State of California

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Laws Affecting Franchise Tax Board:

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Date Filed with the Secretary of the State: May 8, 2002

SUBJECT: Conformity Act of 2002

Federal Acts referred to in this report

- 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)
- CONSOLIDATED APPROPRIATIONS ACT, 2001 (Appropriations Act, 2001, enacted in December of 2000)
- ECONOMIC GROWTH AND TAX RELIEF RECONCILIATION ACT OF 2001, (EGTRRA)
- JOB CREATION AND WORKER ASSISTANCE ACT OF 2002 (Job Creation Act)

Assembly Bill 1122 (Corbett), as enacted on May 8, 2002, made the following changes to California law:

Section 17024.5 of the Revenue and Taxation Code is amended.

AB 1122 changes the "specified date" from January 1, 1998, to January 1, 2001, for taxable years beginning on or after January 1, 2002. By changing the specified date, AB 1122 conforms to numerous federal changes as follows:

1. Exclusion from Income for Employer-Provided Transportation Benefits

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.

Bureau Director	Date
Brian Putler	August 23, 2002

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.

AB 1122 conforms California law to the Transportation Act changes to the transportation fringe benefits rules. This bill would not affect the rules relating to California ridesharing arrangements.

2. Extend Expensing of Environmental Remediation Expenditures

The Ticket to Work and Work Incentives Improvement Act of 1999 extended the expiration date of December 31, 2000 for IRC §198 to include those expenditures paid or incurred before January 1, 2002. The Appropriations Act, 2001, extended the above-mentioned treatment to expenditures incurred before January 1, 2004.

In addition, the Appropriations Act, 2001 eliminated the targeted area requirement, thereby expanding eligible sites to include any site containing (or potentially containing) a hazardous substance that is certified by the appropriate state environmental agency. However, expenditures undertaken at sites that are identified on the national priorities list under the Comprehensive Environmental Response, Compensation, and Liability Act of 1980 would continue to not qualify as eligible expenditures.

AB 1122 conforms state law to the federal extension of the expiration date to include those expenditures paid or incurred on or after January 1, 2002, and before January 1, 2004.

3. Expand Reporting of Cancellation of Indebtedness Income

The Ticket to Work and Work Incentives Improvement 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).

AB 1122 conforms to the expansion of the entities from which a copy of the information return filed with the IRS could be obtained by the department.

4. Limit Conversion of Character of Income from Constructive Ownership Transactions

The Ticket to Work and Work Incentives Improvement Act of 1999 limited the amount of long-term capital gain a taxpayer could recognize from certain derivative contracts (“constructive ownership transactions”) with respect to certain financial assets.

The amount of long-term capital gain is limited to the amount of such gain the taxpayer would have recognized if the taxpayer held the financial asset directly during the term of the derivative contract. Any gain in excess of this amount is treated as ordinary income. An interest charge is imposed on the amount of gain that is treated as ordinary income. The provision does not alter the tax treatment of the long-term capital gain that is not treated as ordinary income.

A taxpayer is treated as having entered into a constructive ownership transaction if the taxpayer (1) holds a long position under a notional principal contract with respect to the financial asset, (2) enters into a forward contract to acquire the financial asset, (3) is the holder of a call option, and the grantor of a put option, with respect to a financial asset, and the options have substantially equal strike prices and substantially contemporaneous maturity dates, or (4) to the extent provided in regulations, enters into one or more transactions, or acquires one or more other positions, that have substantially the same effect as any of the transactions described. Treasury regulations, when issued, are expected to provide specific standards for determining when other types of financial transactions, like those specified in the provision, have substantially the same effect of replicating the economic benefits of direct ownership of a financial asset without a significant change in the risk-reward profile with respect to the underlying transaction. It is not expected that leverage in a constructive ownership transaction would change the risk-reward profile with respect to the underlying transaction.

A “financial asset” is defined as (1) any equity interest in a pass-through entity, and (2) to the extent provided in regulations, any debt instrument and any stock in a corporation that is not a pass-through entity. A “pass-through entity” refers to:

(1) a regulated investment company (RIC),
(2) a real estate investment trust (REIT),
(3) a real estate mortgage investment conduit (REMIC),
(4) an S corporation,
(5) a partnership,
(6) a trust,
(7) a common trust fund,
(8) a passive foreign investment company (PFC) which includes an investment company that is also a controlled foreign corporation,
(9) a foreign personal holding company, and
(10) a foreign investment company.

The amount of recharacterized gain is calculated as the excess of the amount of long-term capital gain the taxpayer would have had absent this provision over the “net underlying long-term capital gain” attributable to the financial asset.

The net underlying long-term capital gain is the amount of net capital gain the taxpayer would have realized if it had acquired the financial asset for its fair market value on the date the constructive ownership transaction was opened and sold the financial asset on the date the transaction was closed (only taking into account gains and losses that would have resulted from a deemed ownership of the financial asset). A taxpayer must establish the amount of the net underlying long-term capital gain with clear and convincing evidence; otherwise, the amount is deemed to be zero.

To the extent that the economic positions of the taxpayer and the counter party do not equally offset each other, the amount of the net underlying long-term capital gain may be difficult to establish. The long-term capital gains rate on the net underlying long-term capital gain is determined by reference to the individual capital gains rates.

> Example 1: On January 1, 2000, Taxpayer enters into a three-year notional principal contract (a constructive ownership transaction) with a securities dealer whereby, on the settlement date, the dealer agrees to pay Taxpayer the amount of any increase in the notional value of an interest in an investment

> partnership (the financial asset). After three years, the value of the notional principal contract increased by $200,000, of which $150,000 is attributable to ordinary income and net short-term capital gain ($50,000 is attributable to net long-term capital gains). The amount of the net underlying long-term capital gains is $50,000, and the amount of gain that is recharacterized as ordinary income is $150,000 (the excess of $200,000 of long-term gain over the $50,000 of net underlying long-term capital gain).

An interest charge is imposed on the underpayment of tax for each year that the constructive ownership transaction was open. The interest charge is the amount of interest that would be imposed had the recharacterized gain been included in the taxpayer's gross income during the term of the constructive ownership transaction.

The recharacterized gain is treated as having accrued such that the gain in each successive year is equal to the gain in the prior year increased by a constant growth rate during the term of the constructive ownership transaction.

> Example 2: Same facts as in example 1, and assume the applicable federal rate on December 31, 2002, is 6%. For purposes of calculating the interest charge, Taxpayer must allocate the $150,000 of recharacterized ordinary income to the three year-term of the constructive ownership transaction as follows: $47,116.47 is allocated to year 2000, $49,943.46 is allocated to year 2001, and $52,940.07 is allocated to year 2002.

A taxpayer is treated as holding a long position under a notional principal contract with respect to a financial asset if the person (1) has the right to be paid (or receive credit for) all or substantially all of the investment yield (including appreciation) on the financial asset for a specified period, and (2) is obligated to reimburse (or provide credit) for all or substantially all of any decline in the value of the financial asset. A forward contract is a contract to acquire in the future (or provide or receive credit for the future value of) any financial asset.

If the constructive ownership transaction is closed by reason of taking delivery of the underlying financial asset, the taxpayer is treated as having sold the contract, option, or other position that is part of the transaction for its fair market value on the closing date. However, the amount of gain that is recognized as a result of having taken delivery is limited to the amount of gain that is treated as ordinary income by reason of this provision (with appropriate basis adjustments for such gain).

The provision does not apply to any constructive ownership transaction if all of the positions that are part of the transaction are marked to market under the IRC or regulations. The Treasury Department is authorized to prescribe regulations as necessary to carry out the purposes of the provision, including to (1) permit taxpayers to mark to market constructive ownership transactions in lieu of the provision, and (2) exclude certain forward contracts that do not convey substantially all of the economic return with respect to a financial asset.

For federal purposes the provision applies to transactions entered into on or after July 12, 1999. For this purpose, it is expected that a contract, option or any other arrangement that is entered into or exercised on or after July 12, 1999, which extends or otherwise modifies the terms of a transaction entered into prior to such date will be treated as a transaction entered into on or after July 12, 1999, unless a party to the transaction other than the taxpayer has, as of July 12, 1999, the exclusive right to extend the terms of the transaction, and the length of such extension does not exceed the first business day following a period of five years from the original termination date under the transaction. No inference is intended as to the proper treatment of a constructive ownership transaction entered into prior to the effective date of this provision.

AB 1122 conforms to the new federal rules regarding constructive ownership transactions entered into on or after January 1, 2002.

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

The Ticket to Work and Work Incentives Improvement 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.

AB 1122 conforms 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, AB 1122 conforms to the provision replacing the present law minimum benefit requirement with the new federal minimum cost requirement.

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

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

AB 1122 conforms California law with the 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.

7. Distributions by a Partnership to a Corporate Partner of Stock in Another Corp

In General

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

1. Amount of the Basis Reduction

Under this provision, the amount of the reduction in 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.

This 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).

This 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.

This 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.

This 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.

AB 1122 conforms to the new federal rules for transactions after January 1, 2002, and makes the federal treatment elected by the taxpayer binding for state purposes.

8. Increase the Low-Income Housing Tax Credit Cap and Make Other Modifications

The Appropriations Act, 2001, makes the following changes in the low-income housing credit:

Credit cap -- Increases the per-capita low-income housing credit cap from $1.25 per capita to $1.50 per capita in calendar year 2001 and to $1.75 per capita in calendar year 2002. Beginning in calendar year 2003, the per-capita portion of the credit cap will be adjusted annually for inflation. For small states, a minimum annual cap of $2 million is provided for calendar years 2001 and 2002. Beginning in calendar year 2003, the small state minimum is adjusted for inflation.

Expenditure test -- Allows a building which receives an allocation in the second half of a calendar year to qualify under the 10% test if the taxpayer expends an amount equal to 10% or more of the taxpayer's reasonably expected basis in the building within six months of receiving the allocation, regardless of whether the 10% test is met by the end of the calendar year.

Basis of building eligible for the credit – The Appropriations Act, 2001, makes three changes to the basis rules of the credit. First, the definition of qualified census tracts for purposes of the enhanced credit is expanded to include any census tracts with a poverty rate of 25% or more. Second, the Appropriations Act, 2001, extends the credit to a portion of the building used as a community service facility not in excess of 10% of the total eligible basis in the building. A community service facility is defined as any facility designed to serve primarily individuals whose income is 60% or less of area median income. Third, the Appropriations Act, 2001, provides that assistance received under the Native American Housing Assistance and Self-Determination Act of 1996 is not taken into account in determining whether a building is federally subsidized for purposes of the credit. This allows such buildings to qualify for something other than the 30% credit generally applicable to federally subsidized buildings.

State allocation plans -- Strikes the plan criteria relating to participation of local tax-exempts, replacing it with two other criteria: (1) tenant populations of individuals with children, and (2) projects intended for eventual tenant ownership. It also provides that the present-law criteria relating to sponsor characteristics include whether the project involves the use of existing housing as part of a community revitalization plan. The Appropriations Act, 2001, adds a third category of housing projects to the preferential list, for projects located in qualified census tracts that contribute to a concerted community revitalization plan.

Credit administration --Requires a comprehensive market study of the housing needs of the low-income individuals in the area to be served by the project and a written explanation available to the general public for any allocation not made in accordance with the established priorities and selection criteria of the housing credit agency. They also require site inspections by the housing credit agency to monitor compliance with habitability standards applicable to the project.

Stacking rule -- Modifies the stacking rule so that each state is treated as using its allocation of the unused state housing credit ceiling (if any) from the preceding calendar before the current year's allocation of credit (including any credits returned to the state) and then finally any national pool allocations.

AB 1122 conforms to the Appropriations Act, 2001, changes, where applicable, effective for taxable years beginning on or after January 1, 2002.

9. Medical Savings Accounts ("MSAs")

The Appropriations Act, 2001, extends the MSA program through 2002. The same rules that apply to the limitation on MSAs for 1999 also apply to 2001 and 2002. Thus, for example, the threshold level in those years is a total of 750,000 taxpayers.

The Appropriations Act, 2001, also renamed MSAs to Archer MSAs. Finally, the Congress clarifies that, as under present law, the cap and reporting requirements do not apply for 2000.

California is in conformity with federal law as it relates to MSAs. §17215 specifically provides "that the amount allowed as a deduction shall be an amount equal to the amount allowed to that individual as a deduction under §220 of the IRC on the federal income tax return filed for the same taxable year by that individual." Therefore, the federal MSA extension already applies for California.

AB 1122 affirms California's conformity to the MSA extension provision contained in the Appropriations Act, 2001.

10. Clarifying the Allowance of Certain Tax Benefits with Respect to Kidnapped Children

The Appropriations Act, 2001, clarifies that the dependency exemption, the child credit, the surviving spouse filing status, the head of household filing status, and the earned income credit are available to an otherwise qualifying taxpayer with respect to a child who is presumed by law enforcement authorities to have been kidnapped by someone who is not a member of the family of such child or the taxpayer. Generally, this treatment continues for all taxable years ending during the period that the child is treated as kidnapped. However, this treatment ends for the taxable year ending after the calendar year in which it is determined that the child is dead (or, if earlier, in which the child would have attained age 18).

California law is in conformity with federal law as it read on January 1, 1998, as it relates to the definition of dependents and head of household. Thus, a kidnapped child would be allowed to be treated as a dependent under the rationale of TAM 200038059. California law does not provide an earned income or young child credit. California law has not conformed to the changes made to the IRC by the Appropriations Act, 2001.

AB 1122 conforms to the statutory change made by the Appropriations Act, 2001, to the definition of dependents and head of household.

11. Prevention of Duplication of Loss Through Assumption of Liabilities Giving Rise to Deduction

The Appropriations Act, 2001, contains a provision to limit the acceleration or duplication of losses through assumption of liabilities.

Under the Appropriations Act, 2001, if the basis of stock (determined without regard to this provision) received by a transferor as part of a tax-free exchange with a controlled corporation exceeds the fair market value of the stock, then the basis of the stock received is reduced (but not below the fair market value) by the amount (determined as of the date of the exchange) of any liability that (1) is assumed in exchange for such stock, and (2) did not otherwise reduced the transferor's basis of the stock by reason of the assumption. Except as provided by the Secretary of the Treasury, this provision does not apply where the trade or business with which the liability is associated is transferred to the corporation as part of the exchange, or where substantially all the assets which the liability is associated are transferred to the corporation as part of the exchange.

The exception for transfers of a trade or business, or substantially all the assets with which a liability is associated, are intended to obviate the need for valuation or basis reduction in such cases. The exceptions are not intended to apply to a situation involving the selective transfer of assets that may bear some relationship to the liability, but that do not represent the full scope of the trade or business (or substantially all the assets) with which the liability is associated.

For purposes of this provision, the term "liability" includes fixed or contingent obligation to make payments, without regard to whether such obligation or potential obligation is otherwise taken into account under the Code. The determination whether a liability (as more broadly defined for purposes of this provision) has been assumed is made in accordance with the provisions of §357(d)(1) of the Code. Under the standard of §357(d)(1), a recourse liability is treated as assumed if, based on all the facts and circumstances, the transferee has agreed to and is expected to satisfy such liability (or portion thereof), whether or not the transferor has been relieved of the liability. For example, if a transferee corporation does not formally assume a recourse obligation or potential obligation of the transferor, but instead agrees and is expected to indemnify the transferor with respect to all or a portion of such an obligation, then the amount that is agreed to be indemnified is treated as assumed for purposes of the provision, whether or not the transferor has been relieved of such liability. Similarly, a nonrecourse liability is treated as assumed by the transferee of any asset subject to such liability.

The application of the provision is illustrated as follows: Assume a taxpayer transfers assets with an adjusted basis and fair market value of $100 to its wholly owned corporation and the corporation assumes $40 of liabilities (the payment of which would give rise to a deduction). Thus, the value of the stock received by the transferor is $60. Under present law, the basis of the stock would be $100. The provision requires that the basis of the stock be reduced to $60 (i.e., a reduction of $40). Except as provided by the Secretary, no basis reduction is required if the transferred assets consisted of the trade or business, or substantially all of the assets, with which the liability associated. The provision does not change the tax treatment with respect to the transferee corporation.

The Secretary of the Treasury is directed to prescribe rules providing appropriate adjustments to prevent the acceleration or duplication of losses through the assumption of liabilities (as defined in the provision) in transactions involving partnerships. The Secretary may also provide appropriate adjustments in the case of transactions involving S corporations. In the case of S corporations, such rules may be applied instead of the otherwise applicable basis reduction rules.

AB 1122 conforms to the Appropriations Act, 2001, changes made to transfers of property for stock to a controlled corporation, effective for transfers made after January 1, 2002.

12. Tax Treatment Of Securities Futures Contracts

The Appropriations Act, 2001, provides that, except in the case of dealer securities futures contracts described below, securities futures contracts are not treated as §1256 contracts. Thus, holders of these contracts are not subject to the mark-to-market rules of §1256 and are not eligible for 60-percent long-term capital gain treatment under §1256. Instead, gain or loss on these contracts will be recognized under the general rules relating to the disposition of property.

A securities futures contract is defined by reference to §3(a)(55)(A) of the Securities Exchange Act of 1934, and is added by the Appropriations Act, 2001, to the Code. In general, that definition provides that a securities futures contract means a contract of sale for future delivery of a single security or a narrow-based security index. A securities futures contract will not be treated as a commodities futures contract for purposes of the Code.

Treatment of Gains and Losses

The Appropriations Act, 2001, provides that any gain or loss from the sale or exchange of a securities futures contract (other than a dealer securities futures contract) will be considered as gain or loss from the sale or exchange of property which has the same character as the property to which the contract relates has (or would have) in the hands of the taxpayer. Thus, if the underlying security would be a capital asset in the taxpayer's hands, then gain or loss from the sale or exchange of the securities futures contract would be capital gain or loss. The Appropriations Act, 2001, also provides that the termination of a securities futures contract that is a capital asset will be treated as a sale or exchange of the contract.

Capital gain treatment will not apply to contracts which themselves are not capital assets because of the exceptions to the definition of a capital asset relating to inventory (sec. 1221(a)(1)) or hedging (sec. 1221(a)(7)), or to any income derived in connection with a contract which would otherwise be treated as ordinary income.

Except as otherwise provided in regulations under §1092(b) (which treats certain losses from a straddle as long term capital losses) and §1234B, as added by the Appropriations Act, 2001, any capital gain or loss from the sale or exchange of a securities futures contract to sell property (i.e., the short side of a securities futures contract) will be short-term capital gain or loss. In other words, a securities futures contract to sell property is treated as equivalent to a short sale of the underlying property.

Wash Sale Rules

The Appropriations Act, 2001, clarifies that, under the wash sale rules, a contract or option to acquire or sell stock or securities shall include options and contracts that are (or may be) settled in cash or property other than the stock or securities to which the contract relates. Thus, for example, the acquisition, within the period set forth in §1091, of a securities futures contract to acquire stock of a corporation could cause the taxpayer's loss on the sale of stock in that corporation to be disallowed, notwithstanding that the contract may be settled in cash.

Short Sale Rules

In applying the short sale rules, a securities futures contract to acquire property will be treated in a manner similar to the property itself. Thus, for example, the holding of a securities futures contract to acquire property and the short sale of property that is substantially identical to the property under the contract will result in the application of the rules of §1233(b). In addition, as stated above, a securities futures contract to sell is treated in a manner similar to a short sale of the property.

Straddle Rules

Stock that is part of a straddle where at least one of the offsetting positions is a securities futures contract with respect to the stock or substantially identical stock will be subject to the straddle rules of §1092. Treasury regulations under §1092 applying the principles of the §1233(b) and (d) short sale rules to positions in a straddle will also apply.

For example, assume a taxpayer holds a long-term position in actively traded stock (which is a capital asset in the taxpayer's hands) and enters into a securities futures contract to sell substantially identical stock (at a time when the position in the stock has not appreciated in value so that the constructive sale rules of §1259 do not apply). The taxpayer has a straddle. Treasury regulations prescribed under §1092(b) applying the principles of §1233(d) will apply, so that any loss on closing the securities futures contract will be a long-term capital loss.

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A corporation will not recognize gain or loss on transactions in securities futures contracts with respect to its own stock.

Holding Period

If property is delivered in satisfaction of a securities futures contract to acquire property (other than a contract to which §1256 applies), the holding period for the property will include the period the taxpayer held the contract, provided that the contract was a capital asset in the hands of the taxpayer.

Regulations

The Secretary of the Treasury or his delegate has the authority to prescribe regulations to provide for the proper treatment of securities futures contracts under provisions of the IRC.

Dealers in Securities Futures Contracts

In general, the Appropriations Act, 2001, provides that securities futures contracts and options on such contracts are not §1256 contracts. The Appropriations Act, 2001, provides, however, that "dealer securities futures contracts" will be treated as §1256 contracts.

The term ''dealer securities futures contract" means a securities futures contract which is entered into by a dealer in the normal course of his or her trade or business activity of dealing in such contracts, and is traded on a qualified board of trade or exchange. The term also includes any option to enter into securities futures contracts purchased or granted by a dealer in the normal course of his or her trade or business activity of dealing in such options. The determination of who is to be treated as a dealer in securities futures contracts is to be made by the Secretary of the Treasury or his delegate not later than July 1, 2001. Accordingly, the Appropriations Act, 2001 authorizes the Secretary to treat a person as a dealer in securities futures contracts or options on such contracts if the Secretary determines that the person performs, with respect to such contracts or options, functions similar to an equity options dealer, as defined under present law.

The determination of who is a dealer in securities futures contracts is to be made in a manner that is appropriate to carry out the purposes of the provision, which generally is to provide comparable tax treatment between dealers in securities futures contracts, on the one hand, and dealers in equity options, on the other. Although traders in securities futures contracts (and options on such contracts) may not have the same market-making obligations as market makers or specialists in equity options, many traders are expected to perform analogous functions to such market makers or specialists by providing market liquidity for securities futures contracts (and options) even in the absence of a legal obligation to do so.

Accordingly, the absence of market-making obligations is not inconsistent with a determination that a class of traders are dealers in securities futures contracts (and options), if the relevant factors, including providing market liquidity for such contracts (and options), indicate that the market functions of the traders is comparable to that of equity options dealers.

As in the case of dealer equity options, gains and losses allocated to any limited partner or limited entrepreneur with respect to a dealer securities futures contract will be treated as short-term capital gain or loss.

Treatment of Options Under §1256

The Appropriations Act, 2001, modifies the definition of “equity option” for purposes of §1256 to take into account changes made by the non-tax provisions of the Appropriations Act, 2001. Only options dealers are eligible for §1256 with respect to equity options. The term “equity option” is modified to include an option to buy or sell stock, or an option the value of which is determined, directly or indirectly, by reference to any stock, or any “narrow-based security index,” as defined in §3(a)(55) of the Securities Exchange Act of 1934 (as modified by the Appropriations Act, 2001). An equity option includes an option with respect to a group of stocks only if the group meets the requirements for a narrow based security index.

As under present law, listed options that are not “equity options” are considered “nonequity options” to which §1256 applies for all taxpayers. For example, options relating to broad-based groups of stocks and broad based stock indexes will continue to be treated as nonequity options under §1256.

Definition of Contract Markets

The non-tax provisions of the Appropriations Act, 2001, designate certain new contract markets. The new contract markets will be contract markets for purposes of the Code, except to the extent provided in Treasury regulations.

AB 1122 conforms to the Appropriations Act, 2001, changes to securities futures contracts.

13. Exclusion of Minimum Required Distributions from AGI for Roth IRA Conversions

The IRS Reform Act, for taxable years beginning after December 31, 2004, excludes minimum required distributions from IRAs for taxpayers 70½ years or older from the definition of modified AGI solely for purposes of determining eligibility to convert from an IRA to a Roth IRA. As under present law, the required minimum distribution would not be eligible for conversion and would be includible in gross income.

Current California law is in full conformity with federal law as it read on January 1, 1998, as it relates to Roth IRAs, except for the required minimum distribution exclusion.

AB 1122 conforms California law with federal law as it relates to exclusion of required minimum distributions from modified AGI for purposes of Roth IRA conversions. The operative date of this provision is for taxable years beginning after December 31, 2004 (the federal operative date).

14. Treatment of Certain Deductible Liquidating Distributions of RICs/REITs

The Tax and Trade Extension Act provides that any amount which a liquidating RIC or REIT may take as a deduction for dividends paid with respect to an otherwise tax-free liquidating distribution to an 80% corporate owner is includible in the income of the recipient corporation. The includible amount is treated as a dividend received from the RIC or REIT. The liquidating corporation may designate the amount distributed as a capital gain dividend or, in the case of a RIC, a dividend eligible for the 70% dividends received deduction or an exempt interest dividend, to the extent provided by the RIC or REIT provisions of the IRC.

The Tax and Trade Extension Act does not otherwise change the tax treatment of the distribution to the parent corporation or to the RIC or REIT. Thus, for example, the liquidating corporation will not recognize gain (if any) on the liquidating distribution and the recipient corporation will hold the assets at a carryover basis, even where the amount received is treated as a dividend. The provision is effective for distributions on or after May 22, 1998, regardless of when the plan of liquidation was adopted. No inference is intended regarding the treatment of such transactions under present law.

AB 1122 conforms California law with federal law as it relates to liquidating distributions from RICs and REITs, effective for distributions made on or after January 1, 2002. This bill would not conform California law with federal law as it relates to “earnings and profits" ordinary distributions of REITs.

15. Tax Treatment of Cash Options for Qualified Prizes

Under federal and California laws, 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.

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. 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 winner 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 do 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.

AB 1122 conforms California law with federal law as it relates to the treatment of prizes other than California lottery winnings.

16. Property Subject to a Liability Treated as Assumption of Liability

Under the Miscellaneous Trade and Technical Corrections Act of 1999, the distinction between the assumption of a liability and the acquisition of an asset subject to a liability generally is eliminated.

In general, a recourse liability (or any portion thereof) is treated as having been assumed if, as determined on the basis of all facts and circumstances, the transferee has agreed to, and is expected to satisfy the liability or portion thereof (regardless of whether the transferor has been relieved of the liability). Thus, where more than one person agrees to satisfy a liability or portion thereof, only one would be expected to satisfy such liability or portion thereof.

Also, a nonrecourse liability (or any portion thereof) is treated as having been assumed by the transferee of any asset that is subject to the liability. However, this amount is reduced in cases where an owner of other assets subject to the same nonrecourse liability agrees with the transferee to, and is expected to, satisfy the liability (up to the fair market value of the other assets, determined without regard to IRC Sec. 7701(g)).

In determining whether any person has agreed to and is expected to satisfy a liability, all facts and circumstances are to be considered. In any case where the transferee does agree to satisfy a liability, the transferee also will be expected to satisfy the liability in the absence of facts indicating the contrary.

In determining any increase to the basis of property transferred to the transferee as a result of gain recognized because of the assumption of liabilities under IRC Sec. 357, in no event will the increase cause the basis to exceed the fair market value of the property (determined without regard to IRC Sec. 7701(g)).

If gain is recognized to the transferor as the result of an assumption by a corporation of a nonrecourse liability that also is secured by any assets not transferred to the corporation, and if no person is subject to federal income tax on such gain, then for purposes of determining the basis of assets transferred, the amount of gain treated as recognized as the result of such assumption of liability shall be determined as if the liability assumed by the transferee equaled such transferee's ratable portion of the liability, based on the relative fair market values (determined without regard to IRC Sec. 7701(g)) of all assets subject to such nonrecourse liability.

In no event will the gain cause the resulting basis to exceed the fair market value of the property (determined without regard to IRC Sec. 7701(g)).

The Treasury Department has authority to prescribe such regulations as may be necessary to carry out the purposes of the provision. This authority includes the authority to specify adjustments in the treatment of any subsequent transactions involving the liability, including the treatment of payments actually made with respect to any liability as well as appropriate basis and other adjustments with respect to such payments. Where appropriate, the Treasury Department also may prescribe regulations that provide that the manner in which a liability is treated as assumed under the provision is applied elsewhere in the IRC.

AB 1122 conforms state law to the Miscellaneous Trade and Technical Corrections Act of 1999 by eliminating the distinction between the assumption of a liability and the acquisition of an asset subject to a liability for transfers on or after January 1, 2002.

Section 17039 of the Revenue and Taxation Code is amended.

Starting in the 2002 taxable year, AB 1122 eliminates the TMT limitation on the joint custody head of household, dependent parent, senior head of household, and child adoption credits.

Section 17052.12 of the Revenue and Taxation Code is amended.

AB 1122 removes deadwood language in the Research and Development Credit no longer needed because of the date change in PITL §17024.5

Section 17062 of the Revenue and Taxation Code is amended.

AB 1122 conforms California law to existing federal law by eliminating the deduction for contributions of appreciated property as an item of tax preference. As a result, taxpayers no longer would need to include in their computation of AMTI the amount by which any allowable deduction for contributions of appreciated property exceeds the taxpayer's adjusted basis in the contributed property. Generally, this change would mean taxpayers may have a lower overall tax liability since it is less likely a taxpayer would become subject to AMT.

Section 17062.3 of the Revenue and Taxation Code is added.

This provision specifically does not conform to amendments made to the federal provisions with respect to the alternative minimum tax for the foreign income exclusion provisions contained in the federal FSC Repeal and Extraterritorial Income Exclusion Act of 2000 (P.L. 106-519). Due to the date change in PITL §17024.5, California would have conformed to this federal change without this provision.

Section 17063 of the Revenue and Taxation Code is amended.

The alternative minimum tax credit provision has been amended to remove the contribution of appreciated property tax preference item from the computation of the alternative minimum tax credit (See PITL §17062 above).

Section 17085 of the Revenue and Taxation Code is amended.

Section 17085 conforms to IRC §72 with modifications. AB 1122 conforms California law to the changes made by EGTRRA to IRC §72. EGTRRA Act §§632 and 641 modified IRC §72 in regards to pension distributions See PITL §17501 below.

Section 17132 of the Revenue and Taxation Code is added.

This provision specifically does not conform to the foreign income exclusion provisions contained in the federal FSC Repeal and Extraterritorial Income Exclusion Act of 2000 (P.L. 106-519). Due to the date change in PITL §17024.5, California would have conformed to this federal change without this provision.

Section 17132.6 of the Revenue and Taxation Code is added.

The Ricky Ray Hemophilia Act treats payments to certain individuals with blood-clotting disorders who contracted the human immunodeficiency virus (HIV) due to contaminated blood products 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.

AB 1122 conforms California law with federal treatment of payments received pursuant to the Ricky Ray Hemophilia Relief Fund Act.

Section 17140 of the Revenue and Taxation Code is amended.

The section is amended to remove deadwood language in a Golden State Scholarshare Trust (IRC §529) provision. The provision was also amended to conform to EGTRRA (Act §402) and Job Creation Act of 2002 provisions affecting qualified tuition program trusts.

Section 17140.3 of the Revenue and Taxation Code is amended.

EGTRRA (Act §402) permits an eligible educational institution to maintain a qualified tuition program, provided such program has received a ruling that such program meets the applicable requirements for a qualified tuition program. The Act excludes from gross income education distributions from qualified tuition programs. It permits the transfer of credits from one qualified tuition program to another qualified program for the benefit of the same beneficiary without the transfer being considered a distribution. It also permits expenses for the special needs services of a special needs beneficiary. The Job Creation Act made technical corrections to the EGTRRA provisions

AB 1122 conforms to the EGTRRA and Job Creation Act of 2002 provisions affecting qualified tuition program trusts.

Section 17144 of the Revenue and Taxation Code is amended.

The United States Supreme Court ruled in the case of *Gitlitz v. Commissioner* that income from the discharge of indebtedness of an S corporation that is excluded from income is treated as an item of income which increases the basis of a shareholder's stock in the S corporation and allows a suspended corporate loss to pass thru to a shareholder. Thus, under the decision, an S corporation shareholder is allowed to deduct a loss for tax purposes that it did not economically incur.

The Job Creation Act of 2002 provided that income from the discharge of indebtedness of an S corporation that is excluded from the S corporation's income is not taken into account as an item of income by any shareholder and thus does not increase the basis of any shareholder's stock in the corporation. The federal effective date of the provision generally applies to discharges of indebtedness after October 11, 2001. The provision does not apply to any discharge of indebtedness before March 1, 2002, pursuant to a plan of reorganization filed with a bankruptcy court on or before October 11, 2001.

AB 1122 conforms to the Job Creation Act of 2002 change to the discharge of indebtedness of an S corporation. Thus, reversing the Gitlitz decision. This provision would apply for California purposes to discharges of indebtedness after December 31, 2001, in taxable years ending after that date. The provision would not apply to any discharge of indebtedness before March 1, 2002, pursuant to a plan of reorganization filed with a bankruptcy court on or before October 11, 2001.

<u>Section 17144.5 of the Revenue and Taxation Code is added</u>.

This provision conforms to EGTRRA §665 - Clarification of treatment of employer-provided retirement advice. §665 of EGTRRA amended IRC §132 to exclude from gross income any fringe benefit qualifying as a qualified retirement planning service. The effective date is January 1, 2002.

<u>Section 17205 of the Revenue and Taxation Code is added</u>.

This provision conforms to EGTRRA §§601 and 641 that amended IRC §219.

> §601 - Modification of IRA contribution limits. Increases the IRA annual dollar contribution limit to $3,000 for 2002 through 2004, $4,000 for 2005 through 2007, and $5,000 for 2008 and thereafter, with indexing in $500 increments thereafter. Provides, for individuals age 50 and older, that such limit shall be increased by $500 for 2002 through 2005 and by $1,000 for years 2006 and thereafter
>
> 641 - Rollovers allowed among various types of plans. Permits rollovers from and to various types of plans under the Internal Revenue Code.

<u>Section 17251.5 of the Revenue and Taxation Code is repealed</u>.

By repealing the exception to federal law, AB 1122 conformed the PITL to existing federal law by allowing the amount of a charitable contribution of publicly traded stock to a private foundation to be the FMV of the stock (IRC §170(e)(5)). This bill does not conform to this provision under the CTL.

<u>Section 17270.5 of the Revenue and Taxation Code is repealed</u>.

By repealing the exception to federal law, AB 1122 conformed California law to existing federal law regarding the denial of the deduction for lobbying expenses (IRC §162(e).

<u>Section 17271 of the Revenue and Taxation Code is repealed</u>.

By repealing the exception to federal law, AB 1122 conformed California law to existing federal law regarding the denial of the club dues expenses (IRC §274(a)(3)).

<u>Section 17275.5 of the Revenue and Taxation Code is amended</u>.

By repealing the exception to federal law, AB 1122 conformed California law to existing federal law regarding the denial of the deduction for contributions made to an organization that used the contribution for lobbying expenses (IRC §170(f)(9)).

Due to the date change in PITL §17024.5, California would have conformed to the federal excise tax on premiums paid (IRC §170(f)(10)(F)). AB 1122 added an exception to the PITL not to conform to the federal excise tax on premiums paid.

<u>Section 17279.5 of the Revenue and Taxation Code is repealed</u>.

The Ticket to Work Act restated present federal law (IRC §264) 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), if in connection with the transfer (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.

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)).

In the case of 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. Section 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.

In the case of a charitable gift annuity obligation that is issued under the laws of a state that requires, in order for the charitable gift annuity to be exempt from insurance regulation by that state, that each beneficiary under the charitable gift annuity be named as a beneficiary under an annuity contract issued by an insurance company authorized to transact business in that state, then 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 IRC 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.

The IRS Reform Act made technical changes to the Ticket to Work Act provision discussed above.

AB 1122 conforms California law to the Ticket to Work and IRS Reform Acts provisions with respect to transfers on or after January 1, 2002. IRC §264 is now conformed by reference.

Section 17501 of the Revenue and Taxation Code is amended.

This section conforms to the following 2001 EGTRRA changes to the various types of deferred compensation plans. The section numbers are references to the section of the EGTRRA.

Sec. 601. Modification of IRA contribution limits. Increases the Individual Retirement Account (IRA) annual dollar contribution limit to $3,000 for 2002 through 2004, $4,000 for 2005 through 2007, and $5,000 for 2008 and thereafter, with indexing in $500 increments thereafter. Provides, for individuals age 50 and older, that such limit shall be increased by $500 for 2002 through 2005 and by $1,000 for years 2006 and thereafter.
Sec. 602. Deemed IRAs under employer plans. Deems certain voluntary employee contributions to accounts and annuities as IRAs rather than pension plans.
Sec. 611. Increase in benefit and contribution limits. Increases annual benefit limits to $160,000 and annual contribution limits to $40,000. Increases, over five years, the annual contribution limits for 401 (k) and other employer-sponsored plan to $15,000. Sets indexes for inflation in various increments on such increased limits.
Sec. 612. Plan loans for subchapter S owners, partners, and sole proprietors. Revises requirements relating to plan loans for subchapter S owners, partners, and sole proprietors.
Sec. 613. Modification of top-heavy rules. Revises specified top-heavy rules. Revises the definition of key employee. Requires that employer-matching contributions be taken into account for purposes of minimum contribution requirements. Provides for distributions during the last year before a determination date is taken into account. Excludes from the definition of top-heavy plan: (1) cash or deferred arrangements using alternative methods of meeting nondiscrimination requirements; and (2) defined contribution plans using alternative methods of meeting nondiscrimination requirements.
Sec. 614. Elective deferrals. Provides that elective deferrals shall not be taken into account for purposes of limits on certain plan contributions.
Sec. 616. Deduction limits. Revises certain deduction limits for stock bonus and profit sharing trusts and for defined contribution plans.
Sec. 617. Option to treat elective deferrals as after-tax Roth contributions. Provides for optional treatment of elective deferrals as Roth contributions.
Sec. 631. Catch-up contributions for individuals age 50 or over. Allows individuals who are age 50 or older to make additional contributions to an applicable employer plan.
Sec. 632. Equitable treatment for contributions of employees to defined contribution plans. Sets forth

requirements relating to equitable treatment for contributions of employees to defined contribution plans. Increases the 25% of compensation limitation on annual additions under a defined contribution plan to 100%. Declares that certain contributions by church plans are not to be treated as exceeding a specified limit. Increases the 33 1/3% of compensation limitation on deferrals under deferred compensation plans of state and local governments and tax-exempt entities (§457 plans) to 100% of compensation.
Sec. 633. Faster vesting of certain employer matching contributions. Provides for faster vesting of certain employer matching contributions.
Sec. 634. Modification to minimum distribution rules. Provides for the modification of the life expectancy tables concerning the minimum distribution rules.
Sec. 635. Clarification of tax treatment of division of §457 plan benefits upon divorce. Revises requirements relating to tax treatment of division of §457 plan benefits upon divorce. Applies the taxation rules for qualified plan distributions pursuant to a qualified domestic relations order to distributions made pursuant to a domestic relations order from a §457 plan. Provides that a §457 plan is not to be treated as violating the restrictions on distributions from such plans due to payments to an alternate payee under a qualified domestic relations order.
Sec. 636. Provisions relating to hardship distributions. Directs the Secretary to reduce from 12 months to six months the safe harbor relief period during which an employee is prohibited from making elective contributions and employee contributions in order for a distribution to be deemed necessary to satisfy a hardship financial need. Provides that a hardship distribution from any qualified plan is not an eligible rollover distribution.
Sec. 637. Waiver of tax on nondeductible contributions for domestic or similar workers. Provides for a waiver of tax on certain nondeductible contributions made for pension coverage for domestic or similar workers, by providing that the 10% excise tax on nondeductible contributions does not apply to contributions to a SIMPLE 401(k) plan or SIMPLE IRA that are nondeductible solely because they are not made in connection with a trade or business of the employer. Declares that nothing in such amendment shall be construed to infer the proper treatment of nondeductible contributions under the laws in effect before such amendment.
Sec. 641. Rollovers allowed among various types of plans. Permits rollovers from and to various types of plans under the Internal Revenue Code.
Sec. 642. Rollovers of IRAs into workplace retirement plans. Permits individual retirement plan (IRA) rollovers into workplace retirement plans only if certain conditions are met.
Sec. 643. Rollovers of after-tax contributions. Permits rollover of after-tax contributions in an exempt trust under specified conditions..
Sec. 644. Hardship exception to 60-day rule. Sets forth a hardship exception to the 60-day rule. Authorizes the Secretary to waive the 60-day rollover period if the failure to waive such requirement would be against equity or good conscience, including cases of casualty, disaster, or other events beyond the reasonable control of the individual subject to such requirement.
Sec. 645. Treatment of forms of distribution. Sets forth requirements for treatment of forms of distribution available under transferor and transferee plans under the Internal Revenue Code.
Sec. 646. Rationalization of restrictions on distributions. Revises restrictions on distributions, including the same desk exception. Repeals business sale requirements.
Sec. 647. Purchase of service credit in governmental defined benefit plans. Authorizes trustee-to-trustee transfers to purchase permissive service credit with respect to governmental defined benefit plans.
Sec. 648. Employers may disregard rollovers for purposes of cash-out amounts. Allows employers to disregard rollovers for purposes of cash-out amounts, under retirement plan provisions of the Internal Revenue Code.
Sec. 651. Repeal of 160 percent of current liability funding limit. Increases, until repeal (2004), the current liability full funding limit.
Sec. 652. Maximum contribution deduction rules modified and applied to all defined benefit plans. Revises

maximum contribution deduction rules. Applies such rules to all defined benefit plans.
Sec. 654. Treatment of multi-employer plans under §415. Makes limitation rules on benefits and contributions for qualified benefit plans (§415 plans) inapplicable to governmental or multi-employer plans. Sets forth special rules relating to the combination or aggregation of multi-employer plans.
Sec. 655. Protection of investment of employee contributions to 401(k) plans. Modifies the effective date of the rule excluding certain effective date deferrals from the definition of individual account plan.
Sec. 656. Prohibited allocations of stock in S corporation ESOP. Requires any employee stock ownership plan (ESOP) holding employer securities consisting of stock in an S corporation to provide that no portion of the assets of the plan attributable to (or allocable in lieu of) such employer securities may, during a nonallocation year, accrue (or be allocated directly or indirectly under any qualified plan of the employer) for the benefit of any disqualified person. Defines a non-allocation year as any ESOP plan year if, at any time during it such plan holds employer securities consisting of stock in an S corporation, and disqualified persons own at least 50% of the number of shares of stock in that corporation. Prescribes attribution rules. Imposes an excise tax for violations of such prohibition.
Sec. 657. Automatic rollovers of certain mandatory distributions. Makes a direct rollover the default option for mandatory distributions exceeding $1,000 and that are eligible rollover distributions from qualified retirement plans.
Sec. 658. Clarification of treatment of contributions to multi-employer plan. States that a determination regarding the taxable year with respect to which a contribution to a multi-employer pension plan is deemed made shall not be treated as a method of accounting.
Sec. 661. Modification of timing of plan valuations. Revises requirements relating to timing of plan valuations.
Sec. 662. ESOP dividends may be reinvested without loss of dividend deduction. Allows applicable dividends of ESOPs to be reinvested without loss of dividend deduction.
Sec. 663. Repeal of transition rule relating to certain highly compensated employees. Repeals a transition rule relating to certain highly compensated employees under the Tax Reform Act of 1986.
Sec. 664. Employees of tax-exempt entities. Directs the Secretary to modify certain regulations with respect to certain plan participation by employees of tax-exempt entities.
Sec. 666. Repeal of the multiple use test. Repeals the multiple use test, and directs the Secretary to prescribe regulations, as necessary, including ones permitting appropriate aggregation of plans and contributions.

The conformity to the above EGTRRA provisions and any future federal changes to federal rules regarding qualified deferred compensation plans is accomplished by making the specified date in PITL §17024.5 not apply. Part I of Subchapter D of Chapter 1 of Subtitle A of the IRC, relating to pension, profit sharing, stock bonus plans, and etc., applies to same extent as under federal law for the same taxable year. This provision makes federal pension qualifications changes applicable for state purposes, thereby eliminating any pension plan qualification issue that could occur in the future.

This bill would not (without future state legislation) conform to any future federal increases in deductions for IRA contributions or increases in exclusion amounts for elective employee deferrals, as defined, to apply for state taxation purposes.

AB 1122 freezes the amounts deductible or excludable for California purposes to the amounts allowed under the Internal Revenue Code, as amended by EGTRRA and the Job Creation Act of 2002. AB 1122, however, excludes from taxable income any pension and retirement savings plan earnings (inside build-up) due to the differences between amounts deductible or excludable for state purposes and future federal increases in these amounts, as well as prevents any disqualification of the plan itself for state purposes resulting from future federal changes.

All the changes made by the EGTRRA sunset on December 31, 2010. By referencing federal law, the provisions of this bill would also sunset on the same date.

Section 17551 of the Revenue and Taxation Code is amended.

This section conforms to the following 2001 EGTRRA changes to deferred compensation plans of state and local governments and tax-exempt organizations (Sec. 457 plans). The section numbers are references to the section of the EGTRRA.

Sec. 611. Increase in benefit and contribution limits. Increases annual benefit limits to $160,000 and annual contribution limits to $40,000. Increases, over five years, the annual contribution limits for 401 (k) and other employer-sponsored plan to $15,000. Sets indexes for inflation in various increments on such increased limits.
Sec. 615. Deferred compensation plans of state and local governments and tax-exempt organizations. Repeals specified coordination requirements for deferred compensation plans of state and local governments and tax-exempt organization.
Sec. 631. Catch-up contributions for individuals age 50 or over. Allows individuals who are age 50 or older to make additional contributions to an applicable employer plan.
Sec. 632. Equitable treatment for contributions of employees to defined contribution plans. Sets forth requirements relating to equitable treatment for contributions of employees to defined contribution plans. Increases the 25% of compensation limitation on annual additions under a defined contribution plan to 100%. Declares that certain contributions by church plans are not to be treated as exceeding a specified limit. Increases the 33 1/3% of compensation limitation on deferrals under deferred compensation plans of state and local governments and tax-exempt entities (§457 plans) to 100% of compensation.
Sec. 634. Modification to minimum distribution rules. Provides for the modification of the life expectancy tables concerning the minimum distribution rules.
Sec. 635. Clarification of tax treatment of division of §457 plan benefits upon divorce. Revises requirements relating to tax treatment of division of §457 plan benefits upon divorce. Applies the taxation rules for qualified plan distributions pursuant to a qualified domestic relations order to distributions made pursuant to a domestic relations order from a §457 plan. Provides that a §457 plan is not to be treated as violating the restrictions on distributions from such plans due to payments to an alternate payee under a qualified domestic relations order.
Sec. 641. Rollovers allowed among various types of plans. Permits rollovers from and to various types of plans under the Internal Revenue Code.
Sec. 646. Rationalization of restrictions on distributions. Revises restrictions on distributions, including the same desk exception. Repeals business sale requirements.
Sec. 647. Purchase of service credit in governmental defined benefit plans. Authorizes trustee-to-trustee transfers to purchase permissive service credit with respect to governmental defined benefit plans.
Sec. 648. Employers may disregard rollovers for purposes of cash-out amounts. Allows employers to disregard rollovers for purposes of cash-out amounts, under retirement plan provisions of the Internal Revenue Code.
Sec. 649. Minimum distribution and inclusion requirements for §457 plans. Revises minimum distribution and inclusion requirements for §457 plans.

The conformity to the above EGTRRA provisions is accomplished by making the specified date in PITL §17024. 5 not apply. IRC §457, relating to deferred compensation plans, applies to same extent as under federal law for the same taxable year. This provision makes federal pension qualifications changes applicable for state purposes, thereby eliminating any pension plan qualification issue that could occur in the future.

This bill would not (without future state legislation) conform to any future federal increases in deductions for IRA contributions or increases in exclusion amounts for elective employee deferrals, as defined, to apply for state taxation purposes.

AB 1122 freezes the amounts deductible or excludable for California purposes to the amounts allowed under the Internal Revenue Code, as amended by EGTRRA and the Job Creation Act of 2002. AB 1122, however, excludes from taxable income any pension and retirement savings plan earnings (inside build-up) due to the differences between amounts deductible or excludable for state purposes and future federal increases in these amounts, as well as prevents any disqualification of the plan itself for state purposes resulting from future federal changes.

All the changes made by the EGTRRA sunset on December 31, 2010. By referencing federal law, the provisions of this bill would also sunset on the same date.

Section 17552.3 of the Revenue and Taxation Code is added.

AB 1122 conforms to the Tax and Trade Extension Act change to receipt of income under the Federal Agriculture Improvement and Reform Act of 1996 (the FAIR Act).

> Under the Tax and Trade Extension Act 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 §112(d)(2) (allowing receipt of one-half of the annual payment on either December 15th or January 15th of the fiscal year) or §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.

AB 1122 conforms California law with federal law as it relates to farm production flexibility payments with the same effective date with respect to payments received in taxable and income years ending after December 31, 1995.

Section 17560 of the Revenue and Taxation Code is amended.

This section is amended to remove an obsolete reference to a federal public law section.

Section 17563.5 of the Revenue and Taxation Code is added.

The IRS Reform Act provided that for purposes of determining whether an item of compensation is deferred compensation (under IRC Sec. 404), the compensation is not considered to be paid or received until actually received by the employee.

In addition, an item of deferred compensation is not considered paid to an employee until actually received by the employee. The provision is intended to overrule the result in Schmidt Baking Co., Inc. v. Commissioner (1996) 107 T.C. 271. For example, with respect to the determination of whether vacation pay is deferred compensation, the fact that the value of the vacation pay is includible in the income of employees within the applicable 2 1/2-month period is not relevant. Rather, the vacation pay must have been actually received by employees within the 2 1/2-month period for the compensation not to be treated as deferred compensation.

Congress intended that similar arrangements, in addition to the letter of credit approach used in Schmidt Baking, do not constitute actual receipt by the employee, even if there is an income inclusion. Thus, for example, actual receipt does not include the furnishing of a note or letter or other evidence of indebtedness of the taxpayer, regardless of whether the evidence is guaranteed by any other instrument or by any third party. As a further example, actual receipt does not include a promise of the taxpayer to provide service or property in the future (regardless of whether the promise is evidenced by a contract or other written agreement).

In addition, actual receipt does not include an amount transferred as a loan, refundable deposit, or contingent payment. Amounts set aside in a trust for employees generally are not considered to be actually received by the employee.

The provision does not change the rule under which deferred compensation (other than vacation pay and sick pay and deferred compensation under qualified plans) is deductible in the year includible in the gross income of employees participating in the plan if separate accounts are maintained for each employee.

While Schmidt Baking involved only vacation pay and severance pay, there is concern that this type of arrangement may be used to try to circumvent other provisions of the IRC where payment is required in order for a deduction to occur. Thus, Congress expressed its intent that the Secretary will prevent the use of similar arrangements, though no inference was intended that the result in Schmidt Baking is present law beyond its immediate facts or that the use of similar arrangements is permitted under present law.

This provision is effective under federal law for taxable years ending after July 22, 1998. Any change in a taxpayer's method of accounting required by this provision will be treated as initiated by the taxpayer with the consent of the Secretary of the Treasury. Any adjustment required by IRC Sec. 481 as a result of the change will be taken into account for federal purposes over a three-year period beginning with the first year for which the provision is effective.

AB 1122 conforms California law to the federal IRS Reform Act law change as it relates to the accrual of vacation and severance pay for taxable years beginning on or after January 1, 2002. This bill would also require any state adjustment required by IRC Sec.481 as a result of the change to be taken into account over a three-year period beginning with 2002.

Section 17570 of the Revenue and Taxation Code is amended.

The IRS Reform Act provides that certain trade receivables are not eligible for mark-to-market treatment. A trade receivable is covered by the provision if it is a note, bond, or debenture arising out of the sale of goods by a person the principal activity of which is selling or providing nonfinancial goods and services and it is held by such person or a related person at all times since it was issued.

Under the IRS Reform Act, a receivable meeting the above definition is not treated as a security for purposes of the mark-to-market rules (IRC §475). Thus, such receivables are not marked-to-market, even if the taxpayer qualifies as a dealer in other securities. A taxpayer will not be treated as a dealer in securities based on sales to unrelated persons of receivables subject to the new provision unless the regulatory exception for receivables held for sale to customers applies.

The IRS Reform Act provision also applies to trade receivables arising from services performed by independent contractors, as well as employees. Thus, for example, if a taxpayer's principal activity is selling non-financial services and some or all of such services are performed by independent contractors, no receivables that the taxpayer accepts for services can be marked-to-market under the new provision.

Pursuant to the authority granted by IRC §475(g)(1), the Secretary of the Treasury is authorized to issue regulations to prevent abuse of the new exception, including through independent contractor arrangements.

The provision provides that, to the extent provided in Treasury regulations, trade receivables that are held for sale to customers by the taxpayer or a related person may be treated as “securities” for purposes of the mark-to-market rules, and transactions in such receivables could result in a taxpayer being treated as a dealer in securities (IRC §475(c)(1)).

For trade receivables that are excepted from the statutory mark-to-market rules (IRC §475) under the new provision, mark-to-market or lower-of-cost-or-market will not be treated as methods of accounting that clearly reflect income under general tax principles (see IRC §446(b)).

The provision generally is effective for taxable years ending after July 22, 1998. Adjustments required under IRC §481 as a result of the change in method of accounting generally are required to be taken into account for federal purposes ratably over the four-year period beginning in the first taxable year for which the provision is in effect.

AB 1122 conforms California law to federal law as it relates to “mark to market” method of accounting for dealers. This bill would also require adjustments under IRC §481 as a result of the change in method of accounting to be taken into account for state purposes ratably over a three-year period beginning in 2002.

Section 17731.5 of the Revenue and Taxation Code is amended.

The provision updates a cross-reference to the IRC.

Section 17751 of the Revenue and Taxation Code is amended.

The provision updates a cross-reference to the IRC.

Section 18038.5 of the Revenue and Taxation Code is amended.

AB 1122 conforms to the IRS Reform Act § 6005(f) change to small business stock:

> Rollover of Gain from Sale of Qualified Stock. Under the provision, a partnership or an S corporation can roll over gain from qualified small business stock held more than six months with respect to interests in the partnership or S corporation held by taxpayers other than corporations.
>
> 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.

Section 19136 of the Revenue and Taxation Code is amended.

AB 1122 conforms California law to federal estimated payment requirements. AB 1122 eliminates the two “80% subject to withholding” safe harbors and conforms to the federal 90% of the current year tax liability safe harbor. California is already conformed to the preceding year safe harbor. AB 1122 does not require alternative minimum tax to be included in the computation of required estimated tax payments. AB 1122 does not conform to the federal $1,000 de minimis safe harbor but instead would retain the state $200 de minimis safe harbor.

Section 19136.8 of the Revenue and Taxation Code is amended.

AB 1122 waives additions to tax imposed for any underpayments of tax or estimated tax for any period before April 15, 2003, with respect to any underpayment for the 2002 taxable year to the extent the underpayment was created or increased by any provision of AB 1122.

Section 19141 of the Revenue and Taxation Code is amended.

AB 1122 adds a Corporation Code reference to a penalty section and clarifies the penalty is assessed under the RTC.

Section 19365 of the Revenue and Taxation Code is amended.

Due to the change to §23801, requiring corporations with a valid federal S elections to be S corporations for state purposes, AB 1122 provides for transitional relief regarding estimated tax payments. A California C corporation that becomes an S corporation, due to the provisions AB 1122, may request to have part (the amount in excess of the S corporation's expected tax liability) of the estimated tax payment transferred to the personal income tax accounts of its shareholders.

Section 19521 of the Revenue and Taxation Code is amended.

Due to the specified date change in §17024.5, AB 1122 would have conformed to the federal change contained in §3301 of the IRS Reform Act – Elimination of interest for overlapping of overpayment and underpayment of tax periods. This provision specifically prevents the specified date change from conforming to the provisions in §3301 of the IRS Reform Act.

Section 23038.5 of the Revenue and Taxation Code is amended.

AB 1122 makes technical changes to the electing 1987 partnership (not to be treated as a corporation) provision clarifying the gross income tax is included in the computation of estimated tax. Thus, the tax is subject to the underpayment of tax penalty.

Section 23456 of the Revenue and Taxation Code is amended.

AB 1122 conforms California law to existing federal law (IRC §56(g)(4)(I) by eliminating the deduction for contributions of appreciated property from the computation of earnings and profits for adjustments relating to alternative minimum tax.

Section 23456.5 of the Revenue and Taxation Code is amended.

This provision specifically does not conform to amendments to IRC, related to alternative minimum tax, with respect to the foreign income exclusion provisions contained in the federal FSC Repeal and Extraterritorial Income Exclusion Act of 2000 (P.L. 106-519). Due to the date change in PITL §17024.5 (referred to in §23051.5), California would have conformed to this federal change without this provision.

Section 23457 of the Revenue and Taxation Code is amended.

AB 1122 conforms California law to existing federal law by eliminating the deduction for contributions of appreciated property as an item of tax preference. As a result, taxpayers no longer would need to include in their computation of AMTI the amount by which any allowable deduction for contributions of appreciated property exceeds the taxpayer's adjusted basis in the contributed property. This provision is in conjunction with §23456 above.

Section 23609 of the Revenue and Taxation Code is amended.

AB 1122 removes deadwood language in the Research and Development Credit no longer needed because of the date change in PITL §17024.5.

Section 23701s of the Revenue and Taxation Code is amended.

IRC §501(c)(18), exemption of pension plan type trusts, was modified by EGTRRA §611 to allow the trusts to accept larger employee contributions to the trust. AB 1122 conformed to this change.

Section 23705 of the Revenue and Taxation Code is amended.

EGTRRA § 611 increase the compensation limit in IRC §505(b) from $150,000 to $200,000 for purposes of nondiscrimination requirements. AB 1122 conformed to this change.

Section 23711 of the Revenue and Taxation Code is amended.

EGTRRA §402 made the following changes to IRC §529, Qualified Tuition Programs:

Qualified tuition program

EGTRRA expands the definition of "qualified tuition program" to include certain prepaid tuition programs established and maintained by one or more eligible educational institutions (which may be private institutions) that satisfy the requirements under §529 (other than the present-law state sponsorship rule). In the case of a qualified tuition program maintained by one or more private eligible educational institutions, persons are able to purchase tuition credits or certificates on behalf of a designated beneficiary (as set forth in sec. 529(b)(1)(A)(i)), but would not be able to make contributions to a savings account plan (as described in sec. 529(b)(1)(A)(ii)). Except to the extent provided in regulations, a tuition program maintained by a private institution is not treated as qualified unless it has received a ruling or determination from the IRS that the program satisfies applicable requirements.

EGTRRA provides that, in order for a tuition program of a private eligible education institution to be a qualified tuition program, assets of the program must be held in a trust created or organized in the United States for the exclusive benefit of designated beneficiaries that complies with the requirements under §408(a)(2) and (5). Under these rules, the trustee must be a bank or other person who demonstrates that it will administer the trust in accordance with applicable requirements and the assets of the trust may not be commingled with other property except in a common trust fund or common investment fund.

EGTRRA repeals the present-law rule that a qualified state tuition program must impose a more than *de minimis* monetary penalty on any refund of earnings not used for qualified higher education expenses of the beneficiary (except in certain circumstances). Instead, EGTRRA imposes an additional 10% tax on the amount of a distribution from a qualified tuition plan that is includible in gross income (like the additional tax that applies to such distributions from education IRAs). The same exceptions that apply to the 10% additional tax with respect to education IRAs apply.

A special rule applies because the exclusion for earnings on distributions used for qualified higher education expenses does not apply to qualified tuition programs of private institutions until 2004. Under the special rule, the additional 10% tax does not apply to any payment in a taxable year beginning before January 1, 2004, which is includible in gross income but used for qualified higher education expenses. Thus, for example, the earnings portion of a distribution from a qualified tuition program of a private institution that is made in 2003 and that is used for qualified higher education expenses is not subject to the additional tax, even though the earnings portion is includible in gross income. Conforming the penalty to the education IRA provisions will make it easier for taxpayers to allocate expenses between the various education tax incentives. For example, under EGTRRA, a taxpayer who receives distributions from an education IRA and a qualified tuition program in the same year is required to allocate qualified expenses in order to determine the amount excludable from income. Other interactions between the various provisions also arise under EGTRRA. For example, a taxpayer may need to know the amount excludable from income due to a distribution from a qualified tuition program in order to determine the amount of expenses eligible for the tuition deduction. It is expected that the Secretary will exercise the existing authority under §§529(d) and 530(h) to require appropriate reporting, e.g., the amount of distributions and the earnings portions of distributions (taxable and nontaxable), to facilitate the provisions of EGTRRA.

Exclusion from gross income

Under EGTRRA, an exclusion from gross income is provided for distributions made in taxable years beginning after December 31, 2001, from qualified state tuition programs to the extent that the distribution is used to pay for qualified higher education expenses. This exclusion from gross income is extended to distributions from qualified tuition programs established and maintained by an entity other than a state (or agency or instrumentality thereof) for distributions made in taxable years after December 31, 2003.

Qualified higher education expenses

EGTRRA provides that, for purposes of the exclusion for distributions from qualified tuition plans, the maximum room and board allowance is the amount applicable to the student in calculating costs of attendance for federal financial aid programs under §472 of the Higher Education Act of 1965, as in effect on June 7, 2001, or, in the case of a student living in housing owned or operated by an eligible educational institution, the actual amount charged the student by the educational institution for room and board. This definition also applies to distributions from education IRAs.

EGTRRA modifies the definition of qualified higher education expenses to include expenses of a special needs beneficiary that are necessary in connection with his or her enrollment or attendance at the eligible education institution. This definition also applies to distributions from education IRAs.

In addition, a special needs beneficiary would be defined as under the provisions relating to education IRAs, described above.

Rollovers for benefit of same beneficiary

EGTRRA provides that a transfer of credits (or other amounts) from one qualified tuition program for the benefit of a designated beneficiary to another qualified tuition program for the benefit of the same beneficiary is not considered a distribution. This rollover treatment does not apply to more than one transfer within any 12-month period with respect to the same beneficiary. The intent of this provision is to allow, for example, transfers between a prepaid tuition program and a savings program maintained by the same state and between a state plan and a private prepaid tuition program.

Member of family

EGTRRA provides that, for purposes of tax-free rollovers and changes of designated beneficiaries, a “member of the family” includes first cousins of the original beneficiary.

Effective Date

The provisions are effective for taxable years beginning after December 31, 2001, except that the exclusion from gross income for certain distributions from a qualified tuition program established and maintained by an entity other than a state (or agency or instrumentality thereof) is effective for taxable years beginning after December 31, 2003.

AB 1122 conforms to the EGTRRA changes to Qualified Tuition Programs with the same effective dates.

Section 23712 of the Revenue and Taxation Code is amended.

EGTRRA §§401 and 402 made the following changes to IRC §530 (Coverdell) Education Savings Accounts:

Annual contribution

EGTRRA increases the annual limit on contributions to education IRAs from $500 to $2,000. Thus, aggregate contributions that may be made by all contributors to one (or more) education IRAs established on behalf of any particular beneficiary is limited to $2,000 for each year.

Qualified education expenses

EGTRRA expands the definition of qualified education expenses that may be paid tax-free from an education IRA to include “qualified elementary and secondary school expenses,” meaning expenses for (1) tuition, fees, academic tutoring, special need services, books, supplies, and other equipment incurred in connection with the enrollment or attendance of the beneficiary at a public, private, or religious school providing elementary or secondary education (kindergarten through grade 12) as determined under state law, (2) room and board, uniforms, transportation, and supplementary items or services (including extended day programs) required or provided by such a school in connection with such enrollment or attendance of the beneficiary, and (3) the purchase of any computer technology or equipment (as defined in sec. 170(e)(6)(F)(i)) or Internet access and related services, if such technology, equipment, or services are to be used by the beneficiary and the beneficiary's family during any of the years the beneficiary is in school. Computer software primarily involving sports, games, or hobbies is not considered a qualified elementary and secondary school expense unless the software is predominantly educational in nature.

Phase-out of contribution limit

EGTRRA increases the phase-out range for married taxpayers filing a joint return so that it is twice the range for single taxpayers. Thus, the phase-out range for married taxpayers filing a joint return is $190,000 to $220,000 of modified AGI.

Special needs beneficiaries

EGTRRA provides that the rule prohibiting contributions to an education IRA after the beneficiary attains 18 does not apply in the case of a special needs beneficiary (as defined by Treasury Department regulations). In addition, a deemed distribution of any balance in an education IRA does not occur when a special needs beneficiary reaches age 30. Finally, the age 30 limitation does not apply in the case of a rollover contribution for the benefit of a special needs beneficiary or a change in beneficiaries to a special needs beneficiary. Treasury regulations are to define a special needs beneficiary to include an individual who because of a physical, mental, or emotional condition (including learning disability) requires additional time to complete his or her education.

Contributions by persons other than individuals

EGTRRA clarifies that corporations and other entities (including tax-exempt organizations) are permitted to make contributions to education IRAs, regardless of the income of the corporation or entity during the year of the contribution.

Contributions permitted until April 15

Under EGTRRA, individual contributors to education IRAs are deemed to have made a contribution on the last day of the preceding taxable year if the contribution is made on account of such taxable year and is made not later than the time prescribed by law for filing the individual's federal income tax return for such taxable year (not including extensions). Thus, individual contributors generally may make contributions for a year until April 15 of the following year.

Qualified room and board expenses

EGTRRA modifies the definition of room and board expenses considered to be qualified higher education expenses. This modification is described with the provisions relating to qualified tuition programs below.

Coordination with qualified tuition programs

EGTRRA repeals the excise tax on contributions made by any person to an education IRA on behalf of a beneficiary during any taxable year in which any contributions are made by anyone to a qualified state tuition program on behalf of the same beneficiary. If distributions from education IRAs and qualified tuition programs exceed the beneficiary's qualified higher education expenses for the year (after reduction by amounts used in claiming the HOPE or Lifetime Learning credit), the beneficiary is required to allocate the expenses between the distributions to determine the amount includible in income.

AB 1122 conforms to the EGTRRA changes to Coverdell Education Savings Accounts with the same effective date.

Section 23801 of the Revenue and Taxation Code is amended.

Effective for taxable years beginning on or after January 1, 2002, AB 1122 requires all taxpayers with a valid S corporation election for federal purposes to be an S corporation for state purposes. Under an uncodified provision of AB 1122 (76), the effective date of the S corporation election for those taxpayers required to be an S corporation under the provisions of AB 1122 would be January 1, 2002, for California purposes (A clean-up provision is contained in SB 1805 (2002) to make the effective date of the election the first day of the taxable year of the corporation beginning in 2002).

<u>Section 23802 of the Revenue and Taxation Code is amended</u>.

AB 1122 made a conforming amendment to §23802 to facilitate the change in §23801.

<u>Section 23811 of the Revenue and Taxation Code is amended</u>.

AB 1122 made a conforming amendment to §23811 to facilitate the change in §23801.

<u>Section 24306 of the Revenue and Taxation Code is amended</u>.

Under the Education Code, the Golden State Scholarshare Trust Act creates qualified tuition programs permitted by IRC §529. CTL §§23711 and 24306 address the state income tax implications of IRC § 529 and the Golden State Scholarshare Trust Act. As discussed above under §23711, EGTRRA §402 made numerous changes to IRC §529. CTL §24306 addresses the state income tax effect of IRC §529 and the Golden State Scholarshare Trust Act as they relate to contributions to and distributions from a Golden State Scholarshare Trust Act account. AB 1122 conforms to the EGTRRA substantive and the Job Creation Act of 2002 technical changes to Qualified Tuition Programs with the same effective dates.

<u>Section 24307 of the Revenue and Taxation Code is amended</u>.

The United States Supreme Court ruled in the case of *Gitlitz v. Commissioner* that income from the discharge of indebtedness of an S corporation that is excluded from income is treated as an item of income which increases the basis of a shareholder's stock in the S corporation and allows the suspended corporate loss to pass thru to a shareholder. Thus, under the decision, an S corporation shareholder is allowed to deduct a loss for tax purposes that it did not economically incur.

The Job Creation Act of 2002 provided that income from the discharge of indebtedness of an S corporation that is excluded from the S corporation's income is not taken into account as an item of income by any shareholder and thus does not increase the basis of any shareholder's stock in the corporation. The federal effective date of the provision generally applies to discharges of indebtedness after October 11, 2001. The provision does not apply to any discharge of indebtedness before March 1, 2002, pursuant to a plan of reorganization filed with a bankruptcy court on or before October 11, 2001.

AB 1122 conforms to the Job Creation Act of 2002 change to the discharge of indebtedness of an S corporation. Thus, reversing the Gitlitz decision. This provision would apply for California purposes to discharges of indebtedness after December 31, 2001, in taxable years ending after that date. The provision would not apply to any discharge of indebtedness before March 1, 2002, pursuant to a plan of reorganization filed with a bankruptcy court on or before October 11, 2001.

<u>Section 24343.7 of the Revenue and Taxation Code is amended</u>.

1. AB 1122 conform state law to federal law and deny the deduction of excess compensation for officers (IRC §162(m)) of a publicly-held company. The conformity is accomplished by repealing the exception in the CTL §24343.7(c) to the Internal Revenue Code, and, therefore, compensation paid under a binding written contract in effect on or before February 17, 1993, will not be subject to this limitation.

2. By repealing the exception to federal law in 24343.7(a), AB 1122 conformed California law to existing federal law regarding the denial of the deduction for lobbying expenses (IRC §162(e)).

Section 24357 of the Revenue and Taxation Code is amended.

AB 1122 conformed California law, by adding a reference, to existing federal law regarding the denial of the deduction for contributions made to an organization that used the contribution for lobbying expenses (IRC §170(f)(9)).

Section 24357.9 of the Revenue and Taxation Code is amended.

The Appropriations Act, 2001, extended the deduction for donations of computer technology and equipment (IRC §170(e)(6)) through December 31, 2003, and expands the enhanced deduction to include donations to public libraries. The Appropriations Act, 2001, provides that qualified contributions include gifts made no later than three years after the date the taxpayer acquired or substantially completed the construction of the donated property. Contributions may be made by a person that has reacquired the property (i.e., if a computer manufacturer reacquires the computer from the original user and then contributes it). Such reacquired property must be contributed within three years of the date the original construction of the property was substantially completed. Congress anticipates that for purposes of computing the enhanced deduction for a reacquirer, the Secretary will provide guidance in determining the retail value of donated computers (or other computer technology) in situations in which the number of actual retail sales of used computers similar to those donated is small in relation to the number of such computers that are donated. In addition, the Appropriations Act, 2001, provides that the Secretary may prescribe by regulation standards to ensure that the donations meet minimum functionality and suitability standards for educational purposes.

AB 1122 conformed to the changes made by the Appropriations Act, 2001, to the augmented deduction for corporate contributions of computer technology in taxable years beginning on or after January 1, 2002, and contributions made through December 31, 2003.

Section 24424 of the Revenue and Taxation Code is repealed and added.

The Ticket to Work Act restated present federal law (IRC §264) 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), if in connection with the transfer (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.

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)).

In the case of 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.

In the case of a charitable gift annuity obligation that is issued under the laws of a state that requires, in order for the charitable gift annuity to be exempt from insurance regulation by that state, that each beneficiary under the charitable gift annuity be named as a beneficiary under an annuity contract issued by an insurance company authorized to transact business in that state, then 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 IRC 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.

The IRS Reform Act made technical changes to the Ticket to Work Act provision discussed above.

AB 1122 conforms California law to the Ticket to Work and IRS Reform Acts provisions with respect to transfers on or after January 1, 2002. IRC §264 is now conformed by reference.

Section 24443 of the Revenue and Taxation Code is amended.

By removing the exception to federal law, AB 1122 conformed California law to existing federal law regarding the denial of the club dues expenses (IRC §274(a)(3)).

<u>Section 24661.3 of the Revenue and Taxation Code is added</u>.

AB 1122 conforms to the Tax and Trade Extension Act change to receipt of income under the Federal Agriculture Improvement and Reform Act of 1996 (the FAIR Act).

> Under the Tax and Trade Extension Act 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 §112(d)(2) (allowing receipt of one-half of the annual payment on either December 15th or January 15th of the fiscal year) or §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.

AB 1122 conforms California law with federal law as it relates to farm production flexibility payments with the same effective date with respect to payments received in taxable and income years ending after December 31, 1995.

<u>Section 24667 of the Revenue and Taxation Code is amended</u>.

AB 1122 deleted an obsolete reference to the Tax Reform Act of 1986 §811(e)(2) regarding installment sales.

<u>Section 24685.5 of the Revenue and Taxation Code is added</u>.

The IRS Reform Act provided that for purposes of determining whether an item of compensation is deferred compensation (under IRC Sec. 404), the compensation is not considered to be paid or received until actually received by the employee.

In addition, an item of deferred compensation is not considered paid to an employee until actually received by the employee. The provision is intended to overrule the result in <u>Schmidt Baking Co., Inc. v. Commissioner</u> (1996) 107 T.C. 271. For example, with respect to the determination of whether vacation pay is deferred compensation, the fact that the value of the vacation pay is includible in the income of employees within the applicable 2 1/2-month period is not relevant. Rather, the vacation pay must have been actually received by employees within the 2 1/2-month period for the compensation not to be treated as deferred compensation.

Congress intended that similar arrangements, in addition to the letter of credit approach used in <u>Schmidt Baking</u>, do not constitute actual receipt by the employee, even if there is an income inclusion. Thus, for example, actual receipt does not include the furnishing of a note or letter or other evidence of indebtedness of the taxpayer, regardless of whether the evidence is guaranteed by any other instrument or by any third party. As a further example, actual receipt does not include a promise of the taxpayer to provide service or property in the future (regardless of whether the promise is evidenced by a contract or other written agreement).

In addition, actual receipt does not include an amount transferred as a loan, refundable deposit, or contingent payment. Amounts set aside in a trust for employees generally are not considered to be actually received by the employee.

The provision does not change the rule under which deferred compensation (other than vacation pay and sick pay and deferred compensation under qualified plans) is deductible in the year includible in the gross income of employees participating in the plan if separate accounts are maintained for each employee.

While <u>Schmidt Baking</u> involved only vacation pay and severance pay, there is concern that this type of arrangement may be used to try to circumvent other provisions of the IRC where payment is required in order for a deduction to occur. Thus, Congress expressed its intent that the Secretary will prevent the use of similar arrangements, though no inference was intended that the result in Schmidt Baking is present law beyond its immediate facts or that the use of similar arrangements is permitted under present law.

This provision is effective under federal law for taxable years ending after July 22, 1998. Any change in a taxpayer's method of accounting required by this provision will be treated as initiated by the taxpayer with the consent of the Secretary of the Treasury. Any adjustment required by IRC Sec. 481 as a result of the change will be taken into account for federal purposes over a three-year period beginning with the first year for which the provision is effective.

AB 1122 conforms California law to the federal IRS Reform Act law change as it relates to the accrual of vacation and severance pay for taxable years beginning on or after January 1, 2002. This bill would also require any state adjustment required by IRC Sec.481 as a result of the change to be taken into account over a three-year period beginning with 2002.

Section 24710 of the Revenue and Taxation Code is amended.

The IRS Reform Act provides that certain trade receivables are not eligible for mark-to-market treatment. A trade receivable is covered by the provision if it is a note, bond, or debenture arising out of the sale of goods by a person the principal activity of which is selling or providing nonfinancial goods and services and it is held by such person or a related person at all times since it was issued.

Under the IRS Reform Act, a receivable meeting the above definition is not treated as a security for purposes of the mark-to-market rules (IRC §475). Thus, such receivables are not marked-to-market, even if the taxpayer qualifies as a dealer in other securities. A taxpayer will not be treated as a dealer in securities based on sales to unrelated persons of receivables subject to the new provision unless the regulatory exception for receivables held for sale to customers applies.

The IRS Reform Act provision also applies to trade receivables arising from services performed by independent contractors, as well as employees. Thus, for example, if a taxpayer's principal activity is selling non-financial services and some or all of such services are performed by independent contractors, no receivables that the taxpayer accepts for services can be marked-to-market under the new provision.

Pursuant to the authority granted by IRC §475(g)(1), the Secretary of the Treasury is authorized to issue regulations to prevent abuse of the new exception, including through independent contractor arrangements.

The provision provides that, to the extent provided in Treasury regulations, trade receivables that are held for sale to customers by the taxpayer or a related person may be treated as "securities" for purposes of the mark-to-market rules, and transactions in such receivables could result in a taxpayer being treated as a dealer in securities (IRC §475(c)(1)).

For trade receivables that are excepted from the statutory mark-to-market rules (IRC §475) under the new provision, mark-to-market or lower-of-cost-or-market will not be treated as methods of accounting that clearly reflect income under general tax principles (see IRC §446(b)).

The provision generally is effective for taxable years ending after July 22, 1998. Adjustments required under IRC §481 as a result of the change in method of accounting generally are required to be taken into account for federal purposes ratably over the four-year period beginning in the first taxable year for which the provision is in effect.

AB 1122 conforms California law to federal law as it relates to “mark to market” method of accounting for dealers. This bill would also require adjustments under IRC §481 as a result of the change in method of accounting to be taken into account for state purposes ratably over a three-year period beginning in 2002.

Section 24942 of the Revenue and Taxation Code is amended.

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 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.

AB 1122 conforms state law to the changes made to federal law by Ticket to Work Act 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, 2002.

Section 24949.1 of the Revenue and Taxation Code is repealed and amended.

In 1995, IRC §1033(e) was modified to permit involuntary conversion treatment on livestock lost due to flood or other weather related condition. California conformed to this change beginning in 1998 by adding a new §24949.1. §24949.1 already existed (since 1961) and conformed to IRC §1033 with stand-alone language.

AB 1122 repeals §24949.1 added in 1998, and amended the 1961 version to conform to the federal 1995 change to IRC §1033(e).

This act is effective January 1, 2002.

This act will not require any reports by the department to the Legislature.