This report is submitted in fulfillment of the requirement in Revenue and Taxation Code Section 19270.

Federal Income Tax Changes
1984

Prepared by Staff of the

FRANCHISE TAX BOARD

State of California

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Executive Summary

In 1984 Congress passed and the President signed legislation which significantly revised the Internal Revenue Code (IRC). The legislation included the Deficit Reduction Act of 1984 (Public Law 98-369) which is composed of two parts:

1. The Tax Reform Act of 1984, and

2. The Spending Reduction Act of 1984

and which was designed to raise an estimated $50 billion in federal revenue. The Tax Reform Act of 1984 portion is a massive piece of tax legislation involving hundreds of provisions which span the entire Internal Revenue Code. The Act covers, among other items, provisions that: (1) reduce the benefit of income averaging, (2) completely restructures the tax laws relating to divorce and separation, and (3) close a variety of tax shelters through changes made to accounting, partnership, and corporate tax rules.

The legislation enacted by the federal government in 1984 also included the following:

1. Federal Income Tax Forgiveness for U.S. Military and Civilian Employees Killed Overseas (Public Law 98-259).

2. Retirement Equity Act of 1984 (Public Law 98-397).

3. Child Support Enforcement Amendments of 1984 (Public Law 98-378).

The report that follows explains the federal changes for each item, with a discussion of current California law, if any; and an estimate of the fiscal impact to the state from conforming to the federal change.

These items have been the subject of review by a Federal Conformity Task Force appointed by the Chairman of the Assembly Revenue and Taxation Committee. Their recommendations for action with regards to each item will be submitted to the Assembly Revenue and Taxation Committee in early 1985.

TAX REFORM ACT OF 1984 SECTION 301

Charitable Contributions - Private Foundation
(IRC Section 170)

Summary

The act makes two changes to the amount an individual may deduct when making contributions to private "non-operating" foundations by increasing the percentage of adjusted gross income (AGI) limitation and allowing the amount in excess of the limit to be carried over for five years.

Old Federal Law

In general, a private foundation is an exempt organization organized exclusively for religious, charitable, or educational purposes which is not a church, hospital, school, public charity, and does not receive broad public support. A key test for broad public support is receiving more than one-third of its annual support from the general public and governmental units while not more than one-third of its annual support comes from the sum of gross investment income and unrelated business income. Another important distinction is drawn between a private "operating" foundation and a private "non-operating" foundation. A private "operating" foundation is defined as one that spends at least 85 percent of its income in the active conduct of its exempt activities and has 65 percent of its assets directly devoted to its exempt purpose. Examples of private "operating" foundations are public museums, Colonial Williamsburg, and Jackson Hole Wyoming. All private foundations which are not private "operating" foundations are private "non-operating" foundations.

The distinctions are important since contributions to private "operating" foundations are deductible up to 50 percent of the individual's AGI with the excess amount carried over for five years, while contributions to private "non-operating" foundations are deductible only up to 20 percent of the individual's AGI, and the excess amount may not be carried over.

Current California Law (PITL 17240, 17241)

The California Personal Income Tax Law (PITL) conforms to the federal law prior to the 1984 changes except that the deduction is limited to 20 percent of the California AGI regardless of the type of organization to which the contribution was made. The California carryover applies to the same organizations as the federal, but the amount carried over is the excess over 20 percent of the California AGI.

New Federal Law

1. Increases the limitation from 20 percent of AGI to 30 percent of AGI for contributions of cash and ordinary income property such as inventory and short-term capital gain property made to private "non-operating" foundations. Effective for contributions made in 1984 and thereafter.

2. Allows a five-year carryover period for excess contributions by individuals to private "non-operating" foundations.

Fiscal Impact

The increase in percentage limit together with the 5-year carryover provision would result in annual revenue losses in the $100,000 to $200,000 range, based on proration of federal estimate for the 1984 Tax Reform Act.

TAX REFORM ACT OF 1984 SECTION 301

Charitable Contributions - Capital Gain Property
(IRC Section 170)

Summary

Appreciated property (i.e. property with a current value greater than the owner's basis) is generally deductible at its full fair market value. However, certain limits apply to contributions of capital-gain property, and the deduction may be further reduced when the donation is to a private "non-operating" foundation.

Old Federal Law

Capital-gain property is appreciated property that would give rise to long-term capital gain if it were sold at its fair market value.

If capital-gain property is given to a private "non-operating" foundation, the individual must reduce the deduction for tax purposes by 40 percent of the amount that would have been long-term capital gain if the property had been sold. The 40 percent reduction is equivalent to the amount of the long-term capital gain.

The contribution is further limited to 20 percent of AGI since this is a contribution to a private "non-operating" foundation.

Current California Law (PITL 17240, 17244)

California requires that the reduction be for the amount which would have been included in California income as gain from property held one to five years (65 percent) or over five years (50 percent) instead of the federal 40 percent reduction since California does not conform to federal treatment of long-term capital gain. All charitable contributions in California are limited to 20 percent of state AGI.

New Federal Law

Under the Act, for a ten-year period beginning with contributions made after July 18, 1984, the 40 percent reduction does not apply where "qualified appreciated stock" is contributed to a private non-operating foundation. Therefore, the contribution can be valued at its full fair market value. The maximum limit of 20 percent of AGI would still apply.

"Qualified appreciated stock" is any stock of a corporation for which (as of the date of contribution) market quotations are readily available on an established securities market and which is long-term capital-gain property.

The full fair market value contribution applies only to the extent that all prior donations by the donor to all private "non-operating" foundations of stock in a particular corporation are less than 10 percent of the value of all outstanding stock of that corporation. For this purpose, a donor is treated as making contributions that are made by any member of his/her family.

Fiscal Impact

Allowing full fair market value to "qualified appreciated stock" instead of reducing the deduction by either 65 percent or 50 percent of the capital gain (depending on the length of time the stock was held) for tax purposes would result in a minor loss of revenue annually, less than $100,000, based on the federal estimate for the 1984 Tax Reform Act.

TAX REFORM ACT OF 1984 SECTION 1031

Charitable Contributions - Mileage
(IRC Section 170)

Summary

A charitable deduction is allowed for the cost of using an individual's vehicle for charitable purposes, but the rate per mile is not specified in the Internal Revenue Code.

Old Federal Law

The statute allows a deduction for unreimbursed traveling expenses, automobile expenses for gasoline and oil (but not depreciation), and other expenses directly connected with and due solely to the donated services. In lieu of itemizing expenses, IRS administrative procedures allow a deduction of 9 cents for each mile driven in rendering the donated service.

Current California Law (PITL 17242)

California specifies in its statute that the deductible charitable mileage rate is 10 cents per mile unless the federal mileage rate is greater, in which case the state rate is increased to the federal rate. This provision is scheduled to sunset on January 1, 1985.

New Federal Law

Codifies the allowable mileage rate for contributions and sets the rate, beginning in 1985, at 12 cents per mile. The 1984 rate established by the IRS is 9 cents per mile.

Fiscal Impact

An increase in the mileage rate from 10 cents to 12 cents beginning in 1985 would result in annual revenue losses in the million dollar range. This estimate is consistent with the estimate for SB 2132 (Presley, 1983-84 R.S.) which provided for a 20.5 cent rate and is also corroborated by proration of the federal estimate for the 1984 Tax Reform Act.

TAX REFORM ACT OF 1984 SECTION 1035

Charitable Contributions - Qualified Conservation Contributions (IRC Section 170)

Summary

The Act creates a narrow exception to the general rule precluding any deduction for a conservation contribution if there is any possibility of surface mining occurring at any time on the land to which the contribution relates. This exception would allow the deduction if the mineral interest had been separated by contract before June 13, 1976, and if the probability of surface mining on the property is so remote as to be negligible. This would apply to contributions made after July 18, 1984.

Old Federal Law

As a general rule, a deduction is not allowed for contributions to charity of less than the taxpayer's entire interest in the contributed property. An exception to the general rule is provided in the case of qualified conservation contributions. The Tax Reform Act of 1976 provided the explicit statutory provisions for deductible "conservation contributions" which were modified and made permanent in 1980. In order to qualify under this exception the contribution must (1) be made to a governmental unit or a publicly supported charity, (2) be exclusively for conservation purposes, and (3) be a qualified real property interest.

A qualified real property interest may be the taxpayer's entire interest in the property other than the mineral rights, a remainder interest in the property, or a restriction (granted in perpetuity) on the use which may be made of the real property.

However, in any conservation contribution where the mineral interest is not going to the donee as part of the contribution, surface mining of the minerals must be precluded before the deduction is allowed.

Current California Law (PITL 17240, B&CTL 24357, 24357.2, 24357.7)

The California Personal Income Tax Law and Bank and Corporation Tax Law were amended in 1982 to allow the deduction for conservation contributions under the same conditions as old federal law.

New Federal Law

The Act allows a deduction for conservation contributions after July 18, 1984, where surface mining is not completely precluded on the donated surface property.

This exception is allowed only where the surface and mineral rights were separated before June 13, 1976, the contribution would qualify in all other respects as a conservation contribution, and the probability of surface mining occurring on the property is so remote as to be negligible. The IRS is to make regulations defining the circumstances which qualify for this treatment.

Fiscal Impact

Qualified Conservation Contributions Changes: conformity would result in annual revenue losses in the $100,000 range, based on proration of federal estimates for the 1984 Tax Reform Act.

TAX REFORM ACT OF 1984 SECTION 155

Charitable Contributions - Special Substantiation Requirements for Large Contributions
(IRC Section 6050L, 6652, 6678, 6659, 6660)

Summary

All property contributions made after 1984 (except securities readily tradeable on an established exchange market) where the claimed value is over $5,000 ($10,000 in the case of stock) must be supported by a written independent appraisal obtained prior to the filing of the return claiming the charitable contribution. The donor must attach a summary of the written appraisal signed by the appraiser, and acknowledged by the donee, to his/her return and must list the appraiser's tax identification number. The donor must also include in his/her return statements of the cost and acquisition date of the donated property.

Old Federal Law

For non-cash contributions the taxpayer must attach a statement to the return claiming the deduction giving the details of the gift (description, date, manner of valuation).

For each gift valued at over $200 and each gift of capital gain or ordinary income property, the taxpayer must include additional information which:

1. Explains any conditions attached to the gift,

2. Tells how the property was acquired, and

3. Shows the cost or other basis, if the gift valued at over $200 has been owned less than five years or if the gift is capital gain or ordinary income property.

In addition, a signed copy of any appraisal must be attached and, if the election to reduce the deduction for contribution of capital gain property is being made, it must be attached to the return along with a computation showing the amount of the reduction.

Reliable written records are required to be maintained by the taxpayer in addition to receipts.

The deduction for ordinary income property is limited to the property's basis. Examples of ordinary income property are inventory, capital assets held one year or less, letters and memoranda, and other property which, if sold, would give rise to ordinary income.

Capital gain property is appreciated property (value greater than basis) that would give rise to long-term capital gain if sold at its fair market value. The deduction for capital gain property given to a private foundation is determined by subtracting 40 percent of the appreciation (capital gain) from the fair market value.

The contribution deduction for capital gain property which is tangible personal property (movable assets) is normally its fair market value. However, if the use by the donee of the contributed property is unrelated to the donee's exempt function, then the deduction is limited to the fair market value less 40 percent of the appreciation (capital gain).

A taxpayer can elect to reduce all contributions of capital gain property by 40 percent of the appreciation (capital gain) and thereby receive a more liberal percentage of AGI limitation (50 percent versus 30 percent) for all contributions of capital gain property.

Current California Law (PITL 17240, 17241, 17244, B&CTL 24357, 24357.1)

The Personal Income Tax Law (PITL) generally conforms to old federal law except that the maximum yearly deduction is 20 percent of California AGI and the capital gain reductions are for the amount which would have been included in California income as gain from property held one to five years (65 percent) or over five years (50 percent) instead of the federal 40 percent reduction.

The Bank and Corporation Tax Law (B&CTL) limits the corporate deduction for contributions of appreciated property to fair market value less 100 percent of the gain that would have arisen had the property been sold at its fair market value (determined at the time of contribution).

New Federal Law

The Treasury Department is required to issue regulations before January 1, 1985, which require (before a deduction is allowed) individuals, partnerships, small business corporations, personal service corporations, and closely held corporations to obtain and retain a qualified written appraisal by a qualified appraiser for the property donated and attach a signed appraisal summary to the return on which the deduction is first claimed.

These donor appraisal requirements will apply if the amount claimed as a charitable deduction exceeds $5,000 for any single item of property ($10,000 in the case of donated stock other than publicly traded securities), or in the aggregate for similar items of property (such as a group of stamps or coins, lithographs, or books) whether donated to one or more donees. These provisions apply to charitable contributions made after December 31, 1984.

Fiscal Impact

The requirement to obtain and furnish independent appraisals of the fair market value of large contributed property claimed as a deduction on the return will result in revenue of an unknown amount.

TAX REFORM ACT OF 1984 SECTION 155

Charitable Contributions - New Reporting Requirement Penalty for Failure to File
(IRC Section 6050L, 6652, 6678, 6659, 6660)

Summary

For those contributions of property subject to the new donor appraisal requirements, a new information return is required when the donee charity sells the property contributed within two years of its receipt. The information return must be sent to both the donor and the Internal Revenue Service (IRS). The penalty for failure to file the return with the IRS is set at $50 per failure, up to $50,000. Failure to furnish the statement to the donor is set at $50 per failure, up to $50,000. Reasonable cause will excuse both penalties.

Old Federal Law

None.

Current California Law

None.

New Federal Law

If the donee charity disposes of the property for which the donor has claimed a deduction for more than $5,000 (including non-publicly traded stock) within two years of receipt, it must file an information return with the IRS and furnish the donor a statement giving the donor's name, identification number, a description of the property, the date of contribution, the amount received on disposition and the date of disposition.

This information reporting requirement applies to charitable contributions subject to the donor appraisal requirements made after December 31, 1984.

A new penalty for failure to file the information return with the IRS is imposed on the donee. The amount is $50 per failure not to exceed $50,000 yearly. The penalty can be waived if there is reasonable cause for the failure to report.

A new penalty for failure to send the written statement to the donor is imposed on the donee. The amount is $50 per failure not to exceed $50,000. The penalty can be waived if there is reasonable cause for the failure to provide that statement.

Fiscal Impact

The new information reporting requirements and penalties for failure to furnish the returns or statements will result in revenue of an unknown amount.

TAX REFORM ACT OF 1984 SECTION 155

Charitable Contributions - Penalty for Valuation Overstatements (IRC Section 6659)

Summary

For returns filed after 1984, the penalty for valuation overstatements is expanded to cover property which the taxpayer has held over five years, and a special rule is provided for valuation overstatements which result in the overstatement of charitable deductions. If the donor's claimed value exceeds 150 percent of the property's correct value, then the penalty is 30 percent of the resulting underpayment of tax. The valuation penalty is extended to cover undervaluation of assets for federal estate and gift tax purposes.

Old Federal Law

The penalty for overstatement of valuation can be applied if a tax deficiency of $1,000 or more results from an overvaluation of donated property, and the property involved was acquired by the taxpayer within the five preceding years, and the valuation claimed is 150 percent or more than its correctly determined value or adjusted basis (whichever was claimed on the return). All or any part of the penalty may be waived upon the taxpayer's showing that a reasonable basis existed for the valuation claimed on the return, and that the claim was made in good faith.

The penalty percentages applicable are determined by the following table:

Claimed Value as a % of Correct Value	Percentage of Resulting Underpayment
Under 150% ...	0
150% but not more than 200% ...	10
Over 200% but not over 250% ...	20
Over 250% ...	30

Current California Law (PITL 18699)

California is in conformity with the provision for valuation statements in old federal law with the same penalty percentages and requirements.

New Federal Law

For returns filed after December 31, 1984, the penalty for valuation overstatements is expanded to apply to property held by the taxpayer for more than five years, and a specific penalty is imposed for the overstatement of a charitable deduction due to a valuation overstatement. If the donor's claimed value exceeds 150 percent of the property's correct value, the penalty is 30 percent of the underpayment of tax attributable to the overstatement of the charitable deduction. The Act allows the penalty to be waived only under limited circumstances where the Secretary determines that:

1. The claimed value was based on a qualified appraisal made by a qualified appraiser, and

2. In addition to obtaining the appraisal, the taxpayer made a good faith investigation of the value of the contributed property.

The Act also extends the valuation penalty to undervaluation of assets for estate and gift tax purposes.

Fiscal Impact

Revenues from additional penalties resulting from federal conformity are unknown.

TAX REFORM ACT OF 1984 SECTION 156

Appraisers Aiding or Assisting in Understatement of Tax Liability
(U.S. Code Title 31, Section 330)

Summary

A new provision is enacted which allows the IRS to disregard appraisals made by a professional appraiser who has been assessed a penalty for aiding or assisting in the preparation or presentation of an appraisal which results in the understatement of tax liability. This is in addition to the penalty assessed against the appraiser for such activities.

Old Federal Law

None.

Current California Law

None.

New Federal Law

Adds a provision which provides that any professional appraiser who has been assessed a penalty for aiding or assisting in the preparation or presentation of an appraisal resulting in an understatement of tax may be barred from appearing before the IRS for the purpose of offering an opinion on the value of property or other assets and gives the IRS discretion to disgard appraisals made by the appraiser in any administrative proceedings before the IRS or the Treasury Department.

These new rules apply to penalties assessed after July 18, 1984.

Fiscal Impact

Revenues resulting from federal conformity are unknown.

TAX REFORM ACT OF 1984 SECTION 311

Exempt Organizations - Unrelated Trade or Business Income - Gambling (IRC 153)

Summary

The Act exempts games of chance (gambling) conducted by exempt organizations after June 30, 1981, from the tax on unrelated trade or business income if a state law was in effect on October 23, 1983, which permitted the conducting of games of chance by the nonprofit organization, although it would have been illegal for any other organization to conduct such an event.

Old Federal Law

Otherwise tax-exempt organizations are taxed on their unrelated trade or business income. An unrelated trade or business includes any type of activity carried on to produce income, when the activity is unrelated to the purposes that entitle them to exemption. It does not make a difference whether or not the activity is profitable, the organization's need for the money, or how it uses the profits from the activity -- the trade or business could still be "unrelated". Conducting bingo games is specifically not included in the term "unrelated trade or business", so income from that activity is currently exempt.

Current California Law (PIT Sections 17631-17651, B&CT Sections 23710, 23731-23741)

Generally, California has the same rules related to "unrelated business income" including an exemption for bingo games, but the tax rate on the taxable unrelated business income for corporations and associations is the corporate tax rate while trusts are subject to the tax rates imposed under the personal income tax law for a single individual.

All income from unrelated trade or businesses has to be reported on the California return. If it is derived from sources within or without California an apportionment of income is required. For trusts which have unrelated trade or business income from sources without California, the trust must report the same proportion of the income as the number of resident trustees bears to the total number of trustees. Also, where a part or all of the unrelated trade or business income is taxed by more than one state, California or the other state may allow a tax credit for that portion of the income which is subject to taxation by another state.

There is no specific statute in California which makes games of chance illegal except for those conducted by exempt organizations.

New Federal Law

A provision of the Act exempts certain games of chance conducted after June 30, 1981, from the term "unrelated trade or business" when conducted by a nonprofit organization. Specific facts which exist as of October 23, 1983 must be met to qualify. Those facts are:

1. There was a State law in effect which permitted the conducting of the game of chance by the nonprofit organization, but

2. The conducting of the game of chance by organizations which were not nonprofit organizations would have violated State law.

This uncodified rule applies to games of chance conducted after June 30, 1981, in taxable years ending after that date.

Fiscal Impact

No revenue impact. It appears that California does not meet the requirements for this general "games of chance" exemption.

TAX REFORM ACT OF 1984 SECTION 1032

Exempt Organizations - Educational Purpose - Day Care
(IRC Sections 501(k), 170(k), 2055, 2522)

Summary

A technical definitional difficulty exists with the term "educational purpose" as currently defined. It centers around whether certain nonprofit day care centers that provide after-school care to children or care for infants or toddlers met the statutory requirements for tax-exempt status and eligibilty for tax-deductible contributions as educational or charitable organizations.

Current California Law (PIT Section 17201, B&CTL Section 23701d)

Both the IRS and the Franchise Tax Board now permit exemptions to day care centers that meet the conditions of this new federal subsection.

New Federal Law

The Act adds a new subsection which clarifies the provisions that allow certain day care facilities to be nonprofit organizations with tax-exempt status as an educational organization.

Fiscal Impact

No revenue effect. Tax-exempt status and the deductibility of contributions are already allowed.

TAX REFORM ACT OF 1984 SECTION 1033

Church Tax Inquiries and Examinations
(IRC Sections 7611, 7428, 7605)

Summary

The Act specifies in the Internal Revenue Code rather than by regulation the procedures for conducting a civil investigation of a church.

Old Federal Law

The Congress in 1970 enacted restrictions on the examination of churches by the Internal Revenue Service. The Internal Revenue Service, through regulation, placed further administrative restrictions on these examinations.

Current State Law

California has never enacted comparable sections.

New Federal Law

The Act embodies, in large part, current IRS guidelines and applys only to civil, not criminal investigations of churches. These codified rules require the IRS to:

1. Give more detailed notice to the organization prior to beginning an investigation,

2. Offer the organization a pre-examination conference, and

3. Complete any audit of church tax liability within two years after commencing an investigation.

Fiscal Impact

Adopting these new federal guidelines would make state examinations more tedious and protracted resulting in revenue losses. These losses would probably be rather minor, less than $100,000 annually.

TAX REFORM ACT OF 1984 SECTION 1034

Exempt Organizations - Exemption for Unrelated Debt-Financed Income - Pension Trusts and Educational Institutions
(IRC Sections 514, 511, 512, 513)

Summary

The Act provides a special exception for educational institutions from application of the tax on unrelated business income which was previously available only to pension trusts. This exception allows income from property held by the pension trust or educational institution to be exempt income even though the property held to produce the income was aquired by borrowing the money rather than from the organization's funds.

The committee reports indicate the intent to recognize that small tax-exempt organizations are precluded from investing in real estate because of the large capital requirements and now should be allowed to pool their resources in order to invest in real estate.

Old Federal Law

An organization, including any qualified pension trust, that is otherwise exempt from tax generally is taxed on income from trades or businesses that are unrelated to the organization's exempt purpose. Specific exclusions are provided for certain types of income, including rents, royalties, dividends, and interest.

Present law provides that an exempt organization's income from "debt-financed property" generally is subject to tax as unrelated business income (UBI) in the proportion to which the property is financed by debt. Debt-financed property is defined as any property held to produce income with respect to which there is acquisition indebtedness at any time during the taxable year, or during the 12 months prior to disposition if the property is disposed of during the taxable year. A debt constitutes acquisition indebtedness if the debt was incurred in acquiring or improving the property, or if the debt would not have been incurred but for the acquisition or improvement of the property.

Present law provides an exception to the rule requiring taxation of debt-financed property. Under this exception, indebtedness incurred by a qualified pension trust as a result of the acquisition or improvement of real property is not considered "acquisition indebtedness." Thus, income or gain received from, or with respect to, that debt-financed real property is not treated as arising from debt-financed property. There are five specific requirements that must be met before the exception will apply.

Current State Law (PIT Sections 17631-17651, B&CTL Sections 23403, 23710, 23731-23741)

California has rules substantially the same regarding the taxing of UBI, however, California did not adopt the exception from UBI tax for real property acquired by a qualified trust, and income from that property is treated as arising from debt-financed property.

New Federal Law

The Act provides treatment similar to the pension trust exception to which California did not conform, to educational institutions qualifying to receive charitable contributions (or any private foundation affiliated with and organized to support such an educational institution). The Act prohibits the seller from providing any type of financing for the transaction under any circumstances.

Fiscal Impact

Based on federal estimates for the 1984 Tax Reform Act, conforming to the special exception from the UBI tax for educational institutions would result in state revenue losses in the $1 - $2 million range annually. If the state also conformed to the pension trust exception on debt-financed property acquisition, the combined revenue loss would probably be in the $2 - $4 million range annually.

TAX REFORM ACT OF 1984 SECTION 1079 \ 2318

Tax Exemptions for Federal Organizations - Central Liquidity Facility (IRC Section 501)

Summary

The Act requires that income tax exemptions for federal organizations be contained in the Internal Revenue Code.

Old Federal Law

Income tax exemptions for federal organizations have in several instances been in the code establishing the organization but not in the Internal Revenue Code.

Current State Law (B&CTL Sections 23701, 23731, 23701a and 23701t)

California generally has exemptions for the same type of organizations as are contained in the Internal Revenue Code with minor differences. When federal law pre-empts state income taxation no State statute is required.

New Federal Law

The Act provides that future tax exemptions must be provided in the Internal Revenue Code rather than in another federal law. The Central Liquidity Facility of the National Credit Union Administration is defined as an exempt organization. Interest income from bonds or other secrities issued by this organization is subject to federal income tax but not to state and local taxation, other than gift, estate, inheritance, or other wealth transfer taxes.

Fiscal Impact

No revenue effect. Exemptions would apply under state law.

TAX REFORM ACT OF 1984 SECTIONS 302-310, 312-314

Private Foundations - Imposition of Excise Taxes
(IRC Sections 507, 4940-4948, 4962-4963, 6104, 6213, 6501, 6503)

Summary

The Act extensively revises the excise tax imposed on private foundations making the taxes less severe, but even more complex. The Act reduces from 2 percent to one percent the excise tax on the investment income of a private foundation.

Old Federal Law

The Tax Reform Act of 1969 established Chapter 42 of the Internal Revenue Code to govern virtually every aspect of a private foundation's activities. This chapter also imposes an excise tax of 2 percent on a foundation's investment income.

Current California Law (B&CT Sections 23707-23709)

I. An organization which receives private foundation status for federal purposes is automatically a private foundation under California law. This results from a provision in B&CTL Section 23708(f) which states that, notwithstanding the California requirements with regard to special rules with respect to private foundations, if the organization meets the requirements under federal law, they are deemed to be met for state purposes.

II. California has never conformed to the imposition of excise taxes on private foundations. In order to limit the impact of these excise taxes and allow a 50 percent contribution limit for certain donations, the federal law contains a subcategory of private foundations called private operating foundations. California has no need for this subcategory since it imposes no excise tax and all contributions are limited to 20 percent of the federal contribution base.

III. Flagrant involvement in prohibited activities is cause for federal termination of exempt status and the imposition of tax on all income received by the organization since its inception. It is, thus, treated as never having been exempt and is also required to pay the taxes that would have been paid by donors who deducted contributions to the organization. State law provides two methods for termination of exempt status:

1. Federal revocation of exempt status, and

2. Action of the California Attorney General.

New Federal Law

The Tax Reform Act of 1984 contains the most extensive revision of the private foundation laws since the Tax Reform Act of 1969. It represents the culmination of a process that began with a series of legislative hearings devoted to the determination of whether the rules enacted by the 1969 Act continued to ensure (without imposing unnecessary or unduly burdensome restrictions) that only those private foundations operating for the public benefit enjoy favorable tax treatment. Almost without exception all federal changes related to private foundations involve the sections of the IRC which impose excise taxes making the taxes somewhat less severe and even more complex. The Act reduces from 2 percent to one percent the excise tax on the investment income of a private foundation.

Fiscal Impact

If the state adopted the federal one percent excise tax on private foundations through an exchange of information arrangement, annual revenues would be in the $10 million range based on a proration of federal estimates for the 1984 Tax Reform Act.

TAX REFORM ACT OF 1984 SECTION 411-414

Estimated Income Tax for Individuals
(IRC Sections 6015, 6073, 6153, 6654, 7701(a)(34), 871(g), 1403(b), 6012(b)(2), 6020(b)(1), 6201(b), 6362(e)(5), 6601(h), 6651(d), 7203, 7216(a))

Introduction

Both state and federal law generally require payment of quarterly estimated taxes if withholding does not produce a certain level of tax payment during the tax years. However, entirely different rules apply to determine whether a taxpayer is exempt from the quarterly estimated payment requirement. In addition, both laws provide for underpayment penalties unless certain exceptions are met. Also, state law requires the submittal of a declaration and payment, while federal law requires only a payment.

Summary of 1984 Changes

The Act changes the annual estimated tax payments required to avoid the underpayment penalty from 80 percent of an individual's final income tax for the tax year to the lesser of 80 percent of the final income tax for the tax year or 100 percent of the tax shown on the prior year's return. In addition, no penalty will be assessed if the installment is based on 80 percent of the tax computed by placing on an annual basis the taxpayer's taxable income, alternative minimum tax, and adjusted self-employment income received before the installment due date. The proper method of annualizing income will be specified by IRS regulations. The two categories of individuals who are automatically exempt from federal estimated tax payments remain the same (i.e. an individual whose tax liability is less than $500 for the tax year and an individual who had no tax liability in the prior year). All other exceptions to the underpayment penalty have been eliminated. The Act also consolidated these provisions into one section and eliminated obsolete language.

Old Federal Law

The general federal rule is that at least 80 percent of an individual's final income tax must be paid through either withholding or estimated tax payments.

Individuals are exempted from estimated tax payments when their tax (reduced by withholding) is less than a minimal amount ($300 in 1983, $400 in 1984 and $500 in 1985 and thereafter), or when they had no tax liability for the preceding taxable year.

There are four exceptions to the underpayment penalty for those individuals who are not exempt from the tax. No penalty is imposed upon a taxpayer if total tax payments for the year (withholding plus estimated tax payments) equal or exceed an installment based on:

1. The preceding year's tax liability, if a return showing a liability for tax was filed the preceding year, or

2. Eighty percent of the taxes which would be due if the income already received during the year were placed on an annual basis, or

3. Ninety percent of the tax which would be due on the income actually received from the beginning of the year to the computation date, or

4. The tax computed by using the facts shown on the prior year's return under the current year's tax rates and exemptions.

The IRS, in 1983, took the position that where a taxpayer with an overpayment of tax from a prior year files a timely return pursuant to an extension of time to file, the crediting of the overpayment to the current year's estimated tax liability could not be made prior to the date the return was filed and the taxpayer made the election to apply the overpayment to estimated tax.

The alternative minimum tax on tax preference was not part of the base for estimated tax.

Federal law does not require the filing of a declaration of estimated taxes, but payment of estimated taxes is required.

Current California Law (PIT Sections 18415, 18685.05, 18685.8, 18685.9)

California law requires personal income taxpayers to file a declaration of estimated taxes and to pay estimated tax, unless exempted by any one of the following:

1. The actual tax for the preceding year or the current year is $100 or less ($50 for a married person filing separately).

2. Eighty percent of the actual tax for the preceding year was covered by the year's withholding.

3. Eighty percent of the actual tax for the current year is covered by withholding.

4. Eighty percent of adjusted gross income for the current year consists of wages subject to withholding (provided a correct withholding exemption certificate is filed).

California has the same four exceptions to the underpayment penalty as old federal law for those individuals who are not exempt from the tax.

California did not follow the IRS position relating to the crediting of overpayments on returns filed under extensions and allowed taxpayers to elect to credit an overpayment to an installment payment of estimated tax prior to the filing of the return.

California does not have an alternative minimum tax but has an "add on" tax on preference income which is not part of the base for estimated tax.

New Federal Law

The Act makes a number of modifications to the present law requirement, consolidates all the rules into one section of the Code, and eliminates obsolete language relating to declarations of estimated tax.

1. Two of the four exceptions to the underpayment penalty were eliminated starting in 1985. The two which were eliminated are the 90 percent rule and using the prior year's income and the current year's rates and exemptions. (Items 3 and 4 under old federal law above). The two remaining exceptions are the "80 percent annualization" rule and using "last year's" tax as this year's tax. In addition, if the installment is based on 80 percent of the tax shown on the return for the current tax year, no penalty will apply.

2. As of 1/1/84 taxpayers may elect to credit an overpayment of tax to next year's estimated tax, even if the installment payment was due before the return, under extension, was filed and can disregard the position of the IRS.

3. Any underpayment penalty for the fourth installment (January 15 of the following year) will be avoided if the taxpayer files his/her tax return on or before January 31 of the year following the tax year and pays the full amount of tax due.

4. Effective for years beginning after 12/31/83, the IRS now has the authority to waive the underpayment penalty, if the underpayment is due to casualty, disaster, or other unusual circumstance. It can also waive the penalty for cause during the first two years after a taxpayer reaches age 62 or becomes disabled.

5. Starting in 1985, taxpayers who pay an alternative minimum tax are now required to include the alternative minimum tax in their estimated tax payments, just as individuals subject to other income taxes are required to do.

Fiscal Impact

Conformity to the higher federal ($500) tax threshold amounts for required estimated tax payments would decrease revenue on a cash flow basis by $43 million in 1985-86 based upon federal estimates for the 1981 Economic Recovery Tax Act.

Based on federal estimates for the 1984 Tax Reform Act, conforming to the penalty revisions would result in net revenue gain of a minor amount, probably less than $100,000 annually.

TAX REFORM ACT OF 1984 SECTIONS 127-130

Foreign Persons - Lenders and Investors
(IRC 163(e)(3), 871(a)(1)(c)(h), 881(a)(3)(c), 6039C(e)(2), 864(c)(2), 1441(c)(9), 1442(a), 1445, 2105(b), 871(g))

Summary

The Act makes four changes to provisions relating to the taxation of foreign individuals and corporations. First is the repeal of the 30 percent withholding tax on interest from sources within the U.S. Second, the amortization rule for original issue discount bond (OID) income is made applicable to foreign persons, and the deduction of interest payments is tied to the reporting of the income from the bond. Third, information reporting of U.S. real property sales by foreign persons is replaced with a withholding system. Fourth, corporations created or organized in Guam or the Virgin Islands must withhold on foreign investors in the same manner as other U.S. corporations.

Old Federal Law

1. The federal law imposed a 30 percent withholding tax on nonresident alien individuals and foreign corporations upon receipt of income (such as interest on portfolio debt) from sources within the United States.

2. The changes made to the original issue discount rules (OID) and stripped bonds and coupons in 1982 by TEFRA did not specifically apply to foreign investors. In general, the method for amortizing original issue discount was changed to parallel the way interest would accrue through barrowing with interest paying nondiscount bonds. Also the basis of the bonds were required to be allocated between the coupons and the bonds when the coupons have been separately sold (stripped).

3. Enforcement of the 1980 Foreign Investment in Real Property Tax Act (FIRPTA) provisions imposing tax on the gain realized by foreign persons on the disposition of U. S. real property interests was through a system of information reporting.

4. Corporations created or organized in, or under the laws of, Guam or the Virgin Islands were not included within the application of the 30 percent withholding tax on passive income payments of U.S. Source income.

Current California Law (PITL 17201, 18805, 18815, 18817, 18819, 17951-17954, B&CT 26131-26132, 24344, 24344.5, Reg (8805(a), LR 372, 1-22-74)

California taxes nonresident individuals on income from California sources. There is no counterpart to the 30 percent withholding tax on passive income since, for California tax purposes, it is considered passive income and taxable by the state of residence.

If the issuer of the bond is located in California, then the amounts applicable to the payment of interest on the bond are deductible under the taxpayer's normal method of accounting (i.e. cash or accural).

California is in conformity with the federal provisions relating to registration required bonds, OID and stripped bonds and coupons.

California law requires that owners and transferors of an interest in real property (except one with a homeowner's exemption) to file an information return providing their social security number (if an individual) or federal employer identification number (if not an individual) within 60 days of a request by the Franchise Tax Board. The Franchise Tax Board can require the withholding at source of California source income including income from real estate transactions.

New Federal Law

1. The Act repeals the 30 percent withholding tax on interest on portfolio indebtedness (on obligations issued after the date of enactment) paid by U.S. borrowers to nonresident aliens and foreign corporations.

2. The Act makes the OID and coupon stripping rules specifically applicable to foreign investors. Also, a provision is added which postpones any OID deductions when there is failure to pay interest on OID obligations to related foreign persons.

3. The Act replaces the system of information reporting relating to sales of U.S. real property interests by foreign persons with a withholding system. When a U.S. real property interest is acquired from a foreign person, the transferee must withhold the smaller of 10 percent of the amount realized on the disposition or the transferor's maximum tax liability (determined as to amount by the IRS). Foreign corporation transferee's must withhold at 28 percent of the FMV of the interest while domestic corporations must withhold at a 10 percent rate. A series of exceptions to the withholding requirement are provided. A new annual return requirement is specified for foreign persons holding direct investments in U.S. real property.

4. The Act makes the 30 percent withholding tax on passive income apply to payments of U.S. source income to corporations created or organized in, or under the laws of Guam or the Virgin Islands. Certain exceptions are specfied.

Fiscal Impact

Conforming to the postponement of deductions for OID and stripped bonds and coupons would produce very minor revenue gains, probably less than $50,000 annually based on federal estimates in the 1984 Tax Reform Act.

There would be a revenue gain of an unknown amount from mandatory withholding on real estate sales in California made by nonresidents.

TAX REFORM ACT OF 1984 SECTIONS 157

Limitation on Mailing of Deposit of Taxes

Current Law

Although both state and federal laws require deposit of withholding taxes at specified times during the quarter, the procedures for making the deposits are completely different. The federal law requires that deposits be made to financial institutions of Federal Reserve Banks. The state law requires that payments be made directly to the Employment Development Department. Government Code Section 11002 and Section 13021 of the Unemployment Insurance Code provides that a timely mailing is indicated by the postmark date. Prior federal law (Section 7502 of the Internal Revenue Code) considered a deposit timely if it was mailed at least two days before the due date.

New Federal Law

Tax Reform Act Section 157 amended Section 7501 of the Internal Revenue Code so that the timely mailing rule will not apply to persons making deposits of at least $20,000 more than once a month. The rule was changed to eliminate the practice of depositors using certified or registered mail for making deposits with distant financial institutions and thereby, retaining use of such funds for a longer period of time.

Fiscal Impact

Conformity would result in an undeterminable loss of revenue. Because of the completely different state and federal deposit requirements this federal law change is not applicable to the State.

TAX REFORM ACT OF 1984 SECTION 159

Penalty for Filing a Fraudulent Withholding Certificate (IRC 7205)

Summary

The IRS is given broader ability to impose penalties against an employee required to supply withholding information to his/her employer where the employee fails to supply the information or willfully supplies false or fraudulent information. For example, an employee whose withholding status changes after filing the withholding exemption certificate is required to amend the certificate to reflect the new withholding status. The new provision allows a prosecution for willful evasion in addition to prosecution for a false certificate.

Old Federal Law

An individual required to supply withholding information who willfully supplies false or fraudulent information or willfully fails to supply information (such as, for example, on a withholding certificate) is subject to a criminal penalty or a fine not to exceed $1,000 or imprisonment of not more than one year, or both. The penalty also applies to certain false certifications made in connection with backup withholding. The penalty is in lieu of any other penalty provided by law, except the civil penalty for providing false withholding information.

Current State Law (PITL 19411, 19411.1)

The state enforcement of the provisions relating to filing a fraudulent withholding exemption certificate was moved to the Franchise Tax Board from the Employment Development Department by AB 3230 (Hannigan) Statutes 1984, Chapter 1490. The state language regarding the criminal penalty for filing fraudulent withholding exemption certificates or wilfully failing to supply information which would require an increase in withholding is the same as federal except that cross references are to the Unemployment Insurance Code and the Revenue and Taxation Code.

The state does not impose backup withholding.

New Federal Law

The Act changes the penalty from a penalty "in lieu" of other penalties (such as willful evasion) to one which is "in addition" to any other penalty provided by law. This change is effective for actions or failures to act occurring after enactment (July 18, 1984), thus allowing prosecution for willful evasion in addition to prosecution for a false certificate.

Fiscal Impact

Additional revenue that would be realized from prosecution for willful evasion are unknown.

TAX REFORM ACT OF 1984 SECTION 1073

Tips Treated as Wages
(IRC Section 3306(s))

Current Law

Section 927 of the California Unemployment Insurance Code (CUIC), defines as wages for both Unemployment Insurance (UI) and Disability Insurance (DI) purposes, tips and gratuities received by an employee from a patron if such tips are controlled by the employer and constitute substantially the only wage paid to the employee. In addition, for DI purposes only, Section 927.5 expands the taxable wage base to include all tips in excess of $20 per month.

Prior federal law (Federal Unemployment Tax Act) included tip income as wages only to the extent that it (1) is paid directly to the employee by the patron, (2) is reported by the employee to the employer in writing, and (3) is used by the employer to satisfy the minimum wage rate applicable under the Fair Labor Standards Act.

For personal income tax withholding purposes, both federal and state laws are uniform in that all tips in excess of $20 per month are taxable.

New Federal Law

All tip income reported by an employee to his or her employer will be considered wages for the Federal Unemployment Tax Act purposes, effective January 1, 1986. There was no change made in the federal withholding law.

Policy Issues

Those tips which are subject only to DI withholding have necessitated separate employer wage detail reporting. Conforming to the new federal law would eliminate this separate wage detail requirement by making all tips subject to unemployment insurance.

Fiscal Impact

Conforming to the new federal law would increase revenues by an unknown amount to the Unemployment Insurance Fund and the Disability Insurance Fund.

TAX REFORM ACT OF 1984 SECTION 1074

Exclusion of Fishing Boat Crews from FICA and FUTA Coverage (IRC Section 3306(c))

Current Law

The Unemployment Insurance Code does not exclude fishing boat crew members from unemployment insurance (UI) coverage. UI coverage is based on application of common law principles. Prior federal law held that the remuneration paid to certain crew members was exempt from both FICA and FUTA taxes for limited period of time.

New Federal Law

The 1984 Tax Act extended this exclusion only until December 31, 1984.

Fiscal Impact

Since federal law will conform with existing state law on January 1, 1984, adopting this federal change will have no fiscal impact on the Department's programs.

TAX REFORM ACT OF 1984 SECTION 173

Income Averaging
(IRC Sections 1301, 1302)

Introduction

Income averaging allows individuals to "average" income across tax years if income fluctuates from year to year. Both state and federal law provide for income averaging.

Income averaging was first authorized by the federal government in 1964. The state conformed with federal law in that year. The federal provisions were liberalized in 1969 by reducing the threshold percentage from 133 percent to 120 percent. That meant that taxpayers would pay less tax if their current-years income was 20 percent more than average base-period income rather than having to be 33 percent more than average base-period income. California did not conform to the liberalized percentage and retained the 133 percent requirement.

Summary of 1984 Tax Reform Act Changes

Effective for computation years after 1983, the Act makes two changes to income averaging to restrict the benefits from this provision. First, the percentage of averageable income required to qualify for income averaging is raised from 120 percent to 140 percent of the base-period income. Second, the base period for income averaging is shortened from a 4-year to a 3-year period.

Old Federal Law

Almost all types of income can be averaged, but adjustments are made for community-earned income. The base period for income averaging is the 4 years preceding the computation year. An individual can elect income averaging if (1) averageable income for a current tax year is more than $3,000 higher than the average income for the base period, and (2) taxable income for the current tax year is more than 1/5 higher (120 percent) than the average income for the base period. Only citizens or residents of the U.S. during the computation year are eligible for the benefits of income averaging.

Current California Law (PIT Sections 18241)

California has the same rules except:

1. Eligibility is restricted to individuals who have been California residents during the full 5-year averaging period,

2. Taxable income for the computation year has to be more than 1/3 (133 percent) higher than the average income for the base period.

3. California does not require adjustments for community-earned income.

New Federal Law

Effective for computation years beginning after 1983, the base period for income averaging is shortened from a 4-year to a 3-year period. This reduces the number of years affecting the averaging formula from 5 years to 4 years. The averageable income is also changed from 120 percent to 140 percent of the average base-period income.

Fiscal Impact

Based on our tax model and federal estimates for the 1984 Tax Reform Act, state revenue gains under conformity would be in the $12 million range annually.

TAX REFORM ACT OF 1984 SECTION 421

Transfers of Property Incident to Divorce - Taxability
(IRC Sections 1041, 72(k), 101, 453(g), 453B(g), 1001, 1015, 1239, 47)

Summary

The Act makes any transfer of property between spouses during marriage or between former spouses incident to divorce a nontaxable event.

Old Federal Law

The U. S. Supreme Court had established the principle that the transfer of property between spouses incident to divorce was a proper event for recognition of gain or loss to the transferor, even though the only consideration for the transfer was the release of support or other marital rights. On the theory that marital rights were worth what was paid for their release, the court held that gain or loss was measured by the difference between the basis of thee property and its fair market value at the time of transfer. This fundamental concept of taxability impacts many individual IRC sections which deal with the treatment of various different types of transfers.

Current California Law (PIT Sections 17081, 17131, 17551, 18031, 18151)

The Personal Income Tax (PIT) law was in conformity with the old federal law in the concept of treating the transfer of property between spouses incident to divorce as a taxable event.

New Federal Law

The 1984 Tax Reform Act makes any transfer of property between spouses during marriage or between former spouses incident to divorce a nontaxable event. The transferee will have the same basis as the transferor (carry over basis). This treatment applies to both transfers of cash or other property and the assumptiom of liabilities in excess of basis or any other consideration. For example, where one spouse receives a piece of property, assumes the debt on the property, and the basis has depreciated below the amount owed on the property, the spouse being forgiven the liability will not recognize any income on the exchange. It doesn't cover transfers to non-resident alien spouses. Generally applies to transfers after July 18, 1984 in tax years ending after that date. Transitional rules are specified.

Fiscal Impact

Insignificant effect - $0 in 1986 rising to $100,000 revenue loss in 1989. Estimate based upon applying a percentage to the federal estimate for the 1984 Tax Reform Act.

TAX REFORM ACT OF 1984 SECTION 422

Alimony and Separate Maintainence Payments
(IRC Sections 71, 215, 219, 6676, 7701)

Summary

The Act allows payments to be considered alimony (deductible by the payor and taxable to the payee) as long as they are made under a divorce or separation agreement, do not extend beyond the death of the spouse, and are in cash. It eliminates the requirement that they be "periodic," which was a key requirement in the past. "Periodic" means payable over a period of indefinite duration. Lump sum payments may now be considered alimony. In addition, the Act characterizes alimony as compensation thus allowing the recipient to establish an Individual Retirement Account (IRA) and make deductible contributions to that account up to $2,000 or 100 percent of compensation received each year. The Act requires that the payor of the alimony disclose on his/her return the taxpayer identification number of the recipient, makes the payee give his/her identification number to the payor, and provides penalties for failure to provide the required numbers.

Old Federal Law

I. Alimony, separate maintenance and support payments are taxable to the payee spouse and deductible by the payor only if they are made under a decree or related instrument, arise out of the marital obligation to support, as established by state law, and can be regarded as "periodic."

II. A divorced spouse, prior to the 1984 change, was allowed a deduction for contributions to an IRA established at least five years prior to the year of divorce. In addition, the former spouse must have had an IRA in effect and been allowed a deduction for three of the five years preceeding the year of the divorce. The deduction limit of the divorced spouse was the lesser of $1,125 or the sum of that individual's compensation and alimony received during the year. In essence this provision is a continuation of a previously established spousal IRA.

III. There were no requirements for the reporting of payee identification numbers relating to alimony.

Current California Law (PIT Sections 17081, 17201, 17272, 17302, 17731)

I. California conforms with the federal rules prior to the 1984 change relating to the treatment of alimony, separate maintenance, and support payments of residents but does not allow the deduction against California source income for alimony payments made while not a California resident.

II. California has not conformed to the divorced-individual rule of federal law allowing the continuation of a previously established spousal IRA.

III. There were no requirements for the reporting of payee identification numbers relating to alimony.

New Federal Law

I. The Act continues the general rule that alimony and separate maintenance payments made under a judicial decree of divorce or legal separation, a written separation agreement, or a decree for support are income to the payee and are deductible by the payor. However, the Act eliminates the requirement that alimony payments be "periodic." It also eliminates the requirement that payments must arise out of the marital obligation of support, as established by state law. Instead payments will qualify as alimony if they:

1. Are in cash,

2. Are made under a divorce or separation instrument,

3. Do not extend beyond the death of the payee-spouse,

4. Extend (if in excess of $10,000 in any calendar year) for at least six years (barring earlier death of either spouse or remarriage of the payee), and

5. Are not between spouses who file a joint return.

II. The Act, for years beginning after 12/31/84, struck out the IRA provisions relating to certain divorced individuals and instead simply includes under the definition of "compensation" any amount includible in an individual's gross income under the alimony rules. This change effectively allows those persons previously eligible for a maximum deduction of $1,125 to contribute and deduct up to $2,000. In addition, since the restriction that the plan had to be established for three of the five years prior to divorce has been removed, <u>any</u> individual receiving alimony will be eligible to establish an IRA and contribute up to $2,000 or 100 percent of the alimony received (assuming that alimony is the sole source of "compensation").

III. The Act requires that the individual making the payments must disclose on his/her return the taxpayer identification number (usually the SSA) of the person receiving the payments. The payee is required to disclose his/her taxpayer identification number (SSA) to the individual making the payments. A penalty provision is established which imposes a $50.00 penalty for each failure to provide the required numbers, unless it is shown that the failure is due to reasonable cause and is not due to willful neglect.

Fiscal Impact

Most of the provisions of this item would result in small revenue losses. The requirement of taxpayer identification numbers from individuals claiming deductions for alimony would result in revenue gains. Federal estimates for the 1984 Tax Reform Act show an estimated net revenue gain for the item as a whole, presumably because the increased revenues from the taxpayer identification number requirements would more than offset the losses from the other parts.

Based on a percentage of the federal estimate for the 1984 Tax Reform Act, California would have a revenue gain of perhaps $300,000 in 1986 from conformity to the changes in alimony and separate maintenance payments, rising to perhaps a $2 million revenue gain in 1989.

TAX REFORM ACT OF 1984 SECTION 423

Dependency Exemptions - Divorced Parents
(IRC Sections 2(b), 43, 44A, 105, 143, 152, 213)

Old Federal and Current California Law (PIT Sections 17021.5, 17042, 17069, 17052.6, 17056, 17201, 17210, 17131)

Federal and state law are the same regarding dependents, medical expenses, and qualification for head of household status. California, in addition, has a provision specifically for joint-custody head of household. The state allows a dependent exemption credit rather than a dependent exemption deduction as provided in federal law. The first dependent which qualifies the adult for head of household is not allowed a separate dependent status credit since the head of household credit is the same amount as is allowed to a married couple. The federal law allows the head of household adult an exemption deduction equal to a single person, but allows an exemption deduction for the qualifying child.

New Federal Law

A. Under the Act, as under present law, the parent having custody of a child for the greater portion of the year (the custodial parent) will generally be treated as having provided more than one-half of the child's support and, therefore, be entitled to the dependency exemption. This rule also will apply to parents not living together during the last 6 months of the calendar year, as well as those divorced or separated under a separation agreement. The act provides three exceptions to the general rule:

   1. The custodial parent can release his or her claim to the exemption for the year to the noncustodial parent. For this exception to apply, the custodial parent will have to sign a written declaration that he or she will not claim the child as a dependent for the year, and the noncustodial parent will have to attach the written declaration to his or her tax return. That declaration may be made for one or more specified calendar years. The parties may make a permanent declaration, a copy of which the noncustodial parent attaches to each year's return, or the declaration may be made by the custodial spouse annually in order to better insure the receipt of child support payments.

   2. As under present law, the general rule will not apply in the case of multiple support agreements where no one person provides more than 50 percent of the support.

   3. An exception is provided to continue existing law for certain decrees or agreements which are executed before January 1, 1985, and under which the custodial parent had agreed to release his or her claim to the dependency exemption to the noncustodial parent. Thus, if such an agreement exists, the noncustodial parent may claim the dependency exemption if he or she provides at least $600 for the support of the child during the year. The parties may modify the decree or agreement to make this rule inapplicable by expressly so providing.

The act also provides that the support by the spouse of a remarried parent will be treated as support provided by that parent in applying these rules.

B. For purposes of the medical expense deduction, any child subject to the rules described above will be treated as a dependent of both parents. Thus, a parent can deduct medical expenses paid by that parent for the child even though a dependency exemption for the child may be allowed to the other parent.

C. Under the act, certain provisions are amended to provide consistent rules among various inter-related sections concerning family status of individuals living apart. The basic rule adopted is that contained in the present child and dependent care credit. These changes are as follows:

1. Provides that a married individual living with a child can be considered "not married," if his/her spouse is not a member of the household for the last six months of the year, rather than the entire year as under present law.

2. The definition of head of household status is amended to provide that the household must be maintained as the principal place of abode for the child for more than one-half of the year, rather than for the entire year as under present law.

3. Provides that any custodial parent who releases a claim to a dependency exemption will still be treated as eligible for the purposes of married status, head of household status, the earned income credit, and the child and dependent care credit. Thus, such a custodial parent could be eligible for unmarried status, head of household status, or the credits if the other conditions of those provisions are met even though the dependency exemption is being claimed by the non-custodial parent.

These provisions will be effective for taxable years beginning after 12/31/84.

Fiscal Impact

The federal estimates for the 1984 Tax Reform Act indicate no federal revenue impact to these changes. However, based upon an examination of the changes to head of household, joint custody head of household, and renters credit required by conformity to these federal provisions, it is estimated that conformity would result in revenue losses in the $14 million range annually beginning in 1985.

This estimate is based on 1982 data for married taxpayers who filed separate returns with dependent credits and for taxpayers who filed head of household returns but were subsequently denied head of household status because the spouse was not absent for the entire year.

Data for the 1982 tax year shows that the dependent credit was reported on 64,710 taxable returns of married taxpayers filing separately. Based on past trends, the number of separate returns with dependent credits grows 10 percent a year. The average tax savings for the taxpayer would be about $250. It is unknown how many of these taxpayers would actually qualify for head of household status, but if it were one third, the tax revenue loss to the state for the 1985 tax year would be $7 million.

In addition, if the taxpayers in this group who are renters are allowed a renter's credit of $137 for head of household rather than $60 for married filing separate, there would be an increase of approximately $1.3 million in renter's credit claims allowed.

Finally, 1982 data shows that approximately 56,500 taxpayers who filed head of household returns were issued audit assessments which disallowed their head of household status. Approximately 48 percent (27,000) of these were disallowed because the taxpayer's spouse was not absent from the household for the entire year. If it is assumed that the number of head of household returns grows 10 percent a year and that one half of the previously denied taxpayers would qualify for head of household under this provision at an average assessment of $300 per NPA (including the renters' credit), the tax revenue loss and renter's credit increase would be approximately $5.5 million.

TAX REFORM ACT OF 1984 SECTION 424

Innocent Spouse
(IRC Sections 66, 6013)

Summary

The Act expands the relief from liability for tax for a spouse who establishes a lack of knowledge of community income generated by the other spouse to also apply where erroneous deductions and credits have been taken by the other spouse whether in a joint return or a separate return.

Old Federal Law

If a joint return was filed for a taxable year and there was income greater than 25 percent of the amount of gross income shown on the return omitted from the return then the spouse to whom the income is not attributable may be relieved of the liability for tax owing on the omitted income.

Current California Law (PIT Sections 18402.9, 18555)

California has a broader relief provision in that:

1. Not only applies to omissions of income, but also to erroneous deductions; but it does not apply to credits,

2. It applies regardless of the amount of the omission or erroneous deduction,

3. Provides a "prudent person" standard regarding the determination of whether the spouse had a "reason to know" of the understatement, and

4. Provides the rules for determining to which spouse the omitted item of income is "attributable."

New Federal Law

Under the Act, innocent spouse relief will apply where there is a substantial understatement of tax (more than $500) attributable to "grossly erroneous items" of one spouse. These grossly erroneous items include erroneous claims for deductions, or credits for which there is no basis, in addition to failures to report income. The deduction overstatements only apply where the deficiency (plus interest and penalty) is more than 10 percent of AGI (less than $20,000 AGI) or 25 percent of AGI if the AGI is greater than $20,000.

Also, the Act provides for innocent spouse relief from tax liability where a spouse filing a separate return fails to include in his/her gross income an item of community income and establishes lack of knowledge of the community income. The IRS must determine that it would be inequitable to include the item in the innocent spouse's return.

If the taxpayer treats an item of income as his or hers alone, the Act allows the IRS to disregard community property laws and tax the income solely to that taxpayer. The key factor is whether or not the taxpayer notified his/her spouse of the income as well as its nature and amount. The Act requires that notice to be made before the due date of the return for the year in which the income was derived (including an extended due date).

This change affects all open years under the 1939 and 1954 Internal Revenue Codes, except the authority to ignore community property laws is effective for tax years beginning after 1984.

Fiscal Impact

There is no measurable revenue impact.

TAX REFORM ACT OF 1984 SECTION 425

Estate and Gift Taxes
(IRC Sections 2043, 2053, 2516)

Deductions are allowed in arriving at the taxable estate.

Current California Law

California does not have an estate or gift tax except for the "pick-up" tax.

New Federal Law

Provides an estate tax deduction for payment of claims under certain written agreements. Virtually all payments to a former spouse from the decedent's estate will be deductible.

Fiscal Impact

Not applicable to California.

TAX REFORM ACT OF 1984 SECTION 426

Dependency - Income Taken Into Account

Summary

A dependency exemption is allowed by both state and federal laws, but the person being claimed as a dependent cannot be earning a yearly income of $1,000 or more unless he/she is the taxpayer's child and a student or is under 19 years old. The Act provides that income after 12/31/84 from a sheltered workshop school for disabled dependents will not be taken into account in computing the $1,000 limitation.

Old Federal Law

A taxpayer may not claim a dependency exemption for a dependent if the dependent has gross income of $1,000 or more, is over 19 years old, and not a student even if the person is the taxpayer's child.

Current California Law (PITL 17054)

California has the same rule as federal regarding the gross income of dependents. California allows a dependent credit rather than the deduction for dependents allowed by federal law.

New Federal Law

The act provides that, after 12/31/84, the dependency exemption is to be determined without regard to income earned by a disabled dependent in a sheltered workshop school operated by a charity or government.

Fiscal Impact

There is no measurable revenue impact.

TAX REFORM ACT OF 1984 SECTIONS 138-139

Non Resident Alien
(IRC 7701, 879)

Federal law contained no definition for resident and nonresident alien in the Internal Revenue Code. Instead, they were provided by regulation.

Current California Law (PIT 17024.5)

California specifically provides that provisions relating to nonresident aliens in the Internal Revenue Code do not apply when using the IRC for state purposes.

New Federal Law

The Act provides that an alien is a resident alien for any taxable year if the individual (1) is a lawful permanent resident, or (2) meets the substantial presence test. An alien who meets neither of these tests is a nonresident alien.

Also, the Act disregards foreign country community property laws when income is effectively connected with a U. S. business.

Fiscal Impact

No revenue impact. Not applicable to California.

TAX REFORM ACT OF 1984 SECTION 482

Medical Expenses
(IRC Sections 213, 152)

Summary

The Act allows lodging expenses to be considered medical expenses, even on an outpatient basis. The amount is limited to $50 per night per eligible individual. An eligible person can be not only the patient but a person who accompanies the individual seeking medical care. For example, a parent accompanying a young child who must travel away from home for medical treatment would qualify for the lodging expense deduction. The $50 per night limit would apply separately to each of them. Meals are not deductible.

Old Federal Law

The statute allows a deduction for unreimbursed transportation expenses primarily for and essential to medical care. Examples are railroad fare to the hospital and cab fare in obstetrical cases and cases of occupational therapy. You can itemize your actual car expenses or you can deduct 9 cents for each mile your car is used for medical transporttion. Medical expense deductions do not include meals and lodging at a location away from home prescribed by a physician or as an outpatient unless they are included in the hospital bill (inpatient) or while en route between home and a distant hospital. Transportation expenses are added to all other medical expenses and the total amount in excess of 5 percent of adjusted gross income is the amount deductible.

Current California Law (PITL 17201, 17210)

California is the same as federal and in fact also uses the federal AGI to determine the amount deductible for state purposes. This insures that the state and federal amounts will be identical.

New Federal Law

Lodging expenses (up to $50 per night per eligible individual) are deductible if the medical care is provided by a physician in a licensed hospital or outpatient clinic and there is no significant element of personal pleasure, recreation, or vacation in the travel away from home. If the trvel expenses of the person accompanying the patient qualify under current law as deductible medical expenses, such as a parent accompanying a young child, then the lodging expenses also qualify as medical expenses. The $50 per night limit would apply separately to each of them. Meals are not deductible.

Fiscal Impact

Based upon a percentage of the federal estimate for the 1984 Tax Reform Act, conformity would result in a revenue loss of approximately $300,000 per year.

TAX REFORM ACT OF 1984 SECTION 16

Net Interest Exclusion
(IRC Sections 128, 57, ERTA Section 302)

Summary

The Act repeals the net interest exclusion.

Old Federal Law

Starting in 1985 the federal law prior to the act provided that an individual would have been entitled to exclude a portion of the interest paid on deposits in banks and other financial institutions, on corporate debt in registered form or in a form generally sold to the public, on U.S. government debt, on certain federally-sponsored participation trusts, and on certain amounts held by life insurance companies. For a single individual or a married taxpayer filing separately, the maximum annual exclusion would have been 15 percent of the lesser of (1) up to $3,000 of such interest (i.e., a maximum annual exclusion of $450), or (2) the excess of such interest received (less any deduction for early withdrawal penalties) over certain interest expenses. For a married couple filing a joint return, the maximum exclusion in (1), above, would have been 15 percent of up to $6,000 (i.e., a maximum annual exclusion of $900) of such interest.

Current California Law (PITL Section 17142)

State law specifically does not allow the net interest exclusion allowed under federal law.

New Federal Law

The act repeals the net interest exclusion enacted in ERTA for taxable years beginning after 1984.

Fiscal Impact

None. Not applicable to California currently.

TAX REFORM ACT OF 1984 SECTION 17

Income Earned Abroad - U.S. Citizens
(IRC Sections 911)

Summary

Freezes the federal foreign-earned income exclusion until 1988.

Old Federal Law

The foreign-earned income exclusion was scheduled to increase from $80,000 in 1983 to $85,000 in 1984, $90,000 in 1985, and $95,000 in 1986 and later years.

Current California Law (PITL Section 17024.5)

The foreign-earned income exclusion does not apply to California in computing income taxable by California.

New Federal Law

The act holds the exclusion at $80,000 until 1988 when it increases to $85,000. The following year (1989) it increases to $90,000 and then to $95,000 in 1990 and later years based upon the estimates of federal tax expenditures for fiscal years 1983-1988.

Fiscal Impact

The allowance of the foreign earned income exclusion in California would result in a revenue loss of approximately $37 million in 1986 rising to $40 million in 1989 and thereafter.

TAX REFORM ACT OF 1984 SECTION 711

Technical Corrections to TEFRA Provisions - Alternative Minimum Tax (IRC Sections 55, 58, 57, 173, 873, 931)

Summary

The Act makes three major changes to the federal alternative minimum tax relating to investment tax credit recapture, elections for investment credit, and ACRS deductions for foreign wells and reduces the amortization period of circulation expenses from 10 years to 3 years. Circulation expenses are the deductible costs of a publisher of a newspaper, magazine or other periodical to establish or increase circulation.

Old Federal Law

TEFRA added several new tax preferences and made modifications to the individual alternative minimum tax. This tax is computed at a 20-percent rate and is payable to the extent it exceeds the taxpayer's regular tax. Regular tax generally means the taxpayer's income tax liability reduced by nonrefundable credits. Generally, individuals are allowed to elect to take ACRS deductions and investment tax credit with respect to intangible drilling costs and thus are receiving a tax preference. Also TEFRA provided that the circulation expense deduction, to the extent it exceeded a deduction based on 10-year amortization, was a tax preference for individuals.

Current California Law (PITL Section 17063, 17201, 17206, 17210, 18151, 18169)

California does not conform to the alternative minimum tax, but instead has a tax on preference income. However, the California preference item relating to circulation expenses is the same as old federal law. The state has no investment credit.

New Federal Law

The major alternative minimum tax changes are:

1. The Act clarifies that the amount of investment credit recapture is not included in the taxpayer's regular tax for purposes of computing alternative minimum liability. As a result, the recapture tax will be a liability in addition to the taxpayer's alternative minimum tax and regular tax.

2. The Act provides that the election to take ACRS deductions and the investment credit in lieu of expensing intangible drilling costs would not be available with respect to oil, gas, and geothermal wells which are not located in the United States, since the investment credit is generally not allowable for property used outside the United States.

3. The Act amends the circulation expense tax preference provisions by

providing a 3-year amortization period (rather than the 10-year period) for individuals to amortize circulation expenses and to measure the tax preference where the expenses are deducted in full.

Fiscal Impact

Unknown revenue impact.

TAX REFORM ACT OF 1984 SECTION 711

Technical Corrections to TEFRA Provisions - Casualty Loss (IRC Sections 165, 1231)

Summary

The Act makes a change in the computation method to resolve the difficulty of determining the casualty loss deduction where the taxpayer also had other gains or losses from involuntary conversions. The new rule is that losses are offset against involuntary conversion gains, and only losses in excess of those gains are subject to the 10 percent of AGI limitation.

Old Federal Law

An itemized deduction for nonbusiness casualty and theft losses is allowed only to the extent the losses exceed 10 percent of the taxpayer's adjusted gross income after reducing the loss by a $100 threshold. In determining adjusted gross income, the deduction for capital gain is allowed. Where a taxpayer's gains from involuntary conversions or other casualties are in excess of the losses for those transactions for a taxable year, the taxpayer's capital gains deduction, and therefore his/her adjusted gross income may depend on the amount of casualty loss which is allowable as a deduction. Thus, in those circumstances, the computation of the casualty loss deduction may not be computed mathematically because of the interrelationship with the computation of adjusted gross income.

Current California Law (PITL Section 17063, 17201, 17206, 17210, 18151, 18169)

California is in conformity to the casualty loss deductions and, in fact, even uses the federal AGI to compute the amount deductible. The state is in conformity with the treatment of gains and losses from involuntary conversions and other casualties.

New Federal Law

The Act provides that adjusted gross income, for purposes of computing the 10-percent floor for the casualty loss deduction, is determined without regard to gains or losses from involuntary conversions and other casualties for tax year 1983, but replaces this rule with a new set of rules with respect to these gains and losses for taxable years beginning after December 31, 1983.

The new rules provide that gains and losses from personal casualties and involuntary conversions (without regard to the period the property was held) will be netted. If the gains exceed the losses from these transactions, then all such gains and losses will be treated as capital gains and losses. The losses will not be subject to the 10-percent of AGI floor. (The amount of any recognized loss will be subject to the $100 floor before netting). If the losses exceed the gains, all gains and losses will be ordinary. Losses to the extent of gains will be allowed in full. Deductible losses in excess of gains will be limited to the amount by which losses exceed 10 percent of the taxpayer's adjusted gross income.

Fiscal Impact

Unknown revenue impact.

TAX REFORM ACT OF 1984 SECTION 711

Technical Corrections to TEFRA Provisions - Medical Insurance (IRC Sections 213)

Summary

The Act provides that to be considered deductible medical insurance the premiums are required to be paid over a contract period of not less than five years where the payments are made by a taxpayer under age 65 for medical coverage after attaining age 65.

TEFRA made medical expense insurance premiums fully subject to the increased AGI floor and provided a minimum contract period of two years where premiums are paid by a taxpayer under 65 years old for medical care after attaining age 65.

Current California Law (PITL Section 17063, 17201, 17206, 17210, 18151, 18169)

California is in conformity to the medical expense deductions and, in fact, even uses the federal AGI to compute the amount deductible.

New Federal Law

Changes the minimum contract period from two years to five years for medical insurance contract payments to be considered as deductible medical expenses.

Fiscal Impact

Unknown revenue impact.

TAX REFORM ACT OF 1984 SECTION 1051

Disaster Loss Deduction
(IRC 165)

Summary

The Act allows a taxpayer to deduct as a casualty loss any loss incurred after December 31, 1981 in demolishing or relocating a personal residence because of the order of a state or local government issued within 120 days of the declaration of the area as a disaster by the President. The residence must have been rendered unsafe because of the disaster. The taxpayer may elect to take the deduction in the return for the year prior to the disaster. Previous law would not have allowed any tax deduction under these circumstances.

Old Federal Law

The general rule is that deductible losses of individuals are those incurred in a trade or business, incurred in any transaction entered into for profit and those arising from fire, storm, or other casualty or from theft, even though not connected with a trade or business.

A casualty is an event due to some sudden, unexpected, or unusual cause. Loss from destruction of non-business property must qualify as a casualty to be deductible. Business or investment property may be deductible even though it fails to qualify as a casualty. For example, a condemnation loss of business or investment property is deductible while a condemnation loss on a personal residence is not.

Deductions for casualty losses are allowed, generally, to taxpayers in the year in which the casualty occurred. However, a taxpayer who has a casualty loss and the area in which the loss occurred is declared to be a disaster area by the President may take the loss deduction on the return for the year prior to the year in which the casualty happened.

The amount of the deduction is the lesser of the adjusted basis of the property (usually its cost in the case of residential property) and the actual loss. The actual loss is the difference between the value of the property just before the casualty less the value of the property immediately after the casualty. The deduction is further reduced by a $100 threshold per event, any insurance received, and 10 percent of the taxpayer's adjusted gross income.

Current California Law (PITL 17201, 17206)

California conforms completely to federal law for casualty losses and in fact even uses the federal AGI to determine the amount of the deduction.

New Federal Law

The Act provides that taxpayers whose residences are located in an area declared to be a disaster area by the President and who are ordered to demolish or relocate their residences, even though not damaged by the disaster, may deduct any loss attributable to the demolition or relocation as a casualty loss. They may elect to take the loss on the return for the year prior to the year of the casualty. The new law is effective for tax years beginning after December 31, 1981.

Fiscal Impact

Conformity to this federal change will result in a revenue loss of approximately $300,000 per year based upon using a percentage of the federal estimate for the 1984 Tax Reform Act.

TAX REFORM ACT OF 1984 SECTION 1052

Parsonage Allowance
(IRC 107)

Summary

The Act delays for one year the disallowance of mortgage interest expense and real estate taxes for ministers receiving tax-free housing allowances who owned and occupied homes before January 3, 1983.

Old Federal Law

In 1983, the IRS ruled that a minister may not take deductions for mortgage interest and real estate taxes on a residence to the extent that such expenditures are allocable to tax-free housing allowances provided for ministers.

The new deduction disallowance rule generally applies beginning July 1, 1983. However, for a minister who owned and occupied a home before January 3, 1983 (or had a contract to purchase a home before that date), the deduction disallowance rule will not apply until January 1, 1985.

Current California Law (PITL 17131, 17201)

California is the same as federal.

New Federal Law

In the case of ministers, the Act extends until January 1, 1986 the transitional rule date applicable to a minister who owned and occupied a home before Janury 3, 1983 (or had a contract to purchase a home before that date). In the case of mortgage interest deductions, the provision in the Act only applies to a mortgage existing on that date (or in connection with a contract to purchase a home before that date).

Revenue Impact

Conformity to this federal provision would result in a one year revenue loss of approximately $100,000 in 1986 based upon applying a percentage to the federal estimate for the 1984 Tax Reform Act.

TAX REFORM ACT OF 1984 SECTION 1053

Sale of Residence - Rollover Period (IRC 1034)

Summary

The rollover of gain period for the replacement of a residence for military personnel is extended to a maximum of 8 years where the individual is stationed outside the U.S. or at a remote site.

Old Federal Law

The length of time allowed for the rollover of gain on the sale of a residence is 2 years for nonmilitary individuals. For active duty military personnel the rollover period can be as long as 4 years following the sale of the old residence.

Current California Law (PITL 18031)

California is the same as federal law prior to the 1984 Act changes.

New Federal Law

In Act provides that, in the case of a member of the Armed Forces who is stationed outside the United States or who is required to reside in government quarters at a remote site, the normal nonrecognition period will not expire until the end of four years after the sale of the old principal residence or one year after the member is no longer stationed outside the U. S. or no longer required to reside in such government quarters, whichever is later, but not to exceed eight years.

Fiscal Impact

Based upon a proration of the federal estimate for the 1984 Tax Reform Act the annual revenue loss from conformity to this provision would be approximately $100,000.

TAX REFORM ACT OF 1984 SECTION 1054, 1075

Retroactive Relief Provisions
(IRC 74,85)

Summary

Two retroactive relief provisions allow the taxpayers involved to settle their cases with the IRS. They do not apply to California law.

Old Federal Law

1. Gross income generally includes amount received as prize, such as cash or property won in a lottery, sweepstakes, or other contest.

2. The Revenue Act of 1978 made unemployment compensation payments (as specified) includable in gross income even for benefits paid after 1978 which were attributable to perids of unemployment in 1978 or before.

Current California Law (PITL 17081, 17083)

1. California conforms to the inclusion in income of prizes, awards or winnings from contests.

2. California specifically does not include unemployment compensation in gross income for any year.

New Federal Law

Under the Act, no interest, penalty or similar addition to tax is payable on the amount of Federal income tax (computed without regard to such amounts) attributable to receipt of a residence won as a prize, where certain conditions apply, but only if such tax liability (as so computed) is paid within one year after the date of enactment of the provision. The provision only applies to a residence which (1) was won by the taxpayer in a local radio contest; (2) was specially designed to meet the needs of a handicapped foster child of the taxpayer; (3) is the principal residence of the taxpayer; and (4) had a lien placed on it by the Internal Revenue Service on May 24, 1983, after an Internal Revenue Service supervisor had overruled two payment schedules negotiated with the taxpayer for the payment of taxes, interest, and penalties on income attributable to such residence for the taxpayer's 1980 taxable year.

The Act provides for the filing of claims for refund for taxes paid on unemployment compensation for periods in 1978 and prior for one year from the date of enactment.

Fiscal Impact

None. Not applicable to California.

PUBLIC LAW 98-259 (4/10/84)

Federal Tax Forgiveness for U.S. Military and Civilian Employees Killed Overseas
(IRC Sections 692)

The federal and state governments exempt from taxation a member of the United States Armed Forces who dies while in active service, if the death occurred while serving in a combat zone. Public Law 98-259, enacted on April 10, 1984, exempts from taxation a military or civilian employee of the United States who dies as the result of wounds or injury incurred outside the United States in a terroristic or military action. The exemption would apply to the taxable year of the taxpayer's death and any prior taxable year in the period beginning wth the last taxable year ending before the taxable year in which the wounds or injury of the taxpayer were incurred with respect to any taxpayer dying after December 31, 1979, as a result of wounds or injury incurred after that date.

Current State Law (PITL Section 17800)

In 1984 legislation (AB 2436 - Statham) California conformed to the new federal provision, except that it applies to the computation of taxes for taxable years beginning on or after January 1, 1984.

TAX REFORM ACT OF 1984 SECTION 1076, 1078

Exclusions from Gross Income (IRC 108)

Summary

Two retroactive exclusions from gross income are provided in the Act.

Old Federal Law

1. The 1976 Tax Reform Act provided that the cancellation of certain student loans would not result in taxable income until 1983.

2. Equity grants are includable in gross income, absent some provision to the contrary.

Current California Law (PITL 17081, 17131)

California conforms to the general definition of gross income.

New Federal Law

1. Cancellation of Certain Student Loans: The Act provides a permanent exclusion from income for cancellation of certain student loans where the student works for a certain period of time in certain professions for any of a broad class of employers.

   The permanent exclusion is effective for discharges of indebtedness that occur after 1982. So, any taxpayer whose loan was partially or wholly forgiven in 1983 and who included the loan forgiveness in income on his 1983 tax return, may file a claim for refund.

2. Boundary Waters Canoe Act Payments: The new law permits qualified resort operators and commercial outfitters to exclude equity grants from the U.S. Forest Service under restricted traffic programs in the Boundary Waters Canoe area. The exclusion applies to amounts timely reinvested in depreciable assets.

Fiscal Impact

Unknown revenue loss.

TAX REFORM ACT OF 1984 SECTIONS 431-432

At-Risk Provisions

Introduction

The Tax Reform Act of 1976 adopted the initial "at-risk rules". Under that act, loss limitation rules were adopted which prevented a taxpayer from deducting losses in excess of actual economic investment in the activity. These rules do not apply to the holding of real property.

Generally, the amount a taxpayer has "at-risk" in an investment is the sum of:

1. Cash paid by the taxpayer,
2. The adjusted basis of property contributed to the activity by the taxpayer, and
3. Amounts borrowed for use in the activity if the taxpayer has personal liability for repayment or has pledged security for repayment (recourse financing).

Loss limitation at-risk rules apply to individuals and certain closely held corporations (i.e. if more than 50 percent in value of the outstanding stock is owned, directly or indirectly, by five or fewer individuals) and are applied on an activity-wide basis (i.e. the taxpayer's loss deductions are limited to his/her "at-risk" investment in the entire actively managed trade or business).

The Economic Recovery Act of 1981 extended the at-risk limitation provisions to apply to the investment tax credit. The investment tax credit at-risk rule was made applicable to the same activities and same taxpayer covered by the loss deductions at-risk rules. However, the investment credit at-risk rule is applied on a property-by-property basis rather than on the activity-wide basis. This has caused a great deal of confusion.

Summary of 1984 Tax Reform Act Changes

The 1984 Tax Reform Act adopts an independent at-risk rule for the investment tax credit. This new rule applies to property placed in service after July 18, 1984. Under the new rule, no investment tax credit will be allowed to the extent the property is financed with nonrecourse financing (financing where the taxpayer is not personally liable for the debt). Also, where a lease of investment credit property is involved, a lessee must reduce the amount of the credit by the amount of the lease attributable to nonrecourse financing.

Old Federal Law

The "at-risk" rules for investment credit property were dependent on the rules for loss deduction limitations, but were to be applied to each item of investment credit property separately. Also, it was not clear whether the investment credit "at-risk" rules were to be applied to a lessee of investment credit property.

Current California Law

California has never adopted an investment tax credit, thus the 1984 Tax Reform Act changes to the federal investment tax credit are not applicable.

New Federal Law

The Act adopts an independent "at-risk" rule within the investment tax credit and specifies that a lessee of investment tax credit property must reduce the credit to the extent of nonrecourse financing in the same manner as an owner of investment tax credit property. Active corporations are exempted from the loss limiting at-risk rules.

Fiscal Impact

None. California does not have an investment tax credit.

TAX REFORM ACT OF 1984 SECTION 171

Tax Benefit Rule
(IRC 111)

Summary

The Act provides that when an amount attributable to a prior year deduction is recovered (i.e. state tax refund, medical expenses, casualty loss reimbursement) the amount may be excluded from gross income only to the extent it did not reduce income subject to tax. Similar provisions are added for credits.

Old Federal Law

Both judicial interpretation and IRS regulations allowed a taxpayer to exclude from gross income an amount recovered in a later year to the extent of the amount of the total deduction which did not reduce income subject to tax. For example, a taxpayer in 1984 with an adjusted gross income of $20,000 has a casualty loss deduction of $30,000 and thus has a taxable income of-$10,000 and pays no tax. In 1985 the taxpayer receives a settlement of an additional $2,000. Under law prior to the Act, none of the $2,000 was includable in income in 1984 since of the total casualty loss deduction of $30,000, $10,000 of that amount did not reduce income subject to tax. Under the Act all of the $2,000 recovered in 1985 will be included in the taxpayer's income since $20,000 of the total $30,000 casualty loss did reduce taxable income.

Current California Law (PITL 17131, B&CTL 24310)

The California tax benefit rule is the same as old federal law for both individuals and corporations.

New Federal Law

Amounts recovered which are attributable to amounts deducted in prior years (i.e. state tax refunds, medical expenses, causalty loss reimbursement) may be excluded from gross income only to the extent it did not reduce income subject to tax. Similar provisions are also added relating to the recovery of credits taken in prior years.

Fiscal Impact

Conforming to the change in the tax benefit rule would result in additional revenues under the Personal Income Tax Law in the $2-$3 million range annually based on a proration of the federal estimate for the 1984 Tax Reform Act.

TAX REFORM ACT OF 1984 SECTION 111

Real Property Recovery Period Extended
(IRC 168, 57)

Summary

The Act extends the recovery period under the accelerated cost recovery system (ACRS) from 15 years to 18 years for real property and modifies the ACRS item of tax preference to reflect this change in the recovery period.

Old Federal Law

The recovery period for real property under ACRS was 15 years. The item of tax preference was the amount by which ACRS deductions on 15 year real property exceeded the straight line amount computed using a 15 year life.

Current California Law (PITL 17250, 17250.5, B&CTL 24349.5)

California did not generally conform to the federal accelerated cost recovery system (ACRS) enacted in 1981. However, in 1984 AB 40 (Nolan) (Chapter 45 of 1984) allowed certain assets in enterprise zones to use the ACRS system. Also, SB 2198 (Royce) (Chapter 1699 of 1984) provides that residential rental property may utilize the ACRS system to compute California depreciation and the property is considered 18-year real property. As an alternative, the straight-line method of depreciation may be used with an election of a recovery period of 18, 35, or 45 years. To qualify the residential rental property must meet all of the following conditions:

1. Be located in California,

2. Construction commenced on or after July 1, 1985 and before July 1, 1988, and

3. Eighty percent or more of the gross rental income from the property must come from the rental of dwelling units.

In addition, ACRS is allowed for low-income rental housing in California in conformity with the federal low income rental housing provision of the ACRS system after the 1984 Tax Reform Act.

California does not currently have an item of tax preference for the difference between ACRS deductions and the amount which computed under the straight-line method over the recovery period.

New Federal Law

The Act extends the recovery period for real property which is not low income housing from 15 years to 18 years for realty placed in service after March 15, 1984. Depreciation under ACRS in excess of straight-line depreciation is added as an item of tax preference.

Fiscal Impact

The revenue gain from conforming to the change from 15 to 18 years for real property ACRS deductions for property in enterprise zones is unknown. There is no revenue effect regarding residential real property in California where construction starts after July 1, 1985 and before July 1, 1988 since the legislation specified that that property was to be considered 18-year recovery property.

TAX REFORM ACT OF 1984 SECTION 112

Installment Sales - Depreciation Recapture
(IRC 453)

Summary

Under the Act the total amount of depreciation recapture income is included in income as ordinary income in the year of sale even when no principal payments are received in that year. Previously, gain didn't have to be included in income until principal payments were received, but when payments were received, they were first treated as ordinary income up to the amount of depreciation recapture income. Depreciation recapture income is the amount of depreciation or ACRS deductions taken on personal property and the amount of depreciation or ACRS deductions taken on real property which are in excess of the amount which would have been deductible if depreciation had been calculated under the straight-line method.

Old Federal Law

When a depreciable asset was sold on the installment basis, the amount of ordinary income (depreciation recapture) and capital gain income were calculated but not included in income until installment payments of principal were made. When installment payments of principal were made, the amount was included in income as ordinary income up to the amount of the total depreciation recapture income and the excess reported as capital gain.

Current California Law

The state calculation of depreciation recapture is the same as the federal calculation except for the starting date when depreciation recapture was adopted by state law for personal property and real property. The amounts included in income as ordinary income are the same, but the amounts included in income as capital gain will be calculated under the state's holding period system rather than under federal law. Payments of principal are required as under old federal law before the recapture is included in income.

New Federal Law

Under the Act the amount of depreciation recapture is to be included in total in the taxpayer's income as ordinary income in the year of sale regardless of whether any principal payments have been made.

Fiscal Impact

The revenue impact from conforming to this is unknown.

TAX REFORM ACT OF 1984 SECTION 113

Depreciation and Investment Tax Credit - Sound Recordings
(IRC 46, 48, 168)

Summary

The Act provides that the taxpayer may elect to treat sound recordings placed in service after March 15, 1984 as 3-year property under the accelerated cost recovery system (ACRS) and take an investment credit at a 6 percent rate. If he/she does not make the election, then no investment credit is allowed, and the recording is not to be treated as ACRS recovery property, and depreciation is to be computed under the income forcast method of accounting. All persons with an ownership interest in the sound recording must join in the election for the election to be valid.

Old Federal Law

It is not clear in current law whether sound recordings are eligible for depreciation under the ACRS system or are eligible for the investment tax credit.

Current State Law (PITL 17250, 17250.5, B&CTL 24349)

California did not generally conform to the federal ACRS enacted in federal law in 1981. ACRS is allowed in California only for property used in a business located in an enterprise zone and residential rental property constructed after July 1, 1985 and located in California.

The income forcast method of depreciation is generally used by California to determine the proper amount of depreciation deductible when income from the property is dependent on its popularity with the public (i.e. hit records and tapes). This method matches the deductions for the cost of the recording with the amount of sales for the year. The income forcast method of depreciation has two steps. First, a percentage is determined by using the income from the recording for the year as the numerator and the estimated income to be received over the recordings life as the denominator. Second, the adjusted cost of the recording is multiplied by that percentage and the result is the depreciable amount for the year.

California has never allowed an investment tax credit.

New Federal Law

The Act allows the taxpayer to elect to depreciate sound recordings placed in service after March 15, 1984 as 3-year ACRS recovery property and to take an investment credit of 16 percent if all the owners join in a unanimous election. If no unanimous election is made, then sound recordings must use the income forcast method of depreciation. The Act states that no inference is intended regarding the proper treatment under law prior to March 15, 1984.

Fiscal Impact

Revenue impact of allowing the ACRS method to sound recording used in a business in an enterprise zone within California is unknown.

TAX REFORM ACT OF 1984 SECTION 113

Depreciation and Investment Tax Credit - Movies and Videotapes (IRC 48, 168)

Summary

Under the Act motion picture films and videotapes are not treated as eligible for depreciation under the accelerated cost recovery system (ACRS) and are not eligible for the general investment credit. Movies and videotapes specifically for use as public entertainment or for educational purposes are eligible for a 6 2/3 percent investment credit. Costs are required to be recovered under the income forcast method of depreciation.

Old Federal Law

It is not clear in current law language that movies and videotapes are not eligible for either the general investment credit of 10 percent or for ACRS deductions as personal property with a 3-year recovery period. The committee reports for the 1984 Tax Reform Act state that the statute was originally intended to restrict movies and videotapes to a specific 6 2/3 percent investment credit if they were primarily for public entertainment or education and that movies and videotapes were never intended to be eligible for the ACRS method of computing depreciation. The intent was to allow the recovery of the cost of movies and videotapes under the income forcast method of depreciation.

Current State Law (PITL 17250, 17250.5, B&CTL 24349)

California did not generally conform to the federal ACRS enacted in federal law in 1981. ACRS is allowed in California only for property used in a business located in an enterprise zone and residential rental property constructed after July 1, 1985 and located in California.

The income forcast method of depreciation is generally used to determine the proper amount of depreciation deductible when income from the property is dependent on its popularity with the public (i.e. movies and videotapes). This method matches the deductions for the cost of the movie or videotape with the income from sales for the year.

California has never allowed an investment tax credit.

New Federal Law

The Act (effective for years after 1980) specifies that the general investment credit is not allowed to movies and videotapes. Movies which are primarily for use as public entertainment or education are eligible for a 6 2/3 percent investment credit. Also, the Act specifies that movies and videotapes are not eligible for ACRS depreciation but must recover their cost using the income forcast method of depreciation. Special transitional rules are specified for those taxpayers who were taking investment tax credit or ACRS deductions for movies and videotapes produced between 1981 and March 16, 1984 to allow them to continue using those methods.

Fiscal Impact

None since no ACRS depreciation is being allowed for movies and videotapes by the 1984 Tax Reform Act.

TAX REFORM ACT OF 1984 SECTION 114

Sale - Leasebacks - Investment Tax Credit and Energy Credit (IRC 48)

Summary

The Act allows a three-month period for a taxpayer to qualify for the investment tax credit and the energy credit when a taxpayer has taken delivery of an asset and placed it in service (after April 11, 1984) before his/her financing is in place. If within a three-month period of placing the property in service the taxpayer sells the property to another person and leases it back from that person, then the property will be treated as property newly placed in service under the lease and thus eligible for the investment tax credit and the energy credit.

Old Federal Law

The three-month rule applied only to the investment tax credit and not the energy credit, and it applied to all leases and not just to a sale-leaseback.

Current State Law (PITL 17052.5)

California has never allowed an investment tax credit.

California does not conform to the federal energy credit but does have a state solar energy credit. The solar energy credit applies to both residential and nonresidential property. For residential property a credit of 50 percent of the cost of a solar energy system installed after August 1, 1983 is allowed, but the maximum deduction is limited to $3,000. If the system is eligible for the federal energy credit, the state credit is reduced so that the combined federal and state credit will not exceed 50 percent of the cost of the solar energy system. For nonresidential property the credit is 25 percent of the cost of the solar energy system. Leased systems on California buildings are eligible for the credit. The credit is taken in the year of installation.

New Federal Law

The Act treats property which is sold and leased back within three months of its having been originally acquired as new property placed in service when the lease is entered into and not on the date it was originally acquired.

Revenue Impact

The revenue impact is unknown.

TAX REFORM ACT OF 1984 SECTION 174

Deductions for Losses, Expenses, and Interest - Related Taxpayers (IRC 170, 267, 368, 514, 1235)

Summary

The rule regarding the deductibility of losses, expenses, and interest payments of accrual-basis taxpayers to related cash-basis taxpayers was changed from disallowing the accrued expense or interest if they were not paid in the year of accrual or within 2 1/2 months of the end of the tax year to allowing the expenses to be deducted on the accrual-basis taxpayer's return in the year that the cash-basis taxpayer is required to include the payments in income. This has the effect of placing the accrual-basis taxpayer on the cash basis for transactions involving a related party. This rule for matching the related deductions applies to partnerships and small business corporations (S corporations). However, the taxpayer is related only if the transaction at issue is related to the operation of the partnership business or to an interest in the partnership.

A related party is one who is:

1. A member of the family,

2. An individual and a corporation when more than 50 percent of the corporation's stock is owned by the individual,

3. Two (or more) corporations which are members of the same controlled group,

4. Grantors, fiduciaries, and beneficiaries of trusts,

5. Individuals and exempt corporations which they or their families control,

6. An individual and a partnership when the person owns any capital or profits interest in the partnership,

7. An individual and a small business corporation (S corporation) when the person owns stock in the corporation,

8. An individual and a partnership and an S corporation or another partnership where the individual owns a capital or profits interest in the partnership and the partnership owns a capital or profits interest in another partnership or an S corporation.

A special rule for losses on sales or exchanges between members of the same controlled group allows the deferral of the loss until the property is transferred outside the controlled group rather than denying the loss in total.

The new rules relating to the timing of deductions do not apply to debts incurred before September 20, 1983. The rules relating to the deferral of

losses by controlled groups apply to transactions occurring after December 31, 1983.

Old Federal Law

An accrual-basis taxpayer had to pay the accrued interest or expense during the year of accrual or within 2 1/2 months of the end of the year when the payee was a related party, or the deduction was not allowed as a deduction on any tax return.

The rules for matching income and deductions applied to small business corporations (S corporations) and did not apply to partnerships.

Deductions for losses from sales or exchange of property between related parties generally were not allowed, and there was no special rule for deferral in the case of controlled group transactions.

The related party definition did not previously include the relationship between a corporation and a partnership if the same persons own more than 50 percent of the corporation's outstanding stock and more than 50 percent of the partnership's capital or profits interest, and the partnership versus partner transactions were not tied to the related party definition.

Current State Law (PITL 17201, 17321, 17240-17245, 17551, 17851, 18151, B&CTL 24427-24430, 24357-24359)

California law is in conformity with old federal law regarding the denial of deductions for losses, interest, and expenses of accrual-basis taxpayers where the payee was a related party on the cash basis. California had the same definition of a related party as old federal law except that California has never enacted small business corporation (S corporation) provisions which permit the pass through of corporate earnings and expenses directly to shareholders in a manner similar to a partnership's method of taxation.

California does not allow consolidated returns of a controlled group of corporations, but instead utilizes a combined report for a unitary group of corporations where income is from both within and without the state. The California corporation law has no capital gain or loss provisions, but instead takes into income 100 percent of all gain or loss from the sale or exchange of property. Losses from transactions with a related party are not allowed as a deduction. The amount of the loss disallowed is an addition to basis for the transferee and reduces the gain in any subsequent sale.

New Federal Law

Accrual-basis taxpayers can deduct interest and expenses paid to a related party only in the year in which the payee is required to include the payment in income (for debts incurred after September 20, 1983). Partnership losses as well as S corporation losses are subject to these deduction matching rules also. Sale or exchange of property between members of a controlled group where a loss occurs are deferred until the property is transferred outside the controlled group rather than denied. Partnerships and corporations which are owned more than 50 percent by the same person are included in the definition of a related party.

Fiscal Impact

The revenue impact of the changes in the deduction for losses, expenses, and interest with related taxpayers, sales of property between members of a controlled group, and the expansion of the definition of related parties would result in revenue gains in the $2-$3 million range annually based on the federal estimates for the 1984 Tax Reform Act.

TAX REFORM ACT OF 1984 SECTION 175

Patent Application Treated as Depreciable Property
(IRC 1239)

Summary

The Act provides that the transfer of a patent application between related parties will result in ordinary income to the extent of any gain on the sale after March 1, 1984. Also, the Act includes in the definition of a related person a trust in which the taxpayer or his/her spouse is a beneficiary. This change is made because the transferee can depreciate the patent granted in connection with the application.

Old Federal Law

Related persons are defined as:

1. A husband and wife, and

2. A person and all entities which are 80 percent owned by that person.

Depreciable property which is sold to a related person is ordinary income to the extent of the amount of the gain. Patent applications are not mentioned as being deemed to be depreciable property.

Current California Law (PITL 18151)

California is in conformity with the old federal law.

New Federal Law

Patent applications transferred after March 1, 1984 between related parties are to be treated as depreciable property, and thus, any gain on the sale will be ordinary income. Also, the definition of related parties is expanded to include any trust in which the taxpayer or his/her spouse is a beneficiary. This change is made because the transferee can depreciate the patent granted in connection with the application.

Fiscal Impact

The revenue impact from this change is unknown.

TAX REFORM ACT OF 1984 SECTION 176

Recapture of Ordinary Losses - Depreciable Business Assets (IRC 1231)

Summary

The Act requires that gains on the sale of trade or business assets in taxable years beginning after December 31, 1984 be treaed as ordinary income to the extent of the total of losses from the sale of trade or business assets in the five most recent prior years beginning after 1981. Losses will be deemed recaptured in the chronological order in which they arose.

Old Federal Law

Gains and losses from property used in the trade or business and from involuntary conversions in each tax year are required to be netted. If the net result is a loss, then each gain or loss is treated as an ordinary gain or loss. If the net result is a gain, then each gain or loss is treated as a long-term gain or loss.

Current California Law (PITL 18151, 18169)

The Personal Income Tax Law is in conformity with old federal law except that coal and domestic iron ore are not considered property used in the trade or business, and the state holding period for California purposes will be mid-term (over 1 year but not more than 5 years) or long-term (over 5 years) rather than the federal holding period for long-term capital gain.

New Federal Law

If a taxpayer has net losses from the sale or exchange of trade or business assets or involuntary conversions in any of the five most recent tax years after 1981, then any current-year net gains from the sale or exchange of that type of asset will be treated as ordinary income to the extent of those losses. Only the excess gains over the losses taken for that five-year period will be eligible to be treatd as long-term gain in the current tax year. Losses will be deemed recaptured in the chronological order in which they arose.

Fiscal Impact

Based on a proration of federal estimates for the 1984 Tax Reform Act, conforming to the treatment of sales of assets used in the trade or business and involuntary conversions would result in annual revenue gains in the $2-$3 million range.

TAX REFORM ACT OF 1984 SECTION 178

Coal Disposed of to Related Persons
(IRC 631)

Summary

The Act denies capital gain treatment to a taxpayer who disposes of coal to a related person after September 30, 1985, but does not cover coal sold under a contract binding on June 15, 1984 until tax years beginning after 1989.

Old Federal Law

The denial of capital gain treatment applied only to iron ore sold to related persons and not to the disposal of coal to related persons even though both coal and iron ore are given capital gain treatment if disposed of to unrelated persons.

Current California Law (PITL 17711, 18169)

California does not allow capital gain treatment to the disposal of either coal and iron ore and specifically provide that the federal section which denies capital gain treatment to coal or iron ore when disposed of to related persons is not applicable to the state.

Fiscal Impact

None. Not applicable to California.

TAX REFORM ACT OF 1984 SECTION 179

Limitation on Credits and Depreciation - Automobiles, Computers, and Other Mixed-Use Property
(IRC 280F, 274)

Summary

Generally, effective for passenger automobiles after June 18, 1984, the investment tax credit and the accelerated cost recovery system (ACRS) deductions for these vehicles which are used more than 50 percent for business may not exceed:

1. $1,000 investment tax credit,

2. $4,000 in ACRS deductions (including any election of an expense deduction) in the year placed in service, and

3. $6,000 per year of ACRS deductions for years after the year the vehicle was placed in service.

The credit and deduction limits are adjusted for the automobile price inflation adjustment rounded to the nearest $100. The inflation adjustment for the 1984 calendar year is zero.

These limits apply before making the allocation between business and non-business use. For example, if only 75 percent of the use of the automobile was business use, only 75 percent of the limit could be claimed resulting in an investment credit limited to a $750 maximum.

If at the end of the three year recovery period for automobiles there is basis still not recovered, the excess may be taken in subsequent years up to a maximum of $6,000 in each year until the unrecovered basis is used up as long as the automobile is still used more than 50 percent for business.

If the business use of an automobile declines, a portion of the investment credit is recaptured as ordinary income.

The lessor of automobiles is not affected by the new rules, but the lessee of a luxury automobile is allowed a reduced deduction for a portion of the lease payments in a manner similar to the investment credit and ACRS recovery limitations. Regulations will be written by the IRS explaining this restriction.

Property other than automobiles, such as entertainment and recreation property, computers not used exclusively at a regular business establishment, and other property to be specified by regulation, are not eligible for the investment credit unless they are used more than 50 percent for business. Those items (including passenger automobiles) used 50 percent or less for business must compute their ACRS deduction using the straight-line method over their earnings

and profits life (computers have a 12 year life). These restrictions apply to leases at the lessor level rather than to the lessee. If there is a reduction in business use to 50 percent or less of the property, there will be a recapture of depreciation deducted in excess of an amount computed using the straight-line method based on the earnings and profits life.

The earnings and profits lives are longer than the ACRS recovery periods as follows:

ACRS Recovery Period	Earnings and Profits Life
3-year property (automobiles)	5 years
5-year property (computers, office furniture and fixtures)	12 years
10-year property (theme park structures, railroad tank cars, and mobile homes)	25 years
15-year public utility property	35 years
18-year real property and low income rental housing (real property, buildings, and structural components)	40 years

Old Federal Law

Personal property with a life of three years or more that was used in a trade or business was eligible for the investment credit and ACRS deductions for the portion of the property used for business. The recovery period for automobiles was three years and for computers was five years. An election could be made to deduct as an expense in the year placed in service up to $5,000 of the cost of the property in lieu of investment credit and ACRS deductions for the amount deducted.

Current California Law (PITL 17250, 17250.5, B&CTL 24349)

California has never allowed an investment tax credit.

California did not generally conform to the federal ACRS enacted in federal law in 1981 nor to the election to expense in the year acquired $5,000 of the cost of the asset. ACRS is allowed in California only for property used in a business located in an enterprise zone and residential rental property constructed after July 1, 1985 and located in California.

California allows a deduction for depreciation for the business use of an asset using either the straight-line method, the double-declining balance method for new property having a useful life of three years or more, or the 150 percent declining balance method for used property over the class life of the asset. The straight-line method simply is the recovery of cost in excess of salvage value in equal amounts over the life of the asset. Under both declining-balance methods the depreciation is greatest in the first year and gets smaller each year. The double-declining-balance method produces deductions in the first year which are twice the deduction computed under the straight-line method. That rate is multiplied against the remaining cost to be depreciated (the declining balance) in each succeeding year. The 150-percent method is the same procedure except that the rate used is only 150 percent of the straight-line rate rather than twice the straight-line rate.

The class-life system measures the period over which assets are to be depreciated. That system specifies a long list of assets by classification. For example, the class life for automobiles is three years, airplanes have a six-year life, office furniture, fixtures, and equipment have a ten-year life, and computers and peripheral equipment have a six-year life.

California allows taxpayers to elect an initial deduction for additional depreciation in the year an asset is acquired equal to 20 percent of the cost, but only for tangible personal property (movable assets) with a class life of six years or more.

New Federal Law

The Act provides that effective for property leased or placed in service after June 18, 1984, "listed" property which is not used more than 50 percent for business will not qualify for investment tax credit. Also, the ACRS recovery allowance (depreciation) is to be determined under the straight-line method over the earnings and profit life for that property. If the percentage of business use was originally more than 50 percent, but drops below 50 percent in a later year, any depreciation taken in excess of the amount computed using the straight-line method over the earnings and profits life will be recaptured as ordinary income in the year the business usage drops to 50 percent or less.

"Listed" property includes:

1. Passenger automobiles and other property used as a means of transportation,

2. Property generally used for purposes of entertainment, recreation, or amusement,

3. Computers not used exclusively at a regular business establishment (including home offices), and

4. Other property to be specified by regulations.

The earnings and profits lives are:

1. A 5-year life for 3-year ACRS property,
2. A 12-year life for 5-year ACRS property,
3. A 25-year life for 10-year property,
4. A 35-year life for 15-year public utility property, and
5. A 40-year life for 18-year real property and low-income housing.

Special limitations are placed on luxury automobiles which are used more than 50 percent for business. These limitations are effective for vehicles placed in service after June 18, 1984.

1. The investment credit is limited to $1,000 unless the taxpayer elects to use a reduced investment credit percentage, in which case the credit is reduced by one-third.
2. The ACRS recovery deduction, including the amount elected to be deducted as an expense, is limited to a total of $4,000 for the year the automobile is placed in service.
3. The ACRS deduction for each succeeding year is limited to $6,000.
4. If there is cost unrecovered attributable to business use at the end of the three year recovery period, that unrecovered basis may be recovered each year to a maximum of $6,000. Property must continue to be used for business.
5. If business use falls to 50 percent or less, the depreciation taken in excess of straight-line over the earnings and profits life will be recaptured as ordinary income in the year of the reduced business use.
6. The credit and deduction limits are adjusted for inflation in the automobile component of the Consumer Price Index. The 1984 adjustment is zero.

These limits apply before making the allocation between business and non-business use.

A lessee is subject to reduced lease deductions for the amount attributable to the limitations on investment credit and depreciation deductions. Regulations will specify the computation of the lease limitation.

Fiscal Impact

Conforming to the changes in the limitation on depreciation for passenger automobiles and the restriction to the straight-line method for property used less than 50 percent for business would result in revenue gains of an unknown amount. Since California has a different depreciation system than federal and does not allow an investment credit, it is not possible to utilize federal estimates of revenue impact.

TAX REFORM ACT OF 1984 SECTION 179

Substantiation of Business Expense (IRC 274)

Summary

Effective for 1985 and later years, taxpayers are required to keep adequate "contemporaneous" records to substantiate:

1. Traveling expenses (including meals and lodging while away from home as well as local travel) that are trade or business expenses or expenses for the production of income,

2. Entertainment expenses,

3. Business gifts, and

4. Any investment tax credit or ACRS deduction claimed for business use of automobiles, computers, entertainment or recreation property, and others to be specified by regulation.

"Contemporaneous" means originating during the same period of time that the expense occurred. These records must reflect the business use of the property including its business purpose. For automobile travel expenses, logs recording the date of the trip and the mileage driven for business purposes are to be kept.

Any underpayment of tax resulting from the claiming of credits and deductions not supported by adequate contemporaneous records is subject to a negligence penalty of 5 percent of the deficiency. The underpayments also may be subject to the penalty for fraud.

Also, effective for 1985 and later years, tax return preparers are required to advise taxpayers of the new substantiation requirements and obtain a written confirmation from the taxpayer that the requirements were met regarding each credit or deduction claimed which is subject to the new rules and the preparer must sign the return.

If written confirmation is not obtained from the taxpayer, the preparer is not to sign the return.

Each failure by a return preparer to comply with these requirements is subject to a $25 penalty unless the failure is due to reasonable cause.

Old Federal Law

Taxpayers were allowed to substantiate their deductions by adequate records or by sufficient evidence which supported their statement including reconstructing the records at a later date. Taxpayers are required to have documentary evidence for any lodging expense while traveling away from home and for any expenditures of $25 or more. Records must include the amount, the time and the place, the business purpose, and the business relationship of the entertained person. To substantiate travel expenses a detailed record must be kept such as a diary account book or other statement of expense.

Current California Law (PITL 17201)

California is in conformity with old federal law.

Fiscal Impact

The revenue gain from conforming to the new substantiation and taxpreparer rules and the new penalties is unknown.

TAX REFORM ACT OF 1984 SECTION 101-105, 107

Stock Transactions - Straddles
(IRC Sections 1092, 256, 263, 1212, 1234, 1256)

Introduction

In 1981 the Economic Recovery Tax Act (ERTA) placed two restrictions on the losses allowed to be deducted on sales of commodity options and futures contracts where taxpayers held similar assets (offsetting positions) which would offset the loss if sold. This type of transaction (i.e. selling an option and simultaneously purchasing an option to buy the same or similar commodity with a differing delivery date) is termed a "straddle." In the stock or commodity market the term "straddle" means the privileged option of either delivering or buying at a specified price within a stated period of time. The practice of "hedging" was not affected by the straddle restrictions. "Hedging" is where, for example, a farmer plants a crop of wheat in October which will be ready for delivery in March of the next year. Since the farmer doesn't know what price the wheat will be in March, he/she sells for a stated price in October a commodity option for x bushels of wheat to be delivered in March. If the price of wheat goes up between October and March, the person who purchased the farmer's March wheat option makes a profit and the farmer got his/her money from the sale of the option in October. However, if the price of wheat falls between October and March the purchaser of the option takes the loss and not the farmer since the farmer still got his/her money from the sale of the option.

Taxpayers, other than those involved in "hedging" transactions, had begun to enter into a series of commodity option transactions on related commodities (offsetting positions) with differing delivery dates which had no substantial economic effect. The characteristics of these types of transactions included the reporting of a loss on the tax return for the year, but having the offsetting gain portion of the straddle not reported until the next year. Also, many transactions were being reported which never took place on any regulated market such as the Chicago Board of Trade but instead were taking place in the broker's office in London or elsewhere and not on a commodity exchange.

The first restriction enacted by ERTA was to defer the loss on the sale until the offsetting position of a straddle is sold. Second, a "mark-to-market" rule was allowed for regulated commodity futures contracts traded on a U.S. board of trade and approved by the IRS. "Mark-to-market" is simply the netting of all offsetting positions at the end of the year and taxed as if 60 percent of the capital gains were long term and 40 percent were short term. This netting is computed by treating each futures contract as if it were sold for fair-market-value on the last business day of the year. Fair-market-value can be established for these contracts by looking at the sales of the same type of contract on the regulated U.S. exchange. This "mark-to-market" rule is less restrictive than the loss-deferral rule, but is limited to these regulated futures contracts and cannot be used for any other type of straddle.

The two restrictions did not apply to stock. Stock options which were traded on a stock exchange were also excluded from these two restrictions.

Summary

The Act expands the application of the loss limiting straddle rules to transactions involving stock and exchange traded stock options when an offsetting position is held in an option on the same or similar stock or is held in a corporation which is engaged in the taking of positions which offset the taxpayer's positions. The IRS is required to prescribe the deferral rule regulations within 6 months and define the straddles to which it applies. The stock options which are traded on a Securities and Exchange Commission (SEC) regulated exchange are added to the regulated-futures contracts as being required to use the mark-to-market rules for reporting gains and losses which treat 60 percent of the gains and losses as long-term capital gain and 40 percent as short-term capital gain, thus subjecting net gains to a maximum 32 percent regular income tax rate.

Old Federal Law

Rules prevent the use of straddles to defer income or to convert ordinary income and short-term capital gain to long-term capital gain. In general, the deduction of losses from straddle positions involving actively traded personal property (other than stock) is deferred until the sale of the offsetting positions. Gains and losses on regulated-futures contracts are reported under the mark-to-market rule which treats all futures contracts as sold on the last business day of the year with 60 percent of the gains and losses treated as long-term capital gain and 40 percent as short-term gain, and thus taxed on net gains at a maximum regular rate of 32 percent.

Current California Law (PITL 18031, 18151, 18152-18154, 18162.5) (B&CTL 24998, 24344, 24344.5)

California Personal Income Tax Law is conformed to the federal straddle rules and mark-to-market rules, and 60 percent of gains and losses are treated as held over 5 years and 40 percent as held less than 1 year, but corporation law includes gains and losses in income at 100 percent. The corporation law is conformed to the federal straddle rules and mark-to-market rules in all other respects.

New Federal Law

The Act repeals the blanket exceptions from the straddle rules for stock and exchange-traded stock options. More limited exceptions are provided relating to hedging transactions unless an economic loss has accurred. In addition, the mark-to-market rule is extended to exchange-traded options held by investors and to options held by dealers in addition to the previously covered regulated-futures contracts. The IRS may specify by regulations that the identification of acquisitions may be made by time within the day an option or future is acquired where the price fluctuates during the day. Within six months the IRS regulations must specify the deferral rules and also define the straddles to which the rule applies.

Fiscal Impact

State conformity to the straddle provisions would result in a revenue gain of approximately $2.1 million in 1986 rising to $2.3 million in 1989 and, thereafter, based upon applying a percentage to the federal estimates for the 1984 Tax Reform Act.

TAX REFORM ACT OF 1984 SECTION 56, 106

Stock Transactions - Deductions in Connection with Short Sales (IRC Sections 163, 263, 265, 1091)

Summary

The Act: (1) restricts deductions for payments of interest made to carry property used in a short sale, and; (2) denies deductions for payments made in lieu of dividends on stock borrowed to make a short sale unless the time between selling the borrowed stock short and the delivery of the stock to close the sale is at least 46 days (more than one year in the case of payments in lieu of extraordinary dividends).

A short sale is one in which a person sells shares of stock that they do not own (usually a broker loans the stock to the individual) in the hope that the price of the stock will fall, and they can then buy stock at the lower price to deliver to the buyer. The problem that is being addressed by this law change arises from the short sale of stock with a dividend attached and the delivery of stock to the purchaser without a dividend attached because the sale was closed with stock purchased after the dividend date. Since the buyer is entitled to the dividend, the short seller must make a payment in lieu of the dividend to that buyer.

The Act makes interest paid to carry the borrowed stock subject to the limitation on the deduction for investment interest. Also, if the income from the asset would produce tax-exempt income, then any interest paid on the borrowed asset will not be allowed as a deduction.

The Act treats any short sale by individuals closed or a second short sale made within 30 days before or after short sale as essentially a simultaneous series of transactions requiring the deferral of any losses until the closing of the last transaction. These are the same rules as currently exist for stock and are termed "wash sale" rules. Those rules are extended to apply to any individual or business except a securities dealer.

Old Federal Law

The Internal Revenue Service had ruled that payment in lieu of a dividend is fully deductible against ordinary income.

A deduction for interest paid to purchase assets which produce tax-exempt income is not allowed, but the disallowance is not specifically extended to costs to purchase or carry property used in a short sale.

The deduction for interest by individuals on funds borrowed to buy or carry investment property is generally limited to the sum of $10,000 plus the excess of investment income over investment expense plus the excess of rental interest, business expenses, and interest over neutral income from the property. The amount disallowed is carried over to future years. Investment income is gross income from interest, dividends, and rents and royalties but cannot be attributable to a trade or business.

Current California Law (PITL 17201, 18031) (B&CTL 24425, 24438, 24998, 24344)

California Personal Income Tax Law is conformed to old federal law for investment interest expense limitations, denial of interest expenses to purchase or carry assets which produce income exempt from California tax, the short-sale rules, and the wash-sale rules.

New Federal Law

Under the Act payments in lieu of dividends are not deductible unless the short sale is held open for at least 46 days (more than one year in the case of payments in lieu of extraordinary dividends). Losses on short sales must be deferred if the taxpayer closes a short sale or enters into a second short sale within 30 days before or after the sale.

The act specifies that the provisions relating to limitations on investment interest expense and denial of interest deductions for expenses to purchase or carry assets which produce exempt income apply to short sales.

Fiscal Impact

State conformity to the federal changes to the short-sale expense deductions would result in a revenue gain of approximately $1 million in 1986 rising to $1.5 million in 1989 and, thereafter, based upon applying a percentage to the federal estimate for the 1984 Tax Reform Act.

In California corporations are required to include in income 100 percent of the gain or loss from a sale or exchange of assets. The Bank and Corporation Tax Law denies a deduction for expenses attributable to income exempt from California tax. The deduction allowed for interest on indebtedness incurred by a corporation to acquire securities or assets of another corporation is limited to a maximum of $5 million dollars. That maximum is reduced by interest on debt incurred to provide money for the acquisition of at least two-thirds of the trade or business assets of another corporation or its stock.

TAX REFORM ACT OF 1984 SECTION 108

Straddle Losses Before 1982

Summary

In order to settle pending litigation cases with the IRS, the Act provides that losses on disposition of straddle positions established before the effective date of the straddle limitation rules (1982) will be allowed as long as the transaction was entered into for profit. Losses by commodity dealers are presumed to have been entered into for profit. The IRS has the burden of proving that the transaction was not entered into for profit. This rule only applies where the transitional rules in the Economic Recovery Tax Act do not apply.

Old Federal Law

The treatment of pre-1982 straddles was a litigation issue on appeal for the IRS since the Tax Court did not agree with the position of the IRS.

Current California Law

California enacted the straddle limitations effective for positions established in 1982 and did not adopt transitional rules. Losses prior to that date are determined under the laws in effect when the transaction took place.

New Federal Law

This uncodified federal rule retroactively allows losses in order to reduce the backlog of cases and settle the issue.

Revenue Impact

There would be an unknown revenue loss from conforming to the retroactive allowance of losses on pre-1982 straddle losses.

TAX REFORM ACT OF 1984 SECTION 481

Preferred Stock in a Small Business Corporation
(IRC Sections 1244)

Summary

The Act extends the allowance of ordinary loss treatment to transactions involving the preferred stock of small business corporations as well as losses from the sale or exchange of common stock.

Old Federal Law

Ordinary loss treatment is granted to losses from the sale of common stock of a small business corporation. For purposes of this treatment a small business corporation is defined as any corporation which has a capital account of $1 million or less at the time the stock is issued.

Current California Law (PITL 18151) (B&CTL 24902)

The California Personal Income Tax Law is conformed to the old federal law. California Bank and Corporation Tax Law includes in income 100 percent of the gains or losses on the sale or exchange of property.

New Federal Law

Under the Act the ordinary loss provisions would be extended to cover losses on preferred stock of small business corporations. All restrictions applicable under present law to losses on common stock would apply to losses on preferred stock.

Fiscal Impact

There would be an unknown revenue loss to conforming with the small business stock expansion to include preferred stock.

TAX REFORM ACT OF 1984 SECTION 1001

Holding Period for Long-Term Capital Gain (IRC Sections 1222)

Summary

The Act reduces the holding period from more than 12 months to more than 6 months to qualify as long-term capital gain or loss for assets acquired after June 22, 1984.

Old Federal Law

Gains or losses on sales or exchanges of capital assets held for more than 12 months are considered long-term capital gains or losses. A deduction for 60 percent of net long-term gains is allowed.

For corporate taxpayers, net long-term capital gains are subject to an alternative tax rate of 28 percent, while net short-term gains are taxed at ordinary corporate rates. Capital losses of corporations are not deductible against ordinary income.

Current California Law (PITL 18152, 18155, 18162.5) (B&CTL 24902)

The California holding periods are completely different than federal and the percentages of gain includable in gross income depend both on the type of asset (i.e., small business stock, passive assets, and other assets) as well as the time the asset has been held. Corporations include in income 100 percent of the gains and losses from the sale or exchange of assets.

California law provides that, for individual taxpayers, preferential treatment is given to gains from the sale of capital assets, by taking into account less than 100 percent of the gain.

As amended by SB 690 (Presley) of 1981 and modified by AB 2476 of 1984, California law now gives more preferential treatment to "small business stock" and less preferential treatment to "nonproductive assets," as demonstrated below:

100% of gain includable in income:

All assets held one year or less (same as old federal law).

70% of gain includable in income:

Nonproductive assets held from one to five years.

65% of gain includable in income:

- o "Small business stock"* held from one to three years.

- o All other assets held from one to five years other than nonproductive assets and small business stock.

<u>50% of gain includable in income:</u>

All assets, other than small business stock, held for more than 5 years.

<u>0% of gain includable in income:</u>

Small business stock* held more than three years.

*If at the time of sale the fair market value of land owned or controlled by the corporation does not exceed 25 percent of the fair market value of the corporation (as reflected in the price at which the stock was sold) and did not receive more than 25 percent of its receipts in the prior year from rents, interest, dividends, or sale of assets.

Small business stock is defined as an equity security issued by a corporation which has the following characteristics at the time of acquisition by the taxpayer:

- o The commercial domicile or primary place of business is located within California.
- o The total employment of the corporation in the prior year is not more than 500 employees; however, if more than 50 percent of the outstanding securities are held by another corporation, the employment of the controlling corporation would be counted.
- o The outstanding issues of the corporation are not listed on the New York Stock Exchange, the American Stock Exchange, or the National Association of Securities Dealers Automated Quotation System.
- o No more than 25 percent of gross revenues in the prior income year were obtained from rents, interest, dividends, or sales of assets except that interest during the first four years of business will not disqualify the stock.
- o The corporation is not engaged primarily in the business of holding land.

Nonproductive assets are defined as:

- o Precious or strategic metals, such as gold and silver.
- o Jewelry or gems.
- o Objects of art.

- Antique items.

- Stamps.

New Federal Law

Effective for assets acquired after June 22, 1984, the holding period for determining whether gain or loss on the sale or exchange of a capital asset or certain business property is long-term or short-term is reduced from 1 year to 6 months. Thus, property held for more than 6 months will be eligible for long-term capital gain or loss treatment.

Fiscal Impact

1. Partial conformity to the federal short- and long-term definitions at a 50-percent exclusion for assets held for more than one year would result in a revenue loss of $28.6 million in 1986 and rising to $33.1 million in 1989 and, thereafter, based upon the tax model estimate.

2. Partial conformity with a 60-percent exclusion for assets held over one year would result in a revenue loss of $89.2 million in 1986 rising to $103.3 million in 1989 and, thereafter, based upon the tax model estimate.

3. Full conformity to the 60-percent exclusion and a 6-month holding period would result in a revenue loss of $90.5 million in 1986 rising to $108.8 million in 1989 and, thereafter, based upon combining the tax model estimate and adding a pro-rata portion of the federal estimate for the 1984 Tax Reform Act.

TAX REFORM ACT OF 1984 SECTION 1002

Capital Loss Carryovers
(IRC Sections 1212)

Summary

The Act repeals a pre-1970 transitional rule relating to capital loss carryovers which is not applicable to California.

Old Federal Law

Federal law contained special rules relating to pre-1970 losses carried over to years after the federal law change in 1969.

Current California Law (PITL 18152-18154)

California provided a different method of determining the amount of a capital loss eligible for carry-over since the state uses the concept of a multi-tiered holding period and specific exclusions from gross income rather than a capital gain deduction as allowed by federal law. Also, the amount eligible to offset other income is $1,000 per year.

New Federal Law

The act repeals the special treatment accorded pre-1970 capital loss carry-overs.

Fiscal Impact

No revenue effect. Not applicable to California.

TAX REFORM ACT OF 1984 SECTION 12

Finance Leasing
(IRC Sections 168)

Summary

The Act generally delays the start of rules relating to finance leasing for four years. Leasing rules were enacted in 1981 by the Economic Recovery Tax Act (ERTA) in connection with the accelerated cost recovery system (ACRS) and restructured in 1982 by the Tax Equity and Fiscal Responsibility Act (TEFRA) to provide reduced tax benefits for leases entered into after 1982, to repeal the ERTA leasing rules and replace them with finance leasing rules which were originally effective for years beginning after December 31, 1983. California did not generally conform to either the ERTA or TEFRA provisions relating to ACRS or the leasing rules.

The purpose of the leasing rules is to provide the method used to determine whether a transaction is to be treated as a lease or a purchase. That determination is important for determining who is entitled to deductions for business expenses, ACRS depreciation, and the investment tax credit.

The finance leasing rules only apply when the lessor is a corporation.

Old Federal Law

Beginning in 1984 the federal law was scheduled to allow a property subject to a "finance lease" to be eligible for ACRS deductions, be exempt from limitations on interest paid by the lessor to the lessee and on carrybacks of investment tax credits, and to allow net operating losses to be taken. A maximum of 40 percent of a lessee's property can be treated as a finance lease. In addition, a lessor cannot reduce its tax liability by more than 50 percent by using finance lease tax benefits. Deductions or credits in excess of the limitation are carried forward to future tax years.

A "finance lease" is an agreement which contains a 10 percent fixed purchase price, is for new property, and meets the following requirements:

1. The lessor is a corporation, a partnership composed of corporations, or a trust having only corporate beneficiaries, and

2. The parties to the agreement must term it a lease.

Current California Law (PITL 17250, 17250.5) (B&CTL 24349)

California has never allowed an investment credit.

California did not generally conform to the federal ACRS enacted in federal law in 1981 and modified by TEFRA in 1982. ACRS is allowed in California only for property used in a business located in an enterprise zone and residential rental property constructed after July 1, 1985 and located in California.

The determination of whether an agreement is a lease for California tax purposes are the same as the pre-1981 federal rules which developed through court litigation. Generally the considerations used are whether the transaction is a genuine multiple party arrangement that has an economic profit reason arising from business needs and is not solely a tax avoidance scheme.

New Federal Law

The Act delays the finance leasing rules for four years.

Fiscal Impact

Conforming to the delay in implementing finance lease rules will result in a revenue gain of an unknown amount.

TAX REFORM ACT OF 1984 SECTION 13, 18

Election to Expense Depreciable Assets - Increase Delayed (IRC Sections 179)

Summary

The Act delays for four years the scheduled increases in the amount of the cost of depreciable property which a taxpayer may elect to deduct as a current-year expense in lieu of taking ACRS depreciation deductions.

Old Federal Law

The Economic Recovery Tax Act (ERTA), which adopted the expensing election, provided that the dollar amount eligible for expensing would increase from $5,000 to $7,500 in 1984 and 1985 and increase to $10,000 in 1986 and later years.

Current California Law (PITL 17260, 17265) (B&CTL 24356.3)

The California law does not conform to the federal election to expense depreciable assets. In 1984 Legislation (AB 514 - Waters), limited expensing of depreciable assets was allowed to both individual and corporate taxpayers in targeted economic development areas. Those taxpayers may elect to expense 40 percent of the cost of depreciable machinery used in the targeted area for fabricating, assembling, or manufacturing. The maximum cost of the property eligible for the expensing election is dependent on the length of time the program area has been targeted for economic development as follows:

Machinery Acquired In Taxable Year in Which:	Maximum Amount Eligible
Program area first designated	$ 5,000
1st year after designation	$ 5,000
2nd year after designation	$ 7,500
3rd year after designation	$ 7,500
Each year thereafter	$10,000

No program areas have been designated.

New Federal Law

The Act keeps the eligible maximum amount at $5,000 for each year until 1988, increases the maximum amount to $7,500 for 1988 and 1989, and then increases the maximum amount to $10,000 for 1990 and later years.

Fiscal Impact

None. The California law is not conformed to the federal allowance of an election to expense depreciable property, and thus, the changes are not applicable to California.

TAX REFORM ACT OF 1984 SECTION 31

Tax-Exempt Entity Leasing
(IRC Sections 46, 48, 168, 7701)

Summary

The Act restricts the investment-tax credit and accelerated cost recovery system (ACRS) deductions of taxpayers who own property and lease the property to tax-exempt organizations, foreign persons, or government agencies as follows:

1. No investment-tax credit is allowed, and

2. ACRS or other depreciation deductions must be computed using the straight-line method over a recovery period equal to the greater of 125 percent of the lease term or the life of the asset listed in the pre-1981 guidelines for the Asset Depreciation Range (ADR).

According to the Senate Finance Committee this restrictive action was taken to prevent the tax system from encouraging tax-exempt organizations to dispose of their assets or to give up control of the assets they use.

Under both old and new law, tax-exempt organizations and government agencies cannot take depreciation deductions on assets they own. Additionally, no investment-tax credit is allowed for property leased to or otherwise used by tax-exempt organizations.

Depreciation and investment-tax credits were designed to reduce the tax burden of taxable persons and not for government agencies, tax-exempt organizations or foreign persons. However, when a tax-exempt organization, government agency, or foreign person leases property, it pays reduced rents that Congress felt was equivalent to a pass-through of investment tax credit and depreciation deductions from the property owner.

Old Federal Law

No investment credit was allowed to the lessor of property to nontaxable entities, but government agencies and foreign persons were not defined as nontaxable entitites.

No deduction for depreciation is allowed to governmental units or other tax-exempt organizations for property owned by them. However, taxable persons were allowed full ACRS depreciation deductions for property leased to a tax-exempt organization or government agency.

For assets placed in service before 1981, the class-life system using the Asset Depreciation Range must be used by a taxpayer to determine the life of the asset being depreciated. The class-life system provides lists of industry classes and specifies the useful economic lives of the assets used in that industry. The taxpayer may chose from a range of depreciable lives that range from 20 percent shorter to 20 percent longer than the established class life. That is known as the Asset Depreciation Range.

Current California Law (PITL 17201) (B&CTL 24349)

California generally utilizes the class-life Asset Depreciation Range to determine useful life for depreciation purposes for all depreciation assets. California did not adopt the 20 percent shorter or 20 percent longer feature contained in pre-1981 federal law.

California has never allowed an investment tax credit.

Depreciation deductions are not allowed to tax-exempt organizations for property owned by them.

Taxable persons are allowed depreciation deductions and are not limited because they lease the property to a tax-exempt organization, government agency, or foreign person.

New Federal Law

The Act adds governmental agency and foreign person to the definition of nontaxable entities for purposes of the investment credit. No investment credit is allowed for the cost of new property leased to nontaxable entities.

The Act limits ACRS or other depreciation deductions to amounts computed using the straight-line method over a recovery period equal to the greater of 125 percent of the lease term or the life of the asset listed in the pre-1981 guidelines for the class-life Asset Depreciation Range (ADR) summarized in the following table:

Type of Property	Life To Be Used
Personal Property with no present class life	12 years
18-year ACRS real property	40 years
All other property	The midpoint of the ADR range (no option for 20 percent shorter or longer)

Fiscal Impact

Restricting depreciation deductions to the straight-line method for property owned by taxpayers who lease the property to tax-exempt organizations would result in an unknown revenue gain.

TAX REFORM ACT OF 1984 SECTION 32

Motor Vehicle Leases
(IRC Sections 168)

Summary

The Act provides that a motor vehicle lease entered into after October, 1984, will be treated as a lease and not a sale even if the contract contains a requirement that the rental price will be adjusted upward or downward at the end of the lease term depending upon the price when the vehicle is ultimately sold. That clause is termed a "terminal rental adjustment clause." This means that the lessor is entitled to investment credit and ACRS deductions on the vehicle, and the lessee can deduct the lease payments as a business expense.

Old Federal Law

Leases which contained a terminal rental adjustment clause were treated as a sale of the vehicle and not a lease. This meant that the lessee rather than the lessor was entitled to investment credit and ACRS deductions. Also, only the portion of lease payments which relate to interest were deductible as business expenses.

Current California Law (PITL 17201) (B&CTL 24349)

California conformes to old federal law regarding the method by which a contract is determined to be a sale or lease.

New Federal Law

The Act provides that the presence of a terminal rental clause in a motor vehicle lease will not be considered a factor in determining whether the contract is a lease. The transaction is to be treated as if the property will be returned to the lessor at the end of the lease term without any terminal rental adjustment.

Fiscal Impact

Conformity to the new federal rule for motor vehicle leases would result in an unknown revenue loss.

TAX REFORM ACT OF 1984 SECTION 91-92

Accounting Method for Timing of Expense Deductions (IRC Sections 88, 172, 461, 467, 468, 468A)

Summary

The Act provides, generally, that for transactions occurring after July 18, 1984, a taxpayer cannot deduct the expense for the item until the property or services are actually received by the taxpayer. An exception to this new rule is provided for recurring minor expenses which are satisfied shortly after the beginning of the next year. This new rule also applies to "tax shelters" to determine the deductibility of prepaid expenses. A "tax shelter" is any enterprise other than a corporation which has offered to sell interests in the enterprise which are considered securities and includes any partnership that allocates more than 35 percent of its losses to limited partners. Any arrangement or partnership designed primarily for tax avoidance or tax evasion is also included in the term "tax shelter."

Special rules are provided to allow deductions for nuclear plant decommissioning costs when the amounts are paid to a separate fund to be used to pay for the ultimate decommissioning. Also, mine and waste disposal reclamation costs are allowed to be deducted when paid rather than when the reclamation or waste disposal takes place. A ten-year net operating loss carryback is allowed for losses on deferred liabilities for claims and damages awarded by federal or state courts.

Deferred payments under rental agreements of property involving more than $250,000 in rental payments must be reported as rental income and interest income by the lessor during each year of the lease in equal amounts. Deductions by the lessee for rental expense and interest expense are limited to the same years and amounts as the lessor is including in income. For example, if the payment of rent is in a lump sum at the end of the lease term, then that lump sum is spread equally over the years of the lease, and a portion is considered a payment of interest. The lessor must include in income and the lessee must deduct as expense that annual amount (termed the "constant rental amount"). These rental agreement rules only apply when at least one amount is to be paid after the close of the following year (deferred payments) or where there are increases in the amount to be paid as rent under the rental agreement (stepped rents).

Old Federal Law

A business taxpayer which elected to utilize the accrual method of accounting could deduct expenses when all events had occurred which established both the amount of the debt and the liability to pay the debt. Income is reportable when the right to receive the income is established and not when the income is actually received. It was thus possible to deduct expenses even though the property or service had not been actually received by the taxpayer. Individuals generally are not allowed to use the accrual method of accounting, but instead use the cash method which consists simply of reporting income when received and deducting expenses when paid.

Net operating loss carrybacks are generally allowed for a three-year period except for product liability losses which are allowed a 10-year carryback period.

Current California Law (PITL 17551) (B&CTL 24661)

California has never allowed net operating loss carrybacks.

California law is in conformity with old federal law regarding the methods of accounting.

New Federal Law

The Act provides that the transactions after July 18, 1984, which involve the advance payment for future goods or services, no deduction is allowed until the taxpayer actually receives the goods or services. This rule is applied whether or not the taxpayer is on the cash basis or the accrual basis and also applies to tax shelters. Exceptions to the rule are provided for small recurring expenses and for payments to a fund for nuclear power plant decommissioning, mine reclamation, or solid waste disposal.

A ten-year carryback of net operating losses is allowed if the loss is attributable to deferred liability costs imposed by state or federal courts.

Income and expense of lessors and lessees under rental agreements with rental payments exceeding $250,000 are required to include in income and deduct as expense the constant rental amount whether or not the payments are made equally over the rental period. This treatment only applies where at least one amount is to be paid after the close of the following year (deferred payments) or where there are increases in the amount to be paid as rent under the rental agreement (stepped rents).

Fiscal Impact

Conforming to the provisions on rental agreements and allowing the deduction for an expense for goods or services only in the year actually received by the taxpayer would result in revenue gains in the $20 million range for 1984, $45 million for 1985, and $65 million for 1986. These estimates are based on a proration of federal estimates for the 1984 Tax Reform Act.

California does not allow any net operating loss carryback.

TAX REFORM ACT OF 1984

Leases of Coal Gasification Facilities Before July 1, 1984
(TEFRA Section 208, IRC 47)

Summary

The Act retroactively extends the TEFRA transitional lease rules which allow treatment as a lease rather than a financing arrangement to leases of coal gasification facilities placed in service before July 1, 1984.

Old Federal Law

Whether a coal gasification facility lease is a lease or a financing arrangement was determined by the economic substance of the arrangement and was not covered by transitional rules contained in the 1982 TEFRA leasing changes.

Current California Law (PITL 17250, 17250.5) (B&CTL 24349)

California did not adopt the transitional rules of 1982 federal legislation.

New Federal Law

Leases of coal gasification facilities placed in service before July 1, 1984, will qualify for lease treatment even though an examination of economic substance may show the arrangement to be a financing arrangement rather than a lease.

Fiscal Impact

None. Applies only to facilities placed in service before July 1, 1984.

TAX REFORM ACT OF 1984 SECTION 141

Registration of Tax Shelters
(IRC Section 6111)

Summary

The Act requires organizers of tax shelters to register with the Internal Revenue Service before any offering is made. The Internal Revenue Service (IRS) will assign an identification number to the shelter and that number is to be furnished to each investor. This identification number is required to be shown on the taxpayer's tax return.

A tax shelter is defined as one which offers a write off of two dollars for every one dollar invested within five years after the investment is offered for sale.

A tax shelter organizer is any person principally responsible for organizing the tax shelter, any other person who participated in organizing the tax shelter, or any person participating in the management or sale of the investment before the tax shelter is registered.

Old Federal Law

There was no law section requiring specific registration requirements for tax shelters before any offering is made or requiring the furnishing of the registration number to investors.

Current California Law

California has no requirement for registration of tax shelters, therefore, there is no registration number to furnish investors.

Fiscal Impact

Revenue gains from conforming to these registration requirements are unknown.

TAX REFORM ACT OF 1984 SECTION 6707

Penalty for not Registering Tax Shelters and Penalty for Failure to Furnish Registration Number to Investors
(IRC Section 6707)

Summary

The Act provides that if a tax shelter promoter fails to register a tax shelter with the Internal Revenue Service before any offering is made, a penalty of $500 or 1 percent of the amount invested (whichever is greater) up to $10,000 shall be assessed. If the failure is intentional, the $10,000 limit will not apply. Also, if a shelter promoter fails to furnish the shelter's registration number to an investor in the shelter, a $100 penalty will be assessed for each failure against the promoter.

Old Federal Law

None.

Current California Law

California has no penalties for failure to register tax shelters or penalties for failure for furnishing of the registration number to investors as California has no requirement for tax shelter promoters to register tax shelters.

Fiscal Impact

Additional penalty amounts that would be collected under conformity are unknown.

TAX REFORM ACT OF 1984 SECTION 142

Requirement to Maintain Lists of Tax Shelter Investors by Promoters (IRC Section 6112)

Summary

The Act provides that any person who organizes or sells a tax shelter which may be potentially abusive, must keep a list of each investor and other information as required by the Secretary of the Treasury.

Old Federal Law

There was no federal law requiring an organizer of a potentially abusive tax shelter to keep a list of investors.

Current California Law

California requires that records be maintained by tax shelter promoters showing each investor to whom an investment has been sold. The promoter or seller of the tax shelter is also subject to information reporting requirements. Penalties for failure to maintain records and failure to furnish the information return are imposed on tax shelter promoters.

Fiscal Impact

None. California has its own specific reporting and recordkeeping requirements in current state law.

TAX REFORM ACT OF 1984 SECTION 142

Penalties for Failure to Maintain Lists of Investors in Potentially Abusive Tax Shelters
(IRC Section 6708)

Summary

This Act provides that any promoter of a potentially abusive tax shelter who fails without reasonable cause, to maintain the lists of investors will be subject to a penalty of $50 for each person omitted. The maximum penalty is $50,000 each calendar year.

Old Federal Law

There is no old federal law requiring promoters or sellers of potentially abusive tax shelters to keep lists, therefore, there is no provision for any penalty.

Current California Law

California has a penalty imposed on promoters or sellers of tax shelters for not keeping records of investors in the tax shelters as well as the amounts invested by each invester. The penalty is $1,000 per inventor improperly reported or recorded or $100,000 if the number of investors cannot be determined.

Fiscal Impact

None. California has its own penalties for failure to report or maintain records of tax shelter investments sold.

TAX REFORM ACT OF 1984 SECTION 143

Penalty for Promoting Abusive Tax Shelters
(IRC Section 6700)

Summary

This Act increases the penalty for promoting or selling abusive tax shelters to the greater of $1,000 or 20 percent of the gross income derived or to be derived by the person from the tax shelter.

Old Federal Law

A penalty of the greater of $1,000 or 10 percent of the shelter's gross income is imposed on anyone who organizes, promotes, or sells any partnership interest, or any other investment which the person knows to be false or fraudulent, or grossly overvalued. Gross overvaluation means the value stated exceeds 200 percent of the correct valuation. The penalty may be waived if there was reasonable cause to believe the valuation was made in good faith.

Current California Law (PITL 19415, 19416) (B&CTL 25957, 25957.1)

California law conforms to old federal law.

Fiscal Impact

Additional penalty amounts that would be collected under conformity are unknown.

TAX REFORM ACT OF 1984 SECTION 143

Authority to Seek Injunction Against Promoters of Abusive Tax Shelters (IRC Section 7408)

Summary

The Act allows the federal government to take civil action to enjoin any person from further promoting abusive tax shelters or aiding and abetting in the understatement of tax liability. If the court finds that any person is subject to the penalty for promoting abusive tax shelters or aiding and abetting in the understatement of tax liability, the court may enjoin that person from engaging in conduct subject to the penalty.

Old Federal Law

Old federal law provides that the federal government may take civil action to enjoin a person from promoting abusive tax shelters.

Current California Law (PITL 19419) (B&CTL 25965)

California law provides that the state may take civil action to enjoin a person or corporation from promoting abusive tax shelters.

Fiscal Impact

Revenue gains from conforming to injunctions against persons who are aiding or abetting in the understatement of tax liability are unknown.

TAX REFORM ACT OF 1984 SECTION 144

Interest Rate With Respect to Substantial Underpayment Attributable to Tax-Motivated Transactions
(IRC Section 6621(d))

Summary

The Act provides that after December 31, 1984, a higher interest rate equal to 120 percent of the normal annual interest rate will be applied when the Tax Court decides that a substantial underpayment of tax has occurred and that it is an underpayment of tax attributable to one or more tax motivated transactions and exceeds $1,000 for the year.

Tax motivated transactions means those involving:

1. Any valuation overstatement of 150 percent or more,

2. Any disallowed loss because of the application of the at-risk rules to a loss or investment tax credit.

3. Tax straddles,

4. Use of any accounting method which results in a substantial distortion of income.

Old Federal Law

There was no federal law which applied a higher interest rate for a substantial underpayment of tax.

Current California Law

There is no provision in California law to have a higher interest rate for a substantial underpayment of tax.

Fiscal Impact

Additionl interest revenue that would result from conformity is unknown.

TAX REFORM ACT OF 1984 SECTION 144

Cross Reference Giving Tax Court Jurisdiction
(IRC Section 6214(e))

Summary

The Act cross references the 120 percent of the annual interest rate provision that the Tax Court is given jurisdiction to determine whether any portion of a deficiency is a substantial underpayment attributable to tax motivated transactions.

Old Federal Law

None.

Current California Law

None.

Fiscal Impact

None. This is a definitional section.

TAX REFORM ACT OF 1984 SECTION 441

Simplification of Treasury Secretary Reports to Congress

Summary

The Act simplifies reports required to be sent by the Treasury Department to Congress covering the following subjects:

1. Intenational boycotts.

2. High-income taxpayers, and

3. Possessions corporations.

Current California Law

None. Not applicable to California.

Fiscal Impact

None. Not applicable.

TAX REFORM ACT OF 1984 SECTION 446

Judicial Review of Jeopardy Assessments and Termination Assessments (IRC Section 7429 (b)(2))

Summary

The law provides that when a taxpayer brings a civil action against the United States in a district court to determine if the making of a jeopardy or termination assessment is reasonable the court has 20 days to make a determination. However, if the court determines that the United States has not been served within five days after the suit was commenced the 20 day period does not begin until the day proper service was made. This provision is effective for actions beginning after July 18, 1984.

Old Federal Law

Previous law provided that the District Court had only 20 days to make a decision in suits to review jeopardy assessments after the suit was started.

Current California Law

California has no provision for a court to review jeopardy assessments since that review is provided as an administrative proceeding.

Fiscal Impact

None. Not applicable.

TAX REFORM ACT OF 1984 SECTION 447

Extension of Statute of Limitations for Certain Amended Returns (IRC Section 6501(c))

Summary

The Act provides that, effective on July 18, 1984, when a taxpayer files an amended return within 60 days of the expiration of an assessment period (3 years), the period of assessment will be extended 60 days after the date the amended return is received by the Internal Revenue Service. This new provision is to allow the Internal Revenue Service to determine if the taxpayers owes an additional amount of tax.

Old Federal Law

If a taxpayer filed an amended return shortly before the statute for the year in question expired the Internal Revenue Service had only until the statute expiration date to discover any deficiency.

Current California Law (PITL 18586 & 19053, B&CTL 25663 & 26073)

If a taxpayer files an amended return just prior to the statute of limitations expiring (4 years) the Franchise Tax Board has only until the statute expiration date to discover any deficiency.

Fiscal Impact

Additional tax revenues that would result from conformity are unknown.

TAX REFORM ACT OF 1984 SECTION 448

United States Lien on Assets of Financial Institutions Issuing Guaranteed Checks
(IRC Section 6311(b)(2)

Summary

The Act provides that if any certified, treasurer's cashiers check or other guaranteed draft or any money order received to pay taxes is not paid, then the federal government has the right to have a preferred lien against all the assets of the financial institution which issued the payment instrument. This is in addition to the government's right to obtain payment from the taxpayer.

Old Federal Law

Under previous federal law if a guarateed check or money order is used to pay taxes, the United States has a preferred lien on the assets of the bank or trust company who issued the draft if it is not paid.

Current California Law

The California Revenue and Taxation Code has no provision to obtain a preferred lien on the assets of the issuer of a draft or money order to pay taxes if it is not paid.

Fiscal Impact

Revenue collected from issuers of guaranteed payments from conformity is unknown.

TAX REFORM ACT OF 1984 SECTION 449

Disclsoure of Windfall Profits Tax Information to State Tax Officials (IRC Section 6103(d)(1))

Summary

This act includes the windfall profit tax in the list of taxes the Internal Revenue Service can disclose to state tax officials.

Old Federal Law

The old federal law allowed disclosure to state tax officials information on the following taxes:

1. Normal Taxes and Surtaxes
2. Tax on Self Employment Income
3. Tax on Consolidated Returns
4. Estate Tax
5. Gift Tax
6. Federal Insurance Contributions Tax
7. Federal Unemployment Tax
8. Collection of Income Tax at Source on Wages
9. Real Estate Investment Trusts

Current California Law

None. Not applicable.

Fiscal Impact

None. Not applicable.

TAX REFORM ACT OF 1984 SECTION 450

Financial Reporting of Investment Tax Credits
(Revenue Act of 1971 Section 101(c) (85 Start 499))

Summary

This act repeals the requirement that taxpayers use the same accounting method for the investment credit in all reports filed with any federal agency. Effective as if included in the Revenue Act of 1971.

Old Federal Law

The Revenue Act of 1971 required a taxpayer to use the same method of financial accounting for the investment tax credit in all reports subject to the jurisdiction of any federal agency unless the Treasury approved a change to another method.

Current California Law

Not applicable.

Fiscal Impact

None. Not applicable.

TAX REFORM ACT OF 1984 SECTION 145

Information Returns for Mortgage Interest Received from Individuals (IRC Section 6050H)

Summary

The Act adds a new section to the Internal Revenue Code. This section requires that an information return be filed by every person who in the course of trade or business receives $600 or more in mortgage interest in any calendar year. The return is to filed with the Internal Revenue Service (IRS) and is to contain the name and address of the individual from whom the interest was received, the amount of interest in the calendar year and other information as required IRS regulation. The individual paying the interest is to receive a statement by January 31 of the following year with the name and address of the person filing the information return and the amount of interest reported.

Old Federal Law

None.

Current California Law

None.

Fiscal Impact

Revenue gains from increased information reporting under conformity are unknown.

TAX REFORM ACT OF 1984 SECTION 145

Penalty for Failure to File Mortgage Interest Information Return (IRC Section 6652(a)(1) & (a)(3)(iii))

Summary

The Act provides for a penalty to be assessed if a person who in the course of trade or business receives $600 or more in mortgage interest fails to file an information return with the IRS. The penalty is $50 for each failure not to exceed $50,000 during any calendar year. The penalty can be waived if the failure is due to reasonable cause and not to willful neglect. However, if the failure is due to intentional disregard of the filing requirement the penalty is $100 for each failure and the $50,000 limitation is not applicable.

Old Federal Law

None.

Current California Law

New federal law section, California has no penalty for failure to file an information return by a person receiving interest of $600 or more in connection with a trade or business.

Fiscal Impact

Additional penalties that would be collected under conformity are unknown.

TAX REFORM ACT OF 1984 SECTION 145

Failure to Furnish a Statement to Payors of Mortgage Interest (IRC Section 6679(a))

Summary

This act assesses a penalty on any person who receives $600 or more in mortgage interest in connection with a trade or business and fails to provide a statement to the payor by January 31 of the following year. The penalty is $50 for each failure not to exceed $50,000 in a calendar year.

Old Federal Law

None.

Current California Law

None.

Fiscal Impact

Additional penalties collected under conformity are unknown.

TAX REFORM ACT OF 1984 SECTION 146

Cash Payments Received in Trade or Business
(IRC Section 6050I)

Summary

Any person who, in the course of its trade or business, receives more than $10,000 in cash or foreign currency after 1984 in one transaction, or in two or more related transactions, must report the transaction or transactions to the IRS at such time as prescribed by regulation. The return is to contain the payor's name, address and taxpayer identification number, the amount received, the date and nature of the transaction or transactions, and any other information required by regulation.

Also, the person required to file the above return with the IRS must furnish the payor a written statement showing the return maker's name and address and the total amount of the payment received. This statement is to be furnished on or before January 31 of the year following the calendar year with respect to which the information pertains.

The above rules do not apply to banks and other financial institutions which are required, under the Bank Secrecy Act, to report cash transactions of more than $10,000 to the Treasury Department. Also, they do not apply to transactions entirely outside the United States except to the extent provided by regulation.

Old Federal Law

None.

Current California Law

California has no law requiring the reporting of the receipt of large amounts of cash or foreign currency in the course of a trade or business.

Fiscal Impact

Revenue gains from increased information reporting are unknown.

TAX REFORM ACT OF 1984 SECTION 146

Penalty for Not Filing an Information Return for Cash Payments Received in Trade or Business
(IRC 6652(a)(1))

Summary

This act provides that any person who is subject to reporting the receipt of $10,000 or more in cash or foreign currency in the course of trade or business who fails to file an information return with the Internal Revenue Service (IRS) is subject to a $50 penalty per failure up to a $50,000 maximum each calendar year.

Old Federal Law

None.

Current California Law

None.

Fiscal Impact

Additional penalties collected from conformity are unknown.

TAX REFORM ACT OF 1984 SECTION 146

Penalty for Not Providing a Statement to Payor
(IRC 6678(a)(1))

Summary

This act provides that any person who is required to furnish the payor of $10,000 or more in cash or foreign currency a written statement and fails to do so is subject to a penalty of $50 for each failure up to $50,000 maximum penalty for each calendar year.

Old Federal Law

None.

Current California Law

None.

Fiscal Impact

Additional penalties collected under conformity are unknown.

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TAX REFORM ACT OF 1984 SECTION 147

Individual Retirement Accounts - Reports
(IRC Section 408(i))

Summary

This act requires that the reports required of Individual Retirement Account (IRA) trustees or employers who make a contribution for an employee to a simplified employee pension (SEP) must specifically show both the total amount contributed each year by the IRA owners or SEP employees contribution and the taxable year to which a particular contribution relates.

Old Federal Law

Previous law required only that the IRA trustees show the total amount contributed to the IRA each year.

Current California Law (PITL 17507)

California is in conformity with old federal law.

Fiscal Impact

Any revenue gains to the state that might result from conformity are unknown.

TAX REFORM ACT OF 1984 SECTION 147

Penalty for not Filing Individual Retirement Account Reports (IRC 6693(a))

Summary

If a trustee of an IRA or an employer who makes a contribution for an employee to a SEP does not file a report to the Internal Revenue Service timely and as required, a penalty of $50 shall be assessed for each failure. If the failure is due to reasonable cause, the penalty can be waived.

Old Federal Law

The penalty for failure to file the required reports to the IRS was $10 for each failure.

Current California Law

California has no provision in its law for a penalty for not filing IRA or SEP reports.

Fiscal Impact

Additional penalty amounts from conformity are unknown.

TAX REFORM ACT OF 1984 SECTION 147

Time Limitation for Taking Contributions to Individual Retirement Plans (IRC Section 219(f)(3)(A))

Summary

This Act requires that all contributions to an individual retirement account (IRA) relating to a taxable year be made no later than the due date for filing the return without regard for any extensions. For most taxpayers this date is April 15. This provision applies to contributions made after December 31, 1984.

Old Federal Law

Old federal law allowed a taxpayer could make a deductible contribution to an IRA for a taxable year, until the due date for filing of that return including extensions of time.

Current California Law

California conforms with old federal law.

Fiscal Impact

Revenue gains from conforming to this time limitation provision are unknown.

TAX REFORM ACT OF 1984 SECTION 148

Reporting of Foreclosures and Abandonments of Security (IRC Section 6050J)

Summary

The Act provides that any person who, in connection with its trade or business, lends money secured by property and then acquires an interest in that property by foreclosure or knows that the property has been abandoned must file an information return with the IRS. The return is to include:

1. The name and address of each borrower,

2. A general description of the property and indebtedness,

3. The amount of indebtedness at foreclosure,

4. The amount of indebtedness satisfied,

5. The amount of indebtedness at the time of abandonment, and

6. Other information required by IRS regulation.

The term person also applies to any governmental unit except the trade or business requirement does not apply to a governmental unit. In the case of a governmental unit, the return must be filed by the officer or employer designated for thhat purpose.

Each person required to file an information return with the IRS must also furnish each person whose name is on the IRS return a written statement with the name and address of the person who made the IRS return. This statement must be furnished on or before January 31 of the year following the calendar year the return was made. This section is effective for acquisitions of property and abandonments of property after December 31, 1984.

Old Federal Law

None.

Current California Law

None.

Fiscal Impact

Any revenue gains that might result from conforming to this information return requirement is unknown.

TAX REFORM ACT OF 1984 SECTION 148

Penalty for Failure to Furnish Information Return Regarding Foreclosure or Abandonment
(IRC Section 6652(a)(1) & (a)(3)(A)(iii))

Summary

The Act provides that any person who is required to report an acquisition of property by foreclosure for full or partial satisfaction of a loan made in connection with its trade or business and secured by that property, or if that property has been abandoned and that person fails to file the information return to the Internal Revenue Service (IRS), that person is subject to a $50 penalty for each failure up to a $50,000 maximum each calendar year.

Old Federal Law

None.

Current California Law

None.

Fiscal Impact

Additional penalties collected under conformity are unknown.

TAX REFORM ACT OF 1984 SECTION 148

Penalty for Not Providing a Statement to Debtor
(IRC Section 6678(a))

Summary

The Act provides that any person who is required to furnish a debtor a statement because of a foreclosure or abandonment of property on which a loan is made in connection with that person's trade or business but fails to do so is liable for a penalty of $50 for each failure up to a $50,000 maximum for each calendar year.

Old Federal Law

None.

Current California Law

None.

Fiscal Impact

Additional penalties collected under conformity are unknown.

TAX REFORM ACT OF 1984 SECTION 149

Reporting Exchanges of Certain Partnership Interests (IRC Section 6050K)

Summary

The Act requires that a partnership must file an information return with the Internal Revenue Service (IRS) for post 1984 exchanges of partnership interests that involve partnership unrealized receivables or appreciated inventory. The return is to cover the calendar year of the exchange and must include the name and address of each transferor and transferee in the exchange and other information as required by regulation. Additionally, the partnership must furnish a statement to each transferor and transferee showing the partnership's name and address and the information sent to the IRS.

Old Federal Law

New law section.

Current California Law

None.

Fiscal Impact

Revenue gains from conforming to additional information return reporting is unknown.

TAX REFORM ACT OF 1984 SECTION 149

Penalty for Failure to File Information Return Reporting Exchanges of Certain Partnership Interests
(IRC Section 6652(a)(1))

Summary

This Act provides that a partnership which is required to file an informtion return with the Internal Revenue Service (IRS) reporting exchanges of partnership interests that involve partnership unrealized receivables or appreciated inventory and does not file such a return is subject to a $50 penalty for each failure up to a maximum of $50,000 during any calendar year. This penalty is effective for exchanges after December 31, 1984. If the failure is due to reasonable cause, no penalty is assessed.

Old Federal Law

New law section.

Current California Law

None.

Fiscal Impact

Additional penalties that would be collected under conformity are unknown.

TAX REFORM ACT OF 1984 SECTION 149

Penalty for Failure to Furnish Statement to Transferor and Transferee Regarding Exchanges of Certain Partnership Interests
(IRC Section 6678(a))

Summary

The Act provides that any partnership which is required to furnish the names of the transferor and transferee in exchanges of partnership interests to the IRS must also furnish a statement showing the information on that return to the transferor and transferee. A penalty of $50 per statement is imposed on the partnership for failing to furnish the statement to the transferor and transferee.

Old Federal Law

None.

Current California Law

None.

Fiscal Impact

Additional penalties collected under conformity are unknown.

TAX REFORM ACT OF 1984 SECTION 150

Stock-Broker Statement for Payments In-Lieu of Dividends
(IRC Section 6045)

Summary

Any stock broker who lends a customer's stock or securities for use in a short sale must give a statement to the customer idendifying any payments in lieu of dividends received while the short sale is open. The purpose is to identify those which qualify for tax-favored treatment such as tax-exempt interest, dividends-received deduction, or other items to be specified in the regulations. Regulations may require an information return be sent to the IRS.

Old Federal Law

None.

Current California Law

None.

Fiscal Impact

Additional revenues from conforming to information reporting requirements is unknown.

TAX REFORM ACT OF 1984 SECTIONS 150-151

Reporting of State and Local Refunds and Identification Numbers for Backup Withholding
(IRC 6045, 6050E)

Summary

The Act provides that states or local agencies do not have to provide an information return regarding state or local tax refunds to individuals who do not itemize deductions.

Also, the Act codifies the temporary regulations which requires the payee of a reportable payment to certify that his/her identification number is correct for backup withholding purposes.

Current California Law (PITL 17041.5)

Local governments in California cannot impose an income tax. Also California did not conform to the federal backup withholding provisions.

Fiscal Impact

None. Not applicable.

TAX REFORM ACT OF 1984 SECTION 158

Interest Computation Date on Certain Additions to Tax
(IRC Section 6601(e)(2))

Summary

The Act provides that the interest on penalties and additions to tax will begin from the due date of the return and will end on the date of payment when payment is not made within 10 days of the notice. This provision applys to taxpayers who, without reasonable cause, fail to file returns on time, who file returns on which there is a valuation understatement or overstatement or substantially understate the tax.

Old Federal Law

The computation date for interest began on the date of the notice.

Current California Law (PITL Section 18686.96, 18689) (B&CTL 25901c)

Current California law provides that interest on penalties if not paid within 10 days of the date of notice will be computed from the date of notice and demand to the date of payment, however, on a penalty which is initially assessed as a deficiency, the interest is computed from the date of the notice of proposed asessment.

Fiscal Impact

Additional interest collected under conformity is unknown.

TAX REFORM ACT OF 1984 SECTION 160

Application of Penalty for Frivolous Proceedings to Pending Tax Court Proceedings
(TEFRA 292(e)(2)) (IRC Section 7430)

Summary

The Act allows the Tax Court to assess damages against taxpayers who instituted or maintained proceedings primarily for delay, or upon frivolous grounds as of February 28, 1983, regardless of when the proceedings were instituted. Amends TEFRA as to enactment date as if it were included in TEFRA.

Old Federal Law

TEFRA increased the penalty assessable against taxpayers for instituting Tax Court proceedings for delay or with frivolous or groundless positions. The increased penalty applied to any action or proceeding in Tax Court after December 31, 1982.

Current California Law (PITL Section 19420)

California conforms to old federal law, but applies the penalty to proceedings commenced on or after July 28, 1983 before the Board of Equalization.

Fiscal Impact

None. Not applicable.

TAX REFORM ACT OF 1984 SECTION 161

Failure to Request a Change of Accounting Method
(IRC Section 446(f))

Summary

This Act provides that for years beginning after July 17, 1984, if a taxpayer does not receive the consent of the Internal Revenue Service (IRS) for a change in accounting method, the absence of IRS consent is not a defense which will prevent any penalty from being assessed or allow a reduction of the amount of the penalty or addition to tax.

Old Federal Law

New law subsection.

Current California Law (PITL Section 17551) (B&CTL 24651)

California generally conforms to the accounting methods in federal law.

Fiscal Impact

Additional penalties that would be collected under conformity are unknown.

TAX REFORM ACT OF 1984 SECTION 162

Change of Venue in Tax Cases
(18 U.S.C. 3237)

Summary

The Act clarifies a provision relating to the change of venue when the use of the mails is not the sole basis for assigning the case to a particular federal district court. The Act does not allow the change of venue in those instances.

Current California Law

California tax cases are not assigned to federal district courts, thus, the provision is not applicable to California.

Fiscal Impact

None. Not applicable to California.

TAX REFORM ACT OF 1984 SECTION 163

Contributions to the Capital of Regulated Public Utilities
(IRC Section 118(c), 6501, 6511)

Summary

This Act adds an exception to the general rule which limits the statutory period for deficiency assessments on a public utility when that utility fails to expend a nontaxable contribution to the capital of the utility which is in aid of construction within the expenditure year. The statute of limitations period for assessing deficiencies will not expire until three years after IRS is notified by the taxpayer that:

1. The contribution has been expended,

2. The taxpayer intends not to make the required expenditure, or

3. The taxpayer has failed to meet the expenditure rule.

Effective for expenditures with respect to the end of the second taxable year after the year in which the amount was received ends after December 31, 1984.

Old Federal Law

The statutory period for assessing deficiencies is three years from the later of the due date of the return or the date the return is filed.

Current California Law

California has no section in the Bank and Corporation Tax Law which excludes from gross income contributions to the capital of a corporation which is a public utility in aid of construction.

Fiscal Impact

None. Not applicable.

TAX REFORM ACT OF 1984 SECTION 1072, 2651, 2653, 2661, 2663

Changes to Tip Reporting, Social Security Eligibility Requirements, and Collection of Non-Tax Debts Owed to the Federal Government (Social Security Act, IRC 6103, 6402, 86, 132, 3121, 3306, 6664)

Summary

A series of corrections are made to the Social Security Act regarding eligibility and the interaction of Social Security inclusion in federal gross income. Also, for purposes of tip reporting by employees of large food and beverage establishments, the employees are allowed to petition the IRS for a reduction in the percentage of gross receipts which their employer must allocate to them. In addition, offset and disclosure rules are provided for the collection of non-tax debts owed to the federal government.

Current California Law (PITL 17087)

California does not include any portion of social security in California gross income, does not conform to the federal tip reporting requirements for large food and beverage establishments, and has its own separate provisions relating to offsets of non-tax debts owed to the state.

Fiscal Impact

None. Not applicable.

TAX REFORM ACT OF 1984 SECTION 511

Funded Welfare Benefit Plans
(IRC 419, 419A, 512, 4976)

Introduction

Plans which are not tax exempt and are established by the employer to provide a method of setting aside funds to make payments to employees for such things as supplemental unemployment compensation benefits (SUB), disability benefits, severance pay benefits, and child care are termed "welfare benefit" plans. A welfare benefit is any benefit provided to an employee by an employer except a benefit provided under a pension plan, a plan of deferred compensation, or a vacation pay plan.

Summary of 1984 Tax Reform Act

The Act places into the law specific definitions of welfare benefit plans and, for tax years beginning after 1984, also restricts employer deductions for payments to these plans to the amount equal to the welfare benefit plan's cost for the year.

The purpose of this change is to prevent employers from taking premature deductions for expenses that have not yet been incurred.

An excise tax is imposed on "disqualified benefits" in an amount equal to the "disqualified benefits."

A "disqualified benefit" is:

1. Any medical or life insurance benefit for a key employee provided outside of the new separate account required under the Act.

2. Any medical or life insurance benefit provided to a retired employee which does not meet the new rules established by the Act, and

3. Any portion of the welfare benefit fund which reverts to the benefit of the employer.

Also, the employer must include in the employer's gross income the income of the welfare benefit plan which is unrelated to the purpose for which the plan was established. This treatment parallels the tax on unrelated business income of a tax-exempt organization.

Old Federal Law

A deduction was allowed to an employer for any payment made to a welfare benefit plan for the payment of claims against the plan. The deduction was allowed as an ordinary and necessary business expense. No tax exemption was allowed to this kind of trust and the trust is taxable on net income (including contributions).

Current California Law (PITL 17201, 17501) (B&CTL 24343, 24601-24614)

California was in conformity with old federal law regarding the deductibility of payments by employers to welfare benefit plans and the taxability of the welfare benefit plan trust.

New Federal Law

For payments made or accrued after 1985 an employer's deduction for payments to a welfare benefit plan cannot exceed the plan's "qualified costs" for the year.

The "qualified costs" are the sum of (1) the direct costs (amounts which would have been deductible had the employer paid the benefit directly to the employee), (2) a pro-rata share of amortization (using 60 months) of additions made to the welfare benefit plan's asset account (such as amortization of a child care facility), (3) the administrative costs of the plan, and (4) insurance funded benefits. The "qualified costs" are reduced by the amount of employee contributions to the plan plus any income of the fund in excess of the cost of producing the income. Thus, investment income in excess of investment costs will serve to reduce the amount of the employer's payment which is deductible in that year.

Payments made by an employer to a welfare benefit plan which are not deductible in the year paid because of this limitation are to be carried over and considered payments in future years.

General limits are established by the Act for additions to the welfare benefit plan's asset account. The general limit is the amount estimated to be necessary using reasonable actuarial assumption to fund the plan liabilities which have been incurred but remain unpaid at the close of the taxable year plus the administrative costs of the claims. A claim is incurred only when an event has occurred which entitles an employee to the benefit (i.e. a separation, a disability, a medical expense, or a death). Regulations are to be made which provide more specific guidance.

Specific rules are provided for additions to asset accounts for plans which provide:

1. Post-retirement medical and life insurance,

2. Medical or life insurance provided to key employees,

3. Supplemental unemployment compensation or severance pay benefits, and

4. Disability benefits.

Transitional rules are provided for the treatment of existing reserves in these plans and regulations specifying the account limits for collectively bargained plans are to be made by July 1, 1985.

An election is allowed for an employer with more than one welfare benefit plan to treat them all as one plan. Rules for plans which are shared by ten or more different employers are provided.

An excise tax is imposed on "disqualified benefits" in an amount equal to the "disqualified benefits."

A "disqualified benefit" is:

1. Any medical or life insurance benefit for a key employee provided outside of the new separate account required under the Act.

2. Any medical or life insurance benefit provided to a retired employee which does not meet the new rules established by the Act, and

3. Any portion of the welfare benefit fund which reverts to the benefit of the employer.

Also, the employer must include in the employer's gross income the income of the welfare benefit plan which is unrelated to the purpose for which the plan was established. This treatment parallels the tax on unrelated business income of a tax-exempt organization.

The Act also, for years after 1985, extends the tax on unrelated business income of tax-exempt organizations to cover group legal service and supplemental unemployment benefit organizations instead of only social clubs and voluntary employee's beneficiary associations (VEBAs). The income of group legal service plans and supplemental unemployment benefit plans in excess of the amount necessary to fund the claims incurred but unpaid at the end of the year will be treated as unrelated business income and subject to tax.

Fiscal Impact

Based on a proration of a single federal estimate for all welfare benefit plan provisions in the 1984 Tax Reform Act, conformity would result in revenue gains in the $2-4 million range annually.

TAX REFORM ACT OF 1984 SECTION 512

Unfunded Deferred Benefits Plans
(IRC 404)

Summary

Plans which provide for future benfits (other than compensation) of employees, their spouses, or their dependents will be treated as deferred compensation plans unless they qualify as a funded welfare benefit plan. A funded plan is one in which a separate account is estblished from which the benefits will be provided and the employer makes payments to that account.

The distinction is important because the deduction for payments to deferred compensation plans is allowed only in the year that the compensation is included in the gross income of the employee, while the deduction for an employer payment to a funded welfare benefit plan is deductible in the year the payment is made by the employer but limited to the cost of the plan for that year.

Also, the Act provides that arrangements for compensation or benefits having the effect of a plan or method of deferring the receipt of compensation do not have to resemble stock bonus, pension, profit sharing, or annuity plans to be subject to the rule which defers the deduction until the compensation is included in the employee's gross income.

Old Federal Law

It was unclear whether an unfunded deferred welfare benefit plan was to be treated as a deferred compensation plan, and thus, the deduction for any employer payments deferred until the amounts are includable in the gross income of the employee.

Current California Law (PITL 17201, 17501) (B&CTL 24433)

California is in conformity with old federal law.

New Federal Law

Under the Act, for amounts paid or incurred after July 18, 1984, an unfunded plan providing for deferred benefits (other than compensation) for employees, their spouses, or their dependents will be considered a plan of deferred compensation for purposes of deferring the deduction for employer payments under the plan until the income is includable in the employee's gross income. Also, the substance of an arrangement to provide deferred compensation will be treated as a deferred compensation plan even though it may not be similar to a pension, profit-sharing, stock bonus or annuity plan, and there may not be a formal plan.

Funded welfare benefit plans and vacation pay trusts are not included in the definition of a plan of deferred compensation.

Fiscal Impact

The revenue estimate for this item is included in the estimate made for Item No. 116.

TAX REFORM ACT OF 1984 SECTION 513

Additional Requirements for Tax-Exempt Status
(IRC 120, 501, 505)

Summary

A new provision, effective for years beginning after December 31, 1984, is enacted which requires voluntary employees' beneficiary associations (VEBAs) and group legal service organizations to provide benefits in a manner which does not discriminate in favor of highly compensated individuals and is approved by the Secretary of the Treasury before being allowed tax-exempt status.

Also, the Act requires, effective for years beginning after December 31, 1984, that a VEBA, group legal service plan, or a supplemental unemployment compensation benefit trust must notify the IRS that it is claiming exempt status, or it will not be considered tax-exempt. Organizations in existence on March 31, 1984, are given until July 18, 1985, to make the notification. New organizations notification dates will be prescribed by regulation.

Old Federal Law

No specific requirement in the tax-exempt qualification provisions mentioned that the nondiscrimination provisions applied to a VEBA or a group legal services plan, although they are clearly mentioned as applying to a supplemental unemployment benefit trust, and a voluntary employee's pension trust.

Current California Law (PITL 17631) (B&CTL 23701i, 23701n, 23701q, 23701s)

California is conformed to old federal law.

New Federal Law

The Act provides that the rules requiring the benefits of supplemental unemployment benefit trusts and voluntary employee's pension trusts, to provide benefits in a manner which does not discriminate in favor of highly compensated individuals, will also apply to VEBA and group legal services organizations in order to determine whether the organization will be tax-exempt.

Also, every new VEBA, group legal services plan, and supplemental unemployment benefit trust must timely notify the IRS of its applying for tax-exempt status. Existing organizations as of March 31, 1984, have until July 18, 1985, to make the notification or lose tax-exempt status.

These provisions are effective for taxable years beginning after December 31, 1984.

Fiscal Impact

The revenue estimate for this item is included in the estimate made for Item No. 116.

TAX REFORM ACT OF 1984 SECTION 521

Pension Plan Required Distribution Rules
(IRC 72, 401, 403, 408)

Changes Made in 1984 Tax Reform Act

A series of changes are made to the rules governing the application of the penalty for premature distributions, requirements for pension plan distributions, and the time period for the payment of the employee's interest in the pension plan.

Under the Act the 10 percent penalty for premature distributions (distributions before age 59 1/2) applies only to amounts put in the pension plan in years when the participant was a "5 percent owner" regardless of whether the plan was top heavy.

A "5 percent owner" is an employee who owns directly or indirectly more than 5 percent of the corporation's stock or total combined voting power. For noncorporate employers, a "5 percent owner" is an employee who owns more than 5 percent of the capital or profits interest in the business.

A "top heavy" plan is any plan (or group of plans) that provides more than 60 percent of its aggregate accumulated benefits to "key employees." A "key employee" is any employee-participant (including self-employed individuals) who at any time in the four preceding plan years is an officer, an employee owning one of the ten largest interests in the employer, a more than 5 percent owner, or a more than 1 percent owner who earns more than $150,000 per year.

The requirement for distributions not later than April 1 of the year the employee reaches 70 1/2 years of age (even though the employee has not retired) applies to only "5 percent owners" rather than to all key employees.

The measurement of the distribution period is to be made using the life expectancies of the employee and designated beneficiary rather than the employee and his or her spouse.

The time period for payment of the employee's interest in the pension plan when the employee dies before all of his/her interest has been distributed, has been extended from a maximum of five years to a period of time which cannot exceed the method of distribution in effect prior to death. In other words, the distributions can continue on the same schedule to the survivor beneficiary. Where distributions have not begun before the employee's death, a five-year distribution period is required with two exceptions. First, if the employee's interest is to be paid to a beneficiary, then distributions can be paid over the beneficiaries life with the starting date being no later than one year after the employee's death. Second, if the employee's interest is to be paid to a surviving spouse over his/her life, the starting date can be as late as the date on which the employee would have reached age 70 1/2.

These modified rules are to be used instead of the rules in TEFRA and are effective for years 1983 and later. Government plans don't have to comply with these rules until after 1986, and collectively bargained plans don't use these rules until the earlier of the bargaining agreement expiration or January 1, 1988.

Old Federal Law

The distribution rules being modified in the 1984 Tax Reform Act were enacted by TEFRA in 1982. TEFRA made the premature distribution penalty apply to all key employees who received distributions before age 59 1/2, but the penalty applied only to amounts put in the plan during years the plan was top heavy.

TEFRA used only the life of the employee and spouse to measure the distribution period and did not take into account beneficiaries who were not spouses.

TEFRA required an acceleration of payments of the employee's interest to be made when the employee died and only allowed a five year maximum spread of the payments.

Current California Law (PITL 17082, 17501)

California is in conformity with old federal law except that the penalty for early distribution for state purposes is 2 1/2 percent instead of the 10 percent federal penalty.

Fiscal Impact

Based on a proration of the federal estimate for the 1984 Tax Reform Act, conformity would result in net revenue gains in the $100,000 range annually.

TAX REFORM ACT OF 1984 SECTION 522

Tax-Free Rollover of Pension Plan Partial Distribution (IRC 402, 403)

Summary

For distributions made after July 18, 1984, a partial distribution from a pension or annuity plan may be rolled over, tax free, by the employee to an individual retirement account (IRA). This tax-free treatment is permitted only if:

1. The distribution equals at least 50 percent of the balance to the credit of the employee,

2. The distribution is not one of a series of periodic payments, and

3. The employee elects tax-free rollover treatment.

The rollover can be made only into an IRA and not another pension plan or tax-sheltered annuity. Subsequent distributions from the plan are not eligible for special 10-year averaging or capital-gain treatment accorded to lump-sum distributions.

The maximum amount rolled over may not exceed the portion of the distribution includible in gross income.

Old Federal Law

No rollover was permitted for a plan distribution that was not a total distribution.

Current California Law (PITL 17085)

California was conformed to old federal law treatment which allows a tax-free rollover only with regard to total distributions.

California does not conform to the capital gain treatment of lump-sum distributions and does not impose a separate tax on those distributions. California, instead, includes the lump-sum distribution in income and provides a special 5-year or 7-year averaging formula for calculation of the tax attributable to the lump-sum distribution.

New Federal Law

Partial distributions from pensions or annuity plans after July 18, 1984, are eligible to be rolled over tax-free to an IRA. The maximum amount which may be rolled over is the amount required to be included in gross income, i.e. the amount which was either previously deducted for tax purposes or earned in the account.

The partial distribution is eligible for tax-free rollover treatment only if:

1. The distribution equals at least 50 percent of the balance to the credit of the employee,

2. The distribution is not one of a series of periodic payments, and

3. The employee elects tax-free rollover treatment.

The rollover is to an IRA only and not another pension or tax-sheltered annuity. Subsequent distributions are not eligible for special 10-year averaging or capital-gain treatment accorded to lump-sum distributions.

Fiscal Impact

Based on prorations of the federal estimate for the 1984 Tax Reform Act, revenue losses to the state under conformity would be in the $100,000 range annually.

TAX REFORM ACT OF 1984 SECTION 523

Distributions From Employee-Contribution-Only Plans (IRC 72)

Summary

The Act establishes a new rule which requires that distributions from plans with benefits which are funded substantially (85 percent or more) by employee contributions are taxable to the extent of any earnings in the employee's account. Only after all the earnings have been received may distributions from these accounts be recovered as non-taxable employee contributions.

This new provision is enacted to ensure that such plans are used as bona fide retirement plans rather than tax-favored savings or brokerage accounts.

Old Federal Law

A pension or annuity plan, tax-sheltered annuity contract, or government plan can be funded solely with employee contributions. Nondeductible employee contributions may be withdrawn at any time without being included in gross income. Only after the nondeductible contributions are exhausted are other withdrawals considered to be income.

Current California Law (PITL 17082, 17084, 17085, 17501)

California is in conformity with old federal law.

New Federal Law

Amounts received (including loans) as distributions after October 16, 1984, from plans where substantially all (85 percent or more) of the benefits are derived from employee contributions are includable in gross income to the extent of earnings in the plan, and those earnings are not eligible for special 10-year forward averaging accorded lump-sum distributions.

Fiscal Impact

Based on a proration of the federal estimate for the 1984 Tax Reform Act, revenue gains under conformity would be in the $100,000 range annually.

TAX REFORM ACT OF 1984 SECTION 524

Rules for Top-Heavy Plans Amended
(IRC 401, 416)

Summary of Amendments

The Act modifies the rules governing the definition of a "top-heavy" pension plan by changing the definition of "key employee," allows salary-reduction plan deferrals to be counted, as contributions to the plan, provides a new 5-yearrule for counting accrued benefits, exempts governmental plans from the "top-heavy" rules and requires the IRS to speedily publish regulations specifying language for pension plan to use that will comply with the top-heavy plan requirements.

Old Federal Law

In 1982 TEFRA restructured the nondiscriminatory pension plan rules using the test of whether or not the plan was a "top-heavy" plan. A "top-heavy" plan is any plan (or group of plans) that provides more than 60 percent of its aggregate accumulated benefits to "key employees." A "key employee" is any employee-participant (including self-employed individuals) who at any time in the four preceding plan years is an officer, an employee owning one of the ten largest interests in the employer, a more-than-5-percent owner, or a more-than-1-percent owner who earns more than $150,000 per year.

Current California Law (PITL 17082, 17501)

California is in conformity with old federal law.

New Federal Law

The following changes are made in the TEFRA top-heavy plan rules:

1. An officer will not be considered a "key employee" unless he or she has annual compensation (for 1984 through 1987) of $45,000 or more. For years after 1987 this amount is adjusted for cost of living adjustments (COLA). (Effective for plan years beginning after 1983.)

2. For purposes of testing whether or not the plan is top-heavy, if an employee has not been an employee under any plan of the employer for 5 years any accrued benefit or account balance of the individual is disregarded. (Effective for plan years beginning after 1984.)

3. Amounts contributed to a plan under a salary reduction arrangement (including deferred compensation plans) are taken into account to determine whether the plan is top-heavy. (Effective for plan years beginning after 1984.)

4. A governmental plan is exempt from the top-heavy plan requirements.

(Effective for plan years beginning after 1983.)

5. Requires the IRS to publish by the end of 1984 either final regulations or at least plan language which is able to be used by pension plans in drafting the plan amendments. If the IRS fails to do so, plans may simply adopt a plan provision which incorporates the rules by reference within their plan language.

Fiscal Impact

Based on prorations of the federal estimate for the Tax Reform Act of 1984, the revenue loss to the state under conformity would be very minor, less than $50,000 annually.

TAX REFORM ACT OF 1984 SECTION 525

Estate Tax Exclusion Repealed
(IRC 2039)

Summary

The Act repeals the $100,000 estate tax exclusion for distributions from a pension plan, a simplified employee plan (SEP), and an individual retirement account (IRA). This repeal is effective for decedents dying after 1984.

Old Federal Law

A $100,000 estate tax exclusion was provided for distributions from pension plans, SEPs, and IRAs.

Current California Law

California does not have an estate tax except for a "pick-up" tax.

New Federal Law

The Act repeals the $100,000 estate tax exclusion for distributions from a pension plan, SEP, and IRA.

A special rule is provided for non-employee spouses in community-property states to exclude from the estate tax their community property share of the pension plan or IRA.

Fiscal Impact

Not applicable to California.

TAX REFORM ACT OF 1984 SECTION 526

Definition of Affiliated Service Groups, Collective Bargaining Agreements, and Employee-Leasing
(IRC 414, 7701)

Changes Made in 1984 Tax Reform Act

The Act changes the rules which determine whether a group of employers are affiliated, and thus, required to (as a group) meet the employee benefit requirements. Also, where employees of an employer are not direct employees, but instead are leased from a third party agency, the lower requirements for pension-plan contributions are not to apply where an employer's direct employees are shifted to a third-party agency for tax purposes. Collectively bargained pension agreements are required to meet all the nondiscrimination standards of other pension plans if more than 50 percent of the membership consists of officers, owners, or executives of the employer.

Old Federal Law

Two different sets of rules exist in federal law to determine whether common ownership of related businesses exist, and thus, should be treated as one business. In 1982 TEFRA used the stock ownership rules to determine whether a group of both corporate and noncorporate employers were interrelated, and thus, required to meet the employee benefit requirements as one group (called an "affiliated-service-group").

Payments to pension plans of leased employees at a rate of 7 1/2 percent of compensation by an employer allows the employer not to include those individuals within the regular pension plans of the employer.

Pension plans covered by a collective bargaining agreement are not required to meet the rules which restrict tax favored status to those pension plans with benefits which do not discriminate in favor of highly compensated employees.

Current California Law (PITL 17501)

California is in conformity with old federal law.

Fiscal Impact

Based on prorations of the federal estimate for the Tax Reform Act of 1984, the revenue gains from conformity would be very minor, less than $50,000 annually.

TAX REFORM ACT OF 1984 SECTION 527

Special Nondiscrimination Rules for Cash or Deferred Arrangements (CODA) (IRC 401)

Summary

Effective for plan years beginning after December 31, 1985, the Act requires all Cash or Deferred Arrangements (CODAs) to pass both the test of whether the plan coverage discriminates in favor of highly paid employees as well as the special actual deferral percentage (ADP) contribution tests applicable to a CODA which insures benefits are not provided only to the highly paid employees. Government plans are exempted from this requirement. If the CODA fails to meet these tests, the amount of the employer contributions that an employee elects to defer will be treated as an employee contribution and includible in the employee's gross income. The plan itself will not be disqualified, however, as long as it meets the general requirements for plan qualifications.

Also, the Act codifies an existing IRS position which applies these new rules to CODAs in existence before June 27, 1974 (the date of enactment of the Employee Retirement Income Security Act (ERISA)).

Old Federal Law

An ambiguity existed in applying nondiscrimination rules to CODAs since some are not stand-alone plans but are within a profit-sharing or stock-bonus plan. In proposed IRS regulations the coverage and ADP tests only applied to a stand-alone CODA which had the effect of allowing social security integration to meet the coverage test for those CODAs within a profit-sharing or stock-bonus plan.

The IRS had taken the position that pre-ERISA plans had to meet the special tax-qualification tests, but had limited employer contributions to the levels allowed on June 17, 1984.

Current California Law (PITL 17501)

California is in conformity with old federal law.

New Federal Law

The Act resolves the ambiguity in old federal law by requiring that a CODA of any kind except a government plan must meet both the coverage and contribution tests to allow an employee to defer tax on the amount of salary reduction which the employer contributes to the plan.

Also, pre-ERISA plans are required to meet these special rules even though the contributions are limited to the levels allowed on June 17, 1984.

Fiscal Impact

Based on a proration of the federal estimate for the Tax Reform Act of 1984, conformity by the state would result in very minor revenue gains, less than $50,000 annually.

TAX REFORM ACT OF 1984 SECTION 528

Medical Benefits for Retirees in Defined-Benefit Plans
(IRC 401, 415)

Summary

The Act makes employer contributions to individual medical benefit accounts subject to the annual benefit and contribution limitations to ensure that plans do not discriminate in favor of highly paid employees. Also, the Act requires that an individual medical benefit account be established and all medical benefits be payable solely from that account, and that those payments can only be for employee participant, the participant's spouse, or their dependents.

Old Federal Law

Post-retirement medical benefits paid to employees were not covered by rules governing the dollar limits on contributions and benefits that apply to a defined benefit plan. A defined benefit plan was not required to maintain a separate account for each participant.

Current California Law (PITL 17501)

California is in conformity with old federal law.

New Federal Law

For plan years beginning after March 31, 1984, post-retirement medical benefits are counted within the annual limitations on benefits and contributions. Also, medical benefit payments for an employee who owns 5 percent or more of the stock or profits interest of the employer must be made into a separate allocated account established for him/her.

Fiscal Impact

Based on a proration of the federal estimate for the Tax Reform Act of 1984, conformity would result in revenue gains to the state in the $200,000 range annually.

TAX REFORM ACT OF 1984 SECTION 529

Alimony Treated as Compensation for IRA Purposes
(IRC 219)

This item was discussed as part of Item No. 38 and the Task Force recommended conformity to the federal treatment.

TAX REFORM ACT OF 1984 SECTION 173

Limitation on Deductions or Simplified Employee Plans (SEPs) Raised (IRC 219)

Summary

The Act retroactively increases the SEP deductible limit from $15,000 to $30,000 as though the increase had been included in TEFRA 1982 which changed the limit on self-employed Keogh plans from $15,000 to $30,000. This change is to correct a drafting error in the 1982 law. Also, other obsolete imitation language on self-employed individuals is repealed as though repealed by TEFRA.

Old Federal Law

In 1982 the deductible limit for self-employed Keogh plans was raised from $15,000 to $30,000, and the amount an employer could contribute to a SEP was raised from $15,000 to $30,000, but the amount deductible by the employee SEP participant was not raised. In making the TEFRA changes, the drafters did not repeal the rule for return of excess contributions, special limits on premiums on annuity contracts, or limitation on level premium contracts for self-employed persons.

Current California Law

California does not conform to the limits on either Keogh or SEP deductions which have been raised several times by the federal government. California limits the deduction for Keogh plans to $2,500 and for SEP plans to the lesser of $2,500 or 15 percent of compensation. California also retained all of the other limitations on pension plans of self-employed individuals.

New Federal Law

The SEP deduction limit is raised from $15,000 to $30,000 as though that increase had been included in the 1982 TEFRA provisions and repeals obsolete limitations on pension plans of self-employed individuals.

Fiscal Impact

Not applicable.

TAX REFORM ACT OF 1984 SECTION 713

Technical Corrections to Pension Provisions
(IRC 46, 72, 101, 219, 401, 402, 404, 408, 409, 416, 414, 415)

Summary

The Act makes a series of eleven technical amendments which clarify the operation of the 1982 TEFRA pension plan provisions.

Comparison of Old Provisions vs. New Provisions

1. The new law revises the definition of key employee to include any employee rather than any participant for purposes of the rules ensuring that pension plans do not discriminate in favor of highly paid employees.

2. The Act clarifies that the actuarial adjustments required by TEFRA for benefits paid under defined benefit plans which begin before age 62 will apply to the dollar limit on annual benefits rather than to the actual benefit itself.

3. Provides a rule for collectively bargained plans allowing the computation of the individual's benefit as of the close of the last year before the bargaining agreement expires or January 1, 1986, rather than the TEFRA required date of January 1, 1983.

4. Provides that transitional rules for defined contribution plans contained in TEFRA only apply to plans in existance on July 1, 1982.

5. Provides that the personal service corporation liquidation rules for nonrecognition of gain or receivables if liquidation occurs in 1983 or 1984 only apply to corporations in existance on September 3, 1982 (the date of TEFRA's enactment.)

6. Clarifies that the TEFRA provision allowing employers to continue to fund pension plans for an employee who is permanently and totally disabled also allow continuation of contributions to stock bonus plans as well as profit-sharing plans. The continuation contributions must be nonforfeitable.

7. TEFRA rules deny tax-free recovery treatment for inherited IRAs received by someone other than the spouse for taxable years beginning after December 31, 1983. The Act clarifies that this provision in TEFRA applies only to individuals dying after December 31, 1983.

8. The Act clarifies the situations in which social security payments are to be included as employer contributions when the pension plan is not integrated with social security. Also, the Act makes it clear that the rules for OASDI contributions also apply to contributions to a simplified employee plan (SEP) including a SEP contribution made on behalf of self-employed individuals.

9. TEFRA did not allow tax-free rollover treatment if any part of the distribution is attributable to contributions made on behalf of a key employee in a top-heavy plan. The Act provides that rollover will be permitted for contributions made while the employee was not a key employee in a top-heavy plan.

10. The Act makes changes to the treatment of loans to plan participants to extend the period of January 1, 1985, for non-key employees to repay plan loans before those loans are considered distributions. Also, the overall limit on plan loans is clarified to be $10,000 even for loans with a 5-year payback schedule. Obsolete language regarding an owner-employee's repayment of loans from Keogh plans was repealed. If the loan is made from deductible employee contributions, the Act provides that the loan will be treated as a distribution regardless of the amount of the loan.

11. The Act clarifies that the death benefit exclusion of $5,000 for self-employed individuals also applies to tax-sheltered annuities as well as pension plans.

Current California Law (PITL 17501)

California was in conformity with old federal law regarding these eleven TEFRA provisions.

Fiscal Impact

The revenue impact from these technical corrections is unknown.

TAX REFORM ACT OF 1984 SECTION 531

Exclusion of Fringe Benefits from Gross Income
(IRC 120, 125, 127, 132)

Introduction

A fringe benefit may be described as an economic benefit (usually in a form other than cash) provided by an employer to an employee in addition to ordinary salary.

The majority of fringe benefits provided to employees have not been specifically exempted from taxation in the Internal Revenue Code, but have been granted exemption by IRS rulings over a period of many years as being substantially the same as those benefits which the code does specifically exempt.

The Internal Revenue Service and the Treasury became concerned that fringe benefits provided by employers had evolved into an alternative form of compensation and had on several occasions attempted to write regulations which would specifically declare certain forms of fringe benefits to be taxable. Because of concerns of employer and employee groups, Congress blocked the issuance of fringe benefit regulations.

Summary of 1984 Changes

In 1984 Congress broke the deadlock and provided a rule that specifically excluded certain categories of fringe benefits and specifically required all other forms of fringe benefits not specifically exempted by provisions of law to be included in income at full fair market value.

The exempt fringe benefit categories added in 1984 are:

1. No additional cost services. This fringe benefit includes services provided to an employee which the employer was already providing to his customers at a fixed cost, and which would be provided to the employee for no significant additional cost to the employer. Examples would be where airlines, railroads, amusement parks, and theaters provide free tickets to their employees.

2. Qualified employee discounts. This provision allows employees to purchase employer's goods at a discount (but not for an amount lower than the employer's cost).

3. Working condition fringes. This provision exempts benefits provided by employers which are directly connected with working conditions. Examples include premium executive offices, luxury automobiles used exclusively for business activities, first class business travel, etc., which may be perceived by some as a fringe benefit because it may serve as an inducement for continued employment in comparison to an employer who provides more

spartan working conditions.

4. De minimis benefits. This category includes benefits to employees which, while direct in nature, are of little per-item value. Taxation of these benefits would create a substantial compliance burden on the employer and employee. Examples might include free coffee for employees, free access to employer equipment for personal use and holiday office entertaining.

5. On-premesis gyms and other athletic facilities. In order to be excluded, however, the facility must be located on the employer's premesis, must be operated by the employer, and substantially all of the use of the facility must be by employees of the employer, their spouses, or their dependent children. Athletic facilities that may qualify are swimming pools, gymnasiums, tennis courts, and golf courses.

The Act modifies the rules relating to "cafeteria plans" in which fringe benefits may be chosen by employees in lieu of cash compensation. For years beginning on or after January 1, 1985, the cafeteria plan may only offer choices between cash and statutorily exempted fringe benefits. The objective is to provide equal treatment for taxpayers regardless of whether they have the option of choosing what benefits they receive.

In addition, the exemption from gross income for educational assistance programs and group legal service benefits have been extended through December 31, 1985.

Old Federal Law

Benefits, such as meals and lodging provided to an employee on the business premises of the employer, have been excluded by statute from taxation on the basis that the benefit provided was not so much compensation as a business decision of the employer to facilitate the business as a whole. For example, a hotel employer might provide an apartment on the premises of the hotel to the hotel manager so that the manager would be immediately available on a 24-hour basis in case of emergency or off-hours business problems.

Additional fringe benefit exemptions have been specifically provided by statute to encourage employers to provide socially desirable benefits to employees which the employee might not have purchased on his own. This type of benefit includes group-term life insurance, health and accident insurance, legal services insurance, vanpooling transportation, educational assistance programs, and plans (called "cafeteria plans") where an employee may choose between two or more benefits.

Current California Law (PITL 17071, 17131)

California was in complete conformity with old federal law.

New Federal Law

For years beginning on or after January 1, 1985, a cafeteria plan may only offer an employee choices between cash and statutorily exempted fringe benefits.

Statutorily exempted fringe benefits are those previously exempted by law plus any that are within the following categories:

1. No additional cost services. This fringe benefit includes services provided to an employee which the employer was already providing to his customers at a fixed cost, and which would be provided to the employee for no significant additional cost to the employer. Examples would be where airlines, railroads, amusement parks, and theaters provide free tickets to their employees.

2. Qualified employee discounts. This provision allows employees to purchase employer's goods at a discount (but not for an amount lower than the employer's cost).

3. Working condition fringes. This provision exempts benefits provided by employers which are directly connected with working conditions. Examples include premium executive offices, luxury automobiles used exclusively for business activities, first class business travel, etc., which may be perceived by some as a fringe benefit because it may serve as an inducement for continued employment in comparison to an employer who provides more spartan working conditions.

4. De minimis benefits. This category includes benefits to employees which, while direct in nature, are of little per-item value. Taxation of these benefits would create a substantial compliance burden on the employer and employee. Examples might include free coffee for employees, free access to employer equipment for personal use and holiday office entertaining.

5. On-premesis gyms and other athletic facilities. In order to be excluded, however, the facility must be located on the employer's premesis, must be operated by the employer, and substantially all of the use of the facility must be by employees of the employer, their spouses, or their dependent children. Athletic facilities that may qualify are swimming pools, gymnasiums, tennis courts, and golf courses.

Also, the exclusions from gross income for educational assistance programs (which sunset on December 31, 1983) and group legal service benefits (scheduled to expire December 31, 1984) have been extended through 1985.

Fiscal Impact

Based on prorations of federal estimates for the 1984 Tax Reform Act, conforming to fringe benefit provisions would result in revenue gains of less than $100,000 annually.

TAX REFORM ACT OF 1984 SECTION 532

Exclusion from Income for Tuition Reductions of Employees (IRC 117)

Summary

Effective for education furnished after June 30, 1985, the Act allows employees of educational institutions to exclude from gross income any reduction in tuition including cash grants received by the employee, spouse, or dependent child. The exclusion applies to tuition for education at any educational institution and not just to the employer's school, The exclusion only applies where the education is below the graduate level.

Old Federal Law

Scholorship and fellowship grants are excluded from the gross income of the recipient if the individual is a candidate for a degree, but the exclusion is limited to $300 per month for individuals who are not candidates for a degree. Regulations specifically provide that tuition reductions under a plan maintained by an educational institution for children of faculty members is to be considered a scholorship grant.

Items which are not considered as scholarship or fellowship grants are:

1. Educational and training allowances to veterans,
2. Tuition and subsistance allowances provided to members of the armed services who are students at educational institutions operated by the United States, such as the U.S. Naval Academy, U.S. Air Force Academy, and the U.S. Military Academy, or
3. Amounts paid as compensation for services or primarily for the benefit of the grantor.

Current California Law (PITL 17131)

California is conformed to old federal law.

New Federal Law

Under the Act a new exclusion from gross income is provided which excludes from gross income not only tuition reductions by educational institutions for children of faculty members, but also tuition reductions, including cash grants for:

1. An individual currently employed by the educational institution,
2. A person separated from service with the institution because of retirement or disability,

3. A widow or widower of an employee who died while employed by the institution, or of a former employee separated from service with the school because of retirement or disability, and

4. Spouses and dependent children of the above.

Rules are provided to insure that tuition reductions must be made available in a manner which does not discriminate in favor of officers, owners, and the highly paid.

The exclusion is limited to education below the graduate level. The regular scholorship and fellowship grant rules still apply to graduate education and any other grant which is not covered in this new provision.

Fiscal Impact

Based on prorations of federal estimates for the 1984 Tax Reform Act, conforming to this exclusion from income would result in a revenue loss of less than $100,000 annually.

TAX REFORM ACT OF 1984 SECTION 541

Tax-Free Sales of Employer Securities of Employee Stock Ownership Plan (ESOP) (IRC 1042, 1223, 1016)

Summary

Under the Act an employer who sells its common stock to an ESOP or worker-owned cooperative may elect to defer gain on the sale. This nonrecognition treatment is only available where the purchaser will own at least 30 percent of thee total value of the employer's outstanding stock after the sale. Also, the employer must purchase "replacement stock" which is defined as stock issued by a domestic corporation which has not more than 25 percent of its income from passive investments such as rents, royalties, dividends, and interest. The gain is deferred by reducing the basis of the "replacement stock" by the amount of gain not recognized on the sale of the employer's stock to the ESOP. If the cost of "replacement securities" is less than the amount of the deferred gain, the difference is currently taxable.

Definitions and special rules are provided for the replacement period, holding period for stock or other members of a controlled group, and a special 3-year statute of limitations for assessments measured from the date the IRS receives notice of non-replacement or partial replacement and the cost of "replacement securities."

The rules on nonrecognition of gain apply to sales of employer securities beginning after July 18, 1984. The acquisition of stock by an underwriter in the ordinary course of business does not qualify for this special treatment.

Old Federal Law

Nonrecognition treatment on the sale of employer securities was available only in the case where a tax-credit employee stock ownership plan was required to sell its stock to the ESOP as a condition of receiving the tax credit.

New Federal Law

Gain on the sale of employer securities to a worker-owned cooperative or ESOP may be deferred to the extent that the securities are replaced by the employer by purchase of stock of another domestic corporation with 25 percent or less of its income from passive investments. The gain is deferred by reducing the basis of the replacement securities. If replacement securities cost less than the gain being deferred, the difference is taxable to the employer on the return for the year of sale. Special definitions and rules are provided to coordinate this new provision with definitions of replacement and holding periods and a new 3-year statute of limitations.

Fiscal Impact

Revenue losses from conforming to these rules are unknown.

TAX REFORM ACT OF 1984 SECTION 542

Deductions to Employer Corporation for Dividends Paid on ESOP Stock (IRC 116, 404, 3405)

Summary

The Act allows the employer to deduct cash dividends paid to an employee stock ownership plan which holds the employer stock on the dividend record date. This deduction is available to the employer only when the dividends are paid directly in cash to participants or paid by the employer to the plan, and the plan in turn pays the dividends to participants within 90 days after the close of the plan year. Plan participants cannot take the $100 ($200 for joint returns) dividends-received exclusion for these dividends since they are deductible by the employer. This provision is effective for taxable years which began after July 18, 1984.

Old Federal Law

Dividends paid by corporations are not deductible. A dividend exclusion of $100 ($200 for joint returns) is allowed for individuals who receive corporate dividends.

Current California Law (PITL 17144) (B&CTL 24341)

California does not conform to the federal dividend exclusion and does not allow a corporation to deduct dividends paid by the corporation to shareholders.

New Federal Law

The Act allows a special corporate deduction for cash dividends paid with respect to stock held by an employee stock ownership plan. The dividends must be paid directly in cash to participants or indirectly to them through the plan within 90 days after the close of the plan year. The dividends are not classified as distributions from the plan and are not subject to withholding.

Fiscal Impact

Revenue losses from conforming to this dividend deduction are unknown.

TAX REFORM ACT OF 1984 SECTION 543

Partial Exclusion of Interest Earned on ESOP Loans (IRC 133)

Summary

Effective for loans made after July 18, 1984, a bank or other commercial lender is allowed to exclude 50 percent of the interest received on loans made to an ESOP (or an employer corporation which lends the proceeds to the ESOP)to acquire securities of the employer. The partial exclusion is not allowed for employer loans to the ESOP or the loans made between corporations which are members of the same controlled group.

Old Federal Law

None.

Current California Law (PITL 17131)

None.

New Federal Law

To encourage banks, insurance companies, and other commercial lending corporations to loan money to employee stock ownership plans to enable them to acquire employer securities, the Act provides a 50 percent exclusion from gross income for interest earned from the loans. This provision is effective for loans made after July 18, 1984.

Fiscal Impact

Revenue loss from conforming to this exclusion is unknown.

TAX REFORM ACT OF 1984 SECTION 544

Assumption of Estate Tax Liability by ESOP
(IRC 2210, 2002, 6018, 6166)

Summary

Under the Act an estate required to file an estate tax return after July 18, 1984, may allow an employee stock ownership plan to assume the executor's liability for the payment of estate tax to the extent of the value of employer securities transferred to the plan administrator by the estate. An election and signed agreements of all parties are required.

Old Federal Law

Executor's are liable for payment of the estate tax liability.

Current California Law

None. California does not have an estate tax except for the "pick-up" tax.

Fiscal Impact

None. Not applicable to California.

TAX REFORM ACT OF 1984 SECTION 545

Premature Distribution Penalty of ESOP
(IRC 4978)

Summary

A 10 percent premature distribution penalty tax is imposed on distributions by worker-owned cooperatives and ESOPs (including a tax credit ESOP) of employer securities (which received the tax-free deferral treatment) within 3 years of receiving the securities. The tax is 10 percent of (1) the amount realized on the sale, or (2) fair market value (FMV) on the disposition to the extent the securities received the tax favored deferral of gain. Distributions on account of death, retirement at or after age 59 1/2, disability, or separation from service for at least one year will escape the 10 percent penalty tax.

Old Federal Law

The deferral of gain is new, and this premature distribution penalty tax is also new. However, a 10 percent premature distribution penalty tax is assessed against distributions from pension plans before age 59 1/2.

Current California Law (PITL 17081, 17082, 17501, 17508)

California conforms to old federal law except that the penalty tax is 2 1/2 percent instead of 10 percent.

Fiscal Impact

Additional revenue from penalty assessments under conformity is unknown.

TAX REFORM ACT OF 1984 SECTION 14

Employee Stock Ownership Credit
(IRC 44G)

Summary

The Act freezes the amount of the tax credit for employer contributions to an ESOP. The rate remains at 0.5 percent of compensation for each year until the credit sunsets in 1987.

Old Federal Law

The tax credit for employer contributions to an ESOP was scheduled to increase from 0.5 percent to 0.75 percent of compensation for payments in 1985 to 1987.

Current California Law

California does not allow any tax credit for employer contributions to an ESOP.

Fiscal Impact

None. Not applicable to California.

RETIREMENT EQUITY ACT OF 1984 - TITLE II

Amendments to the Internal Revenue Code
(IRC 72, 401, 402, 403, 410, 411, 412, 414, 417, 4975, 6057, 6552)

Summary of New Provisions

Generally, for plan years after 1984, or for collectively bargained plans not later than January 1, 1987, the Internal Revenue Code is amended to provide for greater equity under private pension plans for workers and their spouse and dependents by taking into account changes in work patterns, the status of marriage as an economic partnership, and the substantial contribution to that partnership of spouses who work both in and outside the home.

Minimum age requirements for plan participation are generally lowered by five years from age 25 to 21.

Years of service after age 18 (instead of age 22) are taken into account for determining the nonforfeitable percentage of benefit vesting.

Maternity or paternity absences of less than 501 hours are not treated as a break in service.

The Act requires that benefits payable under pension plans must be in the form of joint and survivor annuities for a vested participant who retires under the plan. A pre-retirement survivor annuity is required where the vested participant dies before retirement. A participant may elect to waive this requirement, but that waiver may be changed by the participant at any time. In order to be valid, the participant's waiver must have the written and notarized consent of the spouse.

Special rules are provided for assignments of benefits in divorce proceedings to allow an alternate payee to receive all or a portion of the benefits payable with respect to a participant.

Rules are provided for mandatory distributions, written notification that benefits may be forfeitable, and written explanation for distributions which qualify for tax-free rollover treatment.

The Act also provides the actuarial assumptions and transitional rules for plans in existance on July 18, 1983.

Current California Law (PITL 17081, 17501)

California is in conformity with the qualification requirements for employee pension plans contained in federal law prior to the enactment of the Retirement Equity Act of 1984.

Fiscal Impact

The revenue impact from conforming is unknown.

TAX REFORM ACT OF 1984 SECTION 551-552

Miscellaneous Changes to Pension Plan Distribution Rules
(No IRC section amended)

Summary

Two retroactive provisions in the Act allow (1) relief from the partial termination rules for those partial terminations between 1976 and 1979 which occurred solely because of the completion of the Trans-Alaska Oil Pipline Construction Project for employees in Alaska and (2) tax-free rollover for a particualar taxpayer who received the distribution terminating the pension plan in two payments on December 16, 1976 and on January 6, 1977 and had been denied tax-free rollover treatment by the IRS.

Current California Law

The state is generally not allowed by the Constitution of the State to enact retroactive tax laws since those laws may be considered as making a gift of public funds.

Fiscal Impact

None. These retroactive federal provisions are not applicable to California.

TAX REFORM ACT OF 1984 SECTION 553

Special Treatment for Insurance Company Plans
(No IRC section amended)

Summary

Effective on March 15, 1984 the Act provides that plan disqualification or penalty tax will not apply where required distributions have not been made under IRA or pension plans because the insurance company is being rehabilitated under State insurance laws.

Old Federal Law

Mandatory distributions are rquired for both IRA and pension plans. For pension plans the penalty for failing to make the required distributions is disqualification of the plan as a tax-exempt pension trust. For IRA owners who fail the mandatory distribution requirements, the penalty tax of 50 percent of the difference between the amount paid out and what should have been paid.

Current California Law (PITL 17082, 17201, 1750)

California is in conformity with old federal law.

Fiscal Impact

The federal estimate for the Tax Reform Act of 1984 on this provision is a revenue loss of less than $500,000 annually. The state revenue loss annually under conformity would be less than $50,000 based on prorating this federal estimate.

TAX REFORM ACT OF 1984 SECTION 555

Technical Amendments to Incentive Stock Options (ISO)
(IRC 422A, 425, 57)

Summary

The Act makes two changes to the ISO provisions which relate to the determination of fair market value (FMV) of the stock option. First, effective for options granted after March 20, 1984, the FMV of stock is to be deterined without regard to any restriction on the stock other than one which won't lapse. Second, the effective for options exercised after March 20, 1984, the Act clarifies that a change in the terms of an option to make it nontransferable in order to qualify as an ISO is to be treated as the grant of a new option. Thus, the option grant price must be based on the later grant date for modifications to plans made March 20, 1984.

Old Federal Law

An employee who is granted an incentive stock option is allowed to receive capital gain on the sale of the stock acquired on the exercise of the option rather than ordinary income at the time of exercise. However, the option price of the ISO must equal or exceed the FMV of the stock at the time the option is granted. Also, the "spread" (i.e., the difference between the FMV of the stock on the date the option is exercised and the option price of the stock) is an item of tax preference for purposes of the alternative minimum tax.

Current California Law (PITL 17501, 17514)

California conforms to the ISO provisions of old federal law except that the options must be both granted and exercised on or after January 1, 1982.

California does not treat the "spread" between the FMV of the stock on the date the option is exercised and the option price as an item of tax preference.

Fiscal Impact

The federal estimate for the Tax Reform Act of 1984 on this provision is a revenue impact of less than $500,000 annually. The state impact under conformity would be less than $50,000 annually based on prorating this federal estimate.

TAX REFORM ACT OF 1984 SECTION 2662

FICA (Social Security) and FUTA (Federal Unemployment Tax Act) (IRC 3121, 3306)

Summary

The act clarifies the 1983 Social Security Act Amendments to provide that salary reduction agreements do not have to be in a written form for FICA and FUTA purposes and clarifies the effective dates for 1983 Social Security Amendments relating to certain wages which are exempt from income tax.

Current California Law

The Employment Development Department administers the Unemployment Insurance Code.

California does not have provisions similar to the Social Security Act.

Fiscal Impact

Not applicable under the PITL or the B&CTL.

TAX REFORM ACT OF 1984 SECTION 556

Property Transferred for Services Rendered
(No IRC section amended)

Summary

A special one-time election is allowed by the Act for taxpayers who had acquired stock subject to a restriction in exchanges for services rendered after June 30, 1976 and before November 18, 1982. That election is to report as income the difference between the stock's FMV and its cost in the income tax return for taxable year 1984. This election is allowed because many taxpayers failed to make the election because the FMV of the stock and its cost were the same and it was widely assumed that these elections only needed to be made where the cost of the stock was below its fair market value.

Old Federal Law

When restricted stock is sold to employees at less than FMV, the appreciation is taxed as ordinary income when the restriction lapses. The employee can minimize the realization of ordinary income by making an election to include the bargain element in gross income as ordinary income in the year he/she receives the stock. The election is irrevocable and must be made within 30 days after the date he/she receives the stock.

In 1982 the Tax Court held (and the ruling was affirmed in 1984 by the Ninth Circuit Court of Appeals) that the taxpayer had to report the gain on the sale of stock acquired as ordinary income rather than capital gain. This resulted even though there was no bargain purchase of the stock (i.e., the cost was equal to the FMV) because the stock was subject to a restriction and the employee had not made the election to report the difference (0 in this case) in income in the year the stock was acquired. In this case the restriction on the stock was that the employee couldn't sell the stock before a specific date and he/she had to offer the stock at cost to the company if he/she left its employ prior to the expiration of the restriction.

Current California Law (PITL 17081)

California is in conformity with old federal law.

Fiscal Impact

Based on a proration of the federal estimates for the Tax Reform Act of 1984, conformity would result in net revenue losses in the $200,000 range annually.

TAX REFORM ACT OF 1984 SECTION 557

Sales of Depreciable Property by Employer to Welfare Benefit Fund (IRC 1239)

Summary

The rules which treat gains on sales of depreciable assets between related parties as ordinary income is extended to include sales of depreciable assets after July 18, 1984 by an employer to a related employee association (REA). An REA includes a voluntary employee beneficiary association (VEBA), a supplemental unemployment insurance benefit trust (SUB), a group legal services plan and exempt non-profit recreational clubs controlled by the employer.

Old Federal Law

Any gain realized on the sale of depreciable property to a related party which is controlled by the seller is converted from tax favored capital gain into fully taxed ordinary income.

Current California Law (PITL 18151, B&CTL 24271)

The California Personal Income Tax Law is in conformity with the old federal law.

The California Bank and Corporation Tax Law includes in gross income 100 percent of the gain on the sale of assets of any kind sold by a corporation.

Fiscal Impact

Conformity under the PITL would produce revenue gains of an unknown amount annually.

TAX REFORM ACT OF 1984 SECTION 558

Retroactive Relief for Withdrawal Liability
(ERISA 4217, 4235, 4211, 4219, 4402 & MPPAA 108)

Retroactive Provision

Generally, under the Act, any liability incurred before September 26, 1980, as a result of complete or partial withdrawal from a multiemployer plan is void. The Act provides for refunds (with interest) of amounts paid by an employer to a plan sponsor (such as the Pension Benefit Guaranty Corporation) as a result of such withdrawal liability.

Current California Law

California has no comparable withdrawal penalty provision within the Revenue and Taxation Code.

Fiscal Impact

None. Not applicable to California.

TAX REFORM ACT OF 1984 SECTION 559

Pensions of Employees Involved in the AT&T Divestitures (IRC 219)

The Act extends the pension protection provided for 1984 to years after December 31, 1984. The new rules protect the years of service and accrued benefits of covered employees who are transferred between AT&T and its former subsidiaries, or between former subsidiaries, as a result of the AT&T divestiture. A covered employee is one who is not a supervisor or whose annual base pay rate is not more than $50,000 as adjusted by the consumer price index.

Old Federal Law

The portability of the employees' service only applied to years of service through 1984. Service in years after 1984 is to be taken into account only by the company for whom the service was performed.

Current California Law (PITL 17501)

California is in conformity with old federal law.

Fiscal Impact

No revenue impact would result from conforming to this extension.

TAX REFORM ACT OF 1984 SECTION 560

Study of Employee Welfare Benefit Plans

Summary

The Act directs the Internal Revenue Service to conduct a study relating to the use of welfare benefit plans in providing benefits to current and retired employees and the need for participation, vesting and funding standards.

Old Federal Law

None.

Current State Law

None.

Fiscal Impact

None. Not applicable to California.

TAX REFORM ACT OF 1984 SECTION 15

Freeze on Cost-of-Living Adjustments (COLA) to Pension Plans Extended

Summary

The TEFRA freeze on COLA indexing of defined benefit and defined contribution limits is extended by two years until 1988 at which time the cost-of-living adjustments will start to apply based on post-1986 inflation.

Old Federal Law

TEFRA froze cost-of-living adjustments for defined benefit and defined contribution limits until years beginning after 1985 based on post-1984 COLA increases.

Current California Law (PITL 17501)

California is in conformity with old federal law.

Fiscal Impact

Revenue gains from the delay of COLA adjustments are unknown.

TAX REFORM ACT OF 1984 SECTION 67

Golden Parachute Payments
(IRC 275, 280G, 4999, 3121)

Introduction

Corporations sometimes enter into agreements with their key employees that have come to be called "golden parachutes" under which the corporation agrees to pay these key employees amounts, often in excess of their usual compensation, if control of the corporation changes.

Summary of 1984 Act

The Act codifies the treatment of these "golden parachute" payment agreements. The new law makes payments in money or property in excess of "base amount" under an agreement entered into or amended after June 14, 1984 nondeductible. Also, the recipient is subject to a new nondeductible 20 percent penalty tax on such excess. The payments are also subject to FICA (social security) taxes.

The "base amount" is three times an individual's annualized compensation for the most recent five taxable years before the date on which the control of the corporation changed.

Old Federal Law

Reasonable compensation is deductible as an ordinary and necessary business expense. Compensation which is not reasonable is in the nature of a dividend and not deductible by the corporation even though includible in the employees' gross income.

Current California Law (PITL 17081, B&CTL 24343)

California is in conformity to old federal law.

Fiscal Impact

Based on the federal estimate for the Tax Reform Act of 1984 on this provision, conformity by the state would result in very minor revenue gains, less than $100,000 annually.

TAX REFORM ACT OF 1984 SECTION 491

Repeal of Obsolete Provisions - Bond Purchase Plans and Retirement Bonds (IRC 402, 405, 409)

Summary

Rules relating to bond purchase plans and retirement bonds are repealed effective for obligations issued after December 31, 1983. This repeal results from the fact that the sales of bonds for these two plans under the Second Liberty Bond Act were terminated by the Treasury Department effective April 20, 1982.

In order to allow present bondholders to reinvest the proceeds of their bonds in other retirement arrangements, the Act allows an individual to redeem a bond at any time even though under age 59 1/2 without imposition of the 10 percent premature distribution penalty tax. Also, tax-free rollover treatment is allowed to a rollover to an employer pension plan. Separate accounting is required because these funds are not eligible for special averaging or capital gain treatment.

Old Federal Law

Employers were allowed to maintain qualified bond purchase plans funded by retirement bonds issued under the Second Liberty Bond Act. A premature distribution penalty tax of 10 percent applied to distributions before age 59 1/2.

Current California Law (PITL 17501, 17509)

California conforms to old federal law except that the premature distribution penalty tax is 2 1/2 percent.

Fiscal Impact

Based on prorations of the federal estimate for the Tax Reform Act of 1984, conforming to this provision would result in very minor revenue losses, less than $100,000 annually.

TAX REFORM ACT OF 1984 SECTION 2601, 2603

Federal Unemployment Tax Coverage of Federal Employees and Church Employees

Summary

The Act provides for the coverage of federal employees by the Federal Unemployment Tax Act (FUTA) and provides that church employees are covered by the provisions relating to the tax on self-employment income for OASDI (Social Security).

Old Federal Law

None.

Current State Law

California has no tax on self-employment income.

The Employment Development Department administers the California Unemployment Insurance Code and these items should be analyzed by them for state impact and recommendations.

TAX REFORM ACT OF 1984 SECTION 611

Qualified Mortgage Board - Extends Time to Issue Four Years
(IRC 103A (c)(1)(B))

Summary

A qualified mortgage bond is an obligation which is issued as part of a qualified mortgage issue, whose interest is tax exempt and is one in which all proceeds of the bond issue must be used exclusively to finance owner-occupied residences. This Act extends the date to issue new tax exempt qualified mortgage bonds to December 31, 1987.

Old Federal Law

The last day qualified mortgage bonds could be issued was December 31, 1983.

Current California Law (PITL 17133, 17143 B&CTL 24272)

California does not conform to the federal law provisions relating to mortgage subsidy bonds. All interest earned on bonds issued by this state or any of its political subdivisions is exempt from income tax but California taxes interest earned on bonds issued by any other state or political subdivision of another state.

For purposes of the Bank and Corporation Franchise Tax, gross income includes interest from all state, federal, municipal or other bonds since it is not an income tax, but a tax imposed on a bank or corporation for the privilege of doing business in this state.

Fiscal Impact

None. Not applicable to California.

TAX REFORM ACT OF 1984 SECTION 611

Qualified Veterans' Mortgage Bonds - Requirements for Eligibility (IRC 103A)

Summary

A qualified veteran's mortgage bond issue is now required as a condition of being exempt from tax to comply with new reporting requirements which identify the issuer, the lendable proceeds, date of issue and the terms of the issue (i.e. interest rate, term and face amount). In addition the issue must be used for acquisition of single family residences to be lived in by the veteran within the jurisdiction of the issuer. A veteran is an individual who served on active duty sometime before January 1, 1977 and who applied for financing at the later of January 1, 1985 or 30 years after the last date the veteran served on active duty. Only states which issued qualified veterans mortgage bonds before June 22, 1984 are qualified to issue new bonds under the Act and makes these bond issues subject to a ceiling.

Old Federal Law

Qualfied veterans mortgage bonds had to meet the requirement that no part of the proceeds could be used to acquire or replace existing mortgages.

There were no ceilings on the volume of bonds able to be issued by states and no reporting requirement existed.

Current California Law (PITL 17133, 17143 B&CTL 24272)

California does not conform to the federal law provisions relating to veteran's mortgage bonds. All interest earned on bonds issued by this state or any of its political subdivisions is exempt from income tax but California taxes interest earned on bonds issued by any other state or political subdivision of another state.

For purposes of the Bank and Corporation Franchise Tax, gross income includes interest from all state, federal, municipal or other bonds since it is not an income tax, but a tax imposed on a bank or corporation for the privilege of doing business in this state.

Fiscal Impact

None. Not applicable to California.

TAX REFORM ACT OF 1984 SECTION 612

Mortgage Credit Certificates - Interest on Certain Home Mortgages (IRC 25)

Summary

A new credit is provided in federal law for a Mortgage Credit Certificate (MCC). States and localities may elect to issue MCCs as an alternative to issuing mortgage subsidy bonds for qualified first time homebuyers. Certificate holders arrange financing through conventional sources and may claim a maximum tax credit equal to the greater of twenty percent of qualifying indebtness not to exceed $2,000. Unused credits are not refundable but may be carried over for three years.

Old Federal Law

None. This is a new section in an attempt to curb the usage of tax-exempt mortgage subsidy bonds.

Current California Law

None. California is not generally conformed to the federal law in the tax credit provisions. California does not conform to the federal provisions regarding mortgage subsidy bonds.

New Federal Law

The Tax Reform Act of 1984 allows a credit against income tax for MCCs. A MC'C is any certificate which is issued under a qualified MCC program by the state or political subdivision to provide financing on the principal residence of the taxpayer. The MCC may be issued for acquisition, qualified rehabilitation or qualified home improvement. Certificate holders then arrange financing through conventional sources. The maximum tax credit that a certificate holder may claim is equal to the greater of (1) 20 percent of the taxpayer's qualifying indebtedness or (2) $2000. The taxpayers deduction for interest on qualifying mortgage is reduced by the amount of the credit.

Fiscal Impact

With federal 1984 Tax Reform Act estimates for this provision in the hundreds of millions of dollars, revenue losses to the state from conformity could be substantial and would depend on the size of the credit allowed.

TAX REFORM ACT OF 1984 SECTION 613

Borrowing Authority for the Oregon State Housing Agency
(Does not amend any IRC section)

Summary

Allows the state of Oregon to borrow money from the Federal Financing Bank in amounts necessary to meet the debt service on qualified veteran's mortgage bonds.

Old Federal Law

None.

Current California Law

None. Not applicable to California.

Fiscal Impact

None.

TAX REFORM ACT OF 1984 SECTION 614

Retroactive Amendments to the Mortgage Subsidy Bond Act of 1980
(No IRC section amended)

Summary

Provides that mortgage subsidy bonds issued between June 15, 1984 and January 1, 1985 under the transitional rules contained in the 1980 Act will not be tax-exempt unless they are within the general rules for allocation of state issue ceilings under the new law.

Old Federal Law

Transitional rules allowed the issuance of tax exempt mortgage subsidy bonds outside of the general state ceilings.

Current California Law (PITL 17133, 17143 B&CTL 24272)

California does not conform to the federal law provisions relating to mortgage subsidy bonds.

Fiscal Impact

None. Not applicable to California.

TAX REFORM ACT OF 1984 SECTION 621

Private Activity Bonds - Ceiling Imposed
(IRC Section 103)

Introduction

Interest on state and local governmental obligations has been exempt from federal taxation since the 1913 code. Tax-exempt private activity bonds (commonly called Industrial Development Bonds (IDBs)) were added to federal law in 1968. In addition to IDBs, scholorship funding bonds were allowed tax-exempt status in 1976, and mortgage subsidy bonds gained their exemption in 1980. California has never conformed to any of these provisions since state law on the taxability of interest income from bonds issued by California or any of its political subdivisions is constitutionally not subject to any income tax. Thus, California has no need for language relating to the status of interest income from California state and California municipal bonds. Interest income from bonds issued by other states or their political subdivisions has always been taxable by California.

Summary of 1984 Act Changes

The Act puts a ceiling on the amount of private activity bonds that a state may issue during a calendar year. That ceiling is an amount equal to the greater of $150 per resident or $200 million. The Act provides for a carryover of limits not used and specifies the government authorities which may issue these bonds. The bond limit provisions generally apply to bonds issued after December 31, 1983.

Old Federal Law

Interest earned from private-activity bonds was exempt from tax, and no ceiling was placed on the amount of bonds issued during a year.

Current California Law (PITL 17133, 17143 B&CTL 24272)

California does not conform to the federal law provisions relating to private activity bonds whether they are IDBs, scholorship funding bonds, or mortgage subsidy bonds. All interest earned on bonds issued by this state or any of its political subdivisions is exempt from income tax but California taxes interest earned on bonds issued by any other state or political subdivision of another state.

For purposes of the Bank and Corporation Franchise Tax, gross income includes interest from all state, federal, municipal or other bonds since it is not an income tax, but a tax imposed on a bank or corporation for the privilege of doing business in this state.

Fiscal Impact

None. Limitations on provisions to which California has never conformed are not applicable.

TAX REFORM ACT OF 1984 SECTION 622

Exemption Eliminated for Federally-Guaranteed Bonds Issued by State and Local Governments
(IRC Section 103)

Introduction

Interest on state and local governmental obligations has been exempt from federal taxation since the 1913 code. Tax-exempt private activity bonds (commonly called Industrial Development Bonds (IDBs)) were added to federal law in 1968. In addition to IDBs, scholorship funding bonds were allowed tax-exempt status in 1976, and mortgage subsidy bonds gained their exemption in 1980. California has never conformed to any of these provisions since state law on the taxability of interest income from bonds issued by California or any of its political subdivisions is constitutionally not subject to any income tax. Thus, California has no need for language relating to the status of interest income from California state and California municipal bonds. Interest income from bonds issued by other states or their political subdivisions has always been taxable by California.

Summary of 1984 Act Changes

Generally, for obligations issued after December 31, 1983, the Act eliminates the tax exemption on interest earned on federally guaranteed bonds.

There are two basic broad categories of exceptions to this denial of tax-exemption:

1. Obligations that are not considered federally guaranteed even though they appear to be (i.e. federal guarantee of student loans, Federal Housing Administration (FHA) guraantees, and Veteran's Administration (VA) guarantees and

2. Those obligations that are exempted even though they are federally guaranteed (i.e. investments in obligations issued by the U.S. Treasury).

Old Federal Law

Interest on state and local obligations was exempt whether or not the obligations were guaranteed by the federal government.

Current California Law (PITL 17133, 17143 B&CTL 24272)

California does not conform to the federal law provisions relating to private activity bonds whether they are IDBs, scholorship funding bonds, or mortgage subsidy bonds. All interest earned on bonds issued by this state or any of its political subdivisions is exempt from inoome tax but California taxes interest earned on bonds issued by any other state or political subdivision of another state.

For purposes of the Bank and Corporation Franchise Tax, gross income includes interest from all state, federal, municipal or other bonds since it is not an income tax, but a tax imposed on a bank or corporation for the privilege of doing business in this state.

Fiscal Impact

None. Not applicable to California.

TAX REFORM ACT OF 1984 SECTION 623

Small-Issue IDB Ceiling
(IRC Section 103)

Introduction

Interest on state and local governmental obligations has been exempt from federal taxation since the 1913 code. Tax-exempt private activity bonds (commonly called Industrial Development Bonds (IDBs)) were added to federal law in 1968. In addition to IDBs, scholorship funding bonds were allowed tax-exempt status in 1976, and mortgage subsidy bonds gained their exemption in 1980. California has never conformed to any of these provisions since state law on the taxability of interest income from bonds issued by California or any of its political subdivisions is constitutionally not subject to any income tax. Thus, California has no need for language relating to the status of interest income from California state and California municipal bonds. Interest income from bonds issued by other states or their political subdivisions has always been taxable by California.

Summary of 1984 Act Changes

Generally, for obligations issued after December 31, 1983, the new Act sets a $40 million ceiling on outstanding small issues that may be allocated to a single-bond beneficiary. The law provides that multiple users of facilities financed by small-issue IDBs are to apportion the amount of the issue among the beneficiaries according to ownership interest in or use of the facility for purposes of satisfying the new ceiling.

Old Federal Law

Tax-exempt small issue (issues up to $10 million) Industrial Development Bonds (IDBs) may be issued by state and local governments through 1985.

Current California Law (PITL 17133, 17143 B&CTL 24272)

California does not conform to the federal law provisions relating to private activity bonds whether they are IDBs, scholorship funding bonds, or mortgage subsidy bonds. All interest earned on bonds issued by this state or any of its political subdivisions is exempt from income tax but California taxes interest earned on bonds issued by any other state or political subdivision of another state.

For purposes of the Bank and Corporation Franchise Tax, gross income includes interest from all state, federal, municipal or other bonds since it is not an income tax, but a tax imposed on a bank or corporation for the privilege of doing business in this state.

Fiscal Impact

None. Not applicable to California.

TAX REFORM ACT OF 1984 SECTION 624

Arbitrage Restrictions Increased
(IRC Section 103, 103A)

Introduction

Interest on state and local governmental obligations has been exempt from federal taxation since the 1913 code. Tax-exempt private activity bonds (commonly called Industrial Development Bonds (IDBs)) were added to federal law in 1968. In addition to IDBs, scholorship funding bonds were allowed tax-exempt status in 1976, and mortgage subsidy bonds gained their exemption in 1980. California has never conformed to any of these provisions since state law on the taxability of interest income from bonds issued by California or any of its political subdivisions is constitutionally not subject to any income tax. Thus, California has no need for language relating to the status of interest income from California state and California municipal bonds. Interest income from bonds issued by other states or their political subdivisions has always been taxable by California.

Summary of 1984 Act Changes

Generally, for IDB's issued after December 31, 1984, the new Act further curtails tax-free arbitrage. Arbitrage is the purchase of securties on one market for immediate resale on another in order to profit from a price differential. An issuing authority must rebate its arbitrage profits to the federal government in installments every five years. If the money is not rebated or the limits exceeded, IDBs lose their tax-free status. Unlimited arbitrage is possible and no rebate required as long as all gross proceeds of a state issue are expended on a project within six months of an issue's release.

Old Federal Law

Prior rules did not require the rebating of arbitrage profits. Similar rules in the new Act applied to mortgage subsidy bonds, but not to IDBs.

Current California Law (PITL 17133, 17143 B&CTL 24272)

California does not conform to the federal law provisions relating to private activity bonds whether they are IDBs, scholorship funding bonds, or mortgage subsidy bonds. All interest earned on bonds issued by this state or any of its political subdivisions is exempt from income tax but California taxes interest earned on bonds issued by any other state or political subdivision of another state.

For purposes of the Bank and Corporation Franchise Tax, gross income includes interest from all state, federal, municipal or other bonds since it is not an income tax, but a tax imposed on a bank or corporation for the privilege of doing business in this state.

Fiscal Impact

None. The further restriction of provisions to which the state has never conformed are not applicable to California.

TAX REFORM ACT OF 1984 SECTION 625

Student Loan Bonds
(No section of IRC amended)

Introduction

Interest on state and local governmental obligations has been exempt from federal taxation since the 1913 code. Tax-exempt private activity bonds (commonly called Industrial Development Bonds (IDBs)) were added to federal law in 1968. In addition to IDBs, scholorship funding bonds were allowed tax-exempt status in 1976, and mortgage subsidy bonds gained their exemption in 1980. California has never conformed to any of these provisions since state law on the taxability of interest income from bonds issued by California or any of its political subdivisions is constitutionally not subject to any income tax. Thus, California has no need for language relating to the status of interest income from California state and California municipal bonds. Interest income from bonds issued by other states or their political subdivisions has always been taxable by California.

Summary of 1984 Act Changes

The Act applies the arbitrage rules discussed in agenda item no. 160 to Guaranteed Student Loan (GSL) bonds under regulations prescribed by the Treasury Department. Student loan bonds issued after December 31, 1984, which do not qualify as a GSL bond are required to rebate arbitrage profits to the federal government in installments every five years and are not tax-exempt bonds.

The GSL bond rules will apply six months after the date the new IRS regulations are published.

Old Federal Law

All scholorship funding bonds issued by non-profit corporations operated exclusively to acquire student loan notes under the Higher Education Act of 1965 are tax-exempt bonds. Those were allowed to devote any income (after payment of expenses, debt service, and the creation of reserves for future debt services) to the purchase of additional student loan notes or to pay over any income to the state or local government which sponsored the corporation.

Current California Law (PITL 17133, 17143 B&CTL 24272)

California does not conform to the federal law provisions relating to private activity bonds whether they are IDBs, scholorship funding bonds, or mortgage subsidy bonds. All interest earned on bonds issued by this state or any of its political subdivisions is exempt from income tax but California taxes interest earned on bonds issued by any other state or political subdivision of another state.

For purposes of the Bank and Corporation Franchise Tax, gross income includes interest from all state, federal, municipal or other bonds since it is not an income tax, but a tax imposed on a bank or corporation for the privilege of doing business in this state.

Fiscal Impact

None. Further restrictions on provisions to which the state has never conformed are not applicable to California.

TAX REFORM ACT OF 1984 SECTION 626

Consumer Loan Bonds
(IRC Section 103)

Introduction

Interest on state and local governmental obligations has been exempt from federal taxation since the 1913 code. Tax-exempt private activity bonds (commonly called Industrial Development Bonds (IDBs)) were added to federal law in 1968. In addition to IDBs, scholorship funding bonds were allowed tax-exempt status in 1976, and mortgage subsidy bonds gained their exemption in 1980. California has never conformed to any of these provisions since state law on the taxability of interest income from bonds issued by California or any of its political subdivisions is constitutionally not subject to any income tax. Thus, California has no need for language relating to the status of interest income from California state and California municipal bonds. Interest income from bonds issued by other states or their political subdivisions has always been taxable by California.

Summary of 1984 Act Changes

Under the new law "consumer" bonds, with specified exceptions, are denied tax exemption for interest. "Consumer" bonds are defined as bonds which are used to finance loans to individuals for personal matters.

Old Federal Law

There was no specific denial of tax-exempt interest as related to consumer bonds.

Current California Law (PITL 17133, 17143 B&CTL 24272)

California does not conform to the federal law provisions relating to private activity bonds whether they are IDBs, scholorship funding bonds, or mortgage subsidy bonds. All interest earned on bonds issued by this state or any of its political subdivisions is exempt from income tax but California taxes interest earned on bonds issued by any other state or political subdivision of another state.

For purposes of the Bank and Corporation Franchise Tax, gross income includes interest from all state, federal, municipal or other bonds since it is not an income tax, but a tax imposed on a bank or corporation for the privilege of doing business in this state.

Fiscal Impact

None. Limitations on provisions to which California has never conformed are not applicable.

TAX REFORM ACT OF 1984 SECTION 627

Acquisition of Land, Luxury Items, and Existing Facilities With IDB Proceeds Restricted
(IRC Section 103)

Introduction

Interest on state and local governmental obligations has been exempt from federal taxation since the 1913 code. Tax-exempt private activity bonds (commonly called Industrial Development Bonds (IDBs)) were added to federal law in 1968. In addition to IDBs, scholorship funding bonds were allowed tax-exempt status in 1976, and mortgage subsidy bonds gained their exemption in 1980. California has never conformed to any of these provisions since state law on the taxability of interest income from bonds issued by California or any of its political subdivisions is constitutionally not subject to any income tax. Thus, California has no need for language relating to the status of interest income from California state and California municipal bonds. Interest income from bonds issued by other states or their political subdivisions has always been taxable by California.

Summary of 1984 Act Changes

For industrial development bonds (IDBs) issued after December 31, 1983, the new law curtails the acquisition of land, luxury items (i.e. airplanes, sky boxes, or other luxury boxes, any type of gambling facility, health club, or liquor store), or existing facilities which are not rehabilitated by limiting the percent of proceeds that can be used, directly or indirectly, and have an IDB still qualify for interest tax exemption.

Old Federal Law

The new law restrictions on the use of IDB proceeds were not contained in the prior federal law.

Current California Law (PITL 17133, 17143 B&CTL 24272)

California does not conform to the federal law provisions relating to private activity bonds whether they are IDBs, scholorship funding bonds, or mortgage subsidy bonds. All interest earned on bonds issued by this state or any of its political subdivisions is exempt from income tax but California taxes interest earned on bonds issued by any other state or political subdivision of another state.

For purposes of the Bank and Corporation Franchise Tax, gross income includes interest from all state, federal, municipal or other bonds since it is not an income tax, but a tax imposed on a bank or corporation for the privilege of doing business in this state.

Fiscal Impact

None. Limitations on provisions to which California has never conformed are not applicable.

TAX REFORM ACT OF 1984 SECTION 628 & 648

Miscellaneous Changes to Tax-Exempt Bonds
(IRC Section 103 & 168)

Introduction

Interest on state and local governmental obligations has been exempt from federal taxation since the 1913 code. Tax-exempt private activity bonds (commonly called Industrial Development Bonds (IDBs)) were added to federal law in 1968. In addition to IDBs, scholorship funding bonds were allowed tax-exempt status in 1976, and mortgage subsidy bonds gained their exemption in 1980. California has never conformed to any of these provisions since state law on the taxability of interest income from bonds issued by California or any of its political subdivisions is constitutionally not subject to any income tax. Thus, California has no need for language relating to the status of interest income from California state and California municipal bonds. Interest income from bonds issued by other states or their political subdivisions has always been taxable by California.

Summary of 1984 Act Changes

A series of six categories of technical changes are made by the Act:

1. Bonds issued under federal law provisions outside of the Internal Revenue Code after December 31, 1983, will not be tax exempt unless they also meet the IRC rules relating to IDB, arbitrage bonds, and mortgage subsidy bonds.

2. Property acquired with IDB financing is limited to depreciation recovery of its costs on the straight-line method over the ACRS period unless it is residential rental property.

3. Several changes relate to the small issues of IDBs to combine persons to whom the IDB is issued into one if it is for a single project and raises the limit to $15 million for projects which receive urban development action grants (UDAGs).

4. Partners who hold IDBs cannot exclude the interest if the partnership is a substantial user of the facility financed by an IDB.

5. Tax-exempt status for IDBs issued to provide residential rental housing will not be lost merely because part of the building is used commercially or for some other non-residential use.

6. Clarifies that public approval for airports is to be acquired only by the government unit that owns or operates the airport and repeals a provision which allowed new bonds to be issued more than 180 days before an old bond issue expired and was to be used to replace the old bond issue (called advanced refunding).

Old Federal Law

1. Tax-exempt bonds issued outside of the Internal Revenue Code (i.e. District of Columbia bonds, U.S. possession bonds, and Housing and Urban Development (HUD) bonds) were not subject to the requirements for IDBs, arbitrage bonds, and mortgage subsidy bonds.

2. Greater than straight-line depreciation was allowed for projects receiving urban development action grants (UDAGs), municipal solid waste disposal facilities, and pollution control facilities.

3. If the small issue IDBs were issued to several unrelated persons to build a shopping mall, office building, or other single project, the dollar limits applied to each unrelated person rather than to the project as a whole. The small issue IDB limit was $10 million.

4. A substantial user of the property which was a partnership subject to common control was a related party to those entities which exercised the common control and did not extend to the spouses and dependent children of the partners.

5. Old federal law was unclear as to whether an entire building must consist of low or moderate income rental housing for interest on all the bonds to be tax-exempt.

6. Advance refunding was allowed for convention and trade-show facilities, docks, wharves, mass-commuting vehicles and airports. It was unclear which governmental jurisdictions had to obtain public approval for airports located in more than one jurisdiction.

Current California Law (PITL 17133, 17143 B&CTL 24272)

California does not conform to the federal law provisions relating to private activity bonds whether they are IDBs, scholorship funding bonds, or mortgage subsidy bonds. All interest earned on bonds issued by this state or any of its political subdivisions is exempt from income tax but California taxes interest earned on bonds issued by any other state or political subdivision of another state.

For purposes of the Bank and Corporation Franchise Tax, gross income includes interest from all state, federal, municipal or other bonds since it is not an income tax, but a tax imposed on a bank or corporation for the privilege of doing business in this state.

Fiscal Impact

None. Limitations on provisions to which California has never conformed are not applicable.

Exceptions to the IDB Provisions
(IRC Section 103)

Introduction

Interest on state and local governmental obligations has been exempt from federal taxation since the 1913 code. Tax-exempt private activity bonds (commonly called Industrial Development Bonds (IDBs)) were added to federal law in 1968. In addition to IDBs, scholorship funding bonds were allowed tax-exempt status in 1976, and mortgage subsidy bonds gained their exemption in 1980. California has never conformed to any of these provisions since state law on the taxability of interest income from bonds issued by California or any of its political subdivisions is constitutionally not subject to any income tax. Thus, California has no need for language relating to the status of interest income from California state and California municipal bonds. Interest income from bonds issued by other states or their political subdivisions has always been taxable by California.

Summary of 1984 Act Changes

Three exception categories to the IDB provisions are contained in the ACT:

1. Bonds issued by railroads are excluded from the small-issue restrictions on tax-free IDBs if the bonds are used to purchase railroad tracks or rights-of-way from bankrupt railroads, and the Federal Railroad Administration subsidizes the acquisition.

2. The small-issue exemption for IDBs has been extended to December 31, 1988, for bonds used to finance manufacturing facilities. The regular termination date, December 31, 1986, remains in effect for all other kinds of small issue IDBs.

3. A plethora of selected projects are excluded from many of the new requirements or are granted special tax exemptions. Among these projects are the Power Authority of the State of New York for bonds used to finance the Long Island Lighting Company and the Bradley Lake Hydroelectric Facility. Normally, IDBs for electric facilities are exempt only if the facilities are used by a utility serving no more than two contiguous counties. Here, the two companies serve three contiguous counties. Obligations of the Pennsylvania State University are tax-exempt bonds as are those for a hydroelectric project in Alaska. The Virgin Islands and Samoa may issue tax-exempt IDB subject to the rules in the Internal Revenue Code. The Treasury Department is to file a report to Congress on student-loan bonds which have not been determined to be exempt bonds.

Old Federal Law

Small-issue IDB exemptions were scheduled to sunset for bonds issued after

December 31, 1986.

Current California Law (PITL 17133, 17143 B&CTL 24272)

California does not conform to the federal law provisions relating to private activity bonds whether they are IDBs, scholorship funding bonds, or mortgage subsidy bonds. All interest earned on bonds issued by this state or any of its political subdivisions is exempt from income tax but California taxes interest earned on bonds issued by any other state or political subdivision of another state.

For purposes of the Bank and Corporation Franchise Tax, gross income includes interest from all state, federal, municipal or other bonds since it is not an income tax, but a tax imposed on a bank or corporation for the privilege of doing business in this state.

Fiscal Impact

None. Not applicable to California.

TAX REFORM ACT OF 1984 SECTION 641-642

Estate and Gift Tax
(No IRC section amended)

Summary

The Act clarifies that an income tax exemption under a federal law outside of the Internal Revenue Code (IRC) for interest on obligations does not make those obligations exempt from federal estate, gift, or generation shipping transfer tax. Also, an information return is required for public housing bond transfers between January 1, 1984, and June 18, 1984, to enable the estate and gift tax to be determined. Penalties are provided for failure to file the reports.

Old Federal Law

Non-IRC tax exemption statutes were not clear about whether the exemption extended to the estate and gift taxes or only to income taxes.

Current California Law

California does not have an estate and gift tax except for a "pick-up" tax.

Fiscal Impact

None. Not applicable to California.

TAX REFORM ACT OF 1984 SECTION 41-42

Original Issue Discount - General Rules
(IRC 483, 1271-1278, 1281-1283, 1286-1288, 1232-1232B, 103A, 163, 249, 409, 871, 881, 1037, 1441, 6706)

Introduction

Under the tax law prior to the Tax Reform Act of 1984, the issuer and holder of an original issue discount (OID) bond, or other related instrument, were required to report the interest annually regardless of whether they were on the cash or the accrual basis. However, certain exceptions to the law, such as obligations issued by a natural person or obligations issued in exchange for property or services, have permitted taxpayers to circumvent the law. For example, property could have been exchanged by a cash-basis taxpayer for a multiple-year, single-payment, original issue discount note given by an accrual-basis taxpayer. In such an exchange, the principal amount of the note will exceed the fair market value of the property, but the redemption price of the note will equal the future value of the fair market value of the property at the time of the exchange. Thus, the accrual-basis purchaser would deduct the interest currently and would have an artifically high basis for purposes of taking ACRS deductions and investment credits. On the other hand, the cash-basis seller would not report the interest on the note until the end of the loan term. Further, the use of a below-market interest rate would convert ordinary interest income into capital gain, also reported at the end of the loan term.

Summary of 1984 Act Changes

Generally, effective for tax years ending after July 18, 1984, the Act restructures the code provisions containing debt instrument provisions into the new OID rule structure with technical and conforming changes and extends the application of the OID rules to:

1. Debt instruments that are not publicly traded and that are issued for nontraded property,

2. Obligations issued by individuals,

3. Obligations not held as capital assets by cash-basis taxpayers, and

4. Debt instruments that are issued for services or for the use of property.

Old Federal Law

The issuer and holder of an original issue discount (OID) bond were required to report the interest annually regardless of whether they were on the cash or accrual basis. However, exceptions to this treatment were allowed for obligations issued by natural person or obligations issued in exchange for property or services.

Current California Law (PITL 18031, 18151) (B&CTL 24272.5)

California conforms to the old federal law.

Fiscal Impact

The net revenue impact is unknown.

TAX REFORM ACT OF 1984 SECTION 41-42

Issue Price of Privately Placed Debt Instruments Issued For Property - Imputed Interest
(IRC 483, 1274, 1275)

Summary

The original issue discount rules (OID) have been extended by the Act to apply to a privately placed debt instrument given in consideration for the sale or exchange of property (including right to use property and services) if (1) some or all of the payments are due more than six months after the date of the sale or exchange and (2) the stated redemption price at maturity exceeds either the stated principal amount (if there is adequate stated interest) or the "testing" amount (if there is inadequate stated interest).

There is adequate stated interest on an instrument if the stated principal amount is less than or equal to the "testing" amount. The key to this change, therefore, is the definition of the "testing" amount. The Act specifies that the "testing" amount is an imputed principal amount determined by totaling the present values of all payments due on the instrument, discounted at 110 percent of the following federal rates:

1. For instruments with a term of not over three years, the rate is the average market yield on short-term U.S. obligations,

2. For instruments with a term of over three years but not over nine years, the rate is the average market yield on mid-term U.S. obligations, and

3. For instruments with a term of over nine years, the rate is the average market yield on long-term U.S. obligations.

4. Debt instruments that are issued for services or for the use of property.

Where the instrument is subject to the OID rules, the issue price is treated as equal to either (1) the stated principal amount where there is adequate stated interest or (2) a recomputed imputed principal amount equal to the sum of the present values of all payments due using a discount rate equal to 120 percent of the federal rate applicable to the term of the note.

Thus, two different discount rates are used for different purposes:

1. The 110 percent discount rate is used to determine the "testing" amount to determine whether the debt instrument is subject to the OID rules, and

2. The 120 percent discount rate is used to determine the issue price which will be used to calculate the annual interest and principal amounts the issuer and holder must report on their returns.

The Act makes six exceptions to the application of these new OID rules, and those transactions will continue to use the regular imputed interest rule for deferred payments which remains essentially unchanged for those excepted transactions, but has been conformed to the OID amounts for other transactions.

The six transactions excepted from OID rules are:

1. Sale of a farm for $1 million or less,

2. Sale of a principal residence,

3. Sale of property for $250,000 or less,

4. Debt instrument exchanged for readily traded stock on an established securities market,

5. Transfers of land between related parties, and

6. Sale of patent if payment is contingent on productivity, use, or disposition of the property transferred.

The Act made these rules applicable for transactions after December 31, 1984. However, due to a storm of controversy, Congress has extended the effective date of these rules to those transactions occurring on or after July 1, 1985.

Old Federal Law

The maximum imputed interest rate that applies to real estate transactions between related parties involving $500,000 or less is 7 percent. A rate of 9 percent is used to determine whether stated interest is adequate for sales of personal residences of $250,000 or less and farm sales of $1 million or less. If the note fails, the 9 percent test the imputed interest on the note is deemed to be 10 percent.

The imputed interest determined under these rules is included in the income of the seller and deductible by the buyer in accordance with their respective accounting methods (i.e. when payment is made on the cash basis and when liability is incurred on the accrual method.

Current California Law (PITL 18031, 18151)

California conforms to the old federal law.

Fiscal Impact

The net revenue impact is unknown.

TAX REFORM ACT OF 1984 SECTION 41-44

Market Discount On Bonds
(IRC 1276-1278)

Summary

For obligations issued after July 18, 1984 new rules are established to treat gain on the sale of market discount bonds (MDBs) as ordinary interest income to the extent of the market discount and only the gain over that amount is eligible for capital gain treatment.

Market discount arises when the value of a debt obligation declines after issuance (typically because of an increase in prevailing interest rates).

A taxpayer is allowed to elect to use the OID rules for reporting interest income and deducting interest expense. If no election is made the interest deductions in excess of the OID allowable deductions are deferred until the taxable year when the market discount bond is sold.

Old Federal Law

Capital gain treatment was allowed for the appreciation in value attributable to market discount on an obligation held for more than one year. Interest on indebtedness incurred to purchase or carry a market discount bond was deductible currently against ordinary income, even though the income eventually generated by the investment is not taxed until disposition (and then only at capital gain rates).

Current California Law (PITL 17081, 17201, 18031, 18151)

California was in conformity with old federal law in the Personal Income Tax Law. The Bank and Corporation Tax Law includes gains from the sale of any asset in gross income at 100 percent.

Fiscal Impact

Revenue gains from conformity in the Personal Income Tax Law are unknown. Not applicable to Bank and Corporation Tax Laws.

TAX REFORM ACT OF 1984 SECTION 41-44

Discount on Short-Term Obligations
(IRC 1281-1283)

Summary

For obligations issued after July 18, 1984 such as Treasury bills and OID obligations with fixed maturity dates not exceeding one year from date of issue, the Act requires that the discount received upon the bond's acquisition be included in income (i.e. accrued and reported as interest income in the year acquired). This income reporting method applies only to:

1. Accrual method taxpayers,

2. Banks,

3. Brokers and dealers who acquire the obligations for sale to customers in the ordinary course of trade or business,

4. Regulated investment companies, and

5. Common trust funds.

Pass-through entities (partnerships, small business corporations and trusts) are subject to these accrual rules also.

Taxpayers may elect out of these rules if they use a 5 year period to report the accrued interest in income. This election is only available for the taxpayer's first taxable year ending after July 18, 1984. If mandatory accrual is not required then interest deductions are allowed only to the extent allowed using the OID rules. Amounts in excess are deferred until the obligation is sold.

These new provisions are coordinated with the OID and inputed interest provisions and provide for basis adjustments for interest included in income.

Old Federal Law

Discounts on short-term government obligations payable without interest at a fixed maturity date not exceeding one year are exempt by law from the rules requiring the periodic inclusion of acquisition discount. IRS regulations provide a similar exception for OID on short-term obligations other than government bonds. Interest on indebtedness incurred to purchase or carry the non-governmental bonds is currently deductible against ordinary income and was used to generate a one-year tax deferral.

Current California Law (PITL 17081, 17201, 18031, 18151, B&CTL 24271)

California is in conformity with old federal law.

Fiscal Impact

Revenue gains from conformity are unknown.

TAX REFORM ACT OF 1984 SECTION 172

Interest-Free and Below-Market Loans
(IRC 7872)

Summary

The Act reclassifes interest-free and below-market rate loans as "arms-length" transactions with the parties treated as if:

1. The lender made a loan to the borrower in exchange for a note requiring the payment of interest at the applicable federal rate,

2. The borrower paid interest in the amount of the "forgone" interest. This treatment requires the lender to include the forgone interest as income and the borrower has an interest expense deduction for that amount.

3. In the case of a gift loan the lender made a gift subject to gift tax,

4. In the case of a corporation - shareholder loan, the corporation paid a dividend includible in the shareholders income, and

5. In the case of a compensation related loan (i.e. employer-to-employee or service recipient-to service provider), paid compensation that is includible in the employee's or loan recipient's income and deductible by the lender.

These new rules are generally effective for loans made or renegotiated after June 6, 1984.

Old Federal Law

Interest-free and below-market interest not on an arms length basis (i.e. between family members or corporation-shareholder) were not includible in income of the lender and the forgone interest not deductible by the loan recipient.

Current California Law (PITL 17081, 17201)

California conformed to old federal law.

Fiscal Impact

Based on prorations of the federal estimates for this provision in the Tax Reform Act of 1984, conformity would result in net revenue gains in the $5 million range annually.

TAX REFORM ACT OF 1984 SECTION 177

Federal Home Loan Mortgage Corporation (FREDDIE MAC) Federal Tax Exemption Repealed
(FHLCA Section 303, IRC 246, 172, 177)

Summary

Obligations of the Federal Home Loan Mortgage Corporation (Freddie Mac) issued after December 31, 1984 will be subject to federal taxation. The obligations will remain exempt from state and local income tax.

Old Federal Law

Freddie Mac obligations were exempt from federal income.

Current California Law

The federal law does not allow state income taxation of these obligations either under old or new provisions.

Fiscal Impact

None. Not applicable to California.

TAX REFORM ACT OF 1984 SECTION 51

Dividend-Received Deduction
(IRC Section 246A)

Summary

The Act denies eligibility for the dividend-received deduction (85 percent of the dividend received) allowed to corporations to the extent that stock upon which the dividend is paid was purchased with borrowed money.

Old Federal Law

A corporation which owns stock in another domestic corporation was eligible to deduct 85 percent of the amount of any dividend received from that other corporation (i.e., only 15 percent of such dividend was taxed). In addition, a deduction was allowed for any interest expense incurred by it for borrowing the money to purchase stock in another domestic corporation.

Current State Law (California B&CTL Section 24425)

California tax law contains no provision for the 85 percent dividend-received exclusion contained in old federal law.

California tax law allows a corporate taxpayer a deduction for dividends received on investment stock in other corporations to the extent the income from which the dividend is paid was taxed by California. For corporations paying dividends and doing business both within and without California, the percentage of total income taxed and, therefore, the percentage of the dividend which the receiving corporation can deduct, can range from less than 1 percent to 100 percent.

Current California law does not permit a deduction of interest expense for interest paid on money borrowed to receive tax-exempt dividend income.

Fiscal Impact

A revenue analysis is not applicable since California cannot fully conform and California law already addresses the double taxation issue.

TAX REFORM ACT OF 1984 SECTION 52

Dividend-Received Deduction
(IRC Section 845)

Summary

Federal Regulated Investment Companies (RICs) which deal in mutual funds are allowed to pay their earnings directly to their shareholders as though the shareholder earned the income. The RIC does not pay tax on the distributed income. The change in the law requires interest and other nondividend income (formerly distributed as dividends) to be reported as nondividend income. The effect of this change is to make the payment ineligible for the 85 percent corporated dividend-received deduction or the individual $200 dividend received exclusion.

Old Federal Law

If at least 75 percent of the gross income of a regulated investment company was from dividends received from U.S. corporations, the entire amount distributed was treated as a dividend to the receiving individual or corporation.

Current State Law (California has no direct comparable law sections)

California tax law has no provisions for regulated investment companies. Under California law, diversified management companies are allowed to pass through only exempt interest (California state and municipal bonds) as a dividend to the shareholders. The California diversified management company definition is quite different than a federal regulated investment company. California does not have an 85 percent dividend received deduction for corporations nor a $200 dividend exclusion for individuals.

Fiscal Impact

A revenue analysis is not applicable due to basic differences between state and federal law on diversified management companies and the treatment of distributions.

TAX REFORM ACT OF 1984 SECTION 53

Dividend-Received Deduction
(IRC Sections 1059, 1060, 246, 7701, 1016)

Summary

The new law provides for a reduction in the basis of investment stock in a domestic corporation when the purchasing corporation pays a premium price for that stock, and the premium paid is returned in the form of a dividend.

Old Federal Law

Federal law allows an 85 percent dividend-received deduction for dividends received from a domestic corporation subject to U.S. income tax. Nothing in prior law forbade a corporation from paying an inflated purchase price in exchange for a dividend, generally 85 percent tax free. This procedure reduced the purchase price back to the stock's fair market value, but retained the basis at the higher inflated purchase price.

Current State Law (California B&CTL Sections 24402)

Current California law provides for a deductible-dividend exclusion percentage which is computed by the Franchise Tax Board for each corporation subject to California income or franchise tax. The California law, like the federal law, is designed to avoid double taxation of corporate earnings. California law, like former federal law, does not forbid the manipulation of purchase price and extraordinary dividends to receive an inflated basis.

Fiscal Impact

Conforming to the basis adjustment on account of extraordinary dividends would produce relatively minor revenue gains, less than one million dollars annually according to the department's audit personnel.

TAX REFORM ACT OF 1984 SECTION 54

Taxable Distributions of Appreciated Property (IRC Sections 311, 301)

Summary

The new provisions required gain to be recognized (but not loss) when a corporation distributes appreciated property (property with a fair market value greater than its adjusted basis to the corporation) to its shareholders in an ordinary, nonliquidating distribution. The gain is recognized as if such property had been sold for its fair market value at the time of distribution.

The new rules apply to any ordinary nonliquidating distribution whether or not it is a dividend and whether or not it is in redemption of stock. The gain is intended to be the same as if the corporation sold the property for its fair market value on the distribution date.

Old Federal Law

A corporation did not have to recognize gain or loss on distribution of appreciated property where the distribution was not in redemption of the corporation's stock and generally had to recognize gain but not loss on a distribution in redemption of a shareholder's stock. Exceptions to the nonrecognition of gain provisions were made for: (1) depreciation recapture, (2) distributed LIFO inventory, (3) liabilities transferred that exceed basis of an asset in the hands of the corporation, and (4) in certain situations, redemption distributions of appreciated property.

Current California Law (California B&CTL Section 24483.5)

California law is conformed to prior federal law.

Fiscal Impact

Based on federal estimates in the Tax Reform Act of 1984 and discussions with the department's audit personnel, conforming to this federal change on distributions of appreciated property would result in net revenue gains to the state in the $2-$4 million range annually.

TAX REFORM ACT OF 1984 SECTION 55

Distributions from Regulated Investment Companies (RIC) and Real Estate Investment Trusts (REIT)
(IRC Sections 852, 857)

Summary

The new law provides a recapture provision so that any loss on sale of regulated investment company (RIC) or real estate investment trust (REIT) stock will be long-term capital loss to the extent of any long-term capital gain dividend paid to the shareholder on that particular stock. The holding period of the asset is generally the holding period of the regulated investment company or real estate investment trusts. This change in law stops the practice of receiving long-term capital gain treatment on RIC or REIT transactions in which the RIC or REIT stock is held just 31 days.

Old Federal Law

When a regulated investment company or real estate investment trust distributes long-term capital gains income to its shareholders, it is generally treated as long-term capital gain by the shareholders and no recapture was required.

Current California Law (California No Comparable Law Sections)

California law does not recognize capital-gains dividends from regulated investment companies, diversified management companies or real estate investment trusts. All such dividends are ordinary income.

Fiscal Impact

A revenue analysis is not applicable due to basic differences between state and federal law on capital gain recognition in this area.

TAX REFORM ACT OF 1984 SECTION 57

Acquisition and Lapses on Options to Buy or Sell a Corporation's Own Stock/Treasury Stock (IRC Section 1032)

Summary

The new law provides that a corporation will not recognize gain or loss on the issuance, lapse, or repurchase of a warrant to acquire its own stock. A warrant is defined as an option to buy stock at a specified price, and generally, for a specified time.

Old Federal Law

A corporation recognized no gain or loss on the receipt of money or other property in exchange for its stock, and did not recognize gain or loss upon redemption of its stock with cash for an amount different from that received upon the issuance of the stock. The law was silent regarding the lapse or acquisition of an option, thus requiring that gain or loss be recognized.

Current California Law (B&CTL 24942)

California B&CTL is in full conformity to the old federal law.

Fiscal Impact

The revenue impact from conforming to this provision is unknown, but according to the department's audit personnel, would not be significant.

TAX REFORM ACT OF 1984 SECTION 58

Accumulated Earnings Tax Changes (IRC Sections 532, 535)

Summary

The Act tightens rules under which the accumulated earnings tax is imposed. Any corporation which retains earnings in excess of the reasonable needs of the business is liable for a tax on those accumulated earnings at a rate of 27 1/2 percent on the first $100,000 and 38 1/2 percent on the amount over $100,000. No tax will apply until the accumulated earnings exceed $250,000. Under prior law it was possible to minimize the tax by scheduling capital gains and losses into alternative tax years. The Act also expands the application of the tax to personal holding companies and investment companies, and adopts language to specifically include widely held corporations.

Current State Law (California B&CTL Has No Comparable Law)

California has not adopted the federal provisions for an accumulated earnings tax.

Fiscal Impact

None. Not applicable to California.

TAX REFORM ACT OF 1984 SECTION 59

Discharge of Indebtedness
(IRC Section 108)

Summary

The new law treats a corporation which issues stock in cancellation of its debt in the same manner as if it had satisfied the indebtdness with an amount of money equal to the fair market value of the stock. Thus, the corporation will have income from the discharge of indebtedness to the extent the principal of the debt exceeds the value of the stock and any other property transferred.

Old Federal Law

Under court interpretation of prior law, debt reduction that would otherwise be income from discharge of indebtedness could be excluded from income if debt was cancelled by a solvent taxpayer in exchange for stock in the corporation. The debt had to be a "qualified business indebtedness" defined as debt incurred or assumed by a corporation or an individual in connection with property used in his or her trade or business. The debtor could elect to defer the income by reducing the basis of property.

Current California Law (PITL 17131 B&CTL 24307)

California law is in conformity with old federal law.

Fiscal Impact

Based on a proration of the federal estimate for the Tax Reform Act of 1984, conforming to this discharge of indebtedness provision would result in minor revenue gains, less than $100,000 annually.

TAX REFORM ACT OF 1984 SECTION 60

Affiliated Group Redefined
(IRC Section 1504)

Summary

The Act redefines the requirements for corporations to be considered to be part of an affiliated group. The ownership requirements are modified slightly, reaffiliation provisions are added, the IRS is required to issue extensive regulations related to manipulation of stock to meet the ownership requirements, and the definition is expanded to apply to a larger segment of the IRC.

Current California Law (B&CTL Sections 23361-23364a)

The B&CTL defines affiliated railroads. This is the only state parallel to the affiliated group definition in the federal law.

Fiscal Impact

Not applicable. Any possible conformity regarding railroads would have a negligible impact on revenues.

TAX REFORM ACT OF 1984 SECTION 61

Adjustments to Corporate Earnings and Profits
(IRC Section 312, 1275, 301)

Summary

To be a taxable dividend, a distribution received by a shareholder must be paid out of earnings and profits of the distributing corporation. The new law makes several changes to the computation of a corporation's current earnings and profits. The changes will generally increase earnings and profits that would cover current dividend distributions. These changes are:

1. Construction period interest, taxes, and carrying charges. Interest paid or accrued on debt-incurred or continued to construct or carry property, property taxes, and similar charges must be capitalized and become part of the basis of the asset. The rule covers expenditures that are otherwise deductible for the year, without regard to the amortization rules.

2. Amortization of intangible drilling costs and mineral exploration costs. Certain intangible drilling and development costs of oil and gas wells deducted will be capitalized and amortized ratably over 60 months beginning with the month production begins. Any unamortized capitalized costs become deductible if it's a dry well. A similar rule covers mineral exploration and development costs, except that the amortization period is 120 months. Any unamortized expenditures become deductible when the property is abandoned.

3. Circulation, trademark, tradename, and corporate organizational expenditures. Deductions for circulation expenses for publishers, trademark and trade name expenditures, and organizational expenditures must be capitalized and become part of the basis of the asset.

4. Gain on distribution of appreciated property used to redeem stock. If a corporation distributes appreciated property (other than its obligations) in redemption of its stock, its earnings and profits must be increased by any gain includible in gross income for the year.

5. LIFO recapture amount. earnings and profits will be increased or decreased by LIFO recapture adjustments determined as of the close of each year.

6. Deferred payments on installment sales. All payments on installment sales are treated as received in the tax year the sale occurs.

7. Long-term contracts. Corporations using the completed contract method will compute earnings and profits as if they used the percentage of completion method for the contracts.

8. Capital gain redemptions. The new law generally provides that, on distributions in redemption of stock, earnings and profits are to be reduced by an amount that's not in excess of the redeemed stock's ratable share of the earnings and profits.

9. ACRS 15-year and 18-year real property. Earnings and profits (of corporations other than certain foreign corporations) will reflect recovery deductions for such property on a straight-line basis and a 40-year (up from 35-year) recovery period.

10. Distributions of original issue discount obligations. Under the new law, in case of a distribution by a corporation of its original issue discount obligations with respect to its stock, earnings and profits are reduced by the aggregate issue price of the securities at the time of the distribution, rather than by their principal amount.

The new law makes it clear that the original issue discount (OID) rules apply to debt obligations distributed as dividends.

Old Federal Law

Computation of the current year earnings and profits generally follows the computation of net income for the tax year of the corporation. Basically, if the source of dividends paid is current or prior earnings and profits, then the dividend is taxable. If the source is other than earnings and profits, then the dividend is a return of capital.

Current State Law (California PITL Section 17321; B & CTL Sections 24484 - 24492)

California law conforms to old federal law.

Fiscal Impact

Based on a proration of federal estimates for the Tax Reform Act (TRA) of 1984 conformity to these earnings and profits adjustments would result in revenue gains in the $10 million range annually.

TAX REFORM ACT OF 1984 SECTION 62

Delay in Net Operating Loss (NOL) Carryover Rules
(IRC Sections 382, 383)

Summary

The Tax Reform Act of 1976 imposed special limitations on the carryover of net operating losses and other attributes (unused business credits, unused foreign tax credits, unused research credits, and unused capital losses) after changes of corporate ownership or reorganization. These changes were scheduled to take affect at various times during 1984. The effective date of the changes is postponed and will apply to acquisitions or reorganizations occurring on or after January 1, 1986. The Act also expands this provision to include transfers by a corporation in bankruptcy of all or part of its assets to another corporation.

Current California Law (California B&CTL Sections 24592, 24593)

In 1984, AB 2380, Chapter 938 added sections to the B&CTL to conform to IRC provisions for NOLs generally as in effect prior to the Tax Reform Act of 1976.

Fiscal Impact

None. Not applicable.

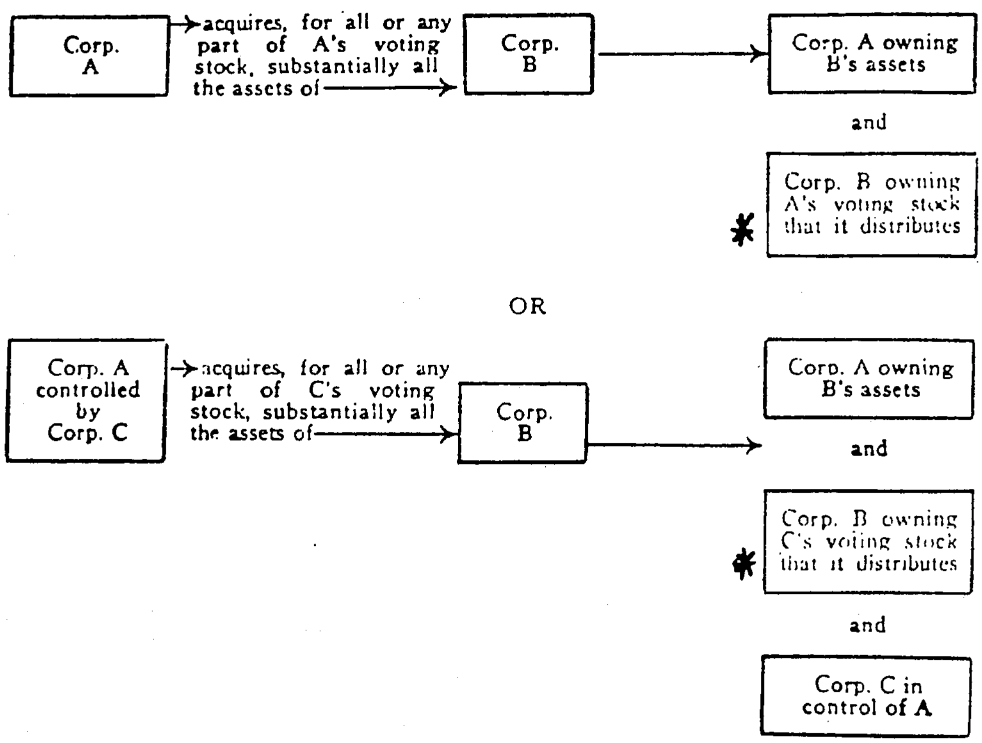
TAX REFORM ACT OF 1984 SECTION 63

Target Corporation must Distribute Assets in Type "C" Reorganization
(IRC Sections 368, 312)

Summary

The table below displayed by Commerce Clearing House (CCH) shows the steps of a Type "C" reorganization. The change initiated by the Tax Reform Act of 1984 requires Corp B, the target corporation, to distribute the stock acquired. See asterisks.

TYPE (C) REORGANIZATION



The Act also directs the IRS to prescribe regulations governing the proper allocation of earnings and profits of a transferor corporation in a reorganization.

Old Federal Law

Under prior law Corporation B above did not have to distribute the stock acquired.

Current State Law (PITL 17321 B&CTL 24512-24564)

Current state law is conformed to prior federal law.

Fiscal Impact

Conformity would result in annual revenue gains of an unknown amount.

TAX REFORM ACT OF 1984 SECTION 64

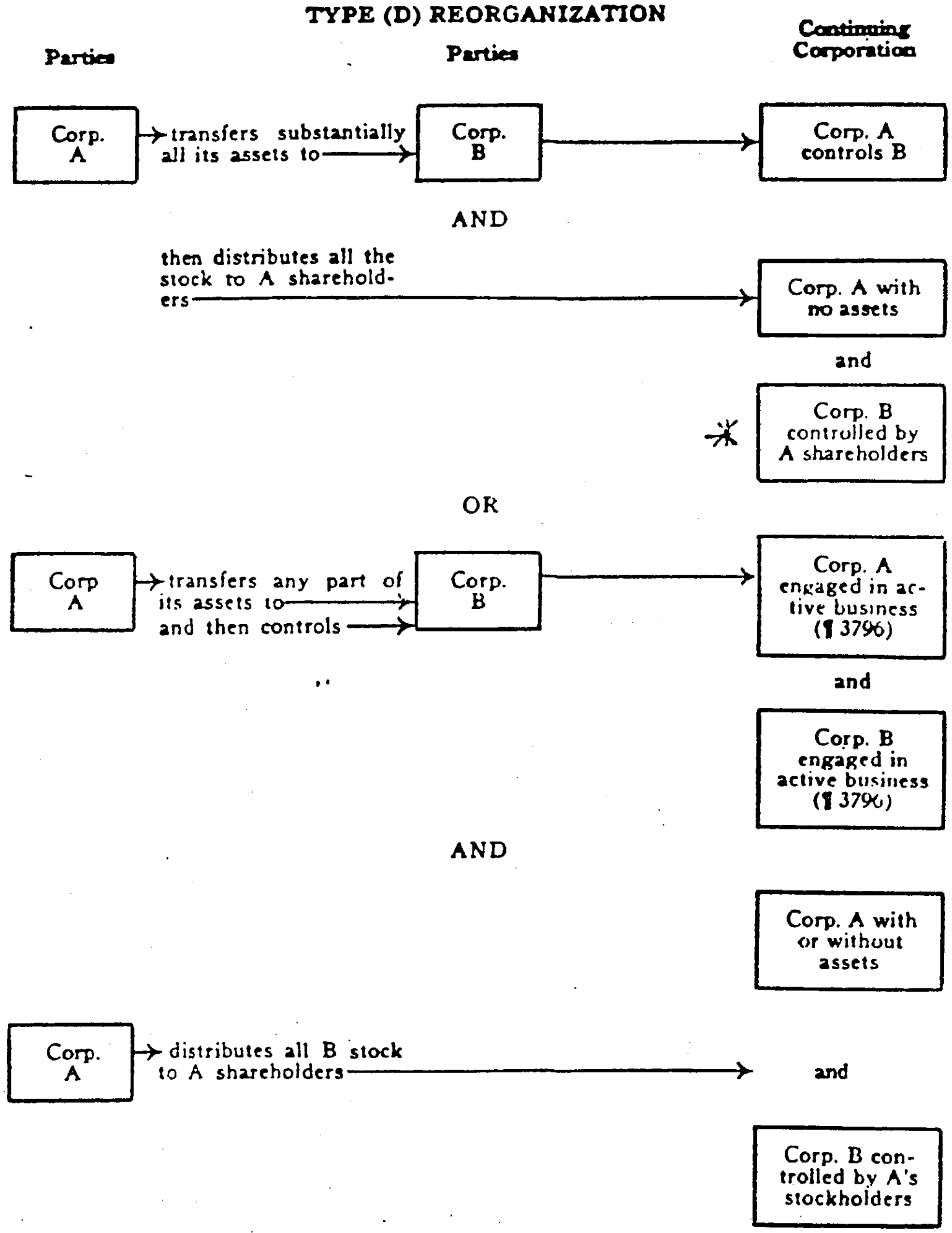
Definition of Control for Purposes of Nondivisive Type "D" Reorganizations (IRC Section 368)

Summary

One of the requirements of a type "D" reorganization is that, after the transfer, the transferor corporation or its shareholders must be in control of the transferee corporation. For nondivisive "D" reorganizations, the definition of control is changed. The new law defines control as ownership of at least 50 percent of the voting stock or 50 percent of the total value of all classes of stock. Former law generally required 80 percent ownership.

The table below displayed by Commerce Clearing House (CCH) shows two alternatives to a type D reorganization. The first alternative is called nondivisive; the second alternative is called divisive. The asterisk (*) indicates where the new 50 percent control rules apply.

TYPE (D) REORGANIZATION



Old Federal Law

Control was defined as ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote, and at least 80 percent of the total number of shares of all other classes of stock. This control rule applied to both alternative types of "D" reorganizations shown on the table.

Current California Law (PITL 17321 B&CTL 24564)

California law is conformed to old federal law.

Fiscal Impact

Conformity would result in annual revenue gains of an unknown amount.

TAX REFORM ACT OF 1984 SECTION 65

Collapsible Corporation Rules Tightened
(IRC Section 341)

Summary of What The New Law Does

Under the new law, a corporation must realize at least two-thirds of the taxable income that could be derived from the sale of collapsible property (specified ordinary income assets held less than three years) in order to avoid the collapsible corporation provisions. If the corporation is considered collapsible, any gain realized from the sale of the stock or from its liquidation is considered ordinary income.

The new law also allows the IRS to issue regulations prescribing when and how the 70/30 rule may be used. The 70/30 rule provides that none of a shareholder's recognized gain is ordinary income if 70 percent or less of his gain is attributable to collapsible property held by the corporation.

Old Federal Law

Through court decision, if a corporations recognized one-third of the income that could be derived from the sale of collapsible property it wasn't considered collapsible and gain on sale of stock was allowed capital gain treatment.

None of a shareholder's recognized gain was ordinary income if 70 percent or less of his gain was attributable to collapsible assets held by the corporation. If the 70 percent rule did not apply all gain was ordinary income.

Current California Law (PITL 17321)

The corporate law contains no provisions for special tax treatment of capital gain income. Since all income is taxed 100 percent as ordinary income, special collapsible corporation rules are not required.

The Personal Income Tax Law is fully conformed to old federal law.

Fiscal Impact

Not applicable under the corporate law. Any revenue impact from conforming under the PITL is unknown.

TAX REFORM ACT OF 1984 SECTION 66

Phase-Out of Graduated Rates For Large Corporations
(IRC Section Numbers 11, & 1561)

Summary

The new law increases the effective tax rate paid by large corporations. The effect of the new provisions is to eliminate all benefits of the graduated rates for corporations having taxable income over $1,405,000.

Old Federal Law

Prior federal law contained progressive tax rates for corporations. The rates were:

Taxable Income

over	but not over	Rate
0	25,000	16%
25,000	50,000	18%
50,000	75,000	30%
75,000	100,000	40%
100,000		46%

Current California Law (California B&CTL -- None comparable)

The California Bank and Corporation Tax is based on a flat tax rate currently set at 9.6 percent for general corporations with an add on percentage for banks and financials that do not pay certain local taxes.

Fiscal Impact

Not applicable.

TAX REFORM ACT OF 1984 SECTION 68

Increase In Cutback on Benefits From Tax Preference
(IRC Sections 291, 57)

Summary

In 1982 TEFRA enacted a percentage cutback in benefits to be derived from certain corporate tax preference items. This act section generally increases the cutback in benefits.

Minor changes are made to the deemed dividend distribution by Domestic International Sales Corporation (DISC). California tax law does not recognize DISCs.

Old Federal Law

TEFRA reduced by 15 percent the benefits of corporate deductions or benefits from 8 tax preference items and applied the minimum tax generally to only 71.6 percent of the corresponding items of tax preference.

Current California Law (PITL 17063-17063.3 B&CTL 23401)

Both the Personal Income Tax Law and the Bank and Corporation Tax Law contain provisions for a tax on preference income. However, the specific items and the application of law are different. California did not conform to the cut backs initiated in TEFRA.

California also does not recognize DISCs.

Fiscal Impact

None. Not applicable.

TAX REFORM ACT OF 1984 SECTION 93

Construction Period Interest and Taxes - Residential Real Property (IRC Sections 712; 189)

Summary

Under new federal law, construction period interest and taxes on residential real property (other than low income housing) must be capitalized and amortized over a ten year period by corporations as well as noncorporate taxpayers.

Old Federal Law

Corporations acquiring, constructing, or holding residential real property requiring capitalization and amortization over a 10-year period were excepted from the general rule and allowed the costs for construction period interest and taxes as a current deduction.

Current California Law (PITL 17201 B&CTL 24373.5)

California is conformed to old federal law.

Fiscal Impact

Reserved.

TAX REFORM ACT OF 1984 SECTION 95

LIFO Conformity Extended to Related Corporations
(IRC Section 472)

Summary

With this change, a group of financially related corporations are treated as if it were one taxpayer for purposes of the "LIFO conformity" rule. This rule in general states that if the LIFO (last in first out inventory valuation) method is used to value inventory for tax purposes, it must also be used for other reporting purposes such as to shareholders or for credit.

Old Federal Law

Under prior federal law, a single taxpayer did not include financially-related corporations.

Current California Law (PITL 17551 B&CTL 24702, 24706)

Both the Personal Income Tax Law and the Bank and Corporation Tax Law are fully conformed to prior federal law.

Fiscal Impact

Based on a proration of federal estimates on this provision in the Tax Reform Act of 1984, conformity would result in revenue gains in the $5-$7 million range annually.

TAX REFORM ACT OF 1984 SECTION 123

Income From Factoring Trade Receivables to Controlled Foreign Corporations (IRC Sections 956, 864)

Summary

This law change is intended to stop the practice of some companies that have been using controlled foreign corporations (CFCs) to factor receivables in order to shift income into foreign tax havens and then receive it back tax free. Factoring receivables to a CFC results in the CFC realizing nontaxable income on the transaction in an amount equal to the difference between the amount collected and the amount paid for the receivable. Without the CFC involved the income would be fully taxable.

The Act provides that a controlled foreign corporation's income from factoring receivables acquired directly or indirectly from related parties is taxable foreign personal holding company (FPHC) income.

Old Federal Law

Prior federal law contained no restriction regarding discounting of receivables (factoring) to controlled foreign corporations.

Current California Law (No comparable California law)

California tax law has no comparable provision. At this time a comparable provision is not needed. California uses the concept of worldwide combination which negates the effects of transactions between related taxpayers including transactions with related foreign taxpayers.

Fiscal Impact

None. Not applicable.

TAX REFORM ACT OF 1984 SECTION 124

Source of Transportation Income
(IRC Sections 863)

Summary

The new law provides that all income from transportation that begins and ends in the U.S. is U.S. income. Specific rules are provided for different combinations of destinations.

Old Federal Law

Prior law allowed carriers operating between points in the U.S. to generate foreign source income by routing travel outside of the U.S. three-mile territorial limit. For foreign carriers, this generated more foreign source income that is not subject to U.S. taxation. In the case of U.S. carriers, such foreign source income increased their foreign tax credit limitation, which in turn provided more shelter from U.S. taxation.

Current California Law (PITL 17954 B&CTL 25101, 25101.3)

There are significant differences in taxing authority and tax policy that make California law entirely different from federal. Those differences are:

1. California taxes only income considered earned in California, and

2. California computes income considered earned in California by formula apportionment.

Fiscal Impact

None. Not applicable.

TAX REFORM ACT OF 1984 SECTION 125

Accumulated Earnings Tax
(IRC Sections 535)

Summary

The new law extends the accumulated earnings tax to U. S. owned foreign corporations.

Old Federal Law

Income earned by a U. S. owned foreign corporation was not considered to be derived from a U. S. source and was not considered to be U.S. accumulated earnings.

Current California Law

California has not adopted an accumulated earnings tax provision.

Fiscal Impact

None. Not applicable.

TAX REFORM ACT OF 1984 SECTION 131

Transfers to Foreign Corporations
(IRC Sections 367, 6038B, 6501, 7477, 1492, 1494, 7482)

Summary

The new law, related to the transfer of property to a foreign corporation, replaced the "principal purpose" test with the "active trade or business" exception. Prior law required a favorable IRS ruling that tax avoidance was not the principal purpose in shifting property to a foreign corporation. The new law sets up specific situations when transfers are considered to be for tax avoidance and, in those situations, disallows tax-free corporate transfers.

Old Federal Law

Under prior law if there was a corporate exchange in which property was transferred by a U.S. person to a foreign corporation, the taxpayer had up to 183 days after the beginning of the exchange (transfer of assets) to file a request with the IRS for a favorable determination that tax avoidance was not a principal purpose of the exchange. Failure to obtain a post-transaction clearance from the IRS could result in the denial of corporate status to the foreign corporation, thereby, disqualifying the transaction for tax-free treatment and forcing the participant corporations and shareholders to recognize any gain or loss.

Current California Law (PITL 17321 B&CTL 24561)

California is in substantive conformity to the old federal law.

Fiscal Impact

Revenue gains from conforming to such transfers of property to foreign corporations are unknown.

TAX REFORM ACT OF 1984 SECTION 132

Amendment Related to Foreign Personal Holding Companies
(IRC Sections 554, 551, 951, 552)

Summary

The new law makes several changes related to foreign personal holding companies (FPHCs). The rules used to determine whether a foreign corporation is a personal holding company are clarified, and rules are provided that prevent the avoidance of U.S. tax by placing a foreign trust or other foreign entity between a personal holding company and a U.S. taxpayer. Further, the foreign personal holding company rules are coordinated with the controlled foreign corporation rules. Also, the same-country dividend exception is extended to the foreign personal holding company rules.

Current California Law (PITL 17024.5

California does not recognize an entity called a foreign personal holding company.

Fiscal Impact

None. Not applicable.

TAX REFORM ACT OF 1984 SECTION 133

Gain From Disposition of Controlled Foreign Corporation (CFC) Stock (IRC Sections 1248, 959)

Summary

Under the Act, if a U.S. corporation owns at least 10 percent of the voting stock of a foreign corporation and the shareholders exchange their stock for stock of the foreign corporation, the U.S. corporation must recognize as ordinary income the difference between the fair market value of the stock received by its shareholders and its basis for the stock in the foreign corporation.

Current California Law (PITL 17024.5)

California tax law does not recognize an entity called a controlled foreign corporation.

Fiscal Impact

None. Not applicable.

TAX REFORM ACT OF 1984 SECTION 134

Definition of Foreign Investment Company
(IRC Section 1246)

Summary

The new provisions expand the definition of "foreign investment company" for purposes of determining when gain on the disposition of stock in a foreign investment company is ordinary versus capital gain. According to the committee reports, the prior definition of foreign investment company is primarily unchanged except that the new definition includes commodity trading companies.

Current California Law

California tax law does not recognize an entity called a foreign investment company.

Fiscal Impact

None. Not applicable.

TAX REFORM ACT OF 1984 SECTION 135

Application of Collapsible Corporation Rules to Foreign Corporations (IRC Section 341)

Summary

The Act does not allow a foreign corporation to make an election which would avoid the collapsible corporation rules. The collapsible corporation rules generally provide that a shareholder relizes ordinary income, instead of capital gains, if the stock is sold at a gain before the corporation realizes a substantial portion of the taxable income on the property that it has manufactured, constructed, or produced.

Old Federal Law

Generally, under prior law, a shareholder's gain on the sale of stock of a collapsible corporation is ordinary income rather than capital gain. However, a shareholder can get capital-gain treatment on the sale of the collapsible corporation's stock if the corporation makes a consent to recognize gain on later dispositions of its noncapital assets.

Current California Law (PITL 17321)

The California Personal Income Tax Law is generally conformed to prior IRC as it relates to collapsible corporations. The corporate law is not conformed to the federal provisions since 100 percent of the gain on all sales of assets is included in income.

Fiscal Impact

Revenue gains under conformity in the PITL are unknown.

Stapling of Corporate Stock
(IRC Section 269 B)

Summary

The new law provides that, when a U. S. and a foreign corporation become a stapled entity (two entitites that must be treated as one when sold or exchanged), the foreign corporation is treated as a U. S. corporation which is taxable on its worldwide income.

Old Federal Law

There was no prior law related to stapling of corporate stock.

Current California Law (California Law Sections -- None)

There is nothing in California law comparable to the new federal rules.

Fiscal Impact

The revenue impact that might result from conforming to "stapling" definitions and qualifications is unknown.

TAX REFORM ACT OF 1984 SECTION 137

Foreign Base Company Service Income From Insurance
(IRC Section 954)

Summary

When a controlled foreign corporation (CFC or sometimes called "tax haven" corporation) receives income from the insurance of risks of related parties that are located in countries other than the country of the CFC, the income is taxable to U.S. shareholders. The CFC provisions, to which California is not conformed, provide that if a foreign corporation is controlled by U.S. shareholders, specified income will be taxed to the U.S. shareholders.

Old Federal Law

Under prior law, income earned by a CFC from insuring U.S. risks was currently taxable to its U.S. shareholders but income earned from insuring non-U.S. risks of a related party was not currently taxable to its U.S. shareholders if it was earned inside the country under which the CFC was created or organized.

Current California Law

California tax law contains no provisions for Controlled Foreign Corporations.

Fiscal Impact

None. Not applicable.

TAX REFORM ACT OF 1984 SECTION 721

Technical Corrections to Subchapter S Revision Act of 1982
(IRC Section 1361-1379, 108, 318, 207, 6659, 6362, 48, 465)

Summary

The Act makes changes to the small business corporation rules to which California is not conformed. The rules were substantially changed in the Subchapter S Revision Act of 1982.

Current California Law

Current California law makes no provisions for "S" corporation.

New Federal Law

The Act modifies the computation of the accumulated adjustments account, changes accounting rules and changes rules governing transactions between the corporation and its shareholders. The Act also clarifies the application of the at-risk rules to the corporation's shareholders, provides a transitional rule for the taxation of investment income and clarifies the law governing distributions of appreciated property by those corporations. The application of the ownership rules to the corporation stock is changed, along with the rules governing tax treatment of the discharge of indebtedness and of worthless debts owed to shareholders. In addition, the Act provides new rules for the application of the investment tax credit and modifies the corporate capital gains tax. It also extends the application of special rules relating to corporate tax preferences to some corporations.

Fiscal Impact

Not applicable.

TAX REFORM ACT OF 1984 SECTION 722

Miscellaneous Provisions -- Death As a Result of Terroristic or Military Activity Overseas
(IRC Section 692)

Summary

This Act plus P.L. 98-259 signed by the President on April 10, 1984, added a provision to the IRC forgiving taxes to certain individuals who died as a result of terroristic or military actions outside the United States.

Old Federal Law

Income tax owed by active U.S. armed forces personnel who die while serving in a combat zone, or as a result of injuries sustained in combat, is forgiven.

Current California Law (California PITL Section 17731) (B&CTL Sections - not applicable)

California PITL is conformed to the new federal law except that the forgiveness is only with respect to taxable years beginning on or after January 1, 1984 (AB 2436, CH. 1467, Stats. 1984).

Fiscal Impact

None. California law is prospective only.

TAX REFORM ACT OF 1984 SECTION 722

Miscellaneous Provisions -- TEFRA Change (Amends Act Section 306(a)(8)(A)(ii) of the TCA of 1982, No law section changes)

Summary

This technical date change is related to transition rules adopted by TEFRA that require recaptured income reported on a selling corporation's consolidated return to apply to contracts entered into on or after September 3, 1982. The date was changed to September 1, 1982.

This change is a technical correction (a 2-day change to an effective date) to IRC Section 338 to which California did not conform.

Fiscal Impact

Not applicable.

TAX REFORM ACT OF 1984 SECTION 722

Miscellaneous Provisions -- Tax Preference on Low-Income Housing (IRC Section 57)

Summary

The change is a technical correction related to tax preference income based on amortization of low income housing. The new law simply moves a provision in prior law to a different subparagraph. The amendment is applicable retroactively to property placed in service after 1980.

Fiscal Impact

None. Not applicable.

TAX REFORM ACT OF 1984 SECTION

Miscellaneous Provisions -- Refund of Windfall Profits Tax Overpayment to Partnership
(IRC Section -- None, Non-code provision)

Summary

The procedure for refunding an overpayment of windfall profit tax on domestic crude oil arising as a result of provisions of the Technical Corrections Act of 1982 has been simplified.

Current California Law

California has no law comparable to the Crude Oil Windfall Profit Tax. The change would, therefore, not be applicable.

Fiscal Impact

None. Not applicable.

TAX REFORM ACT OF 1984 SECTION 722

Miscellaneous Provisions -- Principal Campaign Committees (IRC Section 527(h))

Summary

Where a candidate for Congress has only one political committee, it is not necessary that the candidate designate it as the principal campaign committee for purposes of qualifying it for taxation by use of graduated corporate rates.

Fiscal Impact

None. Not applicable.

TAX REFORM ACT OF 1984 SECTION 722

Miscellaneous Provisions -- Foreign Currency Contracts
(IRC Section 1256)

Summary

For purposes of determining whether a contract qualifies as a foreign currency contract, prior law required delivery of a foreign currency. The new law requires cash settlement determined by reference to the value of the foreign currency. This is a change intended to bring the law more into focus with real world transactions.

Current California Law (PITL 18151)

The Personal Income Tax Law is conformed.

The provisions are not applicable in the Bank and Corporation Tax Law. Since the primary purpose of these provisions is to determine when foreign currency contracts can receive capital gains treatment.

Fiscal Impact

Revenue losses under PITL conformity are unknown.

TAX REFORM ACT OF 1984 SECTION 213

Foreign Sales Corporations
(IRC Sections 921-927, 245, 246, 274, 901, 904, 906, 951, 275, 1248, 934, 956, 7651, 996)

Summary

Foreign Sales Corporations (FSCs) are generally a replacement for Domestic International Sales Corporations (DISCs). The European Economic Community (EEC) has accused the U.S. of being in violation of the General Agreement on Tariffs and Trade (GATT). They took the position that some of the DISC provisions constituted an illegal export subsidy.

Under the Foreign Sales Corporation (FSC) system, a portion of the foreign trade income of an FSC will be exempt from tax at the corporate level, provided it is derived from foreign presence and economic activity of the FSC.

The FSC system is guided by three basic principles consistant with GATT:

1. The U.S. will not tax income attributable to economic activities occurring outside the United States,

2. No corporate level taxation will be imposed upon export income; and

3. Arm's length pricing will be required for exporting entities and foreign buyers under common control.

Old Federal Law

There was no prior law related to Foreign Sales Corporation (FSCs). The prior law regulating international sales was contained in provisions for Domestic International Sales Corporations (DISCs).

Current California Law (PITL 17024.5)

California has no provisions comparable to the former or current Domestic International Sales Corporation (DISC) provisions or to the new Foreign Sales Corporation (FSC) provisions.

Fiscal Impact

None. Not applicable.

TAX REFORM ACT OF 1984 SECTION 802

Interest Charge DISCs
(IRC Sections 995, 992, 993, 999)

Summary

The Foreign Sales Corporation (FSC) system generally replaces the Domestic International Sales Corporation (DISC) system of taxing foreign trade income. However, some DISC provisions called interest-deferred or interest-charged DISCs are retained. The retained DISC provisions are geared only toward small businesses in order to comply with the General Agreement on Tariffs and Trade (GATT). A shareholder of a DISC must pay interest on the amount of the shareholder's DISC-related deferred tax liability.

Old Federal Law

Under prior law, Domestic International Sales Corporations (DISC) were the primary corporate form used by domestic corporations which derive their primary income from export sales and rentals.

Current California Law (California PITL Section 17024.5) (B&CTL Section - None)

The California tax law contains nothing comparable to federal provisions for DISCs.

Fiscal Impact

None. Not applicable.

TAX REFORM ACT OF 1984 SECTION 803

Taxable Year of a DISC or FSC -- Voting Power Determined
(IRC Sections 441)

Summary

The taxable year of an Foreign Sales Corporation (FSC) or a Domestic International Sales Corporation (DISC) must be the same as that of the shareholder or group of shareholders who have the highest percentage of voting power.

Current California Law

California is not conformed to federal provisions for DISCs.

Fiscal Impact

None. Not applicable.

TAX REFORM ACT OF 1984 SECTION 804

Foreign Sales Corporation (FSC) Reports
(IRC Sections - None)

Summary

The Treasury will now be required to file with Congress bi-annual Foreign Sales Corporation (FSC) reports, rather than annual Domestic International Sales Corporation (DISC) reports.

Current California Law

California has never conformed to federal DISC provisions.

Fiscal Impact

None. Not applicable.

TAX REFORM ACT OF 1984 SECTION 805

Effective Date of Transition Rules
(IRC Sections - None)

Summary

The Act contains special procedures for conversion from Domestic International Sales Corporations (DISCs) to Foreign Sales Corporations (FSCs).

Current California Law

California has never conformed to federal DISC provisions.

Fiscal Impact

None. Not applicable.

TAX REFORM ACT OF 1984 SECTION 1066

Investment Income of Small Business (S) Corporations
(IRC Sections - None; adds new TEFRA Section 208(d)(3)(C))

Summary

Under the new law a shareholder may elect to treat income of an S corporation, with an election in effect for tax years beginning in 1982, 1983, and 1984, as investment income for purposes of limitation on interest on investment indebtedness under pre-Subchapter S Revision Act of 1982 rules.

Current California Law

California has never recognized federal S corporations.

Fiscal Impact

None. Not applicable.

TAX REFORM ACT OF 1984 SECTION 1071

Tax Treatment of Regulated Investment Companies
(IRC Sections 851, 852)

Summary

The new law generally permits personal holding companies without accumulated earnings and profits from which taxable dividends are paid to elect regulated investment company status. Those with accumulated earnings and profits can make distributions to qualify.

Current California Law

California tax law contains no provisions for personal holding companies or accumulated earnings tax.

Fiscal Impact

None. Not applicable.

TAX REFORM ACT OF 1984 SECTION 71

Partnership Allocations of Contributed Property
(IRC Sections 704, 613A, 743)

Summary

When appreciated property is contributed by a partner to a partnership after March 31, 1984 the Act requires that the contributing partner be allocated any gain inherent in the property at the time of its contribution to the partnership.

Old Federal Law

The allocation of gain or loss was made as if the property had been purchased by the partnership unless the partnership agreement provided otherwise. This meant that the allocation was made using the same ratio as was used for the sharing of profit or loss.

Current California Law (PITL 17851)

California conforms to old federal law.

Fiscal Impact

Based upon a proration of the federal estimate for this provision in the Tax Reform Act of 1984, conformity would result in revenue gains in the $2 - $4 million range annually.

TAX REFORM ACT OF 1984 SECTION 72

Change in Partners' Interests During Tax Year (IRC Section 706)

Summary

The Act makes partners' shares of any items of income, gain, loss, deduction or credit determinable under methods prescribed by regulations. New rules are adopted for items attributable to periods after March 31, 1984 in cash basis partnerships or tiered partnerships when there is a change in partnership interests during the tax year. A tiered partnership is one in which one partnership (the upper tier partnership) owns an interest in another partnership (the lower tier partnership) and the upper tier partnership must take into account the distributive share of the lower tier partnership's income, gain, loss, deduction or credit in computing its own items to be distributed by it to its partners.

The new rule in general means that the distributive share of partnership items will be calculated on a daily basis with respect to each partner in the partnership on that day and then further divided between the partners based upon their proportionate interest in the partnership on that day.

Old Federal Law

When partners' interests change during the tax year each partner's share of items of partnership income, gain, loss, deduction and credit was determined by taking into account each partner's varying interest in the partnership during the taxable year.

Some taxpayers in tiered partnerships contended that losses sustained by the lower-tier partnership are allocable to the day in the upper-tier partnership's taxable year on which the lower-tier partnership's taxable year closes. Similarly, partnerships using the cash method of accounting have deferred actual payment of accrued deductions until near the end of the partnership's taxable year and then allocated those expenses to the partners within the partnership at that time.

Current California Law (PITL 17851)

California conforms to old federal law.

Fiscal Impact

Based on a proration of federal estimates for this provision in the Tax Reform Act of 1984, conformity would result in revenue gains in the $2 million range annually.

TAX REFORM ACT OF 1984 SECTION 73

Payments to Parters for Property or Services
(IRC Section 707)

Summary

Two new rules are provided in the Act for transactions occurring after March 31, 1984 which are used to determine the proper nature of payments to partners by the partnership. The first rule is enacted to prevent payments by a partnership which are required to be capitalized from being disguised as a payment to a partner for services or property since that type of payment is deductible currently. The rule is that the economic substance of the transaction is to be examined and if the transaction would have required capitalization or ordinary income treatment where the party was not a partner then the same treatment will be required where the party is a partner. The Senate Committee Report indicates that this rule is directly aimed at syndication and organization expenses which are capital expenditures.

The second rule is directed at preventing partners from characterizing a sale or exchange of property as a contribution to the partnership followed by (or preceded by) a partnership distribution to the partner in order to defer or avoid tax on the disguised sale. The rule requires an examination of the economic substance of the transaction and if the transaction would have been characterized as a sale where the party was not a partner then the selling partner will be required to recognize gain or loss on the sale.

The Act authorizes the IRS to prescribe regulations to carry out the puposes of these new rules and are required focus on the underlying economic substance of the transaction.

Old Federal Law

A series of rulings of the IRS as well as IRS regulations require the examination of the substance of transactions to determine whether an expense is to be capitalized or whether a sale has occured rather than a contribution of property to the partnership. However, according to the committee reports, the courts have allowed tax-free treatment in cases which are economically indistinguishable from sales of property to a partnership or another partner and that expenses which are required to be capitalized should not become deductible simply because of the allocations made by a partnership.

Current California Law (PITL 17851, 17854)

California conforms to old federal law and in addition provides that a guaranteed payment to a partner who is not a resident of this state is to be considered income from a California source and thus taxable by California.

Fiscal Impact

Based on a proration of federal estimates for this item in the Tax Reform Act of 1984, conformity would result in revenue gains in the $1 - $2 million range annually.

TAX REFORM ACT OF 1984 SECTION 74

Character of Gain or Loss on Disposition of Contributed Property (IRC Section 724, 735)

Summary

Under the new rules provided by the Act, property contributed to a partnership after March 31, 1984, will retain its character (i.e. ordinary vs. capital) at the partnership level and also when redistributed to a partner in a subsequent transaction. The gain or loss on contributed unrealized receivables will always be ordinary. Contributed inventory items will retain their ordinary character for five years. At the end of five years the character of the gain or loss will be determined at the partnership level (i.e. whether it is partnership inventory or a capital asset). Property which was a capital asset to the contributing partner, and at the time of the contribution had unrecognized capital loss, will be treated as capital loss on a subsequent partnership disposition of the asset (assuming the partnership incurs a loss on the sale of the asset) to the extent of the partner's unrecognized loss.

Old Federal Law

When a partnership disposed of property contributed to it the character of the partnership's gain or loss depended on the character of the asset in its hands and not those of the contributing partner.

Current California Law

California conforms to old federal law in the Personal Income Tax Law.

The Bank and Corporation Tax Law takes into income 100 percent of any gain or loss from the sale or exchange of assets.

Fiscal Impact

Based on a proration of federal estimates for this item in the Tax Reform Act of 1984, conformity of the Personal Income Tax Law would result in revenue gains in the $1 - $2 million range annually.

TAX REFORM ACT OF 1984 SECTION 75-76

Transfers of Partnership and Trust Interests by Corporations
(IRC Section 386, 761, 7701)

Summary

For distributions and exchanges made after March 31, 1984, the Act provides that the amount (and character) of gain on the disposition of partnership or trust interests where the partnership or trust holds recognition property (generally inventory and depreciable property) will equal what would have been recognized had the corporation sold the property. For this purpose the fair market value of the property can not be less than the principal amount of any nonrecourse liability (i.e. secured by the property only). This treatment will apply regardless of the number of partnership or trust tiers involved. This rule is to prevent the corporation from converting a recapture item to an asset not subject to recapture (i.e. the partnership interest). This new rule treats the disposition of the partnership interest as an event which triggers the recognition of income to the corporation.

Recognition property means any property on which gain would be recognized at the corporate level (i.e. recapture) in any of three types of distributions:

1. Distributions of LIFO inventory,

2. Distributions of appreciated property in redemption of stock, and

3. Distributions in a 12-month liquidation.

Old Federal Law

The sale or distribution of a partnership or trust interest was treated as a transaction solely with respect to the interest and did not go to the assets owned by the partnership or trust.

Current California Law (PITL 17321) (B&CTL 24501, 24511-24519)

California is in conformity with the old federal law treatment of sales or dispositions of partnership or trust interests.

Fiscal Impact

Based on a proration of federal estimates for this item in the Tax Reform Act of 1984, conformity would result in revenue gains in the $2 million range annually.

TAX REFORM ACT OF 1984 SECTION 77

Like-kind Exchanges
(IRC Section 1031)

Summary

The Act makes two changes to the rules for qualification of transactions for tax-free treatment as a like-kind exchange. First, partnership interests in different partnerships are no longer considered like-kind property. Thus, the exchange of partnership interests becomes a taxable event for the recognition of gain or loss in the year the exchange takes place.

Second, the Act for all like-kind exchanges requires that the substitute like-kind property be identified within 45 days of the exchange, and that the receipt of the exchange property must occur within 180 days of the exchange. If either condition is not met, the transaction will not qualify as a tax-free like-kind exchange, and the taxpayers involved will recognize gain or loss on the transaction.

These new provisions are effective generally for transactions made after March 31, 1984.

Old Federal Law

Exchanges of interests in different partnerships were considered like-kind property eligible for tax-free exchange rules. Also, no specific time period was required for either the identification of the exchange property to be received or the actual receipt of that exchange property in any like-kind exchanges.

Current California Law (PITL 18031) (B&CTL 24941)

California conforms to old federal law in both the Personal Income Tax Law and the Bank and Corporation Tax Law.

Fiscal Impact

Reserved.

TAX REFORM ACT OF 1984 SECTIONS 78-79

Basis Adjustments - Tiered Partnerships and Guaranteed Nonrecourse Debt (IRC Sections 734, 751, 752)

Summary

The Act prevents taxpayers in tiered partnerships from receiving adjustments to the basis of the property remaining in a partnership when a distribution of a partnership interest has been made, and the second partnership is not required to adjust the basis of property in that second partnership. Also, the Act provides that a general partner who guarantees an otherwise nonrecourse debt will be the only partner to obtain a basis adjustment and that adjustment will be for the full extent of the liability.

These rules are effective for transactions occurring after March 1, 1984.

Old Federal Law

Basis adjustments may be made at the election of the partnership and were generally designed to permit parners to enter and leave a partnership without recognizing gain or loss. No specific rule prevented inconsistent elections between two partnerships where one partnership owned an interest in the other partnership.

Basis adjustments relating to nonrecourse liability are made to each partner in the partnership whether a general partner or a limited partner. There were Revenue Rulings by the IRS which held that debt guaranteed by a general partner was not to be treated as nonrecourse liability, but the Court of Claims did not agree and held that all partners were entitled to a basis adjustment.

Current California Law (PITL 17851)

California conforms to old federal law.

Fiscal Impact

Reserved.

TAX REFORM ACT OF 1984 SECTION 81

Trust Distributions
(IRC Section 643)

Summary

Under the Act, effective for distributions of property after June 1, 1984, the distribution of property is a taxable event resulting in gain or loss to the trust on taxable event resulting in gain or loss to the trust on election by the trustee (or the executor, in the case of an estate). Absent such an election, the basis will be carried over to the beneficiary who will be taxed upon a later disposition.

Old Federal Law

In situations where there was income in a trust (or estate) and property other than money was distributed, the trust recognized no gain or loss from the distrinbution, was able to deduct the property's fair market value (to the extent of the trust's distributable net income), and the beneficiary received as a basis the fair market value of the property.

Current California Law (PITL 17731)

California is conformed to old federal law.

Fiscal Impact

Reserved.

TAX REFORM ACT OF 1984 SECTION 82

Multiple Trusts
(IRC Section 643)

Summary

For tax years beginning after March 1, 1984, the Act provides that two or more trusts are to be treated as one and taxed as one if they had:

1. Substantially the same grantors and beneficiaries,

2. No substantially independent purpose, and

3. Tax avoidance as the principal purpose of creating separate trusts.

dThis new law provides in law the same rules as were contained in the IRS Regulations which the Tax Court had ruled invalid.

Old Federal Law

IRS Regulations provided for these same rules but the Tax Court held them to be invaled.

Current California Law (PITL 17731)

California conformed to old federal law.

Fiscal Impact

Reserved.

TAX REFORM ACT OF 1984 SECTION 94

Capitalization of Startup Expenses
(IRC Section 195)

Summary

The Act clarifies the expenses to which an election to amortize (over a 60-month period) start-up costs will apply. All business start-up expenses up to the time that the active business actually begins are subject to this rule. If the election to amortize these expenses is not made, then the expenses are not currently deductible but instead become part of the basis of the business. These expenses include those incurred before, and in anticipation of income.

The Act also provides for loss deductions in the case where a business is disposed of before the lapse of the 60-month amortization period.

Old Federal Law

Taxpayers could elect to amortize business pre-opening or start-up expenses over a period of 60 months after the business was opened. If the election to amortize was not made, the IRS position was that these expenses were nondeductible capital items. Some taxpayers, however, contended that the items were currently deductible absent the election to amortize them over 60 months.

Current California Law (PITL 17201) (B&CTL 24424)

California conforms to old federal law.

Fiscal Impact

Reserved.

TAX REFORM ACT OF 1984 SECTION 126

Moratorium Extended on R&D Expense Allocations
(No IRC Section Amended)

Summary

The Act delays until taxable years beginning on or after August 13, 1985, the IRS Regulation which allocates a portion of research and experimental expenses conducted within the United States to taxable income from non U.S. sources when the business has income from sources partly within and partly without the United States.

Current California Law (PITL 17954) (B&CTL 25121)

The California structure of taxing business income is based upon the concept of formula apportionment in those instances where a taxpayer has income from business activity both within and without this state. There is no Foreign Tax Credit allowed by California.

Fiscal Impact

None. Not applicable.

TAX REFORM ACT OF 1984 SECTION 492

Repeal of Obsolete Provision
(IRC Section 1251)

Summary

Effective for tax years beginning after 1983, the provision is repealed which applied to farm losses incurred before 1975 to make them recapturable if the losses had been used to offset nonfarm income.

Current California Law (PITL 18174)

California specifically made this provision of federal law not applicable for state purposes.

Fiscal Impact

None. Not applicable to California.

TAX REFORM ACT OF 1984 SECTION 712

Corrections of TEFRA Business Provisions
(IRC 48, 51, 189, 269, 291, 301, 302, 304, 311, 338, 543, 907, 936, 954)

Summary of Changes to Provisions to Which California Has Never Conformed

1. The Act clarifies that when the TEFRA provisions relating to the federal corporate minimum tax require recapture of previously expensed items which normally would have been capitalized as part of land or buildings, the ordinary gain which result will be treated in the same manner as normal recapture.

2. The Act clarifies that the TEFRA basis adjustment required when Investment Tax Credit has been allowed will apply to the basis of an interest in a partnership or Small Business (S) Corporation. In that case the interest is adjusted to reflect a partner's or shareholder's share of the required adjustments to the property receiving the investment tax credit.

3. The Act clarifies provisions of the Safe Harbor Leasing rules within the Accelerated Cost Recovery System (ACRS) relating to the definition of mass commuting vehicles and the definition of which transactions are considered to be "terminal rental adjustment clause" (TRAC) leases.

4. The Act clarifies various foreign oil income and loss provisions dealing with the recapture of foreign oil losses and the definition of foreign base company oil-related income.

5. The Act provides that dividends otherwise constituting personal holding company income will be so treated even when they are made in a partial liquidation of the distributing corporation.

6. The Act provides a retroactive authorization for waiver of penalties for estimated tax which resulted from TEFRA changes to the method of accounting for long-term contracts. The waiver only applies to installments required to be paid before April 13, 1983.

Current California Law

California does not conform to the federal corporation minimum tax, but instead imposes a tax on preference income. Also, California has no Investment Tax Credit, does not allow ACRS deductions for mass commuting vehicles or other motor vehicles, does not impose a tax on foreign oil income, has no provision for personal holding companies, and cannot enact provisions which change the taxability of events which have been completed before the year of enactment (i.e. retroactive).

Fiscal Impact

None. Not applicable to California.

TAX REFORM ACT OF 1984 SECTION 712

Corrections of TEFRA Business Provisions
(IRC 48, 51, 189, 269, 291, 301, 302, 304, 311, 338, 543, 907, 936, 954)

Summary of Changes to Provisions to Which California Has Conformed

1. The Act makes it clear that where a certification has been made of the economically disadvantaged status for the qualified summer youth category under the Jobs Tax Credit no second certification is necessary when the youth continues employment beyond the summer, and that individual is a member of another targeted group.

2. The Act makes several modifications to the rules enacted in TEFRA allowing a corporation that purchases the stock of another corporation to treat the acquisition as a purchase of assets. The purchasing corporation is commonly referred to as the "acquiring corporation" and the corporation whose stock is purchased is referred to as the "target corporation." This asset acquisition election is available if the acquiring corporation acquired at least 80 percent of the voting stock and at least 80 percent of all other classes of stock (except nonvoting preferred stock) of the target corporation within a 12-month period, known as the acquisition period, beginning with the first purchase of stock. A summary of the new rules follows:

   a. The election period ends on the 15th day of the ninth month following the month in which 80 percent control is acquired rather than the previous period of 75 days after the month in which 80 percent control was acquired.

   b. Penalties for underpayments of estimated tax will not apply to tax attributable to the election to treat the stock purchase as a sale of assets.

   c. Rules relating to the basis of the target corporation's stock after the asset acquisition election are modified to specify the manner of determining the fair market value of the target corporation's assets both for determining the sales price and the purchase price.

   d. A target corporation does not recognize gain or loss when an election has been made to treat the transaction as an acquisition. This nonrecognition treatment, however, only applies to the extent of the percentage of stock acquired unless the target corporation is liquidated within 12 months of the acquisition. This nonrecognition limitation means that the target corporation will recognize gain or loss for the percentage in excess of the limitation and is imposed in lieu of a tax on the minority shareholders who do not sell their stock. This tax is referred to as the "surrogate tax." The Act imposes restrictions that are designed to limit nonrecognition treatment for transactions that occur after the acquisition of 80 percent control to those transactions where minority shareholders are disposing of their stock in taxable transactions.

e. A new rule is enacted to grant nonrecognition treatment whem some assets have been sold between the date of the adoption of the liquidation plan and the acquisition of 80 percent control.

f. The Act provides that the election to treat a stock purchase as an asset purchase is disregarded for purposes of determining whether the collapsible corporation rules apply to a disposition of stock by a minority shareholder that occurs within one year of the acquisition of 80 percent contrl of the target corporation. The collapsible corporation rules generally provide that a shareholder realizes ordinary income, instead of capital gains, if the stock is sold at a gain before the corporation realizes a substantial portion of the taxable income on the property that it has manufactured, constructed, or produced.

g. The IRS is permitted to disallow deductions, carryovers, credits, and other items upon the liquidation of a corporation that has been acquired by means of a stock purchase and the asset acquisition election is not made. This will only apply where the target corporation is liquidated and the principal purpose of the liquidation is the evasion or avoidance of federal income tax.

h. The IRS is allowed to issue regulations which make exceptions to the rules which deem that an electin has been made to treat a stock purchase as an asset acquisition. The deemed election will not apply when the basis of the assets are required to be determined wholly using the transferor's basis (i.e., carryover basis).

i. The Act adds several rules for asset acquisitions by affiliated groups of corporations which require all acquisitions by members of the same affiliated group to be treated as though being made by one corporation, and regulations will provide for a single acquisition date for acquisitions made on different dates. A combined return is authorized where an election applies to two or more target corporations that have been purchased from a group which files a consolidated return that includes the target corporations for the taxable period in which the transaction occurs. A new rule is added by the Act to allow asset acquisition elections to be made if a related corporation acquires the target corporation stock in a transaction which otherwise qualifies and has purchased at least 50 percent of the stock from third parties. A corporation is not deemed to have "purchased" stock that it acquired in any transaction where the seller did not entirely recognize gain or loss on the transaction. Regulations are required to be issued which coordinate the asset acquisition rules when the target corporation is a foreign corporation, and a transitional rule effective date is modified by two days.

3. The Act clarifies several rules relating to the taxation of transactions where there are acquisitions or dispositions of stock between related corporations where one or more persons are in control of each of two corporations. Also it provides that owners of less than 5 percent of corporate stock will not be considered related persons and for those owning

less than 50 percent, only a proportionate share of the corporate stock redeemed will be subject to the rules. A clarification of the calculation of a dividend is made relating to which corporation's earnings and profits are used for the calculation. Also, the nonrecognition provisions in other IRC sections are coordinated to determine which provision takes precedence over the other in situations where more than one provision would arrive at a different taxable result.

4. The Act provides that when distributions of appreciated assets occur in redemption of stock and that property is going to a small business (S) corporation, partnership, estate or a trust (i.e. a "pass-through" entity) the determination of whether gain or loss is to be recognized will be made at the partner's or beneficiary's level and not at the "pass-thru" entities level.

Current California Law (PITL 17053.7, 17321 B&CTL 24432, 24457, 24466, 24488, 24518)

1. California conforms to the federal definition of "qualified summer youth" and makes the employer who hires those individuals eligible for the state Targeted Jobs Tax Credit. The certification for federal purposes is deemed to be a certification for state purposes.

2. California completely conformed to the federal asset acquisition rules contained in TEFRA.

3. California has the same rules relating to acquisitions and dispositions of stock with respect to related and subsidiary corporations as are contained in federal law.

4. California has the same rules as were contained in federal law prior to the 1984 Tax Reform Act relating to the distribution of appreciated property in redemption of stock.

Fiscal Impact

Based on federal estimates in the Tax Reform Act of 1984 on these various TEFRA corrections, conforming to these rules would result in net revenue gains in the $2 - $4 million range annually.

TAX REFORM ACT OF 1984 SECTION 1061

Extension of Payment-In-Kind (PIK) Program

Summary

The Act extends the PIK program for the 1984 crop year wheat participants only. This extension will defer the reporting of the income until the wheat received as the PIK is sold.

Current California Law

California allows a recipient of a PIK for the 1983 crop year only to elect the year in which income will be included in state taxable income (i.e., either the year the commodity is sold or the year the PIK is received).

Fiscal Impact

The revenue loss to California from extending the PIK program election to the 1984 wheat participants in California is unknown, but the federal estimate at the national level is a $15 million shift in revenue from 1984 to 1985 income year.

TAX REFORM ACT OF 1984 SECTION 1062

Reinstatement of Deduction For Removing Archetectural and Transportation Barriers to the Handicapped or Elderly
(IRC 190)

Summary

The Act reinstates the deduction for removing architectural and transportation barriers on business buildings and vehicles through 1985. Also, the maximum deduction per year is set at $35,000.

Old Federal Law

The provision sunsetted on December 31, 1983, but the maximum deduction was $25,000 per year.

Current State Law (PITL 17262 B&CTL 24383)

California does not conform to the federal law since the deduction in California applies to buildings and vehicles used both for business and for personal purposes. The maximum amount deductible per year is $25,000.

Fiscal Impact

None. California has its own separate provision.

TAX REFORM ACT OF 1984 SECTION 1063

Demolition of Structures
(IRC 280B)

Summary

The Act provides that for tax years beginning after 1983 any amount expended for or loss sustained on account of the demolition of any structure is to be capitalized as part of the basis of the land on which the structure was located.

Old Federal Law

Demolition costs and losses were currently deductible if the structure was not acquired with the intent to demolish it. From June 30, 1976, to January 1, 1984, demolition costs and losses in connection with the demolition of certified historic structures were required to be capitalized as part of the basis of the land regardless of the purchaser's intent.

Current State Law (PITL 17201 B&CTL 24442)

California is conformed to old federal law.

Fiscal Impact

Revenue gains from capitalizing rather than expensing such costs would be rather minor. Based on a proration of federal estimates in the Tax Reform Act of 1984, these cash flow revenue gains would be in the $100,000 range annually.

TAX REFORM ACT OF 1984 SECTION 1064

Amortization of Rehabilitation Expenses For Low-Income Housing (IRC 167)

Summary

The Act extends for three years the election to amortize rehabilitatin expenditures with respect to low-income housing over a 60-month period.

Old Federal Law

The election had generally expired with respect to expenditures incurred after December 31, 1983.

Current State Law (PITL 17201 B&CTL 24354.2)

California conformed to old federal law, and the election expired at the same time.

Fiscal Impact

Based on federal estimates on this provision in the Tax Reform Act of 1984, conformity would result in revenue losses in the half-million dollar range initially and growing to the $1.5 million range after a few years.

TAX REFORM ACT OF 1984 SECTION 714

Miscellaneous Provisions
(IRC 6233, 6652, 31, 3405, 7430)

Summary

1. The Act clarifies that the U.S. Claims Court can award attorney fees for proceedings commenced after February 28, 1983, and before January 1, 1986.

2. The Act clarifies that the partnership audit rules apply to entities who file partnership returns even though it is later determined that the entity is not a partnership for that year.

3. The Act modifies the rules for withholding on pensions, annuities, and deferred income by excluding from withholding distributions which consist solely of employer securities and less than $200 in cash which is in lieu of fractional shares of employer securities. Also clarified were the following items:

   a. The $5,000 death benefit exclusion is to be taken into account in determining the amount subject to withholding when a non-periodic distribution is paid by reason of death,

   b. Amounts withheld under pension withholding will be credited against any income taxes imposed,

   c. The pension withholding rules do not apply to amounts paid to nonresident aliens if those amounts are already subject to withholding.

The Act also provides a penalty for failure to notify recipients that they have the right to elect not to have withholding apply. The penalty is $10 per failure up to a maximum of $5,000 per year.

Current California Law

California does not have a court of claims as the federal government does. Also, California has not conformed to the partnership audit provisions of federal law.

The California withholding program is administered by the Employment Development Department (EDD) in the Unemployment Insurance Code.

Fiscal Impact

The revenue gains from collections of penalties from conforming to the federal pension withholding notification penalty is unknown.

TAX REFORM ACT OF 1984 SECTIONS 2354, 715

Medicare Corrections and Effective Date Provisions
(IRC 162)

Summary

The Act modified a cross reference in the definition of group health plans and provides for effective dates of various business provisions.

Current State Law (PITL 17201 B&CTL 24343)

California conforms to the federal definition of groups health plans.

Fiscal Impact

None. Cross referencing change only.

TAX REFORM ACT OF 1984 SECTION 11

Investment Credit Limitation for Used Property
(IRC Section 48(C)(2)(A) & (B))

Summary

The maximum amount of used property eligible for the investment credit during a tax year is $125,000 ($62,500 for a married individual who files a separate return). These limits will increase to $150,000 and $75,000 respectively beginning after 1987.

Old Federal Law

Under the old federal law the limits on investment credit during the tax year were to increase for tax years beginning after 1984.

Current California Law

None. California has no provision for an investment tax credit.

Fiscal Impact

None. Not applicable.

TAX REFORM ACT OF 1984 SECTIONS 121 & 122

Foreign Tax Credit
(IRC Section 904(d)(3) and (g),(h),(i))

Summary

This provision is to prevent United States (U.S.) taxpayers from converting U.S. source income into foreign source income, and thereby, avoiding U.S. tax on this income by the use of the foreign tax credit. If at least 10 percent of the current earnings of a U.S. owned foreign corporation is derived from U.S. sources or is effectively connected with a U.S. trade or business, then the distribution or interest payment is U.S. income to the extent it is attributable to U.S. source income or effectively connected income. A foreign corporation is U.S. owned if at least 50 percent of the total voting power of its voting stock or of the total value of its stock is held by U.S. persons. Provides that, for purposes of the separate foreign tax credit limitation on interest income, a part of a corporate distribution is interest, if at least 10 percent of the paying corporation's earnings and profits for the tax year in which the dividend is paid is attributable to interest income. This applies to U.S. owned foreign corporations and U.S. owned regulated investment companies. Effective generally on enactment date, however, there are some special rules.

Old Federal Law

There were no provisions to prevent using the foreign tax credit to offset U.S. tax on foreign income when U.S. taxpayers artifically converted U.S. income to foreign income by routing it through a foreign corporation.

Current California Law (PITL 17024.5(b)(7))

California law excludes foreign tax credit as a credit against tax.

Fiscal Impact

None. Not applicable.

TAX REFORM ACT OF 1984 SECTIONS 471-475

Simplification of Tax Credits
(Adds IRC Sections 2, 38, and 39, renumber the various tax audit sections and make numerous technical conforming amendments to related IRC sections.)

Summary

The new law establishes the order for the following personal nonrefundable credits; 1) dependent care credit, 2) credit for the elderly and disabled, 3) residential energy credit, and 4) political contribution credit. These credits are allowable before all other credits. The residential energy credit may be carried forward to any tax year before 1988 to the extent the tax liability exceeds the total of the three other credits. For business related credits a taxpayer combines the available investment tax credit, targeted jobs credit, alcohol fuels credit, and employee stock option plan credit into a single, general business credit. The general business tax credit may reduce the tax liability to the extent of 100 percent of the first $25,000 of tax liability and 85 percent of the net tax liability over $25,000.

These provisions are effective for tax years starting after 1983. Credits earned in pre-1984 years will continue to be carried to post-1983 years under the substantive rules under which they were earned. Credits earned in post-1983 years may be carried back to pre-1984 years, subject to the new tax liability limitation rules.

Old Federal Law

Old federal law had no specified order or credits.

Current California Law (PITL 17039)

California law specifies the order of credits under the definition of "net tax."

Fiscal Impact

None. Not applicable.

TAX REFORM ACT OF 1984 SECTIONS 1041-1043, 2638

Miscellaneous Tax Credit Provisions
(IRC 32, 48, 51, 3507)

Summary

1. The Act extended the jobs tax credit through December 31, 1985, (a one-year extension) and modifies the credits provision to allow more time to obtain certification, allows successor employers to qualify for the credit, prevents the misuse of leased employees hired after 1984 and coordinates the provision with the work supplementation program in the Social Security Act.

2. The Act increases the maximum earned income credit from $500 to $550. There is no benefit to the new federal credit limit when income exceeds $11,000.

3. The Act modifies the definition of qualified rehabilitated property for purposes of the rehabilitation credit to enable buildings which are not square or rectangular to qualify more easily.

Current California Law (PITL 17053.7 B&CTL 24330)

California does not have a credit for rehabilitating buildings or the earned income credit. The California targeted jobs tax credit is quite different than the federal jobs tax credit. The state targeted jobs tax credit is only applicable to wages paid or incurred to an individual who begins work for the employer before January 1, 1985.

Fiscal Impact

Based on preliminary state data on this credit for the 1983 income year, extension of the jobs tax credit, an additional year would result in additional revenue losses in the $1-$2 million range annually for income years 1985-87.

TAX REFORM ACT OF 1984 SECTION 201, 211-219

Taxation of Life Insurance Companies
(IRC Section 801-818, 845)

Summary

As of January 1, 1984, the Act replaces the prior law's pattern of life insurance company taxation with a new single-phase structure which embodies the tax rules applicable to corporations generally with certain unique exceptions. Those exceptions include:

1. A special deduction for additions to reserves,

2. Limited deductibility of policy holder dividends,

3. A special deduction for small life insurance companies, and

4. A deduction that reduces the aggregate tax burden on the life insurance industry as a whole.

The Act requires that the IRS conduct a study on the effect of these new provisions on the life insurance industry and make a yearly report to Congress regarding the revenues received under the new law.

Old Federal Law

Life insurance companies were taxed on both investment and underwriting income as separate components of a system which measured total income of a life insurance company.

Current California Law

The Personal Income Tax Law and Bank and Corporation Tax Law do not have provisions for life insurance. Life insurance provisions are administered by the Insurance Commissioner under Section 28, Article XIII of the California Constitution, Part 7 of the Revenue and Taxation Code, and the California Insurance Code.

Fiscal Impact

None. Not applicable.

TAX REFORM ACT OF 1984 SECTION 221

Flexible Premium Life Insurance
(IRC Section 101, 7702)

Introduction

In 1982 TEFRA temporary guidelines were established for certain life insurance contracts (called flexible premium life insurance). These contracts must meet the guidelines in order for the proceeds to be excluded from gross income.

Flexible premium life insurance (sometimes referred to as "universal life" or "adjustable life") contracts are similar in some respects to traditional whole life policies, but typically permit the policyholder to change the amount and timing of the premiums and the size of the death benefit automatically as the policyholder's needs change. These contracts may permit the policyholder to invest a substantial cash fund without a related increase in the amount of pure insurance protection offered by the contracts.

If the contracts did not meet the new guidelines then only a portion was treated as term insurance and excluded from the beneficiaries gross income on the insured's death. The remainder of the proceeds were included in the beneficiaries gross income.

Summary

The Act extends to all life insurance contracts rules similar to TEFRA's temporary provisions. Any contract defined as a life insurance contract under state or foreign law will qualify for the exclusion from gross income of the proceeds upon the death of the insured only if it meets one of two alternative tests:

1. A cash value accumulation test where the cash value may not at any time exceed the net single premium required to fund future benefits using an interest rate of no less than 4 percent, or

2. A guideline premium requirement where the sum of the premiums does not exceed the guideline level premiums or the single premium required at issue to fund future benefits using an interest rate of no less than 6 percent. In addition, the cash surrender value of the contract must be less than an amount shown in a table of specified values at various ages.

   If a contract fails the test then only the excess of the death benefit over the net cash value will be excluded from gross income. In addition, the income on the contract during any given year is treated as ordinary income. Any accumulated income for prior taxable years will be treated as ordinary income, in the year the contract fails to qualify under the new tests.

   Generally these new rules apply to life insurance contracts issued after December 31, 1984.

Old Federal Law

Except for qualification requirements for flexible premium life insurance contracts the proceeds paid upon the death of the insured in all other life insurance contracts were excluded from the beneficiary's gross income.

Current California Law (PITL 17131, 24305)

California conforms to old federal law and conformed to the TEFRA guidelines for flexible premium life insurance.

Fiscal Impact

Assuming that insurance policies will be modified to comply with federal guidelines regardless of state action there would be no revenue effect from conformity.

TAX REFORM ACT OF 1984 SECTION 222

Penalty on Premature Withdrawal From Annuity
(IRC Section 72, 83)

Summary

The Act expands the imposition of the 5 percent penalty on premature distributions from an annuity to include any amount distributed to the taxpayer before age 59 1/2 and not just to amounts allocable to any investment made within 10 years of the distribution. This penalty will be applied with respect to annuity contracts issued after January 18, 1985. Also mandatory distribution rules are adopted for annuities which are similar to current pension plans distribution rules.

Old Federal Law

Early withdrawal (amounts withdrawn before age 59 1/2) are includable in gross income to the extent the cash value exceeds the investment in the contract. A 5 percent penalty on the premature distribution is imposed on withdrawals attributable to investments made within 10 years of the withdrawal. No mandatory distribution rules existed for annuity contracts.

Current California Law (PITL 17501)

California conforms to old federal law.

Fiscal Impact

Additional penalties collected under conformity are unknown.

TAX REFORM ACT OF 1984 SECTION 223

Group-Term Life Rules for Retired Employees
(IRC 79)

Summary

Effective for tax years beginning after 1983, the cost to the employer for the first $50,000 of group term life insurance is tax free to the retired employee. The cost for coverage in excess of $50,000 is taxable to the retired employee in the year coverage is received to the extent it exceeds any contributions made by the retired employee. This change puts retirees in the same position as working employees regarding employer paid group-term life insurance. The Act also would not exclude any amount of the cost for key employee insurance under a plan which discriminates in favor of highly paid employees.

Old Federal Law

An employer could cover retired employees with group-term life insurnce in excess of $50,000 without any of the cost of the insurance paid by the employer being included in the retired employee's gross incomes.

Current California Law (PITL 17081)

California conforms to old federal law.

Fiscal Impact

Based on the federal estimate in the Tax Reform Act of 1984, conforming to these rules would result in minor revenue gains, less than $100,000 annually.

TAX REFORM ACT OF 1984 SECTION 224

Definition of Endowment and Life Insurance Contracts (IRC 1035)

Summary

The definition of endowment and life insurance contracts now includes those issued by any insurance company, not just life insurance companies. The change is applicable for contracts issued after July 17, 1984. Thus, upon an exchange of endowment or life insurance contracts, the tax-free exchange rules will apply to contracts issued by any insurance company.

Old Federal Law

The tax-free exchange rules only applied to endowment or life insurance contracts issued by life insurance companies when there was an exchange of those contracts.

Current California Law (PITL 17081)

California conforms to old federal law.

Fiscal Impact

Revenue losses from extension of the tax-free exchange rule are unknown.

TAX REFORM ACT OF 1984 SECTION 21, 1021-1028

Estate and Gift Tax
(IRC 2001, 2032, 2032A, 2053, 2056, 61, 170, 664)

Summary

The Act makes six changes to the Estate and Gift Tax provisions of federal law as follows:

1. Freezes the Estate and Gift Tax maximum rate at 55 percent through 1987.

2. Certain estates may pay the estate tax in installments,

3. Alternate valuation rules relating to the determination of the value of the gross estate have been modified to apply only where their use would reduce the estate tax,

4. Allows certain amended filings of elections under the estate tax,

5. Specific legislation relating to Louisiana life-estates and a transfer of property to a national forest allowing the gross estate to be reduced by those transactions,

6. A retroactive exclusion from a donor's gross income for payment of gift tax by the donee on gifts made before March 4, 1981, and

7. Allowing charitable contributions for individuals and estates retroactively to 1969 where a charitable trust did not qualify under the 1969 Tax Reform Act rules as long as the trust now reforms its governing instrument to comply with the qualification rules.

Current California Law (PITL 17081)

California has no Estate Tax except for the "pick-up" tax.

California cannot grant retroactive deductibility to transactions which were properly determined under state law in the year the transaction occurred since there is a Constitutional restriction on making a gift of public funds.

Fiscal Impact

None. Not applicable to California.

TAX REFORM ACT OF 1984 SECTIONS 25-27, 451-456, 731-736, 901-903, 911-921, 1010-1020, 2681-2682

Excise Tax

Summary

Changes were made to the following federal excise taxes:

1. Windfall Profits Tax
2. Telephone Excise Tax
3. Excise Tax on Distilled Spirits
4. Alcohol and Tobacco Taxes
5. Excise Tax on Used Truck and Trailer Parts
6. Gasoline Excise Tax
7. Excise Tax on Tires and Retreads
8. Excise Tax on Noncommerical Aviation Gasoline
9. Highway Use Tax
10. Retail Truck and Trailer Excise Tax
11. Manufacturers Excise Tax on Motor Vehicles
12. Excise Tax on Diesel and Alcohol Fuels
13. Boating Excise Taxes
14. Excise Taxes on Sport Fishing Equipment
15. Excise Tax on Chemicals
16. Definition of Articles produced in Puerto Rico or Virgin Islands, and
17. Limitation on the Transfer of Excise Tax Revenue.

The change in the windfall profits tax contains a change to the percentage depletion for secondary and tertiary oil production by eliminating the distinction between primary secondary and tertiary recovery processes. Thus, independent producers of oil by a second or third stage recovery method such as injecting petrochemicals into the heavy crude to force it out of the ground will be eligible to take percentage depletion. The deduction for percentage depletion for secondary or tertiary oil production expired at the end of 1983.

Current California Law

California does not impose any of the above listed excise taxes. Also, California does not distinguish between primary, secondary, or tertiary recovery processes to determine a taxpayer's eligibility for percentage depletion.

Fiscal Impact

None. Not applicable.

TAX REFORM ACT OF 1984 SECTIONS 442-445, 461-465, 1065, 1077

Miscellaneous Administrative Provisions

Summary

The Act makes a number of administrative rule changes as follows:

1. Removes the limitation on the working capital fund of the U.S. Treasury,
2. Increases the revolving fund authorization limit of the U.S. Treasury for redemption of real property,
3. Allows the Secretary of the Treasury to accept gifts and bequests for the Treasury Department,
4. Removes the limitation on the Treasury's authority to dispose of obligations,
5. Raises the amount of tax which may be heard by the Tax Court under the small case rules from $5,000 to $10,000,
6. Increases the annuity payments to surviving dependent children of deceased Tax Court judges,
7. Allows special Tax Court trial judges to hear cases other than small tax cases other than small tax cases at the discretion of the Chief Judge,
8. Retitles "Tax Court Commissioner" to "Special Trial Judge,"
9. Allows the Tax Court to prevent disclosure of trade secrets or other confidential information even though the reports and evidence received by the court are open to public inspection,
10. Makes permanent the rules relating to Indian Tribal governments, and
11. Changes rules relating to migratory bird hunting stamps.

Current California Law

California has not conformed to the above administrative rules relating to duck stamps, Indian Tribal governments, Tax Court provisions, or limitations placed by Congress on the U.S. Treasury.

Fiscal Impact

None. Not applicable.

TAX REFORM ACT OF 1984 SECTIONS 701, 931-936, 1081-1082

Studies

Summary

The Act requires that the U.S. Treasuy make five studies relating to Highway Use and Fuel Tax as well as one dealing with the advisability of instituting an alternative tax system and one relating to determining how foreign countries tax income on services performed in the United States.

Current California Law

These studies will be available to California upon their completion by the U.S. Treasury.

Fiscal Impact

None. Not applicable.

TAX REFORM ACT OF 1984

Social Security and Medicare Amendments

Summary

Numerous changes were made to the Social Security Act which do not change the Internal Revenue Code but were made to reduce the cost of the Social Security and Medicare programs.

Current California Law

The Personal Income Tax Law and the Bank and Corporation Tax Law do not contain comparable provisions.

Fiscal Impact

None. Not applicable to the Personal Income Tax Law or the Bank an Corporation Tax Law.