

ANALYSIS OF AMENDED BILL

Franchise Tax Board

Author: Corbett Analyst: Jeff Garnier Bill Number: AB 10

Related Bills: See Legislative History Telephone: 845-5322 Introduced Date: 12/4/00 & 2/6/01

Attorney: Patrick Kusiak Sponsor: _____

SUBJECT: Conformity Act of 2000

SUMMARY

The Personal Income Tax Law (PITL) and the Bank and Corporation Tax Law (B&CTL), in general, conform to the Internal Revenue Code (IRC) either by incorporating the IRC by reference as of a "specified date" or by stand alone language that mirrors the corresponding federal provision. Presently, California law is conformed to the IRC as of January 1, 1998, unless a specific provision provides otherwise.

This bill would change the specified date from January 1, 1998, to January 1, 2000, for years beginning on or after January 1, 2000. Changing the specified date automatically conforms to all federal changes from January 1, 1998, through December 31, 1999, to IRC sections that have been previously incorporated by reference. Thus, California law would conform to numerous changes made to federal income tax law since 1998 by the six federal bills that have been enacted into law during that time that materially affect the IRC. They are:

- IRS RESTRUCTURING AND REFORM ACT OF 1998 (IRS Reform Act)
- TAX AND TRADE RELIEF EXTENSION ACT OF 1998 (Tax and Trade Extension Act)
- SURFACE TRANSPORTATION REVENUE ACT 1998 (Transportation Act)
- RICKY RAY HEMOPHILIA RELIEF FUND ACT OF 1998 (Ricky Ray Hemophilia Act)
- TICKET TO WORK AND WORK INCENTIVES IMPROVEMENT ACT OF 1999 (Ticket to Work Act)
- MISCELLANEOUS TRADE AND TECHNICAL CORRECTIONS ACT OF 1999 (Miscellaneous Trade Act)

This bill also would make numerous changes to not conform to particular federal provisions or to modify the general conformity to certain items in the IRC.

This bill also contains one of the department's legislative proposals for 1999 - "Allowing the Alimony Deduction for Part-Year and Non-Residents."

Board Position:

_____ S _____ NA _____ NP
_____ SA _____ O _____ NAR
_____ N _____ OUA _____ X PENDING

Department Director

Date

Gerald H. Goldberg

2/8/01

The changes that would be made to California tax law by this bill are discussed in detail under "Specific Findings" on the following pages.

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SUMMARY OF AMENDMENTS

The **February 6, 2001, amendment** added language not to conform to the two provisions contained in the federal Ticket to Work Act of 1999. The Ticket to Work Act of 1999 extended the temporary suspension of the taxable income limitation on percentage depletion and the termination date for expensing environmental remediation expenditures. Because this bill would change the "specified date," prior to the amendment this bill would have automatically conformed to the two above extensions contained in the Ticket to Work Act of 1999. The **February 6, 2001, amendment** also added a provision that would allow the alimony deduction for part-year and non-residents. (Item 16).

EFFECTIVE DATE

Except where otherwise specified, this bill would apply to taxable years beginning on or after January 1, 2000. Since certain provisions are effective based on transaction dates, exceptions to the January 1, 2000, effective date are so noted in this analysis.

LEGISLATIVE HISTORY

All of the provisions contained in this bill (including an alimony deduction provision for part year and non-residents) were also contained in the two previous conformity bills, AB 1208 (1999) and AB 2763 (2000). AB 1208 was held in the Senate Appropriations Committee and AB 2763 was held in the Assembly Appropriations Committee. Both AB 1208 and AB 2763 contained numerous other conformity provisions that are not contained in this bill.

FISCAL IMPACT

Departmental Costs

This bill would not significantly impact the department's costs.

Tax Revenue Estimate

Estimated Revenue Impact		
Taxable Years Beginning After January 1, 2000		
Enactment Assumed Before March 15, 2001		
Fiscal Years		
(In Millions)		
2000-1	2001-2	2002-3
\$ -.5	\$ -2	\$ 0

Refer to the table below for a detailed breakdown of the revenue estimate.

Effective January 1, 2000 Assumed Enactment Before March 15, 2001		Personal Income Tax			Bank & Corporation		
		(In Millions)			(In Millions)		
		2000-1	2001-2	2002-3	2000-1	2001-2	2002-3
1	Exclusion from Income for Employer-Provided Transportation Benefits	Insig.	Insig.	Insig.	Insig.	Insig.	Insig.
2	Waiver of Estimated Tax Penalty	No Impact	No Impact	No Impact	No Impact	No Impact	No Impact
3	Exclusion of Value of Meals to Employees	-\$0.5	-\$1	-\$1	-	-	-
4	Farm Production Flexibility Contract Payments	Insig.	Insig.	Insig.	Insig.	Insig.	Insig.
5	Tax Treatment of Cash Options for Qualified Prizes	Minor Loss	Minor Loss	Minor Loss	-	-	-
6	Payments Received Pursuant to the Ricky Ray Hemophilia Relief Fund Act	Insig.	Insig.	Insig.	-	-	-
7	Extend Tentative Minimum Tax Relief for Individuals	Negl. Loss	Negl. Loss	Negl. Loss	-	-	-
8	Provide that Federal Production Payments to Farmers are Taxable in the Year Received	Negl. Impact	Negl. Impact	Negl. Impact	Negl. Impact	Negl. Impact	Negl. Impact
9	Clarify the Tax Treatment of Income and Losses from Derivatives	Negl. Gain	Negl. Gain	Negl. Gain	Insig.	Negl. Gain	Negl. Gain
10	Expand Reporting of Cancellation of Indebt. Income	-	-	-	Insig.	Negl. Gain	Negl. Gain
11	Treatment of Excess Pension Assets Used for Retiree Health Benefits	a/	-	-	-	-	-
12	Denial of Charitable Contribution Deduction for Transfers Associated with Split-Dollar Ins. Arrangements	-	-	-	Negl. Gain	Negl. Gain	Negl. Gain
13	Distributions by a Partnership to a Corporation Partner of Stock in Another Corporation	-	-	-	Minor Gain	Minor Gain	Minor Gain
14	Income and Services Provided by REITs Subsidiaries	-	-	-	\$1	\$4	\$3
15	Modify Estimated Tax Rules for closely Held REITs	-	-	-	\$1	Negl. Gain	Negl. Gain
16	Federal Technical Changes	Insig.	Insig.	Insig.	Insig.	Insig.	Insig.
17	Alimony Deduction – Nonresidents & Part Year Residents	-\$2	-\$5	-\$2	-	-	-
	Totals	-\$2.5	-\$6	-\$3	\$2	\$4	\$3

Insig. = Insignificant

Negligible = Loss or gain of less than \$250,000

Minor = Loss or gain of less than \$500,000

a/ Baseline gains from reduced business deductions are estimated at less than \$1 million annually thru 2004-5.

Policy Considerations

Conforming to federal tax law is generally desirable because it is less confusing for taxpayers, particularly when dealing with complex areas such as those proposed in this bill. With conformity, taxpayers will generally be required to know only one set of rules. Conformity also eases FTB's administration of the law by utilizing many federal forms, instructions, and precedential decisions. This bill conforms to numerous federal law changes that occurred in 1998 and 1999.

BOARD POSITION

Pending.

SPECIFIC FINDINGS

1. Exclusion from Income for Employer-Provided Transportation Benefits

Under **federal and California law**, qualified transportation fringe benefits provided by an employer are excluded from an employee's gross income. Qualified transportation fringe benefits include parking, transit passes, and vanpool benefits. In addition, in the case of employer-provided parking, no amount is includible in income of an employee merely because the employer offers the employee a choice between cash and employer-provided parking. Under prior federal and current California law, transit passes and vanpool benefits were excludable only if provided in addition to, and not in lieu of, any compensation otherwise payable to an employee. Up to \$155 per month of employer-provided parking was excludable from income. Up to \$60 per month of employer-provided transit and vanpool benefits were excludable from gross income. These dollar amounts were indexed annually for inflation, rounded to the nearest multiple of \$5.

Under current and prior federal and state law, qualified transportation fringe benefits include a cash reimbursement by an employer to an employee. However, in the case of transit passes, 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.

Under the **Transportation Act**, employers are permitted to offer employees a choice between cash compensation or any qualified transportation benefit or a combination of any of such benefits. The amount of cash offered is includible in income and wages only to the extent the employee elects cash. Thus, under the provision, no amount is includible in gross income or wages merely because the employee is offered the choice of cash in lieu of one or more qualified transportation benefits (up to the applicable dollar limit). Also, no amount is includible in income or wages merely because the employee is offered a choice among qualified transportation benefits.

It is intended that salary reduction amounts used to provide qualified transportation benefits under the provision be treated for pension plan purposes the same as other salary reduction contributions.

The **Transportation Act** increased the exclusion for employer-provided parking to \$175 per month and the employer-provided transit and vanpool benefits exclusion to \$65 per month. In addition, beginning in 2002, the **Transportation Act** increases the exclusion for transit passes and vanpooling to \$100 per month. Beginning in 2003, the \$100 amount is indexed as under prior law. Further, no qualified transportation benefit will be indexed in 1999.

The provision permitting a cash option for any transportation benefit is effective for taxable years beginning after December 31, 1997; the increase in the exclusion for transit passes and vanpooling to \$100 per month is effective for taxable years beginning after December 31, 2001; and indexing on the \$100 amount for transit passes and vanpooling is effective for taxable years beginning after December 31, 2002.

Current **California law** is in full conformity with federal law as it read on January 1, 1998, as it relates to qualified transportation fringe benefits and annual additions to tax-qualified pension plans.

In addition, **California law** provides that gross income of an employee does not include benefits received for participation in any ridesharing arrangement in California. A ridesharing arrangement includes:

- commuting in a carpool, vanpool, buspool, or taxipool.
- monthly transit passes used by the employee or the employee's dependents, other than dependents attending elementary or secondary school.
- free or subsidized parking.
- commuting by ferry or bicycling.
- travel to or from a telecommuting facility.
- the use of any transportation used to go to or from the place of employment that reduces the use of a motor vehicle occupied by a single person.

This bill would conform California law to the **Transportation Act** changes with respect to the transportation fringe benefits rules. This bill would not affect the rules relating to California ridesharing arrangements.

2. Waiver of Estimated Tax Penalty

This bill would waive additions to tax imposed for any underpayments of tax or estimated tax for any period before April 16, 2001, with respect to any underpayment for the 2000 taxable or income year to the extent the underpayment was created or increased by any provision of this bill.

3. Deductibility of Meals Provided for the Convenience of the Employer

In general, subject to several exceptions, only 50% of the cost of business meals and entertainment is allowed as a deduction (IRC Sec. 274(n)). Under the Tax Relief and Reform Act of 1997 (TRA of 1997) exception, meals that are excludable from employees' incomes as a de minimis fringe benefit (IRC Sec. 132) are fully deductible by the employer. In addition, the courts have held that if substantially all of the meals are provided for the convenience of the employer pursuant to IRC Sec. 119, the cost of such meals is fully deductible because the employer is treated as operating a de minimis eating facility within the meaning of IRC Sec. 132(e)(2). However, the judicial decisions did not provide a bright line definition of "substantially all," and thus disputes continued between taxpayers and the IRS.

The **IRS Reform Act** provides a new safe harbor rule for the employee exclusion and the employer deduction. Under that new safe harbor, all meals furnished to employees at the employer's place of business for the convenience of the employer are treated as provided for the convenience of the employer under IRC Sec. 119 if more than one-half of employees furnished meals on the premises are furnished such meals for the convenience of the employer under IRC Sec. 119.

If these conditions are satisfied, the value of all such meals are excludable from the employee's income and fully deductible to the employer. No inference is intended as to whether the cost of such meals are fully deductible under prior law. This provision is effective for all taxable years for which the applicable statute of limitations has not expired.

California law is in full conformity with federal law as it read on January 1, 1998, as it relates to the deduction of meals provided to employees.

This bill would conform California law with the new federal safe harbor rule as it relates to the deductibility of meals provided by an employer with the same effective date as under federal law.

4. Farm Production Flexibility Contract Payments

Under **federal and California law**, a taxpayer generally is required to include an item in income no later than the time of its actual or constructive receipt, unless such amount is properly accounted for in a different period under the taxpayer's method of accounting. If a taxpayer has an unrestricted right to demand the payment of an amount, the taxpayer is in constructive receipt of that amount regardless of whether the taxpayer actually receives the payment.

The Federal Agriculture Improvement and Reform Act of 1996 (the FAIR Act) provides for production flexibility contracts between certain eligible owners and producers and the Secretary of Agriculture. These contracts generally cover crop years from 1996 through 2002.

Annual payments are made under such contracts at specific times during the federal government's fiscal year. Section 112(d)(2) of the FAIR Act provides that one-half of each annual payment is to be made on either December 15th or January 15th of the fiscal year, at the option of the recipient. This option to receive the payment on December 15th potentially results in the constructive receipt (and thus potential inclusion in income) of one-half of the annual payment at that time, even if the option to receive the amount on January 15th is elected.

The remaining one-half of the annual payment must be made no later than September 30th of the fiscal year. The Emergency Farm Financial Relief Act of 1998 added Section 112(d)(3) to the FAIR Act, which provides that all payments for fiscal year 1999 are to be paid at such time or times during fiscal year 1999 as the recipient may specify. Thus, the one-half of the annual amount that would otherwise be required to be paid no later than September 30, 1999, can be specified for payment in calendar year 1998. This potentially results in the constructive receipt (and thus required inclusion in taxable income) of such amounts in calendar year 1998, regardless of whether the amounts actually are received or the right to their receipt is fixed.

Under the **Tax and Trade Extension Act of 1998**, the time a production flexibility contract payment under the FAIR Act is properly includible in income would be determined without regard to the options granted by Section 112(d)(2) (allowing receipt of one-half of the annual payment on either December 15th or January 15th of the fiscal year) or Section 112(d)(3) (allowing the acceleration of all payments for fiscal year 1999) of that Act. The provision is effective for production flexibility contract payments made under the FAIR Act in taxable years ending after December 31, 1995.

Under the **Ticket to Work Act of 1999** any unexercised option to accelerate the receipt of any payment under a production flexibility contract payable under the FAIR Act, as in effect on December 17, 1999, is disregarded in determining the taxable year in which such payment is properly included in gross income.

Options to accelerate payments that are enacted in the future are covered by this rule, providing the payment to which they relate is mandated by the FAIR Act as in effect on December 17, 1999. The provision does not delay the inclusion of any amount in gross income beyond the taxable period in which the amount is received.

Current state law follows federal law as it read on January 1, 1998, for the tax accounting concept of "constructive receipt." Therefore, the time a production flexibility contract payment received under the FAIR Act is properly includible in income would be determined by taking into account the options granted under the FAIR Act.

This bill would conform California law with federal law changes made by the Tax and Trade Extension Act of 1998 and the Ticket to Work Act of 1999 as they relate to farm production flexibility payments. The federal effective date, with respect to payments received in taxable years ending after December 31, 1995, would apply to the Tax and Trade Extension Act of 1998 changes. Taxable years beginning on or after January 1, 2000 would be the effective date for the Ticket to Work Act of 1999 changes.

5. Tax Treatment of Cash Options for Qualified Prizes

Under **federal and California law**, a taxpayer generally is required to include an item in income no later than the time of its actual or constructive receipt, unless the item properly is accounted for in a different period under the taxpayer's method of accounting. If a taxpayer has an unrestricted right to demand payment of an amount, the taxpayer is in constructive receipt of that amount regardless of whether the taxpayer makes the demand and actually receives the payment. Under the principle of constructive receipt, the winner of a contest who is given the option of receiving either a lump-sum distribution or an annuity after winning the contest is required to include the value of the award in gross income, even if the annuity option is exercised. Alternatively, the principle of constructive receipt does not apply if, prior to the declaration of a winner (such as at the time of purchase of a lottery ticket), a taxpayer designates whether he or she chooses to receive a lump-sum distribution or an annuity. This is the case because the taxpayer does not have an unrestricted right to demand payment of the winnings since the taxpayer has not yet in fact won.

Under the **Tax and Trade Extension Act**, the existence of a "qualified prize option" is disregarded in determining the taxable year for which any portion of a qualified prize is to be included in income. A qualified prize option is an option that entitles a person to receive a single cash payment in lieu of a qualified prize (or portion thereof), provided such option is exercisable not later than 60 days after the prize winner becomes entitled to the prize. Thus, a qualified prize winner who may choose either cash or an annuity not later than 60 days after becoming entitled to the prize is not required to include amounts in gross income immediately if the annuity option is exercised merely by reason of having the option. This provision applies with respect to any qualified prize to which a person first becomes entitled after October 21, 1998.

In addition, the **Tax and Trade Extension Act** also applies to any qualified prize to which a person became entitled on or before October 21, 1998, if the person has an option to receive a lump-sum cash payment only during some portion of the 18-month period beginning on July 1, 1999. This is intended to give previous prize winners a one-time option to alter previous payment arrangements.

Qualified prizes are prizes or awards from contests, lotteries, jackpots, games or similar arrangements that provide a series of payments over a period of at least 10 years, provided that the prize or award does not relate to any past services performed by the recipient and does not require the recipient to perform any substantial future service. Appearing in advertising relating to the prize or award is not (in and of itself) treated as substantial. The provision applies to individuals on the cash receipts and disbursements method of accounting. Income and deductions resulting from this provision retain their character as ordinary, not capital. In addition, the Secretary is to provide for the application of this provision in the case of a partnership or other pass-through entity consisting entirely of individuals on the cash receipts and disbursements method of accounting.

Any offer of a qualified prize option must include disclosure of the method used to compute the single cash payment, including the discount rate that makes equivalent the present values of the prize (or relevant portion thereof) and the single cash payment offered. Any offer of a qualified prize option must also clearly indicate that the prize winner is under no obligation to accept a single cash payment and may continue to receive the payments to which he or she is entitled under the terms of the qualified prize.

Current **California law** is generally conformed to federal law as of January 1, 1998, as it relates to the taxation of awards and prizes. California law specifically exempts California lottery winnings from taxable income for state purposes.

This bill would conform California law with federal law as it relates to the treatment of prizes other than California lottery winnings.

6. Payments Received Pursuant to the Ricky Ray Hemophilia Relief Fund Act

Generally, gross income does not include any damages received (whether by suit or agreement and whether as a lump sum or as periodic payments) on account of a personal physical injury or physical sickness (IRC Sec. 104(a)(2)). If an action has its origin in a physical injury or physical sickness, then all damages (other than punitive damages) are treated as payments received on account of physical injury or physical sickness, regardless of whether the recipient of the damages is the injured party.

The term "damages received whether by suit or agreement" is defined under Treasury regulations to mean an amount received (other than workmen's compensation) through prosecutions of a legal suit or action based upon tort or tort type rights, or through a settlement agreement entered into in lieu of such prosecution. Under prior law, payments not meeting the requirements of IRC Sec. 104 were not excludable from income under that section.

The **Ricky Ray Hemophilia Act** provides that payments made pursuant to provisions of the Act to certain individuals with blood-clotting disorders who contracted the human immunodeficiency virus (HIV) due to contaminated blood products are treated for purposes of the IRC as damages received on account of personal physical injury or physical sickness described in IRC Sec. 104(a)(2). Thus, such payments made to individuals are excluded from gross income.

Current **California law** is in full conformity with federal law as it read on January 1, 1998, as it relates to the exclusion from income any damages received on account of a personal physical injury or physical sickness.

This bill would conform California law with federal treatment of payments received pursuant to the Ricky Ray Hemophilia Relief Fund Act.

7. Extend Tentative Minimum Tax Relief for Individuals

Federal law provides for certain nonrefundable personal tax credits (i.e., the dependent care credit, the credit for the elderly and disabled, the adoption credit, the child tax credit, the credit for interest on certain home mortgages, the HOPE Scholarship and Lifetime Learning credits, and the D.C. homebuyer's credit). Except for taxable years beginning during 1998, these credits are allowed only to the extent that the individual's regular income tax liability exceeds the individual's tentative minimum tax (TMT), determined without regard to the minimum tax foreign tax credit.

For taxable years beginning during 1998, these credits are allowed to the extent of the full amount of the individual's regular tax (without regard to TMT).

The **Ticket to Work Act of 1999** extends to taxable years beginning in 1999. The provision that allows the personal nonrefundable credits to offset the individual's regular tax liability in full (as opposed to only the amount by which the regular tax exceeds TMT).

For taxable years beginning in 2000 and 2001, the personal nonrefundable credits may offset both the regular tax and the alternative minimum tax (AMT). The foreign tax credit will be allowed before the personal credits in computing the regular tax for these years. The refundable child credit will not be reduced by the amount of an individual's minimum tax in taxable years beginning in 1999, 2000, and 2001.

Current state law is generally in conformity with federal law as it relates to the computation of AMT and TMT as well as the limitation on credits to the excess of regular tax over TMT. The amounts included in the computation may differ due to other differences in the laws such as the threshold amounts and the California AMT rate of 7%.

Prior to AB 1637 (Ch. 930, Stats. 1999), the only "personal" type credit allowed to reduce the regular tax amount below TMT was the renter's credit.

Starting in the 1999 tax year, AB 1637 eliminated the TMT limitation on personal exemption credits by allowing the "exemption" credits to reduce regular tax below TMT.

"Exemption" credits are the personal, dependent, blind and senior credits only. California law still limits other "personal" type credits to the excess of regular tax over TMT.

Other "personal" type credits are the joint custody head of household, dependent parent, senior head of household and child adoption credits. The senior head of household and child adoption credits have AGI limitations. The interaction of the AGI limitations and the AMT threshold amounts reduce the number of taxpayers taking one of these two credits being affected by the TMT limitation.

Starting in the 2000 taxable year, this bill would eliminate the TMT limitation on the joint custody head of household, dependent parent, senior head of household and child adoption credits.

8. Clarify the Tax Treatment of Income and Losses from Derivatives

Under federal and state law capital gain treatment applies to gain on the sale or exchange of a capital asset. Capital assets include property other than (1) stock in trade or other types of assets includible in inventory, (2) property used in a trade or business that is real property or property subject to depreciation, (3) accounts or notes receivable acquired in the ordinary course of a trade or business, (4) certain copyrights (or similar property), and (5) U.S. government publications. Gain or loss on such assets generally is treated as ordinary income or loss, rather than capital gain or loss. Certain other provisions also treat gains or losses as ordinary income or loss. For example, the gains or losses of securities dealers or certain electing commodities dealers or electing traders in securities or commodities that are subject to "mark-to-market" accounting are treated as ordinary income or loss (IRC Sec. 475).

Treasury regulations, which were finalized in 1994, require ordinary income or loss character treatment for most business hedges and provide timing rules requiring that gains or losses on hedging transactions be taken into account in a manner that matches the income or loss from the hedged item or items. The regulations apply to hedges that meet a standard of "risk reduction" with respect to ordinary property held (or to be held) or certain liabilities incurred (or to be incurred) by the taxpayer and that meet certain identification and other requirements (Treas. Reg. Sec. 1.1221-2).

Effective for any instrument held, acquired, or entered into, any transaction entered into, and supplies held or acquired on or after December 17, 1999, the **Ticket to Work Act of 1999** adds three categories to the list of assets the gain or loss on which is treated as ordinary (IRC Sec. 1221) income or loss.

The new categories are: (1) commodities derivative financial instruments held by commodities derivatives dealers; (2) hedging transactions; and (3) supplies of a type regularly consumed by the taxpayer in the ordinary course of a taxpayer's trade or business. In defining a hedging transaction, the provision generally codifies the approach taken by the Treasury regulations, but modifies the rules. The "risk reduction" standard of the regulations is broadened to "risk management" with respect to ordinary property held (or to be held) or certain liabilities incurred (or to be incurred). Additionally, the Act provides that the definition of a hedging transaction includes a transaction entered into primarily to manage such other risks as the Secretary may prescribe in regulations.

Current state law conforms with federal law as it relates to taxation of income and losses on derivatives prior to the passage of the **Ticket to Work and Work Incentives Improvement Act of 1999**. However, California's capital gain tax rate is the same as the ordinary income tax rate.

This bill would conform state law to the changes made to federal law with respect to taxation of income and losses on derivatives effective for any instrument held, acquired, or entered into, any transaction entered into, and supplies held or acquired on or after January 1, 2000.

9 Expand Reporting of Cancellation of Indebtedness Income

Under federal and state law a taxpayer's gross income includes income from the discharge of indebtedness.

Federal law requires “applicable entities” to file information returns with the Internal Revenue Service (IRS) regarding any discharge of indebtedness of \$600 or more. The information return must set forth the name, address, and taxpayer identification number of the person whose debt was discharged, the amount of debt discharged, the date on which the debt was discharged, and any other information that the IRS requires to be provided. The information return must be filed in the manner and at the time specified by the IRS. The same information also must be provided to the person whose debt is discharged by January 31 of the year following the discharge.

“Applicable entities” include: (1) the Federal Deposit Insurance Corporation (FDIC), the Resolution Trust Corporation (RTC), the National Credit Union Administration, and successor or subunit of any of them; (2) any financial institution (as described in IRC Sec. 581 (relating to banks) or IRC Sec. 591(a) (relating to savings institutions)); (3) any credit union; (4) any corporation that is a direct or indirect subsidiary of an entity described in (2) or (3) that, by virtue of being affiliated with such entity, is subject to supervision and examination by a federal or state agency regulating such entities; and (5) an executive, judicial, or legislative agency (as defined in 31 U.S.C. Section 3701(a)(4)).

Failures to file correct information returns with the IRS or to furnish statements to taxpayers with respect to these discharges of indebtedness are subject to the same general penalty that is imposed with respect to failures to provide other types of information returns. Accordingly, the penalty for failure to furnish statements to taxpayers is generally \$50 per failure, subject to a maximum of \$100,000 for any calendar year. These penalties are not applicable if the failure is due to reasonable cause and not to willful neglect.

The **Ticket to Work Act of 1999** requires information reporting on indebtedness discharged by any organization for which a significant trade or business is the lending of money (such as finance companies and credit card companies regardless of whether affiliated with financial institutions).

Current state law conforms with the federal information reporting requirements for cancellation of indebtedness income prior to the passage of the Act by allowing the department to request a copy of the information return filed with the IRS.

This bill would conform to the expansion of the entities from which a copy of the information return filed with the IRS could be obtained by the department.

10. Treatment of Excess Pension Assets Used for Retiree Health Benefits

Under federal and state law defined benefit pension plan assets generally may not revert to an employer prior to the termination of the plan and the satisfaction of all plan liabilities. A reversion prior to plan termination may constitute a prohibited transaction and may result in disqualification of the plan. Certain limitations and procedural requirements apply to a reversion upon plan termination. **Under federal and state law** any assets that revert to the employer upon plan termination are includible in the gross income of the employer.

Under federal law such assets are subject to an excise tax. **Under federal and state law** upon plan termination, the accrued benefits of all plan participants are required to be 100% vested.

Under federal and state law a pension plan may provide medical benefits to retired employees through an IRC Sec. 401(h) account that is a part of such plan. A qualified transfer of excess assets of a defined benefit pension plan (other than a multi-employer plan) into an IRC Sec. 401(h) account that is a part of such plan does not result in plan disqualification and is not treated as a reversion to the employer or a prohibited transaction. Therefore, the transferred assets are not includible in the gross income of the employer and are not subject to the federal excise tax on reversions.

Qualified transfers are subject to amount and frequency limitations, use requirements, deduction limitations, vesting requirements, and minimum benefit requirements. Excess assets transferred in a qualified transfer may not exceed the amount reasonably estimated to be the amount that the employer will pay out of such account during the taxable year of the transfer for qualified current retiree health liabilities. No more than one qualified transfer with respect to any plan may occur in any taxable year.

The transferred assets (and any income thereon) must be used to pay qualified current retiree health liabilities (either directly or through reimbursement) for the taxable year of the transfer. Transferred amounts generally must benefit all pension plan participants, other than key employees, who are entitled upon retirement to receive retiree medical benefits through the IRC Sec. 401(h) account. Retiree health benefits of key employees may not be paid (directly or indirectly) out of transferred assets. Amounts not used to pay qualified current retiree health liabilities for the taxable year of the transfer are to be returned at the end of the taxable year to the general assets of the plan. These amounts are not includible in the gross income of the employer, but are treated as an employer reversion and are subject to a 20% federal excise tax.

No deduction is allowed for (1) a qualified transfer of excess pension assets into an IRC Sec. 401(h) account, (2) the payment of qualified current retiree health liabilities out of transferred assets (and any income thereon) or (3) a return of amounts not used to pay qualified current retiree health liabilities to the general assets of the pension plan.

In order for the transfer to be qualified, accrued retirement benefits under the pension plan generally must be 100% vested as if the plan terminated immediately before the transfer.

The minimum benefit requirement requires each group health plan under which applicable health benefits are provided to provide substantially the same level of applicable health benefits for the taxable year of the transfer and the following four taxable years. The level of benefits that must be maintained is based on benefits provided in the year immediately preceding the taxable year of the transfer. Applicable health benefits are health benefits or coverage that are provided to (1) retirees who, immediately before the transfer, are entitled to receive such benefits upon retirement and who are entitled to pension benefits under the plan and (2) the spouses and dependents of such retirees.

The provision permitting a qualified transfer of excess pension assets to pay qualified current retiree health liabilities expires for taxable years beginning after December 31, 2000.

The **Ticket to Work Act of 1999** extends the present-law provision permitting qualified transfers of excess defined benefit pension plan assets to provide retiree health benefits under an IRC Sec. 401(h) account through December 31, 2005.

In addition, the present law minimum benefit requirement is replaced by the minimum cost requirement that applied to qualified transfers before December 9, 1994, to IRC Sec. 401(h) accounts. Therefore, each group health plan or arrangement under which applicable health benefits are provided is required to provide a minimum dollar level of retiree health expenditures for the taxable year of the transfer and the following four taxable years. The minimum dollar level is the higher of the applicable employer costs for each of the two taxable years immediately preceding the taxable year of the transfer. The applicable employer cost for a taxable year is determined by dividing the employer's qualified current retiree health liabilities by the number of individuals to whom coverage for applicable health benefits was provided during the taxable year.

The Secretary of the Treasury is directed to prescribe such regulations as may be necessary to prevent an employer who significantly reduces retiree health coverage during the cost maintenance period from being treated as satisfying the minimum cost requirement. In addition, the provision contains a transition rule regarding the minimum cost requirement

Current state law conforms with federal law on qualified transfers of excess defined benefit pension plans as it read on January 1, 1998. However, California does not impose the excise tax on assets that revert to the employer upon termination of the plan.

This bill would conform to the provision permitting qualified transfers of excess defined benefit pension plan assets to provide retiree health benefits under an IRC Sec. 401(h) account through December 31, 2005. In addition, **this bill would conform** to the provision replacing the present law minimum benefit requirement with the new federal minimum cost requirement.

11. Denial of Charitable Contribution Deduction for Transfers Associated with Split-Dollar Insurance Arrangements

Under **current federal and state law**, in computing taxable income, a taxpayer who itemizes deductions generally is allowed to deduct charitable contributions paid during the taxable year. The amount of the deduction allowable for a taxable year with respect to any charitable contribution depends on the type of property contributed, the type of organization to which the property is contributed, and the income of the taxpayer. A charitable contribution is defined to mean a contribution or gift to or for the use of a charitable organization or certain other entities. The term "contribution or gift" is not defined by statute, but generally is interpreted to mean a voluntary transfer of money or other property without receipt of adequate consideration and with donative intent.

If a taxpayer receives or expects to receive a "quid pro quo" in exchange for a transfer to charity, the excess of the amount transferred over the fair market value of any benefit received in return may be deducted, provided the excess is intended as a gift.

In general, no charitable contribution deduction is allowed for a transfer to charity of less than the taxpayer's entire interest (i.e., a partial interest) in any property. In addition, no deduction is allowed for any contribution of \$250 or more unless the taxpayer obtains a contemporaneous written acknowledgment from the donee organization. The acknowledgment must include a description and good faith estimate of the value of any goods or services provided by the donee organization to the taxpayer in consideration for the taxpayer's contribution (i.e., the "quid pro quo").

Deduction Denial

The Ticket to Work Act Of 1999 restates present law to provide that no charitable contribution deduction is allowed for purposes of federal tax for a transfer to or for the use of an organization described in IRC Sec. 170(c) under certain circumstances. If, in connection with the contribution (1) the organization directly or indirectly pays, or has previously paid, any premium on any "personal benefit contract" with respect to the transferor, or (2) there is an understanding or expectation that any person will directly or indirectly pay any premium on any "personal benefit contract" with respect to the transferor. It is intended that an organization be considered as indirectly paying premiums if, for example, another person pays premiums on its behalf.

A personal benefit contract with respect to the transferor is any life insurance, annuity, or endowment contract, if any direct or indirect beneficiary under the contract is the transferor, any member of the transferor's family, or any other person (other than an IRC Sec. 170(c) organization) designated by the transferor.

For example, such a beneficiary would include a trust having a direct or indirect beneficiary who is the transferor or any member of the transferor's family, and would include an entity that is controlled by the transferor or any member of the transferor's family. It is intended that a beneficiary under the contract include any beneficiary under any side agreement relating to the contract. If a transferor contributes a life insurance contract to an I.R.C. Sec. 170(c) organization and designates one or more IRC Sec. 170(c) organizations as the sole beneficiaries under the contract, generally, it is not intended that the deduction denial rule under the provision apply. If, however, there is an outstanding loan under the contract upon the transfer of the contract, then the transferor is considered as a beneficiary. The fact that a contract also has other direct or indirect beneficiaries (persons who are not the transferor or a family member, or designated by the transferor) does not prevent it from being a personal benefit contract. The provision is not intended to affect situations in which an organization pays premiums under a legitimate fringe benefit plan for employees.

It is intended that a person be considered as an indirect beneficiary under a contract if, for example, the person receives or will receive any economic benefit as a result of amounts paid under or with respect to the contract. For this purpose, as described below, an indirect beneficiary is not intended to include a person that benefits exclusively under a bona fide charitable gift annuity (within the meaning of IRC Sec. 501(m)).

For a charitable gift annuity, if the charitable organization purchases an annuity contract issued by an insurance company to fund its obligation to pay the charitable gift annuity, a person receiving payments under the charitable gift annuity is not treated as an indirect beneficiary, provided certain requirements are met. The requirements are that (1) the charitable organization possess all of the incidents of ownership (within the meaning of Treas. Reg. Sec. 20.2042-1(c)) under the annuity contract purchased by the charitable organization; (2) the charitable organization be entitled to all the payments under the contract; and (3) the timing and amount of payments under the contract be substantially the same as the timing and amount of payments to each person under the organization's obligation under the charitable gift annuity (as in effect at the time of the transfer to the charitable organization).

Under the provision, an individual's family consists of the individual's grandparents, the grandparents of the individual's spouse, the lineal descendants of such grandparents, and any spouse of such a lineal descendant.

States may exempt charitable gift annuity obligations from insurance regulation of the state if each beneficiary under the charitable gift annuity is named as a beneficiary under an annuity contract issued by an insurance company authorized to transact business in that state. Under these conditions, the foregoing requirements (1) and (2) are treated as if they are met, provided that certain additional requirements are met. The additional requirements are that the state law requirement was in effect on February 8, 1999, each beneficiary under the charitable gift annuity is a bona fide resident of the state at the time the charitable gift annuity was issued, the only persons entitled to payments under the annuity contract issued by the insurance company are persons entitled to payments under the charitable gift annuity when it was issued, and the timing and amount of payments under the annuity contract to each person are substantially the same as the timing and amount of payments to the person under the charitable gift annuity (as in effect at the time of the transfer to the charitable organization).

In the case of a charitable remainder annuity trust or charitable remainder unitrust that holds a life insurance, endowment, or annuity contract issued by an insurance company, a person is not treated as an indirect beneficiary under the contract held by the trust, solely by reason of being a recipient of an annuity or unitrust amount paid by the trust, provided that the trust possesses all of the incidents of ownership under the contract and is entitled to all the payments under such contract. No inference is intended as to the applicability of other provisions of the Internal Revenue Code with respect to the acquisition by the trust of a life insurance, endowment or annuity contract, or the appropriateness of such an investment by a charitable remainder trust.

Nothing in the provision is intended to suggest that a life insurance, endowment, or annuity contract would be a personal benefit contract solely because an individual who is a recipient of an annuity or unitrust amount paid by a charitable remainder annuity trust or charitable remainder unitrust uses such a payment to purchase a life insurance, endowment or annuity contract, and a beneficiary under the contract is the recipient, a member of his or her family, or another person he or she designates.

The federal deduction denial provision applies to transfers after February 8, 1999.

Current state law conforms with federal law as it relates to charitable contribution deduction of split-dollar insurance prior to the passage of the **Ticket to Work Act of 1999**.

This bill conforms to the deduction denial provision with respect to transfers on or after January 1, 2000.

12. Distributions by a Partnership to a Corporate Partner of Stock in Another Corporation

Current federal and state law generally provides that no gain or loss is recognized on the receipt by a corporation of property distributed in complete liquidation of another corporation in which it holds 80% of the stock (by vote and value) (IRC Sec. 332). The basis of property received by a corporate distributee in the distribution in complete liquidation of the 80% owned subsidiary is a carryover basis, i.e., the same as the basis in the hands of the subsidiary (provided no gain or loss is recognized by the liquidating corporation with respect to the distributed property) (IRC Sec. 334(b)).

Current federal and state law provides two different rules for determining a partner's basis in distributed property, depending on whether or not the distribution is in liquidation of the partner's interest in the partnership.

Generally, a substituted basis rule applies to property distributed to a partner in liquidation. Thus, the basis of property distributed in liquidation of a partner's interest is equal to the partner's adjusted basis in its partnership interest (reduced by any money distributed in the same transaction) (IRC Sec. 732(b)).

By contrast, generally, a carryover basis rule applies to property distributed to a partner other than in liquidation of its partnership interest, subject to a cap (IRC Sec. 732(a)). Thus, in a non-liquidating distribution, the distributee partner's basis in the property is equal to the partnership's adjusted basis in the property immediately before the distribution, but not to exceed the partner's adjusted basis in its partnership interest (reduced by any money distributed in the same transaction). In a non-liquidating distribution, the partner's basis in its partnership interest is reduced by the amount of the basis to the distributee partner of the property distributed and is reduced by the amount of any money distributed (IRC Sec. 733).

If corporate stock is distributed by a partnership to a corporate partner with a low basis in its partnership interest, the basis of the stock is reduced in the hands of the partner so that the stock basis equals the distributee partner's adjusted basis in its partnership interest. No comparable reduction is made in the basis of the corporation's assets, however. The effect of reducing the stock basis can be negated by a subsequent liquidation of the corporation under IRC Sec. 332.

In General

The **Ticket to Work Act of 1999** provides for a basis reduction in the assets of a corporation, if stock in that corporation is distributed by a partnership to a corporate partner. The basis reduction rule applies if, after the distribution, the corporate partner controls the distributed corporation.

1. Amount of the Basis Reduction

Under the provision, the amount of the reduction in the basis of property of the distributed corporation generally equals the amount of the excess of (1) the partnership's adjusted basis in the stock of the distributed corporation immediately before the distribution, over (2) the corporate partner's basis in that stock immediately after the distribution.

The provision limits the amount of the basis reduction in two respects. First, the amount of the basis reduction may not exceed the amount by which (1) the sum of the aggregate adjusted bases of the property and the amount of money of the distributed corporation exceeds (2) the corporate partner's adjusted basis in the stock of the distributed corporation.

For example, if the distributed corporation has cash of \$300 and other property with a basis of \$600 and the corporate partner's basis in the stock of the distributed corporation is \$400, then the amount of the basis reduction could not exceed \$500 (i.e., $(\$300 + \$600) - \$400 = \500).

Second, the amount of the basis reduction may not exceed the adjusted basis of the property of the distributed corporation. Thus, the basis of property (other than money) of the distributed corporation could not be reduced below zero under the provision, even though the total amount of the basis reduction would otherwise be greater.

The provision provides that the corporate partner recognizes long-term capital gain to the extent the amount of the basis reduction exceeds the basis of the property (other than money) of the distributed corporation. In addition, the corporate partner's adjusted basis in the stock of the distribution is increased in the same amount.

For example, if the amount of the basis reduction were \$400, and the distributed corporation has money of \$200 and other property with an adjusted basis of \$300, then the corporate partner would recognize a \$100 capital gain under the provision. The corporate partner's basis in the stock of the distributed corporation is also increased by \$100 in this example, under the provision.

The basis reduction is allocated among assets of the controlled corporation in accordance with the rules provided under IRC Sec. 732(c).

2. Partnership Distributions Resulting in Control

The basis reduction generally applies with respect to a partnership distribution of stock if the corporate partner controls the distributed corporation immediately after the distribution or at any time thereafter. For this purpose, the term control means ownership of stock meeting the requirements of IRC Sec. 1504(a)(2) (generally, an 80% vote and value requirement).

The provision applies to reduce the basis of any property held by the distributed corporation immediately after the distribution, or, if the corporate partner does not control the distributed corporation at that time, then at the time the corporate partner first has such control. The provision does not apply to any distribution if the corporate partner does not have control of the distributed corporation immediately after the distribution and establishes that the distribution was not part of a plan or arrangement to acquire control.

For purposes of the provision, if a corporation acquires (other than in a distribution from a partnership) stock the basis of which is determined (by reason of being distributed from a partnership) in whole or in part by reference to IRC Sec. 732(a)(2) or (b), then the corporation is treated as receiving a distribution of stock from a partnership.

For example, if a partnership distributes property other than stock (such as real estate) to a corporate partner, and that corporate partner contributes the real estate to another corporation in an IRC Sec. 351 transaction, then the stock received in the IRC Sec. 351 transaction is not treated as distributed by a partnership, and the basis reduction under this provision does not apply.

As another example, if a partnership distributes stock to two corporate partners, neither of which have control of the distributed corporation, and the two corporate partners merge and the survivor obtains control of the distributed corporation, the stock of the distributed corporation that is acquired as a result of the merger is treated as received in a partnership distribution; the basis reduction rule of the provision applies.

In the case of tiered corporations, a special rule provides that if the property held by a distributed corporation is stock in a corporation that the distributed corporation controls, then the provision is applied to reduce the basis of the property of that controlled corporation. The provision is also reapplied to any property of any controlled corporation that is stock in a corporation that it controls.

Thus, for example, if stock of a controlled corporation is distributed to a corporate partner, and the controlled corporation has a subsidiary, the amount of the basis reduction allocable to stock of the subsidiary is applied again to reduce the basis of the assets of the subsidiary, under the special rule.

The provision also provides for regulations, including regulations to avoid double counting and to prevent the abuse of the purposes of the provision. It is intended that regulations prevent the avoidance of the purposes of the provision through the use of tiered partnerships.

The provision is effective generally for distributions made after July 14, 1999. However, in the case of a corporation that is a partner in a partnership as of July 14, 1999, the provision is effective for any distribution made (or treated as made) to that partner from that partnership after June 30, 2001.

In the case of any such distribution after the date of enactment and before July 1, 2001, the rule of the preceding sentence does not apply unless that partner makes an election to have the rule apply to the distribution on the partner's return of federal income tax for the taxable year in which the distribution occurs.

No inference is intended that distributions that are not subject to the provision achieve a particular tax result under present law, and no inference is intended that enactment of the provision limits the application of tax rules or principles under present or prior law.

Current state law conforms with federal law as it relates to partnership distributions of corporate stock prior to the passage of the **Ticket to Work Act of 1999**.

This bill would conform to the new federal rules for distributions after January 1, 2000, and make the federal treatment elected by the taxpayer binding for state purposes.

13. Income and Services Provided by Taxable REIT Subsidiaries

A real estate investment trust (REIT) is an entity that receives most of its income from passive real-estate related investments and that essentially receives pass-through treatment for income that is distributed to its shareholders.

If an electing entity meets the requirements for REIT status, the portion of its income that is distributed to the investors each year generally is taxed to the investors without being subjected to a tax at the REIT level. In general, a REIT must derive its income from passive sources and not engage in any active trade or business.

A REIT must satisfy a number of tests on a year by year basis that relate to the entity's (1) organizational structure; (2) source of income; (3) nature of assets; and (4) distribution of income. Under the source-of-income tests, at least 95% of its gross income generally must be derived from rents from real property, dividends, interest, and certain other passive sources (the "95% test"). In addition, at least 75% of its gross income generally must be from real estate sources, including rents from real property and interest on mortgages secured by real property. For purposes of the 95% and 75% tests, qualified income includes amounts received from certain "foreclosure property," treated as such for three years after the property is acquired by the REIT in foreclosure after a default (or imminent default) on a lease of such property or on indebtedness that such property secured.

In general, for purposes of the 95% and 75% tests, rents from real property do not include amounts for services to tenants or for managing or operating real property. However, there are some exceptions. Qualified rents include amounts received for services that are “customarily furnished or rendered” in connection with the rental of real property, so long as the services are furnished through an independent contractor from whom the REIT does not derive any income. Amounts received for services that are not “customarily furnished or rendered” are not qualified rents.

An independent contractor is defined as a person who does not own, directly or indirectly, more than 35% of the shares of the REIT. Also, no more than 35% of the total shares of stock of an independent contractor (or of the interests in assets or net profits, if not a corporation) can be owned directly or indirectly by persons owning 35% or more of the interests in the REIT. In addition, a REIT cannot derive any income from an independent contractor.

Rents for certain personal property leased in connection with real property are treated as rents from real property if the adjusted basis of the personal property does not exceed 15% of the aggregate adjusted bases of the real and the personal property.

Rents from real property do not include amounts received from any corporation if the REIT owns 10% or more of the voting power or of the total number of shares of all classes of stock of such corporation. Similarly, in the case of other entities, rents are not qualified if the REIT owns 10% or more of the assets or net profits of such person.

At the close of each quarter of the taxable year, at least 75% of the value of total REIT assets must be represented by real estate assets, cash and cash items, and Government securities. Also, a REIT cannot own securities (other than Government securities and certain real estate assets) in an amount greater than 25% of the value of REIT assets. In addition, it cannot own securities of any one issuer representing more than 5% of the total value of REIT assets or more than 10% of the voting securities of any corporate issuer. Securities for purposes of these rules are defined by reference to the Investment Company Act of 1940 (15 U.S.C. Sec. 80a-1 and following).

Under an exception to the ownership rule, a REIT is permitted to have a wholly owned subsidiary corporation, but the assets and items of income and deduction of such corporation are treated as those of the REIT, and thus can affect the qualification of the REIT under the income and asset tests.

A REIT generally is required to distribute 95% of its income before the end of its taxable year, as deductible dividends paid to shareholders. This rule is similar to a rule for regulated investment companies (RICs) that requires distribution of 90% of income. Both REITs and RICs can make certain “deficiency dividends” after the close of the taxable year, and have these treated as made before the end of the year. The regulations applicable to REITs state that a distribution will be treated as a “deficiency dividend” (and, thus, as made before the end of the prior taxable year) only to the extent the earnings and profits for that year exceed the amount of distributions actually made during the taxable year.

A REIT that has been or has combined with a C corporation will be disqualified if, as of the end of its taxable year, it has accumulated earnings and profits from a non-REIT year. A similar rule applies to regulated investment companies (RICs). In the case of a REIT, any distribution made in order to comply with this requirement is treated as being first from pre-REIT accumulated earnings and profits. RICs do not have a similar ordering rule.

In the case of a RIC, any distribution made within a specified period after determination that the investment company did not qualify as a RIC for the taxable year will be treated as applying to the RIC for the non-RIC year, "for purposes of applying [the earnings and profits rule that forbids a RIC to have non-RIC earnings and profits] to subsequent taxable years." The REIT rules do not specify any particular separate treatment of distributions made after the end of the taxable year for purposes of the earnings and profits rule. Treasury regulations under the REIT provisions state that "distribution procedures similar to those for regulated investment companies apply to non-REIT earnings and profits of a real estate investment trust."

The Ticket to Work Act of 1999 made the following changes:

A. Investment limitations and taxable REIT subsidiaries

Under the provision, a REIT generally cannot own more than 10% of the total value of securities of a single issuer, in addition to the present law rule that a REIT cannot own more than 10% of the outstanding voting securities of a single issuer.

In addition, no more than 20% of the value of a REIT's assets can be represented by securities of the taxable REIT subsidiaries that are permitted under the Act.

Exception for safe-harbor debt

For purposes of the new 10% value test, securities are generally defined to exclude safe harbor debt owned by a REIT (as defined for purposes of IRC Sec. 1361(c)(5)(B)(i) and (ii)) if the issuer is an individual, or if the REIT (and any taxable REIT subsidiary of such REIT) owns no other securities of the issuer. However, in the case of a REIT that owns securities of a partnership, safe harbor debt is excluded from the definition of securities only if the REIT owns at least 20% or more of the profits interest in the partnership. The purpose of the partnership rule requiring a 20% profits interest is to assure that if the partnership produces income that would be disqualified income to the REIT, the REIT will be treated as receiving a significant portion of that income directly through its partnership interest, even though it also may derive qualified interest income through its safe harbor debt interest.

Exception for taxable REIT subsidiaries

An exception to the limitations on ownership of securities of a single issuer applies in the case of a "taxable REIT subsidiary" that meets certain requirements. To qualify as a taxable REIT subsidiary, both the REIT and the subsidiary corporation must join in an election. In addition, any corporation (other than a REIT or a qualified REIT subsidiary under IRC Sec. 856(i) that does not properly elect with the REIT to be a taxable REIT subsidiary) of which a taxable REIT subsidiary owns, directly or indirectly, more than 35% of the vote or value is automatically treated as a taxable REIT subsidiary.

Securities (as defined in the Investment Company Act of 1940) of taxable REIT subsidiaries could not exceed 20% of the total value of a REIT's assets.

A taxable REIT subsidiary can engage in certain business activities that under present law could disqualify the REIT because, but for the Act, the taxable REIT subsidiary's activities and relationship with the REIT could prevent certain income from qualifying as rents from real property.

Specifically, the subsidiary can provide services to tenants of REIT property (even if such services were not considered services customarily furnished in connection with the rental of real property), and can manage or operate properties, generally for third parties, without causing amounts received or accrued directly or indirectly by the REIT for such activities to fail to be treated as rents from real property.

However, rents paid to a REIT generally are not qualified rents if the REIT owns more than 10% of the value (as well as of the vote) of a corporation paying the rents. The only exceptions are for rents that are paid by taxable REIT subsidiaries and that also meet a limited rental exception (where 90% of space is leased to third parties at comparable rents) and an exception for rents from certain lodging facilities (operated by an independent contractor).

However, the subsidiary cannot directly or indirectly operate or manage a lodging or healthcare facility. Nevertheless, it can lease a qualified lodging facility (e.g., a hotel) from the REIT (provided no gambling revenues were derived by the hotel or on its premises), and the rents paid are treated as rents from real property so long as the lodging facility was operated by an independent contractor for a fee. The subsidiary can bear all expenses of operating the facility and receive all the net revenues, minus the independent contractor's fee.

For purposes of the rule that an independent contractor may operate a qualified lodging facility, an independent contractor will qualify so long as, at the time it enters into the management agreement with the taxable REIT subsidiary, it is actively engaged in the trade or business of operating qualified lodging facilities for any person who is not related to the REIT or the taxable REIT subsidiary. The REIT may receive income from such an independent contractor with respect to certain pre-existing leases.

Also, the subsidiary generally cannot provide to any person rights to any brand name under which hotels or health care facilities are operated. An exception applies to rights provided to an independent contractor to operate or manage a lodging facility, if the rights are held by the subsidiary as licensee or franchisee, and the lodging facility is owned by the subsidiary or leased to it by the REIT.

Interest paid by a taxable REIT subsidiary to the related REIT is subject to the earnings stripping rules of IRC Sec. 163(j). Thus the taxable REIT subsidiary cannot deduct interest in any year that would exceed 50% of the subsidiary's adjusted gross income.

If any amount of interest, rent, or other deductions of the taxable REIT subsidiary for amounts paid to the REIT is determined to be other than at arm's length ("redetermined" items), an excise tax of 100% is imposed on the portion that was excessive. "Safe harbors" are provided for certain rental payments where (1) the amounts are de minimis, (2) there is specified evidence that charges to unrelated parties are substantially comparable, (3) certain charges for services from the taxable REIT subsidiary are separately stated, or (4) the subsidiary's gross income from the service is not less than 150% of the subsidiary's direct cost in furnishing the service.

In determining whether rents are arm's length rents, the fact that such rents do not meet the requirements of the specified safe harbors shall not be taken into account. In addition, rent received by a REIT shall not fail to qualify as rents from real property by reason of the fact that all or any portion of such rent is redetermined for purposes of the excise tax.

The Treasury Department is to conduct a study to determine how many taxable REIT subsidiaries are in existence and the aggregate amount of taxes paid by such subsidiaries and shall submit a report to the Congress describing the results of such study.

B. Health Care REITs

The provision permits a REIT to own and operate a health care facility for at least two years, and treat it as permitted "foreclosure" property, if the facility is acquired by the termination or expiration of a lease of the property. Extensions of the two-year period can be granted.

C. Conformity with regulated investment company rules

Under the provision, the REIT distribution requirements are modified to conform to the rules for regulated investment companies. Specifically, a REIT is required to distribute only 90%, rather than 95%, of its income.

D. Definition of independent contractor

If any class of stock of the REIT or the person being tested as an independent contractor is regularly traded on an established securities market, only persons who directly or indirectly own 5% or more of such class of stock shall be counted in determining whether the 35% ownership limitations have been exceeded.

E. Modification of earnings and profits rules for RICs and REITs

The rule allowing a RIC to make a distribution after a determination that it had failed RIC status, and thus meet the requirement of no non-RIC earnings and profits in subsequent years, is modified to clarify that, when the sole reason for the determination is that the RIC had non-RIC earnings and profits in the initial year (i.e., because it was determined not to have distributed all C corporation earnings and profits), the procedure would apply to permit RIC qualification in the initial year to which such determination applied, in addition to subsequent years.

The Act clarifies the RIC and REIT earnings and profits ordering rules in the case of a distribution to meet the requirements that there be no non-RIC or non-REIT earnings and profits in any year.

Both the RIC and REIT earnings and profits rules are modified to provide a more specific ordering rule, similar to the present-law REIT rule. The new ordering rule treats a distribution to meet the requirement of no non-RIC or non-REIT earnings and profits as coming, on a first-in, first-out basis, from earnings and profits that, if not distributed, would result in a failure to meet such requirement. Thus, such earnings and profits are deemed distributed first from earnings and profits that would cause such a failure, starting with the earliest RIC or REIT year for which such failure would occur.

F. Rental income from certain personal property

The provision modifies the present law rule that permits certain rents from personal property to be treated as real estate rental income if such personal property does not exceed 15% of the aggregate of real and personal property. The provision replaces the present law comparison of the adjusted bases of properties with a comparison based on fair market values.

G. Federal effective date and transition rules

The provision is effective for federal purposes for taxable years beginning after December 31, 2000. The provision with respect to modification of earnings and profits rules is effective for distributions after December 31, 2000.

In the case of the provisions relating to permitted ownership of securities of an issuer, special transition rules apply. The new rules forbidding a REIT to own more than 10% of the value of securities of a single issuer do not apply to a REIT with respect to securities held directly or indirectly by such REIT on July 12, 1999, or acquired pursuant to the terms of written binding contract in effect on that date and at all times thereafter until the acquisition.

Also, securities received in a tax-free exchange or reorganization, with respect to or in exchange for such grandfathered securities, would be grandfathered. The grandfathering of such securities ceases to apply if the REIT acquires additional securities of that issuer after that date, other than pursuant to a binding contract in effect on that date and at all times thereafter, or in a reorganization with another corporation the securities of which are grandfathered.

This transition rule also ceases to apply to securities of a corporation as of the first day after July 12, 1999, on which such corporation engages in a substantial new line of business, or acquires any substantial asset, other than pursuant to a binding contract in effect on such date and at all times thereafter, or in a reorganization or transaction in which gain or loss is not recognized by reason of IRC Sec. 1031 or 1033. If a corporation makes an election to become a taxable REIT subsidiary, effective before January 1, 2004, and at a time when the REIT's ownership is grandfathered under these rules, the election is treated as a reorganization under IRC Sec. 368(a)(1)(A).

The new 10% of value limitation for purposes of defining qualified rents is effective for taxable years beginning after December 31, 2000. There is an exception for rents paid under a lease or pursuant to a binding contract in effect on July 12, 1999, and at all times thereafter.

Current state law conforms to the federal treatment of RICs and REITs with certain modifications.

The California modifications are:

- REIT taxable income does:
 - not include a deduction for dividends received,
 - not include a deduction for the tax imposed for not meeting the 95% or 75% income test,
 - include income from foreclosure property, and
 - include income from prohibited transactions.
- Federal excise taxes on "income from foreclosed property," "income of a prohibited transaction," "alternative tax on capital gains" and failure to meet the 95% or 75% income test do not apply.
- A REIT is subject to the corporate minimum franchise tax (currently \$800).
- A REIT cannot be part of a stapled group.

Additionally, to avoid other state and federal law differences as to whether a REIT will qualify as such for state purposes, California has a rule whereby if the REIT satisfies the distribution requirements of federal law so as to be treated as a REIT, it will be deemed to satisfy such requirements for state purposes (even if federal-state REIT income differences make it otherwise impossible for the REIT to satisfy the distribution requirements for state purposes).

This bill would conform to the new federal qualification provisions except that no excise tax would be imposed. The effective date will be the same for California as it is for federal purposes (i.e., for taxable years beginning after December 31, 2000). The provision with respect to modification of earnings and profits rules would be effective for distributions after December 31, 2000, the same date as under federal law. California also would conform to the federal transition rules. In addition, **this bill** makes qualification as a California REIT dependent on qualification as a federal REIT for the taxable year with no separate state election allowed, and makes a qualified federal REIT a qualified state REIT for the same taxable year.

14. Modify Estimated Tax Rules for Closely Held REITs

If a person has a direct interest or a partnership interest in income-producing assets (such as securities generally, or mortgages) that produce income throughout the year, that person's estimated tax payments must reflect the quarterly amounts expected from the asset.

However, a dividend distribution of earnings from a REIT is considered for estimated tax purposes when the dividend is paid. Some corporations have established closely held REITs that hold property (e.g., mortgages) that if held directly by the controlling entity would produce income throughout the year. The REIT may make a single distribution for the year, timed such that it need not be taken into account under the estimated tax rules as early as would be the case if the assets were directly held by the controlling entity. The controlling entity thus defers the payment of estimated taxes.

The **Ticket to Work Act of 1999** provides that in the case of a REIT that is closely held, any person subject to the corporate estimated tax rules owning at least 10% of the vote or value of the REIT is required to accelerate the recognition of year-end dividends attributable to the closely held REIT, for purposes of such person's estimated tax payments due on or after December 15, 1999.

A closely held REIT is defined as one in which at least 50% of the vote or value is owned by five or fewer persons. Attribution rules apply to determine ownership.

No inference is intended regarding the treatment of any transaction prior to the effective date.

Current state law does not contain any similar corporate estimated tax provisions that would require owners of a closely held REIT to accelerate the recognition of REIT dividends for estimated tax purposes.

This bill would conform to the new federal rule that accelerates the recognition of year-end dividends attributable to the closely held REIT for estimated tax purposes under the B&CTL. These estimated tax changes are made effective for estimated tax payments due on or after January 1, 2001.

15. Federal Technical Changes

Numerous technical changes were made to the Internal Revenue Code in 1998. Where California law is in conformity with the underlying federal provision affected by the technical change, **this bill** would conform to the technical change. The effective dates for the technical changes are either the later of the effective date for federal law or the effective date that California adopted the underlying federal law. This bill would conform to the following technical changes:

Clarification of the Deduction for Student Loan Interest (IRS Reform Act § 6004(b)). The provision clarifies that the student loan interest deduction may be claimed only by a taxpayer who is legally obligated to make the interest payments pursuant to the terms of the loan.

Clarification of Qualified State Tuition Programs (IRS Reform Act § 6004(c)). The provision clarifies that distributions from qualified state tuition programs are treated as representing a pro-rata share of the principal (i.e., contributions) and accumulated earnings in the account.

In addition, the provision clarifies that for purposes of tax-free rollovers and changes of designated beneficiaries, a "member of the family" includes the spouse of the original beneficiary.

Clarification of Education IRAs (IRS Reform Act § 6004(d)). The provision provides that any balance remaining in an education IRA will be deemed to be distributed within 30 days after the date that the designated beneficiary reaches age 30 (or, if earlier, within 30 days of the date that the beneficiary dies). The provision further clarifies that, in the event of the death of the designated beneficiary, the balance remaining in an education IRA may be distributed (without imposition of the additional 10% tax) to any other (i.e., contingent) beneficiary under the age of 30 or to the estate of the deceased designated beneficiary.

If any member of the family of the deceased beneficiary becomes the new designated beneficiary of an education IRA, then no tax will be imposed on such redesignation and the account will continue to be treated as an education IRA.

The provision also clarifies that for purposes of the special rules regarding tax-free rollovers and changes of designated beneficiaries, the new beneficiary must be under the age of 30.

Under the provision, the additional 10% tax on unqualified distributions will not apply to a distribution from an education IRA, which (although used to pay for qualified higher education expenses) is includible in the beneficiary's gross income solely because the taxpayer elects to claim a HOPE or Lifetime Learning credit with respect to the beneficiary. The provision further provides that the additional 10% tax will not apply to the distribution of any contribution to an education IRA made during a taxable year if the distribution is made on or before the date that a return is required to be filed (including extensions of time) by the beneficiary for the taxable year during which the contribution was made. If the beneficiary is not required to file such a return, the return is deemed to be required on April 15th of the year following the taxable year during which the contribution was made.

In addition, the provision provides that the 10% excise tax penalty applies under that section for each year that an excess contribution remains in an education IRA (and not merely the year that the excess contribution is made).

The provision clarifies that, in order for taxpayers to establish an education IRA, the designated beneficiary must be a "life-in-being." The provision also clarifies that, under annuity rules contained in present-law IRC Sec. 72, distributions from education IRAs are treated as representing a pro-rata share of the principal (i.e., contributions) and accumulated earnings in the account.

In addition, regarding the exclusion from income of interest earned from U.S. Savings Bonds used to pay for higher education tuition and fees, the provision broadens the definition of higher education tuition and fees to conform to the definition used in education IRAs and state tuition programs.

Clarification of the Enhanced Deduction for Corporate Contributions of Computer Technology and Equipment (IRS Reform Act § 6004(e)). The provision clarifies that the special rule applies to contributions made during taxable years beginning after December 31, 1997, and before December 31, 2000.

In addition, the provision clarifies that the requirements of "qualified elementary or secondary educational contributions" apply regardless of whether the recipient is an educational organization or a tax-exempt charitable entity.

Note: The revenue loss associated with this technical change was included in AB 2797 (Stat. 1998, Ch. 322) as if the enhanced deduction for the computer technology and equipment was available to corporations for income years beginning after December 31, 1997, and before January 1, 2001. A \$4 million loss was attributed to that bill.

Clarification of the Cancellation of Certain Student Loans (IRS Reform Act § 6004(f)). The provision clarifies that gross income does not include amounts from the forgiveness of loans made by educational organizations and certain tax-exempt organizations to refinance any existing student loan (and not just loans made by educational organizations).

In addition, the provision clarifies that refinancing loans made by educational organizations and certain tax-exempt organizations must be made pursuant to a program of the refinancing organization (e.g., school or private foundation) that requires the student to fulfill a public service work requirement.

Clarification of Limitations for Active Participation in an IRA (IRS Reform Act § 6005(a)). The provision clarifies the intent of the TRA of 1997 relating to the AGI phase-out ranges for married individuals who are active participants in employer-sponsored plans and the AGI phase-out range for spouses of such active participants.

Clarification of the Penalty-Free Distributions for Education Expenses and Purchase of First Homes (IRS Reform Act § 6005(c)). The provision modifies the rules relating to the ability to roll over hardship distributions from certain employer-sponsored retirement plans to prevent avoidance of the 10% early withdrawal tax.

Distributions from cash or deferred arrangements and similar arrangements made on account of hardship of the employee are not eligible rollover distributions. Such distributions will not be subject to the 20% withholding applicable to eligible rollover distributions.

Rollover of Gain from Sale of Qualified Stock (IRS Reform Act § 6005(f)). Under the provision, a partnership or an S corporation can roll over gain from qualified small business stock held more than six months only if at all times during the taxable year all the interests in the partnership or S corporation are held by individuals, estates, and trusts with no corporate beneficiaries. The term "estate" is intended to include both the estate of a decedent and the estate of an individual in bankruptcy.

The provision also provides that the benefit of a tax-free rollover with respect to the sale of small business stock by a partnership will flow through to a partner who is not a corporation if the partner held its partnership interest at all times the partnership held the small business stock. A similar rule applies to S corporations.

Election to Use AMT Depreciation for Regular Tax Purposes (IRS Reform Act § 6006(b)). For property placed in service after 1998, a taxpayer is allowed to elect, for regular tax purposes, to compute depreciation on tangible personal property otherwise qualified for the 200% declining balance method by using the 150% declining balance method over the recovery periods applicable to the regular tax (rather than the longer class lives of the alternative depreciation system (ADS) of IRC Sec. 168(g)).

Election for 1987 Partnerships to Continue Exception from Treatment of Publicly Traded Partnerships as Corporations. (IRS Reform Act § 6009(b)) Tax on Partnership. The technical correction clarifies that the 3.5% tax (California rate is 1%) is paid by the partnership. The general rule of section 701(a) that a partnership as such is not subject to income tax, rather the partners are liable for the tax in their separate or individual capacities, does not apply to the payment of the 3.5% tax by the partnership.

Estimated Tax Payments. The technical correction provides that the corporate estimated tax payment rules of section 6655 are applied to the 3.5% tax payable by an electing 1987 partnership in the same manner as if the partnership were a corporation and the tax were imposed under section 11 (relating to corporate tax rates). References in section 11 to taxable income are to be applied for this purpose as if they were references to gross income of the partnership for the taxable year from the active conduct of trades and businesses by the partnership.

Depreciation Limitations for Electric Vehicles (IRS Reform Act § 6009(c)). Annual depreciation deductions with respect to passenger automobiles are limited to specified dollar amounts, indexed for inflation. Any cost not recovered during the six-year recovery period (the recovery period) of such vehicles may be recovered during the years succeeding the recovery period, subject to similar limitations.

Current law provides the recovery period limitations are trebled for vehicles that are propelled primarily by electricity.

The provision provides that the depreciation limitations applicable to post-recovery periods under IRC Sec. 280F are trebled for vehicles that are propelled primarily by electricity.

Clarification of Constructive Sales Rules (IRS Reform Act § 6010(a)(1)). The provision clarifies that, to qualify for the exception for positions with respect to debt instruments, the position would either have to meet the requirements as to unconditional principal amount, non-convertibility and interest terms or, alternatively, be a hedge of a position meeting these requirements. A hedge for purposes of the provision includes any position that reduces the taxpayer's risk of interest rate or price changes or currency fluctuations with respect to another position.

The provision also clarifies that the definition of a forward contract includes a contract that provides for cash settlement with respect to a substantially fixed amount of property at a substantially fixed price.

Additionally, the provision clarifies that the special effective date rule does not apply if the constructive sale transaction is closed at any time prior to the end of the 30th day after the date of enactment of the TRA of 1997.

Treatment of Mark-to-Market Gains of Electing Traders (IRS Reform Act § 6010(a)(3)). The provision clarifies that gain or loss of a securities or commodities trader that is treated as ordinary solely by reason of an election of mark-to-market treatment is not treated as other than gain or loss from a capital asset for purposes of determining "net earnings from self-employment" for the Self-Employed Contributions Act tax purposes, determining whether the passive-type income exception to the publicly-traded partnership rules is met, or for purposes of any other Internal Revenue Code provision specified by the Treasury Department in regulations.

Treatment of Certain Corporate Distributions (IRS Reform Act § 6010(c)). The provision clarifies that the acquisitions described in IRC Sec. 355(e)(3)(A) are disregarded in determining whether there has been an acquisition of a 50% or greater interest in a corporation. However, other transactions that are part of a plan or series of related transactions could result in an acquisition of a 50% or greater interest.

In the case of acquisitions under IRC Sec. 355(e)(3)(A)(iv), the provision clarifies that the acquisition of stock in the distributing corporation or any controlled corporation is disregarded to the extent that the percentage of stock owned directly or indirectly in the corporation by each person owning stock in the corporation immediately before the acquisition does not decrease.

Certain Preferred Stock Treated as "Boot" (IRS Reform Act § 6010(e)). The provision provides that the statutory period for the assessment of any deficiency attributable to a corporation failing to be a family-owned corporation shall not expire before the expiration of three years after the date the Secretary of the Treasury is notified by the corporation (in such manner as the Secretary may prescribe) of such failure, and such deficiency may be assessed before the expiration of such three-year period notwithstanding the provisions of any other law or rule of law that would otherwise prevent such assessment.

The provision also clarifies that IRC Sec. 351(b), relating to the receipt of property, applies to a transferor who transfers property in an IRC Sec. 351 exchange and receives nonqualified preferred stock in addition to stock that is not treated as "other property" under that section. Thus, if a transferor received only nonqualified preferred stock but the transaction in the aggregate otherwise qualified as an IRC Sec. 351 exchange, such a transferor would recognize loss and the basis of the nonqualified preferred stock and of the property in the hands of the transferee corporation would reflect the transaction in the same manner as if that particular transferor had received solely "other property" of any other type.

Modify UBI Rules Applicable to Second-Tier Subsidiaries (IRS Reform Act § 6010(j)). The provision clarifies that rent, royalty, annuity, and interest income that would otherwise be excluded from “unrelated business income” (UBI) is included in UBI if such income is received or accrued from a taxable or tax-exempt subsidiary that is controlled by the parent tax-exempt organization. The provision further clarifies that the provision does not apply to any payment received or accrued during the first two taxable years beginning on or after July 22, 1998 if such payment is received or accrued pursuant to a binding written contract in effect on June 8, 1997, and at all times thereafter before such payment (but not pursuant to any contract provision that permits optional accelerated payments).

Clarification of Allocation of Basis of Properties Distributed to a Partner by a Partnership (IRS Reform Act § 6010(m)). The technical correction clarifies that for purposes of the allocation rules of IRC Sec. 732(c), “unrealized receivables” has the meaning in IRC Sec. 751(c) including the last two sentences of IRC Sec. 751(c), relating to items of property that give rise to ordinary income. Thus, in applying the allocation rules of IRC Sec. 732(c) to property listed in the last two sentences of IRC Sec. 751(c), such as property giving rise to potential depreciation recapture, the amount of unrealized appreciation in any such property does not include any amount that would be treated as ordinary income if the property were sold at fair market value, because such amount is treated as a separate asset for purposes of the basis allocation rules.

Clarification of Expanding the Limitations on Deductibility of Premiums and Interest with Respect to Life Insurance, Endowment and Annuity Contracts (IRS Reform Act § 6010(o)). The technical correction clarifies that if coverage for each insured individual under a master contract is treated as a separate contract for purposes of IRC Secs. 817(h), 7702, and 7702A, then coverage for each such insured individual is treated as a separate contract for purposes of the exception to the pro rata interest disallowance rule for a policy or contract covering an individual who is a 20% owner, employee, officer or director of the trade or business at the time first covered.

A master contract does not include any contract if the contract (or any insurance coverage provided under the contract) is a group life insurance contract within the meaning of IRC Sec. 848(e)(2). No inference is intended that coverage provided under a master contract, for each such insured individual, is not treated as a separate contract for each such individual for other purposes under present law.

The technical correction clarifies that the required reporting to the Treasury Secretary is an information return and any reporting required to be made to any other person is a payee statement.

Thus, the \$50-per-report penalty imposed for failure to file or provide such an information return or payee statement applies. It is clarified that the Treasury Secretary may require reporting by the issuer or policyholder of any relevant information either by regulations or by any other appropriate guidance (including but not limited to publication of a form).

The technical correction clarifies that the treatment of additional covered lives under the effective date of the TRA of 1997 provision applies only with respect to coverage provided under a master contract, provided that coverage for each insured individual is treated as a separate contract for purposes of IRC Secs. 817(h), 7702 and 7702A, and the master contract or any coverage provided thereunder is not a group life insurance contract within the meaning of IRC Sec. 848(e)(2).

Information Reporting with Respect to Certain Foreign Corporations and Partnerships (IRS Reform Act § 6011(f)). The provision provides clarification and guidance relating to the furnishing of required information to be provided by the Secretary of the Treasury (not specifically through regulations) and conforms the use of the defined term "foreign business entity."

Travel Expenses of Federal Employees Participating in a Federal Criminal Investigation (IRS Reform Act § 6012(a)). The provision clarifies that prosecuting a federal crime or providing support services to the prosecution of a federal crime is considered part of investigating a federal crime, thus permitting these employees to deduct their travel expenses in connection with temporary employment away from home even though such temporary employment lasts for more than one year.

Modification of Distribution Rules for REITs (IRS Reform Act § 6012(g)). The provision amends the simplification provision to provide that any distribution from a REIT will be deemed to first come from earnings and profits that were generated when the entity did not qualify as a REIT. The provision does not change the requirement that a REIT must distribute a specified percentage of its REIT earnings, or any other requirement.

Provision of Regulatory Authority for Simplified Reporting of Funeral Trusts Terminated During the Taxable Year (IRS Reform Act § 6013(b)). The provision clarifies that a pre-need funeral trust may continue to qualify for these special rules for the 60-day period after the decedent's death, even though the trust ceases to be a grantor trust during that time.

Treatment of Certain Disability Payments to Public Safety Employees (IRS Reform Act § 6015(c)). In order to address problems taxpayers are encountering with the IRS in seeking refunds under the old provision, the new provision clarifies the scope of the provision.

The provision provides that payments made on account of heart disease or hypertension of the employee received in 1989, 1990, or 1991 pursuant to a state law as described under present law, or received by an individual referred to in the state law under any other statute, ordinance, labor agreement, or similar provision as a disability pension payment or in the nature of a disability pension payment attributable to employment as a police officer or as a fireman, will be excludable from income.

Application of Requirements for SIMPLE IRAs in the Case of Mergers and Acquisitions (IRS Reform Act § 6016(a)). The provision conforms the treatment applicable to SIMPLE IRAs upon acquisition, disposition or similar transactions for purposes of (1) the 100-employee limit, (2) the exclusive plan requirement, and (3) the coverage rules for participation. In the event of such a transaction, the employer will be treated as an eligible employer and the arrangement will be treated as a qualified salary reduction arrangement for the year of the transaction and the two following years, provided rules similar to the rules of IRC Sec. 410(b)(6)(C)(i) are satisfied and the arrangement would satisfy the requirements to be a qualified salary reduction arrangement after the transaction if the trade or business that maintained the arrangement prior to the transaction had remained a separate employer.

Treatment of Indian Tribal Governments (IRS Reform Act § 6016(a)). The provision clarifies that an employee participating in an IRC Sec. 403(b)(7) custodial account of an Indian tribal government may roll over amounts from such account to an IRC Sec. 401(k) plan maintained by the Indian tribal government.

Disclosure of Returns and Return Information (IRS Reform Act § 6019(c)). The provision clarifies that disclosures to one ex or estranged spouse regarding whether there has been an attempt to collect the deficiency from the other ex or estranged spouse, like certain other disclosures permitted under present law, may be made to the duly authorized attorney in fact of the person making the disclosure request.

Treatment of Interest on Qualified Education Loans (Trade and Extenders Act § 4003(a)). The provision clarifies that otherwise deductible qualified education loan interest is not treated as nondeductible personal interest. The provision also clarifies that, for purposes of phasing out the deduction, modified AGI is determined after application of IRC Sec. 135 (relating to income from certain U.S. saving bonds) and IRC Sec. 137 (relating to adoption assistance programs).

The provision also provides that a qualified education loan does not include any indebtedness owed to any person by reason of a loan under any qualified employer plan or under any contract purchased under a qualified employer plan.

Abatement of Interest by Reason of Presidentially Declared Disasters (Trade and Extenders Act § 4003(e)). Under a provision of the TRA of 1997, if the Secretary of the Treasury extends the filing date of an individual tax return for individuals living in an area that has been declared a disaster area by the President during 1997, no interest is charged as a result of the failure of the individual taxpayer to file an individual tax return, or to pay the taxes shown on such return, during the extension period. The 1998 provision extends the rule so that it is available for disasters declared in 1997 or 1998 with respect to the 1997 tax year.

Determination of Unborrowed Policy Cash Value Under COLI Pro Rata Interest Disallowance Rules (Trade and Extenders Act § 4003(i)). The provision clarifies the meaning of "unborrowed policy cash value" with respect to any life insurance, annuity or endowment contract.

The technical correction clarifies that if the cash surrender value (determined without regard to any surrender charges) with respect to any policy or contract does not reasonably approximate its actual value, then the amount taken into account for this purpose is the greater of (1) the amount of the insurance company's liability with respect to the policy or contract, as determined for purposes of the annual statement approved by the National Association of Insurance Commissioners, (2) the amount of the insurance company's reserve with respect to the policy or contract for purposes of such annual statement; or (3) such other amount as is determined by the Treasury Secretary. No inference is intended that such amounts may not be taken into account in determining the cash surrender value of a policy or contract in such circumstances for purposes of any other provision of the Code.

Casualty Loss Deductions (Trade and Extenders Act § 4004). The provision clarifies that all deductions for nonbusiness casualty and theft losses are taken into account in computing a net operating loss (NOL). Also, these deductions are not treated as miscellaneous itemized deductions subject to the 2% adjusted gross income floor, or as itemized deductions subject to the overall limitation on itemized deductions, and are allowed to nonresident aliens.

16. Allow the Alimony Deduction to Part-Year and Non-Residents

LEGISLATIVE HISTORY

AB 2380 (Stats. 1984, Ch. 938) added the nonresident alimony deduction provisions.

This provision was contained in SB 2234 (1998). The Governor vetoed SB 2234 on September 29, 1998, due to a provision contained in SB 2234 that is unrelated to the alimony deduction provision.

Federal Constitution

The **United States Constitution**, under what is known as the Privileges and Immunities Clause, provides that the citizens of each state shall be entitled to all the privileges and immunities of the citizens of the several states. The United States Supreme Court has interpreted this clause, as it applies to taxes, as follows:

"...One right thereby secured is the right of a citizen of any State to remove to and carry on business in another without being subjected in property or person to taxes more onerous than the citizens of the latter State are subjected to."¹

In *Lunding*, the U.S. Supreme Court struck down a New York statute that denied nonresidents an alimony deduction in computing New York adjusted gross income. The Court held that New York's categorical denial of the deduction to nonresidents violated the Privilege and Immunities clause of the Federal Constitution,² stating that New York had not substantially justified its discriminatory treatment of nonresidents. In striking down the New York statute, the Court accepted the petitioners' determination that the deduction should be allowed in the same ratio that their business income was attributable to New York sources.³

State Law

The existing **California Personal Income Tax Law (PITL)** imposes tax on the basis of residency and source. Residents and part-year residents (while they are residents) are taxed on all income earned, regardless of source. Nonresidents and part-year residents (while they are nonresidents) are taxed only on income from sources within California.

Existing law imposes an income tax on the income of nonresidents that is derived from or attributable to sources within this state. "Income from sources within this state" is defined by regulation as income from tangible or intangible property located or having a situs in this state and income from any activity carried on in this state, regardless of whether carried on in intrastate, interstate, or foreign commerce. The law provides six personal income tax rate brackets ranging from 1% to 9.3%.

¹ *Lunding Et Ux. v. New York Appeals Tribunal et al.*(1998) 118 S.Ct. 766 (citations and internal quotation marks omitted).

² Although New York's nonresident alimony statute, New York Tax Law Section 631(b)(6), is worded differently than California's Revenue and Taxation Code Section 17302, the effect is identical.

³ It is unclear whether in *Lunding* the petitioner computed his deduction by applying the ratio of New York to total business income or adjusted gross income, or if, in his situation, the ratio was the same. From a constitutional standpoint, however, it makes little difference exactly how the deduction is prorated so long as the method can be substantially justified and does not result in a categorical denial of the deduction to nonresidents.

Existing law requires nonresident taxpayers to include income from all sources to determine the rate at which California tax is imposed on their California source income. The total taxable income is computed as if the nonresident were a resident for the entire year. The amount of tax that would be imposed on the total income is prorated based upon the ratio of California-sourced adjusted gross income to total adjusted gross income from all sources to determine the tax imposed on the California-sourced taxable income. The California tax before personal exemption is the tax that bears the same ratio to total tax, as California source adjusted gross income bears to total adjusted gross income. This method effectively results in the nonresident or part-year resident computing their tax at the same graduated tax brackets as used for computing the tax of a resident.

In determining California-source income, **existing law** does not allow a deduction for alimony payments made by a nonresident or a part-year resident (while a nonresident), even if paid to a California resident. This provision denying a deduction was first introduced in 1957. The justification appears to have been that California does not tax nonresident taxpayers on alimony income and, thus, should not allow nonresidents an alimony deduction.

California's categorical denial of an alimony deduction to nonresidents is unique in that business and investment expenses are allowed as deductions in computing California adjusted gross income if the expenses are attributable to the production of California source income. Itemized deductions are, in effect, allowed in the ratio that California adjusted gross income bears to total adjusted gross income because the California method requires that tax on total taxable income, which includes total itemized deductions, be prorated by the ratio of California adjusted gross income to total adjusted gross income.

The effect of **existing state law** is identical to the New York statute, and there appear to be no arguments that could reasonably be advanced to support its application that were not presented to and rejected by the U.S. Supreme Court in *Lunding*. Thus, it appears that the existing state law that denies the alimony deduction to nonresidents facially violates the Privilege and Immunities Clause of the Federal Constitution.

The **California Constitution** prohibits an administrative agency from refusing to enforce a California statute on the grounds that it is unconstitutional, unless an appellate court has determined that such statute is unconstitutional.

This bill would provide that nonresidents prorate the deduction for alimony payments in the same manner as the tax is prorated. This ratio would compare California-sourced adjusted gross income (without regard to the alimony deduction) to total adjusted gross income from all sources (without regard to the alimony deduction).

This bill also would provide that a part-year resident would be allowed an alimony deduction for the full amount paid during the portion of the year the individual is a California resident and a prorated amount for the portion of the year the individual is a nonresident.

This bill provides language that would apply the nonresident alimony deduction changes to all taxable years in which the statute of limitations for issuing proposed assessments or allowing claims for refund remains open. The purpose of the retroactive application is to avoid potential disputes with taxpayers over the continued enforcement of an unconstitutional statute.

Policy Considerations

Article 3, Section 3.5 of the California Constitution prohibits a state agency from refusing to enforce a statute on the basis that it is unconstitutional unless there is an appellate court decision that determines the statute is unconstitutional. There is no case law that defines the phrase “refuse to enforce”. The California statute that denies the alimony deduction to nonresidents may violate the federal constitution based on the U.S. Supreme Court’s decision in *Lunding*. However, it appears that FTB must continue to enforce R&TC Section 17302.

This provision of the bill, with its retroactive operative date, would relieve the FTB from defending R&TC Section 17302 in administrative and judicial proceedings. Thus FTB would avoid expending resources in disputes when the probable outcome would be R&TC Section 17302 being declared unconstitutional by an appellate court.

By allowing a pro-rata deduction for alimony, this bill would recognize that the amount of alimony paid generally correlates with a taxpayer’s total income or wealth and, thus, bears some relationship to earnings, regardless of their source.

Implementation Considerations

Implementing the nonresident alimony provision would require some changes to existing tax forms and instructions and information systems, which could be accomplished during the normal annual update. The department would receive additional amended returns for the years the statute of limitations is open, but this workload is not expected to be significant.