definition of qualified small business means a domestic C corporation that meets the following:

- The aggregate gross assets of the corporation (or its predecessor) at all times on or after July 1, 1993, and before the issuance of the stock, did not exceed $50 million;
- The aggregate gross assets of the corporation immediately after the issuance did not exceed $50 million; and
- At least 80 percent of the corporation's payroll is attributable to employment located within California (at time of stock issuance).

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[314] The stock must be that of a domestic C corporation that is not a DISC or former DISC, a regulated investment company, a real estate investment trust, a real estate mortgage investment conduit, or a cooperative.

[315] Super. Ct. L. A. County, 2012, No. BC421864.

[316] *Cutler v. Franchise Tax Board* (2012) 208 Cal. App. 4th 1247.

[317] See FTB Notice 2012-03 at: https://www.ftb.ca.gov/law/notices/2012/2012_03.pdf.

Impact on California Revenue

Not applicable.

Section	Section Title
325	Extension of Basis Adjustment to Stock of S Corporations Making Charitable Contributions of Property

Background

Under present law, if an S corporation contributes money or other property to a charity, each shareholder takes into account the shareholder's pro-rata share of the contribution in determining its own income tax liability.[318] A shareholder of an S corporation reduces the basis in the stock of the S corporation by the amount of the charitable contribution that flows through to the shareholder.[319]

In the case of charitable contributions made in taxable years beginning before January 1, 2012, the amount of a shareholder's basis reduction in the stock of an S corporation by reason of a charitable contribution made by the corporation is equal to the shareholder's pro-rata share of the adjusted basis of the contributed property. For contributions made in taxable years beginning after December 31, 2011, the amount of the reduction is the shareholder's pro-rata share of the fair market value of the contributed property.

New Federal Law (IRC section 1367)

The provision extends the rule relating to the basis reduction on account of charitable contributions of property for two years to contributions made in taxable years beginning before January 1, 2014.

Effective Date

The provision applies to charitable contributions made in taxable years beginning after December 31, 2011.

California Law (R&TC sections 17087.5, 23800, and 23804)

The Personal Income Tax Law and the Corporation Tax Law generally conform to the federal rules relating to the tax treatment of S corporations and their shareholders as of the "specified date" of

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[318] IRC section 1366(a)(1)(A).

[319] IRC section 1367(a)(2)(B).

January 1, 2009.[320] As a result, the Personal Income Tax Law and the Corporation Tax Law do not conform to the temporary federal pro-rata-share-of-adjusted-basis reduction rule for contributions made by S corporations. Under California law, if an S corporation contributes money or other property to a charity, the amount of the shareholder's California basis reduction in the stock of the S corporation is the shareholder's pro-rata share of the fair market value of the contributed property.

Impact on California Revenue

None (this provision expires for contributions made in taxable years beginning after December 31, 2013).

Section	Section Title
326	Extension of Reduction in S-Corporation Recognition Period for Built-in Gains Tax

Background

In General

A "small business corporation" (as defined in IRC section 1361(b)) may elect to be treated as an S corporation. Unlike C corporations, S corporations generally pay no corporate-level tax. Instead, items of income and loss of an S corporation pass through to its shareholders. Each shareholder takes into account separately its share of these items on its own income tax return.[321]

Under IRC section 1374, a corporate level built-in gains tax, at the highest marginal rate applicable to corporations (currently 35 percent), is imposed on an S corporation's net recognized built-in gain[322] that arose prior to the conversion of the C corporation to an S corporation and is recognized by the S corporation during the recognition period, i.e., the 10-year period beginning with the first day of the first taxable year for which the S election is in effect.[323] If the taxable income of the S corporation is less than the amount of net recognized built-in gain in the year such built-in gain is recognized (for example, because of post-conversion losses), no tax under

[320] R&TC sections 17087.5 and 23800 conform to IRC section 1367, relating to the tax treatment of S corporations and their shareholders, as of the "specified date" of January 1, 2009, with modifications.

[321] IRC section 1366.

[322] Certain built-in income items are treated as recognized built-in gain for this purpose. IRC section 1374(d)(5).

[323] IRC section 1374(d)(7)(A). The 10-year period refers to ten calendar years from the first day of the first taxable year for which the corporation was an S corporation. Treas. Reg. section 1.1374–1(d). A regulated investment company (RIC) or a real estate investment trust (REIT) that was formerly a C corporation (or that acquired assets from a C corporation) generally is subject to the rules of IRC section 1374 as if the RIC or REIT were an S corporation, unless the relevant C corporation elects "deemed sale" treatment. Treas. Reg. sections 1.337(d)–7(b)(1) and (c)(1).

IRC section 1374 is imposed on the excess of such built-in gain over taxable income for that year. However the untaxed excess of net recognized built-in gain over taxable income for that year is treated as recognized built-in gain in the succeeding taxable year.[324] Treasury regulations provide that if a corporation sells an asset before or during the recognition period and reports the income from the sale using the installment method under IRC section 453 during or after the recognition period, that income is subject to tax under IRC section 1374.[325]

The built-in gains tax also applies to net recognized built-in gain attributable to any asset received by an S corporation from a C corporation in a transaction in which the S corporation's basis in the asset is determined (in whole or in part) by reference to the basis of such asset (or other property) in the hands of the C corporation.[326] In the case of such a transaction, the recognition period for any asset transferred by the C corporation starts on the date the asset was acquired by the S corporation in lieu of the beginning of the first taxable year for which the corporation was an S corporation.[327]

The amount of the built-in gains tax under IRC section 1374 is treated as a loss by each of the S corporation shareholders in computing its own income tax.[328]

Special Rules for 2009, 2010, and 2011

For any taxable year beginning in 2009 and 2010, no tax was imposed on the net recognized built-in gain of an S corporation under IRC section 1374 if the seventh taxable year in the corporation's recognition period preceded such taxable year.[329] Thus, with respect to gain that arose prior to the conversion of a C corporation to an S corporation, no tax was imposed under IRC section 1374 if the seventh taxable year that the S corporation election was in effect preceded the taxable year beginning in 2009 or 2010.

For any taxable year beginning in 2011, no tax was imposed on the net recognized built-in gain of an S corporation under IRC section 1374 if the fifth year in the corporation's recognition period preceded such taxable year.[330] Thus, with respect to gain that arose prior to the conversion of a C corporation to an S corporation, no tax was imposed under IRC section 1374 if the S corporation election was in effect for five years preceding the taxable year beginning in 2011.

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[324] IRC section 1374(d)(2).

[325] Treas. Reg. section 1.1374–4(h).

[326] IRC section 1374(d)(8).

[327] IRC section 1374(d)(8)(B).

[328] IRC section 1366(f)(2). Shareholders continue to take into account all items of gain and loss under IRC section 1366.

[329] IRC section 1374(d)(7)(B).

[330] IRC section 1374(d)(7)(C).

New Federal Law (IRC section 1374)

For taxable years beginning in 2012 and 2013, the provision applies the term "recognition period" in IRC section 1374, for purposes of determining the net recognized built-in gain, by substituting a five-year period[331] for the otherwise applicable 10-year period. Thus, for such taxable years, the recognition period is the five-year period beginning with the first day of the first taxable year for which the corporation was an S corporation (or beginning with the date of acquisition of assets if the rules applicable to assets acquired from a C corporation apply). If an S corporation with assets subject to IRC section 1374 disposes of such assets in a taxable year beginning in 2012 or 2013 and the disposition occurs more than five years after the first day of the relevant recognition period, gain or loss on the disposition will not be taken into account in determining the net recognized built-in gain.

A technical amendment provides that the rule requiring the excess of net recognized built-in gain over taxable income for a taxable year to be carried over and treated as recognized built-in gain in the succeeding taxable year applies only to gain recognized within the recognition period. Thus, for example, built-in gain recognized in a taxable year beginning in 2013, from a disposition in that year that occurs beyond the end of the temporary 5-year recognition period, will not be carried forward under the income limitation rule and treated as recognized built-in gain in the taxable year beginning in 2014 (after the temporary provision has expired and the recognition period is again 10 years).

If an S corporation subject to IRC section 1374 sells a built-in gain asset and reports the income from the sale using the installment method under IRC section 453, the treatment of all payments received will be governed by the provisions of IRC section 1374(d)(7) applicable to the taxable year in which the sale was made. Thus, for example, if an S corporation sold a built-in gain asset in 2008 in a sale occurring on or before the recognition period in effect at that time, and reported the gain using the installment method under IRC section 453, gain recognized under that method in 2012 or 2013 (including, for example, any gain under IRC section 453B from a disposition of the installment obligation in those years)[332] is subject to tax under IRC section 1374. On the other hand, if a corporation sold an asset in a taxable year beginning in 2012 or 2013, and the sale occurred beyond the end of the then-effective 5-year recognition period (but not beyond the end of the otherwise applicable 10-year recognition period), then gain reported using the installment method under IRC section 453 in a taxable year beginning in 2014 (after the temporary provision expires) is not subject to tax under IRC section 1374, because the sale was made after the end of the recognition period applicable to that sale. As a third example, if an S corporation sold an asset in a taxable year beginning in 2011, and no tax would have been imposed on the net recognized built-in gain from the sale under IRC section 1374(d)(7)(B)(ii) because the fifth taxable year in the recognition period preceded such taxable year, then gain

[331] The five-year period refers to five calendar years from the first day of the first taxable year for which the corporation was an S corporation.

[332] IRC section 453B requires gain or loss to be recognized on disposition of an installment obligation and treated as gain or loss resulting from the sale or exchange of the property in respect of which the installment obligation was received.

from such sale reported using the installment method under IRC section 453 in a taxable year beginning in 2014 is not subject to tax under IRC section 1374.

Effective Date

This provision applies to taxable years beginning after December 31, 2011.

California Law (R&TC sections 17087.5, 23800, and 23809)

California conforms by reference to IRC section 1374, relating to tax imposed on certain built-in gains, as of the "specified date" of January 1, 2009, with modifications. The federal special rules that temporarily reduce the recognition period for the built-in gains tax[333] and the subsequent extension and modification of those rules[334] were enacted after the "specified date;" thus, California does not conform to them. Under California law, the recognition period for the built-in gains tax is 10 years.

Impact on California Revenue

None (this provision expires for taxable years beginning after 2013).

Section	Section Title
327	Extension of Empowerment Zone Tax Incentives

Background

The Omnibus Budget Reconciliation Act of 1993 (OBRA 93)[335] authorized the designation of nine empowerment zones ("Round I empowerment zones") to provide tax incentives for businesses to locate within certain targeted areas[336] designated by the Secretaries of the Department of Housing and Urban Development (HUD) and the U.S Department of Agriculture (USDA). The Taxpayer Relief Act of 1997[337] authorized the designation of two additional Round I urban empowerment zones, and 20 additional empowerment zones ("Round II empowerment zones").

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333 Section 1251 of Public Law 111-5, February 17, 2009.

334 Section 2014 of Public Law 112-240, September 27, 2010.

335 Public Law 103-66.

336 The targeted areas are those that have pervasive poverty, high unemployment, and general economic distress, and that satisfy certain eligibility criteria, including specified poverty rates and population and geographic size limitations.

337 Public Law 105-34.

The Community Renewal Tax Relief Act of 2000 ("2000 Community Renewal Act")[338] authorized a total of ten new empowerment zones ("Round III empowerment zones"), bringing the total number of authorized empowerment zones to 40.[339] In addition, the 2000 Community Renewal Act conformed the tax incentives that are available to businesses in the Round I, Round II, and Round III empowerment zones, and extended the empowerment zone incentives through December 31, 2009.[340] The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 extended the empowerment zone incentives through December 31, 2011.[341]

The tax incentives available within the designated empowerment zones include a federal income tax credit for employers who hire qualifying employees, accelerated depreciation deductions on qualifying equipment, tax-exempt bond financing, deferral of capital gains tax on sale of qualified assets sold and replaced, and partial exclusion of capital gains tax on certain sales of qualified small business stock.

The following is a description of the tax incentives.

Wage Credit

A 20-percent wage credit is available to employers for the first $15,000 of qualified wages paid to each employee (i.e., a maximum credit of $3,000 with respect to each qualified employee) who: (1) is a resident of the empowerment zone, and (2) performs substantially all employment services within the empowerment zone in a trade or business of the employer.[342]

The wage credit rate applies to qualifying wages paid before January 1, 2012. Wages paid to a qualified employee who earns more than $15,000 are eligible for the wage credit (although only the first $15,000 of wages is eligible for the credit). The wage credit is available with respect to a

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[338] Public Law 106-554.

[339] The urban part of the program is administered by the HUD and the rural part of the program is administered by the USDA. The eight Round I urban empowerment zones are Atlanta, GA; Baltimore, MD, Chicago, IL; Cleveland, OH; Detroit, MI; Los Angeles, CA; New York, NY; and Philadelphia, PA/Camden, NJ. Atlanta relinquished its empowerment zone designation in Round III. The three Round I rural empowerment zones are Kentucky Highlands, KY; Mid-Delta, MI; and Rio Grande Valley, TX. The 15 Round II urban empowerment zones are Boston, MA; Cincinnati, OH; Columbia, SC; Columbus, OH; Cumberland County, NJ; El Paso, TX; Gary/Hammond/East Chicago, IN; Ironton, OH/Huntington, WV; Knoxville, TN; Miami/Dade County, FL; Minneapolis, MN; New Haven, CT; Norfolk/Portsmouth, VA; Santa Ana, CA; and St. Louis, Missouri/East St. Louis, IL. The five Round II rural empowerment zones are Desert Communities, CA; Griggs-Steele, ND; Oglala Sioux Tribe, SD; Southernmost Illinois Delta, IL; and Southwest Georgia United, GA. The eight Round III urban empowerment zones are Fresno, CA; Jacksonville, FL; Oklahoma City, OK; Pulaski County, AR; San Antonio, TX; Syracuse, NY; Tucson, AZ; and Yonkers, NY. The two Round III rural empowerment zones are Aroostook County, ME; and Futuro, TX.

[340] If an empowerment zone designation were terminated prior to December 31, 2009, the tax incentives would cease to be available as of the termination date.

[341] Public Law 111-312.

[342] IRC section 1396. The $15,000 limit is annual, not cumulative such that the limit is the first $15,000 of wages paid in a calendar year which ends with or within the taxable year.

qualified full-time or part-time employee (employed for at least 90 days), regardless of the number of other employees who work for the employer. In general, any taxable business carrying out activities in the empowerment zone may claim the wage credit, regardless of whether the employer meets the definition of an "enterprise zone business."[343]

An employer's deduction otherwise allowed for wages paid is reduced by the amount of wage credit claimed for that taxable year.[344] Wages are not to be taken into account for purposes of the wage credit if taken into account in determining the employer's work opportunity tax credit under IRC section 51 or the welfare-to-work credit under IRC section 51A.[345] In addition, the $15,000 cap is reduced by any wages taken into account in computing the work opportunity tax credit or the welfare-to-work credit.[346] The wage credit may be used to offset up to 25 percent of alternative minimum tax liability.[347]

Increased IRC Section 179 Expensing Limitation

An enterprise zone business is allowed an additional $35,000 of IRC section 179 expensing (for a total of up to $535,000 in 2010 and 2011)[348] for qualified zone property placed in service before January 1, 2012.[349] The IRC section 179 expensing allowed to a taxpayer is phased out by the amount by which 50 percent of the cost of qualified zone property placed in service during the year by the taxpayer exceeds $2,000,000.[350] The term "qualified zone property" is defined as depreciable tangible property (including buildings) provided that (i) the property is acquired by the taxpayer (from an unrelated party) after the designation took effect, (ii) the original use of the property in an empowerment zone commences with the taxpayer, and (iii) substantially all of the use of the property is in an empowerment zone in the active conduct of a trade or business by the taxpayer. Special rules are provided in the case of property that is substantially renovated by the taxpayer.

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[343] IRC sections 1397C(b) and 1397C(c). However, the wage credit is not available for wages paid in connection with certain business activities described in IRC section 144(c)(6)(B), including a golf course, country club, massage parlor, hot tub facility, suntan facility, racetrack, or liquor store, or certain farming activities. In addition, wages are not eligible for the wage credit if paid to: (1) a person who owns more than five percent of the stock (or capital or profits interests) of the employer, (2) certain relatives of the employer, or (3) if the employer is a corporation or partnership, certain relatives of a person who owns more than 50 percent of the business.

[344] IRC section 280C(a).

[345] IRC sections 1396(c)(3)(A) and 51A(d)(2).

[346] IRC sections 1396(c)(3)(B) and 51A(d)(2).

[347] IRC section 38(c)(2).

[348] Section 2021 of the Small Business Jobs Act of 2010, Public Law 111–240.

[349] IRC sections 1397A and 1397D.

[350] IRC sections 1397A(a)(2) and 179(b)(2). For 2012, the limit is $500,000. For taxable years beginning after 2012, the limit is $200,000.

An enterprise zone business means any qualified business entity and any qualified proprietorship. A qualified business entity means, any corporation or partnership if for such year: (1) every trade or business of such entity is the active conduct of a qualified business within an empowerment zone; (2) at least 50 percent of the total gross income of such entity is derived from the active conduct of such business; (3) a substantial portion of the use of the tangible property of such entity (whether owned or leased) is within an empowerment zone; (4) a substantial portion of the intangible property of such entity is used in the active conduct of any such business; (5) a substantial portion of the services performed for such entity by its employees are performed in an empowerment zone; (6) at least 35 percent of its employees are residents of an empowerment zone; (7) less than five percent of the average of the aggregate unadjusted bases of the property of such entity is attributable to collectibles other than collectibles that are held primarily for sale to customers in the ordinary course of such business; and (8) less than five percent of the average of the aggregate unadjusted bases of the property of such entity is attributable to nonqualified financial property.[351]

A qualified proprietorship is any qualified business carried on by an individual as a proprietorship if for such year: (1) at least 50 percent of the total gross income of such individual from such business is derived from the active conduct of such business in an empowerment zone; (2) a substantial portion of the use of the tangible property of such individual in such business (whether owned or leased) is within an empowerment zone; (3) a substantial portion of the intangible property of such business is used in the active conduct of such business; (4) a substantial portion of the services performed for such individual in such business by employees of such business are performed in an empowerment zone; (5) at least 35 percent of such employees are residents of an empowerment zone; (6) less than five percent of the average of the aggregate unadjusted bases of the property of such individual which is used in such business is attributable to collectibles other than collectibles that are held primarily for sale to customers in the ordinary course of such business; and (7) less than five percent of the average of the aggregate unadjusted bases of the property of such individual which is used in such business is attributable to nonqualified financial property.[352]

A qualified business is defined as any trade or business other than a trade or business that consists predominantly of the development or holding of intangibles for sale or license or any business prohibited in connection with the employment credit.[353] In addition, the leasing of real property that is located within the empowerment zone is treated as a qualified business only if (1) the leased property is not residential property, and (2) at least 50 percent of the gross rental income from the real property is from enterprise zone businesses. The rental of tangible personal property is not a qualified business unless at least 50 percent of the rental of such property is by enterprise zone businesses or by residents of an empowerment zone.

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[351] IRC section 1397C(b).

[352] IRC section 1397C(c).

[353] IRC section 1397C(d). Excluded businesses include any private or commercial golf course, country club, massage parlor, hot tub facility, sun tan facility, racetrack, or other facility used for gambling or any store the principal business of which is the sale of alcoholic beverages for off-premises consumption. IRC section 144(c)(6).

Expanded Tax-Exempt Financing for Certain Zone Facilities

States or local governments can issue enterprise zone facility bonds to raise funds to provide an enterprise zone business with qualified zone property.[354] These bonds can be used in areas designated enterprise communities as well as areas designated empowerment zones. To qualify, 95 percent (or more) of the net proceeds from the bond issue must be used to finance: (1) qualified zone property whose principal user is an enterprise zone business, and (2) certain land functionally related and subordinate to such property.

The term enterprise zone business is the same as that used for purposes of the increased IRC section 179 deduction limitation (discussed above) with certain modifications for start-up businesses. First, a business will be treated as an enterprise zone business during a start-up period if: (1) at the beginning of the period, it is reasonable to expect the business to be an enterprise zone business by the end of the start-up period, and (2) the business makes bona fide efforts to be an enterprise zone business. The start-up period is the period that ends with the start of the first tax year beginning more than two years after the later of: (1) the issue date of the bond issue financing the qualified zone property, and (2) the date this property is first placed in service (or, if earlier, the date that is three years after the issue date).[355]

Second, a business that qualifies as an enterprise zone business at the end of the start-up period must continue to qualify during a testing period that ends three tax years after the start-up period ends. After the three-year testing period, a business will continue to be treated as an enterprise zone business as long as 35 percent of its employees are residents of an empowerment zone or enterprise community.

The face amount of the bonds may not exceed $60 million for an empowerment zone in a rural area, $130 million for an empowerment zone in an urban area with zone population of less than 100,000, and $230 million for an empowerment zone in an urban area with zone population of at least 100,000.

Elective Roll Over of Capital Gain from the Sale or Exchange of any Qualified Empowerment Zone Asset

Taxpayers can elect to defer recognition of gain on the sale of a qualified empowerment zone asset[356] held for more than one year and replaced within 60 days by another qualified

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[354] IRC section 1394.

[355] IRC section 1394(b)(3).

[356] The term "qualified empowerment zone asset" means any property which would be a qualified community asset (as defined in IRC section 1400F, relating to certain tax benefits for renewal communities) if in IRC section 1400F: (i) references to empowerment zones were substituted for references to renewal communities, (ii) references to enterprise zone businesses (as defined in IRC section 1397C) were substituted for references to renewal community businesses, and (iii) the date of the enactment of this paragraph were substituted for "December 31, 2001" each place it appears. IRC section 1397B(b)(1)(A).

A "qualified community asset" includes: (1) qualified community stock (meaning original-issue stock purchased for cash in an enterprise zone business), (2) a qualified community partnership interest (meaning a partnership interest acquired for cash in an enterprise zone business), and (3) qualified community business property (meaning tangible property originally used in an enterprise zone business by the taxpayer) that is purchased or substantially improved after the date of the enactment of this paragraph.

empowerment zone asset in the same zone.[357] The deferral is accomplished by reducing the basis of the replacement asset by the amount of the gain recognized on the sale of the asset.

Partial Exclusion of Capital Gains on Certain Small Business Stock

Generally, individuals may exclude a percentage of gain from the sale of certain small business stock acquired at original issue and held at least five years.[358] For stock acquired prior to February 18, 2009, or after December 31, 2011, the percentage is generally 50 percent, except that for empowerment zone stock the percentage is 60 percent. For stock acquired after February 17, 2009, and before January 1, 2012, a higher percentage applies to all small business stock with no additional percentage for empowerment zone stock.[359]

Other Tax Incentives

Other incentives not specific to empowerment zones but beneficial to these areas include the work opportunity tax credit for employers based on the first year of employment of certain targeted groups, including empowerment zone residents (up to $2,400 per employee), and qualified zone academy bonds for certain public schools located in an empowerment zone, or expected (as of the date of bond issuance) to have at least 35 percent of its students receiving free or reduced lunches.

<u>New Federal Law (IRC sections 1202 and 1391)</u>

The provision extends for two years, through December 31, 2013, the period for which the designation of an empowerment zone is in effect, thus extending for two years the empowerment zone tax incentives, including the wage credit, increased IRC section 179 expensing for qualifying equipment, tax-exempt bond financing, and deferral of capital gains tax on sale of qualified assets replaced with other qualified assets.[360] In the case of a designation of an empowerment zone the nomination for which included a termination date which such designation if the entity which made such nomination amends the nomination to provide for a new termination date in such manner as the Secretary of the Treasury may provide.

The provision extends for two years, through December 31, 2018, the period for which the percentage exclusion for qualified small business stock (of a corporation which is a qualified business entity) acquired on or before February 17, 2009, is 60 percent. Gain attributable to periods after December 31, 2018, for qualified small business stock acquired on or before

[357] IRC section 1397B.

[358] IRC section 1202.

[359] Section 324 of the Act extends the higher percentage for two years (for stock acquired before January 1, 2014). For a more detailed description of the present-law exclusion, see the explanation in this report to that section of the Act.

[360] A technical correction may be necessary to clarify that the elective rollover provision applies to qualified empowerment zone assets acquired after December 21, 2000, and before January 1, 2014.

February 17, 2009, or after December 31, 2013, is subject to the general rule which provides for a percentage exclusion of 50 percent.

Effective Date

The provision relating to the designation of an empowerment zone and the provision relating to the exclusion of gain from the sale or exchange of qualified small business stock held for more than five years applies to periods after December 31, 2011.

California Law (R&TC sections 17053.33, 17053.45, 17053.46, 17053.47, 17053.70, 17053.74, 17053.75, 18038.5, 18152, 18152.5, 23612.2, 23622.7, 23622.8, 23633, 23644, and 23646)

Empowerment Zones

California does not conform to the federal empowerment-zone tax incentives. Thus, the two-year federal extension of empowerment zone designations is not applicable under California law.

Prior to 2014, California provided its own tax incentives for taxpayers conducting business activities within geographically targeted economic development areas (EDAs), including Enterprise Zones,[361] Manufacturing Enhancement Areas,[362] Targeted Tax Areas,[363] and Local Agency Military Base Recovery Areas.[364] The California EDA hiring credits generally cease to be operative for taxable years beginning on or after January 1, 2014; however, the credits continue to apply for taxable years beginning on or after January 1, 2014, with respect to qualified employees who are employed by qualified taxpayers within the 60-month period immediately preceding that date.[365]

California Qualified Small Business Stock Provisions - Deemed Unconstitutional

Overview of California Small Business Stock Provisions – Prior to Being Deemed Unconstitutional

The Personal Income Tax Law specifically did not conform to the federal exclusion for gain on qualified small business stock,[366] and instead had its own exclusion that provided that noncorporate taxpayers could exclude from gross income 50 percent of gain from the sale or exchange of California qualified small business stock acquired at original issue and held for more

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361 R&TC sections 17053.70, 17053.74, 17053.75, 23612.2, and 233622.7.

362 R&TC sections 17053.47 and 23622.8.

363 R&TC sections 17053.33, 23633 and 23644.

364 R&TC sections 17053.45, 17053.46, 23644 and 23646.

365 See Chapter 69 of the Statutes of 2013.

366 R&TC section 18152.

than five years.[367] The amount of gain eligible for the exclusion with respect to any corporation was the greater of: (1) ten times the taxpayer's basis in the stock; or (2) $10 million.

California qualified small business stock generally meant stock in a C corporation[368] that: (1) had gross assets that do not exceed $50 million; (2) had at least 80 percent of its payroll attributable to employment located in California; and (3) used at least 80 percent of the value of its assets in the active conduct of one or more qualified trades or businesses in California.

Deemed Unconstitutional by the Second District Court of Appeal – August 28, 2012

In the superior court case of *Cutler v. Franchise Tax Board,*[369] a taxpayer raised the issue of the constitutionality of California's qualified small business stock provisions (R&TC sections 18152.5 and 18038.5). The superior court upheld the constitutionality of these statutes. However, on appeal, the Second District Court of Appeal reversed the trial court's determination and held that because the purpose and effect of California's qualified small business stock statutes is to favor California corporations—those with property and payroll primarily within California—over their foreign competitors in raising capital among California residents, the statutes are discriminatory and cannot stand under the commerce clause of the U.S. Constitution.[370]

As a result, the FTB determined that because the Court of Appeal held that R&TC sections 18152.5 and 18038.5 are unconstitutional, these sections are now invalid and unenforceable.[371]

2013 Legislation Allows a Limited, Modified California Qualified Small Business Stock Exclusion

AB 1412 (Chapter 546 of the Statutes of 2013) provides a limited, modified California qualified small business stock exclusion by allowing taxpayers to exclude 50 percent of the gain from the sale or exchange of their California qualified small business stock for taxable years beginning on or after January 1, 2008, and before January 1, 2013. In addition, taxpayers are allowed to exclude 50 percent of the gain included in installment payments received, or that will be received, in taxable years beginning on or after January 1, 2008, for sales of California qualified small business stock made in taxable years beginning before January 1, 2013.

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[367] R&TC section 18152.5. The California exclusion under R&TC section 18152.5 generally parallels the federal exclusion under IRC section 1202, with modifications. Additionally, prior to being deemed unconstitutional, R&TC section 18038.5 generally paralleled the federal rules for the rollover of gain of qualified small business stock under IRC section 1045 by providing that noncorporate taxpayers could defer the gain from the sale of California qualified small business stock held more than six months where other California qualified small business stock (replacement stock) was purchased within the 60-day period beginning on the date of the sale.

[368] The stock must be that of a domestic C corporation that is not a DISC or former DISC, a regulated investment company, a real estate investment trust, a real estate mortgage investment conduit, or a cooperative.

[369] Super. Ct. L. A. County, 2012, No. BC421864.

[370] *Cutler v. Franchise Tax Board* (2012) 208 Cal. App. 4th 1247.

[371] See FTB Notice 2012-03 at: https://www.ftb.ca.gov/law/notices/2012/2012_03.pdf.

For purposes of this limited, modified exclusion, the definition of qualified small business means a domestic C corporation that meets the following:

- The aggregate gross assets of the corporation (or its predecessor) at all times on or after July 1, 1993, and before the issuance of the stock, did not exceed $50 million;
- The aggregate gross assets of the corporation immediately after the issuance did not exceed $50 million; and
- At least 80 percent of the corporation's payroll is attributable to employment located within California (at time of stock issuance).

Impact on California Revenue

Not applicable.

Section	Section Title
328	Extension of Tax-Exempt Financing for New York Liberty Zone

Background

An aggregate of $8 billion in tax-exempt private activity bonds is authorized for the purpose of financing the construction and repair of infrastructure in New York City ("Liberty Zone bonds"). The bonds must be issued before January 1, 2012.

New Federal Law (IRC section 1400L)

The provision extends authority to issue Liberty Zone bonds for two years (through December 31, 2013).

Effective Date

The provision is effective for bonds issued after December 31, 2011.

California Law (R&TC section 17143)

The Personal Income Tax Law specifically does not conform to federal law regarding private activity bonds. The California Constitution provides an exemption from income taxation for all interest from bonds issued by this state or a local government of this state. Federal law, other than the IRC, prohibits state taxation of interest on federal bonds if the interest on state obligations is exempt from tax. Taxpayers subject to the corporate franchise tax under the Corporation Tax Law must include in the measure of franchise tax all interest received including interest on governmental obligations that is exempt from income tax. Interest received from federal obligations and California obligations or its political subdivisions is excluded from income subject to the corporation and personal income tax.

Impact on California Revenue

Not applicable.

Section	Section Title
329	Extension of Temporary Increase in Limit on Cover over of Rum Excise Taxes to Puerto Rico and the Virgin Islands

Background

A $13.50 per proof gallon[372] excise tax is imposed on distilled spirits produced in or imported into the United States.[373] The excise tax does not apply to distilled spirits that are exported from the United States, including exports to U.S. possessions (e.g., Puerto Rico and the Virgin Islands).[374]

The IRC provides for cover over (payment) to Puerto Rico and the Virgin Islands of the excise tax imposed on rum imported (or brought) into the United States, without regard to the country of origin.[375] The amount of the cover over is limited under IRC section 7652(f) to $10.50 per proof gallon ($13.25 per proof gallon before January 1, 2012).

Tax amounts attributable to shipments to the United States of rum produced in Puerto Rico are covered over to Puerto Rico. Tax amounts attributable to shipments to the United States of rum produced in the Virgin Islands are covered over to the Virgin Islands. Tax amounts attributable to shipments to the United States of rum produced in neither Puerto Rico nor the Virgin Islands are divided and covered over to the two possessions under a formula.[376] Amounts covered over to Puerto Rico and the Virgin Islands are deposited into the treasuries of the two possessions for use as those possessions determine.[377] All of the amounts covered over are subject to the limitation.

New Federal Law (IRC section 7652)

The provision suspends for two years the $10.50 per proof gallon limitation on the amount of excise taxes on rum covered over to Puerto Rico and the Virgin Islands. Under the provision, the

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[372] A proof gallon is a liquid gallon consisting of 50 percent alcohol. See IRC section 5002(a)(10) and (11).

[373] IRC section 5001(a)(1).

[374] IRC sections 5214(a)(1)(A), 5002(a)(15), 7653(b) and (c).

[375] IRC sections 7652(a)(3), (b)(3), and (e)(1). One percent of the amount of excise tax collected from imports into the United States of articles produced in the Virgin Islands is retained by the United States under IRC section 7652(b)(3).

[376] IRC section 7652(e)(2).

[377] IRC sections 7652(a)(3), (b)(3), and (e)(1).

cover over limitation of $13.25 per proof gallon is extended for rum brought into the United States after December 31, 2011, and before January 1, 2014. After December 31, 2013, the cover over amount reverts to $10.50 per proof gallon.

Effective Date

The provision is effective for distilled spirits brought into the United States after December 31, 2011.

California Law

The FTB does not administer excise taxes. Defer to the Board of Equalization (BOE).

Impact on California Revenue

Defer to the BOE.

Section	Section Title
330	Modification and Extension of American Samoa Economic Development Credit

Background

A domestic corporation that was an existing credit claimant with respect to American Samoa and that elected the application of IRC section 936 for its last taxable year beginning before January 1, 2006, is allowed a credit based on the corporation's economic activity-based limitation with respect to American Samoa. The credit is not part of the IRC but is computed based on the rules of IRC sections 30A and 936. The credit is allowed for the first four taxable years of a corporation that begin after December 31, 2005, and before January 1, 2012.

A corporation was an existing credit claimant with respect to a American Samoa if: (1) the corporation was engaged in the active conduct of a trade or business within American Samoa on October 13, 1995, and (2) the corporation elected the benefits of the possession tax credit[378] in

[378] For taxable years beginning before January 1, 2006, certain domestic corporations with business operations in the U.S. possessions were eligible for the possession tax credit. IRC sections 27(b) and 936. This credit offsets the U.S. tax imposed on certain income related to operations in the U.S. possessions. Subject to certain limitations, discussed below, the amount of the possession tax credit allowed to any domestic corporation equaled the portion of that corporation's U.S. tax that was attributable to the corporation's non-U.S. source taxable income from: (1) the active conduct of a trade or business within a U.S. possession, (2) the sale or exchange of substantially all of the assets that were used in such a trade or business, or (3) certain possessions investment. No deduction or foreign tax credit was allowed for any possessions or foreign tax paid or accrued with respect to taxable income that was taken into account in computing the credit under IRC section 936.

Under the economic activity-based limit, the amount of the credit could not exceed an amount equal to the sum of: (1) 60 percent of the taxpayer's qualified possession wages and allocable employee fringe benefit expenses, (2) 15 percent of depreciation allowances with respect to short-life qualified tangible property, plus 40 percent of depreciation allowances with respect to medium-life qualified tangible property, plus 65 percent of depreciation allowances with respect to long-life qualified tangible property, and (3) in certain cases, a portion of the taxpayer's possession income taxes. A taxpayer could elect, instead of the economic activity-based limit, a limit equal to the an election in effect for its taxable year that included October 13, 1995.[379] A corporation that added a substantial new line of business (other than in a qualifying acquisition of all the assets of a trade or business of an existing credit claimant) ceased to be an existing credit claimant as of the close of the taxable year ending before the date on which that new line of business was added.

The amount of the credit allowed to a qualifying domestic corporation under the provision is equal to the sum of the amounts used in computing the corporation's economic activity-based limitation with respect to American Samoa, except that no credit is allowed for the amount of any American Samoa income taxes. Thus, for any qualifying corporation the amount of the credit equals the sum of: (1) 60 percent of the corporation's qualified American Samoa wages and allocable employee fringe benefit expenses, and (2) 15 percent of the corporation's depreciation allowances with respect to short-life qualified American Samoa tangible property, plus 40 percent of the corporation's depreciation allowances with respect to medium-life qualified American Samoa tangible property, plus 65 percent of the corporation's depreciation allowances with respect to long-life qualified American Samoa tangible property.

The IRC section 936(c) rule denying a credit or deduction for any possessions or foreign tax paid with respect to taxable income taken into account in computing the credit under IRC section 936 does not apply with respect to the credit allowed by the provision.

The credit applies to the first four taxable years of a taxpayer which begin after December 31, 2005, and before January 1, 2012.

<u>New Federal Law (Uncodified Act Section 330 Affecting Section 119 of Division A of the Tax Relief and Heath Care Act of 2006)</u>

The provision extends the credit to apply to the first eight taxable years of a taxpayer beginning after December 31, 2005, and before January 1, 2014. For taxable years of a taxpayer beginning after December 31, 2011, the provision modifies the credit in two ways. First, the provision allows domestic corporations with operations in American Samoa to claim the credit even if those corporations are not existing credit claimants. Second, the credit is available to a domestic corporation (either an existing credit claimant or a new credit claimant) only if, in addition to satisfying all the present law requirements for claiming the credit, the corporation also has

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applicable percentage of the credit that otherwise would have been allowable with respect to possession business income, beginning in 1998, the applicable percentage was 40 percent.

To qualify for the possession tax credit for a taxable year, a domestic corporation was required to satisfy two conditions. First, the corporation was required to derive at least 80 percent of its gross income for the three-year period immediately preceding the close of the taxable year from sources within a possession. Second, the corporation was required to derive at least 75 percent of its gross income for that same period from the active conduct of a possession business. IRC section 936(a)(2). The IRC section 936 credit generally expired for taxable years beginning after December 31, 2005.

[379] A corporation will qualify as an existing credit claimant if it acquired all the assets of a trade or business of a corporation that: (1) actively conducted that trade or business in a possession on October 13, 1995, and (2) had elected the benefits of the possession tax credit in an election in effect for the taxable year that included October 13, 1995.

qualified production activities income (as defined in IRC section 199(c) by substituting "American Samoa" for "the United States" in each place that latter term appears).

Effective Date

The provision is effective for taxable years beginning after December 31, 2011.

California Law (None)

California does not conform to the American Samoa economic development credit.

Impact on California Revenue

Not applicable.

Section	Section Title
331	Extension and Modification of Bonus Depreciation

Background

In General

An additional first-year depreciation deduction is allowed equal to 50 percent of the adjusted basis of qualified property placed in service between January 1, 2008, and September 8, 2010, or between January 1, 2012, and January 1, 2013 (January 1, 2014, for certain longer-lived and transportation property).[380] An additional first-year depreciation deduction is allowed equal to 100 percent of the adjusted basis of qualified property if it meets the requirements for the additional first-year depreciation and also meets the following requirements. First, the taxpayer must acquire the property after September 8, 2010, and before January 1, 2012 (January 1, 2013, for certain longer-lived and transportation property).[381] Second, the taxpayer must place the property in service after September 8, 2010, and before January 1, 2012 (January 1, 2013, in the case of certain longer-lived and transportation property). Third, the original use of the property must commence with the taxpayer after September 8, 2010.

The additional first-year depreciation deduction is allowed for both regular tax and alternative minimum tax purposes, but is not allowed for purposes of computing earnings and profits. The basis of the property and the depreciation allowances in the year of purchase and later years are appropriately adjusted to reflect the additional first-year depreciation deduction. In addition, there

[380] IRC section 168(k). The additional first-year depreciation deduction is subject to the general rules regarding whether an item must be capitalized under IRC section 263 or IRC section 263A.

[381] For a definition of "acquire" for this purpose, see section 3.02(1)(a) of Rev. Proc. 2011–26, 2011–16 I.R.B. 664.

are no adjustments to the allowable amount of depreciation for purposes of computing a taxpayer's alternative minimum taxable income with respect to property to which the provision applies. The amount of the additional first-year depreciation deduction is not affected by a short taxable year. The taxpayer may elect out of additional first-year depreciation for any class of property for any taxable year.

The interaction of the additional first-year depreciation allowance with the otherwise applicable depreciation allowance may be illustrated as follows. Assume that in 2009, a taxpayer purchased new depreciable property and placed it in service.[382] The property's cost is $1,000, and it is five-year property subject to the half-year convention. The amount of additional first-year depreciation allowed is $500. The remaining $500 of the cost of the property is depreciable under the rules applicable to five-year property. Thus, 20 percent, or $100, is also allowed as a depreciation deduction in 2009. The total depreciation deduction with respect to the property for 2009 is $600. The remaining $400 adjusted basis of the property generally is recovered through otherwise applicable depreciation rules.

Property qualifying for the additional first-year depreciation deduction must meet all of the following requirements. First, the property must be: (1) property to which the modified accelerated cost recovery system (MACRS) applies with an applicable recovery period of 20 years or less; (2) water utility property (as defined in IRC section 168(e)(5)); (3) computer software other than computer software covered by IRC section 197; or (4) qualified leasehold improvement property (as defined in IRC section 168(k)(3)).[383] Second, the original use[384] of the property must commence with the taxpayer after December 31, 2007.[385] Third, the taxpayer must acquire the property within the applicable time period (as described below). Finally, the property must be placed in service before January 1, 2013. An extension of the placed-in-service date of one year (i.e., January 1, 2014) is provided for certain property with a recovery period of 10 years or longer and certain transportation property.[386]

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[382] Assume that the cost of the property is not eligible for expensing under IRC section 179.

[383] The additional first-year depreciation deduction is not available for any property that is required to be depreciated under the alternative depreciation system of MACRS. The additional first-year depreciation deduction is also not available for qualified New York Liberty Zone leasehold improvement property as defined in IRC section 1400L(c)(2).

[384] The term "original use" means the first use to which the property is put, whether or not such use corresponds to the use of such property by the taxpayer. If in the normal course of its business a taxpayer sells fractional interests in property to unrelated third parties, then the original use of such property begins with the first user of each fractional interest (i.e., each fractional owner is considered the original user of its proportionate share of the property).

[385] A special rule applies in the case of certain leased property. In the case of any property that is originally placed in service by a person and that is sold to the taxpayer and leased back to such person by the taxpayer within three months after the date that the property was placed in service, the property would be treated as originally placed in service by the taxpayer not earlier than the date that the property is used under the leaseback. If property is originally placed in service by a lessor, such property is sold within three months after the date that the property was placed in service, and the user of such property does not change, then the property is treated as originally placed in service by the taxpayer not earlier than the date of such sale.

[386] Property qualifying for the extended placed-in-service date must have an estimated production period exceeding one year and a cost exceeding $1 million. Transportation property generally is defined as tangible personal property used in the trade or business of transporting persons or property. Certain aircraft which is not transportation property, other than for agricultural or firefighting uses, also qualifies for the extended placed-in-service-date, if at the

To qualify, property must be acquired: (1) after December 31, 2007, and before January 1, 2013, but only if no binding written contract for the acquisition is in effect before January 1, 2008, or (2) pursuant to a binding written contract which was entered into after December 31, 2007, and before January 1, 2013.[387] With respect to property that is manufactured, constructed, or produced by the taxpayer for use by the taxpayer, the taxpayer must begin the manufacture, construction, or production of the property after December 31, 2007, and before January 1, 2013. Property that is manufactured, constructed, or produced for the taxpayer by another person under a contract that is entered into prior to the manufacture, construction, or production of the property is considered to be manufactured, constructed, or produced by the taxpayer. For property eligible for the extended placed-in-service date, a special rule limits the amount of costs eligible for the additional first-year depreciation. With respect to such property, only the portion of the basis that is properly attributable to the costs incurred before January 1, 2013 ("progress expenditures") is eligible for the additional first-year depreciation deduction.[388]

Property does not qualify for the additional first-year depreciation deduction when the user of such property (or a related party) would not have been eligible for the additional first-year depreciation deduction if the user (or a related party) were treated as the owner. For example, if a taxpayer sells to a related party property that was under construction prior to January 1, 2008, the property does not qualify for the additional first-year depreciation deduction. Similarly, if a taxpayer sells to a related party property that was subject to a binding written contract prior to January 1, 2008, the property does not qualify for the additional first-year depreciation deduction. As a further example, if a taxpayer (the lessee) sells property in a sale-leaseback arrangement, and the property otherwise would not have qualified for the additional first-year depreciation deduction if it were owned by the taxpayer-lessee, then the lessor is not entitled to the additional first-year depreciation deduction.

The limitation under IRC section 280F on the amount of depreciation deductions allowed with respect to certain passenger automobiles is increased in the first year by $8,000 for automobiles that qualify (and for which the taxpayer does not elect out of the additional first-year deduction).[389] The $8,000 increase is not indexed for inflation.

Special Rule for Long-Term Contracts

In general, in the case of a long-term contract, the taxable income from the contract is determined under the percentage-of-completion method. Solely for purposes of determining the percentage of completion under IRC section 460(b)(1)(A), the cost of qualified property with a MACRS

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time of the contract for purchase, the purchaser made a nonrefundable deposit of the lesser of 10 percent of the cost or $100,000, and which has an estimated production period exceeding four months and a cost exceeding $200,000.

[387] Property does not fail to qualify for the additional first-year depreciation merely because a binding written contract to acquire a component of the property is in effect prior to January 1, 2008.

[388] For purposes of determining the amount of eligible progress expenditures, it is intended that rules similar to IRC section 46(d)(3) as in effect prior to the Tax Reform Act of 1986 apply.

[389] IRC section 168(k)(2)(F).

recovery period of 7 years or less is taken into account as a cost allocated to the contract as if bonus depreciation had not been enacted for property placed in service after December 31, 2009, and before January 1, 2011 (January 1, 2012, in the case of certain longer-lived and transportation property). Bonus depreciation is taken into account in determining taxable income under the percentage-of-completion method for property placed in service after December 31, 2010.

Election to Accelerate Minimum Tax Credit in Lieu of Claiming Bonus Depreciation

A corporation otherwise eligible for additional first-year depreciation under IRC section 168(k) may elect to claim additional minimum tax credits in lieu of claiming deprecation under IRC section 168(k) for "eligible qualified property" placed in service after December 31, 2010, and before January 1, 2013 (January 1, 2014, in the case of certain longer-lived and transportation property).[390] A corporation making the election increases the limitation under IRC section 53(c) on the use of minimum tax credits in lieu of taking bonus depreciation deductions. The increases in the allowable credits under this provision are treated as refundable. The depreciation for eligible qualified property is calculated for both regular tax and alternative minimum tax purposes using the straight-line method in place of the method that would otherwise be used absent the election under this provision.

The minimum tax credit limitation is increased by the bonus depreciation amount, which is equal to 20 percent of bonus depreciation[391] for certain eligible qualified property that could be claimed as a deduction absent an election under this provision.

The bonus depreciation amount is limited to the lesser of: (1) $30 million, or (2) six-percent of the minimum tax credits allocable to the adjusted minimum tax, imposed for taxable years beginning before January 1, 2006. All corporations treated as a single employer under IRC section 52(a) are treated as one taxpayer for purposes of the limitation, as well as for electing the application of this provision.

In the case of a corporation making an election which is a partner in a partnership, for purposes of determining the electing partner's distributive share of partnership items, IRC section 168(k)(1) does not apply to any eligible qualified property and the straight-line method is used with respect to such property.

Generally an election under this provision for a taxable year applies to subsequent taxable years.[392]

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[390] IRC section 168(k)(4). Eligible qualified property means qualified property eligible for bonus depreciation with minor effective date differences.

[391] For this purpose, bonus depreciation is the difference between (i) the aggregate amount of depreciation for all eligible qualified property determined if IRC section 168(k)(1) applied using the most accelerated depreciation method (determined without regard to this provision), and the shortest life allowable for each property, and (ii) the amount of depreciation that would be determined if IRC section 168(k)(1) did not apply using the same method and life for each property.

[392] Special election rules apply as the result of prior extensions of this provision.

Normalization Accounting

Under present law, in order for public utility property to qualify for certain accelerated depreciation allowances for federal income tax purposes, the benefits of accelerated depreciation must be normalized.[393] Normalization accounting as applied to accelerated tax depreciation generally requires regulatory tax expense to be computed using the depreciation methods and periods used for regulatory, rather than federal income tax, purposes. Any deferred tax reserve resulting from the use of the normalization method of accounting may be used to reduce the rate base upon which a utility earns its rate of return.

New Federal Law (IRC sections 168, 460, 1400L, and 1400N)

The provision extends the 50-percent additional first-year depreciation deduction for one year, generally through 2013 (through 2014 for certain longer-lived and transportation property).

The provision provides that solely for purposes of determining the percentage of completion under IRC section 460(b)(1)(A), the cost of qualified property with a MACRS recovery period of 7 years or less which is placed in service after December 31, 2012, and before January 1, 2014 (January 1, 2015, in the case of certain longer-lived and transportation property), is taken into account as a cost allocated to the contract as if bonus depreciation had not been enacted.

The provision also generally permits a corporation to increase the minimum tax credit limitation by the bonus depreciation amount with respect to certain property placed in service after December 31, 2012, and before January 1, 2014 (January 1, 2015, in the case of certain longer-lived and transportation property). The provision applies with respect to "round-3 extension property," which is defined as property that is eligible qualified property solely because it meets the requirements under the extension of the additional first-year depreciation deduction for certain property placed in service after December 31, 2012.[394]

Under the provision, a corporation that has previously made an election to claim credits in lieu of bonus depreciation may choose not to make this previous election apply for round-3 extension property. The provision also allows a corporation that has not made a previous election to claim credits in lieu of bonus deprecation to make the election for round-3 extension property for its first taxable year ending after December 31, 2012, and for each subsequent year. A separate bonus depreciation amount, maximum amount, and maximum increase amount is computed and applied to round-3 extension property.[395]

393 IRC section 168(i)(9).

394 An election under new IRC section 168(k)(4)(J) with respect to round 3 extension property is binding for any property that is eligible qualified property solely by reason of the amendments made by section 331(a) of the Act (and the application of such extension to this paragraph pursuant to the amendment made by section 331(c)(1) of the Act), even if such property is placed in service in 2014.

395 In computing the maximum amount, the maximum increase amount for round 3 extension property is reduced by bonus depreciation amounts for preceding taxable years only with respect to round 3 extension property.

The provision clarifies that for public utility property elections, such as an election out of bonus depreciation, must be respected in determining when normalization accounting may be used.

Effective Date

The provision is effective for property placed in service after December 31, 2012, in taxable years ending after such date.

California Law (R&TC sections 17201, 17250, and 24349)

This provision is not applicable under California law.

The Personal Income Tax Law generally conforms to MACRS as of the "specified date" of January 1, 2009,[396] but specifically does not conform to bonus depreciation.[397]

The Corporation Tax Law does not adopt MACRS, and instead is generally in substantial conformity to the pre-1981 federal asset depreciation range (ADR) depreciation rules that generally allow property to be depreciated based on its "useful life."[398]

Impact on California Revenue

Not applicable.

Section	Section Title
401	Extension of Credit for Energy-Efficient Existing Homes

Background

Present law[399] provides a 10-percent credit for the purchase of qualified energy efficiency improvements to existing homes. A qualified energy efficiency improvement is any energy efficiency building envelope component that: (1) meets or exceeds the prescriptive criteria for such a component established by the 2009 International Energy Conservation Code as such Code (including supplements) is in effect on the date of the enactment of the American Recovery and Reinvestment Tax Act of 2009 (February 17, 2009) (or, in the case of windows, skylights and doors, and metal roofs with appropriate pigmented coatings or asphalt roofs with appropriate

[396] R&TC section 17201 conforms to MACRS under IRC section 168 as of the "specified date" of January 1, 2009, with modifications.

[397] R&TC section 17250(a)(2)(C)(4).

[398] R&TC section 24349.

[399] IRC section 25C.

cooling granules, meets the Energy Star program requirements); (2) is installed in or on a dwelling located in the United States and owned and used by the taxpayer as the taxpayer's principal residence; (3) the original use of which commences with the taxpayer; and (4) reasonably can be expected to remain in use for at least five years. The credit is nonrefundable.

Building envelope components are: (1) insulation materials or systems which are specifically and primarily designed to reduce the heat loss or gain for a dwelling and which meet the prescriptive criteria for such material or system established by the 2009 International Energy Conservation Code, as such Code (including supplements) is in effect on the date of the enactment of the American Recovery and Reinvestment Tax Act of 2009 (February 17, 2009); (2) exterior windows (including skylights) and doors; and (3) metal or asphalt roofs with appropriate pigmented coatings or cooling granules that are specifically and primarily designed to reduce the heat gain for a dwelling.

Additionally, present law provides specified credits for the purchase of specific energy efficient property originally placed in service by the taxpayer during the taxable year. The allowable credit for the purchase of certain property is: (1) $50 for each advanced main air circulating fan, (2) $150 for each qualified natural gas, propane, or oil furnace or hot water boiler, and (3) $300 for each item of energy efficient building property.

An advanced main air circulating fan is a fan used in a natural gas, propane, or oil furnace and which has an annual electricity use of no more than two percent of the total annual energy use of the furnace (as determined in the standard Department of Energy test procedures).

A qualified natural gas, propane, or oil furnace or hot water boiler is a natural gas, propane, or oil furnace or hot water boiler with an annual fuel utilization efficiency rate of at least 95.

Energy-efficient building property is: (1) an electric heat pump water heater which yields an energy factor of at least 2.0 in the standard Department of Energy test procedure, (2) an electric heat pump which achieves the highest efficiency tier established by the Consortium for Energy Efficiency, as in effect on January 1, 2009,[400] (3) a central air conditioner which achieves the highest efficiency tier established by the Consortium for Energy Efficiency as in effect on January 1, 2009,[401] (4) a natural gas, propane, or oil water heater which has an energy factor of at least 0.82 or thermal efficiency of at least 90 percent, and (5) biomass fuel property.

Biomass fuel property is a stove that burns biomass fuel to heat a dwelling unit located in the United States and used as a principal residence by the taxpayer, or to heat water for such dwelling unit, and that has a thermal efficiency rating of at least 75 percent. Biomass fuel is any plant-derived fuel available on a renewable or recurring basis, including agricultural crops and trees,

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[400] These standards are a seasonal energy efficiency ratio (SEER) greater than or equal to 15, an energy efficiency ratio (EER) greater than or equal to 12.5, and heating seasonal performance factor (HSPF) greater than or equal to 8.5 for split heat pumps, and SEER greater than or equal to 14, EER greater than or equal to 12, and HSPF greater than or equal to 8.0 for packaged heat pumps.

[401] These standards are a SEER greater than or equal to 16 and EER greater than or equal to 13 for split systems, and SEER greater than or equal to 14 and EER greater than or equal to 12 for packaged systems.

wood and wood waste and residues (including wood pellets), plants (including aquatic plants), grasses, residues, and fibers.

The credit is available for property placed in service prior to January 1, 2012. The maximum credit for a taxpayer for all taxable years is $500, and no more than $200 of such credit may be attributable to expenditures on windows.

The taxpayer's basis in the property is reduced by the amount of the credit. Special proration rules apply in the case of jointly-owned property, condominiums, and tenant-stockholders in cooperative housing corporations. If less than 80 percent of the property is used for nonbusiness purposes, only that portion of expenditures that is used for nonbusiness purposes is taken into account.

For purposes of determining the amount of expenditures made by any individual with respect to any dwelling unit, expenditures which are made from subsidized energy financing are not taken into account. The term "subsidized energy financing" means financing provided under a federal, state, or local program a principal purpose of which is to provide subsidized financing for projects designed to conserve or produce energy.

<u>New Federal Law (IRC section 25C)</u>

The provision extends the credit for two years, through December 31, 2013.

<u>Effective Date</u>

The provision applies to property placed in service after December 31, 2011.

<u>California Law (None)</u>

California does not conform to the credit for energy-efficient existing homes (i.e., the nonbusiness energy property credit under IRC section 25C).

<u>Impact on California Revenue</u>

Not applicable.

<u>Section</u>	<u>Section Title</u>
402	Extension of Credit for Alternative Fuel Vehicle Refueling Property

<u>Background</u>

Taxpayers may claim a 30-percent credit for the cost of installing qualified clean-fuel vehicle refueling property to be used in a trade or business of the taxpayer or installed at the principal residence of the taxpayer.[402] The credit may not exceed $30,000 per taxable year per location, in the case of qualified refueling property used in a trade or business and $1,000 per taxable year per location, in the case of qualified refueling property installed on property which is used as a principal residence.

Qualified refueling property is property (not including a building or its structural components) for the storage or dispensing of a clean-burning fuel or electricity into the fuel tank or battery of a motor vehicle propelled by such fuel or electricity, but only if the storage or dispensing of the fuel or electricity is at the point of delivery into the fuel tank or battery of the motor vehicle. The original use of such property must begin with the taxpayer.

Clean-burning fuels are any fuel at least 85 percent of the volume of which consists of ethanol, natural gas, compressed natural gas, liquefied natural gas, liquefied petroleum gas, or hydrogen. In addition, any mixture of biodiesel and diesel fuel, determined without regard to any use of kerosene and containing at least 20 percent biodiesel, qualifies as a clean fuel.

Credits for qualified refueling property used in a trade or business are part of the general business credit and may be carried back for one year and forward for 20 years. Credits for residential qualified refueling property cannot exceed for any taxable year the difference between the taxpayer's regular tax (reduced by certain other credits) and the taxpayer's tentative minimum tax. Generally, in the case of qualified refueling property sold to a tax-exempt entity, the taxpayer selling the property may claim the credit.

A taxpayer's basis in qualified refueling property is reduced by the amount of the credit. In addition, no credit is available for property used outside the United States or for which an election to expense has been made under IRC section 179.

The credit is available for property placed in service after December 31, 2005, and (except in the case of hydrogen refueling property) before January 1, 2012. In the case of hydrogen refueling property, the property must be placed in service before January 1, 2015.

New Federal Law (IRC section 30C)

The provision extends for two years (through 2013) the 30-percent credit for alternative fuel refueling property (other than hydrogen refueling property, the credit for which continues under present law through 2014).

Effective Date

The provision is effective for taxable years beginning after December 31, 2011.

California Law (None)

California does not conform to the alternative fuel vehicle refueling property credit.

[402] IRC section 30C.

Impact on California Revenue

Not applicable.

Section	Section Title
403	Extension of Credit for 2- or 3-Wheeled Plug-In Electric Vehicles

Background

A 10-percent credit is available for qualifying plug-in electric low-speed vehicles, motorcycles, and three-wheeled vehicles.[403] Two- or three-wheeled vehicles must have a battery capacity of at least 2.5 kilowatt-hours. Other vehicles must have a battery capacity of at least 4 kilowatt-hours. The maximum credit for all qualifying vehicles is $2,500. The credit is part of the general business credit. The credit is available for vehicles acquired after February 17, 2009, and before January 1, 2012.

New Federal Law (IRC section 30D)

The provision combines the credit for electric motorcycles and three-wheeled vehicles (but not low-speed vehicles) with the IRC section 30D credit for plug-in electric drive motor vehicles. The new credit provides the same incentives as the existing credit and expires for vehicles acquired on or before December 31, 2013.

Effective Date

The provision is effective for vehicles acquired after December 31, 2011.

California Law (None)

California does not conform to the federal credit for 2- or 3-wheeled plug-in electric vehicles.

Impact on California Revenue

Not applicable.

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[403] IRC section 30.

Section	Section Title
404	Extension and Modification of Cellulosic Biofuel Producer Credit

Background

The "cellulosic biofuel producer credit" is a nonrefundable income tax credit for each gallon of qualified cellulosic fuel production of the producer for the taxable year. The amount of the credit is generally $1.01 per gallon.[404]

"Qualified cellulosic biofuel production" is any cellulosic biofuel which is produced by the taxpayer and which is: (1) sold by the taxpayer to another person (a) for use by such other person in the production of a qualified cellulosic biofuel mixture in such person's trade or business (other than casual off-farm production), (b) for use by such other person as a fuel in a trade or business, or (c) who sells such cellulosic biofuel at retail to another person and places such cellulosic biofuel in the fuel tank of such other person; or (2) used by the producer for any purpose described in (1)(a), (b), or (c).

"Cellulosic biofuel" means any liquid fuel that: (1) is produced in the United States and used as fuel in the United States, (2) is derived from any lignocellulosic or hemicellulosic matter that is available on a renewable or recurring basis, and (3) meets the registration requirements for fuels and fuel additives established by the Environmental Protection Agency (EPA) under section 211 of the Clean Air Act. Cellulosic biofuel does not include fuels that: (1) are more than four percent (determined by weight) water and sediment in any combination, (2) have an ash content of more than one percent (determined by weight), or (3) have an acid number greater than 25 ("unprocessed or excluded fuels").[405]

The cellulosic biofuel producer credit cannot be claimed unless the taxpayer is registered by the Internal Revenue Service (IRS) as a producer of cellulosic biofuel. The IRS permits a taxpayer to register as a cellulosic biofuel producer after the cellulosic biofuel has been produced. Thus, a person may register as a cellulosic biofuel producer in 2010 for cellulosic biofuel produced in 2009 and then claim the credit.

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404 In the case of cellulosic biofuel that is alcohol, the $1.01 credit amount is reduced by the credit amount of the alcohol mixture credit, and for ethanol, the credit amount for small ethanol producers, as in effect at the time the cellulosic biofuel fuel is produced. The alcohol mixture credit and small ethanol producer credits expired December 31, 2011, so there is no reduction for cellulosic biofuel that is alcohol if produced after December 31, 2011.

405 IRC section 40(b)(6)(e)(iii). Water content (including both free water and water in solution with dissolved solids) is determined by distillation, using for example ASTM method D95 or a similar method suitable to the specific fuel being tested. Sediment consists of solid particles that are dispersed in the liquid fuel and is determined by centrifuge or extraction using, for example, ASTM method D1796 or D473 or similar method that reports sediment content in weight percent. Ash is the residue remaining after combustion of the sample using a specified method, such as ASTM D3174 or a similar method suitable for the fuel being tested.

Cellulosic biofuel eligible for the IRC section 40 credit is precluded from qualifying as biodiesel, renewable diesel, or alternative fuel for purposes of the applicable income tax credit, excise tax credit, or payment provisions relating to those fuels.[406]

Because it is a credit under IRC section 40(a), the cellulosic biofuel producer credit is part of the general business credits in IRC section 38. However, the credit can only be carried forward three taxable years after the termination of the credit. The credit is also allowable against the alternative minimum tax. Under IRC section 87, the credit is included in gross income. The cellulosic biofuel producer credit terminates on December 31, 2012.

New Federal Law (IRC sections 40 and 4101)

The provision extends the income tax credit for cellulosic biofuel for one additional year (through December 31, 2013). The provision makes a technical drafting correction by separately restating, apart from the general IRC section 40 termination provisions, the rule that the cellulosic biofuel producer credit may only be carried forward three years after any termination of the cellulosic biofuel producer credit.

The provision expands qualified cellulosic biofuel production to include algae-based fuel. Producers of fuel derived from cultivated algae, cyanobacteria, or lemna will qualify for the cellulosic biofuel producer credit, a $1.01 income tax credit for each gallon of qualified cellulosic biofuel production. In addition, for algae-based fuel, the provision expands qualified cellulosic biofuel production to include fuel derived from algae that is sold by the taxpayer to another person for refining by such other person into a fuel that meets the registration requirements for fuels and fuel additives under section 211 of the Clean Air Act. Thus, algae-based fuel sold for further refining, not just as end use as a fuel, would qualify for the credit.

Effective Date

The provision generally is effective for fuels sold or used after January 2, 2013. The technical drafting correction is effective as if included in section 15321(b) of the Heartland, Habitat, Harvest, and Horticulture Act of 2008.

California Law (None)

California does not conform to the federal income tax credit for cellulosic biofuel.

Impact on California Revenue

Not applicable.

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[406] See IRC sections 40A(d)(1), 40A(f)(3), and 6426(h).

Section Section Title

405 Extension of Incentives for Biodiesel and Renewable Diesel

Background

Biodiesel

Present law provides an income tax credit for biodiesel fuels (the "biodiesel fuels credit").[407] The biodiesel fuels credit is the sum of three credits: (1) the biodiesel mixture credit, (2) the biodiesel credit, and (3) the small agri-biodiesel producer credit. The biodiesel fuels credit is treated as a general business credit. The amount of the biodiesel fuels credit is includible in gross income. The biodiesel fuels credit is coordinated to take into account benefits from the biodiesel excise tax credit and payment provisions discussed below. The credit does not apply to fuel sold or used after December 31, 2011.

Biodiesel is monoalkyl esters of long-chain fatty acids derived from plant or animal matter that meet: (1) the registration requirements established by the EPA under section 211 of the Clean Air Act (42 U.S.C. section 7545), and (2) the requirements of the American Society of Testing and Materials (ASTM) D6751. Agri-biodiesel is biodiesel derived solely from virgin oils including oils from corn, soybeans, sunflower seeds, cottonseeds, canola, crambe, rapeseeds, safflowers, flaxseeds, rice bran, mustard seeds, camelina, or animal fats.

Biodiesel may be taken into account for purposes of the credit only if the taxpayer obtains a certification (in such form and manner as prescribed by the Secretary of the Treasury) from the producer or importer of the biodiesel that identifies the product produced and the percentage of biodiesel and agri-biodiesel in the product.

Biodiesel Mixture Credit

The biodiesel mixture credit is $1.00 for each gallon of biodiesel (including agri-biodiesel) used by the taxpayer in the production of a qualified biodiesel mixture. A qualified biodiesel mixture is a mixture of biodiesel and diesel fuel that is: (1) sold by the taxpayer producing such mixture to any person for use as a fuel, or (2) used as a fuel by the taxpayer producing such mixture. The sale or use must be in the trade or business of the taxpayer and is to be taken into account for the taxable year in which such sale or use occurs. No credit is allowed with respect to any casual off-farm production of a qualified biodiesel mixture.

Per IRS guidance, a mixture need only contain one-tenth of one percent of diesel fuel to be a qualified mixture.[408] Thus, a qualified biodiesel mixture can contain 99.9 percent biodiesel and 0.1 percent diesel fuel.

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[407] IRC section 40A.

[408] Notice 2005–62, I.R.B. 2005–35, 443 (2005). "A biodiesel mixture is a mixture of biodiesel and diesel fuel containing at least 0.1 percent (by volume) of diesel fuel. Thus, for example, a mixture of 999 gallons of biodiesel and 1 gallon of diesel fuel is a biodiesel mixture."

Biodiesel Credit (B–100)

The biodiesel credit is $1.00 for each gallon of biodiesel that is not in a mixture with diesel fuel (100 percent biodiesel or B–100) and that during the taxable year is: (1) used by the taxpayer as a fuel in a trade or business, or (2) sold by the taxpayer at retail to a person and placed in the fuel tank of such person's vehicle.

Small Agri-Biodiesel Producer Credit

The IRC provides a small agri-biodiesel producer income tax credit, in addition to the biodiesel and biodiesel mixture credits. The credit is 10 cents per gallon for up to 15 million gallons of agri-biodiesel produced by small producers, defined generally as persons whose agri-biodiesel production capacity does not exceed 60 million gallons per year. The agri-biodiesel must: (1) be sold by such producer to another person (a) for use by such other person in the production of a qualified biodiesel mixture in such person's trade or business (other than casual off-farm production), (b) for use by such other person as a fuel in a trade or business, or, (c) who sells such agri-biodiesel at retail to another person and places such agri-biodiesel in the fuel tank of such other person, or (2) used by the producer for any purpose described in (a), (b), or (c).

Biodiesel Mixture Excise Tax Credit

The IRC also provides an excise tax credit for biodiesel mixtures.[409] The credit is $1.00 for each gallon of biodiesel used by the taxpayer in producing a biodiesel mixture for sale or use in a trade or business of the taxpayer. A biodiesel mixture is a mixture of biodiesel and diesel fuel that: (1) is sold by the taxpayer producing such mixture to any person for use as a fuel, or (2) is used as a fuel by the taxpayer producing such mixture. No credit is allowed unless the taxpayer obtains a certification (in such form and manner as prescribed by the Secretary of the Treasury) from the producer of the biodiesel that identifies the product produced and the percentage of biodiesel and agri-biodiesel in the product.[410]

The credit is not available for any sale or use for any period after December 31, 2011. This excise tax credit is coordinated with the income tax credit for biodiesel such that credit for the same biodiesel cannot be claimed for both income and excise tax purposes.

Payments With Respect to Biodiesel Fuel Mixtures

If any person produces a biodiesel fuel mixture in such person's trade or business, the Secretary of the Treasury is to pay such person an amount equal to the biodiesel mixture credit.[411] The biodiesel fuel mixture credit must first be taken against tax liability for taxable fuels. To the extent the biodiesel fuel mixture credit exceeds such tax liability, the excess may be received as a payment. Thus, if the person has no IRC section 4081 liability, the credit is refundable. The

[409] IRC section 6426(c).

[410] IRC section 6426(c)(4).

[411] IRC section 6427(e).

Secretary of the Treasury is not required to make payments with respect to biodiesel fuel mixtures sold or used after December 31, 2011.

Renewable Diesel

"Renewable diesel" is liquid fuel that: (1) is derived from biomass (as defined in IRC section 45K(c)(3)), (2) meets the registration requirements for fuels and fuel additives established by the EPA under section 211 of the Clean Air Act, and (3) meets the requirements of the ASTM D975 or D396, or equivalent standard established by the Secretary of the Treasury. ASTM D975 provides standards for diesel fuel suitable for use in diesel engines. ASTM D396 provides standards for fuel oil intended for use in fuel-oil burning equipment, such as furnaces. Renewable diesel also includes fuel derived from biomass that meets the requirements of a Department of Defense specification for military jet fuel or an ASTM specification for aviation turbine fuel.

For purposes of the IRC, renewable diesel is generally treated the same as biodiesel. In the case of renewable diesel that is aviation fuel, kerosene is treated as though it were diesel fuel for purposes of a qualified renewable diesel mixture. Like biodiesel, the incentive may be taken as an income tax credit, an excise tax credit, or as a payment from the Secretary of the Treasury.[412] The incentive for renewable diesel is $1.00 per gallon. There is no small producer credit for renewable diesel. The incentives for renewable diesel expire after December 31, 2011.

<u>New Federal Law (IRC sections 40A, 6426, and 6427)</u>

The provision extends the income tax credit, excise tax credit, and payment provisions for biodiesel and renewable diesel for two years (through December 31, 2013).

<u>Effective Date</u>

The provision is effective for sales and uses after December 31, 2011.

<u>California Law</u>

Income Tax Credit

California does not conform to the biodiesel fuels credit.

Excise Tax Credits and Payments

The FTB does not administer excise taxes. Defer to the Board of Equalization (BOE).

[412] IRC sections 40A(f), 6426(c), and 6427(e).

Impact on California Revenue

Income Tax Credit

Not applicable.

Excise Tax Credits and Payments

Defer to the BOE.

Section	Section Title
406	Extension of Production Credit for Indian Coal Facilities Placed in Service Before 2009

Background

A credit is available for the production of Indian coal sold to an unrelated third party from a qualified facility for a seven-year period beginning January 1, 2006, and ending December 31, 2012. The amount of the credit for Indian coal is $1.50 per ton for the first four years of the seven-year period and $2.00 per ton for the last three years of the seven-year period. Beginning in calendar years after 2006, the credit amounts are indexed annually for inflation using 2005 as the base year. The credit amount for 2012 is $2.267 per ton.

A qualified Indian coal facility is a facility placed in service before January 1, 2009, that produces coal from reserves that on June 14, 2005, were owned by a federally recognized tribe of Indians or were held in trust by the United States for a tribe or its members.

The credit is a component of the general business credit,[413] allowing excess credits to be carried back one year and forward up to 20 years. The credit is also subject to the alternative minimum tax.

New Federal Law (IRC section 45)

The provision extends the credit for the production of Indian coal for one year (through December 31, 2013). The placed-in-service date for qualified facilities is not extended.

Effective Date

The provision is effective for Indian coal produced after December 31, 2012.

[413] IRC section 38(b)(8).

California Law (None)

California does not conform to the federal credit for the production of Indian coal.

Impact on California Revenue

Not applicable.

Section	Section Title
407	Extension and Modification of Credits With Respect to Facilities Producing Energy from Certain Renewable Resources

Background

Renewable Electricity Production Credit

An income tax credit is allowed for the production of electricity from qualified energy resources at qualified facilities (the "renewable electricity production credit").[414] Qualified energy resources comprise wind, closed-loop biomass, open-loop biomass, geothermal energy, solar energy, small irrigation power, municipal solid waste, qualified hydropower production, and marine and hydrokinetic renewable energy. Qualified facilities are, generally, facilities that generate electricity using qualified energy resources. To be eligible for the credit, electricity produced from qualified energy resources at qualified facilities must be sold by the taxpayer to an unrelated person.

[414] IRC section 45. In addition to the renewable electricity production credit, IRC section 45 also provides income tax credits for the production of Indian coal and refined coal at qualified facilities.

SUMMARY OF CREDIT FOR ELECTRICITY PRODUCED FROM CERTAIN RENEWABLE RESOURCES

Eligible Electricity Production Activity (IRC section 45)	Credit amount for 2012[1] (cents per kilowatt-hour)	Expiration[2]
Wind	2.2	December 31, 2012
Closed-loop biomass	2.2	December 31, 2013
Open-loop biomass (*including agricultural livestock waste nutrient facilities*)	1.1	December 31, 2013
Geothermal	2.2	December 31, 2013
Solar (*pre-2006 facilities only*)	2.1	December 31, 2005
Small irrigation power	1.1	December 31, 2013
Municipal solid waste (*including landfill gas facilities and trash combustion facilities*)	1.1	December 31, 2013
Qualified hydropower	1.1	December 31, 2013
Marine and hydrokinetic	1.1	December 31, 2013

[1] In general, the credit is available for electricity produced during the first 10 years after a facility has been placed in service.

[2] Expires for property placed in service after this date.

Municipal Solid Waste

One feedstock that can be used to generate credit-eligible renewable electricity is municipal solid waste. For this purpose, the term "municipal solid waste" has the meaning given the term "solid waste" under section 2(27) of the Solid Waste Disposal Act.[415] Under that Act, the term "solid waste" generally means any garbage, refuse, or sludge from a waste treatment plant, water supply treatment plant, or air pollution control facility and other discarded material, including solid, liquid, semisolid, or contained gaseous material resulting from industrial, commercial, mining, and agricultural operations, and from community activities, but does not include solid or dissolved material in domestic sewage, or solid or dissolved materials in irrigation return flows or industrial discharges.

Election to Claim Energy Credit in Lieu of Renewable Electricity Production Credit

A taxpayer may make an irrevocable election to have certain property which is part of a qualified renewable electricity production facility be treated as energy property eligible for a 30-percent investment credit under IRC section 48. For this purpose, qualified facilities are facilities otherwise eligible for the renewable electricity production credit with respect to which no credit under IRC section 45 has been allowed. A taxpayer electing to treat a facility as energy property may not claim the renewable electricity production credit. The eligible basis for the investment credit for taxpayers making this election is the basis of the depreciable (or amortizable) property

[415] IRC section 45(c)(6).

that is part of a facility capable of generating electricity eligible for the renewable electricity production credit.

New Federal Law (IRC sections 45 and 48)

The provision extends and modifies the expiration dates for the renewable electricity production credit and the 30-percent investment credit in lieu of such production credit. The provision extends the wind credits (production and investment) for one year, through December 31, 2013. In addition, the expiration date for all renewable power facilities (including wind facilities) is modified such that qualified facilities or property will be eligible for the renewable electricity production credit, or the investment credit in lieu of such credit, if the construction of such facilities or property begins before January 1, 2014.

The provision also modifies the definition of municipal solid waste to exclude commonly recycled paper that has been segregated from such waste for purposes of this credit.

Effective Date

The provision is effective on January 2, 2013.

California Law (None)

California does not conform to the energy production and energy investment credits.

Impact on California Revenue

Not applicable.

Section	Section Title
408	Extension of Credit for Energy-Efficient New Homes

Background

Present law provides a credit to an eligible contractor for each qualified new energy-efficient home that is constructed by the eligible contractor and acquired by a person from such eligible contractor for use as a residence during the taxable year. To qualify as a new energy-efficient home, the home must be: (1) a dwelling located in the United States, (2) substantially completed after August 8, 2005, and (3) certified in accordance with guidance prescribed by the Secretary of the Treasury to have a projected level of annual heating and cooling energy consumption that meets the standards for either a 30-percent or 50-percent reduction in energy usage, compared to a comparable dwelling constructed in accordance with the standards of chapter 4 of the 2003 International Energy Conservation Code as in effect (including supplements) on August 8, 2005, and any applicable federal minimum efficiency standards for equipment. With respect to homes that meet the 30-percent standard, one-third of such 30-percent savings must come from the building envelope, and with respect to homes that meet the 50-percent standard, one-fifth of such 50-percent savings must come from the building envelope.

Manufactured homes that conform to federal manufactured home construction and safety standards are eligible for the credit provided all the criteria for the credit are met. The eligible contractor is the person who constructed the home, or in the case of a manufactured home, the producer of such home.

The credit equals $1,000 in the case of a new home that meets the 30-percent standard and $2,000 in the case of a new home that meets the 50-percent standard. Only manufactured homes are eligible for the $1,000 credit.

In lieu of meeting the standards of chapter 4 of the 2003 International Energy Conservation Code, manufactured homes certified by a method prescribed by the Administrator of the Environmental Protection Agency under the Energy Star Labeled Homes program are eligible for the $1,000 credit provided criteria (1) and (2), above, are met.

The credit applies to homes that are purchased prior to January 1, 2012. The credit is part of the general business credit.

<u>New Federal Law (IRC section 45L)</u>

The provision extends the credit to homes that are acquired prior to January 1, 2014. Additionally, the provision updates the home construction standard from the 2003 International Energy Conservation Code to the 2006 International Energy Conservation Code as in effect on January 1, 2006.

<u>Effective Date</u>

The provision applies to homes acquired after December 31, 2011.

<u>California Law (None)</u>

California does not conform to the credit for energy efficient new homes.

<u>Impact on California Revenue</u>

Not applicable.

Section	Section Title
409	Extension of Credit for Energy-Efficient Appliances

Background

In General

A credit is allowed for the eligible production of certain energy-efficient dishwashers, clothes washers, and refrigerators. The credit is part of the general business credit.

The credits are as follows:

Dishwashers

- $45 in the case of a dishwasher that is manufactured in calendar year 2008 or 2009 that uses no more than 324 kilowatt hours per year and 5.8 gallons per cycle,
- $75 in the case of a dishwasher that is manufactured in calendar year 2008, 2009, or 2010 and that uses no more than 307 kilowatt hours per year and 5.0 gallons per cycle (5.5 gallons per cycle for dishwashers designed for greater than 12 place settings),
- $25 in the case of a dishwasher that is manufactured in calendar year 2011 and that uses no more than 307 kilowatt hours per year and 5.0 gallons per cycle (5.5 gallons per cycle for dishwashers designed for greater than 12 place settings),
- $50 in the case of a dishwasher that is manufactured in calendar year 2011 and that uses no more than 295 kilowatt hours per year and 4.25 gallons per cycle (4.75 gallons per cycle for dishwashers designed for greater than 12 place settings), and
- $75 in the case of a dishwasher that is manufactured in calendar year 2011 and that uses no more than 280 kilowatt hours per year and 4 gallons per cycle (4.5 gallons per cycle for dishwashers designed for greater than 12 place settings).

Clothes Washers

- $75 in the case of a residential top-loading clothes washer manufactured in calendar year 2008 that meets or exceeds a 1.72 modified energy factor and does not exceed an 8.0 water consumption factor,
- $125 in the case of a residential top-loading clothes washer manufactured in calendar year 2008 or 2009 that meets or exceeds a 1.8 modified energy factor and does not exceed a 7.5 water consumption factor,
- $150 in the case of a residential or commercial clothes washer manufactured in calendar year 2008, 2009, or 2010 that meets or exceeds a 2.0 modified energy factor and does not exceed a 6.0 water consumption factor,
- $250 in the case of a residential or commercial clothes washer manufactured in calendar year 2008, 2009, or 2010 that meets or exceeds a 2.2 modified energy factor and does not exceed a 4.5 water consumption factor,
- $175 in the case of a top-loading clothes washer manufactured in calendar year 2011 that meets or exceeds a 2.2 modified energy factor and does not exceed a 4.5 water consumption factor, and

- $225 in the case of a clothes washer manufactured in calendar year 2011 that: (1) is a top-loading clothes washer and that meets or exceeds a 2.4 modified energy factor and does not exceed a 4.2 water consumption factor, or (2) is a front-loading clothes washer and that meets or exceeds a 2.8 modified energy factor and does not exceed a 3.5 water consumption factor.

Refrigerators

- $50 in the case of a refrigerator manufactured in calendar year 2008 that consumes at least 20 percent but not more than 22.9 percent less kilowatt hours per year than the 2001 energy conservation standards,
- $75 in the case of a refrigerator that is manufactured in calendar year 2008 or 2009 that consumes at least 23 percent but not more than 24.9 percent less kilowatt hours per year than the 2001 energy conservation standards,
- $100 in the case of a refrigerator that is manufactured in calendar year 2008, 2009, or 2010 that consumes at least 25 percent but not more than 29.9 percent less kilowatt hours per year than the 2001 energy conservation standards,
- $200 in the case of a refrigerator manufactured in calendar year 2008, 2009, or 2010 that consumes at least 30 percent less energy than the 2001 energy conservation standards,
- $150 in the case of a refrigerator manufactured in calendar year 2011 that consumes at least 30 percent less energy than the 2001 energy conservation standards, and
- $200 in the case of a refrigerator manufactured in calendar year 2011 that consumes at least 35 percent less energy than the 2001 energy conservation standards.

Definitions

A dishwasher is any residential dishwasher subject to the energy conservation standards established by the Department of Energy. A refrigerator must be an automatic defrost refrigerator-freezer with an internal volume of at least 16.5 cubic feet to qualify for the credit. A clothes washer is any residential clothes washer, including a residential-style coin-operated washer that satisfies the relevant efficiency standard.

The term “modified energy factor” means the modified energy factor established by the Department of Energy for compliance with the federal energy conservation standard.

The term “gallons per cycle” means, with respect to a dishwasher, the amount of water, expressed in gallons, required to complete a normal cycle of a dishwasher.

The term “water consumption factor” means (with respect to a clothes washer) the quotient of the total weighted per-cycle water consumption divided by the cubic foot (or liter) capacity of the clothes washer.

Other Rules

Appliances eligible for the credit include only those produced in the United States and that exceed the average amount of U.S. production from the two prior calendar years for each category of appliance. The aggregate credit amount allowed with respect to a taxpayer for all taxable years beginning after December 31, 2010, may not exceed $25 million, with the exception that the $200 refrigerator credit and the $225 clothes washer credit are not limited. Additionally, the credit allowed in a taxable year for all appliances may not exceed four percent of the average annual gross receipts of the taxpayer for the three taxable years preceding the taxable year in which the credit is determined.

New Federal Law (IRC section 45M)

The provision extends the credits available for appliance production in 2011 for two additional years (through 2013), with the exception that the $25 dishwasher credit and the $175 clothes washer credit are not extended.

Effective Date

The provision applies to appliances produced after December 31, 2011.

California Law (None)

California does not conform to the credit for energy efficient appliances.

Impact on California Revenue

Not applicable.

Section	Section Title
410	Extension and Modification of Special Allowance for Cellulosic Biofuel Plant Property

Background

Present law[416] allows an additional first-year depreciation deduction equal to 50 percent of the adjusted basis of qualified cellulosic biofuel plant property. In order to qualify, the property generally must be placed in service before January 1, 2013.

Qualified cellulosic biofuel plant property means property used in the U.S. solely to produce cellulosic biofuel. For this purpose, cellulosic biofuel means any liquid fuel which is produced from any lignocellulosic or hemicellulosic matter that is available on a renewable or recurring basis.

[416] IRC section 168(l).

The additional first-year depreciation deduction is allowed for both regular tax and alternative minimum tax purposes for the taxable year in which the property is placed in service. The additional first-year depreciation deduction is subject to the general rules regarding whether an item is deductible under IRC section 162 or subject to capitalization under IRC section 263 or IRC section 263A. The basis of the property and the depreciation allowances in the year of purchase and later years are appropriately adjusted to reflect the additional first-year depreciation deduction. In addition, there is no adjustment to the allowable amount of depreciation for purposes of computing a taxpayer's alternative minimum taxable income with respect to property to which the provision applies. A taxpayer is allowed to elect out of the additional first-year depreciation for any class of property for any taxable year.

In order for property to qualify for the additional first-year depreciation deduction, it must meet the following requirements: the original use of the property must commence with the taxpayer on or after December 20, 2006, and the property must be acquired by purchase (as defined under IRC section 179(d)) by the taxpayer after December 20, 2006, and placed in service before January 1, 2013. Property does not qualify if a binding written contract for the acquisition of such property was in effect on or before December 20, 2006.

Property that is manufactured, constructed, or produced by the taxpayer for use by the taxpayer qualifies if the taxpayer begins the manufacture, construction, or production of the property after December 20, 2006, and the property is placed in service before January 1, 2013 (and all other requirements are met). Property that is manufactured, constructed, or produced for the taxpayer by another person under a contract that is entered into prior to the manufacture, construction, or production of the property is considered to be manufactured, constructed, or produced by the taxpayer.

Property any portion of which is financed with the proceeds of a tax-exempt obligation under IRC section 103 is not eligible for the additional first-year depreciation deduction.[417] Recapture rules apply if the property ceases to be qualified cellulosic biofuel plant property.[418]

Property with respect to which the taxpayer has elected 50-percent expensing under IRC section 179C is not eligible for the additional first-year depreciation deduction.[419]

New Federal Law (IRC section 168)

The provision extends the present-law special depreciation allowance for one year, to qualified cellulosic biofuel plant property placed in service prior to January 1, 2014. The provision expands the definition of qualified cellulosic biofuel plant property to include property used in the U.S. solely to produce algae-based fuel, including fuel derived from cultivated algae, cyanobacteria, or lemna.

[417] IRC section 168(l)(4)(C).

[418] IRC section 168(l)(7).

[419] IRC section 168(l)(8).

Effective Date

The provision to extend the placed in service date is effective for property placed in service after December 31, 2012. The provision to expand the definition of qualified cellulosic biofuel plant property is effective for property placed in service after January 2, 2013.

California Law (R&TC sections 17201 and 17250)

This provision is not applicable under California law.

The Personal Income Tax Law specifically does not conform to the special allowance for cellulosic biofuel plant property,[420] and that special allowance has not been adopted under the Corporation Tax Law.[421]

Impact on California Revenue

Not applicable.

Section	Section Title
411	Extension of Special Rule for Sales or Dispositions to Implement FERC or State Electric Restructuring Policy for Qualified Electric Utilities

Background

A taxpayer selling property generally recognizes gain to the extent the sales price (and any other consideration received) exceeds the seller's basis in the property. The recognized gain is subject to current income tax unless the gain is deferred or not recognized under a special tax provision.

One such special tax provision permits taxpayers to elect to recognize gain from qualifying electric transmission transactions ratably over an eight-year period beginning in the year of sale if the amount realized from such sale is used to purchase exempt utility property within the applicable period[422] (the "reinvestment property").[423] If the amount realized exceeds the amount used to

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[420] The Personal Income Tax Law generally conforms to modified accelerated cost recovery system provisions of IRC section 168 under R&TC section 17201, but specifically dos not conform to the special allowance for cellulosic biofuel plant property under R&TC section 17250(a)(2)(C)(8).

[421] The Corporation Tax Law does not adopt the modified accelerated cost recovery system provisions of IRC section 168, and instead is generally in substantial conformity to the pre-1981 federal asset depreciation range (ADR) depreciation rules that generally allow property to be depreciated based on its "useful life" under R&TC section 24349.

[422] The applicable period for a taxpayer to reinvest the proceeds is the four-year period beginning on the date the qualifying electric transmission transaction occurs.

[423] IRC section 451(i).

purchase reinvestment property, any realized gain is recognized to the extent of such excess in the year of the qualifying electric transmission transaction.

A qualifying electric transmission transaction is the sale or other disposition of property used by a qualified electric utility to an independent transmission company prior to January 1, 2012. A qualified electric utility is defined as an electric utility, which as of the date of the qualifying electric transmission transaction, is vertically integrated in that it is both: (1) a transmitting utility (as defined in the Federal Power Act)[424] with respect to the transmission facilities to which the election applies, and (2) an electric utility (as defined in the Federal Power Act).[425]

In general, an independent transmission company is defined as: (1) an independent transmission provider[426] approved by the Federal Energy Regulatory Commission (FERC), (2) a person (i) who the FERC determines under section 203 of the Federal Power Act (or by declaratory order) is not a "market participant" and (ii) whose transmission facilities are placed under the operational control of a FERC-approved independent transmission provider no later than four years after the close of the taxable year in which the transaction occurs, or (3) in the case of facilities subject to the jurisdiction of the Public Utility Commission of Texas, (i) a person which is approved by that Commission as consistent with Texas State law regarding an independent transmission organization, or (ii) a political subdivision, or affiliate thereof, whose transmission facilities are under the operational control of an organization described in (i).

Exempt utility property is defined as: (1) property used in the trade or business of generating, transmitting, distributing, or selling electricity or producing, transmitting, distributing, or selling natural gas, or (2) stock in a controlled corporation whose principal trade or business consists of the activities described in (1). Exempt utility property does not include any property that is located outside of the United States.

If a taxpayer is a member of an affiliated group of corporations filing a consolidated return, the reinvestment property may be purchased by any member of the affiliated group (in lieu of the taxpayer).

<u>New Federal Law (IRC section 451)</u>

The provision extends for two years the treatment under the present-law deferral provision to sales or dispositions by a qualified electric utility that occur prior to January 1, 2014.

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[424] 16 U.S.C. sec. 796 (23), defines "transmitting utility" as any electric utility, qualifying cogeneration facility, qualifying small power production facility, or federal power marketing agency which owns or operates electric power transmission facilities which are used for the sale of electric energy at wholesale.

[425] 16 U.S.C. sec. 796 (22), defines "electric utility" as any person or state agency (including any municipality) which sells electric energy; such term includes the Tennessee Valley Authority, but does not include any federal power marketing agency.

[426] For example, a regional transmission organization, an independent system operator, or an independent transmission company.

Effective Date

The provision applies to dispositions after December 31, 2011.

California Law (R&TC sections 17551, 24661, and 24661.6)

The Personal Income Tax Law and the Corporation Tax Law generally conform to the federal rules relating to the taxable year of inclusion;[427] however, both the Personal Income Tax Law and the Corporation Tax Law specifically do not conform to the special rule for sales or dispositions to implement FERC or state electric restructuring policy.[428]

Impact on California Revenue

Not applicable.

Section	Section Title
412	Extension of Alternative Fuels Excise Tax Credits

Background

Fuel Excise Taxes

Fuel excise taxes are imposed on taxable fuel (gasoline, diesel fuel or kerosene) under IRC section 4081. In general, these fuels are taxed when removed from a refinery, terminal rack, upon entry into the United States, or upon sale to an unregistered person. A back-up tax under IRC section 4041 is imposed on previously untaxed fuel and alternative fuel used or sold for use as fuel in a motor vehicle or motorboat to the supply tank of a highway vehicle. In general, the rates of tax are 18.3 cents per gallon (or in the case of compressed natural gas 18.3 cents per gasoline gallon equivalent), and in the case of liquefied natural gas, and liquid fuel derived from coal or biomass, 24.3 cents per gallon.

Alternative Fuel and Alternative Fuel Mixture Credits and Payments

The IRC provides two per-gallon excise tax credits with respect to alternative fuel: the alternative fuel credit, and the alternative fuel mixture credit. For this purpose, the term "alternative fuel" means liquefied petroleum gas, P Series fuels (as defined by the Secretary of Energy under

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[427] Under the Personal Income Tax Law, R&TC section 17551 conforms to Subchapter E of Chapter 1 of Subtitle A of the IRC, containing IRC sections 441-483, as of the "specified date" of January 1, 2009, with modifications. Under the Corporation Tax Law, R&TC section 24661 conforms to IRC section 451, relating to the general rule for taxable year of inclusion, as of the "specified date" of January 1, 2009.

[428] R&TC sections 17551(f) and 24661.6.

42 U.S.C. sec. 13211(2)), compressed or liquefied natural gas, liquefied hydrogen, liquid fuel derived from coal through the Fischer-Tropsch process ("coal-to-liquids"), compressed or liquefied gas derived from biomass, or liquid fuel derived from biomass. Such term does not include ethanol, methanol, or biodiesel.

For coal-to-liquids produced after December 30, 2009, the fuel must be certified as having been derived from coal produced at a gasification facility that separates and sequesters 75 percent of such facility's total carbon dioxide emissions.

The alternative fuel credit is allowed against IRC section 4041 liability, and the alternative fuel mixture credit is allowed against IRC section 4081 liability. Neither credit is allowed unless the taxpayer is registered with the Secretary of the Treasury. The alternative fuel credit is 50 cents per gallon of alternative fuel or gasoline gallon equivalents[429] of non-liquid alternative fuel sold by the taxpayer for use as a motor fuel in a motor vehicle or motorboat, sold for use in aviation or so used by the taxpayer.

The alternative fuel mixture credit is 50 cents per gallon of alternative fuel used in producing an alternative fuel mixture for sale or use in a trade or business of the taxpayer. An "alternative fuel mixture" is a mixture of alternative fuel and taxable fuel (gasoline, diesel fuel or kerosene) that contains at least one-tenth of one percent taxable fuel. The mixture must be sold by the taxpayer producing such mixture to any person for use as a fuel, or used by the taxpayer producing the mixture as a fuel. The credits generally expire after December 31, 2011 (September 30, 2014 for liquefied hydrogen).

A person may file a claim for payment equal to the amount of the alternative fuel credit and alternative fuel mixture credits. The alternative fuel credit and alternative fuel mixture credit must first be applied to the applicable excise tax liability under IRC section 4041 or IRC section 4081, and any excess credit may be taken as a payment. These payment provisions generally also expire after December 31, 2011. With respect to liquefied hydrogen, the payment provisions expire after September 30, 2014.

For purposes of the alternative fuel credit, alternative fuel mixture credit and related payment provisions, "alternative fuel" does not include fuel (including lignin, wood residues, or spent pulping liquors) derived from the production of paper or pulp.

New Federal Law (IRC sections 6426 and 6427)

The provision extends the alternative fuel excise tax credit, and related payment provisions (for non-hydrogen fuels), for two additional years (through December 31, 2013). The alternative fuel mixture excise tax credit is extended for two additional years (through December 31, 2013) but the companion payment (outlay) provision is not extended.

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[429] "Gasoline gallon equivalent" means, with respect to any non-liquid alternative fuel (for example, compressed natural gas), the amount of such fuel having a Btu (British thermal unit) content of 124,800 (higher heating value).

Effective Date

The provision is effective for fuel sold or used after December 31, 2011.

California Law

The FTB does not administer excise taxes. Defer to the Board of Equalization (BOE).

Impact on California Revenue

Defer to the BOE.

Sections	Section Title
501-503	Extensions of Unemployment Compensation Provisions

Background

Basic income support for unemployed workers is generally provided through the joint federal-state unemployment compensation program, which generally pays up to 26 weeks of unemployment benefits. Unemployment benefits may be extended at the state level by the permanent extended-benefits (EB) program if high unemployment exists within the state. Once regular unemployment benefits are exhausted, the EB program may provide additional weeks of benefits, depending on worker eligibility, state law, and state economic conditions. Under permanent law,[430] the EB program is funded 50 percent by the federal government and 50 percent by the states. The American Recovery and Reinvestment Act of 2009[431] and subsequent federal acts temporarily provided for 100 percent federal funding of the EB program.

New Federal Law (IRC section 3304)

These provisions:

- Extend the EB program to weeks of employment ending on or before January 1, 2014;
- Extend until December 31, 2013, 100 percent federal funding of the EB program;
- Exempt weeks of unemployment between enactment of this Act and June 30, 2014, from the prohibition in the Federal-State Extended Unemployment Compensation Act of 1970 (FSEUCA of 1970) against federal matching payments to a state for the first week in an individual's eligibility period for which extended compensation or sharable regular compensation is paid if the state law provides for payment of regular compensation to an individual for his or her first week of otherwise compensable unemployment, and thus

[430] Public Law 91-373.

[431] Public Law 111-5.

allows temporary federal matching for the first week of extended benefits for states with no waiting period;

- Amend the FSEUCA of 1970 to postpone similarly from December 31, 2012, to December 31, 2013, termination of the period during which a state may determine its "on" and "off" indicators according to specified temporary substitutions in its formula; and
- Appropriate funds out of the employment security administration account through fiscal year 2014 to assist states in providing reemployment and eligibility assessment activities.

California Law

The FTB does not administer unemployment compensation provisions. Defer to the Employment Development Department (EDD).

Impact on California Revenue

Defer to the EDD.

Section	Section Title
902	Amounts in Applicable Retirement Plans May be Transferred to Designated Roth Accounts Without Distribution

Background

Individual Retirement Arrangements

There are two basic types of individual retirement arrangements (IRAs) under present law: traditional IRAs,[432] to which both deductible and nondeductible contributions may be made,[433] and Roth IRAs, to which only nondeductible contributions may be made.[434] An annual limit applies to contributions to IRAs.[435]

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[432] IRC section 408.

[433] IRC section 219.

[434] IRC section 408A.

[435] The contribution limit is coordinated so that the aggregate maximum amount that can be contributed to all of an individual's IRAs (both traditional and Roth IRAs) for a taxable year is the lesser of a certain dollar amount ($5,500 for 2013) or the individual's compensation. In the case of a married couple, contributions can be made up to the dollar limit for each spouse if the combined compensation of the spouses is at least equal to the contributed amount. An individual who has attained age 50 before the end of the taxable year may also make catch-up contributions to an IRA. For this purpose, the aggregate dollar limit is increased by $1,000. In addition, deductible contributions to traditional IRAs, and contributions to Roth IRAs, generally are subject to AGI limits. IRA contributions generally must be made in cash.

The principal difference between these two types of IRAs is the timing of income inclusion. For a traditional IRA, an eligible contributor may deduct the contributions made for the year, but distributions are includible in gross income and may be subject to the 10-percent additional tax on early distributions.[436] For a Roth IRA, all contributions are after-tax (no deduction is allowed) but amounts held in a Roth IRA that are withdrawn as a qualified distribution are not includible in income or subject to the 10-percent early-withdrawal tax. A qualified distribution is a distribution that: (1) is made after the five-taxable year period beginning with the first taxable year for which the individual made a contribution to a Roth IRA, and (2) is made after attainment of age 59½, on account of death or disability, or is made for first-time homebuyer expenses of up to $10,000.

Distributions from a Roth IRA that are not qualified distributions are includible in income to the extent attributable to earnings.[437] Under special ordering rules, after-tax contributions are recovered before earnings rather than being recovered pro rata with earnings.[438] The amount includible in income is also subject to the 10-percent early-withdrawal tax unless an exception applies.

Roth IRA Conversions

Taxpayers generally may convert amounts in a traditional IRA that are eligible for rollover.[439] A conversion may be accomplished by means of a 60-day rollover,[440] trustee-to-trustee transfer, or account re-designation. Regardless of the means used to convert, any amount converted from a traditional IRA to a Roth IRA is treated as distributed from the traditional IRA and rolled over to the Roth IRA. The amount converted is includible in income as if a withdrawal had been made, except that the 10-percent early withdrawal tax does not apply. A special recapture rule relating to the 10-percent additional tax on early distributions applies for distributions made from a Roth IRA within a specified five-year period after a rollover.[441]

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[436] Under IRC section 72(t), unless another exception applies, distributions from IRAs, qualified retirement plans, and IRC section 403(b) plans before the employee or IRA owner attains age 59½ are subject to an additional tax equal to 10 percent of the amount of the distribution that is includible in gross income.

[437] This tax treatment applies also to distributions from a traditional IRA to which nondeductible contributions were made, with the portion attributable to earnings determined on a pro-rata basis.

[438] IRC section 408A(d)(4).

[439] Under IRC section 408(d)(3), most distributions from an IRA are eligible for rollover. The exceptions are distributions to a beneficiary other than a surviving spouse and distributions that are required minimum distributions.

[440] A 60-day rollover is a rollover under which an amount distributed that is eligible for rollover is contributed to an eligible retirement plan within 60 days of the distribution. See IRC section 408(d)(3)(A)(ii) and IRC section 402(c)(3).

[441] IRC section 408A(d)(3)(F), Treas. Reg. section 1.408A–6, A–5, and Notice 2008–30, Q&A–3.

Qualified Roth Contribution Programs

IRC Section 401(k) Plans, IRC section 403(b) Plans, and Governmental IRC Section 457(b) Plans

A qualified retirement plan[442] that is a profit-sharing plan or stock bonus plan (and certain money purchase pension plans) may allow an employee to make an election between cash and an employer contribution to the plan pursuant to a qualified cash or deferred arrangement.[443] A plan with this feature is generally referred to as an IRC section 401(k) plan. An IRC section 403(b) plan may allow a similar salary reduction agreement under which an employee may make an election between cash and an employer contribution to the plan.[444]

Amounts contributed pursuant to these qualified cash or deferred arrangements and salary reduction agreements generally are referred to as elective contributions. The elective contributions generally are excludable from gross income (pretax elective contributions) and only taxed along with attributable earnings upon distribution from the plan. Alternatively the plan may include a qualified Roth contribution program under which eligible employees are offered a choice of either making pretax elective contributions or making elective contributions that are not excluded from income and are designated as Roth contributions.[445] Similar to distributions from Roth IRAs, if certain requirements are satisfied, distributions of designated Roth contributions and earnings attributable to such contributions are excluded from gross income. The employer may also make nonelective and matching contributions for employees under an IRC section 401(k) or an IRC section 403(b) plan. These are not permitted to be designated as Roth contributions and generally are pretax contributions.

A dollar limit applies to the aggregate amount of elective contributions that an employee is permitted to contribute to IRC section 401(k) and IRC section 403(b) plans for a taxable year, which is $17,500 for 2013.[446] An additional catch-up amount that employees age 50 or over are allowed to contribute is $5,500 for 2013.[447]

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[442] Qualified retirement plans include plans qualified under IRC section 401(a) and IRC section 403(a) annuity plans.

[443] IRC section 401(k).

[444] IRC section 403(b) plans may be maintained only by (1) tax-exempt charitable organizations, and (2) educational institutions of state or local governments (including public schools). Many of the rules that apply to IRC section 403(b) plans are similar to the rules applicable to qualified retirement plans, including IRC section 401(k) plans.

[445] IRC section 402A.

[446] An employee with compensation less than $17,500 may make elective contributions only up to the amount of his or her compensation. Pursuant to IRC sections 415(c) and 403(b)(1), total contributions (including elective contributions) for an employee to an IRC section 401(k) plan or an IRC section 403(b) plan for a plan year for an employee generally cannot exceed $51,000 for 2013 (or the employee's compensation, if less). In some cases additional elective contributions or other contributions may be made under an IRC section 403(b) plan.

[447] The total of an employee's elective contributions, including catch-up contributions, cannot exceed the employee's compensation.

Elective contributions under an IRC section 401(k) plan are subject to explicit statutory in-service distribution restrictions under the plan.[448] Such contributions generally may only be distributed after attainment of age 59½, death of the employee, termination of the plan, or severance from employment with the employer maintaining the plan. These contributions are also permitted to be distributed on account of hardship. These limitations also apply to certain other contributions to the plan except that such distributions cannot be distributed on account of hardship. Similar distribution restrictions apply to salary reduction contributions under IRC section 403(b) plans.[449]

Amounts under a qualified plan are distributable only as permitted under the plan terms. Even if no other statutory distribution restriction applies to an amount, in order to meet the regulatory definition for a profit-sharing plan, the plan generally may only allow an in-service distribution of an amount contributed to the plan after a fixed number of years (not less than two).[450] In the case of a money purchase pension plan, the plan generally may not allow an in-service distribution prior to attainment of age 62 (or attainment of normal retirement age under the plan if earlier).[451]

The Thrift Savings Plan (TSP) is a qualified defined contribution plan under which federal employees may make elective contributions.[452] The TSP includes a qualified Roth contribution program and allows employees to make both pretax elective contributions and designated Roth contributions (subject to the applicable limit). These contributions are generally subject to the same tax treatment as contributions to an IRC section 401(k) plan.[453] The TSP also provides for employer matching contributions and nonelective contributions. Distributions from the TSP are permitted after separation from employment or attainment of age 59½ or in the case of financial hardship.[454]

A governmental IRC section 457(b) plan may also provide for elective contributions. Contributions to a governmental IRC section 457(b) plan are subject to a dollar limit of $17,500 for 2013 plus an additional $5,500 catch-up contribution limit for participants at least age 50 (or the participant's compensation, if less).[455] This limit is separate from the limit on elective deferrals to IRC section 401(k) and IRC section 403(b) plans.[456] As in the case of an IRC section 401(k) plan

[448] IRC section 401(k)(2)(B).

[449] IRC sections 403(b)(7)(A)(ii) and 403(b)(11).

[450] Rev. Rul. 71–295, 1971–2, C.B. 184 and Treas. Reg. section 1.401–1(b)(1)(ii). Similar rules apply to a stock bonus plan. Treas. Reg. section 1.401–1(b)(1)(iii).

[451] IRC section 401(a)(37) and Treas. Reg. section 1.401(a)–1(b)(1).

[452] The provisions of the TSP are governed by sections 8430 through 8440f of Title 5 of the United States Code.

[453] IRC section 7701(j).

[454] 5 U.S.C. sec. 8433.

[455] Under a special rule, additional catch-up contributions may be made by a participant to a governmental IRC section 457(b) for the last three years before attainment of normal retirement age.

[456] For example, if an employee participates in both an IRC section 403(b) plan and a governmental

or an IRC section 403(b) plan, the plan may include a qualified Roth contribution program under which employees are given the choice between making pretax elective contributions and designated Roth contributions. Deferrals under a governmental IRC section 457(b) plan are also subject to explicit statutory in-service distribution restrictions similar to those applicable to IRC section 401(k) and IRC section 403(b) plans, except that distributions from a governmental IRC section 457(b) plan prior to severance from employment are generally not permitted until the employee attains age 70½ (rather than being allowed after attainment of age 59½).[457]

Designated Roth Accounts

All designated Roth contributions made under the plan must be maintained in a separate account (a designated Roth account). A qualified distribution from a designated Roth account is excludable from gross income. A qualified distribution is a distribution that is made after: (1) an employee's completion of a specified 5-year period, and (2) the employee's attainment of age 59½, death, or disability.

A distribution from a designated Roth account (other than a qualified distribution) is included in the distributee's gross income to the extent allocable to income under the contract and excluded from gross income to the extent allocable to investment in the contract (commonly referred to as basis), taking into account only the designated Roth contributions as basis.[458]

Eligible rollover distributions from designated Roth accounts may only be rolled over to another designated Roth account or a Roth IRA.

Rollovers from Eligible Employer Plans (Other than from Designated Roth Accounts)

Rollover to Eligible Retirement Plan that is not a Roth IRA or a Designated Roth Account

An eligible rollover distribution from an eligible employer plan that is not from a designated Roth account may be rolled over to another such plan (other than to a designated Roth account) or to a traditional IRA. An eligible employer plan is a qualified retirement plan, an IRC section 403(b) plan, and a governmental IRC section 457(b) plan. If rolled over, the distribution generally is not currently includible in the distributee's gross income. An eligible rollover distribution is any distribution from an eligible employer plan with certain exceptions. Distributions that are not eligible rollover distributions generally are certain periodic payments, any distribution to the extent the distribution is a minimum required distribution, and any distribution made on account of hardship of the employee.[459] Only an employee, a surviving spouse, or certain alternate payees

IRC section 457(b) plan of the same employer, the employee may contribute up to $17,500 (plus $5,500 catch-up contributions if at least age 50) to the IRC section 403(b) plan and up to $17,000 (plus $5,500 catch-up contributions if at least age 50) to the IRC section 457(b) plan.

[457] IRC section 457(d)(1)(A).

[458] The special basis-first recovery rule for Roth IRAs does not apply to distributions from designated Roth accounts.

[459] IRC section 402(c)(4).

are allowed to roll over an eligible rollover distribution from an eligible employer plan to another eligible employer plan.[460]

Rollover to a Roth IRA

A distribution from an eligible employer plan that is not from a designated Roth account is also permitted to be rolled over into a Roth IRA, subject to the rules that apply to conversions from a traditional IRA into a Roth IRA. Thus, a rollover from an eligible employer plan into a Roth IRA is includible in gross income (except to the extent it represents a return of after-tax contributions), and the 10-percent early distribution tax does not apply.[461] In the case of a distribution and rollover of property, the amount of the distribution for purposes of determining the amount includable in gross income is generally the fair market value of the property on the date of the distribution.[462] As in the case of a Roth IRA conversion of an amount from a traditional IRA, the special recapture rule relating to the 10-percent additional tax on early distributions applies for distributions made from the Roth IRA within a specified five-year period after the rollover.[463]

In-Plan Roth Rollover

If an IRC section 401(k) plan, IRC section 403(b) plan, or governmental IRC section 457(b) plan has a qualified Roth contribution program, any amount eligible under the plan for distribution and rollover to another eligible employer plan is permitted to be rolled over from an account under the plan that is not a designated Roth account into a designated Roth account under the plan for the individual (referred to as an "in-plan Roth rollover").[464] As in the case of a rollover of a distribution from an eligible employer plan (other than from a designated Roth Account) to a Roth IRA, this rollover is essentially a form of Roth conversion, and the distribution is subject to the rules that apply to conversions from a traditional IRA into a Roth IRA. Thus, the amount transferred is includible in gross income (except to the extent it represents a return of after-tax contributions), and the 10-percent early distribution tax does not apply.[465] An in-plan Roth rollover may be accomplished at the election of the employee (or surviving spouse) through a direct rollover (operationally through a transfer of assets from the account that is not a designated Roth account to the designated Roth account) (an "in-plan Roth direct rollover"), or by a distribution of funds to the individual who then rolls over the funds into his or her designated Roth account in the plan within 60 days (an "in-plan Roth 60-day rollover").

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[460] IRC section 402(c)(10) allows non-spouse beneficiaries to make a direct rollover to an IRA but not another eligible employer plan.

[461] IRC section 408A(d)(3) and Notice 2008–30, 2008–12 I.R.B. 638.

[462] Treas. Reg. section 1.402(a)–1(a)(iii).

[463] IRC section 408A(d)(3)(F), Treas. Reg. section 1.408A–6 A–5, and Notice 2008–30, Q&A–3.

[464] IRC section 402A(c)(4). Notice 2010–84, 2010–2 C.B. 872, provides guidance on IRC section 402A(c)(4).

[465] As in the case of a rollover from an eligible employer plan that is not from a designated Roth account to a Roth IRA, the special recapture rule relating to the 10-percent additional tax on early distributions applies.

A plan that does not otherwise have a qualified Roth contribution program is not permitted to establish designated Roth accounts solely to accept these rollover contributions. Further, whether the rollover is an in-plan Roth direct rollover or an in-plan Roth 60-day rollover, the distribution to be rolled over must be otherwise allowed under the plan and be an eligible rollover distribution. For example, an amount under an IRC section 401(k) plan subject to distribution restrictions cannot be rolled over to a designated Roth account. If property is transferred in a direct in-plan Roth rollover, the individual must be eligible for an in-kind distribution of that property. If the direct rollover is accomplished by a transfer of property to the designated Roth account (rather than cash), the amount of the distribution is the fair market value of the property on the date of the transfer. A plan is permitted to allow a distribution only in the form of a direct in-plan Roth rollover even though the plan does not otherwise allow in-service distributions or distributions prior to normal retirement age.[466]

Because an in-plan Roth direct rollover merely changes the account in a plan under which an amount is held and the tax character of the amount, a distribution that is rolled over in an in-plan direct rollover is not treated as a distribution for certain purposes under the plan, including certain purposes related to participant or spousal consent, plan loans, and anti-cut-back protections under the plan.[467]

<u>New Federal Law (IRC section 402A)</u>

The provision expands the amounts eligible for in-plan Roth direct rollover to include amounts that are not distributable under the plan. Under the provision, an IRC section 401(k) plan (including a TSP), an IRC section 403(b) plan or a governmental IRC section 457(b) plan that includes a qualified Roth contribution program, is permitted to allow individuals to elect an in-plan transfer of any amount not otherwise distributable under the plan from an account that is not a designated Roth account under the plan to a designated Roth account maintained under the plan for the benefit of the individual.

This in-plan transfer is treated as an in-plan Roth direct rollover, even though the plan may not otherwise be allowed to provide for distribution of the amount transferred. Thus, as in the case of present-law in-plan Roth direct rollovers, the transfer is essentially a form of Roth conversion, and the amount transferred is subject to the rules that apply to conversions from a traditional IRA into a Roth IRA. Thus, the amount transferred is includible in gross income (except to the extent it represents a return of after-tax contributions), and the 10-percent early distribution tax does not apply unless the special recapture rule applies based on a subsequent distribution.

The provision specifies that a plan is not treated as violating the distribution restrictions applicable to IRC section 401(k), IRC section 403(b) and governmental IRC section 457(b) plans solely by reason of an in-plan transfer under the provision. An in-plan transfer under the provision is also permitted for an amount that is not distributable for any other reason. For example, if an amount in a profit-sharing plan is not distributable because the requisite fixed number of years

[466] Q&A–4 of Notice 2010–84.

[467] Q&A–3 of Notice 2010–84.

has not elapsed, the plan would not be treated as violating this distribution limitation solely by reason of an in-plan transfer of such amount under the provision. Moreover, the statutory provision governing TSP distributions is not violated solely by reason of an in-plan transfer under the provision.

Similar to an in-plan Roth direct rollover for otherwise distributable amounts, an amount transferred in an in-plan transfer under the provision merely changes the account in a plan under which an amount is held and the tax character of the amount. Thus, the provision does not change the basic character of these amounts as not being distributable under the plan. For example, an amount subject to a distribution restriction in an IRC section 401(k), IRC section 403(b) or governmental IRC section 457(b) plan before an in-plan transfer must remain subject to the relevant distribution restriction after the transfer. As a further example, an amount in a profit-sharing plan that is not distributable because the requisite fixed number of years has not elapsed remains not distributable for the remainder of the fixed number of years.

Effective Date

The provision applies to transfers after December 31, 2012, in taxable years ending after that date.

California Law (R&TC sections 17501 and 24601)

In general, California law automatically conforms to the federal IRA and Roth IRA rules,[468] and automatically conforms to this provision that expands the amounts eligible for in-plan Roth direct rollover to include amounts that are not distributable under the plan. Additionally, California law provides that the additional tax on early distributions from qualified retirement plans applies as applicable for federal income tax purposes for the same taxable year, modified to provide that the California additional tax is 2½ percent of the amount includible in income rather than the federal rate of 10 percent.[469]

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468 R&TC sections 17501 and 24601 conform by reference to Subchapter D of Chapter 1 of Subtitle A of the IRC, relating to deferred compensation, consisting of Part I (IRC sections 401 to 420, relating to pension, profit-sharing, stock bonus plans, etc.), Part II (IRC sections 421 to 424, relating to certain stock options), and Part III (IRC sections 430 to 436, relating to rules relating to minimum funding standards and benefit limitations). Additionally, California conforms by reference to IRC 457, relating to deferred compensation plans of state and local governments and tax-exempt organizations, in R&TC section 17551.

Under the Personal Income Tax Law, except for increases in the maximum amount of elective deferrals that may be excluded from income under IRC section 402(g), R&TC sections 17501(b) and 17551(c) specifically provide that federal changes to Part I (IRC sections 401 to 420) and Part III (IRC sections 430 to 436) of Subchapter D of Chapter 1 of Subtitle A of the IRC, and IRC section 457, automatically apply without regard to taxable year to the same extent as applicable for federal income tax purposes, and thus adopt all changes made to the IRC sections within those parts without regard to the "specified date" contained in R&TC section 17024.5. Under the Corporation Tax Law, R&TC section 24601(b) specifically provides that federal changes to Part I (IRC sections 401 to 420) of Subchapter D of Chapter 1 of Subtitle A of the IRC automatically apply without regard to taxable year to the same extent as applicable for federal income tax purposes, and thus adopts all changes made to the IRC sections within that part without regard to the "specified date" contained in R&TC section 23051.5.

469 California generally conforms to IRC section 72, relating to the additional tax on early distributions from qualified retirement plans, as of the "specified date" of January 1, 2009, in R&TC section 17081, with modifications in

Impact on California Revenue

Baseline—based on a proration of the federal estimate developed for this provision by the Joint Committee on Taxation, baseline revenue gains are estimated to be $25,000,000, $34,000,000, and $39,000,000 in fiscal years 2013-14, 2014-15, and 2015-16, respectively.

R&TC section 17085. R&TC section 17085(c) provides that the additional tax on early distributions from qualified retirement plans under IRC section 72(t) is modified to provide that the early-distribution tax is 2½ percent of the amount includible in income rather than the federal rate of 10 percent, and such modified additional tax applies as applicable for federal income tax purposes for the same taxable year.

Fallen Firefighters Assistance Tax Clarification Act of 2013
Public Law 113-63, December 20, 2013

Section	Section Title
2	Payments by Charitable Organizations with Respect to Certain Firefighters Treated as Exempt Payments

<u>Background</u>

Four firefighters were shot in an ambush in West Webster, New York, on December 24, 2012; two firefighters were killed, and two were injured. Many donations were made directly to the West Webster Fire Department, a tax-exempt organization, and donations were specifically requested to be used to help firefighters and families affected by the ambush. However, the IRC does not allow a tax-exempt organization to raise money for a group as small and specific as the West Webster firefighters and their families.

<u>New Federal Law (Uncodified Act Section Affecting IRC section 501)</u>

This act contains an uncodified provision that provides that for purposes of the IRC, payments made by a tax-exempt organization to any firefighter who was injured as a result of the ambush of firefighters responding to an emergency on December 24, 2012, in Webster, New York, and the spouse or any dependent of any firefighter who died as a result of such ambush, are treated as related to the purpose or function forming the basis of such organizations tax-exempt status, if such payments are made in good faith using a reasonable and objective formula which is consistently applied.

<u>Effective Date</u>

This provision applies to payments made on or after December 24, 2012, and before January 19, 2014.

<u>California Law</u>

California does not conform by reference to IRC section 501, relating to exempt charitable organizations, but instead has stand-alone law in R&TC section 23701d that parallels the federal rules for exempt organizations.

<u>Impact on California Revenue</u>

Not applicable.

EXHIBIT A – 2013 MISCELLANEOUS FEDERAL ACTS IMPACTING THE IRC NOT REQUIRING A CALIFORNIA RESPONSE

1. Public Law 113-15, an Act to amend the IRC to include vaccines against the seasonal influenza vaccine within the definition of taxable vaccines subject to the 75-cent-per-dose excise tax.

IRC Section	Public Law No.	Act Section No.	127 Stat. Page
4132	113-15	1(a)	476
4132	113-15	1(b)	476

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2. Public Law 113-22, an Act to amend the IRC to rename the heading of IRC section 219(c), relating to special rules for the individual retirement savings deductions of certain married individuals, as the "Kay Bailey Hutchison Spousal IRA."

IRC Section	Public Law No.	Act Section No.	127 Stat. Page
219	113-22	1	492

EXHIBIT B – EXPIRING TAX PROVISIONS

California Sunset[470]	California Section	Federal Section	Federal Sunset	Description
12/31/15	18754 – 18754.3	N/A	N/A	Voluntary Contribution: California Sea Otter Fund
12/31/15	18801 - 18804	N/A	N/A	Voluntary Contribution: California Firefighter's Memorial Fund
12/31/15	18805 - 18808	N/A	N/A	Voluntary Contribution: California Peace Officer's Memorial Foundation Fund
6/30/16	19558	N/A	N/A	Permit the FTB to Disclose Income Tax Return Information to the Public Employees Retirement System Regarding the Early Retiree Reinsurance Program
12/31/16	17053.86 & 23686	N/A	N/A	Credit: College Access Tax Credit
12/31/16	17053.57 & 23657	N/A	N/A	Credit: Community Development Financial Institution Deposits
12/31/17	18711 - 18716	N/A	N/A	Voluntary Contribution: State Children's Trust Fund
12/31/17	18741 - 18744	N/A	N/A	Voluntary Contribution: Fish and Game Preservation Fund
12/31/17	18791 - 18796	N/A	N/A	Voluntary Contribution: Designations to California Breast Cancer Research Fund
12/31/17	18861 - 18864	N/A	N/A	Voluntary Contribution: California Cancer Research Fund
12/31/17	17053.62 & 23662	45H	Permanent	Credit: Environmental Credit for Production of Ultra Low Sulfur Diesel Fuel
12/31/18	17141	N/A	N/A	Exclusion of Reimbursement for Federal Taxes Imposed on Health Benefits for Same-Sex Spouses and Domestic Partners

[470] In general, this is the last taxable year to which the provision applies. Fiscal years beginning within this taxable year are, in general, also covered by the provision. In some cases, the repeal date of the section is listed or the expiration applies to transactions occurring after this date.

EXHIBIT B – EXPIRING TAX PROVISIONS

California Sunset	California Section	Federal Section	Federal Sunset	Description
12/31/18	19551 & 19551.5	N/A	N/A	City Business Tax/License Information Mandate
12/31/18	18851 - 18855	N/A	N/A	Voluntary Contribution: Emergency Food Assistance Program Fund
12/31/19	18721 - 18724	N/A	N/A	Voluntary Contribution: California Fund for Senior Citizens
12/31/19	18761 - 18766	N/A	N/A	Voluntary Contribution: California Alzheimer's Disease and Related Research Fund
12/31/17	18416.5	N/A	N/A	Allow Electronic Communication to Taxpayers to Inform of Tax Change
12/31/21	17501 - 24601	420	12/31/21	Transfer of Excess Pension Assets to Retiree Health Accounts
12/31/21	17501 - 24601	420	12/31/21	Transfer of Excess Pension Assets to Fund Group-Term Life Insurance
12/01/24	17053.73 & 23626	N/A	N/A	New Employment Credit[471]
12/31/24	17059.2 & 23689	N/A	N/A	California Competes Tax Credit

[471] The new-employment-credit law sections (R&TC sections 17053.73 and 23626) are repealed on December 1, 2024. Those law sections generally apply to taxable years beginning on or after January 1, 2014, and before January 1, 2021; however, they continue to be operative for taxable years beginning on or after January 1, 2021, but only with respect to qualified full-time employees who commence employment with a qualified taxpayer in a designated census tract or former enterprise zone in a taxable year beginning before January 1, 2021.

EXHIBIT C – REVENUE TABLES

Assumed Enactment after June 30, 2014

Table 1 – American Taxpayer Relief Act of 2012 (ATRA)
(Public Law 112-240)

Act Section	Provision	2014-15	2015-16	2016-17
101 102 103	Permanent Extension and Modification of 2001 Tax Relief Permanent Extension and Modification of 2003 Tax Relief Extension of 2009 Tax Relief *See A through M below.*			
A	Individual Income Tax Rate Reductions	N/A	N/A	N/A
B	The Overall Limitation on Itemized Deductions and the Personal Exemption Phase-Out	N/A	N/A	N/A
C	Increase the Child Tax Credit	N/A	N/A	N/A
D	Marriage Penalty Relief and Earned Income Tax Credit Simplification	N/A	N/A	N/A
E	Education Incentives			
	Income and Wage Exclusion for Awards under the NHSC Scholarship Program and the Armed Forces Health Professions Scholarship Program	Baseline & Defer to the EDD	Baseline & Defer to the EDD	Baseline & Defer to the EDD
	Income and Wage Exclusion for Employer-Provided Educational Assistance	Baseline & Defer to the EDD	Baseline & Defer to the EDD	Baseline & Defer to the EDD
	Deduction for Student Loan Interest	Baseline	Baseline	Baseline
	Coverdell Education Savings Accounts	Baseline	Baseline	Baseline
	Amount of Governmental Bonds that May be Issued by Governments Qualifying for the "Small Governmental Unit" Arbitrage Rebate Exception; and, Issuance of Tax-Exempt Private Activity Bonds for Public School Facilities	N/A	N/A	N/A

Act Section	Provision	2014-15	2015-16	2016-17
F	Other Incentives for Families and Children			
	Adoption Credit and Exclusion from Income for Employer-Provided Adoption Assistance	Baseline & N/A	Baseline & N/A	Baseline & N/A
	Employer-Provided Child Care Tax Credit	N/A	N/A	N/A
	Expansion of Dependent Care Tax Credit	Baseline	Baseline	Baseline
G	Alaska Native Settlement Trusts	N/A	N/A	N/A
H	Estate, Gift, and Generation Skipping Transfer Taxes	Defer to the State Controller's Office	Defer to the State Controller's Office	Defer to the State Controller's Office
I	Reduced Rates on Capital Gains and Dividends	N/A	N/A	N/A
J	The American Opportunity Tax Credit	N/A	N/A	N/A
K	Extension of Reduced Earnings Threshold for Additional Child Tax Credit	N/A	N/A	N/A
L	Extension and Modification of the Earned Income Tax Credit	N/A	N/A	N/A
M	Refunds Disregarded in the Administration of Federal Programs and Federally Assisted Programs	N/A	N/A	N/A
104	Permanent Alternative Minimum Tax Relief	N/A	N/A	N/A
201	Extension of Deduction for Certain Expenses of Elementary and Secondary School Teachers	N/A	N/A	N/A
202	Extension of Exclusion from Gross Income of Discharge of Qualified Principal Residence Indebtedness	Expired	Expired	Expired
203	Extension of Parity for Exclusion from Income for Employer-Provided Mass Transit and Parking Benefits	Baseline	Baseline	Baseline

Act Section	Provision	2014-15	2015-16	2016-17
204	Extension of Mortgage Insurance Premiums Treated as Qualified Residence Interest	N/A	N/A	N/A
205	Extension of Deduction of State and Local General Sales Taxes	N/A	N/A	N/A
206	Extension of Special Rule for Contributions of Capital Gain Real Property Made for Conservation Purposes	Expired	Expired	Expired
207	Extension of Above-the-Line Deduction for Qualified Tuition and Related Expenses	N/A	N/A	N/A
208	Extension of Tax-Free Distributions from Individual Retirement Plans for Charitable Purposes	Baseline	Baseline	Baseline
209	Improve and Make Permanent the Provision Authorizing the Internal Revenue Service to Disclose Certain Return and Return Information to Certain Prison Officials	Baseline	Baseline	Baseline
301	Extension and Modification of Research Credit			
	Extension	N/A	N/A	N/A
	Modifications to Acquisitions, Dispositions, and Aggregation of Expenditures	Negligible	Negligible	Negligible
302	Extension of Temporary Minimum Low-Income Tax Credit Rate for Non-Federally Subsidized New Buildings	No Impact	No Impact	No Impact
303	Extension of Housing Allowance Exclusion for Determining Area Median Gross Income for Qualified Residential Rental Project Exempt Facility Bonds	No Impact	No Impact	No Impact
304	Extension of Indian Employment Tax Credit	N/A	N/A	N/A
305	Extension of New Markets Tax Credit	N/A	N/A	N/A

Act Section	Provision	2014-15	2015-16	2016-17
306	Extension of Railroad Track Maintenance Credit	N/A	N/A	N/A
307	Extension of Mine Rescue Team Training Credit	N/A	N/A	N/A
308	Extension of Employer Wage Credit for Employees Who Are Active Duty Members of the Uniformed Services	N/A	N/A	N/A
309	Extension of Work Opportunity Tax Credit	$3,700,000	$1,000,000	$400,000
310	Extension of Qualified Zone Academy Bonds	N/A	N/A	N/A
311	Extension of 15-Year Straight-Line Cost Recovery for Qualified Leasehold Improvements, Qualified Restaurant Buildings and Improvements, and Qualified Retail Improvements	N/A	N/A	N/A
312	Extension of 7-Year Recovery Period for Motorsports Entertainment Complexes	N/A	N/A	N/A
313	Extension of Accelerated Depreciation for Business Property on an Indian Reservation	N/A	N/A	N/A
314	Extension of Enhanced Charitable Deduction for Contributions of Food Inventory	N/A	N/A	N/A
315	Extension of Increased Expensing Limitations and Treatment of Certain Real Property as Section 179 Property	N/A	N/A	N/A
316	Extension of Election to Expense Mine Safety Equipment	N/A	N/A	N/A
317	Extension of Special Expensing Rules for Certain Film and Television Productions	N/A	N/A	N/A
318	Extension of Deduction Allowable with Respect to Income Attributable to Domestic Production Activities in Puerto Rico	N/A	N/A	N/A

Act Section	Provision	2014-15	2015-16	2016-17
319	Extension of Modification of Tax Treatment of Certain Payments to Controlling Exempt Organizations	Expired	Expired	Expired
320	Extension of Treatment of Certain Dividends of Regulated Investment Companies	N/A	N/A	N/A
321	Extension of RIC Qualified Investment Entity Treatment Under FIRPTA	N/A	N/A	N/A
322	Extension of Subpart F Exception for Active Financing Income	Baseline	Baseline	Baseline
323	Extension of Look-Thru Treatment of Payments Between Related Controlled Foreign Corporations Under Foreign Personal Holding Company Rules	Baseline	Baseline	Baseline
324	Extension of Temporary Exclusion of 100 Percent of Gain on Certain Small Business Stock	N/A	N/A	N/A
325	Extension of Basis Adjustment to Stock of S Corporations Making Charitable Contributions of Property	Expired	Expired	Expired
326	Extension of Reduction in S-Corporation Recognition Period for Built-in Gains Tax	Expired	Expired	Expired
327	Extension of Empowerment Zone Tax Incentives	N/A	N/A	N/A
328	Extension of Tax-Exempt Financing for New York Liberty Zone	N/A	N/A	N/A
329	Extension of Temporary Increase in Limit on Cover over of Rum Excise Taxes to Puerto Rico and the Virgin Islands	Defer to the BOE	Defer to the BOE	Defer to the BOE
330	Modification and Extension of American Samoa Economic Development Credit	N/A	N/A	N/A
331	Extension and Modification of Bonus Depreciation	N/A	N/A	N/A

Act Section	Provision	2014-15	2015-16	2016-17
401	Extension of Credit for Energy-Efficient Existing Homes	N/A	N/A	N/A
402	Extension of Credit for Alternative Fuel Vehicle Refueling Property	N/A	N/A	N/A
403	Extension of Credit for 2- or 3-Wheeled Plug-In Electric Vehicles	N/A	N/A	N/A
404	Extension and Modification of Cellulosic Biofuel Producer Credit	N/A	N/A	N/A
405	Extension of Incentives for Biodiesel and Renewable Diesel	N/A and Defer to the BOE	N/A and Defer to the BOE	N/A and Defer to the BOE
406	Extension of Production Credit for Indian Coal Facilities Placed in Service Before 2009	N/A	N/A	N/A
407	Extension and Modification of Credits With Respect to Facilities Producing Energy from Certain Renewable Resources	N/A	N/A	N/A
408	Extension of Credit for Energy-Efficient New Homes	N/A	N/A	N/A
409	Extension of Credit for Energy-Efficient Appliances	N/A	N/A	N/A
410	Extension and Modification of Special Allowance for Cellulosic Biofuel Plant Property	N/A	N/A	N/A
411	Extension of Special Rule for Sales or Dispositions to Implement FERC or State Electric Restructuring Policy for Qualified Electric Utilities	N/A	N/A	N/A
412	Extension of Alternative Fuels Excise Tax Credits	Defer to the BOE	Defer to the BOE	Defer to the BOE
501 - 503	Extensions of Unemployment Compensation Provisions	Defer to the EDD	Defer to the EDD	Defer to the EDD
902	Amounts in Applicable Retirement Plans May be Transferred to Designated Roth Accounts Without Distribution	Baseline	Baseline	Baseline

Table 2 – Fallen Firefighters Assistance Tax Clarification Act of 2013 (Public Law 113-63)				
Act Section	**Provision**	**2014-15**	**2015-16**	**2016-17**
2	Payments by Charitable Organizations with Respect to Certain Firefighters Treated as Exempt Payments	N/A	N/A	N/A