

ANALYSIS OF AMENDED BILLAuthor: Klehs Analyst: John Pavalasky Bill Number: AB 115Related Bills: _____ Telephone: 845-5322 Amended Date: May 2, 2005Attorney: Patrick Kusiak Sponsor: _____**SUBJECT:** Conformity Act of 2005**SUMMARY**

This bill would change California's specified date of conformity to federal income tax law from January 1, 2001, to January 1, 2005, and thereby, in general, conform to the numerous changes made in federal income tax law during that four-year period.

SUMMARY OF AMENDMENTS

The May 2, 2005, amendments removed the previous provisions of the bill and added the conformity language discussed in this analysis.

PURPOSE OF THE BILL

According to the author's office, the purpose of the bill is to conform to numerous changes in federal law to simplify the preparation of California income tax returns.

EFFECTIVE/OPERATIVE DATE

This bill is a tax levy. Thus, it would be effective immediately, and unless otherwise specified, it would apply to taxable years beginning on or after January 1, 2005. The provisions of this bill that conform to federal provisions that are subject to the Economic Growth and Tax Relief Reconciliation Act (EGTRRA) termination date would apply to taxable years beginning before January 1, 2011. In addition, the bill specifically provides that conformity to the federal health savings account (HSA) provisions are retroactive and are to be applied to taxable years beginning after December 31, 2003, with amended returns allowed.

POSITION

Pending.

ANALYSISFEDERAL/STATE LAW

Board Position:

<input type="checkbox"/> S	<input type="checkbox"/> NA	<input type="checkbox"/> NP
<input type="checkbox"/> SA	<input type="checkbox"/> O	<input type="checkbox"/> NAR
<input type="checkbox"/> N	<input type="checkbox"/> OUA	<input checked="" type="checkbox"/> PENDING

Department Director

Date

Gerald H. Goldberg

5/10/05

See the Franchise Tax Board's (FTB) annual report titled "Summary of Federal Income Tax Changes – 2004" at <http://www.ftb.ca.gov/law/04fedtax.pdf> for a detailed discussion of federal law prior to the 2004 change as well as the new federal law and state law for each federal provision changed in 2004.

See Attachment I for a detailed description of federal and state law for items that this bill is conforming to that were changed in federal law before 2004. See Attachment II for a detailed explanation of provisions relating to low-sulfur diesel fuel that are the same as AB 810 (Parra) as introduced.

THIS BILL

This bill would change the specified date from January 1, 2001, to January 1, 2005, for taxable years beginning on or after January 1, 2005. Changing the specified date automatically conforms state law to all changes from January 1, 2001, through December 31, 2004, to IRC sections that have been previously incorporated by reference. Thus, California law would conform to most of the changes made to the federal income tax during that four-year period. Also, this bill would waive any penalty for underpayment of estimated tax for the 2005 taxable year resulting from the changes made by this bill.

In addition, this bill would make numerous changes to specifically not conform to or modify certain items in the IRC. Also, numerous technical changes regarding cross references and the deletion of unnecessary language that was used to conform to federal law changes subsequent to January 1, 2001, and prior to January 1, 2005, are being made by this bill.

The following tables list federal Act sections that impact provisions of the Personal Income Tax Law (PITL), Administration of Franchise and Income Tax Laws (AFITL), and Corporation Tax Law (CTL), the beginning page number in the FTB's annual report where that provision is discussed, and whether AB 115 conforms or does not conform to that provision. The federal changes that are not applicable to the PITL, AFITL, and CTL are not listed and are not discussed in this analysis. See the FTB's annual report of federal changes at <http://www.ftb.ca.gov/law/04fedtax.pdf> for a detailed discussion of the federal changes that are not applicable to the PITL, AFITL, and CTL. For certain federal provisions, California law automatically conforms to the federal change and is indicated in the table under the "conforms" column.

Conformity to Provisions Changed in Federal Law Before 2004

Federal Act Section	Description of Provisions	FTB's Annual Report Page No.	Conforms	Does Not Conform
13143	Revenue Reconciliation Act (RRA) of 1993 (PL 103-66) - IRC 469 (c)(7) – Exception to passive loss rules for real estate professionals -- See detailed discussion in Attachment I	-	X	

404	Job Creation and Worker Assistance Act (JCWAA) of 2002 (P.L. 107-147) - Expansion of the exclusion from income for qualified foster care payments – See detailed discussion in Attachment I	-	X	
1201	Medicare Prescription Drug, Improvement, And Modernization Act of 2003 (P.L. 108-173) - Health savings accounts (HSA) – Conformity retroactive to taxable year 2004 with amended returns allowed – See detailed discussion in Attachment I	-	X	

Conformity to the Working Families Tax Relief Act (WFTRA) of 2004 (P.L. 108-311) Applies to Taxable Years Beginning After December 31, 2004

Federal Act Section	Description of Provisions	FTB Annual Report Page No.	Conforms	Does not conform
201-208	Uniform definition of child, etc.	9	X	
306	Extension of expiring provisions-Deduction for corporate donation of scientific property and computer technology	29		X
308	Extension of expiring provisions-Expensing of environmental remediation costs	31		X
314	Extension of expiring provisions-Taxable income limit on percentage depletion for oil and natural gas produced from marginal properties	37		X
320	Disclosures relating to terrorist activities	44	X	
322	Extension of expiring provisions-Availability of medical savings accounts	47	X	
401-408	Technical amendments related to Medicare Prescription Drug, Improvement, and Modernization Act of 2003, Jobs and Growth Tax Relief Reconciliation Act of 2003, Job Creation and Worker Assistance Act of 2002, Economic Growth and Tax Relief Reconciliation Act (EGTRRA) of 2001, Community Renewal Tax Relief Act (CRTRA) of 2000, Taxpayer Relief Act (TRA) of 1997, Small Business Job Protection Act of 1996, and clerical amendments	49	X	

Conformity to the American Jobs Creation Act (AJCA) of 2004 (P.L. 108-357)
 Applies to Taxable Years Beginning After December 31, 2004

Federal Act Section	Description of Provisions	FTB Annual Report Page No.	Conforms	Does not conform
102	Deduction relating to income attributable to domestic production activities	67		X
201	2-year extension of increased expensing for small business	76		X
211	Recovery period for depreciation of certain leasehold improvements and restaurant property	79		X
231-240	S corporation reform and simplification	85	X	
242	Modification of application of income forecast method of depreciation	99		X
243	Improvements related to real estate investment trusts	102	X	
244	Special rules for certain film and television productions	112		X
247	Modification of unrelated business income limitation on investment in certain small business investment companies	116	X	
311	Special rules for livestock sold on account of weather-related conditions	128	X	
312	Payment of dividends on stock of cooperatives without reducing patronage dividends.	130	X	
315	Capital gain treatment under Section 631(b) to apply to outright sales by landowners	134	X	
318	Certain expenses of rural letter carriers	137	X	
320	Exclusion for payments to individuals under National Health Service Corps loan repayment program and certain State loan repayment programs	142	X	
321	Modification of safe harbor rules for timber REITs.	143	X	
322	Expensing of certain reforestation expenditures	147	X	

331	Net income from publicly traded partnerships treated as qualifying income of regulated investment companies	149	X	
335	Charitable contribution deduction for certain expenses incurred in support of native Alaskan subsistence whaling	154	X	
336	Modification of depreciation allowance for aircraft	156		X
338	Expensing of capital costs incurred in complying with Environmental Protection Agency sulfur regulations – Provisions same as AB 810 (Parra) as introduced – See Attachment II for explanation	163	X	
339	Credit for production of low sulfur diesel fuel – Provisions same as AB 810 (Parra) as introduced – See Attachment II for explanation	165	X	
406	Clarification of treatment of certain transfers of intangible property	184		X
407	United States property not to include certain assets of controlled foreign corporation.	186		X
410	Equal treatment of interest paid by foreign partnerships and foreign corporations.	191		X
411	Treatment of certain dividends of regulated investment companies	192		X
412	Look-thru treatment for sales of partnership interests	199		X
413	Repeal of foreign personal holding company rules and foreign investment company rules	201		X
414	Determination of foreign personal holding company income with respect to transactions in commodities	202		X
415	Modifications to treatment of aircraft leasing and shipping income	206		X
416	Modification of exceptions under Subpart F for active financing	201		X
417-418	10-year foreign tax credit carryover; 1-year foreign tax credit carryback - Modification of the treatment of certain REIT distributions attributable to gain from sales or exchanges of United States real property interests	212		X

419	Exclusion of income derived from certain wagers on horse races and dog races from gross income of nonresident alien individuals	216		X
420	Limitation of withholding tax for Puerto Rico corporations	217		X
421	Foreign tax credit under alternative minimum tax	219		X
422	Incentives to reinvest foreign earnings in United States	220		X
423-424	Delay in effective date of final regulations governing exclusion of income from international operation of ships or aircraft - Study of earnings stripping provisions	224		X
702	Exclusion of gain or loss on sale or exchange of certain brownfield sites from unrelated business taxable income	234	X	
703	Civil rights tax relief	242	X	
704	Modification of class life for certain track facilities	245	X	
706	Certain Alaska natural gas pipeline property treated as seven-year property	248	X	
708	Method of accounting for naval shipbuilders	251	X	
709	Modification of minimum cost requirement for transfer of excess pension assets	252	X	
811-820	Provisions relating to reportable transactions and tax shelters	285	X	
831	Treatment of stripped interests in bond and preferred stock funds, etc.	307	X	
833	Disallowance of certain partnership loss transfers	312	X	
834	No reduction in basis under Section 734 of stock held by partnership in corporate partner	319	X	
835	Repeal of special rules for FASITS	321	X	
836	Limitation on transfer or importation of built-in losses	326	X	
838	Denial of deduction for interest on underpayments attributable to nondisclosed reportable transactions	330	X	
839	Clarification of rules for payment of estimated tax for certain deemed asset sales.	331	X	

840	Recognition of gain from the sale of a principal residence acquired in a like-kind exchange within 5 years of sale	333	X	
841	Prevention of mismatching of interest and original issue discount deductions and income inclusions in transactions with related foreign persons	334	X	
842	Deposits made to suspend running of interest on potential underpayments	338	X	
843	Partial payment of tax liability in installment agreements.	342	X	
845	Expanded disallowance of deduction for interest on convertible debt	348	X	
847-849	Reform of tax treatment of certain leasing arrangements	350	X	
882	Treatment of charitable contributions of patents and similar property	363	X	
883	Increased reporting for noncash charitable contributions	366	X	
884	Donations of motor vehicles, boats, and airplanes	369	X	
885	Treatment of nonqualified deferred compensation plans	373	X	
886	Extension of amortization of intangibles to sports franchises	384	X	
888	Modification of straddle rules	387	X	
896	Recognition of cancellation of indebtedness income realized on satisfaction of debt with partnership interest	402	X	
897	Denial of installment sale treatment for all readily tradable debt.	404	X	
898	Modification of treatment of transfers to creditors in divisive reorganizations	405	X	
899	Clarification of definition of nonqualified preferred stock	406	X	
902	Consistent amortization of periods for intangibles	412	X	
903	Freeze of provisions regarding suspension of interest where Secretary fails to contact taxpayer	414	X	
905	Treatment of sale of stock acquired pursuant to exercise of stock options to comply with conflict-of-interest requirements	418	X	

907	Limitation of employer deduction for certain entertainment expenses	424	X	
909	Sales or dispositions to implement FERC or State electric restructuring policy	430		X

PROGRAM BACKGROUND

The PITL and the CTL, in general, conform to the Internal Revenue Code (IRC) either by reference to federal law as of a “specified date” or by stand-alone language that mirrors the federal provision. Currently, California law is conformed to the IRC as of January 1, 2001, unless a specific provision provides otherwise.

OTHER STATES’ INFORMATION

The states surveyed include *Florida, Illinois, Massachusetts, Michigan, Minnesota, and New York*. These states were selected due to their similarities to California’s economy, business entity types, and tax laws.

Research indicated that only *Florida and Illinois* have significantly conformed to the 2004 federal income tax law changes. *Florida* only has a corporation income tax therefore federal changes affecting personal income tax are not applicable.

FISCAL IMPACT

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

SUMMARY OF ECONOMIC IMPACT

Revenue Estimate

Conformity to Provisions Changed in Federal Law Before 2004
 Applies to Taxable Years Beginning On Or After January 1, 2005, Except as Noted

Federal Act Section	Description	(In millions)		
		2005-06	2006-07	2007-08
13143	RRA of 1993 (PL 103-66) - IRC 469 (c)(7) – Exception to passive loss rules for real estate professionals.	-\$35	-\$25	-\$25
404	JCWAA of 2002 (P.L. 107-147) - Expansion of the exclusion from income for qualified foster care payments.	-\$4	-\$3	-\$3
1201	Medicare Prescription Drug, Improvement, And Modernization Act of 2003 (P.L. 108-173) - Health savings accounts. Applies to taxable years beginning after December 31, 2003, with amended returns allowed.	-\$29	-\$18	-\$23

Conformity to the WFTRA of 2004 (PL 108-311)
 And The AJCA (PL 108-357)
 Applies to Taxable Years Beginning On Or After January 1, 2005

Federal Act Section	Provisions	(In millions)		
		2005-06	2006-07	2007-08
WFTRA 201-208	Uniform definition of child, etc.	-\$10	-\$7	-\$7
320	Disclosures relating to terrorist activities	-	-	-
322	Extension of expiring provisions-Availability of medical savings accounts	Baseline loss [1]	Baseline loss [1]	Baseline loss [1]
401-408	Technical amendments	-	-	-
AJCA 231	Members of family treated as 1 shareholder	Baseline loss [1]	Baseline loss [1]	Baseline loss [1]
232	Increase in number of eligible shareholders to 100	Baseline loss [1]	Baseline loss [1]	Baseline loss [1]
233	Expansion of bank S corporation eligible shareholders to include IRAs	Baseline loss [1]	Baseline loss [1]	Baseline loss [1]
234	Disregard of unexercised powers of appointment in determining potential current beneficiaries of ESBT	Baseline loss [1]	Baseline loss [1]	Baseline loss [1]
235	Transfer of suspended losses incident to divorce, etc.	b/	b/	b/
236	Use of passive activity loss and at-risk amounts by qualified subchapter S trust income beneficiaries	b/	b/	b/
237	Exclusion of investment securities income from passive income test for bank S corporations.	Baseline loss [1]	Baseline loss [1]	Baseline loss [1]
238	Relief from inadvertently invalid qualified subchapter S subsidiary elections and terminations	b/	b/	b/
239	Information returns for qualified subchapter S subsidiaries.	b/	b/	b/
240	Repayment of loans for qualifying employer securities	Baseline loss [1]	Baseline loss [1]	Baseline loss [1]
243	Improvements related to real estate investment trusts	b/	b/	b/
247	Modification of unrelated business income limitation on investment in certain small business investment companies	b/	b/	b/
311	Special rules for livestock sold on account of weather-related conditions	-\$1	-\$1	f/
312	Payment of dividends on stock of cooperatives without reducing patronage dividends.	b/	b/	b/
315	Capital gain treatment under Section 631(b) to apply to outright sales by landowners.	b/	b/	b/
318	Certain expenses of rural letter carriers	b/	b/	b/

320	Exclusion for payments to individuals under National Health Service Corps loan repayment program and certain State loan repayment programs	b/	b/	b/
321	Modification of safe harbor rules for timber REITs.	Baseline loss [1]	Baseline loss [1]	Baseline loss [1]
322	Expensing of certain reforestation expenditures	-\$1	-\$1	f/
331	Net income from publicly traded partnerships treated as qualifying income of regulated investment companies	b/	b/	b/
335	Charitable contribution deduction for certain expenses incurred in support of Native Alaskan subsistence whaling	b/	b/	b/
338	Expensing of capital costs incurred in complying with Environmental Protection Agency sulfur regulations. Revenue same as AB 810 (Parra) as introduced. [2]	d/	b/	a/
339	Credit for production of low sulfur diesel fuel. Revenue same as AB 810 (Parra) as introduced. [2]	d/	-\$1	-\$1
702	Exclusion of gain or loss on sale or exchange of certain brownfield sites from unrelated business taxable income	b/	b/	b/
703	Civil rights tax relief	-\$1	-\$1	-\$1
704	Modification of class life for certain track facilities	-\$1	-\$1	-\$1
706	Certain Alaska natural gas pipeline property treated as 7-year property	\$0	\$0	\$0
708	Method of accounting for naval shipbuilders	-\$4	-\$7	-\$6
709	Modification of minimum cost requirement for transfer of excess pension assets.	Baseline loss [1]	Baseline loss [1]	Baseline loss [1]
811-820	Provisions relating to reportable transactions and tax shelters	Baseline gain [1]	Baseline gain [1]	Baseline gain [1]
831	Treatment of stripped interests in bond and preferred stock funds, etc.	e/	e/	c/
833	Disallowance of certain partnership loss transfers	e/ +Baseline gain [1]	e/ +Baseline gain [1]	e/ +Baseline gain [1]
834	No reduction of basis under Section 734 in stock held by partnership in corporate partner	e/	e/	e/
835	Repeal of special rules for FASITS	a/	a/	a/
836	Limitation on transfer or importation of built-in losses	e/ +Baseline gain [1]	\$1 +Baseline gain [1]	\$1 +Baseline gain [1]
838	Denial of deduction for interest on underpayments attributable to nondisclosed reportable transactions	a/	a/	a/
839	Clarification of rules for payment of estimated tax for certain deemed asset sales.	\$2	\$1	-
840	Recognition of gain from the sale of a principal residence acquired in a like-kind exchange within 5 years of sale	\$1	\$1	\$1
841	Prevention of mismatching of interest and original issue discount deductions and income inclusions in transactions with related foreign persons	\$2	\$3	\$1
842	Deposits made to suspend running of interest on potential underpayments	-\$2	d/	d/

843	Partial payment of tax liability in installment agreements.	\$1	c/	f/
845	Expanded disallowance of deduction for interest on convertible debt	\$3	\$3	\$3
847-849	Reform of tax treatment of certain leasing arrangements	\$3 +Baseline gain [1]	\$4 +Baseline gain [1]	\$5 +Baseline gain [1]
882	Treatment of charitable contributions of patents and similar property	e/	e/	e/
883	Increased reporting for noncash charitable contributions	a/	a/	a/
884	Donations of motor vehicles, boats, and airplanes	\$7	\$8	\$8
885	Treatment of nonqualified deferred compensation plans	Baseline gain [1]	Baseline gain [1]	Baseline gain [1]
886	Extension of amortization of intangibles to sports franchises	\$3	\$3	\$1
888	Modification of straddle rules	\$1	\$1	\$1
896	Recognition of cancellation of indebtedness income realized on satisfaction of debt with partnership interest	\$2	\$1	\$1
897	Denial of installment sale treatment for all readily tradable debt.	\$2	\$1	e/
898	Modification of treatment of transfers to creditors in divisive reorganizations	e/	e/	e/
899	Clarification of definition of nonqualified preferred stock	c/	c/	c/
902	Consistent amortization of periods for intangibles	\$5	\$15	\$15
903	Freeze of provisions regarding suspension of interest where Secretary fails to contact taxpayer [2]	\$2	\$2	\$1
905	Treatment of sale of stock acquired pursuant to exercise of stock options to comply with conflict-of-interest requirements	Baseline gain [1]	Baseline gain [1]	Baseline gain [1]
907	Limitation of employer deduction for certain entertainment expenses	\$6	\$6	\$7
	TOTAL (excluding baseline estimates and footnoted estimates)	-48	-15	-22

[1] For baseline estimates see revenue impact discussion in the individual sections.

[2] Estimates based on State data. Otherwise, all estimates are based on Federal pro-rations.

- a/ Insignificant gains of less than \$150,000
- b/ Insignificant losses of less than \$150,000
- c/ Negligible gains of less than \$250,000
- d/ Negligible losses of less than \$250,000
- e/ Minor gains of less than \$500,000
- f/ Minor losses of less than \$500,000

LEGAL IMPACT

This bill contains provisions that would target certain provisions relating to low-sulfur diesel fuel to California.

The U.S. Court of Appeals for the 6th Circuit ruled in *Cuno v. DaimlerChrysler, Inc.* (2004) 386 F. 3d 738 that Ohio's Investment Tax Credit is unconstitutional because it gives improper preferential treatment to companies to locate or expand in Ohio rather than in other states and, therefore, violates the Commerce Clause of the U.S. Constitution. Ohio is seeking review by the U.S. Supreme Court. Although the outcome of this decision and its affects on the income tax credits of other state, including California, is unknown, targeted tax incentives that are conditioned on activities in California may be subject to constitutional challenge.

ARGUMENTS/POLICY CONCERNS

Conforming to federal tax law is generally desirable because it is less confusing for the taxpayer. With conformity, the taxpayer is required to know only one set of rules. Additionally, the taxpayer needs to maintain only one set of books. Conformity also eases the burden of the Franchise Tax Board to administer the law by utilizing many federal forms, instructions, and regulations. In addition, whenever possible the department uses federal information to verify that taxpayers pay the proper amount of tax. This eliminates the need for the taxpayer to submit the same information to both the IRS and the department.

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ATTACHMENT I – CONFORMITY TO PROVISIONS CHANGED IN FEDERAL LAW BEFORE 2004

1. Act Section 13143 – Revenue Reconciliation Act (RRA) of 1993 (P.L. 103-66) - Exception to Passive Loss Rules for Real Estate Professionals

Background

The passive activity loss (PAL) rules limit deductions and credits from passive trade or business activities. Deductions attributable to passive activities, to the extent they exceed income from passive activities, generally may not be deducted against other income, such as wages, portfolio income, or business income that is not derived from a passive activity. A similar rule applies to credits. Deductions and credits that are suspended under these rules are carried forward and treated as deductions and credits from passive activities in the next year. The suspended losses from a passive activity are allowed in full when a taxpayer disposes of his or her entire interest in the passive activity to an unrelated person.

The PAL rules apply to individuals, estates, trusts, closely held C corporations, and personal service corporations. A special rule permits closely held C corporations to apply passive activity losses and credits against active business income (or tax liability allocable thereto) but not against portfolio income.

Passive activities are defined to include trade or business activities in which the taxpayer does not materially participate. Rental activities (including rental real estate activities) are also treated as passive activities, regardless of the level of the taxpayer's participation. A special rule permits the deduction of up to \$25,000 of losses from rental real estate activities (even though they are considered passive), if the taxpayer actively participates in them. This \$25,000 amount is allowed for taxpayers with adjusted gross incomes (AGI) of \$100,000 or less, and is phased out for taxpayers with AGI between \$100,000 and \$150,000.

Federal Law (IRC Section 469(c)(7))

For tax years 1994 and later the RRA of 1993 treats a taxpayer's rental real estate activities in which he or she materially participates as not subject to limitation under the PAL rules if the taxpayer meets eligibility requirements relating to real property trades or businesses in which the taxpayer performs services.

Real property trade or business means any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business.

An individual taxpayer meets the eligibility requirements if both of the following apply:

- More than half of the personal services the taxpayer performs in trades or businesses during the taxable year are performed in real property trades or businesses in which the taxpayer materially participates.
- That taxpayer performs more than 750 hours of services during the taxable year in real property trades or businesses in which the taxpayer materially participates.

In the case of a joint return, the eligibility requirements are met only if either spouse separately satisfies the requirements. Thus, one of the spouses separately must satisfy the requirement with

ATTACHMENT I – CONFORMITY TO PROVISIONS CHANGED IN FEDERAL LAW BEFORE 2004

respect to half of that spouse's personal services and the requirement with respect to 750 hours of services, without regard to services performed by the other spouse. In determining material participation, however, there is no change to the rule that the participation of the spouse of the taxpayer is taken into account.

Current California Law (R&TC Section 17551, 17561, and 24692)

California conforms to the federal PAL rules except for the RRA provision allowing an exception to the general PAL rules for real estate professionals. California also makes the PAL rules applicable to S corporations for purposes of computing the corporation's corporate level tax.

THIS BILL

AB 115 would conform to the changes made to the IRC by the RRA for tax years 2005 and later.

2. Act Section 404 – JCWAA of 2002 (P.L. 107-147) - Expansion of the Exclusion from Income for Qualified Foster Care Payments

Background

Prior to the JCWAA, if certain requirements are satisfied, an exclusion from gross income is provided for qualified foster care payments paid to a foster care provider by either (1) a state or local government; or (2) a tax-exempt placement agency. Qualified foster care payments are amounts paid for caring for a qualified foster care individual in the foster care provider's home and difficulty of care payments. A qualified foster care individual is an individual living in a foster care family home in which the individual was placed by: (1) an agency of the state or local government (regardless of the individual's age at the time of placement); or (2) a tax-exempt placement agency licensed by the state or local government (if such individual was under the age of 19 at the time of placement).

Federal Law (IRC Section 131)

Effective for taxable years beginning after December 31, 2001, the JCWAA made two modifications to the exclusion for qualified foster care payments. First, the JCWAA expanded the definition of qualified foster care payments to include payments by any placement agency that is licensed or certified by a state or local government, or an entity designated by a state or local government to make payments to providers of foster care. Second, the JCWAA expanded the definition of a qualified foster care individual by including foster care individuals placed by a qualified foster care placement agency (regardless of the individual's age at the time of placement).

Current California Law

California is in conformity with federal law as of January 1, 2001, as it relates to the exclusion from gross income of certain foster care payments. California law has not conformed to the changes made to the IRC by the JCWAA.

THIS BILL

ATTACHMENT I – CONFORMITY TO PROVISIONS CHANGED IN FEDERAL LAW BEFORE 2004

AB 115 would conform to the changes made to the IRC by the JCWAA for tax years 2005 and later.

3. Act Section 1201 - Medicare Prescription Drug, Improvement, And Modernization Act of 2003 (P.L. 108-173)

Background

Present federal and state laws contain a number of provisions dealing with the tax treatment of health expenses and health insurance coverage including Archer medical savings accounts (MSA).

Federal Law (IRC Section 223)

Starting in 2004 P.L. 108-173 created HSAs that provide tax-favored treatment, modeled after individual retirement account (IRA) provisions, for current medical expenses as well as the ability to save on a tax-favored basis for future medical expenses.

HSAs are tax-exempt trusts or custodial accounts created exclusively to pay for the qualified medical expenses of the account holder and his or her spouse and dependents. Earnings in the accounts are tax deferred until distribution and, if used for qualified medical expenses, are never taxed. Amounts can be rolled over tax-free into an HSA from another HSA or from an MSA.

Within limits, contributions to HSAs are deductible in the year made if made by or on behalf of an eligible individual and are excludable from gross income and wages for employment tax purposes if made by the employer of an eligible individual on that individual's behalf. Thus, for example, contributions made by an eligible individual's family members are deductible by the eligible individual to the extent the contribution would be deductible if made directly by the eligible individual.

Eligible individuals are defined as individuals who are covered by a "high deductible health plan" that has a deductible of at least \$1,000 for self-only coverage or \$2,000 for family coverage and that has an out-of-pocket expense limit of no more than \$5,000 in the case of self-only coverage and \$10,000 in the case of family coverage. An eligible individual may have no other health plan that is not a "high deductible health plan" except for worker's compensation insurance, tort liability insurance, auto insurance, or other similar liability insurance provided by regulations. In addition, the following types of insurance are permitted and will not disqualify an otherwise eligible individual:

- Insurance for a specified disease or illness.
- Insurance that provides a fixed payment for hospitalization.
- Coverage (whether provided through insurance or otherwise) for accidents, disability, dental care, vision care, or long-term care.

The maximum contribution amount that is deductible is equal to the lesser of the following:

- The deductible amount in the taxpayer's "high deductible health plan."
- The maximum deductible permitted under an MSA, as adjusted for inflation. For 2004, that amount is \$2,600 in the case of self-only coverage and \$5,150 in the case of family coverage.

Contributions in excess of the maximum contribution amount are generally subject to a 6% excise tax.

Distributions from HSAs for qualified medical expenses are not includible in gross income. However, distributions that are not for qualified medical expenses are taxable and also subject to an additional

ATTACHMENT I – CONFORMITY TO PROVISIONS CHANGED IN FEDERAL LAW BEFORE 2004

10% penalty tax. The additional 10% penalty tax does not apply after death, disability, or the individual attains the age of Medicare eligibility (i.e., age 65).

Current California Law

California law is conformed to the federal rules for MSAs and allows a deduction equal to the amount deducted on the federal return. California imposes a 10% additional tax rather than the 15% additional federal tax on distributions from an MSA not used for qualified medical expenses.

However, California has not conformed to any of the federal HSA provisions. The California return starts with federal adjusted gross income (AGI) and requires adjustments to be made for differences between federal and California law. Adjustments relating to HSAs are required under current law, as follows:

- A taxpayer taking an HSA deduction on the federal return is required to increase AGI on the taxpayer's California return by the amount of the federal deduction.
- Any interest earned on the account is added to AGI on the taxpayer's California return.
- Any contribution to an HSA (including salary reduction contributions made through a cafeteria plan) made on the employee's behalf by their employer is not excluded from income and is added to AGI on the employee's California return.

Since a tax-free rollover from an MSA to an HSA is not allowed under California law, any distribution from an MSA that is rolled into an HSA must be added to AGI on the taxpayer's California return. Additionally, under California law that MSA distribution is not treated as being made for qualified medical expenses and is, therefore, subject to the MSA 10% penalty tax.

THIS BILL

This bill would conform California law to the federal HSA provisions retroactively to the 2004 tax year as follows:

1. Allows the same above-the-line deduction of contributions to an HSA by or on behalf of an individual and adopts the rules applicable to the trust itself in order for the trust to be exempt from tax. This bill is not conforming to the federal 6% excise tax on excess contributions and the federal estate tax provisions.
2. Allows the same exclusion from an employee's gross income for the amount of any contributions to an HSA (including salary reduction contributions made through a cafeteria plan) made on the employee's behalf by their employer.
3. Allows rollovers from MSAs to be made to HSAs as well as rollovers between HSAs without penalty.
4. Adopts the same \$50 penalty for failure to make required reports.
5. Adds one year to the normal statute of limitations for initiating a claim for refund with respect to HSAs.

ATTACHMENT II – LOW SULPHUR DIESEL PROVISIONS

Small Refiners Ultra-Low Sulfur Diesel Fuel Credit/Depreciation Deduction

FEDERAL/STATE LAW

Existing federal and state laws require that petroleum refiners produce diesel fuel for use in highway vehicles with a sulfur content of no more than 15 parts per million (ppm) beginning on June 1, 2006. This fuel is known as ultra-low sulfur diesel fuel (ULSD), or low sulfur diesel fuel. State law expands the requirement to also include diesel fuel produced for off-highway use.

The federal American Jobs Creation Act of 2004 (AJCA) (P.L. 108-357) created provisions similar to those proposed in this bill. This federal act permits small business refiners, as defined, to immediately deduct as an expense up to 75% of the costs paid or incurred to comply with federal clean air requirements. The act also provides that a small refiner may claim a credit equal to five cents per gallon of low sulfur diesel fuel produced during the taxable year to a maximum credit of 25% of total costs paid or incurred to comply with clean air requirements. A “small refiner” is defined less restrictively in the AJCA than in AB 115.

Existing federal and state laws generally provide that the basis of property is its cost. Property acquired in a tax-deferred exchange for other property has a basis equal to the basis of the property given up. The original basis of property must be adjusted for expenditures that are properly capitalized, such as improvements, and for other amounts, such as depreciation.

Under prior law, the Manufacturers’ Investment Tax Credit (MIC) was available to taxpayers making capital expenditures for refinery equipment. The MIC statute was repealed by its own terms, due to a reduction in manufacturing sector jobs, and ceased to be operative as of January 1, 2004.

Existing state and federal laws generally allow as a depreciation deduction a reasonable allowance for the exhaustion, wear, tear, and obsolescence of property used in a trade or business or property held for the production of income. A depreciation deduction is allowed for property that will provide economic benefits for more than one year. The depreciation deduction is generally allowed over a period approximating the property’s economic life. As an incentive for businesses to invest in property, occasionally an accelerated depreciation deduction is allowed. That is, a deduction is allowed at a faster rate than the decline in the property’s economic value would warrant.

Existing state and federal laws provide various tax credits designed to provide tax relief for taxpayers that incur certain expenses (e.g., child adoption) or to influence behavior, including business practices and decisions (e.g., research credits or economic development area hiring credits). These credits generally are designed to provide incentives for taxpayers to perform various actions or activities that they may not otherwise undertake.

THIS BILL

1. Environmental Tax Credit

AB 115 would provide a credit in the amount of five cents for each gallon of ultra-low sulfur diesel fuel produced. The taxpayer would have to be a “small refiner,” the refinery would have to be located in California, and the fuel would have to be produced in a taxable year beginning on or after January 1, 2006, and before January 1, 2012.

ATTACHMENT II – LOW SULPHUR DIESEL PROVISIONS

A “small refiner” means a refiner that meets the following conditions:

- Has and at all times had since January 1, 1978, a crude oil capacity of not more than 55,000 barrels per stream day,
- Has not been at any time since September 1, 1988, owned or controlled by any refiner that at the same time owned or controlled refineries in California with a total combined crude oil capacity of more than 55,000 barrels per stream day, and
- Has not been at any time since September 1, 1988, owned or controlled by any refiner that at the same time owned or controlled refineries in the United States with a total combined crude oil capacity of more than 137,500 barrels per stream day.

The aggregate amount of the credit with respect to any facility would be limited to 25% of the qualified capital costs paid or incurred during the applicable period with respect to that facility for items certified by the California Air Resources Board (CARB). The applicable period would begin January 1, 2004, and end on May 31, 2007.

This bill would provide that the CARB must certify that the taxpayer’s capital costs are for compliance with specified U.S. Environmental Protection Agency (EPA) or CARB requirements and that the items for which the capital costs were paid or incurred have been placed in service by the small refiner.

The increase in the basis of any property that might otherwise be increased by a qualified capital cost expenditure would be reduced by any credit allowed.

This bill would allow any unused credit to be carried over a maximum of seven years or until exhausted, whichever occurs first.

This bill requires that a prorated portion of the credit would be recaptured if the facility is sold, transferred, or otherwise disposed of, either directly or indirectly, within five years of the taxable year the taxpayer first claimed the credit.

This bill would repeal the credit provisions on January 1, 2013.

2. Expensing Deduction

AB 115 would allow small refiners, as defined for the environmental tax credit, to elect to deduct, in lieu of depreciation, 75% of the qualified capital costs paid or incurred during the period beginning on January 1, 2004, and ending on May 31, 2007, for items certified by CARB that are placed in service by the taxpayer during the taxable year. The basis of those items would be required to be reduced by the amount deducted during the taxable year.

The deduction would be repealed on January 1, 2009.